Spotlight: Econ Op-eds in Summary

Week ended 27th November '19

In Summary

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

1. Sri Lanka needs monetary discipline to avoid further downgrades
By: Bellwether

- All credit rating downgrades since Sri Lanka got its BB- credit rating from Fitch in 2005, had resulted from monetary indiscipline. In turn, this indiscipline, has triggered balance of payment crises due to the interest rate targeting monetary policy by the CBSL as well as sterilizing of forex interventions.

- Another downgrade would take Sri Lanka to B-, and rating agencies have been been negative in their language about Sri Lanka. While we'll still be able to access capital markets, Sri Lanka will only be one rating notch above 'CCC', which is a distressed debt level. This will not allow any space for risky monetary policy.

- As such, 2020 would be a crucial year for the country. The country could recover as the credit contraction from the 2018 currency crisis end, given the authorities decide not to have further rate cuts or money printing. However, continued monetary indiscipline could lead to depreciation and high nominal rates, ultimately resulting in dollarization.

2020 Sri Lanka is not 2005

When Sri Lanka got its credit rating from Fitch in 2005 it was BB-. That was two notches below investment grade. Sri Lanka's downgrades have generally come in the wake of monetary indiscipline.

In 2008, there were external factors also involved and fuel subsidies and global collapse, but monetary policy was for all intents and purposes 'leaning against the wind'.

Monetary Downgrades

All downgrades since then (including 2018) have come amid an economic recovery because of balance of payments crises triggered by interest rate targeting by and sterilizing forex interventions or both.

Money printing has worsened in recent years due to a more Keynesian interventionism creeping into the central bank and highly discretionary 'flexible' policies being adopted, with the approval of the International Monetary Fund.

If money printing is tracked as the stock of central bank credit to government and liquidity injections to the banking system, it can be seen how monetary instability triggered rating cuts in the past.

This is because rating agencies do not downgrade just because the deficit spikes in a single year.

They may even high levels of debt and sit out a period of low growth as long as there are no forex troubles from a soft-peg.

The first downgrade from BB- to B+ was followed by an upgrade in 2011. The upgrade happened just before another BOP crisis was triggered by liquidity injections. Fitch stayed put during that crisis but S&P cut the outlook to negative. Because the rupee was allowed to appreciate after the previous crisis, many foreign investors also stayed put.

When money was printed in 2015 to flush markets with excess money and push down rates, and the crisis worsened in 2016, the rating was cut to B+.

Following the experience of the 2012 crisis, where the exchange was kept at 130 to the US dollar without appreciating, foreign investors fled.

When the economy was barely recovering from that crisis in the first quarter of 2018 money was again printed by the central bank to target rates and another crisis was triggered, generating two busts in a row.

In December 2018, the rating was downgraded to B.

A BB rating is generally called speculative. B is highly speculative.

Barely Above Distress

The next downgrade will take Sri Lanka to B-. Sri Lanka will probably be able to access credit markets even at that rating.

Pakistan, whose central bank also prints money with a peg, and frequently runs to the IMF now has a B- rating.

But B- is barely above CCC.

From two levels below investment grade in 2005, Sri Lanka is now a little above CCC, which is a distressed debt level. The same tricks that were done 10 or 15 years ago cannot be done now.

Sri Lanka's foreign debt is now much greater than before. The numbers are also not certain, because many state enterprises have borrowed directly, and not through on-lending like in earlier years.

Chinese debt have at least built some infrastructure, the sovereign bonds have built nothing much.

Recovery

There will be a recovery in 2020 as the credit contraction from the 2018 currency crisis ends.
But 2020 will be like 2015, there will be a spike in spending. Any tax cuts will also dampen a recovery in revenues.

While it brings benefits when income taxes are cut, indirect tax cuts will not help.

There will be a stock market and an economic recovery.

The central bank and others are talking about the need to get down interest rates. That is not re-asssuring.

It is doubtful whether China will give loans like earlier to boost growth as it is having its own troubles. China's flexible exchange rate is taking a toll, as are state owned enterprises. However, China may give debt relief to Sri Lanka.

Rating Space

If rates are cut further and money is printed, the recovery in 2020 will be short-lived or not at all, and another currency crisis will be generated, and downgrades will follow.

In 2018, rating agencies were more jittery than usual. When growth is weak for long periods, there is a tendency for rating agencies to be jittery.

Unlike Argentina, Sri Lanka's central bank got away with lower inflation due to tight liquidity after the 2018 currency crisis began, at the expense of a smaller output shock, like the better managed countries during the East Asian crisis.

However, the advantage was not utilized to appreciate the currency during the credit downturn.

The proposed central bank reforms will not help, as it will be more of the same monetary indiscipline with 'flexible' exchange rate and 'flexible inflation targeting.

