Spotlight: Econ Op-eds in Summary

Week ended 20th August '21

In Summary

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

1. Rupee under stress as trade deficit expands
By: Professor Sirimevan Colombage

- The country's trade deficit expanded in 1H2021 despite a recovery in exports as the import bill surged. In conjunction to this, a sharp reduction in foreign reserves has put increased pressure for the currency to depreciate. Despite moral suasion efforts by the CBSL, banks have reported buying dollars from exporters at Rs. 210 while selling to importers at Rs. 215, with the black-market rate being even higher.

- Currency depreciation can have significant impacts on worsening the country's debt burden as the CBSL is unable to maintain the rupee at a desired level due to a lack of foreign reserves, which currently only provide an import cover of 2½ months. Excessive borrowings by the government has resulted in a sharp increase in money supply, putting pressure on wages and currency depreciation.

- Money printing can be counterproductive for an economy as it can lead to accelerating levels of inflation and a wider trade deficit. Several policy adjustments are necessary to correct macroeconomic imbalances prevailing in the economy. To this end, the rupee should be allowed to float freely and an inflation targeting policy framework should be set up alongside the maintenance of fiscal discipline.

Amidst the foreign exchange crisis intensified in recent months, the Central Bank has been attempting hard to manage the currency float so as to prevent a free fall of the rupee. Meanwhile, exporters are reported to have been lobbying the Government to depreciate the rupee to restore export competitiveness.

The trade deficit expanded in the first half of this year despite a remarkable recovery of exports during the pandemic. This was mainly due to the substantial increase in imports of intermediate and investment goods reflecting the revival of economic activities. Consumer goods imports too rose in spite of the import restrictions that are in force.

The country's foreign reserves depleted as a result of the external payments deficit compounded by heavy foreign debt repayments, causing a severe dearth of dollars in the forex market.

Black market exchange rate much higher

The indicative exchange rate has remained around Rs. 200 a dollar in the past couple of weeks, as per daily figures published by the Central Bank (Chart 2). But commercial banks are buying dollars from exporters at Rs. 210, and selling to importers at Rs. 215 levels, according to media reports. This is happening in spite of a request made by the Central Bank to commercial banks to maintain the exchange rate at Rs. 202/204 levels.

The US dollar is said to sell in the black market at exorbitant rates of nearly Rs. 260 per dollar. Back market is a typical characteristic of a controlled economic environment.

As I predicted in this column last February, the Central Bank cannot hold the exchange rate at an artificially fixed level for long, while entertaining low interest rates and free capital flows at the same time, in terms of the "policy trilemma" or "impossible trinity". No central bank can escape this time-tested rule.

CB adopts moral suasion to stabilise the rupee

Central Bank Governor Prof. W.D. Lakshman, in a recent TV interview on Derana's Hyde Park, mentioned that the rupee has depreciated in the recent past due to the pandemic, although the present Government promised to maintain a stable exchange rate. But now the Central Bank is maintaining the official exchange rate at a certain level through moral suasion, he says. Moral suasion means persuading commercial banks to cooperate with the Central Bank to adopt a particular monetary policy measure.

The Governor further stated that the exchange rate is the price which affects not only imports and exports, but also various other things including people's cost of living and the Government's debt burden. Hence, he emphasised the need to avoid a substantial depreciation of the rupee.

It may be noted here that the Central Bank attempted to keep the exchange rate at Rs. 180 a dollar a few months ago without success.

The Central Bank's position on the exchange rate is understandable, given the ramifications of a rupee depreciation. For instance, the Government would have incurred an additional domestic currency cost of around Rs.1 bn in settling the International Sovereign Bond of $1 bn last month, had the currency depreciated by one rupee more.

While admitting that it is difficult to stabilise the exchange rate, Prof. Lakshman stated that export promotion is imperative to overcome the current account deficit in the balance of payments persisted over several decades.

But it is questionable how export promotion could be carried out while keeping the exchange rate at an administratively fixed level as at present, eroding export competitiveness. Currently, exporters are lobbying the Government to depreciate the rupee so as to make their exports competitive in global markets. They have requested to depreciate the rupee to Rs. 230 a dollar.

