Spotlight: Econ Op-eds in Summary

Week ended 29th April '20

In Summary

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

1. Covidonomics challenge for Central Bank Revive Keynes but clamp import controls
By: W.A. Wijewardena

- Sri Lanka was reaching macroeconomic stability when the Covid-19 pandemic bought the economy to a standstill. In such a situation, following the rest of the world, Sri Lanka adopted "Covidonomics" – a Keynesian like approach where the government is expected to save an economy deprived of demand for its output.

- Using such Keynesian policy can be a fundamental issue in the current world, because they would work very effectively only in a closed economy. In an open economy the money spent by the government would leak out from the economy in the form of imports, creating balance of payments issues. For Sri Lanka in particular, this is not an easy task, since the government budget now runs on a very tight rope.

- In such a situation, the government would have to turn to the Central Bank to finance. This can create pressure on the CBSL. As such, while the country might meet its short-term requirements through CBSL support, its medium to long-term adjustments should come from policy reforms making Sri Lanka's market flexible for business.

Central Bank is the biggest loser

The Central Bank had announced some three years ago that it would change from the money supply controlling monetary policy platform to an inflation targeting framework.

The bank was in fact well into its target of maintaining inflation in the target corridor between 4 and 6% in the following two years.

Then, the bank had endorsed the previous Government's strategy for taming the budget by raising the bar for revenue goals since there was limited prospect for curtailing expenditure, especially, the capital expenditure, without hurting the economy.

Macroeconomic stability was gradually being restored and the bank had even upgraded its growth targets from around 3% to 4% over the medium term. All these plans of the bank have now been thwarted by the unexpected onslaught on the economy by the prolonged global pandemic now code-named COVID-19.

Covidonomics: Bring Keynes back to life

One good thing that has come out of COVID-19 is Covidonomics – the policy consensus that is being practiced throughout the globe to resuscitate the near-dead economies in the respective countries. This is to be contrasted with Washington Consensus that became the vogue in late 1980s as the way out for crisis-stricken developing countries.

Washington Consensus advocated for market reforms to facilitate the private initiatives to take economies to prosperity. Covidonomics, in contrast, has placed the Government at the steering wheel to drive the economies out of the deep depths to which they have fallen.

In essence, Covidonomics suggests that the governments should flood their economies with moneys – in the form of handouts, subsidies or loans or all or a part of these in a combo – so that people who matter in running an economy will get a money stimulus. This is the old Keynesian prescription for driving an economy when it is temporarily down due to a fall in the demand for its potential output. It became popular as a policy strategy after the World War II and was used increasingly whenever the global economy was hit by deep economic crises such as the one in 2007/9.

Keynes' magic wand to quick prosperity

Keynes presented his thesis in response to the economic depression that hit the world in early 1930s in a path-breaking book he published in 1936 under the title 'The General Theory of Employment, Interest, and Money'.

What he said was that if the economy is not performing at the optimal level due to a deficiency in demand, the Government can step in and create a demand for the output by increasing the Government expenditure levels. To finance the increased expenditure, it can get the Central Bank of the country to print new money and release to the Government.

Open economies run the risk of facing BOP deficits

One feature about Keynes' model was that it was relevant only to economies which did not have international dealings. Since modern economies are such economies, there is a risk as well as a limitation in using his strategy to promote an economy.

This was well-understood even in 1949 when the Monetary Law Act, the law governing the Central Bank, was drafted. Its architect, John Exter, the first Governor of the Bank, warned those who think that Keynesian strategy could be used by a country like Sri Lanka for the development of the economy.

Making new mistakes to solve previous mistakes

In an open economy with international trade the Keynesian type of stimulating policies via deficit budgets and cheap money would leak out of the country through imports creating balance of payments deficits and consequently pressure for the domestic currency to lose its international value.

Disregarding this warning, Sri Lanka adopted deficit budgets year after year. When it was clear that it led to balance of payments deficits putting pressure on the exchange rate to depreciate, the Sri Lanka Government clamped prohibitive import and exchange controls on the economy. Though it was considered as a solution, it was the root cause for a series of other problems. Import and exchange controls created a shortage of goods in the market causing prices to go up.

To prevent prices from going up, price controls were introduced. Since price controls gave rise to black markets, a compulsory rationing system was introduced to distribute the essential goods among the needy people. Rationing led to formation of queues and preparation of waiting lists to distribute goods. It starved industries of essential raw materials leading to an economic slump and unemployment. To get import and exchange licenses, firms had to employ full-time pushers. They used underhand tactics to get the licences issued making bribery and corruption a rampant activity. All these economic

mishaps could have been avoided had the Government, in the first place, listened to Exter's advice and refrained itself from resorting to Keynesian type stimulation policies.

