Spotlight: Econ Op-eds in Summary

Week ended 1st September '21

In Summary

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

1. Dwindling worker remittance inflow tightens foreign exchange market
By: Professor Sirimevan Colombage

- Remittance inflows is a key source of foreign exchange earnings for Sri Lanka, accounting for 25% of total foreign exchange earnings. Though remittances broke its downward trend in 2020, it returned to this trend in 2021, putting pressure on the rupee to depreciate. The CBSL's attempt to prevent the LKR from depreciating has failed, with the black-market exchange rate being significantly higher than the official CBSL rate.

- This divergence in rates between the CBSL and the black-market has incentivized migrant workers to channel their remittances through informal channels instead of through banks. This is a reason for concern as past governments have postponed adjustments required to improve the external sector competitiveness, as worker remittances have helped mitigate external sector pressure to an extent.

- In fact, there hasn't been any significant progress to ensure that the export sector benefits from utilizing modern technological inputs, in contrast to countries like South Korea. Thus, a shift away from the overdependence on remittance inflows and policy implementation aimed at promoting export-led growth is key in improving external sector imbalances.

Reflecting the global economic setback caused by the COVID-19 pandemic, Sri Lanka's worker remittances are on a declining trend since the beginning of this year. The domestic economic uncertainties, particularly with regard to foreign exchange market distortions, also seem to have contributed to the fall in inward remittances.

Worker remittances contribute one fourth of the country's foreign exchange earnings, and they account for nearly 10% of GDP. Hence, the decline in worker remittances will exert immense pressures on the foreign exchange market, which is already hit by export stagnation, breakdown of the tourist industry and heavy foreign debt settlements. The remittance shortfall is likely to further weaken the rupee, given the scarcity of dollars in the market in the backdrop of historically low level of international reserves fallen to $ 2.8 billion by now.

Worker remittances down

Worker remittances recorded a marginal increase of 2.6% in the first half of this year, compared with last year. This was due to the lower base in 2020. The monthly inflow of remittances is down from a peak level of $ 813 million in December 2020 to $ 453 million in last June.

The downward trend of remittances is rather alarming, since they have served as the lifeline in dealing with the balance of payments difficulties experienced during the past several decades. The average annual inflow of worker remittances amounted to $ 7 billion during the period 2016-2020, and it was sufficient to finance around 35% of the country’s import payments. This implies that the external payments deficit would have been much larger, if not for the inward remittances.

Exchange rate disparities among banks create uncertainty

The rupee has been under severe stress in recent months with a rapid decline in the country’s foreign reserves

Recently, the Central Bank has declared that the exchange rate will be maintained around Rs. 200 per dollar with a “gentlemen’s agreement” with commercial banks. This type of understanding is known as “moral suasion”, which means persuasion of commercial banks to be in agreement with the Central Bank’s decision. The Central Bank’s attempt to keep the exchange rate at Rs. 180 per dollar a few months ago was not successful, as it did not have sufficient foreign reserves to defend the rupee.

The buying and selling rates of the US dollar remain at Rs. 198 and Rs. 202, respectively, according to the indicative exchange rates published by the Central Bank based on the average currency rates quoted by commercial banks for Telegraph Transfers.

In contrast, last Friday, some private commercial banks were buying dollars from exporters at Rs. 215, and selling to importers at Rs. 222, as published in their websites. This has been the case during the past several weeks. The State-owned banks, however, maintain their rates within the indicative rate corridor published by the Central Bank, though it is unknown whether they adhere to such rule in practice.

Such wide exchange rate disparities among banks create severe market distortions, causing immense uncertainties among market participants. This may have motivated migrant workers to use informal channels to remit part of their money to Sri Lanka, instead of relying on banks.

Black market offers attractive rates

Higher dollar rates offered in the informal market vis-à-vis the formal market seem to have been a significant factor that led to a decline in the worker remittances recorded in the balance of payments. The US dollar is said to sell in the black market at exorbitant rates of around Rs. 260 per dollar. Back market is a typical characteristic of a controlled economic environment.

