Spotlight: Econ Op-eds in Summary

Week ended 22nd September '21

In Summary

The underneath contains summaries of the articles given above, including key extracts from these articles.

1. How Sri Lanka's IMF-backed 'Young Plan' fired a foreign debt death spiral
By: Bellwether

- Sri Lanka has seen a surge in foreign debt since 2014, as budget deficit's continued to grow alongside unstable monetary policy. The inflation targeting framework imposed at the time led to a strong depreciation of the currency, with the Central Bank injecting excessive liquidity, leading to a growth in ISB debt.

- Sri Lanka is in a 'death spiral' due to monetary instability, with nearly half the budget deficit being financed through foreign sources. The current strategy to reduce foreign debt has seen the foreign deficit in 2020 being recorded as a net payback, albeit coming at the cost of running down reserves.

- The IMF SDR allocation will help provide respite to reserves, although interest would have to be paid on their allocation, thus, the country's situation must be assessed using net foreign assets, which do not account for SDRs or swaps. The government must focus on ensuring bond auctions are subscribed prior to further policy rate hikes.

While Sri Lanka's monetary meltdown accelerated with historic low interest rates driven by money printing after the tax cuts of 2019, the storm gathered pace from 2015, when rapid foreign debt accumulation greater than the annual foreign financed deficits began.

That was due to monetary instability coming from a non-rule based monetary regime of 'flexible exchange rate' and 'flexible inflation targeting' with built in contradictions of epic proportions which created forex shortages and forced maturing debt to be repaid with more foreign borrowings.

Even in 2020, when authorities claimed that foreign debt had fallen, and foreign financing of the budget was negative, the net foreign debt had risen by over US$ 600 mn when the fall in net international reserves are taken into account.

Cascading Errors

A country that has monetary stability (no forex shortages) and does not inflate the domestic reserve money supply above a consistent anchor can transfer wealth from the domestic economy to repay foreign loans through the credit system.

However, a country which inflates reserve money, cannot transfer wealth to repay foreign debt through the credit system as it runs into 'foreign exchange shortages'.

Any country which follows a similar set of cascading policy errors, ends up at the same place.

Why did foreign debt rocket, despite a 'primary surplus'?

If fiscal problems were solved, why did foreign debt ratchet up so fast? Why did foreign dollar denominated debt rocket in particular? Why did foreign investors flee from rupee debt?

While fiscal problems are usually there from time to time, foreign debt default in a pegged exchange rate regime is at its core a problem with monetary instability.

To know why it happens, there has to be a clear understanding of what inflationary and deflationary policy is in a pegged exchange rate regime.

As long as deflationary policy is run (central bank withdraws liquidity), it is very easy to repay foreign debt (or build massive foreign reserves), however if the opposite inflationary policy is run for several years in a row (the central bank injects liquidity), foreign debt default is almost certain as ad hoc 'stop-go' policies also slows growth.

The contradictory and unstable monetary regime triggered rapid stop-go policies, confidence shocks, which led to subdued growth.

This was topped off by the Liability Management Law (borrowing abroad instead of transferring wealth from the domestic economy through savings) which is also an automatic and inevitable consequence of the mindset of any country with chronic monetary instability and is founded on Keynesian thinking.

If anyone tries to fix Sri Lanka's economic problems without understanding this phenomenon, it will keep recurring, as it happens in Latin America despite repeated IMF programs.

The core misunderstanding behind these cascading policy errors that leads to foreign debt default is an economic fallacy spread by most Anglo-Saxon Keynesian universities that foreign debt cannot be repaid with domestic resources or a domestic transfer of wealth.

While people can understand that it can be done with real goods (give a building in return for debt or a port for that matter), it is almost impossible to imagine how it can be done through a credit system when paper money of different note-issue banks are involved in what is generally called 'foreign exchange'.

Automatic Transfer

Sri Lanka's Liability Management Law which came alongside an International Monetary Fund program was a classic Young Plan with 'JP Morgan' style International Sovereign Bonds to raise dollars to repay maturing debt.

"The truth is that the maintenance of monetary stability and of a sound currency system has nothing whatever to do with the balance of payments or of trade," Mises explained.

"There is only one thing that endangers monetary stability—inflation. If a country neither issues additional quantities of paper money nor expand credit, it will not have any monetary troubles.

Petroleum Weimar 'Young Plan'

This is the reason why economists and analysts want fuel to be market priced. Then the enhanced payments to the CPC by its customers, would reduce non-oil consumption and savings and therefore non-oil imports and credit.