Full burden of adjustment to be borne by the Central Bank

Covidonomics being adopted by Sri Lanka has required the Central Bank to bear the full burden of financing the cash starved economy. The measures adopted by the Government to prevent the spread of COVID-19 and bring it under control have brought a virtual standstill to economic activities. There is a cashflow problem being faced by the self-employed to the big corporates making them cry out for financial helps from the Government.

However, the Sri Lanka Government is unable to meet this demand due to two reasons.

- First, it has no space to do so because it is already facing budgetary problems due to ballooning of expenditure on one side and slow-growing revenue on the other. The budget deficit is estimated to be around 7% of GDP in 2019. This is projected to accelerate to a level of about 10% in 2020.

- Second, the tax concessions offered by the present Government when it was elected to power in November 2019 to income tax and VAT payers are estimated to take a slice of about Rs. 500 to 600 bn out of the Government's estimated revenue.

In the circumstances, there is no other option except using the Central Bank's money for the Government's expenditure programmes. The bank has accommodated it liberally by increasing its reserve money base – an index for money printing by a central bank – from Rs. 933 bn at end-2019 to Rs. 1035 bn as on 23 April 2020. This is a massive increase in the reserve money base by Rs. 102 bn within a matter of slightly less than four months. Out of this Rs. 102 bon, Rs. 67 bn has been created within the first three weeks of April.

Prospect of a future monetary explosion

This is a monetary explosion and as Exter warned, it would be reflected in a bigger deficit in the balance of payments. To avoid it, the Central Bank together with the Government has introduced import and exchange controls on what it has termed as inessential imports valid for three months.

Policy reforms are the way out

Certainly, Sri Lanka could meet its short-term requirements through Central Bank support. But, medium to long-term adjustments should come from policy reforms making Sri Lanka's market flexible for business. If it is ignored, Sri Lanka will lose another opportunity.

For the full article - Refer the Daily FT

2. Preparing for economic prosperity beyond the COVID-19 crisis
By: Dr. Pradeep Perera

- It is possible that industries focused on the domestic market may experience some relief as domestic consumption recovers over the next 03 months, after the curfew is lifted. The same cannot be said for Sri Lanka's export industries due to the economic impacts in Sri Lanka's key trading partners.

- The pandemic's impact on Sri Lanka include potential reduction in remittances, reduction in tax revenues due to spending cuts and import restrictions. These developments combined with the high levels of external debt will amplify the twin deficit Sri Lanka faces.

- It is vital that stimulus measures such as debt moratoriums do not compromise the stability of the banking sector. Funding the fiscal deficit must also be done using non-inflationary sources. Sri Lanka must first bridge her deficits so that she can embark on a long-term revival plan with structural reform to diversify exports and attract FDI.

Short-term – economic impacts of shutdown

The short-term impacts to economic sectors that depend on the domestic market are likely to be limited to the reduced demand for goods and services during the curfew period. This include retail traders, industries making goods for domestic market and service providers to local population and farmers. The income loss to large number may affect the demand for these goods and services in next couple of months and the domestic consumption should recover within the next three months.

Medium-term impacts on fiscal deficit and current account deficit

The external demand for certain goods and services exported by Sri Lanka is likely to be subdued for next 12 months as most of Sri Lanka's trading partners are still badly affected by COVID-19.

The tourism sector is likely to be badly affected and is unlikely to recover for some time as entry will be restricted to tourists from affected countries. This includes some of the key tourist source markets. This would impact close to one million people depending on tourism and many related businesses including hotels.

These are likely to go out of business and may be compelled to default on loans taken for business expansion. This would also have a significant impact to domestic demand for goods and service and overall GDP growth of the country in 2020 as tourism contributes to about 5% of the GDP.

The apparel industry is likely to have a modest and limited impact due to the closure of shopping malls in USA and Europe and export order cancellations. The supply of material from China is likely to be restored from May after the disruptions experienced in February/March.

If Sri Lanka's apparel industry adjust to meet the increased demand for personal protection equipment (PPE), Sri Lanka may even be able to achieve an increase in apparel exports in this year. The demand for rubber goods such as gloves for health sector is also likely to increase. The agriculture exports such as tea, coconut products, spices and sea food are not likely to be affected to a significant extent.

The COVID-19 related disruption has affected the global oil demand by about 20% and resulted in a steep reduction in oil prices. This is likely to reduce the oil import expenditure of Sri Lanka by about $ 2 billion in 2020.

