Spotlight: Econ Op-eds in Summary

Week ended 21st April '21

In Summary

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

1. Sri Lanka's central bank should guard against bankruptcy as Fed lights commodity fires
By: Bellwether

- Sri Lanka is running low on reserves and the rupee has depreciated continuously over time. With the country unwilling to obtain IMF support, the Central Bank now faces the issue of taking on excessive swaps, where any default on a swap is legally regarded as a default. IMF transactions, unlike swaps do not expand the monetary base when given to the Central Bank and only results in a net foreign reserve increase, which must be paid back in forex as well.

- Running out of reserves is not a severe problem, if the Central Bank is willing to freely float the currency and the IMF allows for it. However, there may be a lack of political will to do so as it could result in a complete meltdown as shown in other countries in the past.

- A recovering economy and rising Fed rates can result in further disruptions in the exchange rate, given reckless Modern Monetary Theory style liquidity injections being made and interest rates being at historic lows. Worsening the impacts, floating the currency will not work in 2021, due to issues of excessive central bank swaps, credit downgrades, the likelihood of defaults and a possibility of bank failures among other factors. As such, pre-emptive action by the CBSL needs to be taken before the economic crises worsens.

Sri Lanka's central bank is running out of reserves, a part of the remaining reserves are tied up in swaps, the country already has a 'CCC' rating, modern monetary theorists are in control and if that was not enough, the US Federal Reserve is firing a bubble.

Sri Lanka's central bank and the rupee it produces has been swept like a tsunami by Fed actions in the past, starting from the early 1950s commodity bubble which Mercantilists call the 'Korean War Boom' to the 'food crisis' from Greenspan/Bernanke's mother of all liquidity bubbles.

This time it may be no different.

When oil prices go up, Sri Lanka will subsidize by cutting taxes and replacing them with printed money, or getting credit from state banks which are in turn re-financed with printed money. Either way, the impact on the balance of payments from interventionist policy errors will not be pretty.

Central bank insolvency?

Sri Lanka balance of payments problems, trade controls and the path to a closed economy and import substitution making it a lagging nation in Asia was started by the Latin America style central bank set up by the Americans in 1950.

Sri Lanka's central bank now has the worst record among South Asian central banks having depreciated the rupee from 4.70 to 200 to the dollar since the end of British rule.

The Maldives has the best monetary authority having depreciated the Rufiyaa only to around 15 to the US dollar. If a central bank was set up by Americans in the Maldives, it would have degenerated into Haiti or Cuba.

The Philippines' central bank, also set up by Americans went bankrupt. Korea's 1953 central bank and South Vietnam fared worse.

A central bank's main liability is its note issue. The note issue pays no interest.

If the notes were issued against foreign reserves, it collects all the interest from invested reserves, makes a profit and builds up reserves further with the interest – unless it is transferred to the Treasury.

That is how Sri Lanka's currency board, the Hong Kong currency board or any pegged central bank are expected to make profits (seigniorage), which can also be transferred to a sovereign wealth fund every year to be used for an emergency.

However, the domestic currency notes, while not paying interest, come up for redemption in forex markets at the current exchange rate.

In a currency board, the exchange rate is fixed.

In a (crawling) soft-peg, this rate is periodically reduced (depreciated) when money is printed (extra notes are issued against T-bills instead of dollars) imposing a hair cut on the holders of central bank notes so that the monetary authority gives fewer dollars back to the public than it took from them in the first place.

Depreciation is a haircut

Currency depreciation is a default on the holders of domestic banknotes and holders of debt denominated in that currency.

Through a smokescreen of Keynesian hocus pocus, neo-Mercantilists have obscured this fact from an unsuspecting public who have little knowledge of high finance and central banking machinations.

When central banks were private this action was immediately recognized as a fraud and they were punished.

However 'economists' or bureaucrats working for the government have ensured that no such backlash happens to state-run central banks.

In a currency board, imposing a hair cut is illegal.

New currency liabilities cannot be created through the purchase of Treasury bills. That is also illegal.

Therefore, the currency issued by a currency board cannot be depreciated and there cannot be a balance of payments deficits.

In a gold standard central bank, the convertibility undertaking was written in gold in the note itself.

In others, it was written in the monetary law. It was the same with Sri Lanka's central bank when it was set up, 70 years ago.

Centuries ago the Bank of England had to seek parliamentary approval to suspend gold convertibility or break the gold peg (devalue). It was called a Bank Restrictions Act. Without it, the Governor and the Bank of England would have ended up in jail, like others have been guillotined or hanged before and after in Europe and elsewhere.

Sri Lanka's central bank, like others created by the Federal Reserve after World War II – with artful pressure from the State Department – was essentially a creature of the International Monetary Fund and was designed to break the Sterling Area.

The Exter Report which laid the foundation for the central bank and later to forex shortages, the balance of payments crises and import controls, is replete with multiple reasons why the Sterling peg should be broken in favour of a unified dollar area as envisaged by Harry Dexter White, the arch-New Dealer/Keynesian who was behind the failed Bretton Woods soft-pegs and the IMF.

Exter pointed out that the IMF requires all members to have par values of currencies "in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 01, 1944."

The rupee was therefore defined as 2.88 grains of fine gold.

Many reasons were given to break the hard peg with Sterling.

That it was in line with modern thinking, that the IMF which Ceylon had applied to join required money to defined in terms of gold or the US dollar.