In any case Sri Lanka no longer has the rating space for either monetary indiscipline or fiscal indiscipline.

Dollarization and Golderization

If there is no serious monetary discipline that brings stability, all talk of economic programs are meaningless.

When countries have chronic monetary indiscipline, which leads to depreciation and high nominal rates, economic players dollarize. There may be deposit dollarization (like NRFC), when the currency falls, and liability dollarization (getting dollar loans) whenever there is some stability in the peg.

For the full article - Economy Next

2. Gotanomics: Can it turn around the ailing Sri Lanka's economy?
By: W.A Wijewardena

- The economic policy package of the new president (Gotanomics) should be properly assessed when implementing. Despite having some modest economic goals, targets such as reducing lending rates and stabilizing exchange rates are market determined and are beyond powers of the president. Attempts at influencing the market could have harmful consequences, making central bank consultation a priority.

- A National Policy and Planning Commission should assess Gotanomics, in consultation with the Central Bank and design detailed work programmes during implementation. Since privatisation of state-owned enterprises (SOEs) is discouraged, competent managers should be hired. SOEs can also be reformed under state ownership to assure their profitability and viability. Overly focusing on financial audits should be replaced with much needed enterprise audits.

- The proposed simple tax system with higher tax bases, reduced tax rates, and discontinuation of advanced tax collection and ancillary taxes is a gamble with high risks on widening the current budget deficit. Proposed measures to introduce new technology should coincide with the generation of the required talent pool, especially via privately owned higher educational institutions, in order to successfully equip Sri Lanka with such technologies.

Sri Lanka's economy was in a dire state, moving from bad to worse on each passing day. Economic policy managers should have taken effective measures quickly to arrest the declining trend, turn it around and push it back to the long-term potential growth path.

If early action is not taken, the economy would descend to a further depth. It will certainly deny Sri Lanka the opportunity of attaining the economic glory.

Viyathmaga, the think-tank behind Gotanomics

Gotanomics comes from a series of such open consultations done by a think-tank which branded itself 'Viyathmaga'.

It is now necessary to reassess the main components of Gotanomics in the light of emerging global as well as local developments. Further, a Manifesto is just a blueprint outlining only the major policies being pursued. Each policy has to be developed into a detailed work programme eliminating inconsistencies, focusing on the future rather than the present.

In developing these work programmes, it is essential to get the inputs of the Central Bank to prevent Gotanomics from conflicting with bank's policies. Once finalised, it is necessary to have it signed off by the bureaucracy, private sector and policy leaders.

Modest economic goals in Gotanomics

Gotanomics has some modest economic goals to be achieved during 2020-5. Economic growth is to be lifted from the current below 3% to 6.5%. Per capita income which stands at present at $ 4,000 is to be increased to $ 6,500, a midpoint in Sri Lanka's journey toward a high-income country.

Unemployment is to be kept below 4% which is the current rate in that number. Inflation will be below 5%, one percentage point above the maximum of this number at present. Budget deficit is targeted to be below 5% of GDP, a drastic reduction from the current 6% plus percent.

Two difficult if not impossible goals have also been targeted. One relates to lending rates of commercial banks where Gotanomics is planning to bring them below 10%, compared to the current levels between 11% and 20%. The other one relates to the exchange rate. Gotanomics plans to stabilise the exchange rates meaning that it will not fall below the current level of Rs. 182 per US dollar. Both are market determined and therefore are beyond the edicts of a President.

Any attempt at subverting the market would have disastrous consequences for the other goals immediately and the long-term economic growth later. That is why it is necessary to work closely with the Central Bank which is the authority on both policies.

The return of the big government

The main feature of Gotanomics is the central role which the government is going to assume in directing the economy. A National Policy and Planning Commission (NPPC) is to be established under the President. Most probably, it will be headed by the veteran economist Dr. P.B. Jayasundera, Secretary to the President. As Finance Secretary earlier, he has proved himself to be an able policy manager and an on-time deliveryman.

There were two similar bodies under the previous administration too: A Cabinet Committee on Economic Management or CCEM under the Prime Minister in the first three years and a National Economic Council or NEC under the President in the balance two years.

Both these bodies failed to come up with a comprehensive national plan. The proposed NPPC should avoid this pitfall. It already has a fairly comprehensive economic plan covering all the sectors as designed by the think-tank Viyathmaga to begin with. It is a matter for NPPC to reassess it, in consultation with the Central Bank and convert the final product to detailed work programmes to be implemented by different Government agencies.

