Spotlight: Econ Op-eds in Summary

Week ended 21st October '20

In Summary

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

1. Understanding the Indo-Lanka economic relationship
By: Pathfinder Economic Alert

- Indo-Sri Lanka trade relationships carry a number of tailwinds that can be positive for Sri Lanka. India's regional focus and the willingness of regional firms to partner within the everchanging global supply chain rearrangement are key among these, and Sri Lanka's integration within these could prove quite helpful for the country.

- Although Sri Lanka does have an existing free trade agreement, the bilateral trade deficit has become a sticking point. However, most of the deficit between the countries come from imports from India falling beyond the scope of the FTA. In fact, Sri Lanka enjoyed a surplus of $ 291 mn on the preferential trade that took place under the FTA in 2019, and even that can improve.

- As such, with Sri Lanka's exports to India being only a negligible portion of India's imports, the scope exists for India to show great flexibility in accommodating Sri Lanka in its bilateral negotiations on the ETCA (Economic and Technology Cooperation Agreement). Sri Lanka, in turn, needs to be sensitive to India's strategic interests, so as to further develop the Indo-Lanka relationship.

Sri Lanka-India relations are multifaceted and are characterised by strong civilisational links that span many millennia. Currently, trade and economic relations are structured around an institutional and legal architecture which includes regional platforms such as SAARC and BIMSTEC; as well as bilateral agreements such as the Indo-Sri Lanka Free Trade Agreement (ISLFTA), the bilateral investment promotion and protection agreement, the double taxation avoidance agreement and several MOUs involving Chambers in the two countries.

In addition, India has also been a source of concessional and grant assistance. The Exim bank of India has provided $ 1.8 bn by way of credit lines over the years, much of it to develop the railway sector. There have also been a variety of grants for the resettlement and rehabilitation in the post-conflict areas, and most notably, recently there has been grant assistance to establish the all island emergency ambulance service (Suwaseriya), which is greatly appreciated by the people of Sri Lanka. India has also provided many capacity development programs for both the public and private sectors in Sri Lanka.

On the principles that should underlie a bilateral relationship between two very asymmetric economies, a rules-based framework is very much in the interest of the smaller country because ad-hoc transactional relationships work to the disadvantage of the smaller economy which has less leverage. At the present historical conjuncture, the geopolitics of the Indian Ocean region do give Sri Lanka some leverage. However, as a general principle there is evidence from around the world that rules-based agreements favour the smaller countries.

However, for this to happen such bilateral agreements should be based on the twin principles of non-reciprocity and special and different treatment. India recognised these principles in negotiating the ISLFTA. Under the ISLFTA, India's positive list is longer; Sri Lanka's negative list is longer; Sri Lanka was given longer transition periods to fulfil its obligations This is a useful foundation for moving forward.

What are some of the tailwinds which make it propitious to strengthen bilateral economic and trade relations? One is India's Neighbourhood First Policy. There seems to be a political consensus in India around this policy and we have seen progress on the ground, particularly in the north-east of the sub-region. The BBIN (Bangladesh, Bhutan, India and Nepal) countries have made some progress in cooperating on energy, water transit and water management, as well as grid connectivity.

In the South, India has engaged more actively with the Maldives since the change of government there and very recently India has provided prompt assistance to Sri Lanka in dealing with the pandemic, which includes medical supplies, and the RBI has provided a SAARC SWAP arrangement of $ 400 mn. A further SWAP arrangement of a $ 1 bn and bilateral debt relief is being negotiated.

Of course, it is in India's strategic interest to have stability in its neighbourhood. In this respect, a stable and prosperous Sri Lanka will contribute materially to protect India's southern flank. Given the instability in the northern border of India, many of India's strategic assets are in the south of the country. In fact, Shivshankar Menon, in his book, wrote that "Sri Lanka is like an unsinkable aircraft carrier parked 20 miles off the coast of India." He has indicated that his intention was to highlight Sri Lanka's strategic importance for India. This can be utilised to achieve positive outcomes for Sri Lanka through an enhanced economic and trading relationship. Equally, India's commitment to prosperity in Sri Lanka would serve its interests in terms of stabilising and protecting its sensitive southern flank.

The second tailwind is related to the 'Make in India Strategy' (MIS) and the reconfiguration of global supply chains. If the MIS gains momentum, there is the prospect of replicating, in South Asia, what happened in East and Southeast Asia. When first Japan and then China rose economically, the countries in their neighbourhood were able to plug into Chinese and Japanese company supply chains and they all rose together. This is termed the "wild geese formation." Similarly, if India's industrialisation gathers momentum, there are likely to be opportunities where local companies could plug into the supply chains of an expanding manufacturing base in India.