Also given as reasons were that Indian rupees were under exchange controls – India had nationalized the RBI and it was printing money and that the Sterling was also in trouble and had devalued.

Sterling had devalued due to machinations of Harry White in the Anglo-American Loan agreement of 1946, which forced convertibility on the UK and the unwillingness of Keynesians to have market interest rates – the usual culprit in fact.

Harry White in fact had expressed a similar idea in a report in 1935 to support a dollar hegemony and undermine the sterling area.

White's plan eventually defeated Keynes' plan for the post World War II monetary order. In the end, it was White's plan for the post War monetary order that won and Sri Lanka ended up with an IMF style soft-peg with liquidity injections powers which was artfully marketed as 'sovereignty'.

As it turned out with open market operations and output targeting, it was not possible for either the Sterling (Sterling crises) or the US dollar (Nixon suspending gold convertibility) to keep parity with the gold in the end.

In 1969 the Import and Export Control Act was brought in, when Sri Lanka's foreign reserves dwindled to 40 million dollars from 190 in 1950.

When the Bretton Woods collapsed in 1971, the import control law played a key role in closing the economy under the next administration and ratcheting up import substitution. In 1978 Sri Lanka removed most of the remaining threads of a convertibility undertaking from the central bank law and the Monetary Board was allowed to change the exchange rate at its discretion and default on the people against the exchange rate peg.

Britain under Thatcher, however, fixed the currency on their own without an IMF program, eliminated the exchange controls which were present for 40 years through 11 IMF programs and the Sterling became a strong currency and inflation fell.

In Sri Lanka, the 1980s set the stage for unchecked depreciation, inflation and civil unrest. To make possible unchecked depreciation, without any parliamentary debate, the Monetary Law was changed giving carte blanche for the Monetary Board to destroy the rupee at will.
Though the IMF no longer had any relevance after the collapse of the Bretton Woods, the agency's influence towards monetary instability can be seen.

That single action doomed Sri Lanka's open market economy to severe monetary instability. The economy was originally also closed due to the American/Keynesian soft-pegged central bank.

The most successful East Asian nations did the complete opposite. In the 1980s as the rupee depreciated rapidly and people's living standards fell, workers went on mass strikes, and the public was unable to derive the full benefits of a sound monetary system or free trade as they did in Singapore, Malaysia or the Maldives. Wage-earners were systematically impoverished by the depreciating currency from a central bank that had "suspended convertibility" as it were.

Civil unrest followed.

Unhedged Exposure

Now the central bank is caught in another trap that it did not face in the 1980s. That is currency swaps.

When the central bank creates domestic currency through the purchase of dollars via swaps, there is a convertibility undertaking in the agreement. There can be no automatic default or hair cut unlike in depreciation to impoverish the counterparty.

That is why it is a reversible swap and not a final purchase of dollars for domestic currency. Article (3) of the MLA, through which 'haircuts' are imposed, does not apply.
A swap is a forward contract with a convertibility undertaking written into it in foreign currency like the earlier rupee notes were written in gold.

Furthermore, when the counterparty is a bank, for which the central bank is responsible as a regulator, it is not easy to mistreat them cavalierly and deny convertibility as a central bank does to the helpless individual members of the public who had sold dollars to the central bank in return for worthless domestic money.

The central bank will have to honour the obligations at the original rate indicated in the swap. Any default of a swap, unlike the devaluation, is legally still recognized as a default. By the end of January 2021 Sri Lanka's central bank had swaps with domestic counterparties and the Reserve Bank of India as totalling US$ 1.3 bn.

By the end of February 2021 swaps were down to US$ 836 mn after the RBI swap was paid off and some others had also not been revenues.

Central-bank-to-central-bank swaps were also invented by the Fed as it desperately tried to ward off the effects of its reckless open market operations in the run-up to and collapse of the Bretton Woods system in 1971.

Open market operations were also accidentally invented by the Fed in the 1920s triggering the Great Depression.

Net Reserves

In this century as of January 2021, the Central Bank of Sri Lanka had US$ 4,841 mn of gross reserves.

Dollars borrowed from domestic counterparties can be used for various purposes, such as giving to the Treasury to pay loans. However, when they mature those swaps have to be paid back at the original exchange rate in dollars.

Another US$ 1,340 mn from the reserves are owed to the IMF.

Unlike swaps or other central bank forex transactions, IMF transactions do not give rise to rupee notes or an expansion of the monetary base when they are taken to the central bank balance sheet. That is why IMF money results in a net foreign reserve increase, like a sterilized purchase of dollars.

While IMF money can be used for various purposes, it has to be paid back in forex – the IMF actually deals in SDRs.

The foregoing shows that at the end of January the central bank only has US$ 2.1 bn to give the government by defaulting on holders of rupee notes by floating (ending convertibility and not defending the currency). Sri Lanka's reserves also include balances with the Asian Clearing Union.

The 100 bn or so excess liquidity in money markets will also result in a US$ 500 mn loss of reserves at 200 to the dollar (or some other depreciated rate). That is baked in the cake so to speak. If the domestic swaps mature they will take up some of the liquidity.

A currency board has zero interest bearings rupee notes as a liability and interest-bearing securities as foreign assets. The Central Bank of Ceylon inherited foreign assets worth 11 months from the Ceylon Currency Board.

By 2021 January, about a third of reserves, which is about three months worth of imports are now impaired by foreign exchange liabilities.

Net Foreign Liabilities

As the economy is showing signs of gradually picking up, the central bank will have to give out more dollars as the excess liquidity is used up in loans if it wants to defend the currency peg at 200 to the US dollar.

