Spotlight: Econ Op-eds in Summary

Week ended 19th January '22

In Summary

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

1. Sri Lanka's sovereign foreign debt to restructure or not
By Dr. Dushni Weerakoon

- Given the current economic conditions of Sri Lanka there's a push towards debt restructuring b man parties. Sovereign debt restructure could be pre-emptive or post default. A pre-emptive restructuring is better compared to the latter. Today, a restructure had become complex compared to past due to more countries burrowing from international bond markets, private investors and lenders such as China.

- Even though there has been progress in governance frameworks to deal with sovereign debt crisis, considerable gaps still exist. Given the research evidence that countries that have defaulted on their debt obligations in the past are more likely to default again in the future, creditors have an added incentive to enter negotiations for restructuring than to endure a default.

- High uncertainty during a restructuring, and the risk of prolonged negotiations means debt restructuring is still the last resort, to be done only if you must. As such, the decision to restructure should be taken only after excessive net benefit calculation, where policy makers should assess whether the country's economic conditions will worsen further without a restructure or whether a timely restructure may return debt to sustainable level with lowest cost.

Sovereign debt restructuring can be pre-emptive or post-default. A default is inherently costly as it can result in a sustained loss of access to capital markets. That leaves pre-emptive restructuring when a country deems itself unable to service outstanding debt.

The complex creditor landscape of today though makes governments reluctant to entertain sovereign debt restructuring. The landscape of sovereign borrowing has evolved from a small group made up of multilateral organizations, a few commercial banks, and the 'Paris Club' of rich countries to something much more complicated. In recent decades, emerging markets and developing economies have borrowed proportionately more from international bond markets with their dispersed private investors, and tapped new non-Paris Club lenders like China. From the sovereign's perspective, this makes a potential debt restructuring operation particularly complicated.

The first step in any restructuring is calculating how much a country owes and to whom. This involves sharing detailed information on all categories of sovereign debt denominated in foreign currency, including collateralized liabilities and the debts of state-owned enterprises. The adoption of an IMF program may be conditioned as a part of a restructuring to underwrite the data, economic plan and the promise of macroeconomic and fiscal supervision.

Lenders will weigh the upfront losses of a debt standstill and restructuring against the total magnitude of losses in the event of a default. In entering restructuring talks, though, they will also demand to do so on the principle of comparable treatment of creditors in any proposed debt reprofilings and restructurings. Lenders will be mindful that any relief offered does not give preferential treatment to other creditors, especially in the face of new geopolitical power rivalries. This would typically mean that a country in distress asks for debt relief from friendly governments to whom it owes money and then seeks a comparable deal from private lenders.

The holdout problem

Over the past decades, there has been progress in governance frameworks to deal with sovereign debt crises, but considerable gaps persist. In the COVID-19 era, the G-20 Common Framework for Debt Treatments apply only to low-income countries (LICs), and even then, do not compel the participation of private creditors. Emerging markets that have undergone debt restructuring most recently (e.g. Argentina and Ecuador) are categorized in academic research as countries with a track record of serial default – i.e. more than two default spells or episodes. Given research evidence that countries that have defaulted on their debt obligations in the past are more likely to default again in the future, creditors have an added incentive to enter into negotiations in such cases.

All told, with the creditor landscape transformed, debt restructuring is still very much a matter of ad hoc negotiations between a sovereign and its creditors.

The creditors are aware of their special legal protection that comes down to a question of money due but not paid. At the same time, creditors too have virtually no choice but to negotiate as there will be inadequate assets to satisfy every creditor's claims even with a successful legal remedy. In the extreme, 'vulture funds' have used litigation as an investment strategy to buy the debt at a hefty discount and pursue full payment through the courts. Confronted with this reality, a negotiated resolution should appeal to both creditors and debtor country.

At the centre of such a coordinated effort will be creditor (especially bondholder) committees. The composition of such committees – inclusive of large institutional investors, hedge funds, etc. – is critical to obtain a relatively quick resolution. However, there are no guarantees of fast and efficient mechanisms, and countries still risk fighting creditor lawsuits from those who may hold out.

