Spotlight: Econ Op-eds in Summary

Week ended 24th February '21

In Summary

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

1. Sri Lanka has to fix monetary instability, budgets to avoid default, sudden stop
By: Bellwether

- Sri Lanka is currently facing both a liquidity and debt crisis, and monetary instability could be a prime cause for both. As more and more money gets printed and inflation rises, the currency weakens. This is similar to what happened in past depreciation crises in Sri Lanka.

- This situation is worsened by the fact that Sri Lanka consistently has weaker fiscal policy, with taxation being below par and high expenditures mostly due to state enterprises and salaries. As a result, Sri Lanka's Central Bank ends up printing money to finance these deficits instead of rolling it over.

- To get out of the current situation, an IMF programme is a great first step to restore confidence in Sri Lanka. However, unless Sri Lanka abandons its policies of monetary injections and loose fiscal spending, and fixes its currency policy with a consistent one, any short term solution will remain just a short term solution.

Both government debt and government money (rupees) are in crisis. There is no people's money in Sri Lanka and there is no currency competition – only a monopoly of state money.

For long term growth, a series of liberalizations which removes state controls on the community, and favours special interests and state monopolies have to be made.

Achilles Heel

Sri Lanka's Achilles heel since independence has been the lack of a rule-based monetary policy and a reliance on highly soft-pegged regimes with 'flexible' or 'discretionary' policy where some floating rate practices are applied to a peg.

That money printing to keep down interest rates amid a credit spike will weaken the currency in a peg, is a law of nature, not a figment in the imagination of classical economists.

That has to be fixed first of all.

Sri Lanka devalued from 8 to 15 in 1978, held till about the end of 1980 and then everything went downhill from there, though there were no import controls and people were able to do things and get more jobs and expropriation ended. Instead there was privatization.

But Sri Lanka was far removed from high performing East Asian nation. The central bank creating inflation, de facto targeted the real effective exchange rate, triggered political unrest, strikes and so on until A S Jayewardene came to office in 1994 and did some central bank reforms.

The basic principles behind those reforms were progressively abandoned in favour of aggressive open market operations from 2011 onwards and intensified in 2018.

Debt Problems

Debt problems are not the same as pure soft-peg problems, but they can be worse in countries with soft-pegs because currency collapses and debt feeds on each other.

A sudden peg collapse, as the one that happened with Argentina will lead to a default of foreign loans even if the country has a low level of debt.

If not an outright default due to 'foreign exchange shortages' it will at least lead to an inflation of foreign debt.

It may be compounded by controls, interventions or expropriation which block or discourage freedoms of the people and free enterprise, stifling them and preventing them from making full use of the investments.

But the problems with fixed exchange rates come when floating rate style 'open market operations' are administered.

Sri Lanka's low recent growth came with two currency crises coming from the lack of rule-based monetary policy due to 'flexible inflation targeting' 'flexible exchange rate' involving open market operations to generate excess liquidity.

In Sri Lanka two currency crises in 2015 and 2018 bloated dollar debt and triggered capital flight.

State Finances

In a debt crisis, a credible plan to fix state finances inspires confidence and persuades lenders to stop demanding their money back and gives motivation to roll-over debt.

Sri Lanka cut the taxes in 2019 taxes in a misguided move to 'stimulate' the economy without waiting for the automatic recovery that usually accompanies a currency crisis.

The revenue problem had been worsened by Coronavirus.

Salaries have been frozen and many expenses cut. However, tens of thousands of people are being hired into the state sector.

Fitch Ratings went by the numbers and said the budget deficit increased, but actually it is a little improvement from the previous year. With economic activities recovering there will be some increases in tax revenues.

The valued added taxes lost to the budget have increased profits of import substitution companies owned by so-called 'cronies' to very high levels.

The firms were already benefitting from import controls which are also a loss of taxes to the Treasury.

Bleeding Reserves

The Treasury is printing the lost money to make up for lost taxes that are creating foreign exchange problems.

But foreign reserves are steadily declining. Boosting them with swaps is a temporary solution only.

The foreign exchange problems are not coming from lack of tourism revenues. Lack of tourism or other export revenues will lead to an automatic collapse in imports when the salaries of the people in the sector are cut like in other countries including the Maldives.

When foreign loans are not available to bridge the deficit and spend, imports will automatically fall also.

In general, weak credit which stops savings of the people from being turned into imports through the credit system allows foreign reserves to be built in a peg, which can be used for debt repayments.

The government can directly borrow the savings and repay foreign debt also by crowding out domestic credit and therefore imports.

The first step is to stop additional bleeding of reserves through liquidity injections and low interest rates by allowing market rates to come back. Already some excess liquidity had been allowed to leave through dollar outflows.

