Spotlight: Econ Op-eds in Summary

Week ended 8th September '21

In Summary

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

1. Avoiding IMF prolongs SL's macroeconomic instability
By: Professor Sirimevan Colombage

- Sri Lanka has sought IMF assistance multiple times in the past, although opponents of IMF based policies have argued that their program conditionalities constrains the country's long run growth. Currently, the government and the CBSL are resorting to their own set of economic measures which include import restrictions, excessive money printing and moral suasion amongst other measures.

- However, the lack of an IMF-styled fiscal framework has led to the budget deficit skyrocketing, a growing debt burden, inflationary pressures and persistent pressures for the currency to depreciate. Import restrictions imposed currently are reminiscent to the restrictive trade policies implemented in the country prior to 1977, where policy choices were at the time were based on an import substitution argument.

- Sri Lanka last obtained an IMF program in 2016, with fiscal consolidation being the overall goal under the program. To further help this, the Monetary Law Act was replaced with a Central Bank Act to provide greater independence to the CBSL. However, these reforms since then have been scrapped, and if they were kept in place, the country would not be in such a dire economic position.

Macroeconomic stability is crucial to sustain economic growth. The International Monetary Fund (IMF), which is known as the 'global financial firefighter,' provides support to its member countries that have problems with internal stability (inflation) and external stability (balance of payments, exchange rate, foreign indebtedness and international reserves).

Being a member of the IMF since 1950, Sri Lanka has obtained its assistance through different facilities on 16 occasions to tackle the economic difficulties from 1965 onwards.

Currently, the Sri Lankan economy is facing acute problems pertaining to both internal and external stability. Inflation is picking up due to excessive money growth, exchange rate depreciation and supply-side constraints. The balance of payments deficits exacerbated by heavy foreign debt commitments have led to depletion of foreign reserves and rapid rupee depreciation over the past couple of weeks.

Debate: For and against IMF

In this background, a heated debate has erupted between two schools of thought regarding the desirability of seeking assistance from the IMF to rescue Sri Lanka from the current economic catastrophe. The debate is gathering momentum, as the country is plunging into a deep economic crisis.

The proponents of IMF programs, who are mostly outside the official arena, argue that such assistance is essential to eliminate the country's macroeconomic imbalances, and to resolve the debt crisis, and thereby to boost investor confidence. There is urgent need to adopt IMF-styled policy reforms to put the house in order so as to overcome the present crisis, as I emphasised in a recent FT column.

On the contrary, the opponents assert that the IMF programs implemented in Sri Lanka from time to time worsened the country's economic problems due to their vicious conditionalities. They accuse that those programs are based on neoliberalism, which is a resurgence of free-market capitalism that was in vogue in the 19th century.

Policymakers avert IMF

The top policymakers of the Government and the Central Bank are claiming that they are in a position to overcome the current economic problems without resorting to the IMF by adopting a home-grown alternative strategy. The Central Bank, which is the apex monetary body set up to ensure macroeconomic stability, is taking a hardline to avert IMF assistance without any sound justification.

In the backdrop of the ongoing controversy, it would be pertinent to look at the rationale behind IMF assistance objectively from the viewpoint of national interest, leaving aside any emotional attachments to a particular line of ideology or personal affiliations with individuals who are in the corridors of power.

IMF Monetary Model

The IMF's model of macroeconomic stabilisation is based on a framework, known as the "monetary approach to balance of payments". This model was developed in 1957 by Jaques J. Polak, who functioned as the Research Director of the IMF during 1958-1979. He is considered as the founder of the monetary model that the IMF has applied to date, and therefore, it is also known as the Polak model. The IMF applies financial programming based on the Polak model to assess the impact of a borrowing country's Government finances and foreign reserves on its economic growth, money supply, inflation and balance of payments.

In its simplest form, the model investigates and determines the impact of changes in (a) domestic bank credit, and (b) exports and imports of goods and services on the money supply, and in turn, on inflation, income and balance of payments. Given the significant impact of government borrowings on domestic bank credit and money supply, pruning the budget deficit through expenditure cuts is a key conditionality in IMF's lending programs.

Similarly, the balance of payments deficit is required to be brought down by bringing down the money supply growth, and ensuring a competitive exchange rate system. These are the basic conditionalities of the Fund's programs, which are always subject to severe attack by the critics.

The IMF's financial programming integrates monetary, fiscal, external and real sectors into a single quantifiable framework. This model is used to identify the types of macroeconomic policies that are required to achieve final targets such as the inflation rate and foreign reserves of countries that require IMF support to overcome their macroeconomic instability.

SL's economic imbalances

Sri Lanka now faces both internal and external imbalances. Internally, the budget deficit running over 12% of GDP limits monetary policy space, resulting in an increase in the money supply by 21% over the last 12 months. The rapid money supply growth has brought about adverse consequences on price stability and balance of payments.