Further depreciation of the exchange rate would be unavoidable in time to come with the erosion of export competitiveness emanating from inflationary pressures manifested by excessive money growth.

Dirty float?

Sometime ago, the Central Bank sought to maintain the exchange rate at a desired level by supplying dollars from its foreign reserves. This is not possible now, as the Central Bank does not have sufficient reserves. Therefore, it exercises the tactic of moral suasion.

My former colleague Dr. W. A. Wijewardena, in a recent FT column, rightly states that the Central Bank tries to adopt an unconventional tactic that could be called 'immoral suasion' or arm-twisting of the forex dealers in commercial banks.

This kind of undue central bank intervention in the forex market is also known as 'dirty float'.

Balance of payments deficit rising

In spite of the significant recovery of exports, the trade deficit expanded by $ 1.1 bn to $ 4.3 bn in the first half of this year from $ 3.3 bn in the same period last year on account of rising imports. Worker remittances increased while tourist earnings remained at minimal levels during the first half of the year.

In the financial account, both foreign investment in the Government securities market and the stock market recorded net outflows, and foreign direct investment continued to remain low. Hence, the overall deficit in the balance of payments rose to $ 1.3 bn in the first half of this year, resulting in a depletion of foreign reserves. The country's usable foreign reserves are down to $ 2.8 bn, providing an import cover of only 2½ months.

Poor debt dynamics

The widening balance of payments deficit aggravates Sri Lanka's debt sustainability, which is already in bad shape. A country's public debt is considered sustainable if the government is able to meet all its current and future debt payment obligations without exceptional financial assistance or going into default. While Sri Lanka has maintained its unblemished record of debt repayment so far, as frequently claimed by the authorities, it should be noted that such prompt settlements were done through continuous foreign borrowings.

The situation has become so worse now that even foreign borrowings are constrained owing to the country's low sovereign credit ratings. Therefore, the Central Bank is compelled to exhaust its foreign reserves for debt settlements.

Merits of flexible exchange rates

The basic idea behind exchange rate flexibility – depreciation or appreciation of the domestic currency against foreign currencies depending on market forces – is to alter the relative domestic profitability of tradable. The tradables consist of exportables and importables. The domestic prices of tradable goods are determined by the global factors and the exchange rate, plus international transport costs, tariffs, and export subsidies, if any. The prices of nontradables, largely consisting of services, are determined by domestic supply and demand.

A depreciation of the rupee results in an increase in the domestic prices of exports and imports, thereby raising the price of tradables relative to nontradables. This encourages production of exports, and discourages imports, and thereby helping to reduce the balance of payments deficit. Thus, the exchange rate works as an equilibrating tool or a shock absorber in a flexible exchange rate regime.

In contrast, under a fixed exchange rate regime, a balance of payments deficit or a surplus directly affects the country's foreign reserve stock, and in turn, the monetary base and the money supply. Hence, the monetary authority does not have the freedom to conduct monetary policy at its will in such an environment.

In a flexible exchange rate regime, the monetary authority can exercise independent monetary policy, since external imbalances are transmitted to exchange rate movements, instead of reserve movements.

In the absence of a self- equilibrating mechanism under the fixed exchange rate regime, administrative controls such as import restrictions become necessary. Import and foreign exchange restrictions imposed in Sri Lanka since last year are a good example. Such restrictions could have been avoided, had the exchange rate been allowed to be determined by market forces.

Money creation is wrong treatment to the ailing economy

As reiterated in this column previously, excessive borrowings by the Government from the banking sector has led to a substantial increase in the money supply. Net bank credit to the Government rose by 44% over the last 12 months resulting in an increase in the money supply by 22%. The excess liquidity in the economy has raised domestic expenditure, exerting demand pressures on imports. It has also exerted pressures on the prices of nontradables and wages.

As the Central Bank has kept the rupee at a pre-determined rate through moral suasion, the role of the exchange rate as an equilibrating mechanism is lost by now. Therefore, import controls have been introduced since last year to curb the trade deficit.