There is likely to be reduction in remittances from Middle Eastern and European countries such as Italy due to the COVID-19 related impacts on likely loss of income of Sri Lankan migrant workers.

The Sri Lankan economy has demonstrated significant downside risks and vulnerability to economic shocks even before the onset of COVID-19. The IMF has identified high level of

public debt (i.e. 90% of GDP including government guaranteed loans of SOEs), high level of foreign currency denominated debt including both public and private sector external debt (i.e. 59% % of the GDP in 2018), persistently high twin deficits of high budget deficit (i.e. over 5% during last 10 years) and current account deficit close to 3% of the GDP during past 5 years and high external financing requirement of over $ 5 billion compared to gross international reserves during 2020-2024 period. The COVID-19 is likely to further exacerbate the highly vulnerable fiscal and external financing situation of Sri Lankan economy.

The tax reduction announced in January 2020 and the proposal to employ large number of unemployed youth and graduates will also have a significant impact on the fiscal deficit even without considering the COVID-19 induced impacts.

The anti-COVID-19 measures have lowered the economic activities during the past six weeks and would further reduce the fiscal revenues. The recently-announced import restrictions will also reduce the import tax revenues. On the other hand, the government expenditure will increase due to additional expenditure incurred on anti-COVID-19 efforts including cash pay-outs to affected people. There could be savings on capital expenditure as construction activities have been disrupted in the past six weeks.

The Export Development Board (EDB) has estimated that the exports of goods and services will drop by $ 7 billion in 2020. After adjusting for the import content of exports, the net impact is likely to be lower than this amount. The current account deficit is likely to increase to $ 6 billion-$ 7.5 billion compared to current account deficit of $ 3 billion.

The external financing requirement for 2020 is likely to increase from $ 5 billion to $ 7.5 billion to $ 8 billion. It is likely Sri Lanka will have to restrict the foreign exchange outflows (i.e. current account transfers) and impose certain controls over the discretionary imports to maintain the current account deficit and external financing requirement at a manageable level.

Government response to mitigate impacts

Fiscal stimulus packages of 5%-10% of GDP is not an option available to the Sri Lankan Government given the extremely limited fiscal space. It would be imperative to prune all unnecessary expenditure while targeting the fiscal subsidies to affected sectors.

The Government has announced series of debt payment moratoriums and the banks would provide these concessions to the affected businesses. If the commercial banks are forced to bear the cost of bailout of affected businesses, the viability of banking sector in Sri Lanka will be badly affected and will have long term implications on future growth prospects of the country.

While the Central Bank can provide liquidity and bring down the interest rates to lower the impact on banks, a more sustainable option is for the Government to provide targeted subsidies to temporary affected businesses to keep them afloat. This should be restricted to businesses that was viable prior to the COVID-19 onset and have good prospects of turnaround within the next 12 months.

Businesses struggling to make loan payments even before the COVID-19 crisis with little prospects for turnaround need to be liquidated in an orderly manner and banks should be allowed to recover the dues to the extent possible. This strategy will minimise the fiscal cost while maintaining the financial health of banking sector to support the future economic growth.

The increase in fiscal deficit due to COVID-19 would have to be funded to the maximum extent possible using noninflationary sources. If long-term concessionary financing can be

mobilised by external official lenders that need to be tapped to the maximum extent possible.

The Government needs to negotiate a moratorium on scheduled debt repayment for 2020-21 with external official lenders to reduce the external financing gap and off-set the expected increase in current account deficit. This may require reaching an understanding with international lenders like IMF on future economic strategy and a trajectory for bringing down the Sri Lanka's twin deficits and the public debt to a sustainable level.

Once these deficits are bridged, Sri Lanka has to embark on a long-term economic revival strategy with less dependency on foreign borrowings. This requires far-reaching structural reforms to the economy, export diversification strategy and attracting Foreign Direct Investments to both manufacturing and service sectors. The skill base of Sri Lankan youth should be developed to enable them to effectively participate in the dynamic global economy and some of the restrictive labour and employment practices may have to be relaxed.

For the full article – Refer the Daily FT

3. 'The Great Lockdown' and the Sri Lankan economy
By: Bhadraja Mullegamgoda

- The "Great Lockdown" will likely result in a recession that will eclipse the Global Financial Crisis of 2008. Fiscal stimulus to protect the economy is challenging as the pandemic has affected all dimensions of the economy. This compounds Sri Lanka's lack of policy alternatives given existing fiscal constraints.