This offsetting series of events would generate the dollars required to pay the import bills.
But if the central bank printed money (ran inflationary policy), there would be a forex shortage regardless of whatever the CPC did with fuel pricing because the entire credit system runs with central bank money.

When the central bank printed money in 2018, CPC was made to borrow, like the JP Morgan loan to Weimar Republic. In the end CPC ended up with massive losses when the currency fell.

That is one of the cascading policy errors in Sri Lanka.

However, in 2017 and 2019, when the central bank was selling down its Treasury bill stocks (when the central bank was running deflationary policy), there was plenty of dollars not only to pay the current bills but reduce CPCs past borrowings as well.

In fact, in all recent years with monetary stability, the net growth in foreign debt in Sri Lanka, is lower than the foreign financed debt component of the budget deficit.

In all years with inflationary policy, debt after foreign reserves went up faster than the dollar financed debt.

Spiraling Up

Sri Lanka's death spiral started in late 2014, when liquidity was injected (inflationary policy) to keep rates down.

It accelerated after the 100 day program of fiscal profligacy, which did not lead to a rate hike as credit expanded but rates were instead cut because 'inflation was low', despite having a peg.

It is however not possible to run an inflation targeting framework with a peg. So, the currency collapsed under 'flexible exchange rate' in 2015 and 2016 with excess liquidity being injected.

In 2017, there was stabilization or a deflationary policy. In 2018 money printing began again to target the call money rate and an output gap with discretionary flexible inflation targeting. The flexible exchange rate collapsed again.

Current State Minister for Capital Markets Nivard Cabraal had said that when the Mahinda Rajapaksa administration left in 2015 International Sovereign Bonds were US$ 5.0 bn and when they came back in 2019 it was US$ 15.0 bn.

Most people dismiss this as politicking. However, that is not so. This was a classic Young Plan in action. The death spiral happened in several ways.

REER Targeting, Flexible Exchange Rate, Capital Flight

In the case of market debt, the REER targeting, led to flight of capital from rupee debt markets.

Remember depreciation leads to the expropriation of foreign capital unless they are dollarized. As a result, any investor will try to protect themselves against monetary expropriation.

"Devaluation of a country's currency has now become a regular means of restricting imports and expropriating foreign capital. It is one of the methods of economic nationalism. Few people now wish stable foreign exchange rates for their own countries.

In 2013 when the rupee was at 131 to the US dollar US$ 3.6 bn equivalent was in rupee securities. At the time the total market debt including ISBs and foreign held SLDBs was US$ 7.1 bn.

By 2019, two currency crises later the rupee debt was down to US$ 573 mn and the total market debt was US$ 15.6 bn.

The people of the country however faced this debilitating expropriation. The debilitating depreciation will make it that much more difficult to generate resources to repay debt.

Rapid depreciation, the monetary expropriation of domestic savings will make it even more difficult to generate real resources to repay debt.

In 2020 debt holders also began to flee after downgrades following the December 2019 tax cut and the March 'flexible exchange rate episode when the rupee fell to 200 to the US dollar.

Total foreign owned commercial debt went up from US$ 8.4 bn in 2014 to US$ 14.1 bn in 2020 after rising to US$ 15.6 bn in 2019. In 2019 however foreign reserves also grew.

But this is just one side of the problem.

Death Spiral

This is where the death spiral from monetary instability comes in. In Sri Lanka, about half the budget deficit is foreign financed.
From 2014 to 2019 the dollar financing ranged from about a billion to three billion dollars each year.

Under revenue based fiscal consolidation, as the state was expanded with higher salary payments, budgets expanded, and so did foreign financing of the budget. The interest bill was also financed abroad in years with monetary instability.

Based on ALM thinking one would imagine that foreign debt grows by the foreign financed deficit. But that is not so.

In 2020, the central bank said a lot of foreign debt has been paid. In fact, foreign financing of the deficit was US$ 448 mn negative or a net pay back.

However, it was achieved with a massive run down of reserves due to the money printing.
Debt after net reserves actually went up by US$ 603 mn to US$ 28.9 bn from US$ 28.3 bn.

Overall debt with SOEs, banks and the private sector seems to have come down with more dollar deposits being raised domestically for banks to use.

In Summary

The simplest way to understand the foreign reserves and foreign repayments and the fallacy of the Transfer Problem and ALM Law is to think about Sri Lanka's history.

Sri Lanka has been taking World Bank, Asian Development Bank and Japanese loans for decades.

However not all these loans (and interest) were paid back with fresh dollar loans, like the ALM law.

The growth in dollar debt was not linear and in step with the part of the deficit that was financed with foreign debt.