The central bank earlier indicated that it wanted to give a convertibility undertaking at 185 to the US dollar but it has settled around 200 in March. This is the classic story of the Bretton Woods and any soft-peg.

To redeem the 100 bn in excess liquidity, US$ 500 mn dollars will be needed. That will leave the central bank with around US$ 1.5 bn to play around with. Of that around US$ 75 mn is an IMF reserve balance.

But given the focus on targeting call money rates, started under the last administration more money will be printed.

Due to this reason, any economic recovery will worsen the run on the central bank's reserves. If there are commercial bank or finance company failures, more money will be printed and more reserves will be lost.

However over the past year the run on the central bank basically came from settling foreign liabilities of the government.

While defending the rupee against excess imports or capital flight to escape from a hair cut on the rupee notes or assets denominated in rupees (depreciation) like Sri Lankan stocks or bonds is purely a run on the central bank to avoid depreciation, the run on government dollar obligations is something new to Sri Lanka.

In the 1953 or any other currency crisis generated by low interest rates, there was no run on the government. The run was purely on the central bank.

Now the government's dollar liabilities have been downgraded to 'CCC'.

That is the reason that foreign investors did not come back to rupee securities in 2020 even when a forward exchange guarantee (depreciation hair cut eliminated) was given.

In May a bunch of Sri Lanka Development Bonds are maturing. In July a billion-dollar bond has to be paid off because we cannot roll it over not counting other loan instalments that fall due every month, plus coupons on sovereign bonds such as in the month of March.

While there is excess liquidity in money markets and stronger credit growth, the central bank will not be able to collect significant volumes of dollars from the interbank market.

As can be seen, there is not much time before the central bank will end up with negative foreign assets.

Chinese or other swaps with private counterparties do not improve the solvency of the central bank as they will also contribute to negative foreign assets.

The swaps did not help the Fed, the swaps did not help the Philippines, the swaps did not help the Bank of Thailand during the East Asian crisis and the swaps did not help the Bank of England during the ERM crisis.

They will not help Sri Lanka either.

There is a new IMF Special Drawing Rights allocation due which can boost reserves and extend D-Day by a few more months.

It simply buys time and is not a solution. SDR allocations can be turned into dollars through a roundabout exchange with surplus countries.

Fear of Floating

Running out of reserves by itself is not a big problem if the central bank is prepared to free float and the IMF allows it on a permanent basis, without a foreign reserve target.

Even if reserves go down to zero it is possible for a central bank to always float cleanly and escape liability.

In fact, the Federal Reserve also went bankrupt in 1971 technically, just as the Bank of England did in 1797 when it suspended convertibility and several times later including in 1931 when it went off the Gold Standard (the float held) to cheers from John Maynard Keynes.

But soft-pegged central banks that do not know how to float get into much deeper trouble, dragging the country along with it.

It is psychologically difficult for a soft-pegger to float.

Or there may not be the political will do it when the currency falls deeply and pressure comes to intervene. As a result there is a complete meltdown.

That is why there are complete meltdowns in Latin America, Africa and Asia but it did not happen in 1797 UK, 1931 or the 1971 Fed.

In 2012 Sri Lanka's central bank did 'off-market interventions' and the float did not take hold quickly like in 2009.

This column has pointed out in the past that Sri Lanka cannot succeed in 'inflation targeting' without a proper floating exchange rate which was subsequently proved in the stagflation that followed.

Neither can it peg effectively with a 'flexible exchange rate'.

Usually, in a central bank with repeated currency crises, the bureaucrats have a serious 'fear of floating' and have no idea of how pegs work either.

As a result, such central banks will end up generating very high rates of interest, running up to 20 to 50 per cent or more as they struggle between fixed and floating regimes in a 'flexible exchange rate'.

The unwillingness and the 'fear of floating' in the psychology of soft-peggers are reflected on their clutching at a disorderly market condition (DMC) rule in an IMF backed 'flexible exchange rate' regime.

The IMF also goes along with it, since the currency has to be pegged eventually for the central bank to repay its own loan.

Deadly Flexible Exchange Rate

A flexible exchange rate is an extreme form of soft-peg, where instead of a step devaluation which gives into market expectations and which is then fixed with a rate hike restoring credibility – like in the Bretton Woods era, or the way Bank Negara did during the East Asian crisis – unplanned depreciation and interventions take place through a 'disorderly market conditions rule'.

In Pakistan's program, the DMC was articulated as follows
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"Going forward, the SBP might intervene to prevent a possible overshooting or disorderly market conditions (DMCs), while at the same time not suppressing an underlying trend and in a manner consistent with rebuilding reserves," the IMF program for Pakistan said in 2019.
"These sales will not be sterilized, such that the stance of monetary policy will be correspondingly tightened if intervention is needed."

An unsterilized dollar sales is a currency board rule. However, no credibility can come to a peg with a piecemeal currency board rule implemented at different levels.

If interventions are unsterilized a policy rate cannot be maintained. That is why in Argentina the overnight rate went up over 60 percent with the DMC and 'flexible exchange rate'
However since the interventions are ad hoc (due to the DMC) there is no credibility at any given exchange rate, leading to a continuous slide of the currency.

Reflecting the problem with swaps the Pakistan IMF program also said: "Finally, to remove future drains on its reserves, the SBP has agreed to gradually scale back its short swap/forward foreign exchange position to US$ 4 billion by the end of the program."

