Spotlight: Econ Op-eds in Summary

Week ended 21st August '19

In Summary

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

1. Emerging signals of a US recession
By: Prof. Lalith Samarakoon

- Inverted yield curves on US government bonds have signalled upcoming recessions in the US economy in the past. During a yield curve inversion, uncertainty causes investors to expect more returns in the short-term than in the long-term. Recent inversions of the US 2-year and 10-year are causing similar worries of a US recession again.

- Such a recession is likely to negatively impact the already struggling Sri Lankan economy. Lower demand for exports is likely to be a key result of a global recession, which lowers domestic economic activity leading to a contraction in imports as well. Tourism inflows and foreign remittances are expected to further decline, while the budget deficit is likely to expand via higher public investments to offset subdued FDI flows.

- However, it is possible that emerging markets perform better than developed markets. This could improve the flow of capital to countries such as Sri Lanka, lowering borrowing costs. Such a situation could also cause strength in the rupee's value. However, any positive effects will remain dependent on Sri Lanka's political stability and policy certainty.

Long-term yield dropped below short-term yield

On 14 August, 2019, the yield on 10-year treasury bonds briefly dipped below the yield on two-year bonds. The 10-year Treasury bond is considered the benchmark for long-term interest rates in the US economy. This implies that investors are becoming pessimistic about future economic conditions.

An inverted yield curve is often followed by an economic downturn or a recession with a time lag. On average, yield curves have inverted 16 months before the last five US recessions.

Possible implications for Sri Lanka

Sri Lanka is already facing a subdued growth environment. After recording a 3.2% GDP growth in 2018, growth is expected to slow down to 3% or below in 2019 largely due to the economic impact of the Easter attacks.

An US recession combined with a worldwide economic downturn could cause a decline in demand for Sri Lanka's exports. This will likely lower domestic economic activity could further dampen aggregate demand by reducing domestic demand, leading to reduced demand for imports as well. Thus, Sri Lanka's export as well as import growth could slow leading to a narrower trade balance. During the last US recession in 2009, Sri Lanka's exports declined by 13%, imports fell by 28% and, as a result, the trade balance shrank by 48%.

Tourism is the largest contributor to the services account of the BOP. A global slowdown will likely cause people to be more cautious about discretionary spending on leisure leading to a decline in tourism earnings. Sri Lanka has already experienced a decline following the Easter Sunday attacks, with tourism earnings dropping by 19% in dollar terms the first seven months of 2019.

Workers' remittances are the largest contributor to the income account of the BOP of Sri Lanka. A global economic slowdown could dampen the demand for foreign workers. Growth in workers' remittances has exhibited a secular downturn and growth has already declined by about 10% in the first half of 2019. The growth in remittances slowed down in 2009 as well.

Lower economic activity could widen the budget deficit due to the fall in tax revenue. Any fiscal stimulus programs implemented by the government in order to mitigate the impact of a downturn will lead to higher government expenditure. The expected lower domestic growth combined with a global slowdown could result in a 2019 budget deficit larger than the target of 4.4%.

In a global economic downturn, foreign investments abroad also tend to decline due to a decreased appetite for making new equity investments and lending funds to foreign enterprises. This means potential decline in new foreign direct investments (FDI) to Sri Lanka. Those investors who have already been approved and are committed may also postpone their investments until they see better global economic conditions or might face difficulties in obtaining the necessary capital. It is worth noting that FDI flows to Sri Lanka fell by 44% in 2009.

Foreign capital inflows to government securities could also accelerate if investors see opportunities to pick up extra return by investing in emerging markets. Interest rates worldwide are likely to be lower as more and more central banks start cutting rates in order to mitigate against potential economic slowdown. This might result in further shrinking of interest rate differentials between emerging markets and the US. Despite this, some foreign portfolio investors will look for countries to earn a higher yield than what is available in the West.

If Sri Lanka maintains a higher inflation-adjusted return in dollar terms on government securities, then we might see more foreign capital flow into government securities. During the last US recession in 2009, Sri Lanka received a record level of USD 1,369 Mn of net foreign inflows into government securities. In addition to attractive interest rates offered by government securities, this sharp increase of inflows was also influenced by the peaceful environment after the end of war, the political stability and improvement of macro fundamentals.