Such potential holdout creditors may not necessarily take the view that what is good for the many is always good for the few. A disgruntled holdout creditor has the leverage to cause disturbing headlines, especially when countries resume bond market access once again at some point. Holdout creditors can be reined in through exit consents – where a majority of holders can amend terms, or as more commonly used now, employ collective action clauses (CACs) in bond agreements to bind minority holders. In the latter case, a specified supermajority of holders (usually 75%) can bind a minority to the terms of a debt restructuring. But much depends on whether a debtor country's outstanding stock of international sovereign bonds contains these clauses. Some countries have also adopted anti-vulture fund legislation that limits holdout creditor recovery as a deterrent.

Net benefit calculation

High uncertainty during a restructuring, and the risk of prolonged negotiations means debt restructuring is still the last resort, to be done only if you must. A restructuring is a costly exercise with reputational downsides, loss of market access and more expensive debt issuances, weighed down further by concerns about adverse legal implications. For policymakers, a decisive step can be taken after a careful net benefit calculation of whether a country's economic conditions are likely to deteriorate further without a restructuring, or whether a timely restructure may reduce the total magnitude of upfront losses and return debt to a sustainable level at the lowest cost to both the country and its creditors.

For full article – Refer Daily FT

2. Sri Lanka has to hike rates, tourism recovery will not help end forex crisis By Bellwether

- Sri Lanka should raise interest rates immediately and float the currency without too much delay to put a end to the ongoing misery on the import trade and head off a monetary meltdown and shortages that will lead to severe social unrest as well as default.
- At the current policy rates, and sterilization, forex problems will get worse, and the non-financial sector will get hammered from the fallout. For the diversion of dollars to happen, rates must rise. The biggest mistake a central bank can do is to accommodate the harvest failure with more money printing and low rates.
- The pick-up in tourism will not help with the foreign exchange shortages, though it certainly has the potential to generate more savings at the correct interest rate. Owners of hotels will do urgent repairs and later pay back loans which will also be loaned back to others, which will trigger more investments and imports.

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At the current policy rates, and sterilization of interventions, forex problems will get worse and the non-financial sector will get hammered from the fallout.

The Finance Minister hit an own goal with the 'relief package' by boosting consumption and imports with billion US dollars spending spree which will make that much more difficult to generate savings in the economy to repay debt and stabilize the exchange rate.

A successful float – following a rate hike – will end forex shortages in the figurative 'couple of weeks' and make fuel available for power and industries. It will also make available dollars for food imports as construction and other sectors slowdown.

There need be no food shortages from the fertilizer fiasco.

Sri Lanka’s food and beverage imports – including sugar imported for moonshine and after the ethanol ban – are around US$ 1.5 Bn a year, while building materials are also US$ 1.5 Bn, machinery and equipment are around US$ 2.0 to 2.5 Bn.

But for the diversion of dollars to happen, rates have to rise. The biggest mistake a central bank can do is to accommodate the harvest failure with more money printing and low rates.

Monetary history is littered with central banks which accommodated such ‘supply shocks’ with loose policy and has led to external collapses. The anti-bullionists of the UK also blamed a harvest failure for the plight of the pound around 1800 – and its error was amply explained by David Ricardo.

In then Ceylon at the time, the printing of Rix dollars led to a collapse of the Ceylon paper note against the Madras Star Pagoda and soaring prices in Colombo and the poor paid the price through malnutrition.

A harvest failure, like the cancellation of a coal plant, makes it less easy to generate savings to repay foreign debt and has the effect of driving up interest rates to divert savings from other areas.

A tourism recovery will not solve the forex crisis

The pick-up in tourism will not help with the foreign exchange shortages, though it certainly has the potential to generate more savings at the correct interest rate. Tourism revenues will simply boost imports as sector workers spend the money and travels around.

Owners of hotels will do urgent repairs and later pay back loans which will also be loaned back to others, which will trigger more investments and imports.

However, their saving are available to be captured by the government, either directly though SLDBs if dollar savings accounts are allowed, or indirectly through bond markets if dollars are force converted.

Even if the banks buy bonds with the loan repayments, some of it will be go to state workers as the Rs. 5,000 salary hike which will end up as imports.

The lesson here is that as long as money printing continues including to sterilize, interventions (reserves for imports), forex shortages will be created on top of the tourism receipts.

However, tourism receipts will create the potential for more savings provided the central bank stops printing money and allows the government to capture the savings at a market determined interest rate.

That the Covid tourism downturn created the economic crisis was a red herring from the beginning.

The economic and forex crisis was created by money printed to keep interest rates down: nothing else nothing more.