Justifying the excessive currency issues by the Central Bank, State Minister Ajith Nivard Cabraal, in a recent interview with the Daily Mirror, has stated that money printing is like drastic treatment to a major illness (Daily Mirror, 2 August).

But I would like to counter-argue that money printing is wrong treatment to the ailing economy that might lead even to killing the patient! Money creation will only aggravate economic sicknesses by widening the trade deficit and accelerating inflation.

Policy directions

Although the export sector has recovered remarkably in spite of the pandemic, export earnings still remain below the pre-pandemic levels. It is important, therefore, to consider removing the obstacles that hinder export growth. In particular, maintaining the exchange rate at an artificially fixed level is detrimental to export competitiveness. Import restrictions are only a temporary solution.

In a broader sense, it would be necessary to revisit the macroeconomic policy strategies with a fresh approach. It is understandable that drastic policy reforms cannot be adopted during these hard times, in the backdrop of the pandemic. But the policymakers need to be humble enough at least to recognise the grave economic crisis on our doorstep, instead of painting a rosy picture of the ailing economy.

No economic strategy will be successful, unless policy adjustments are carried out to rectify the macroeconomic imbalances. As reiterated in this column many a times previously, the fiscal deficit – the root cause of most economic ills – needs to be pruned down by means of revenue mobilisation and expenditure cuts.

Ideally, fiscal discipline should be enforced effectively paving the way to set up an inflation targeting monetary policy framework while permitting free float of the rupee.

For the full article – Refer The Daily FT

2. Confusion and uncertainty on banning chemical fertilizer
By Nimal Sanderatne

- There is a considerable confusion whether the ban on chemical fertilizer is lifted or not. Mostly this is due to contradictory statements issued by Finance Minister, Secretary to the Finance Ministry and Secretary to the Treasury as well as President's office. Finally, basic elements of fertilizer Nitrogen, Phosphorus and Potassium with mixtures of fertilizer are permitted.

- In nation's Agriculture perspective the priority is to increase the production as well as the livelihood of the farmers and country's economy. Lack of fertilizer will affect negatively towards Sri Lanka's external finances. It will also decrease food availability, increase food prices and food import expenditure. Decrease in Tea production will affect the export earnings.

- Scientists, agronomists, crop and soil scientists and economists all have pointed out that a sudden fertilizer ban would overall do more harm than good for the country. Rather, a phased substitution of organic is much suited. Finally, it would be better if Sri Lanka could achieve the necessary agricultural production next year to feed the population, if not the outcome will be adverse towards the economy.

There is considerable confusion and uncertainty as to whether the ban on chemical fertiliser was lifted or not. Is it or is it not?

Confusion

The Finance Minister issued a statement that was widely interpreted as a removal of the ban on chemical fertiliser. This was immediately contradicted by the Secretary to the Finance Ministry and Secretary to the Treasury that there was no change in the fertiliser import policy.

President's office

Soon after, a statement from the President's office stated categorically that there has been no change in the fertiliser ban. On the other hand, several categories of fertiliser are allowed to be imported.

Such contradictions are not uncommon in the country's post-independent history. A celebrated paradox was the 'Sinhala only Tamil also policy'.

An interpretation

How do we interpret the current policy on fertiliser?

In as far as we can interpret the Government's revised fertiliser policy, the three basic elements of fertiliser— NPK-Nitrogen, phosphorous and potassium —will be permitted under licence. Nitrogen imports are to increase the nitrogen content in organic fertiliser. Other chemicals are also to be permitted to meet the nutrient deficiencies of organic fertiliser.

Furthermore, the import of mixtures of fertiliser are permitted. These include, superphosphates under phosphate and the essential fertiliser elements – nitrogen, phosphorus and potassium and other chemicals will be permitted.

Chemical or organic?

This leaves some doubt as to whether the fertiliser available to farmers would be organic! What is clear is that these imports would be permitted on licences and on a restricted basis. It is most likely that further adaptations to fertiliser import policies would be made as problems emerge.

Adequate fertiliser

In as far as the nation's agriculture is concerned, the livelihood of farmers, the country's food production and the economy, adequate fertiliser by whatever name that increases production is best.