As can be seen from the earlier narrative, swaps are a threat to the repayment of loans to the IMF. Pakistan has more reserves than Sri Lanka. In Sri Lanka swaps were a third of the gross reserves by January.

A Storm from the Fed

While pegs break due to domestic policy, bad domestic policy is usually triggered by shifting Fed policy, which the pegged country tries to resist, as wrongly advocated by Exter in his report.

The non-existent ability to resist the Fed was a carrot that the US State Department and Treasury held out to convert consistent sterling pegs to US dollars.

This is how Exter explained it – "If fact whenever a country voluntarily links its currency to another it establishes a satellite-planet relationship which in effect proclaims that the satellite will always move with the planet. This is tantamount to a renunciation of a basic element of monetary sovereignty."

This was perhaps the most famous monetary last words written in Ceylon.

As the Fed tightened policy from 1951, Sri Lanka ended up with its first BOP crisis and the country's 3 month T-bill yield jumped from 0.40% immediately after abolishing the currency board to 1.40%.

The Planet and Satellite came back pretty fast and sovereignty went out of the window.

In 2021 Sri Lanka is also printing money to keep rates down under a non-existent 'sovereignty' and having run the biggest BOP deficit in the island's history in 2020, is facing a foreign debt crisis on top of it.

In the Exter, Report floating – or depreciation haircut – was put as a distant possibility.
"It will be required, unless it takes the emergency step of suspending payment (horror of horrors!) to buy and sell foreign exchange in unlimited quantities on the initiative of the commercial banks…"

What was illustrated as a distant possibility in the Exter report to the unsuspecting citizens of the island became fact.

In fact, what eventually happened was convertibility was suspended forever in Sri Lanka and it was given legal effect in 1978.

The reason was contained in the previous sentence.

The difference between a currency board and soft – peg Exter explained to the poor ignorant citizens of Sri Lanka – "is that Bank's foreign exchange operations will be compulsory, whereas its domestic operations will be discretionary."

In that discretionary policy lay the beginning and the end of Sri Lanka's post-colonial economy.

Any peg that does not change interest rates in line with the Fed is in danger of breaking. The 1985 Latin America debt crisis came from the second Volcker tightening that drove up the Fed overnight rate to 11%.

East Asia in its growth phase kept interest rates in line, having mercifully escaped the Exter/White style reasoning that brought down Latin America.

But countries like the Philippines, which did not and following flexible exchange rate and semi-independent policy collapsed and had to be re-capitalized.

A central bank set up by Arthur Bloomfield, another Fed money doctor in 1953 completely collapsed in 1960 taking Korea's First Republic along with it and a new central bank was built from scratch by the military dictator.

Yet, after the East Asian crisis, IMF is advocating a flexible exchange rate with dual anchors without any credibility which had already destroyed many countries in Latin America.
Sri Lanka's peg has been hit when the Fed loosens policy and also when the Fed tightens.

Oil Shock

When initially when the Fed loosens policy and drives up oil and other commodity prices Sri Lanka tends to subsidize energy with printed money hitting the exchange rate.

The shock from oil comes not from rising prices, but the money printed to subsidize retail prices. When the currency depreciates, authorities are usually reluctant to raise prices and more money is printed worsening depreciation and energy costs.

There are already signs that the commodity super-cycle is on the way and inflation will go higher than expected by Jerome Powell, according to economists who track Fed operations closely.

The Fed's record in creating global crises from the Great Depression to the Great Inflation to Great Recession is well known.

However when the Fed tightens policy later as inflation picks up, and Sri Lanka does not raise rates in line with it the exchange will also take a hit.

This has happened to Sri Lanka many times, from what was misnamed 'Korean War boom' when the Fed was buying Liberty Bonds like Sri Lanka is now buying Treasury bills to inject liquidity and the most recent incidents in 2014 and 2018 when the Fed was tightening and Sri Lanka cut rates.

What is different in 2021 is that remarkably reckless Modern Monetary Theory style liquidity injections are being made, interest rates are at near historic lows and for the first time in post-independence history Sri Lanka has borrowed money from capital markets and access has been cut off.

So both a recovering Sri Lanka economy and loose Fed policy can trip the country up.

The Options

A clean float is always a solution. Afloat works when reserves run out because a float also matches inflows to outflows of dollars.

Sri Lanka has done this before when reserves were at a low level and Sri Lanka did not have much commercial debt and the problem was limited to strong credit growth and weak confidence in the peg on mostly trade transactions.

However, in 2021 a mere float does not solve the problem because in summary:

a) on top of the problem of trade transactions – which will intensify when the economic activity picks up given Modern Monetary Theory
b) there is a problem with central bank swaps.
c) Then there is a problem with government credit downgrade and the likelihood of default which needs a fiscal correction at the minimum and a debt workout

There are three looming problems on the horizon:

d) Fed commodity which will trip up the credit system due to fixed fuel prices
e) Any Fed tightening will also trip up the system like in 2018 due to unwillingness to raise rates and lack of will to independently float
f) The third is the possibility of bank failures.

It is always smart to start fixing the system before bank failures start.

Sri Lanka is expecting growth to solve the problem. However, growth will not solve the problem as long as money is printed under MMT and bill auctions fail.

As was shown in last month's column the government's domestic debt solvency has to be restored to prevent the default on foreign loans.

Defaults and sudden stops of financing can lead to an implosion of economies.
Steep depreciation will add to it. As more subsidies are required to keep oil prices down, there will be a bigger meltdown, perhaps rationing.

