Spotlight: Econ Op-eds in Summary

Week ended 14th August '19

In Summary

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

1. Fiscal consolidation derailed by increased expenditure
By: Nimal Sanderatne

- Even though Sri Lanka achieved significant progress in fiscal consolidation from 2016 to 2018, revenue shortfalls and increased public expenditure after the Easter attacks are likely to derail the process. Populist expenditures targeting the forthcoming elections will likely lead to exceeding the targeted fiscal deficits of 4.8% in 2019 and 3.5% in 2020.

- Such populist measures could include increased employment and transfer payments, alongside other priorities like Enterprise Sri Lanka, security and compensation expenses for April violence, are likely to increase public expenditure. Furthermore, the increased rupee cost of debt servicing due to depreciation would to this. On the revenue side, slow economic growth, setbacks in tourism and imports are likely to lead to tax revenue shortfalls.

- This expansion in the fiscal deficit will generate greater inflationary pressures, negatively impact the balance of payments position and worsen the country's debt burden. With this irresponsibility been inherent to the Sri Lankan political economy, election years become severe constraints to the fiscal consolidation process.

Although the government's strategy was to reduce the fiscal deficit and thereby the outstanding debt to a sustainable level over the medium term, the current spending spree of the government is likely to derail the fiscal consolidation process, destabilise the economy and slow economic growth.

Fiscal slippage

In as much as 2015–the first year of the coalition government– was one of fiscal slippage, the final year is also likely to be a deviation from its avowed intent of fiscal consolidation. This year's fiscal deficit is likely to be above the target of 4.8% of GDP due to increased public expenditure.

There may also be revenue shortfalls due to the setback to the economy after the Easter Sunday bomb blasts and the consequent economic slowdown.

Populist expenditure

The government's populist expenditure in the runup to the forthcoming elections is likely to expand the fiscal deficit to over 5% of the GDP. This would destabilise the economy and affect medium term economic growth.

Fiscal consolidation

The government committed itself to a programme of fiscal consolidation in 2016 after the fiscal deficit reached as much as 7.6% of GDP in 2015 owing to increased expenditure after the election of the President in January and before the parliamentary election in August that year. A fiscal deficit of this magnitude was unsustainable. Consequently, the government committed itself to progressively reduce the deficit and bring down the fiscal deficit to 3.5% of GDP in 2020.

Significant progress was achieved in 2016, 2017 and 2018 by increased revenue collection that brought down the fiscal deficit to 5.7% of GDP in 2016, 5.5% in 2017 and to 5.3% in 2018.

The objective was to bring down the fiscal deficit to 4.8% this year. However, this year's fiscal deficit is likely to exceed the target of 4.8% of GDP owing to expenditure overruns and revenue shortfalls. And the fiscal deficit target of 3.5% of GDP in 2020 is also unachievable as next year is the year of parliamentary elections.

This year the fiscal deficit is likely to be over 5% of GDP. In the first quarter of this year the fiscal deficit was 6% of GDP.

Increased expenditure

Although the fiscal deficit was expected to be contained at 4.8% of GDP last year this was not realised for several reasons, including the political anarchy in the latter part of the year. Consequently, the fiscal deficit increased to 5.3% of GDP last year.

Additional expenditure

The increased expenditure on salaries, pensions, employment of unemployed graduates, and increased Samurdhi payments are likely to increase public expenditure significantly. Enterprise Sri Lanka and loan concessions, among other additional expenditures are likely to increase government expenditure. On the other hand, the slow growth of the economy, the impact of the dip in tourism and lesser import duties are likely to result in a shortfall in revenue that would increase the deficit beyond the budget target of 4.8% of GDP. The April bomb blasts and new concerns in security will entail higher public expenditure. Compensation for victims of the April violence is a further additional public expenditure.

Revenue

There is also the possibility of some measures of tax relief that would expand the fiscal deficit by decreasing revenue. The fall in imports would also result in lower revenue from imports. Furthermore, the depreciation of the rupee is increasing the rupee cost of debt servicing that would also impact adversely on the fiscal outturn. The treasury has already admitted a significant shortfall in revenue collection in the first half of the year.