The reconfiguring of global supply chains was already taking place before the pandemic. This was attributable to re-shoring because of the 4th industrial revolution. There was also some relocation of investment from Southern China due to rising costs. This process has accelerated significantly post-pandemic because of the greater preoccupation with diversification and resilience of supply chains. Pressures stemming from global trade, technology and geopolitical tensions are adding further momentum to supply chain reconfiguring. India stands to benefit from this.

In addition, by very successfully containing the COVID-19 virus, opening the economy early and demonstrating the resilience of supply chains, Sri Lanka is also in a position to gain from this trend. There is an opportunity for Sri Lankan companies to work together with Indian companies to attract these reconfigured supply chains.

The third tailwind relates to the improved infrastructure in both countries. There was proximity for millennia but very poor infrastructure in both countries created distance. Transaction costs were high thereby constraining commercial relations. Now, there is an improvement in infrastructure in both countries, bringing down transaction costs and providing new opportunities to develop cross-Palk Strait economic and trade links. In addition, this has improved connectivity and logistics. Colombo is a major transshipment port for India. Of the trans-shipment container handling in Colombo Port (2019) 82.4% involved India.

Port development in India and the new port in the Nicobar and Andaman Islands could change the parameters. However, India's economy was averaging 7% growth between 2015 and 2019. Though the Indian economy has been badly affected by the pandemic, the consensus is that it is likely to bounce back – with strong growth which should result in trade expansion. This should contribute to providing continued transshipment opportunities for the Colombo Port. There is also excellent air services connectivity. Prior to the pandemic, SriLankan Airlines had the highest number of arrivals per week in Indian destinations.

The fourth tailwind is the General Sales Tax (GST). It has had some glitches but if these are ironed out, the GST can become what it was marketed as: 'one nation, one market, one tax'. The creation of a single market can facilitate the ease of doing business in India. This is a positive in terms of promoting Sri Lankan businesses in India. The fifth tailwind is the increase in people to people contacts through tourism in both directions as well as other forms of contact through education, training, etc. All of the above taken together mean that there are a number of favourable factors which underpin the economic and trade relations between the two countries. They constitute a good foundation to build on. Another positive factor is Sri Lanka's proximity to South India. The five South Indian states have enjoyed high growth with a rapidly growing middle class. This is again a positive for Sri Lanka in terms of creating opportunities going forward.

Assessment of the ISLFTA

From a Sri Lankan perspective, there is a considerable body of opinion which feels that the ISLFTA has not been a success. Not only has it not been a success, but that it has positively damaged Sri Lanka's economic interests. It would be instructive to unpackage this narrative as it is much more nuanced than this simplistic conclusion. It can be a mistake to look at the bilateral deficit to try to determine the benefit of a trade relationship.

Since the signing of the FTA, in 2000, total trade has increased from $ 623 mn to $ 4.7 bn in 2019. Sri Lankan exports have increased from $ 55 mn to $ 763 mn. Imports from India to Sri Lanka have increased from $ 568 mn to $ 3.9 bn. There was, therefore, substantial trade deficit of $ 3.1 bn. This is what people are mistakenly displeased with.

The picture changes very materially if one examines trade that has taken place on items covered by the bilateral agreement. Total trade on a preferential basis, was $ 689 mn in 2019. Of this, Sri Lankan exports to India under the FTA amounted to $ 490 mn out a total of $ 763 million. This meant 64 % of Sri Lanka's exports to India were on a preferential basis. Sri Lankan imports from India under the FTA were only $ 199 mn out of a total of $ 3.9 bn. This indicates that only 5% of Indian exports to Sri Lanka were on a preferential basis. As a result, Sri Lanka enjoyed a surplus of $ 291 mn on the preferential trade that took place under the FTA, in 2019. It should be noted that 95% of imports from India have come into Sri Lanka because they were price competitive. If these were sourced from elsewhere, Sri Lanka's overall trade deficit would have been larger.

Even this presents a misleading picture. The ISLFTA benefits Sri Lanka, if you consider trade flows within its parameters. However, it can be a lot better. Impediments, such as non-tariff barriers, including sanitary and phytosanitary standards, quotas on key Sri Lankan exports, customs clearance procedures, excess documentation charges and delays mean there is considerable unrealised potential from a Sri Lankan perspective. There has also been the issue of Sri Lanka not being able to produce sufficient competitive supplies. This needs to be addressed through reforms to remove the anti-export bias in the domestic policy framework.

Economic and Technology Cooperation Agreement (ETCA)

There have been 11 rounds of negotiations; the last in September 2018. Very high priority should be given by both governments to revive these negotiations. Addressing India's non-tariff barriers up-front will be an important confidence-building measure. The FTA, at present, is only on goods and needs to be deepened and widened to allow product diversification. It should be extended to cover services in the interest of both countries. Here, the Sri Lankans are concerned about labour movement. The Government of Sri Lanka has been clear that mode 4, the movement of natural persons, will not be included in this Agreement.