Whatever the IMF's faults – and its deadly 'flexible exchange rate' which can drive up interest rates to 60 percent in a crisis – it has the clout to get G20 countries and also private debtors behind a debt workout and provide breathing space.

China has also fallen in line with the G20 initiatives.

In fact, if the Chinese US$ 1.5 bn swap is drawn down and used, the central bank's insolvency would get worse in the end.

Indians withdrew its swap early and also gave good advice to go to the IMF.

Neither India nor the People's Bank of China has the capacity to influence domestic monetary policy, unlike the IMF, of which the central bank is a creature and has an agreement in place with Sri Lanka's government.

Markets also have confidence in IMF programs, however, misplaced it is.
Even with an IMF programme, the road ahead is fraught with danger with a non-credible Keynesian/IMF 'flexible exchange rate' with a DMC.

As was seen in Sri Lanka in 2015 and 2018 and also in 2020 the 'flexible exchange rate' has zero credibility and creates more problems than it solves and drives out foreign investors.
This is what Exter said of the Ceylon Currency Board though making a false claim about 'economic pressures' also taking a swipe at colonialism.

No currency board has ever succumbed to economic pressures.

Singapore kept this 'relic of colonialism' which was based on sound monetary principles and rules that upheld the monetary sovereignty of the individual.

Instead Sri Lanka went on a Keynesian discretionary policy which was also British and dates back to John Law.

In some areas, Colonials had used discretionary policy and destroyed countries also.
After 2015, the 'flexible exchange rate' led to massive capital flight from the rupee debt market during MMT version 01 involving output targeting, and the current outflow from the stock market in 2020 and 2021 during MMT version 02.

Argentina IMF program also failed due to a flexible exchange rate and unsterilized DMC pushing short term rates to over 60 percent even as the exchange rate fell.

In fact Argentian Raul Prebisch's central bank is now defaulting on its 45 billion dollar debt to the IMF.

"We can't pay because we don't have the money to pay," Cristina Fernandez de Kirchner said in March 2021.

Unlike a step devaluation that restores credibility, there is no relief from a 'flexible exchange rate', where market participants are on tenterhooks permanently.

The anchor conflicts in the 'flexible exchange rate', with a reserve money target working against a loose domestic anchor (a high ceiling inflation rate) are much more violent than a conventional soft-peg subject to steep devaluation.

In Sri Lanka, this was seen in 2012 and also in 2018, where the IMF program left room for Keynesians within the central bank to print money and the lender gave technical support to calculate an output gap and start MMT version 01.

An untamed central bank will lead to dollarization

The only way to tame a soft-pegged central bank is to place a falling ceiling on domestic assets which is complementary to the forex reserve target as a continuous performance criterion (PC). There is no need for a reserve money target.

The PC on domestic assets ceiling will take care of it as long as overnight rates are allowed to fluctuate. An untamed central bank will lead to unofficial dollarization at a great cost to society.

Now it is too late to officially dollarize as Ecuador did with very little reserves left.
In 2018 and 2019 it may have been possible to exchange the entire money issue of about a trillion rupees (reserve money) for US dollars at around 200 to the US dollar and have some reserves left.

It was a short jump from 180 to 200 to the US dollar.

Extending the same logic it is possible to dollarize the current trillion rupee reserve money at 500 to the US dollar with the remaining two billion US dollars in net reserves and let the chips fall where they may on the foreign debt.

But that is too much of a political hit for any elected government. What usually happens in such cases is unofficial community-based dollarization.

Central Banks that are re-capitalized will still live to fight another day like a bad penny.

But some central banks get into bigger difficulties, and with very steep currency falls the people start to use dollars after domestic currency and bank deposits become worthless. That means people will give up using domestic currency and will use dollars instead.
As the value of the domestic currency dwindles to almost nothing over a few months, amid fuel and electricity shortages and people start trading in whatever dollars and Euros they have at hand. The outcome will be the same as a currency board, the country will be stabilized.

If both US dollars and Euros are used there will be currency competition.
Currency competition will be good for stability and growth. Zimbabwe recovered very fast under multiple currencies.

That is how Cambodia is growing so fast. The riel fell to 4,000 and has stopped because monetary policy is no longer effective.

Zimbabwe experienced rapid recovery under multiple currency dollarization.
Growth has started to collapse with the RTGS dollar of the Reserve Bank of Zimbabwe being forced on users.

In Cambodia, IMF is trying to get 'monetary policy to work again, despite the country's previous Zimbabwe like experience. It may well become a Zimbabwe again. Harry Dexter White lives on. IMF is also trying to turn Vietnam into Sri Lanka with a 'flexible exchange rate'.

In fact, Sri Lanka can be dollarized and also have a currency board at the same time, which will give some seigniorage profits for the budget. Community driven dollarization or multiple currencies will finally free Sri Lanka from monetary instability. But in between now and dollarization there will be a lot of casualties and pain.

None of this need to happen, if pre-emptive action is taken and decision-makers learn a little monetary policy.

For the full article – Refer Economynext

2. Is Sri Lanka's debt problem a dramatised story?
By: Prof. Sirimevan Colombage

- At its most recent Monetary Policy Review meeting, the CBSL viewed debt settlement as a smooth operation, and thus, downplayed the gravity of the debt burden amidst fiscal deterioration and balance of payments difficulties. However, as a result of declining tax revenue the budget deficit (% GDP) for 2020 is expected to widen to the likes of 12% which would require more funding.

