Spotlight: Econ Op-eds in Summary

Week ended 17th March '21

In Summary

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

1. Money printing does not lead to inflation
By: Dr. Kenneth De Silva

- Sri Lanka can achieve a 6.5% - 7% growth rate in 2021, given the current coordinated and aligned macro-economic policy framework targeting growth. The downgrades in credit rating will only have a muted impact on growth given that credit lines will remain available for banks engaged in international trade finance. On the back of this, the securing of the US$1.5 Bn swap from China serves as a blow to doomsday advocates, who harped on about default possibilities.

- Money printing does not lead to inflation, rather it is a myth proven globally. Many Central Banks have resorted to monetary stimulus in recessionary periods without severe consequences on inflation. Similarly, the monetary policy adopted by the CBSL would not be inflationary given that domestic and global demand have excess production capacity at the moment.

- Policies such as the conversion of export proceeds to be handed over to the CBSL are reasonable in the current circumstance. There are no easy adjustments to be made for these policies, as Sri Lanka is currently faced with the choice of permitting consumer imports and plunging it into further debt or going through a restructuring of its national balance sheet. Support by the IMF through structural adjustments have not helped Sri Lanka be free of its vicious import dependent cycle, all the while permitting the depreciation of the currency on multiple occasions.

How do you assess the overall growth prospect of Sri Lanka under the prevailing circumstances?

I remain extremely optimistic about the growth prospective of Sri Lanka in 2021, and therefore will not be surprised if Sri Lanka outdoes many of its peers and reaches a 6.5% to seven percent growth rate in 2021.

"By this swap, Sri Lanka has shown that it still has friends it can depend on and it can secure (non-conditional) funding apart from IMF on top of the improving external cash flows and trade, service sector balances."

What is the rationale behind your optimism?

The rationale for my optimism is twofold. Sri Lanka has witnessed an average growth rate of 4.45% even during the 30-year period of the civil war with the exception of the 2015-2019 period where Sri Lanka's growth plummeted below the average. During this period of below average growth there were hardly any exogenous shocks to the economy. We did not see a global financial crisis, a global food crisis, a global energy crisis nor a global environmental crisis such as the Tsunami.

Therefore, the below average growth was the lack of a cohesive and aligned development plan which resulted in the country achieving a 2.3% growth in 2019 and a stagnant per capita income of US$ 4000 only. However, now for once, we see a coordinated and aligned macro-economic policy framework targeting growth. This policy framework enshrines four key pillars namely monetary policy, fiscal policy, industrial policy and export policy.

In 2020, the world economy was reset to zero and witnessed the worst decline of GDP growth rate since the history of capitalism, which prompted countries to internalize many of its import dependant industries. Sri Lanka is no different as it looks to restructure its economic model based on the four macro foundation pillars mentioned earlier in order to capture the Jetstream of economic growth that would dawn with the new business cycle and the rise of the Asian economies.

From a mathematical point of view Sri Lanka's 2020 economic growth declined to Rs. 14.56 Tn and this value could be equated to the value of GDP reported in 2018. Therefore, achieving 6.5% growth is a strong possible reality given the low base.

Sri Lankan companies and banks are facing issues in accessing financial capital in the international market due to downgrading of the country by the rating agencies. What kind of an impact will it have on the growth prospects?

There will be a muted impact on growth aspects, and this should not impede the prospects of Sri Lanka as finance is a business for western banks that are flushed with excess liquidity for lack of returns given the flattening of global interest rate curves. The downgrade has only impacted the cost of balance sheet liquidity. There have been a few banks which have seen the tenure of banking facilities being revised due to the unilateral downgrading of Sri Lanka's external credit by the US based credit rating agencies.

However, the credit lines per say continue to be granted to all commercial banks engaged in international trading and finance. What has happened is that as a result of the downgrade, cost of liquidity has increased as the international sovereign bonds held by a few US funds were sold and the price of the short-term bonds declined sharply thereby increasing the yields of sovereign bonds. Despite these conditions' banks' liquidity remains intact as the ALCO (Asset and Liability Community) of banks have the responsibility and duty to ensure balance sheet liquidity remains adequate for Business-as-Usual (BAU) operations to continue.

I am confident that all bank treasurers who are the designated chairmen of ALCO would now put their own professionalism on the line and rise to the national challenge as a result of
the downgrades.