Concluding reflections

Fiscal discipline is difficult to expect in the current political context. The populist budget and subsequent actions of the government would derail the much-needed fiscal consolidation.

The increased fiscal deficit will undermine economic stability in several ways. A large deficit generates inflationary pressures, increases the public debt, distorts public expenditure, reduces export competitiveness and increases the trade deficit.

These destabilising features of large fiscal deficit are not understood by the public that holds the erroneous view that government has unlimited funds to give the public.

Consequently, governments seeking re-election are profligate in their spending. This irresponsibility is a conspicuous feature of the country's political economy.

For the full article – Refer The Sunday Times

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2. The issue of an independent Central Bank Should it be or should it not be
By: W.A. Wijewardena

- The prospect of a new Monetary Law Act (MLA), to improve the independence of the CBSL, has given rise to a debate on its pros and cons. The central bank's independence is important given that the people trust the central bank to preserve the value of their money and avoid inflationary pressures.

- In Sri Lanka, the current MLA restricts the Finance Minister from giving directives to the central bank. Such directives are only given as the last resort when the monetary board and the government cannot agree on a policy, where the government will have to take responsibility for the implemented policy. In essence, this provides the bank with both policy and budgetary independence.

- Such independence allows the employees to work independently and the bank to incur interest expenditure to absorb any excess liquidity. This in turn would result in the citizens' money being free of undue interference from politicians. Thus, the central bank's independence is important and desirable as pointed out by many ex-governors, despite the critics pointing out that monetary and fiscal policies should work in tandem and that a little inflation is always desirable for a developing economy.

With the news release that the Government is going to introduce a new Monetary Law Act, commonly known as MLA – the law under which the present Central Bank (CBSL) has been established – to make the Bank more independent, many concerned citizens have begun to express their views on the subject.

People trust central banks if money value is preserved

CBSL is an important subject in which citizens should get themselves engaged in a public debate if there is any move to change its governing law. This is because every citizen has a stake in CBSL: the paper money issued by it is being held by all as a way to keep a part of their wealth or to make payments.

If the value of the paper money so held falls against the prices of goods and services, it would lead to inflation where people stand to lose. The loss comes from the fact that they become poorer since the paper money they hold now can command a smaller basket of goods and services than before. In such a situation, it is inevitable that citizens will lose faith in CBSL as well as the paper money issued by it.

If, on the other hand, the value of this paper money is kept stable over time, it will cause the citizens to have faith in both CBSL and its money, which is essential for an economy to conduct its transactions and ensure the continuous production of goods and services that would bring prosperity to all.

CBSL and the Government are two arms of the State

The legislators who approved of MLA in 1949 had decided to set up the Bank as a semi-autonomous institution within the sovereign state of Sri Lanka. In this case, it is important to remember that both CBSL and the Government are two arms of the State created for the common benefit of citizens. Hence, neither one should override the other.

Two types of Central Bank independence

In terms of the law, the Bank enjoys two types of independence which other government bodies do not have.

- Policy Independence - related to the policy measures which the Bank has to adopt for maintaining the stability of the general prices in the economy.

- Budget Independence - independence it enjoys to handle its budget without going through the normal budgetary process which other public institutions have to compulsorily comply with.

Finance Minister cannot issue directives to the Central Bank

Though the Bank is listed under the Ministry of Finance for administrative purposes, the Minister cannot issue any policy direction to the Bank as in the case of other public institutions which come under his purview.

Hence, the Central Bank's monetary policy – the policy to change interest rates and the quantity of money and credit in the economy – is a preserve of the Monetary Board which is specifically entrusted by Law to do the job. This vital power is given to the Board in order to protect the value of the money being held by the public. As such, it is the responsibility of the Monetary Board to keep such price increases within permissible limits by keeping money supply increases in check.