- In addition, weakening of the rupee results in an increase in the rupee cost of foreign debt repayments and interest payments. It leads to further increase in Government expenditure and a deterioration of the budget deficit, requiring to raise fresh loans. In the short run the debt servicing capacity of the country is expected to be boosted by an IMF SDR allocation. However, authorities have indicated its unwillingness to enter into a more longer-term arrangement with the IMF.

- The CBSL has introduced several interim measures in recent weeks to ease the external payments situation and the debt burden. Such measures coupled with the bilateral swap arrangements and other foreign borrowings may be imperative to meet the immediate debt commitments. However, such efforts would be futile in the medium and long run without addressing the root-cause of the debt problem.

As such, committed fiscal consolidation agenda, is imperative not only to reduce the future borrowing requirements, but also to boost investor confidence.

Government borrowing is rising rapidly amidst the widening budget deficit, which rose to 12% of GDP in 2020. This year's deficit is likely to be even higher in the backdrop of the pandemic-hit economic activities, rupee depreciation and interest rate hike.

Given the revenue shortfalls that arose from the haphazard tax cuts implemented in 2019, the total tax revenue is hardly sufficient to meet debt service payments. Interest payments alone account for 50% of tax revenue. Foreign debt commitments in the next 12 months amount to 50% of the country's export earnings.

Inevitably, the Government has to raise new loans continuously to repay the old loans. This type of debt rollover situation is known as the "debt trap" in which the borrowing country finds it difficult to meet the debt commitments, typically because high interest payments prevent repayment of the principal

Hence, it is inaccurate to identify Sri Lanka's debt problem as the most dramatised story as stated by the Secretary to the President Dr. P.B. Jayasundera at a recent webinar. The debt burden has become a bitter reality in spite of the country's unblemished track record of debt settlements.

Debt rollover

In response to an alleged erroneous report that appeared recently in Sunday Times on a planned delay in debt service commitments, the Central Bank of Sri Lanka (CBSL) states that the Government has no intention to tarnish its unblemished debt service record by delaying the settlement of maturing debt obligations.

However, the concerned newspaper claims that it received information from the CBSL that market participants holding such debt instruments have expressed their willingness to rollover a sizeable portion of these liabilities fallen due in the period ahead. One could interpret such debt "rollover" as postponement of debt settlements.

At its most recent Monetary Policy Review (MPR) meeting, the CBSL viewed debt settlement as a smooth operation, and thus, downplayed the gravity of the debt burden amidst fiscal deterioration and balance of payments difficulties.

The MPR states, "… the CBSL and the Government continue to engage with investment and lending partners to secure foreign financing and remain committed to honouring foreign currency debt service obligations on time."

Tax revenue falling

The budget deficit has widened largely as an outcome of a significant decline in tax revenue in 2020. Following the Presidential Election in November 2019, the Inland Revenue Act was revised so as to provide wide range of concessions to tax payers, without considering their adverse fiscal implications for economic stability.

Accordingly, personal income tax rates, tax-free thresholds and tax slabs were relaxed significantly with effect from 1 January 2020.

Also, Pay-As-You-Earn (PAYE) tax on employment receipts, withholding Tax and Economic Service Charge were removed effective from the above date. Downward revisions were made to the Value Added Tax and Nation Building Tax to stimulate business activities.

As a result, the total tax revenue was down by 30% from Rs. 1,613 bn in January-November 2019 to Rs. 1,128 bn in the same period of 2020. Thus, the tax revenue realised in 2020 is likely to be less than the projected tax revenue of Rs. 1,358 bn in the Budget speech 2021.

The tax revenue expected in the Budget speech for this year is Rs. 1,724 bn, and it appears to be over-optimistic, given the lower tax rates and slowdown in economic activities due to the pandemic.

Budget deficit expanding

As a result of the decline in tax revenue, the budget deficit which stood at Rs. 913.6 bn in January to November in 2019 rose to Rs. 1,576 bn in the same period of 2020.

In consequence, the budget deficit to GDP ratio increased from 9.6% in 2019 to around 12% in 2020. This contrasts with the anticipated deficit of 7.9% of GDP for 2020 given in the Budget speech-2020.

Rupee depreciation and interest rate hikes

The rupee continues to depreciate further as the selling rate of dollar recorded over Rs. 205 per dollar and the buying rate over Rs. 200 per dollar last week. Meanwhile, the yield rates of Treasury bills have moved upwards in recent auctions reflecting the demand pressures exerted by heavy Government borrowings on the money market.

The country has also been experiencing capital outflows from the Government security market and the stock market in recent months, worsening the fiscal and balance of payments positions.

As revealed at the previous MPR meetings, the declared policy of the CBSL was to keep the exchange rate around Rs. 185 per dollar while maintaining low interest rates.

Contradicting such policy stance, the rupee depreciation and interest rate hike are unavoidable in terms of the phenomenon of "impossible trinity" or "policy trilemma", which asserts that no central bank can fix the exchange rate and interest rates at the same time without experiencing capital outflows.

Weaker rupee escalates debt service cost

Weakening of the rupee results in an increase in the rupee cost of foreign debt repayments and interest payments. It leads to further enhance the Government expenditure and budget deficit, requiring to raise fresh loans.

For instance, the Government now has to pay additional Rs. 20 for each dollar of foreign debt settlement at the current selling rate of Rs. 205 per dollar as against Rs. 185 per dollar that prevailed six months ago.