Informal channels have been a popular means to transfer money across countries for many decades due to their lower costs and convenience, as against formal channels. The lower dollar rates offered by banks aligning with the Central Bank’s fixed exchange rate policy in recent times have been a major push factor for migrant workers to use channels such as Hawala – an informal fund transfer system in which money is transferred through a network of brokers (known as Hawaladars) without physical movement of cash across borders.

Economic reforms postponed

As inward remittance inflow has significantly contributed to mitigate Sri Lanka’s balance of payments difficulties over the last four decades, it has provided prolonged breathing space for the successive Governments to postpone the essential policy adjustments needed to facilitate export-led growth.

In particular, no significant attempt has been made to transform the export sector from low-technology and low-value added industries such as apparel manufacturing into high-technology industries applying modern technological knowledge inputs that require high research and development (R&D) investments.

In contrast, South Korea, which was an under-developed nation a few decades ago, soon became a high-income country by evolving export strategies to produce state-of-the-art consumer electronics and modern IT. High-tech exports are products with high R&D intensity such as computers, pharmaceuticals, scientific instruments and electrical machinery.

Dutch disease

Another disadvantage created by worker remittances has been its influence on the country's exchange rate management. The remittances cushioned the balance of payments deficits to a great extent over the decades, and therefore, such inflows have prevented the depreciation of the rupee that would have been required otherwise to maintain export competitiveness.

This phenomenon is known as the "Dutch disease," which refers to the adverse implications of substantial increases in a country's foreign exchange earnings due to factors such as discovery of oil reserves. In the 1960s, the discovery of large natural gas deposits in the North Sea led to a rapid increase in wealth of the Netherlands. As a result, the Dutch guilder became stronger, eroding export competitiveness.

Similarly, in the case of Sri Lanka, inward remittances have helped to maintain the rupee at an overvalued exchange rate over the years causing anti-export bias.

Policy perspectives

The economic setback amidst the COVID-19 pandemic reflects the formidable challenges faced by Sri Lanka in dealing with such an unprecedented external shock, as in the case of the rest of the world. Given the continuation of the pandemic, the economy will continue to be adversely affected by low levels of both worker remittances and tourist earnings for a longer time. The external payment imbalance has been exacerbated by accumulated foreign debt to be settled in the near future.

The distortions in the foreign exchange market manifested by the fixed exchange rate system adopted by the Central Bank have intensified the transfer of remittances through informal channels, thereby causing a significant loss of foreign exchange to the country.

While implementing the short-run policy adjustments pertaining to the foreign exchange market to attract worker remittances, overdependence on remittances needs to be phased out in the medium-term by adopting robust policy strategies targeting export-led growth.

For the full article – Refer Daily FT

2. Addressing fundamental economic issues is imperative
By Nimal Sanderatne

- Sri Lanka's critically low foreign reserves had recently resulted in restrictions in importation of essential items, burdening people with shortages and soaring prices of goods. Core structural weaknesses as well as fragile state of the economy can be highlighted as the root causes of the present foreign currency crisis.

- To overcome this crisis, a sound long term strategy based on an economic analysis is a must. This needs to be a public backed plan that could regain the lost credibility of Sri Lanka. Regaining credibility will allow Sri Lanka to raise funds at international markets at reasonable rates. It is also imperative that the Government's policies remain consistent in order to resolve the current economic issues.

- Recently the government has initiated measure to increase its reserves through currency swaps, lines of credit, and loans. However, in order to recover the economy in a sustainable manner the country will have to develop a long term vision on economic and social development, make decisions on the basis of economic development rather than social interest and make bold and logical decisions based on scientific facts.

The country is facing a plethora of economic problems. The one most discussed of these has been the critically low level of the country's foreign currency reserves. This has drawn the most attention as the import of essential items is being restricted and the day-to-day life of the people is increasingly burdened by scarcities and soaring prices.

Structural weaknesses

In fact, the foreign currency crisis is a manifestation of structural weaknesses and fragile state of the Sri Lankan economy. The persistent fiscal and trade deficits, enormous losses in state enterprises, wasteful expenditure on unprofitable infrastructure projects are prime examples of economic mismanagement.

Economic problems

The fundamental economic problems include the accumulated and increasing public debt that requires a very high proportion of Government revenue to be used for debt servicing. This starves developmental needs and distorts priorities in public spending.

The correction of these and enhancing productivity are crying needs of the economy. Corruption is a root cause of many of these problems and the inability to solve them.