It was less, due to squeezing the current account to repay debt.

Grave Situation

The situation with Sri Lanka's central bank is grave.

The US$ 800 mn IMF SDR allocation will briefly improve the situation. But SDRs are also debt or a swap. As soon as SDR holdings are sold for dollars, interest will have to be paid on the allocation. The net reserves also contain items like swaps, partly because that was a trick used to shore up reserves, but it is also a borrowing.

Net foreign assets on the other hand show the correct situation. It does not count SDRs or swaps.

Without net reserves, if the central bank intervenes it will eat into reserve assets and could become even more insolvent.

The first order of priority is to get bond auctions working. Then the CB's Treasury bill stock has to be sold down. This is not about policy rates.

Before any policy rate hike, bond auctions and the sell-downs should begin. If necessary, policy rates can be raised later.

A tax hike will keep the rates lower than they need be. So will a debt restructuring, and a debt sustainability sign off from the IMF which will unlock World Bank and ADB budgetary finance. It may be barely possible to do without an IMF program, but the corrective rate would be higher.

On the other hand, if interventions are made and bond auctions are not allowed to happen, the central bank itself can default on the IMF loan and it can default on the swaps.

Dollarization

When central banks lose the ability to intervene it can float. But usually soft-peggers do not know how to float and will intervene at crucial points. This will make the currency fall faster.

Eventually it could lead to market dollarization as people lose confidence in the currency. Already there is significant deposit dollarization, with dollar accounts. The black market rates also show that people are chasing after US dollars.

But de facto dollarization happens when people start selling and pricing in US dollars and imagining their lives in dollars. The reason dollarization did not happen earlier is because there are legal tender laws prohibiting the domestic use of foreign currency and people had some confidence in the rupee.

If these laws are removed allowing any currency to be used, Sri Lanka's economic and monetary instability will end.

In 2018 there was a chance for official dollarization by converting forex reserves and exchanging the note issue to rupee notes.

But parallel dollarization can still be done to cushion people and companies from any default shock. Several high performing stable economies have such arrangements.

For the full article – Refer Economynext

2. CB likely to continue money expansion, direct controls
By Prof. Sirimevan Colombage

- CBSL has increased money supply since last year, due to continuous borrowings by the Government from the CBSL and commercial banks. The trend is mostly likely to continue as the government does not have any other funding sources. In addition, the CBSLs monetary space had also become limited due to fiscal dominance.

- The newly appointed CBSL Governor strongly denies that there is any correlation between money supply and inflation. He believes that excess money issues can be absorbed by CBSL whenever they require. However, CBSL's recent drop of Open Market Operations and recent heavy under subscription to ISBs suggests otherwise.

- CBSLs more direct monetary controls including interest rate caps, credit ceilings and exchange rate fixing, and abandonment of inflation targeting,is expected to affect free market activity negatively. Thus, in order to stabilize the economy CBSL will have to move towards market based monetary policies while managing the pressures for monetary expansions.

The Central Bank of Sri Lanka (CBSL) has been subject to severe criticism over the rapid expansion of the money supply since last year. The aggregate money supply rose by 21% during the last 12 months. Currency held by the public, which is commonly known as money printing, rose by around 23% during this period. This was resulted from the continuous borrowings by the Government from the CBSL and commercial banks.

This trend would continue in the coming months unless the Government reduces its dependence on the banking sector to finance the budget deficit. Such possibility is rather remote, as there are hardly any other funding sources. Also, the CBSL is unlikely to reduce fiscal accommodation in the backdrop of political pressures.

CBSL Governor's view on money supply and inflation unacceptable

The newly-appointed CBSL Governor Ajith Nivard Cabraal asserts that money printing has no impact on inflation. He further stated that excess money issued can be absorbed by the CBSL whenever the need arises. This view involves at least two fundamental caveats.

1. The statement that there is no relationship between money printing and inflation contravenes basic economic principles. Based on rigorous quantitative studies across the world, the bidirectional relationship between money supply and inflation is undeniable.

2. The CBSL is not in a position to absorb excess liquidity whenever necessary as claimed by the Governor. The reason is that the CBSL continues to buy the unsold portion of Treasury bills and bonds directly from the primary auctions to fill the Government coffers, instead of selling such securities through open market operations for mopping up excess liquidity.

CBSL's holdings of Government securities rising

Continuous lending to the Government by CBSL has resulted in a substantial increase in its holdings of Treasury bills and bonds. Such holdings rose by 52% from Rs. 874 bn to Rs. 1,330 bn during the last 3 months.

