Spotlight: Econ Op-eds in Summary

Week ended 24th November '21

In Summary

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

1. Budget 2022: What's the missing link?
By: Dr. W.A Wijewardena

- The Budget 2022 failed to address three key issues the economy is currently facing. These were that the country is running out of reserves, facing significant pressure for the rupee to depreciate, and difficulty in servicing foreign debt. Furthermore, the country is now facing severe food shortages and a gradual move toward a debt default.

- The external sector's share of GDP has continued to fall since 2010, although its import bill has risen. This has led to a situation where net foreign assets of commercial banks and the CBSL are negative, putting further pressure on the external sector.

- The Budget has also been silent on the possibility of an IMF program, with the Governor having implemented home grown policies which attempted to correct excessive money printing implemented by the previous Governor, alongside other measures. The Government needs to understand that seeking an IMF solution is the only option, before it is too late.

A budget with roses and brickbats

Minister Basil Rajapaksa, unveiled his maiden Budget – that was for 2022 – on 12 November. Much has been said about this Budget by his supporters as well as critics so far. Supporters have seen only the virtues of the Budget, while critics have not seen any merit in it.

There is one point which both hailers and wailers have missed. That is how effectively the Budget has addressed the main burning issue faced by the country today. That is the missing link in the Budget.

Sri Lankans licking a honeycomb ignoring multiple death threats

To drive this burning issue to our heads, Basil had used an apt parable when he presented the Tax Amnesty Bill and the Securities and Exchange Commission Bill in Parliament a month ago. Drawing from a poem from a leading textbook on Buddhism, he said that Sri Lankans today could be compared to the man who is licking a honeycomb oblivious to three types of death threats waiting for him in the immediate vicinity.

At that time, the three death threats were

- depleting foreign exchange reserves,
- mounting foreign debt servicing problem, and
- pressure for the rupee to depreciate in the market.

After one month, the list has been added to by three more new death threats. They are the

- Possibility of facing a severe food shortage due to low production,
- inability to import essential medicines, fuel, and foods due to lack of foreign exchange, and
- the Government's gradual movement toward bankruptcy.

A government becomes bankrupt when it cannot finance its expenditure programs through normal tax channels and is forced to print money in excessive amounts to fill the gap.

All these, except the last one, relate to the fragile external sector of the country. The last one is the handiwork of the Government by offering an attractive income tax and value added tax concession that resulted in a drop of revenue by a minimum of Rs. 500 bn in both 2020 and 2021.

An untenable tax concession: Sow a wind and reap a whirlwind

When this proposal was made, I warned the Government in December 2019 that it should not be implemented because of the obvious dent in revenue. It had been hailed by the Government's policymaking leaders as a stimulus package to accelerate economic growth via what is known as 'supply side economics'.

Disagreeing with them, I argued that it would not work because of the structural issues present in the economy. I, therefore, concluded the article with the following warning: "With the new Revenue Administration Management Information System or RAMIS and the arrangement to pay taxes through LankaPay operated by LankaClear, it is not a serious issue for IRD to upgrade its systems and handle more tax files with the available human resource base. But it takes time and unless it is handled carefully, the stimulus package will backfire causing a large gap in the budgetary financing. Avoiding this pitfall should be the topmost priority of the Gotabaya Rajapaksa administration."

This warning went unheeded and the Government implemented the proposal. A wind was sown with no concern for the outcome, but now when things have gone wrong, Basil has been asked to reap a whirlwind.

The sick economy

Sri Lanka's economy had been ailing for some time, but now the ailment has become severe, turning to a terminal illness. Basil has taken over the finance portfolio in this background. The entire country expects him to do the impossible. He is required to cure this terminally-ill person through an effective system of medication. However, the Budget he has presented has fallen short of this requirement on many counts.

This is the background to the Budget 2022

The missing link in the Budget is the expressed silence about the sickness of the economy. It has come up with expenditure proposals without a sufficient revenue base. There are some onetime revenue proposals made, but such temporary measures will not help the Government to continue the promised expenditure programs. Hence, if the economy dies due to the acute illness, all hopes of ushering prosperity and splendour will also die.