That has been the case throughout history of pegged exchanges, whether in the case of Sri Lanka, sterling float of 1897, the Sterling crises after Keynes, the collapse of the Bretton Woods, Latin America, Korea or Zimbabwe.

For 70-years this has been the problem in the country, though the exact triggers of the money printing may change.

In 2008 and 2009, the central bank under Nivard Cabraal/W A Wijewardena resisted fiscal dominance through several ruses, after that money has been printed willingly through also various ruses to keep rates down.

Mercantilists and others in Sri Lanka have attributed currency troubles to imports, trade deficits, current account deficits, to rupee bond holders and now tourism.

That is why a higher level of export has also not helped the forex crisis.

Sri Lanka should hike rates by at least 200 basis points before a float to slow credit and reduce imports through a slowdown of economic activity.
This columnist would not predict a post-float exchange rate but kerb rates and Undiyal rates are already around 240/250.

But bigger rate hike of 300 basis points to 9.0% will make sure that the currency does not fall too far.

Many importers are experiencing severe difficulties and have been paying that price and that is why the rate is at those levels.

Sri Lanka should reverse the current policy and allow domestic forex earners to keep dollars in deposits to help fund the dollar loans of banks to the government.

The dollar surrender requirement of taxes should be replaced by dollar payments of taxes and utility bills by exporters and hotels.

Negative Interest Rates

The current Central Bank Governor lifted price controls on bonds started by the Governor W D Lakshman and allowed market rates to go up. A correction has happened.

However, the relief package will require more funds.

There is now strong demand at least for 3-month bills.

The wholesale monetization of bonds is no longer taking place. Selling large volumes of three-month bills by itself is not a bad strategy since high rates will disappear quickly once monetary stability is restored.

However, it is clear that the central bank cannot sell down its Treasury bill stock permanently and re-build reserves to repay bonds without restoring the spot market and buying dollars.

At the moment any bills sold from its permanent portfolio ends up as collateral in the overnight liquidity window.

The dollar conversion rules also tend to undermine pegs which are already weak by creating liquidity.

In Sri Lanka the central bank is liberally giving rupees overnight at 6.0 percent – which is better than printing money to target the middle of the corridor – but not by much.

In Sri Lanka most dollars flow in to the better managed foreign and local banks which generally do not borrow from central bank windows.

The central bank is also conducting rep auctions to take back excess rupees, which is good.

However, it cannot really alleviate the policy error of the mandatory surrender rules imposed on the export and services revenues, which creates more money on a peg which is already broken.

Conversion rules are negative

However, the larger negative fallout will be that the new conversion rules will also reduce inflows to the country. This will in turn reduce savings and tend to require a higher interest rate than otherwise to keep the economy in balance.

If there are no dollar deposits, state banks which have loaned dollars will not be able to raise dollars to fund their dollar liabilities which were financed with borrowings.

The correction of the net foreign assets position outside of the central bank which was happening due to exporter deposits will also be more difficult without service sector dollars being saved.

Commercial Bank negative net foreign assets position fell to 563.4 Bn rupees by end September from 824 Bn rupees a year earlier.

With tighter conversion rules kicking in therefore, the situation will stop improving as more and more people will hold dollars outside the country and many other service related inflows could dry up.

The higher swap premia is also sign of the stress. The price control on swap interest rates is also a cascading policy error.

Why a VAT hike

The budget has raised taxes. Due to politics and the reluctance to reverse a VAT cut, the tax system has got complicated and large companies have been hit.

This column has said several times before that a hike of VAT to 20% is better for the poor. Such a VAT hike would have been preferable to a steep currency fall and very higher inflation for the general public, especially the less affluent.

Even now VAT could be raised to 20%. That will be steady revenues and will help prevent a too deep fall in the currency.

The budget has avoided raising income taxes and wealth taxes which kill future jobs, which is one bright spot.

Finance Minister Basil Rajapaksa had also acknowledged that the state workers are problem, defying the JVP view that had dominated politics since 2004.

He has also said that state enterprises were a national liability and not national assets as maintained by the JVP in 2003/4 and adopted as state policy since then.

However, with inflation already created by money printing in 2020 and 2021 beginning to trigger unrest among state worker unions he has suddenly raised salaries.

Therefore, the interest rate cannot be the same as earlier. Talk of 'budget neutral' re-allocation is a polite fiction. Supplementary estimates will come soon, though inflation will push up taxes.