Consequences

If the ban on chemical fertilisers is confirmed certain and irreversible, the nation would have to face its horrendous economic and social consequences that has been pointed out by the scientific community. In contrast, the importation of the three basic elements of fertiliser; NPK, is a great leap forward.

Explanation

The Government's explanation of the apparent confusion is that "The Government has not granted permission to import chemical fertilisers for local agricultural purposes, neither has it made any changes to the decision taken by the President to use only organic fertilisers for local agriculture. And there will be no changes to this decision in the future either."

However the statement added that Cabinet had granted approval to the proposal made by the Minister of Agriculture on May 31, to import plant nutrients – which included natural chelated minerals and micro matter. While these natural chelated minerals and micro matter were already being imported under the HS Code, it was prohibited by the gazette notification No. 2226/48. Therefore, to grant Cabinet approval to the aforesaid Cabinet paper submitted by the Minister of Agriculture, the gazette notification No. 2226/48 was amended.

"Therefore, in accordance with the Imports and Exports (Control) Regulations No. 11 of 2021 issued by the Minister of Finance on the July 30, only the following types of specialised fertilisers are allowed to be imported through the Department of Agriculture and other relevant institutions under a special licensing system. Only organic fertilisers, which are up to the International Organic Fertiliser Standards, will be allowed to be used for local agricultural purposes."

Suitable fertiliser

If farmers obtain fertiliser that is suitable for their crops by whatever regulation and means, the country would avoid an economic and social disaster of a huge magnitude. Otherwise, the nation would face horrendous economic and social consequences while COVID is spreading exponentially.

Vibrant discussion

There has been a vibrant discussion on the agronomic and economic consequences of the fertiliser ban in the media, among the scientific community and agricultural economists. Yet, as is often the case, these do not appear to have had any influence on policy makers.

Adverse consequences

Scientists, agronomists, crop scientists, soil scientists, agricultural economists and economists have pointed out the adverse consequences of a fertiliser ban on crop production. These have gone unheeded. Consequently, if the new fertiliser policy fails, the country would have to face dire economic and social consequences.

Economic consequences

The ban of chemical fertilisers, weedicides and pesticides would have dire economic consequences on agricultural production, livelihoods of farmers and external finances of the country. It would reduce production of the staple rice, food crops and export crops. Consequently, it would impoverish farmers, decrease food availability, increase food prices and reduce accessibility of low incomes to adequate food. There is a serious threat to food security later this year and in 2022.

Fertiliser imports

Although the ban on fertiliser imports are expected to save US$ 450 million (actual fertiliser imports are much less, only about US$ 250 million), there would be an increase in import expenditure, due to reduced food production.

Imports

The shortfall in rice production would entail imports costing several-fold the expenditure on fertiliser imports, especially as international grain prices are escalating. Tea production in smallholdings would reduce export earnings and worsen the country's weak external finances.

Livelihoods

The loss in agricultural production means a sharp loss of farmer incomes and a threat to the livelihoods of a large proportion of the country's population.

Advice

Considering these economic consequences, the scientific community has advised the Government to adopt a phased introduction of organic agriculture on scientific principles and realistic possibilities.

Social and political consequences

The decision to ban the import of chemical fertiliser in one stroke of the pen was undoubtedly a rash decision that was not based on scientific advice. It did not take into consideration either its economic or social consequences or even political repercussions. Perhaps it is sober second thoughts that prompted the gazette notification of the Finance Minister. Its ambiguity may be a means of modifying the ban.

Summing up

The quintessence of the issue is whether the farmers of this country will be able to produce their crops at their attained levels of productivity to ensure their livelihoods and meet the nation's food requirements. Will smallholder tea cultivators who produce the bulk of the country's tea for export be able produce tea for export?

The essential need is to ensure the nation's agricultural production to feed the population and not weaken the perilous external finances by increasing food imports and reducing agricultural exports, especially tea.

Conclusion

Will these economic objectives be achieved by banning chemical fertiliser, importing certain fertiliser components, including NPK, or by importing and producing organic fertiliser?

If the answer to these questions are in the affirmative there would be no economic or social problems next year. If not, the consequences could be horrendous.

For the full article – Refer The Sunday Times