The acutely sick external sector is the main risk factor

The acutely sick external sector is the main risk factor for the Sri Lanka's economy today. This is not a new development and was known as far back as early 2010s. Because of the domestic economy based economic growth model used, the growth in exports fell far short of the growth in the economy.

Accordingly, the share of exports in GDP began to fall from around 15% in 2010 to 13% in 2015. By 2020, it fell to 12%. At the same time, the import bill began to rise relative to GDP. In 2010, it amounted to 24%. By 2015, it increased to 25%, but fell to about 19% in 2020 due to import restrictions imposed.

Negative net forex position of the Central Bank

However, since Sri Lanka's foreign exchange out-payments were higher than inflows, there was a chronic foreign exchange shortage which became acute by mid-2021. From May 2006, the net foreign assets of commercial banks had been negative, but with positive net foreign assets of the Central Bank, the country could still maintain an overall positive net foreign exchange position.

With the decline in the net foreign assets of the Central Bank, this began to change from May 2020 when the overall net foreign asset position of the banking sector became negative. The net foreign assets of the Central Bank fell sharply in the following months due to high out-payments without compensating inflows. As a result, in August 2021, the net foreign assets of the bank became negative by US $ 400 mn.

The negative position increased to US $ 790 mn by September, and further to US $ 1200 mn by October. With the reported decline of the gross assets of the Central Bank to US $ 1.6 bn, the negative net asset position is deemed to have risen to above US $ 2 bn now.

Will Thai forex fiasco in 1997 be repeated in Sri Lanka?

There are further foreign exchange commitments of the bank in the next six weeks on account of meeting the forex requirements of oil, medicines, and food imports. Unless the bank can generate a net inflow of foreign exchange amounting to about US $ 3 bn during this ensuing period from non-borrowing sources, the negative net position of the Central Bank's foreign assets will deteriorate further. It is a highly alarming situation because it reduces the bank's ability to intervene in the market to hold the artificially set exchange rate of Rs. 203 to dollar, make available foreign exchange for debt repayment, and meet the requirements of essential imports like fuel, medicines and foods.

When a central bank reaches the wall with no option available, it has to allow the exchange rate to have a freefall. This was what happened to Thailand in 1997 when it had lost an estimated US $ 25 bn in a futile attempt at holding the Baht at 25 to a dollar, triggering the infamous East Asian financial crisis of 1997-'98. With a rising negative foreign asset position, our central bank is also reaching this level fast. These are the new death threats which Sri Lankans are facing today.

A road map dismissing IMF support

This is a crucial issue. Strangely, the Budget 2022 has been silent about it. It seems that Basil has placed full confidence in the goals and strategies of the Six-month Road Map presented by Governor Ajith Nivard Cabraal on 1 October 2021.

In the Road Map, dismissing the suggestions that Sri Lanka should seek IMF support to get out of the current forex crisis, Governor Cabraal reiterated that he has a homegrown solution to the problem, will buy back the International Sovereign Bonds maturing in 2022 and cancel them, and there are sufficient bilateral forex flows lined-up to meet the forex gap. He was confident that Sri Lanka could get over the crisis without IMF.

The mixed track record of Governor Cabraal

A month and a half has now passed since these promises. The country's forex situation had changed from bad to worse during Governor Lakshman's era. Governor Cabraal made a valiant attempt at securing the funding which he had promised in the Road Map. Yet, because of the unexpected out-payments from the reserves of the Central Bank to meet urgent import needs, the level of reserves is reported to have fallen to US $ 1.6 bn by mid-November. He had also attempted to correct the excessive money printing permitted by his predecessor by following the recommendations of a breakaway group of economists called Modern Monetary Theory.

During the 21-month period from end December 2019 to end September 2021, Lakshman had permitted the money stock to rise by Rs. 2.9 tn or 38%, when economic growth during this period was just 1%. Governor Cabraal has placed a plug to money growth by allowing the Government securities rates to rise by about 2.5% and avoiding Central Bank's financing of Treasury bills. But still the Treasury bill market is concentrated in short maturity bills, indicating that investors are not ready to place their money in six-month and 12-month bills at the rates offered by him. Hence, if he is to realise the full benefits out of his new move, he needs to allow the rates to surpass 10% in the case of 12-month Treasury bills.