The Treasury should not reject bids to roll-over bond maturities. Any rejection of bids turns debt from past deficits into printed money and instability in the current year.

The central bank should always roll over coupon payments as paper Treasury bills or bonds instead of trying to pay cash by printing money.

Primary Deficit

The reason that the IMF uses a primary deficit as a target is to allow interest rates to be hiked to stop the currency crisis without disturbing the target. Though lost in the mists of time, interest can also be rolled over as paper in auction, leaving the remaining items such as salaries to be settled via banks notes which are exchangeable for dollars.

If interest payments are rolled over as paper, a big chunk of current budget spending is taken away from triggering currency pressure. That is the value of the primary deficit.

By rolling over debt and also rolling over interest rate payments as paper debt – at an appropriate market rate, whatever that is each month – a large chunk of state spending can be blocked from becoming reserve money.

If money is printed for interest rate payments on debt, more currency problems would come and import controls, weak growth and weak tax revenues would continue in a vicious circle.

Sri Lanka's negative forward premium is one weird outcome of misaligned interest rates. Closing the forward market may reduce the need for spot dollars but that does not solve the fundamental problem of upside down interest rates.

The stock market is another. Importers who were put out business by trade controls, may continue to use their credit lines and working capital loans to play the stock market as they are now doing.

But that is not sustainable.

Confidence

Sri Lanka has to have credible fiscal plan and monetary policy to regain stability and confidence.

In Sri Lanka a rise in interest rates and opening of imports will allow taxes to flow back to the Treasury, in a virtuous cycle.

A steeper rise in rates would also allow all the debt repayments that are coming up for repayment to be paid with domestic debt sales which crowd out consumption and halt imports. However that has its limits.

Sri Lanka also has to raise taxes. A value added tax hike is preferable to steep collapse of the currency.

A 20 percent value added tax and the removal of other niggling taxes under a pre-announced plan is preferable to a meltdown which will also destroy bank deposits, pension funds and salaries.

Raising value added tax 2021 is not the same as 'revenue based fiscal consolidation' that the IMF then advocated. It was based on getting the tax take up to some mindless abstract number, which politicians then busted up (quite naturally) in higher state salaries and subsidies.

Sudden Stop

However Sri Lanka's falling reserves are only partly due to trade and current account and forcing the CPC to borrow dollars and run positions.

Because of earlier money printing and currency falls under the 'flexible inflation targeting/flexible exchange rate' framework Sri Lanka's debt has been downgraded to CCC and the country cannot roll-over debt.

The problem is not just sovereign debt.

Sri Lanka's banks are finding it difficult to roll-over foreign credit lines. Limits have been cut by foreign counterparties. Import letters of credit from Sri Lanka banks are not being accepted by some foreign shippers. As a result they have to be re-confirmed back to back by foreign banks.

Some foreign banks which used to confirm have run out of limits amid higher demand or limits have been cut. Second tier banks in India and the Middle East are coming forward but premiums are high.

Sri Lanka is already drifting to a 'sudden stop' event, though default has not happened.

While it is possible to raise rates and generate dollars to repay foreign debt by curtailing domestic credit, it is not practical to do it on an ongoing basis for many years.

If investors see foreign reserves going up after debt repayments confidence may could come back. But it is a painful affair, which may or may not work given the current ideology.

IMF Program

An effective way to restore confidence is to go for an IMF program.

The IMF can if necessary do a debt workout and delay some of the repayments giving breathing space allowing domestic rates to be lower than they would otherwise be.

A front loaded disbursement would also push up foreign reserves and again allow interest rates to be lower than otherwise.

Any IMF programs should come with ceilings on domestic assets of the central bank and a low inflation target of around 2 percent. A 6 or 8 percent inflation target will land the country in another currency crisis, as this column warned before.

If foreign exchange swaps are available from India or China, it makes more sense to get them with an IMF program after raising rates sufficiently to at least stop the forex reserves bleeding from current transactions.

An IMF program can be used to consolidate available support.

IMF programs also fail to fix economic problems in the long term due to the failure to fix central banks and leaving room for state interventions.

It is always better to take pre-emptive action, rather than be pushed into a situation where there are no options.

But whatever is done, the faster it is done the better. It is messy to pick up too many pieces.

For the full article - Refer EconomyNext

2. Resolving the perilous external financial vulnerability
By: Nimal Sanderatne

- Sri Lanka is in a debt crisis, with reserves falling to $5.7 Bn at end 2020 and foreign debt obligations worth $4.5 Bn due over 2021. To provide imminent assistance to this, the Government is negotiating a $1.5 Bn foreign currency swap from China. This funding is much needed, with the BOP position expected to worsen given a likely recovery of oil prices in 2021.