- The informal sector and SMEs may suffer the greatest economic hit, as global supply chains get affected as well. Recession in export markets along with relatively less effected import markets will result in a widening trade deficit too. Any continuation of the recent currency depreciation will compound the issue.

- It is important that policymakers consider the most effective alternatives given fiscal constraints. These may include developing business and entrepreneurship, strengthening and integrating with value chains, and reinforcing existing social safety nets.

As specified by the IMF, 'The Great Lockdown' may lead to a global recession in 2020 which could be worse than the one triggered by the Global Financial Crisis.

Unlike the 1929 Great Depression and 2008 Great Recession, fiscal stimulation will be very challenging as the epidemic would hit households, businesses, financial institutions, and markets all at same time. However, it is too early to fathom COVID-19's long-term implications for global high powers and emerging markets even with trillions of dollars stimulation package.

Sri Lankan economy

Both formal and informal sectors would be seriously affected by this pandemic in the context of exports, imports, domestic production and services. But real danger is associated with most unexplained parts of the informal sector.

Export destinations

In a recession time, production for exports triggers with a dual effect, factors of production and features of export destinations. In the setting of trade account in Sri Lanka, main export destinations are the US 25%, U.K 8%, EU 22% and India 6%.

Recent survey reports show the uncertainty of consumer confidence has increased with lower wages. Retail and wholesale deterioration of 6%-10% would directly affect the fashion and lifestyle industry, where it signals a faded exports destination for Sri Lanka.

Comparatively, exports to the EU have diversified with other major productions such as rubber products, machinery, mechanical appliances and tea. Major states that received domestic exports are Germany, Italy, Belgium and France.

Sri Lankan industrial exports to the EU region would be covered with a grey forecast for the rest of this year.

India is the major diversified export destination for Sri Lanka that comprises 32% agriculture and more than 45% industrial exports. If the measures taken by the Indian Government work out as planned, it will be good news for Sri Lanka.

The beverage price index expected to increase by 2% in 2020 followed by spiralled downward due to pressure on tea prices in previous years. Since Sri Lanka is a price taker with numerous constraints on further production, it would only leave local producers to form expectations on traditional beverage prices to increase in world market.

Imports and exchange rate

Most intermediate and investment imports are used as inputs for production processes and inputs for value chains.

The top imports origins of Sri Lanka are India 20%, China 17%, Singapore 7.9%, UAE 7% and Japan 4.8%. Such domestic markets are not severely affected by the epidemic. But there are three dimensions that would affect the economy in terms of imports- global price level, domestic inflation and exchange rate pressure.

The USD/LKR also hit the 200 mark in April. This was mainly due to the responses of market actors expectations regarding the pandemic by taking risk averse positions in their balance sheets. The risk of such overshooting of the exchange rate is that the market rate would settle down at a higher bound and will continue without any downward pressure in respect of weak cash inflows to Sri Lanka.

Under the pessimistic scenario, Sri Lanka would face dual effect on inflation, increase in global prices of inputs for domestic production and imported inflation due to higher exchange rate. This will reduce the real wealth of consumers and would affect the demand.

Domestic production/services

Nearly half of Sri Lanka's economic activity is within the informal sector. Informal sector employment recorded as 68% of total employment. Major composition is in Agriculture, forestry and fishing 88%, followed by construction and other industries 77%, hotel and accommodation 55% and manufacturing 46%.

Deceleration of global activities would directly affect the local informal sector and consequently reduce GDP of the country. All MSMEs value chain actors from input providers to service providers would be distressed under such a situation.

Lack of information, data and validity of existing data of the informal sector would make it difficult for policymakers to track any changes and introduce countermeasures for the majority segments of this sector.

Short-medium term strategies

Recent tax cuts, prior spending programs and debt obligations have left us with a narrow space for further proactive fiscal stimulus. Consequently, the Government would be attentive on other strategies in a given fiscal space.

Government may entail to use existing fiscal space to direct funds towards following programs to provide some relief for most affected sectors, but not limited to;

1) Business and entrepreneurship development in terms of coaching, counselling and mentoring. This can be adopted as a business lifecycle approach.

2) Picking up inactive and potential actors by using product space framework. Accordingly, such actors would link with active value chains of the area. Main benefit of this process is, it would pressingly create and strengthen the integrated value chains.

3) Enhance existing space for safety nets. Authorities can increase benefits of prevailing welfare programs at least for a shorter period of time, where there are more than 35 programs in the country.

4) Relax some import restrictions for a limited time frame in order to reduce the price of selected non-durables, where it would have some spiral effect on consumption as whole.

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