Despite this rating downgrade Sri Lanka continues to maintain its unblemished debt servicing track record to its external creditors' platform. This too was at a time when the global economy was completely paralyzed and the operation of cash flows were a challenge. In fact, the data published by the Central Bank indicates that the liquidity cover ratio for all currencies increased from 164% in September 2019 to 207.5% in September 2020 indicating that the banking sector is well positioned to handle any liquidity risk in any macro-economic headwinds that may come about as a result of such downgrades.

The government or the Central Bank has resorted to money printing. It has created excess liquidity triggering fears of inflation? What are your comments on this?

Firstly, money printing does not lead to inflation and that myth has been proven globally. But it is loosely used by neo-liberal economist particularly monetarists in Sri Lanka to invoke baseless fears about price inflation as they find their theories being exposed

globally. Central Banks globally continue to print rapid amounts of money while price inflation has steadily declined and this inexplicable situation has been termed 'dark matter' by theoretical monetary economists. In fact, Bloomberg had an interesting interview with Jens Nordvij on December 15, 2020. In this discussion, they dealt with this myth and exposed the flaws of such misleading money printing inflation hypothesis.

Money printing is nothing new and has to be done by all Central Banks in the world to facilitate asset growth and liquidity in the banking system as and when required depending on the prevailing business cycle. What we have seen is that many Central Banks have resorted to monetary stimulus when the economy is facing recession or is in a trough and such actions are evident in the balance sheet expansion or contraction of Central Banks. In an expansionary situation Central Bank buys already issued treasury bills and bonds or corporate bonds and infuses money into the system in order to stimulate economic growth and real sector production expansion.

This money remains as liquidity, until corporate balance sheets are strengthened and have the capacity to expand increasing real assets moving away from financial assets. This would only happen in an upward swing of the business cycle at which point Central Banks could use counter cyclical tools to manage any liquidity or price concerns. Sri Lanka too for the first time seems to be managing its monetary policy based on growth objectives as opposed to the traditional inflation targeting framework, therefore, is an exciting period for Sri Lanka's Central Banking. I am confident that the monetary policy adopted by the Central Bank of Sri Lanka would not be inflationary as both domestic demand and global demand have excess production capacity for the moment. This particular aspect has been reflected by the continuous decline in global and local inflation indexes.

The government has proposed some measures to replenish the foreign exchange reserves. Now the exporters are asked to surrender a percentage of their incomes. How practical is this decision from an economist's point of view?

Yes, this is correct. Particularly at a time the global economy has collapsed in 2020 and is just recovering from its worst cash flow contraction. The requirement to repatriate foreign exchange is a reasonable one. Extensive and permanent exchange control regimes prevailed in Australia, Canada, Finland, New Zealand, Sweden and the UK since World War II periodically when acute shortages of foreign exchange persisted and measures were used to prevent the depletion of international reserves. The Central Bank of Sri Lanka too is faced with challenging times and has to manage this unforeseen cashflow crisis by requesting to convert 25% of their earnings as it does not exert excessive pressure on exporters who have a moral obligation to bank all earnings.

Exporters have been given the flexibility to retain 75% of their earnings needed for value addition purposes and importation of raw materials. These requirements are essential in a period the country's main service sector earner namely the tourism sector which has seen a cash flow of US$3.0 Bn on average declined to US$1.0 Bn. Therefore, other measures have to be pursued until such time the recovery is adequate. These requirements are not uncommon as seen in Asian and African economies which have displayed stronger export results than Sri Lanka. India despite being a country with large reserves continues to have such surrender requirements for exporters.

Import restrictions have impacted a lot of business activities such as the sale of ceramic products, vehicles etc. How long will it take for the government to relax the restrictions?

Well, there is no quick solution, as we have to make a choice if we are to continue the unsustainable imports or pay off our external creditors. Therefore, the choice between permitting all forms of consumer imports to flood the economy and put us into further debt or pay our debt obligations and restructure our national balance sheet is one that has

to be made by all Sri Lankans. And it is by no means easy. Our merchandise goods deficit is circa US$ 8 to 10 Bn annually and is increasingly becoming unsustainable, as it has to be financed using various methods including external borrowings.

For years we have been living beyond our means by importing many of these consumer goods that can be produced locally given the liberal doctrine of comparative advantage being aggressively marketed by the import industry rent seekers.

The comparative advantage has not only made us prone to exogenous consumer habits, but also consumed our hard-earned domestic savings thereby impoverishing the country placing significant reliance on external borrowings to bridge the gap. This unsustainable import consumption needs to be reversed. Since 1977 we have been running current account deficits as a result of trade deficits and continued to talk about it while not addressing the issue. As a means of appeasing consumer habits successive governments have sought IMF financial assistance on 16 occasions since 1965 to 2018 for Balance of Payments related issues. It should be obvious by now that we have not managed to come out of this vicious import dependent cycle as the IMF assistance was based on further liberalisation measures being adopted by the governments.