However, the attractiveness of Sri Lankan Government securities to foreign investor is predicated on Sri Lanka maintaining a fairly stable political and macro environment. The upcoming election cycle and the expected slower growth due to the impact from Easter attacks might increase the risk premium on Sri Lanka in the global financial markets.

Even in a US downturn scenario, the US stock markets might still be considered relatively attractive since stock markets in emerging markets are likely to be affected by slower growth in their economies. A significant correction and volatility in the US stock market will also cause declines in stock markets worldwide. If US stocks suffer a correction, they might be considered attractive from a valuation standpoint as well.

In such a situation, equity capital flows might in fact reverse from emerging markets. Sri Lanka's stocks are already attractive in terms of valuation multiples, and its ability to attract more foreign flows will depend on the domestic political stability and better economic prospects. Net equity flows to the Colombo Stock Exchange declined by 32% during the last US recession in 2009.

The impact on the exchange rate critically depends on the behaviour of all the factors above. Sri Lankan rupee has appreciated by 3.2% against the US dollar so far this year. Due to lower interest rates and growth, the US dollar's strength might dampen if not weaken. In the best-case scenario, increased capital flows into government securities and a narrow trade balance could mitigate against a possible drop in tourism earnings and remittances. This will support the stability of the Sri Lankan rupee. In the worst-case scenario, increased political and macroeconomic risks in the country will lead to further acceleration of net capital outflows and depreciation of the currency above the depreciation rate of 4.5% observed in the last 10 years.

A lower world interest rate environment will lower external borrowing costs for Sri Lanka. The country's external debt service liabilities are estimated to be $ 6,071, 5,499 and 5,520 Mn in 2020, 2021 and 2022 respectively. The Government will need to borrow from abroad in order to service some of these foreign debts. However, the ability to lower borrowing costs will be influenced by the country risk premium demanded by lenders. Any deterioration of political and macroeconomic stability will likely increase the risk premium and negate any advantage brought by lower interest rates.

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2. Monetary policy changes around the world and implications for Sri Lanka
By: Prof. Lalith Samarakoon

- The Fed lowered its interest rates in July after almost 11 years. The act was induced by an expectation of an economic slowdown and a lower inflation. The rate cut was made in the hopes of giving a boost to a worsening economic landscape.

- Given the negative global economic landscape, many economies including Sri Lanka followed suit and lowered their interest rates, which critics say could ultimately result in asset price bubbles. It is expected that the Fed will move for a further rate cut during this year. However, a positive scenario is also not out of reach if the US-China trade war were to end.

- On the other hand, if the rate cuts continue, the dollar is expected to fall. This means that the rupee will be more stable and supportive of foreign currency flow to the country. The low interest rates would also mean that Sri Lanka will be able to borrow at lower rates in international markets. If the economic landscape improves, Sri Lanka will benefit from improved demand for its exports.

Slower growth and subdued inflation are concerns

On 31 July 2019, the US Federal Reserve Bank (Fed) lowered interest rates by a quarter-percentage point for the first time since the Great Recession in 2008. What are the reasons behind the Fed's move to reduce the interest rate at this time? The two main factors driving the Fed's decision are the;

- expected economic slowdown
- lower inflation

Over the past five years from 2014-2018, the US economy grew at an average rate of 2.5%. Since the start of the year, there has been increasing evidence of a slowdown in global and US growth.

- World economic growth is expected to decline from 3% in 2018 to 2.6% in 2019.
- Growth in advanced economies is forecasted to slow down from 2.1% last year to 1.7% this year.
- Growth is expected to be 1.2% in the Euro-area and 0.8% in Japan.
- China's growth is also likely to slow down to 6.2% in 2019. In fact, Chinese economic growth in the second quarter of 2019 was 6.2%, the weakest rate in at least 27 years.
- The US growth is also expected to slow down to 2.5% in 2019 in comparison to 2.9% last year.

So far in 2019, the US GDP growth has slowed down from 3.1% in the first quarter to 2.1% in the second quarter. Slowdown in trade due to ongoing US-China trade disputes has been a key factor affecting economic slowdown. Business investment has slowed as well. Under the current scenario, the growth in world trade volume is forecasted to decline from 4.1% in 2018 to 2.6% next year. The Fed is concerned that trade uncertainties and slowdown in other economies could lead to a slowdown in the US economy and undermine its longest economic expansion in the history.