Float

Sri Lanka is now operating without a working exchange rate regime. The peg is no longer working at current interest rates and reserves are being given for imports. 'Reserves for imports' is a clear sign of a broken peg.

A working monetary regime is a must for any country to end forex shortages.

That is why the IMF insists of a float as a prior action. This is the 'magic' of an IMF program.

The float stops interventions (suspends convertibility) and induces dollar earners to bring down money and sell. However the key benefit is that is stops the need to sterilize interventions with printed money, which automatically leads to a balancing of imports and outflows.

Under an IMF program the currency is usually re-pegged – loosely – and the central bank starts buying dollars to rebuild reserves after paying for all imports. This loose peg is unstable, and also needs higher than normal rates to work.

The loose re-pegging sometimes results in very steep falls and a credible peg is not restored. That is why IMF programs sometimes fail and the Argentina program in 2018 failed.

However once the peg is re-established the central bank can collect dollars. At the moment the central bank is borrowing dollars abroad to avoid raising rates and repay debt, while boosting imports trough sterilized interventions.

From the foregoing it can be seen that repaying debt on a net basis also requires a higher interest rate to curb domestic consumption and investment and generate the required savings to repay debt.

Any government to government inflows will help.

Is foreign debt unsustainable?

In any pegged exchange rate country foreign debt is not unsustainable on an absolute basis. It depends on the political willingness to impose the squeeze on the economy required to repay debt.

In Sri Lanka is certainly possible to generate the savings of 6 Bn dollars required to repay debt, since private savings rates are high in Asian nations.

Whether foreign debt is sustainable or not depends on the total domestic credit, the interest rates which are required to squeeze domestic consumption and investment to generate savings to repay foreign debt.

This is not happening at the moment, as shown by the steady fall in reserves and the indebting of the central bank through swaps.

The relief package has therefore reduced the likelihood of the debt being sustainable. A 5.0% growth rate is likely to increase the likelihood of making the debt unsustainable.

The current administration seems to be banking on growth to reduce debt. The rating agency Moody's has made similar comments.

This is an error. Higher the economic growth the more unsustainable the external debt, as consumption and investment will go up, reducing savings for external debt.

The IMFs debt sustainability equation involving economic growth as a factor in making (total) debt sustainable no longer applies if the peg is broken and reserves are leaching for imports and there is also no operating float.

These formulas involving growth do not apply with a broken peg (like Sri Lanka has now). If there is a credible peg or a floating exchange rate, higher growth will help reduce the debt. But in their absence higher growth will worsen the external hit and make external default more likely.

That Sri Lanka's economic policies similar to those of German the deadly social democrats of the Weimar Republic would result is rapid rises in dollar debt and likely default was warned earlier.

A central bank which builds foreign reserves essentially take money out (so-called below the line) and invests them abroad, depriving them for use. Repaying foreign debt is the same.

It is 'savings stupid' as the saying goes.

Floating Rate Bonds

However, is not likely to happen with a policy rate at 6.0 percent.

With a dysfunctional forex market without spot trading it is not possible to buy dollars and collect reserves or enable CPC or the Treasury to buy dollars with rupee money rose.

Dysfunctional forex markets can drive interest rates to very high levels.

The budget deficit is already set at 10 percent for 2022.

A 6.0 percent policy rate is not going to cut it though the higher market rates help a great deal.

2022 will not be pretty. A rate hike and a wider corridor are needed. A 200 to 300 basis point hike would be preferable before a float.

A one-off rate hike will end the reluctance of investors buy bonds.

However, this can be solved to some extent by introducing floating rate bonds indexed to the three-month bill yield. It also has the advantage of bringing down interest costs fast after the economy is stabilized.

But will also increase the risk on coupon payments. All this shows the need to raise rates and get over it.

As soon as bond markets get used to the rate, the currency can be floated. Raising rates to some extent can be done regardless of whether a decision is made to go for an IMF program.

An IMF program will be better, but IMF programs are also based on the same principles.

That is why IMF programs require a float as a prior action as said before. That reserves can be used for imports is a Mercantilist myth that is found is countries with currency crises.

Without a working forex market all bets are off.

An IMF program can fail later due to the so-called "disorderly market condition rule" DMC with even with unsterilized interventions (a currency board principle) which makes rates go up sharply.