If we look closer at the IMF assistance, we find that we have obtained a total of US$ 4.2 Bn over this period by way of structural adjustment and external funding arrangements loans. While at the same time we have heeded their advice on asset sales and also permitting the depreciation of the currency many a time. All of it was done in order to stabilise the overall chronic balance of payments conditions, brought about by the widening trade imbalance.
Ironically in 2018 alone the Central Bank used up US$ 1.8 Bn or 42% of the total IMF allocation to defend unsustainable imports. So, the question remains whether we are going to borrow to import or rationalize our imports, payoff our external debt obligations and develop our merchandise export product range and restructure our national balance sheet. Therefore, we have a choice. Do we continue to relax import restrictions and go to the IMF for funding or do we stand on our own two feet and change our economic model and national balance sheet?

The answer should be obvious, for the only solution to this problem is through developing a home-grown production economy model which supports value-added manufacturing. However, for that to happen, an aligned macro-economic framework is always a prerequisite, and for once I can confidently say that Sri Lanka has such a framework is in place. This home-grown macro framework requires a trade-off between short-term pains for long-term gains, as there is no silver bullet for structural change.

What is the contribution of such restrictions to boost the local production?

Permit me to correct this statement, imports have not been restricted, as capital and intermediary imports are permitted and encouraged. However, import items than can be produced locally have been rationalised. In this regard import rationalization provides local entrepreneurs and industries significant opportunity to capture both domestic and global market share of import, competing goods and services. For we import US$ 2900 Mn of fabric, US$ 300 Mn worth of dairy, US$ 350 Mn of wheat/maize, US$ 400 Mn of pharmaceuticals, US$ 185 Mn of furniture, US$ 260 Mn of fish, US$ 250 Mn of chillies, onions and potatoes, US$ 300 Mn of sugar, US$ 250 Mn of vehicle spare parts and US$ 200 Mn of fertilizer.

All of these import competing industries should be and can be considered as revenue opportunities that local businesses could establish onshore viz a viz JV's and other forms of investment models. This is not easy, but it's possible, as it requires local companies to raise the bar and invest in their production capacity, product standards, technology and also to develop new products needed to satisfy consumer pallets and the required product

quality of such products. To do these local businesses need to change their business models and utilize the current institutionalized macro-economic framework to their advantage. The policy framework that has been provided by the government for businesses is to ensure these local companies become global players and not think only about supplying local consumer markets.

Hence the focus on making companies becomes 'Global Sri Lankan' businesses. So, it's up to our local entrepreneurs to step out of the box and act. As the government has ushered in a business-friendly fiscal policy, growth oriented monetary policy and an outward looking industrial and export-oriented policy framework, which provide the backbone and creates the enabling environment needed to support these local entrepreneurs and industries. We are already seen encouraging signs on the export product diversification front, and it's a matter of time before we could see a trade surplus by 2025.

How helpful is the currency swap of 10 billion Yuan approved by the People's Bank of China?

Now, this is a double body blow to the sleepy foreign investment banks, credit rating agencies, and our very own doomsday advocates who wanted Sri Lanka to go bust.

Despite these hyper active negative bandwagon who did everything possible to scuttle the funding and who were in fact responsible for financial unsustainability, Sri Lanka has today secured the US$ 1.5 Bn swap (10 Bn Yuan) to the disappointment of all those who screamed and danced about "default", and "default" possibilities.

For the full article – Refer The Daily Mirror

2. Sri Lanka debt crisis trapped in spurious Keynesian 'transfer problem' and MMT By: Bellwether

- While money printing and low interest rates have contributed to the economic woes of Sri Lanka, the main problem lies in a Keynesian mis-understanding of international trade and capital flows that is generally called the 'transfer problem'

- Based on this thinking, countries are unable to make repayments due to a trade deficit. As a result, countries needed to boost exports and make them more competitive through reduced domestic costs. This thinking is what led to real effective exchange rate targeting. However, in reality, the trade deficit itself is caused by foreign borrowings which improves the purchasing power and hence the demand for imports.

- Printing money worsens the condition as imports then rise due to not just foreign borrowings but also due to foreign investments as the value of the currency weakens. Sri Lanka needs to realize this. And in order to obtain the necessary money to solve the budgetary issue and to repay the loans Sri Lanka either needs to increase taxes or Treasury auctions need to be successful.