- Economists have urged the government to seek multilateral assistance, in specific IMF assistance to meet debt repayments this year, citing that that they are low interest programmes due over a long period of time. The current government strategy of import controls and stringent control of the economy is reminiscent of the unsuccessful policies in the 1970 – 1977 period, and will not work now as well.

- The 1970- 1977 period was accompanied by low economic growth and government policies creating shortages on basic items including food and clothing. Further reluctance by the government on negotiating an IMF agreement could lead to a period of extreme economic austerity in the future, as a last bid attempt to manage debt repayments.

Although the country's external financial vulnerability is increasing, there is considerable complacency and confidence among officials that it would be resolved. The repetitive refrain has been that the country has always met its debt obligations and it will do so now. We are told that the nation's external finances are under control and that the government has its own way of resolving it.

Recognising the problem

There is no acknowledgement of the crisis in the external finances, nor an indication of how the country would be able to repay her debt obligations, except that the Central Bank of Sri Lanka expects a foreign currency swap of US$ 1.5 Bn soon. Recognising the gravity of the problem is the first step towards the resolution of the crisis.

Facts and figures

The plain facts of our external finances indicate the gravity of the crisis. Foreign debt obligations this year are estimated at about US$ 4.5 Bn, while foreign reserves were only US$ 4.1 Bn. The country's external reserves that fell to US$ 5.7 Bn at the end of 2020, have fallen precipitously to US$ 4.1 billion at the end of January according to the Central Bank of Sri Lanka. This is higher than the foreign reserves of the country and the trade deficit is likely to increase during the course of the year, despite further import restrictions.

Prospect

The prospect of the country coming to a currency swap arrangement of US$ 1.5 Bn for 18 months with China is the expected immediate relief. The conditions underlying such an arrangement is not known.

Balance of payments

Last year's balance of payments deficit increased to US$ 2.327 Bn compared to a small surplus of US$ 771 Mn in 2019. In spite of this serious deterioration in the balance of payments, the focus has been on the low trade deficit of US$ 6.3 Bn last year that was achieved by import controls and reduced prices of oil.

The reduced expenditure on oil imports was mainly due to the fall in international prices to about US$ 32 per barrel owing to lesser international demand for oil. This will not be so this year as oil prices are touching US$ 60 per barrel and forecast to increase further as the global economy picks up.

Fuel imports

Fuel imports were about US$ 1.4 Bn less last year mainly due to lower prices. It was US$ 2.54 Bn in 2020 compared to US$ 3.89 Bn in 2019. This year's fuel imports that are likely to cost about US$ 4 Bn would make a serious dent in the balance of payments.

Recognise facts

These facts must be recognised. The gravity of the situation in the external finances must be a foremost concern of the government. The reasons for the current external vulnerability are many. They are not necessarily any fault of the present government. However, the recognition of the problem and its resolution is the responsibility of the Government. The government must adopt the least cost solution to it.

China's assistance

Indications are that the government expects assistance from China in the form of a currency swap arrangement for US$ 1.5 Bn. This is a temporary palliative. It would require to be repaid perhaps in about a year or 18 months. The government is asking other countries too to give currency swaps that would amount to US$ 4 – 5 Bn. These are however unlikely without an agreement with the International Monetary Fund (IMF). The Government is adamant on not securing IMF assistance for wrong reasons.

Multilateral assistance

Many economists have urged the government to seek multilateral assistance, especially from the IMF. They have pointed out that IMF finances would be at low interest rates and repayable over a long period. Even more important is the benefit such IMF involvement

brings with it. It is for these reasons that the Pathfinder Foundation has advised the government to seek IMF assistance.

IMF assistance

In the past we have been able to meet perilous exchange reserve positions because the IMF rescued us 16 times before. It is not only the finances of the IMF that matters, It is the assurance to our creditors that we will handle the situation in an economically sound and feasible way through a programme that will induce a disciplined way to handle the Country's finances.

Alternate ways

Seeking "alternative means" as promised by the Governor of the Central Bank of Sri Lanka, would cause a bigger crisis for us, as it depends on import controls and stringent control of the economy reminiscent of the 1970-77 period when the then coalition government's policies created huge shortages of basic items: basic foods, medicines and clothing. The country produced high-cost inferior products and industries performed with underutilized capacities. The 1970-77 regime was one of the lowest periods of economic growth. The economy grew by only 2.9% in 1970-74 and by 3.3% in 1975-77. The economic difficulties of the 1970-77 period undoubtedly paved the way for the resounding UNP victory in 1977.

Way Forward

The only way forward in this crisis is to seek IMF assistance. This the Government has stubbornly rejected. Why are we not resorting to the least cost sources of borrowing to resolve our crisis? Are we intent on ushering in a period of extreme economic austerity?

For the full article – Refer The Sunday Times