Externally, the country's foreign reserves have fallen to less than $ 3 billion, as against the debt commitments of over $ 6 billion to be settled within the next 12 months, apart from having to meet day-to-day import outlays. The banking sector is running short of foreign exchange. As a result, the US dollar is traded at around Rs. 230 within the banking circles, despite the Central Bank's insistence to keep it at Rs. 200 per dollar. The black-market rate is reported to be high as much as Rs. 260 per dollar.

IMF-styled measures in piecemeal

The lack of an IMF-styled macroeconomic framework is the root cause of most of the macroeconomic imbalances faced by Sri Lanka today.

The policymakers are now compelled to adopt some arbitrarily chosen IMF-styled measures such as monetary tightening, rupee depreciation, Government expenditure cuts and fuel price hikes, despite their resistance to approach the IMF. But such piecemeal measures fail to overcome the crisis, as they are not integrated into a unified monetary model described above.

Obsolete import restrictions reintroduced

As remedial measures, import restrictions in the form of quantitative restrictions (QRs), quotas, licenses and exchange controls are back in full swing. The outcomes are price controls, food shortages, long queues, monopolies, rising prices, black market, raids, and corruption, that we witness today. These were the characteristics of controlled trade regimes adopted in many developing countries including Sri Lanka around four decades ago.

The restrictive trade policies adopted prior to 1977 in Sri Lanka could be justified today at least on the grounds that those policies were based on the "import substitution" argument, which was the paradigm accepted worldwide during that time. But as trade liberalisation has enabled numerous countries across the world to accelerate economic growth and to reduce poverty levels significantly in recent decades, import substitution became obsolete many years ago.

Policy reforms under EFF (2016-2020)

The last facility obtained by Sri Lanka from the IMF was under the Extended Fund Facility (EFF) for the period 2016-2020. It contained a set of policy reforms that could have prevented the present macroeconomic instability to a large extent.

Fiscal consolidation with targeted reduction of the overall fiscal deficit was the linchpin of the EFF program. Rebuilding tax revenues through comprehensive reforms of both tax policy and administration were key in this regard. Those were to be supplemented by steps toward more effective control over expenditures and putting state enterprise operations on a more commercial footing.

Another major policy reform in the EFF was to replace the Monetary Law Act with a new Central Bank Act so as to provide greater independence to the Central Bank by permitting it to adopt inflation targeting monetary policy. It would have restricted the Central Bank's accommodation of fiscal shortfalls and the resulting money supply growth, as experienced now.

Policy reforms scrapped

The present Government scrapped the EFF arrangement without drawing its last tranche.

Aggressive tax cuts were implemented last year, and the fiscal policy targets were postponed until 2030. The Central Bank Bill was abolished. Thus, the envisaged EFF policy reforms were abandoned, and as a result, the macroeconomic situation has worsened.

The outcome of the revenue downfall resulting from the tax cuts was the rise in the budget deficit to over 12% of GDP. Being subservient to the political authorities, the Central Bank has accommodated Treasury's cash requirements which led to an unprecedented increase in currency issues and bank credit to the Government.

Reforms imperative with or without IMF

The economic turmoil that we are experiencing today could have been avoided, had the policy reforms laid down in the EFF been continued without interruption, irrespective of political divisions.

The present economic catastrophe speaks for itself in justifying the urgent need of a robust policy framework, with or without IMF assistance, to tackle the macroeconomic imbalances.

For the full article – Refer Daily FT

2. Trade-off between containing COVID and keeping the economy functioning By Nimal Sanderatne

- Fragile state of Sri Lanka's economy makes it harder to go for a strict lockdown even when it is essential. Developed countries may have a better edge than developing countries on this front due to strong domestic economic conditions. Lack of strict observation of lockdown by public as well as lack of stringent enforcement could make the lockdown less effective.

- Considering this government imposed a lockdown only allowing essential economic activities. These include exports which is much needed for the government at this moment. Due to the resilient nature of the apparel industry government needed to continue the export industry to maintain a steady flow of foreign revenue.

- Long term mismanagement has resulted in an inability to take correct decisions in a timely manner. Further inappropriate policies on agriculture, trade, monetary and fiscal matters will make the matters worse. Finally, Sri Lanka is left with no option other than to require international assistance to contain the Covid and strengthen the economy.

The choice between a complete shutdown of the country for an extended period to contain the spread of COVID or not to do so to keep the economy functioning is a hard choice.

People must work to live but people must live to work. This is the dilemma countries all over the world are faced with, but the fragile state of our economy has made that choice extremely difficult.

Developed and poor countries

Developed countries can afford to shut down their economies to an extent and ensure the livelihoods of their people. Not so poor countries that do not have the capacity to provide income support for livelihoods nor forego production of goods and services.