Will this homegrown policy package work?

Governor Cabraal still believes in his homegrown policy package and refuses to seek IMF support for financing the balance of payments crisis. Perhaps he may be waiting for the exhaustion of all the options available to him to secure a sufficient inflow of foreign exchange to change his stance as he did in 2009.

Bypassing the international sovereign bond market in which Sri Lanka could not issue bonds except at high yields, he has proposed to tap two unconventional commercial funding flows.

- One is the tapping of the green bond market in which funds could be borrowed for implementing specific environment protection projects. This will take time since projects acceptable to investors cannot be designed overnight.

- The other is the proposal to securitise the remittances flows to Sri Lanka.

Securitisation is a technique available for an asset holder to convert an illiquid asset to liquid cash. For instance, a lender could borrow immediately by issuing a security against a loan he has granted and is scheduled to mature after a period. But the remittances which he is planning to securitise are already available to him as liquid cash and once they are transferred to an overseas entity called a Special Purpose Vehicle or SPV, he loses the right to use them. What will happen is that he will get money for longer maturity at a cost. Hence, the securitisation of remittances in this case is a technique to convert an already liquid asset to a costly liquid asset. From a prudential point, this is a meaningless exercise.

What this means is that the possibility for Sri Lanka to secure a sufficient quantum of forex to meet its immediate payment commitments is a remote possibility.

Avoidance of the death of the sick economy

Hence, the current policy strategy adopted by Sri Lanka's policy authorities to come out of the acute forex crisis is like the strategy adopted by the parents with a child suffering from a cancer. Without taking the necessary correct action in time, the parents permitted the child to die. Governor Cabraal can avoid a similar outcome if he advises Basil that there is no other alternative for Sri Lanka at this stage except seeking IMF support.

This is the missing link in the Budget for 2022.

For the full article – Refer Daily FT

2. Is the 2022 budget a step towards fiscal consolidation?
By Nimal Sanderatne

- Bringing down the budget deficit to a single digit number would prove difficult due to high government expenditures and revenue shortfalls. Although the government has identified the need of reducing the fiscal deficit, no adequate measures have been taken to achieve this, with the focus mainly being put on taxation rather than reducing the expenditure.

- Finance Minister has identified that expenditure could be reduced by minimizing the losses of SOE and reducing samurdhi expenditure. But the budget did not have any policy reforms to correct these. Further, the tax changes were mainly on-off taxes charged retrospectively.

- Retrospective taxes introduced could be disadvantageous in attracting foreign income. High taxes on banking and finance could result in negative effects on interest rates. In conclusion, it would be challenging to achieve financial stability and economic growth under the presented budget.

Budget deficit

Although, prior to the 2022 Budget, key officials indicated that the fiscal deficit would be brought down to 5% of GDP, the budget expectation of the deficit is 8.5% of GDP.

Even this fiscal deficit would be an achievement owing to the prevailing economic conditions, and the state of public finances, especially the committed expenditures and political compulsions in expenditure.

Targets

Budgetary targets are rarely achieved. Expenditure overruns and revenue shortfalls widen the deficit significantly. As in the past, the fiscal deficit is likely to be double digit owing to government expenditures being much higher than budgeted and revenue shortfalls.

Only recognition

The need for reducing the fiscal deficit has been recognized by the Government and a few measures taken to reduce expenditure and increase revenue. However, there has not been substantial curtailment of expenditure nor comprehensive tax reforms to increase the woefully
Inadequate revenue to GDP ratio.

Expectation

The 2022 budget expects the fiscal deficit to be reduced to 8.5% of GDP from 11.4% in 2021.There is however many reasons to doubt that this could be achieved without an adequate reduction in expenditure, on the one hand, and insufficient revenue measures, on the other hand.