As a result, the CBSL had to drop one of its key monetary policy instruments, i.e. open market operations (OMO). The CBSL can usually adopt OMO to mop up any excess liquidity in the market by selling its government securities, and vice-versa. There is less market demand for such securities due to their low yield rates, and therefore, CBSL is unable to sell them for contractionary monetary policy purposes even if it wants to do so, as mentioned above.

There are constraints to foreign borrowings as reflected in heavy under-subscriptions of international sovereign bonds in the recent auctions. Even the local Treasury bill and bond auctions have been heavily undersubscribed due to their unattractive yield rates. For example, the Treasury bill auction held last week was undersubscribed to the extent of 50%. The rest of the Treasury bills had to be purchased by the CBSL to meet fiscal needs causing a rise in its holdings of Government securities and currency issues. This has been the practice in recent months.

Is money printing the right treatment for the ailing economy?

Governor Cabraal, in his previous capacity as a State Minister, strongly advocated money printing for the revival of the pandemic-hit economy. In an interview with the Daily Mirror last month, he mentioned that money printing is just like a drastic treatment prescribed by a doctor to a major illness.

He further said that money printing leads to inflation only during normal times. As there is a contraction of the economy at present, the risk of occurring inflation as a result of money printing is much less. Once the economy gets back to normalcy, you have to pull it back, according to him.

He also reiterated in several forums that the Government can resolve the debt problem without resorting to the IMF.

It should be noted here that the money printing was not due to the pandemic but it was an outcome of the Government borrowings from the banking sector to finance the budget deficit. The excessive money growth resulted from increased bank lending to the Government led to exert demand pressures on the domestic market and imports, thereby causing inflation, foreign trade imbalance, and rupee deterioration, quite contrary to Cabraal's claims. The annual inflation, measured in terms of the Colombo Consumer Price Index (CCPI) has gone up to 6% by now.

It is impossible to contract the money supply in the current inflationary situation, as argued by Cabraal since the banking sector will have to continue lending to the Government to meet its revenue shortfalls, caused by drastic tax cuts implemented last year.

Contrary to Cabraal's advocacy, money printing is a wrong treatment to the ailing economy that might lead even to kill the patient. The money creation will only aggravate economic sickness by widening the trade deficit and accelerating inflation.

CBSL lost market-based monetary tools

The CBSL reformulated its monetary policy in the 1980s and 1990s by moving away from direct controls to market-based tools to be aligned with the liberalised economic environment. It gradually eliminated credit controls and overall credit ceilings. Eventually, the open market operations and policy interest rates along with a flexible exchange rate system became the key monetary policy tools.

The recently-introduced direct monetary controls including interest rate caps, credit ceilings, exchange rate fixing, and forex regulations reflect a reversal of market-based monetary policy. They have adverse effects on free-market activity, as already reflected in inflationary pressures, commodity shortages, undersubscribed Government securities, foreign exchange depletion, and exchange rate distortions.

Inflation targeting monetary policy abandoned

The previous Government envisaged implementing flexible inflation targeting monetary policy framework by 2020 under the Extended Fund Facility (EFF) with the International Monetary Fund (IMF). For this purpose, the now-abandoned Central Bank Bill was to be approved by the Parliament to replace the present Monetary Law Act.

Inflation targeting is a monetary policy strategy under which a country's central bank aims to keep a pre-announced inflation rate over a specific time frame. Transparency and accountability are two essential components of inflation targeting. Transparency implies that the central bank should convey the inflation target with justification through public announcements. Accountability means that the central bank should not miss the inflation target.

Inflation targeting monetary policy would have provided greater independence to the CBSL shielding itself from political pressures to conduct monetary policy targeting its core objective of price stability.

Independent central banking vital

The policy space available to CBSL in conducting independent monetary policy is severely restricted by the fiscal dominance.

The fiscal deficit running over 12% of GDP at present will continue to remain high with mounting debt commitments in the coming years. The persistent fiscal deficit demotivates CBSL to adopt a flexible interest rate policy stance, while inflationary pressures and the mounting external debt commitments restrict its ability to maintain exchange rate flexibility. In effect, the monetary policy has become inactive by now.

In the circumstances, the present monetary expansion along with direct credit and exchange controls will continue to prevail in the coming months causing detrimental effects on price and financial stability, as already evident from market tensions.

The capacity of the CBSL to reactivate market-based monetary policy for economic stabilisation purposes depends on its strength to diffuse political pressures that urge for monetary expansion. This would be an impossible task as long as the CBSL's leadership is subservient to political masters.

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