Sri Lanka's economy

The perilous state of the Sri Lankan economy makes such a lockdown a danger to the livelihoods of people and the stability of the economy. The fragile state of the country's foreign currency reserves at around US$ three billion makes it expedient to ensure the production of the country's exports.

Critical issue

The critical issue is that the lockdown to contain COVID should not jeopardise vital economic activities such as export production. Hence a lockdown while "essential economic activities" were permitted. These included export manufactures and suppliers of essential items such as food, medicines and services such as banking.

Dilemma

The Government was in a dilemma as to whether the countrywide lockdown that ended on August 30 should be extended to contain the surging spread of the COVID pandemic or relax it to allow industry and commerce to function. It was a difficult decision to take owing to the perilous state of the economy, especially the dangerously low level of external finances.

Ensuring export manufacturing is a Government priority as a shutdown could jeopardise export earnings and cripple the already weak external finances, export industries were deemed essential services.

Extension of lockdown

Consequently, the extension of the countrywide lockdown until September 6 was a hesitant decision. There was no alternative as the daily count of infections was growing exponentially and the daily death toll had crossed 200. The medical fraternity and health professions insisted that a lockdown was imperative.

Lockdown

The earlier lockdown till August 30 was thrust upon the Government by the public. Traders and trade unions effectively implemented a partial shutdown. The Government was compelled to follow. The country emerged on August 30 after this ten-day lockdown that was faulty. Conspicuous exceptions, ineffective implementation and irresponsible social behaviour weakened its efficiency. Yet, hopefully, it has checked the fast spreading COVID and not retarded the economy too adversely. Time will tell.

Extended lockdown

The continuation of the lockdown on medical advice till September 6 was a step in the right direction. For once scientific and rational thinking appear to have prevailed over superstition, short-sightedness and political motives. However, it is too early to gauge the impact of the on-going lockdown on the spread of the pandemic and the fatality rate.

What we are currently reaping is what we sowed collectively before the beginning of the lockdown. Whether we have behaved responsibly while the country was closed this week will be known when the infection and fatality figures are announced in the coming weeks.

Extended

At the time of writing, indications are that the lockdown would be extended beyond September 6. The salient question is whether the recent lockdowns were effectively implemented and whether people responded responsibly; unfortunately, no.

The costly preventive measures currently in place to curb the runaway transmission of the virus will yield the desired results only if the lockdown is strictly observed and enforced. There is no such strict observation by society or a stringent enforcement of the lockdown.

Exceptions

The lack of understanding that the virus could be contained only by social distancing, a lack of social responsibility and exemptions from the lockdown reduced the effectiveness of the lockdowns. The exemptions from the lockdowns were a severe threat to the spreading of COVID. For instance, the holding of the traditional Kandy Esala Perahera was a breach of the lockdown regulations.

Although crowds did not line the streets of Kandy, the large number of people who participated in it as drummers, dancers and other artistes, performed without any protective equipped till the last two days of the Perahera. Consequently, and as to be expected, more than 500 performers and Police officers were reported to have contracted COVID even before the end of the Perahera. Such a new cluster would surely cause a community spread of COVID in the Kandy district.

Summing up

Developed countries can afford to shut down their economies to an extent and ensure the livelihoods of their people. Not so for poor countries that do not have the capacity to provide income support for livelihoods. Export-import dependent Sri Lanka starved of foreign currency reserves is compelled to keep export manufactures at full capacity at the risk of large number of lives.

The decision making on the country's COVID prevention measures are motivated by the perilous state of the economy. The shutting down of the country is seen as a serious threat to the economy, especially export manufactures. Therefore, every effort was made to keep the wheels of export industry and commerce functioning at full capacity. This was especially so in respect of the apparel industry that displayed resilience amidst COVID.

The crux of the issue is the trade-off between the containment of COVID and the impact of a lockdown on the economy. The dilemma is whether there should be a more stringent country-wide lockdown to contain the virus or take only partial measures so that the economy could function.

Medical advice is that the spreading of the virus and its variants has reached proportions when a prolonged lockdown is essential to prevent a disaster. International experts and the World Health Organisation (WHO) too recommended such a course of action.

All things considered, should the Government shut the country for a further extended period after tomorrow to contain the spreading of COVID or impose limited restrictions to enable the economy to function at a near normal level to ensure the production of goods and services?

Conclusion

The mismanagement of the country over a long period has resulted in the economy's fragile and unstable state. The inability to have taken timely correct decisions to save the country from the impending human tragedy is to a good extent owing to the weakness of the economy.

The further weakening of the economy by inappropriate policies on agriculture, trade, monetary and fiscal matters has aggravated the economic crisis.

There is no doubt that the containment of COVID and the strengthening of the economy require international assistance. From whom can we expect such assistance?

For the full article – Refer The Sunday Times

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