This means an additional cost of Rs. 134 bn will have to borne in repaying the principal and interest payments of foreign debt amounting to $ 6,691 mn fallen due in the next 12 months. The additional rupee cost goes up further as the rupee depreciates in time to come.

Sri Lanka to receive SDR allocation from IMF

The International Monetary Fund (IMF) has decided to support its member countries' foreign exchange reserves through a new allocation of Special Drawing Rights (SDR) of

US$ 650 bn. SDRs is the reserve asset of the IMF, which could be exchangeable for dollars, euros, sterling, yen and Chinese yuan.

The new allocation to be implemented in August will benefit around 75 low income countries including Sri Lanka to help them dealing with the external financial implications of the COVID-19 pandemic. It will also benefit all countries to ease external sector constraints and to boost their economies, and thereby to attain global economic recovery.

The IMF allocates SDRs to members in proportion to their quota shares. The new SDR allocation will provide a direct liquidity boost for all IMF member countries without adding to debt burdens. Members receiving SDRs can transfer them to other members in exchange for convertible or hard currencies to meet their external payments needs.

Sri Lanka will receive US$ 800 mn under the new SDR allocation, and this will help to improve the country's debt servicing capacity in the short run.

However, the authorities have expressed their unwillingness to have any financial arrangement with the IMF, as the conditionalities attached to such programmes are said to be incompatible with the Government's home-grown economic development strategy.

Foreign borrowing by finance companies allowed

The CBSL introduced new regulations a few days ago to permit Licensed Finance Companies (LFCs) to obtain low-cost borrowing from foreign sources to support their business expansions. The LFCs satisfying criteria such as utilisation for purposes with national interest, maturities over five years, complying with the prudential requirements, etc. are eligible to raise foreign currency borrowings on a case-by-case basis up to 10% of total assets. The tenure of foreign currency borrowings shall be two years or more.

Any foreign currency borrowings up to 10% of a company's total assets do not require CBSL approval except prior notification, while the borrowings exceeding 10% require prior approval of CBSL.

LFCs are allowed to borrow foreign currency up to 20% of a company's total assets under three stages based on the overall performance of each company including capital and liquidity levels, utilisation purposes, nature of collaterals and the credit rating.

While these new regulations are helpful to raise foreign borrowings amidst the country's dwindling reserve position, they will lead to aggravate the debt burden since principal repayments and interest payments on account of such loans will have to be met through the country's foreign reserves, irrespective of the type of the borrower.

Already, the total foreign debt stock held by the Government, Central Bank, commercial banks and blue-chip companies amounts to US$ 55 bn, equivalent to 65% of GDP.

Policy reforms for debt sustainability

The CBSL has introduced several interim measures in recent weeks to ease the external payments situation and the debt burden, and some of those measures were withdrawn in double quick time. Making the second change in one month, the CBSL, last Friday, doubled the time period for foreign exchange earnings conversion given for exporters from two weeks to 30 days.

Such measures coupled with the bilateral swap arrangements and other foreign borrowings may be imperative to meet the immediate debt commitments.

However, such efforts would be futile in the medium and long run without addressing the root-cause of the debt problem, i.e. fiscal imbalance. The haphazard tax cuts implemented in 2019 without considering their adverse economic effects have led to expand the budget deficit compelling the Government to borrow more and more. Hence, fiscal consolidation is essential, possibly by reviving the Fiscal Responsibility (Management) Act.

Past foreign borrowings were raised from capital markets, particularly from China, without paying adequate attention to the rate of return on investment, unlike in the case of loans disbursed by the multilateral agencies such as the World Bank and the Asian Development Bank.

As a result, many debt-funded projects have failed to generate economic growth or foreign exchange earnings. This makes debt service payments extremely difficult in the next five years when the bulk of such loans get matured. Proper debt evaluation needs to be introduced for future borrowings to avoid debt sustainability crisis.

The ongoing rupee depreciation and upward movements of interest rates aggravate the country's debt service burden.

A committed fiscal consolidation agenda, therefore, is imperative not only to reduce the future borrowing requirements, but also to boost investor confidence.

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3. Proceed with caution Is Sri Lanka's approach to import substitution sensible
By: Pathfinder Foundation

- After the pandemic there was a rise in protectionism, this was mostly fueled by supply side shocks. Further this exposed the weaknesses of complex supply chains that restricted the cross border production. However overtime, globalization was back on track on account of access for vaccines by different manufactures as well as remote working and living arrangements. Central bank's and treasuries took immediate policy changes to expedite the recovery.

- In Sri Lanka, the policy decisions were more biased towards import substitution and protectionism. Import controls specially on manufactured goods had proven not to conserve forex but rather misallocate resources and create poor quality products with higher prices for helpless consumers. It further strengthened small and inefficient firms that serve domestic markets. These firms will never be export competitive. Thus, dragging the whole economy towards disaster.

- A different approach was practiced by East and South Asian countries. It had more trade liberalization, attracted more FDI and know how. This led to export expansion. Thus, Sri Lanka should focus on increasing productivity rather than import substitution. More focus should be on a production economy with high productive agriculture sector. It should never be on rent seeking individuals by import restrictions.

In the immediate aftermath of the onset of the COVID-19 pandemic and the unprecedented health and economic crises it unleashed, there was a widespread backlash in sentiment against globalization and open economic policies. The greatly increased human mobility associated with these phenomena were blamed for the rapid spread of the virus to all parts of the globe.