This is because unsterilized interventions are not made at a single exchange rate but a flexible rate. Unlike Malaysia which fixed the rate after the East Asian crisis and maintained it, Argentina had failed due to unsterilized interventions made at different levels.

IMF program

In any case a float is what the IMF does to stop sterilization injections, this is what the US Fed did in 1971, the Bank of England in 1933 and after declaring war in 1914. It is a standard trick.

However, IMF programs have other advantages.

a) Even if a country does the correct things, it may not raise confidence among external investors due to dented credibility and the past record in past bad policy and overt statism.
b) Instead of just selling land assets it is better to bundle the privatizations into a private sector development budget support loan. The government can privatize Sri Lanka Insurance easily and a number of other state agencies.
c) There is no specific IMF performance criterion in programs that strictly enforces depreciation. Floats are required to end contradictory monetary policy and depreciation is kind of byproduct. It is temporary if consistent deflationary policy is followed.
d) The REER index is below 100. However with two years of inflationary policy and broad money also having grown and state sector wages gone up, going back to the status quo is almost impossible since the entire price structure has already changed. But whether or not the exchange rate appreciates after a float is a matter of domestic operations and the interest rate.
e) The reversion to a 15 or 20 percent VAT is better for the poor than currency collapses and ongoing inflation as said before.
f) Under an IMF program, a clean floating exchange rate is not encouraged as pegging is required for the central bank to collect dollars and settle the loan. In other words the currency will be pegged again. That peg has to be managed on classical principles like GCC countries and East Asia and not the 'flexible' snake oil peddled by US mercantilists. Whether or not it appreciates is a matter for domestic operation of the central bank.
g) Sri Lanka has done well to negotiate a funding package from India. The credit line can be used to generate cash for the Treasury including through the oil credit. But for that to happen a working exchange rate regime is needed to match inflows to outflows and the credit line dollars to be sold for cash. Credit line dollars should not be surrendered to the central bank to create money and boost the monetary base. All of this can be consolidated into an IMF program.
h) A distressed debt exchange will reduce the corrective squeeze on the economy. This squeeze is higher due to lost confidence conversion rules which has discouraged savings and encouraged perverse behaviour. But the funding lines will reduce the pressure.

As said earlier whether or not the external debt is sustainable depends on the corrective measures a government can credibly take. That is a political decision. Sri Lanka has one or two maturing bonds in a year of about US$ 1 to 1.5 Bn.

Sudden default should not be encouraged. It is likely to trigger cross-default clauses in multiple other contracts including term loans and private contracts if there are any and make it very difficult to import foods and other essential on top of it.

i) There is no harm in encouraging parallel dollarization. It will reduce the burden on domestic reserve money and allow transactions to be cleared directly.

More on parallel dollarization can be found here. Already pressure is growing for dollarization in multiple areas as predicted.

A key point to remember is that no debt re-structuring will work unless there is a credible exchange rate regime in place to transfer wealth out after the DDE. The country will not be able to repay the re-structured debt and will be exactly the same place as now after the re-structuring without a working exchange rate regime.

Already pressure is being seen in energy. In the first quarter droughts will come. Pressure has come faster due to the breakdown of the coal plant. It is better to float before the dry season in February and March when there will be more pressure to fund energy sector losses with credit.

A fuel pricing formula and a fuel surcharge on electricity should also accompany a float – or even if there is no float.

This column has shown earlier how energy subsidies are a weak link in monetary stability both in Sri Lanka and Latin America. It is now being seen.

Fed tightening is also looming. Most soft-pegs collapse when Fed tightens as they do not raise rates in tandem and economic growth continues. Latin America which was relatively stable during the Bretton Woods, collapsed like nine-pins due to active policy rates and open market operations to sterilize interventions.

Though gross reserves are at 3.0 Bn, the central bank's liabilities are bigger – which means its external borrowings are greater than the reserves there are in fact no reserves to intervene.

The central bank faces the prospect of defaulting – to the IMF for example – not just the government.

Unless rates are raised and working monetary regime restored – a float will achieve this at a lower interest rate – Sri Lanka's current path is unsustainable and market dollarization may be the result.

This column is based on 'The Price Signal by Bellwether' published in the July 2021 issue of the Echelon Magazine. It is updated with recent data and the impact of the relief package. To read Bellwether columns as soon as they are published, subscribe to Echelon Magazine at this link.

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