Progressive reductions

Progressive reductions in subsequent years to contain the deficit to around 5% of GDP by 2025 could stabilize the economy and be conducive for economic growth. However, such expectations are rather unrealistic in the current state of public finances and incapacity to curtail expenditure.

Reduction

In reality the reduction of the budget deficit is almost entirely dependent on increased taxation. The reduction of expenditure is mostly cosmetic. For example, the reduction in the petrol allowance of ministers and officials is such an instance. Other measures too like extending the number of years and Parliamentarian should be in parliament to receive a pension from five to ten years will hardly reduce expenditure.

State enterprises

The Finance Minister identified two areas where expenditure could be reduced. These were the

- huge losses of state owned enterprises (SOEs) and
- expenditure on Samurdhi.

SOEs

The huge losses of SOEs are a severe burden. However the Budget did not indicate how these would be reformed. Will they be privatized? Will they be made private sector state partnerships? Without any indication of what the reforms would be, the reduction of losses in SOEs is unlikely.

Samurdhi

Similarly, studies have shown that most Samurdhi beneficiaries are not the needy and the needy are not beneficiaries. In addition, the administrative costs are disproportionate and benefit supporters. Reducing Samurdhi expenditure is unlikely for these reasons.

Politics

Both these policies cannot be reformed owing to the political disadvantages of such reforms. They are severe hindrances to reducing the fiscal deficit.

Taxation

Prior to the budget there were expectations of comprehensive changes in taxation such as an imposition of a wealth tax. There were no such radical changes to increase revenue, only a few "once and for all" taxation measures.

Tax measures

A significant change in taxation was the imposition of a 12% surcharge on companies that had made profits of above Rs. 2 bn in 2020.This was to some extent a reversal of the tax benefit granted to the corporate sector in the 2021 Budget when the tax threshold was increased significantly. The estimated revenue is likely to be achieved as it is a retrospective tax.

Retrospective taxation

However, such retrospect taxes are considered bad taxation measures as they render the country's tax system uncertain and unpredictable. It is another disincentive to foreign investment.

Banking and finance

The tax of 12% on profits of banks and finance companies on their 2020 profits should yield the expected revenue. Although they are not expected to pass on this cost to customers, they are likely to adjust their interest rate policies to garner profits. There is also an issue as to whether this would have an adverse impact on their capital adequacy ratios requirement by the Basle requirements.

Conspicuous omission

The Budget was conspicuous in its omission of any reference to the external finances of the country. It was no doubt a contrived omission as there could have been no good news for the Government members to thump on the benches.

Nevertheless, the perilous state of the country's external reserves at only US$ 2.3 bn at the end of October is the most serious economic problem.

This omission in the budget is a clear indication of a lack of a strategy to resolve the problem. The Finance Minister wisely left the external finances in the hands of the Central Bank, whose optimistic expectations of international assistance are yet to materialize.

Summary

The "strategy" adopted in the Budget to reduce the deficit has been one of increasing revenue rather than reducing expenditure. There is a good rationale for this. Much of government expenditure is committed expenditure and there is no scope for their reduction. For instance, the expenditure on salaries, pensions and debt repayment absorbs the entirety of government revenue.

Summing up

Once again next year's Budget has demonstrated the inbuilt rigidities and difficulties of reducing government expenditure, as well as the lack of a political motivation to reduce unproductive and wasteful expenditure. The increase in defense expenditure and funds for provincial councils are clear items of such expenditure.

The budget has also made cosmetic and insubstantial expenditure cuts such as on the Government's petrol allowances to ministers and officials that would not make any significant dent on government expenditure.

Some of the revenue proposals to tax super profit making companies, banks and finance companies may yield increased revenue. However, there has not been a significant tax reform to ensure a more progressive taxation of the rich who evade and avoid taxation. Higher indirect taxes on the consumption of the rich, such as taxes on luxury vehicles and property are missing.

Conclusion

There is a conspicuous absence of substantial measures to reduce government expenditure or increase government revenue. The Budget for 2022 is hardly a step in the right direction. Fiscal stability for economic growth remains a mirage.

[For the full article – Refer The Sunday Times]