The supply-side shocks, extended even to basic goods, such as food and medicines, as well as demand pressures emanating from a rise in protectionism, were seen as being the

result of the complex supply chains that underpinned the web of cross-border production networks that constitute a major part of the global economy on the one hand, and the destruction of employment and incomes in an integrated world economy on the other.

However, as time passed, there has been a shift in sentiment. The focus has shifted to seeking ways and means of maintaining the substantial gains of globalization, while reducing the risks that were exposed and amplified by the pandemic. On the health front, the extraordinary achievement of scientists in developing highly efficacious vaccines, in record time, has created the very real prospect of opening up global mobility again. This has been supplemented by the exponential acceleration of remote working and living.

On the economic front, the focus has been shifted from efficiency to resilience in maintaining global supply chains. There has been diversification as well as shortening of supply chains. On the demand side, the unprecedented policy actions of Treasuries and Central Banks around the world has propped up businesses and livelihoods to an extent where a relatively strong recovery, though multi-speed, is being seen in the world economy. These trends explain why there has been a shift in sentiment, as mentioned above.

While protectionist pressures are still present, the case for an open and rules-based international trading system is being reinforced, led by China. The Biden administration has also taken measures to revive the World Trade Organization, including through the appointment of a former Finance Minister of Nigeria, and Managing Director of the World Bank, as the first female head of the institution. The dispute resolution panel of the WTO is also being reconstituted. Protectionist sentiments and a shift to autarkic policies were also ascendant in Sri Lanka. The world seems to have realized that it is not advisable to "throw the baby out with the bath water." It is important that Sri Lanka absorbs this lesson as well.
It would be useful to trace the evolution of the thinking on import substitution and to examine briefly some of its sub-optimal practical outcomes. A paper by Douglas A Irwin, titled 'The Rise and Fall of Import Substitution', (Working Paper, Peterson Institute for International Economics; July 2020) traces the evolution of the thinking on import-substitution. Import substitution policies initially came to the fore in the early 1950s. It is probably no coincidence that they gained salience at a time when decolonization was gathering momentum. The ex-colonies sought to augment their political freedom with policies that reduced their dependence on the metropolitan centers.

Many developing countries came to the conclusion that import substitution was the best trade strategy to promote industrialization and economic growth within a global economic system based on colonial structures that was geared very much against them through exploitative trading relations. Raoul Prebisch, based at the UN Economic Commission for Latin America, is widely recognized as the father of the import-substitution industrialization (ISI) strategy. However, he and other leading contemporary figures in development economics, in the 1950s, identified fairly quickly some of the weaknesses of import substitution policies in practice.

Import controls, particularly on manufactured goods, did not necessarily conserve foreign exchange as intended; rates of tariff protection were high, resulting in a misallocation of resources and higher priced and poor quality products for consumers; small and inefficient firms were created that served only domestic markets, and taken together, these policies became an obstacle to promoting exports. These shortcomings are relevant even today. Prebisch's own views changed by the 1970s. It can be argued that the intellectual demise of import substitution had taken place by the 1970s.

The Pathfinder Foundation believes that there is considerable evidence that openness to trade increases the growth, employment and incomes trajectories of economies. It is noteworthy that the unleashing of the potential of Asian economies (particularly in East

and Southeast Asia) was greatly facilitated by two of the key pillars of globalization: liberalization of trade and capital flows. This enhanced the capacity of countries to take advantage of the opportunities created by rising external demand. The successful countries of Asia were able to attract FDI, with its capital, market access and know-how, to drive export expansion and take advantage of this increasing external demand brought about by globalization.

In practice, countries as large as China or as small as Singapore have been able to transform their economies through this combination of increased FDI and rising exports. In this context, it is noteworthy that the coastal regions of China, which were significantly more integrated with the world economy, have experienced far more dynamic growth and development than the hinterland, which is significantly less integrated, and more backward. The experience in China vividly illustrates within one country the tangible benefits of policies which are open to greater integration with the global economy.

It is also important to learn lessons from historical experience closer to home. The inward-looking policies adopted by Sri Lanka in the 1970s resulted in a low-investment, low growth and high unemployment syndrome. Long queues for even essential goods were emblematic of this period. The benefits of liberalizing the economy in 1977-78 have been curtailed by the three- decade-long civil conflict and the partial nature of reforms due to a lack of political consensus around policies that attract FDI and promote exports. Weak implementation has also amplified poor overall performance. The time has come to have a concerted and holistic approach to transforming the Sri Lankan economy.

In today's world of ever-increasing climate and other risks, there is a case for attaching high priority to food security. Well-targeted import substitution policies in agriculture can be justified on these grounds. However, the overarching focus should be on increasing productivity to avoid imposing high prices and poor quality on the consumers. The paddy sector reveals what should not be done. Sri Lanka has now reached self-sufficiency in rice production in most years. However, the outcome has been a long tail of low productivity, low income farmers whose subsistence has to be secured by inefficient and costly subsidies as well as guaranteed prices. Lessons need to be learned from past experience to avoid the same mistakes in the present and future.

In conclusion, the Pathfinder Foundation believes that it is encouraging that the most senior policy-makers have been stressing the need to develop 'a production economy' driven by FDI and exports, along with a high-productivity agricultural sector. These goals should not be derailed by vested interests which focus on rent-seeking activity based on import restrictions. History, in Sri Lanka and elsewhere, teaches us that the outcomes will inevitably be bad.

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