Why do people think that foreign debt cannot be repaid by raising domestic debt?

While it is true that money printing by Sri Lanka's central bank and its obsession to keep interest rates down is at the root of most of Sri Lanka's monetary problems, it does not answer all of the questions.

The answer to the questions lies in a Keynesian mis-understanding of international trade and capital flows that is generally called the 'transfer problem', which does not exist in the real world.

The Transfer Problem

The non-existent problem dates back to German monetary instability in the 1920s involving war reparations – which is similar to repaying foreign debt.

In 1929, John Maynard Keynes published a piece in the UK based The Economic Journal called 'The German Transfer Problem' claiming in a nutshell that the Germany would not be able to make war reparations, because the country had a trade (or current account in modern parlance) deficit.

In order to be able pay reparations, Germany had to boost exports and it also had to reduce domestic wages and costs to be more competitive (price effect) it was argued.

It is this 'price effect' belief that drove the last administration to target the real effective exchange rate.

Bertil Ohlin

One economist who pointed out the error of Keynes thinking was Bertil Ohlin. He pointed out that the excess of imports over exports came from higher spending power that was given to the German economy through foreign borrowings.

Foreign borrowings not only increased the demand for imports, they may also increase the domestic demand for previously exported goods.

"A and B are two countries with normal employment for their factors of production," Ohlin tried to explain in the June 1929 issue of 'The Economic Journal'.

"A borrows a large sum of money from B this year and the same sum during each of the following years. This transfer of buying power directly increases the A's demand for foreign goods while it reduces B's. Thus A's imports grow and its exports fall off.

"If the sum borrowed is 100 mn. Marks a year the excess of imports in A brought about in this direct manner may be 20 mn. Marks. For in large countries only a small part of demand turns directly to foreign goods or to export goods. The rest, 80 mn. Marks increases the demand in A for home market goods."

This is the type thinking in Sri Lanka that goes to say tourism receipts or apparel exports have some imported inputs, therefore the actual difference will get piled up somewhere and help the trade deficit.

If Sri Lanka produces more domestic goods and block imports the country will therefore 'save' the foreign exchange – which gets piled up somewhere – and reduce the trade or current account deficit.

Here is the crux of the problem in this type of thinking. The cycle does not end at that point.

Monetary Instability

When money is printed not only does not trade deficit increase, there may also be a fall in the currency as more outflows than inflows hit the forex market.

Imports will rise over and above current receipts, and not just due to foreign borrowings or foreign investments.

Monetary systems are credit systems. They are made up of banks. A pegged central bank is an agency which takes deposits in dollars and issues a 'bank note' as it a commercial bank issued fixed deposit certificate with zero interest. Unless the money is sterilized (mopped up) they are used by the recipients.

As the Reichsbank printed money, The Weimar Republic collapsed into hyperinflation. The allies then suspended reparation payments.

Ludwig von Mises an Austrian economist later wrote that the Western Allied politicians were roundly misled by the "spurious " transfer problem.

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

"If a country neither issues additional quantities of paper money nor expands credit, it will not have any monetary troubles.

The Budgetary Problem

Like the Weimar Republic, Sri Lanka is now printing money again, creating forex shortages and there are worse import controls and default is much closer.

The dollar inflows that come into the country do not belong to the government. Even when they are converted to rupees, the rupee proceeds belongs to private citizens.

To get hold of the rupees the government has to tax or borrow the money. Since taxes have been cut only borrowing is the alternative.

But Treasury auctions are failing, and money is being printed.

To solve Sri Lanka's 'budgetary problem' in repaying debt, Treasuries auctions have to succeed. When that is done, the 'transfer problem' of foreign exchange will be automatically solved. But this is beyond the ken of Keynesians.

Instead with failed Treasury bill auctions filled with printed money under Modern Monetary Theory the country is slipping deeper into imbalances.

So far the dollar peg has been maintained to some degree at the cost of reserve losses. If the peg starts to slide, it will be an Argentina (the country printed more money in 2020) or a Weimar Republic.

A monetary meltdown is much worse than a default, though it is admirable that Sri Lanka's rulers and policymakers genuinely do not want to default.

The foregoing shows that opening imports in Sri Lanka will not be a problem.

It will only impact the interest rates, as private credit will pick up, but not the exchange rate as long Treasury bill auctions are successful.

But opening imports will bring more tax revenues and reduce the rate of interest that is needed for successful bill auctions, while allowing economic activities to resume and prices to fall.

For the full article - Refer Economy Next

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