A full-stop to privatisation

Gotanomics has very clearly pronounced that no state enterprise will be privatised and even gone to the extent of proposing the enactment of laws to prohibit it. These are weak propositions since no one can bind a future Parliament to uphold them. Even with regard to the ones already privatised, the Government is going to issue directions and all private sector stakeholders within those enterprises are required to comply with them.

Since many past privatisation activities have been marred with alleged corruption charges and not been driven by pure efficiency-based changeover plans, there is a political logic behind these three moves. But the political logic has subsumed the economic logic which is based on efficiency requirements and the need for changing business strategies in line with emerging global developments. A management body functioning under a politician is unlikely to act swiftly and with foresight to save an enterprise from an unforeseen external shock.

Hiring competent managers

Gotanomics is planning to overcome this issue by introducing two measures. In one measure, it is proposed to hand over the management of these enterprises to competent and talented managers who would be paid market salaries and are subject to continuous performance audits. If they fail, like in a private company, they have to quit. This was the model used by Singapore for State enterprises under State ownership.

A likely hindrance to this model is the non-availability of a sufficient number of talented managers to run these enterprises. Singapore overcame this by hiring foreign managers on lucrative salaries but assigning time-bound targets to them. Gotanomics is silent on this possibility and therefore, it is the job of NPPC to assess it and make suitable adjustments.

Another bureaucracy

The other measure is to bring these enterprises under the control of a newly established National Enterprises Authority to reform them under state ownership to assure their profitability and viability. The target is to free the taxpayers from the responsibility to bail them out if they become bankrupt.

The present model followed by Sri Lanka is to subject these enterprises to continuous evaluation by a team of technocrats housed in the Public Enterprise Department of the Ministry of Finance and assist the Parliamentary Committee on Public Enterprises (COPE) to make a final recommendation.

The past COPE reports have over-focused on financial audit to the exclusion of the needed 'enterprise audit'. In an enterprise audit, what is being looked at is whether a programme carried out by a state enterprise is in accord with its mission to mitigate emerging global and local risks.

When the financial audit focuses on financial irregularities and the media give the widest possible publicity to them, managers in these enterprises will become extra-cautious and refrain themselves from making appropriate decisions. This is the main reason for the wide-spread inefficiency in state enterprises. As such, this possibility also has to be avoided under the proposed NEA system.

Proposal for a simple tax system

Gotanomics has proposed a simple tax system with low rates and a wider tax net to ease the burden on the present taxpayers.

Currently, a multitude of taxes to generate revenue from every possible tax base has made it very complex, forcing taxpayers to evade taxes which in turn has resulted in a low tax yield.

Both measures will reduce the continuous cash inflow into the Treasury requiring it to raise more liquid cash by way of issuing Treasury bills.

The challenge is to limit this practice to a short period and decide on an exit point. The gamble is if the tax net does not expand as expected and as a result, the cash shortage becomes permanent. Then, the proposed strategy becomes a curse rather than a blessing.

A gamble with high risks

The corporate income tax is to be reduced from 28% to 18%. The lower taxes are expected to increase the retained profits within the corporate system and plough back the excess income into new investments.

The higher profit base in the corporate sector will increase the total tax revenue despite the lower tax base. However, the reinvestment of excess profits by the corporate sector will depend on many factors over which President Gotabaya Rajapaksa has no control. It will depend on market demand, both local and foreign, competitive edge which the Sri Lankan firms have over their external competitors, new technology they have acquired, the environment for doing business, etc.

If these ground requirements are not conducive, the Government will lose in the gamble creating widened gaps in the budget.

The scrapping of the advance tax collection system

A similar gamble is proposed to be played with respect to personal income taxes as well. The present early tax collection system – Pay-As-You-Earn or PAYE tax – imposed on both private sector and corporation sector employees is to be abolished and the marginal tax rate which is at 24% at present is to be reduced to 15%.

At the same time, the tax-free threshold in the case of the employment income which stands at Rs. 700,000 will be increased to employees who file annual tax returns. Similar to the reduction in the corporate income tax, this measure will also reduce the monthly cash inflow to the Treasury.

But, after the abolition of the PAYE tax, all liable employees and others will have to file annual tax returns and pay taxes not only on the employment income but also on the other types of income. If it happens, it will certainly increase the total tax revenue despite the low tax base. If it does not, once again the Government will face a widened budget gap.

Taking out offensive taxes

There are also proposals to abolish or reduce other types of ancillary taxes. The Nation Building Tax (NBT), Economic Service Charge (ESC) and Withholding Taxes (WHT) will be abolished. The Value Added Tax (VAT) will be reduced from 15% to 8%.