Some of the skill gaps, particularly in the ICT/BPM sector, the fastest growing segment of our export, can be filled by streamlining procedures under the existing laws. It is very important that investment is also included in the ETCA as Sri Lanka is now pivoting from debt to equity and is attaching priority to FDI inflows at a time when the country's external debt dynamics are fragile. More investment will be forthcoming if there is a clear framework within which the investment from India can come into Sri Lanka. Training and technology transfer are crucial areas and there is much Sri Lanka can gain by having a framework within which this can take place.

A second area with promise are the Special Economic Zones. The government is giving priority to the Port City development, Hambantota, Bingiriya, Milleniya and other special economic zones. Indian investment can play an important role in this. There are certain areas, such as pharmaceuticals, ICT/BPM, automotive components, electronic and electrical goods, which have been identified as having potential.

Another area where there are opportunities is transport. The Colombo Port is being expanded and there has been high-level contact on developing the East Container Terminal. A fifth terminal will be built in Colombo, the Hambantota port is being expanded with value added services, BIA is being expanded, Mattala RIA is being revived and Jaffna has an international airport. All these improvements in connectivity and logistics create a new playing field for developing Indo-Lanka economic and trade relations. Another area which can be explored is grid connectivity. There is technical feasibility to have grid connectivity between the two countries. This would help Sri Lanka in terms of load management and for facilitating the expansion of renewable energy-based power generation.

Fisheries is a source of contention. There is a need to minimise incursions, institutionalise assistance for salvage operations of vessels, pay attention to ecological and conservation considerations and also consider a bilateral MOU. The last meeting of the joint working group on fisheries was in October 2017. This needs revival.

Indian companies, particularly Serum, are now involved in massive manufacturing of COVID-related vaccines. They have linked up with the Jenner Centre at Oxford University and AstraZeneca. It would be tremendously beneficial for Sri Lanka, if there can be some kind of agreement to access the vaccine when available.

In the current geopolitical environment, it is important to place Sino-Lanka relations in the appropriate context. It is in Sri Lanka's interest to maximise the benefits it can derive from the massive amount of capital that China is deploying around the world, much of it within the BRI framework. Sri Lanka is extremely well-located geographically to benefit from this. The Government is moving from debt to equity and needs to find ways and means of maximising Chinese investment. However, as the GOSL has publicly recognised, this should be done while taking account of India's strategic interests, as Sri Lanka is within India's defence perimeter. In addition, despite Indo-Pakistan tensions, there is a fair amount of trade that goes through Dubai. Perhaps Indian and Sri Lankan companies can explore whether some of it can be routed via Sri

Lanka, particularly trade from southern India to Pakistan. The Sri Lanka-Pakistan Free Trade Agreement offers preferential routing for this.

Finally, Dr. Montek Ahluwalia has stated that even if Sri Lanka exports everything it produces of any item to India, it will not have a material impact. Between 2000 and 2019, Sri Lankan imports into India averaged 0.2% of total Indian imports. So even if we increase our exports to India 10-fold, it will only be 2%. The scope, therefore, exists for India to show great flexibility in accommodating Sri Lanka in its bilateral negotiations on the ETCA. Sri Lanka, in turn, needs to be sensitive to India's strategic interests. There is a promising foundation and considerable scope to build on.

For the full article - Refer the Daily FT

2. Moving towards a more sustainable foreign debt
By: Nimal Sanderatne

- As Sri Lanka is facing a debt trap, it is important to understand the roots of these issues. Right now, reserves are getting low with most of these being borrowed funds. With around US$ 4.5 bn of debt repayments as well as BOP deficits over the next few years, an immediate solution of partnering with the IMF is needed.

- However, no immediate solution can fully deal with the longer term issues of debt sustainability that Sri Lanka faces. These issues are exacerbated by a greater expense bill in terms of imports compared to the smaller income bill of exports that Sri Lanka holds. Addressing these areas will be crucial.

- Therefore, governments need to take targeted action to diversify and grow our exports, and look at more sustainable ways to handle our import bill. Import controls can't be sustained and have failed in other countries, and export inputs must be allowed in. It is only through combining responsible financing with export growth can Sri Lanka leave the current debt trap.

Achieving a more sustainable foreign debt profile is a national priority and economic imperative. Borrowing at high interest rates to repay debt will only worsen the country's external financial vulnerability. International financial assistance from multilateral financial institutions and friendly countries is vital to lessen the severity of the problem, boost international confidence and prevent the escalation of interest rates for borrowing.