The permissible limit of price increases is simply the rate of increase in prices that would not discourage money holders to make long term choices concerning consumption, investment, saving or working. It is generally accepted that this limit pertaining to Sri Lanka is about 4% per annum. Any price increase above that limit is therefore considered injurious to the economy.

Government can change monetary policy but should take responsibility

If there is any disagreement between the Monetary Board and the Minister of Finance about the appropriate interest rate policy, the present MLA has called both parties to reach agreement on the appropriate policy. However, if an agreement cannot be reached, taking into account the sovereign powers of the sovereign state, MLA has permitted the Government's view to prevail on the Central Bank. Accordingly, the Minister of Finance has been empowered to give direction to the Monetary Board to implement the Government policy having informed the Board that the Government will take responsibility for any consequence of adopting such policy.

Job security of Governor, Board members and senior officers

The Central Bank has been given budget independence to attain two objectives.

- One is that its employees can work independently without the fear of losing their salaries if they do not yield to the pressure of the Government.

- The other is that the Bank can incur interest expenditure without Finance Ministry approval to take out excess liquidity from the market by issuing its own interest bearing securities.

To strengthen these goals, there are several other provisions that have been introduced to the current MLA.

- One is the tenure and the removal processes relating to the CEO of the Bank, the Governor, and the policy deciders of the Bank, Monetary Board members. The Governor is to be appointed not by the President. Once appointed, he holds office for six years.

- Similarly, the Monetary Board members, other than the Secretary to the Ministry of Finance, are to be appointed by the President for a period of six years on the recommendation of the Minister of Finance and with the concurrence of the Constitutional Council set up under the Constitution.

- The removal of both the Governor and the Monetary Board members, except again the Secretary to Ministry of Finance, cannot be done arbitrarily and there is a set procedure that has to be followed in that connection. Similar provisions have been made in MLA with respect to the removal of Deputy Governors, the next level senior officers in CBSL.

Central Bank independence is for citizens

Central Bank's independence is not independence of those who work in the Bank. It is the independence of the citizens from undue interference from politicians who desire the Bank to print money and help them finance budgets that basically allocate resources for unproductive purposes in the absence of a mechanism for deciding on priorities in the economy.

Critics of Central Bank independence

Those who argue against Central Bank independence normally present two views to support their arguments.

- One is that both monetary policy and fiscal policy should work together to create wealth in a country.

- The other is that for a developing economy like Sri Lanka, a little bit of inflation is always desirable in the initial stage of economic development.

Money is not a real product but a mental thought

Both these arguments are based on a misidentification of money's role in an economy. Money as against a real good, say like rice, is only a mental notion without any real existence. It, therefore, assumes only a nominal role. It can facilitate the acquisition of a real good like rice or a house, if people are willing to use it to make payments for same.

Hence, in ushering economic prosperity, money is only a facilitator and not a real contributor. Real contribution, as the first Singaporean Finance Minister Dr. Goh Keng Swee said in 1991, comes from hard work done by people of all walks of life –and not from the money printed by the Central Bank.

In today's context where the world is moving toward the Fourth Industrial Revolution, it is not just hard work but 'smart work' that would bring prosperity to a country. Central banks can only facilitate this process by keeping price changes in check or keeping inflation within limits. The real contribution should come from the Government which is in a position to influence the real production of goods and services.

Woes of ex-Central Bank Governors

In this background, it is encouraging that four ex-Chairs of USA's Federal Reserve System – Paul Volcker. Allen Greenspan, Ben Bernanke and Janet Yellen – have called for making the Federal Reserve System independent of the government

Several former Governors of the Reserve Bank of India have done better by calling for greater autonomy for the Bank throughout the period. Highlighting the danger of RBI functioning as an arm of the Ministry of Finance.

A critic might say that these ex-central bankers had been responsible for compromising the independence of the respective institutions while they held office. But, their value judgment based on experience should not be discounted by those who aspire to have a stable money system.

For the full article - Refer Daily FT