The Fed hopes that lower interest rates will boost economic activity

The US inflation has been running below the Fed's 2% target as well. For the 12 months ended in June 2019, the inflation rate is 1.6% compared to 1.8% in May. In this environment of slower growth and low inflation, the Fed hopes that monetary easing will provide a boost to the economy and help sustain the expansion through increasing aggregate demand for goods and services which might lead companies to invest more. Personal consumption accounts for 69% of the US economy and increase in borrowing-led consumption could provide a boost to economic activity.

Monetary easing continues to gain pace worldwide

The world is now entering a period of extraordinary monetary easing. Following the US rate cut, India, Philippines, and New Zealand also cut their policy rates citing growth concerns. Central banks in a number of other countries including Malaysia, Russia, Ukraine, Nigeria, South Africa, Egypt, Brazil and Paraguay also lowered interest rates recently.

The Central Bank of Sri Lanka also reduced its policy interest rates in May 2019. It lowered standard deposit facility rate (SDFR) and standard lending facility rate (SLFR) by 0.5% to 8.5% and 9.0% respectively to support the slowing economy in the wake of bomb attacks last April. These actions by central banks to follow more accommodative monetary policy clearly reflect worries about slowing economic growth and the need to boost aggregate demand and business investments.

However, critics argue that lower interest rates lead people to invest more in financial assets such as stocks. Further, lower rates will motivate more people to buy homes giving rise to higher home prices. Thus, lower rates could ultimately cause asset price bubbles in stock and housing markets which could ultimately burst like what happened in 2008.

What could happen next?

If the US-China trade war escalates and economic data weaken further, the Fed might cut rates again this year. In fact, the markets are expecting another rate cut in September this year.

On the other hand, if the US-China trade negotiations lead to some positive resolutions and inflation picks up in the coming months, then the Fed might pause for the rest of the year. Overall, the current evidence suggests that the economic outlook is tilted to the downside.

Implications for Sri Lanka

Lower Dollar could help stabilize capital outflows

Most analysts believe that the dollar is unlikely to strengthen in a significant way. This is good news for Sri Lanka. The Sri Lankan rupee came under tremendous pressure in 2018. With net selling of government securities by foreign investors of $ 990 mn, the rupee depreciated by 16.4% against the dollar last year. In contrast, the Sri Lankan Rupee has appreciated by about 3% against the dollar so far this year. The net capital outflows from government securities have been only $ 133 mn in 2019. The lower US rates might at least help stabilise capital outflows.

Sri Lanka will be able to borrow at lower rates

Lower US rates and easy monetary conditions worldwide will also help Sri Lanka to borrow at relatively lower rates in international markets. Of course, this assumes that the prevailing country risk premium will not increase. Currently, Sri Lanka's country risk premium is about 6%. However, a number of factors may lead to a higher risk premium. They include slower growth and heightened political uncertainties due to the upcoming elections cycle which could lead investors to demand a higher risk premium for investing in Sri Lankan government bonds.

More foreign inflows – stable Rupee

Persistent slower growth and continuation of trade uncertainties could force the US Fed to cut interest rates further in the coming months and years. In such a scenario, foreign investors could once again look to invest in emerging market bonds in search of relatively higher yields. Sri Lanka could also see more capital inflows into government securities which will help to stabilise the rupee and build foreign currency reserves.

Higher exports

A resolution of trade uncertainties could tilt the balance in favour of renewed expectations of growth. Such a scenario could result in the dollar strengthening. A China trade deal and expectations of higher global growth will be positive for export-oriented emerging markets and Sri Lanka. Particularly, higher growth in advanced economies such as the US and the European Union will create more demand for exports.

Central Bank must be pragmatic and flexible

The world is facing an increasingly challenging and complicated macroeconomic and geo-political environment. Slower economic growth and benign inflation will pose greater monetary policy challenges for central banks. In such a scenario, the Central Bank of Sri Lanka should have its entire toolbox of monetary policy at its disposal to deal with future macroeconomic uncertainties in a flexible and pragmatic way. The bank should not narrow or restrict its monetary policy regimes nor its ability to support the government when needed given the fiscal perils and significant macroeconomic imbalances faced by the country.

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