Longer run

While such immediate measures are needed to reduce the nation's external financial vulnerability, a medium and long term strategy has to be implemented to ensure that the nation's foreign debt is sustainable in the future.

Debt data

Recognising the severity of our foreign debt problem is vital to resolving it. We are in a foreign debt trap as we have to borrow to meet our debt servicing obligations.

Our foreign debt is about US$ 56 billion or about 86 percent of GDP. Annual debt repayments in the next few years are around US$ four to 4.5 billion. As the country is likely to have BOP deficits, the reserves could be eroded to critical levels. Owing to the state of our debt dynamics the costs of foreign borrowing is high and increasing.

Foreign reserves that are about US$ 6.4 billion are mostly borrowed rather than earned funds. As we have to borrow to repay our debt obligations, interest costs of new loans from commercial lenders are high owing to perceived risk.

Growth of debt

Foreign debt that was US$ nine billion in 2000, increased to US$ 11.3 billion in 2005, to US$ 21.2 billion in 2010, US$ 44.8 billion in 2015 and to US$ 56 billion in 2020.

There are many reasons for the exponential growth of foreign debt. The need to borrow at high interest rates to repay maturing debt, large defence expenditures, massive infrastructure projects that did not increase tradable goods and persistent large trade deficits are among the reasons for the escalation of foreign debt.

Debt reduction

Progressive reduction of the foreign debt in the next five years is imperative. Debates on how this debt escalated, who was responsible for it and the ability or inability to meet debt repayment obligations are futile now. There must be a national effort to reduce foreign debt.

Economic policies must be geared to reduction or at least not increasing the debt. Foreign borrowing must be on the most favourable terms and for investments that enhance tradable goods. The budget for 2021 must reduce the fiscal deficit and prioritise expenditure that enhances exports and reduces imports.

Domestic economic performance

A country's external finances are largely a reflection of its domestic economic performance. Persistent trade deficits due to imports exceeding exports by far have been a root cause of this deterioration of external finances. This has been aptly described as the nation "living beyond its means."

Strategies

A multifaceted strategy is needed to strengthen the external finances. Most important of these is to reduce the trade deficit. While decreasing non-essential imports and other imports by local production of these and their substitutes will help reduce import expenditure, the more pragmatic solution is to increase export earnings as import restrictions could also affect exports that have a high import content.

Restricting imports has not been successful in the past. Other countries like India that is better endowed with raw materials too abandoned this strategy to transform its economy to be more competitive. In fact freer and lower import costs could improve the country's international competitiveness.

Solution

An export enhancing strategy is the viable solution to reducing the trade deficit. Exports are only about half the value of imports. For instance, in 2019 before the COVID-19 pandemic struck the global economy, Sri Lanka's exports were US$ 11 billion compared to imports of US$ 19 billion.

In recent years large trade deficits have been offset or reduced substantially by tourist earnings and workers' remittances. Both these have reduced owing to the global pandemic. This makes the reduction of the debt more difficult.

Exports

The trade deficit must be improved by increasing the country's exports. Manufactured exports such as apparel, tyres and ceramics were severely affected by the global shut down. However, export manufacturing diversified into rubber gloves, surgical gloves and personal protection equipment (PPE) to increase exports. Consequently exports reached the previous levels of about US$ one billion a month since May this year.

It is this kind of resilience and enterprise that is needed to diversify exports and find new markets for new goods. This is the way forward. Opportunities must be seized when the global economy revives.

Imports

There has been a reduction of the trade deficit in the first seven months of this year by lesser imports. This has been due to both restriction of imports and autonomous factors. The dip in international oil prices reduced oil imports significantly. The slowing down of the economy also reduced imports of intermediate goods needed for construction. In addition, the government imposed import restrictions on gold and motor vehicles that reduced import expenditure. Owing to these reasons, import expenditure was reduced in the first eight months of 2020.

Restricting imports

This has led to advocating import restrictions to reduce the trade deficit. While restricting selected items of imports such as gold and motor vehicles may do no harm to the economy and would benefit the trade balance, broader import restrictions could affect our export manufactures as most manufactured exports have a high import content and reduce export competitiveness.

In conclusion

The severity of the country's debt burden is such that it should get the assistance of the IMF to replenish the reserves and boost international confidence. Disagreeing with rating agencies will not bring any relief. The fact that the country could meet its debt obligations this year and the next should not lull us to complacency as the borrowing of new loans to repay loan repayment obligations are escalating the foreign debt. The time when this debt repayment cost is beyond our capacity is not too far away.

Fiscal, monetary and other government policies must focus on those that decrease import expenditure and increase merchandise exports and earnings from services. The fiscal deficit should be reduced by increasing government revenue and reducing unproductive expenditure. Fiscal monetary and other government policies have an important bearing on the trade balance and balance of payments.

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