Foreign reserves

However, the crisis in foreign reserves has been the main focus of discussion owing to its severity and impact on the availability of essentials. There has been much debate whether the Government should turn for assistance to the International Monetary Fund (IMF) or not.

In fact a recent seminar titled "How to resolve Sri Lanka's debt crisis without seeking assistance from the International Monetary Fund (IMF)" was expected to address this issue. What turned out to be its main thrust and contribution was the vital contribution of Dr. Nishan de Mel that a longer view of the nation's fundamental economic problems are needed and that a long term sustained strategy was needed.

Advocata Institute seminar

At this seminar, Dr. Nishan De Mel, Executive Director of Verité Research, raised fundamental and critical issues concerning Sri Lanka's sustained economic development rather than answer the question whether the country should seek IMF assistance to resolve the debt crisis. Yes, IMF is one of the solutions to the current crisis, but what we need is a sound long term strategy based on an economic analysis.

Good economic analysis

Dr. Nishan De Mel hit the nail on the head when he said: "Whatever Sri Lanka decides about dealing with its debt and paying its way through the world, the country needs to formulate a very good economic analysis and a publicly-backed plan that will establish credibility of the world in its economy going forward." This is the critical issue.

Further, he said: "Such an analysis needs to be thorough and well-structured with the focus on real economic activity and the financial conditions in the economy. That would be the first step to build credibility of the world about the Sri Lankan economy.

Credibility

Dr. De Mel emphasised that it is credibility that we lack rather than foreign reserves. If we can build that credibility about us in the countries that we deal with, we may not need assistance from the IMF to resolve our liquidity issue. When such a favourable environment is created and other countries repose their trust in Sri Lanka's economy, its sovereign credit ratings would see an upgrade and Sri Lanka would be able to raise funds at the international capital market at reasonable interest rates, The skill we need for this is to present an analysis and a plan and then demonstrate our commitment to stick to it."

Plan

Further he said: "Whatever Sri Lanka decides about dealing with its debt and paying its way through the world, the country needs to formulate a very good economic analysis and a publicly-backed plan that will establish credibility of the world in its economy going forward." This was the important thrust of Dr. Nishan de Mel's presentation at the Advocata Institute seminar.

Paramount need

The paramount need for the country's economic recovery is an analysis of the causes for the economic crisis and well thought out plan for stabilisation of the economy and a longer vision for economic development. Policy formulation he said lacked addressing the core issues of the economy.

The fundamental weaknesses, he stressed, was the inability to have a longer perspective and vision to resolve the core problems in the economy.

Obita dicta

In addition, we may add that the Government's ill-considered policies have weakened the Government's finances and capacity to resolve issues. They have even aggravated the weaknesses in the economy by reducing production, employment, incomes and livelihoods of people. The weakening of the country's fiscal position and the reduction in agricultural production are prime examples of these mistakes.

These mistakes are in a context of a rapidly spreading COVID pandemic that increases Government expenditure on vaccines, health care and needed Government interventions to alleviate the increasing poverty and deprivations of the unemployed and destitute. In this context of increased Government expenditure, instead of enhancing Government revenue, it has reduced Government revenue. The fiscal deficit is expected to rise to a phenomenal 14 per cent of GDP this year. This is a serious destabilising factor in the economy.

Firefighting

What we have witnessed this year is a firefighting exercise; Finding solutions to emerging critical problems, especially the repayment of debt and replenishing the perilously low foreign reserves of the country by various palliatives. Currency swaps, lines of credit and loans to buttress the reserves that have fallen to less than US$ three billion are the

Government's economic preoccupations. These foreign currency arrangements are undoubtedly critically important in the current crisis, but do not solve the fundamental problems of the economy.

Concluding reflection

Is there recognition that the country lacks a long run vision of the country's economic and social development? Are the decision makers deciding policy on their whims and fancies rather than rational long run economic and social interest?

Is there a political resole to face up to the severity of the economic problems and take bold decisions? Do we have a form of Government that could take decisions in a scientific and rational manner rather than for short run political advantage?

Regrettably the dictum that good economics is bad politics in the short run and good politics only in the long run is a truism.

For the Full Article – Refer The Sunday Times