Two other tax proposals aiming at incentivising businesses appear to be non-working. One is the five-year holiday given to agriculture and small and medium enterprises. Since these enterprises are not in the tax net at present, the particular tax holiday is irrelevant for the purpose. The other is the zero-VAT rate given to businesses in the tourism sector provided they use 60% of local inputs when providing their services to tourists. Since it is the worldwide practice that VAT on the sector is passed onto tourists, this particular holiday does not leave a surplus with the cash-strapped tourism sector businesses.

Going for new technology

One important aspect in Gotanomics is the measures to introduce new technology. Though not explicitly expressed, it will prepare the country to the Fourth Industrial Revolution or Industry 4.0. This aims at eliminating fear of technology, on the one hand, and making the people accustomed to new technologies, on the other.

But the full burden of equipping people with capacity has been passed onto the State university system. Since the present cash position of the Government does not allow it to increase the capacity of the State university system immediately, Gotanomics will have to activate the private sector owned higher learning system to meet the demand.

Inviting high-ranked Indian universities to Sri Lanka

In 2004, the Government had an arrangement with the Indian Government to have a few Institutes of Technology. With the change in the government in that year, this proposal was abandoned midway through. Hence, Sri Lanka will benefit if President Gotabaya Rajapaksa opens up the abandoned dialogue when he meets Prime Minister Narendra Modi toward the end of this month.

Without quality-minded private sector-owned higher learning institutions, it is unlikely that Sri Lanka could have the needed critical pool of scientists and engineers to help it to attain its main economic goals. Gotabaya's manifesto is silent on this issue. But the emerging ground realities might compel his administration to review this stance.

Capacity improvement in the Government sector

Can Gotanomics make a turnaround of the country's ailing economy? It may, as it has worked successfully in Taiwan, Singapore, South Korea and even in post-war Japan.

The secret of success in these countries was the capacity improvement in the central government to act with foresight. Thus, Gotanomics will work if the same Central Government machinery is established in Sri Lanka.

For the full article – Refer DailyFT

3. Entrepreneurship key to economic development
By: Talal Rafi

- Entrepreneurship is one of the most important means of improving a nation's prospects and growing it's economy. Entrepreneurs do so by solving problems within a society and hence, creating new value. This also helps the government by increasing tax revenue.

- Entrepreneurship also improves job prospects for many within a society. Not only do new products mean that there is a greater demand for more labour, but the training provided to people means that they remain skilled for other jobs as well. This is especially helpful when entrepreneurs move to rural areas, since it can help lift people out of poverty.

- The economy of a country benefits further when entrepreneurship increases industries that can export to foreign markets. Hence, entrepreneurship often ends up driving important sources of foreign earnings. Therefore, it is in any government's best interest to improve entrepreneurship due to the beneficial impacts on the country's overall economy.

Solution to problems

Solving problems in society does not just make entrepreneurs into billionaires, it also leads to economic development. As these entrepreneurs solve a problem which the Government had to and the Government did not have to use its resources to do so. The entrepreneurs just did what the Government had to do and these entrepreneurs pay taxes to the Government for solving the problems of the Government.

One reason why the Government should love entrepreneurs: Entrepreneurs bring in new products and create a whole new industry like how Apple did with its iPads and Ford did with cars. Even if they do not bring in new products, a new enterprise selling the same thing its competitor is selling can bring competition. Competition is good as it keeps prices down and leads to innovation.

Creating new jobs and new businesses

A new entrepreneur means one less job seeker. It also means a job creator. Entrepreneurs also create products and services, which all lead to the increase in GDP and economic development. Job creation is a great benefit, especially in the high tech industry where employees earn a lot of money leading to a new upper-middle-class developing which is always good for the economy.

Even in regions where there is full employment, a new enterprise means there is more demand for jobs than supply which means an increase in salaries due to lack of human capital, which is a positive. Entrepreneurs also create more entrepreneurs.

Entrepreneurs need supply chains and distributors for their products which create a new demand for people to start new ventures to fill the supply chain and distribution needs.

Improving trade

Entrepren-eurship is a key foreign exchange earner. As companies grow, they start looking for markets beyond the borders of their respective countries and eventually become exporters. Exports are key to economic development. Even importers greatly benefit a country. Importers bring in needed products and services. Also, importers create distribution channels and sales teams which result in economic growth and job creation.

Poverty reduction

Entrepreneurs into manufacturing locate their factories in the rural areas. This leads to the development of the rural region as the people there get jobs and are given training. Even if the factory closes or moves away from that region, because of the training received these people can get jobs elsewhere. It also leads to infrastructure development in the rural areas.

Increase in trade within a country results in development of roads and railways which is a benefit to the entire country. Land and labour are not used very productively in the rural regions so entrepreneurship is a good way of making use of the resources available.

Entrepreneurship and economic development

Developing entrepreneurship is the single most important factor when looking at economic development and this must be encouraged.

For the full article – Refer DailyFT