Spotlight: Econ Op-eds in Summary

Week ended 22nd July '20

In Summary

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

1. C-19 economic recovery: Most probably it will be a flattened U-shaped one
By: W.A. Wijewardena

- Economic growth in Sri Lanka had been slowing down prior to the pandemic amid a twin deficit situation. Debt servicing issues and currency depreciation has also placed pressure on reserves. Achieving a 6.5% economic growth target by 2025 is only possible if a quick economic recovery is made and future negative economic shocks are absent.

- However, among the factors impeding the achievement of this target are costly tax reforms resulting in the erosion of the revenue base. The lead time on the new tax system could drive public debt to unaffordable levels, as seen by the debt stock rising to 90% of GDP by the end of April 2020.

- Given this backdrop, growth will be negative in 2020 and recovery will take a flattened U-shape. Eroding investor confidence has led to high costs for external financing, resulting in domestic borrowing from inflationary sources. If Sri Lanka is to aim for a V-shaped recovery, it must first attain sufficient fiscal space to undertake expenditure programs.

The new world order of living in isolation

COVID-19 is to deliver a massive negative shock to the entire world economy without exception. Economic growth at least in the current year is to recede to a negative range. If mishandled, economic recovery to pre-C-19 levels would be prolonged for another three to four years.

The global goods and services as well as financial flows are to fall to levels well below those that could sustain the global economy.

Sri Lanka's economy was sick even before C-19

Economic growth had been slowing down from 2013 and in 2019, it fell to 2.3%, the lowest in a decade. Exports have been virtually stagnant at around $ 11 billion on average during this period. Since the import bill was almost double this amount, the trade gap stood at about $ 10 billion on average. Since the net earnings on account of services, incomes and remittances could not fill this gap, the current account of the balance of payments was in deficit at around 2.5% of GDP.

The government budget had been infected with a difficult-to-cure disease: the revenue base was falling, while expenditures were rising. As a result, the overall deficit in the budget amounted on average to 6% of GDP and was on the increase. The deficit had been financed in turn by borrowing leading to an unwarranted increase in the stock of public debt from 72% of GDP in 2013 to 87% in 2019. Debt servicing became problematic forcing the government to borrow more year after year to avoid a possible debt default. This was

specifically true for foreign debt. Without borrowing anew, the country could not honour its foreign debt obligations.

Since the inflow of foreign exchange was insufficient to meet the annual foreign exchange demand, the rupee was under continuous pressure for depreciation. The Central Bank kept on holding onto the exchange rate by supplying dollars out of its foreign reserves to the market intermittently. However, this could not keep the exchange rate stable and it saw a one-way journey to depreciation. Accordingly, the US dollar that was traded at Rs. 127 at end-2012 fell to Rs. 182 at end 2019. In the first half of 2020, the rupee came under severe pressure for further depreciation and at one point it even crossed the mark of Rs. 200 per US dollar. Though there was a slight reversal of this trend recently pushing down the rate below Rs. 200, the uncured sickness in the external sector forebodes a massive adjustment in the rate in the coming months.

Time to become a rich nation is to be further deferred

According to the Central Bank, the economic fallout of C-19 would be short-lived with a quick V-shaped recovery. The growth rate would fall from 2.3% in 2019 to 1.5% in 2020 but start to recover steadily though at a slow pace in the succeeding years. Accordingly, growth will bounce back to 4.5% in 2021, 6.0% in 2022, 6.2% in 2023 and finally, 6.5% in 2024. This 6.5% growth rate goal could still be attained in 25 years if the economy makes a quick recovery as predicted by the Central Bank, sets on an annual average growth of 6.5% and there are no other negative economic shocks hitting the economy in the intervening period.

Impediments created by the Government

Thus, the challenge before Sri Lanka's economic policy makers has been to make this predicted quick economic recovery a reality. However, there are certain impeding factors that stand to foil the realisation of this goal.

Costly tax reforms

The most prominent one is the dearth of funds within the government – known as lack of fiscal space – to undertake expenditure programs needed to initiate a quick recovery. One reason for this is the erosion of the revenue base of the government by offering a series of generous tax concessions to income tax and VAT payers. Another is the absence of a budget for almost the entirety of 2020 and having to operate on a truncated expenditure programme known as a Vote on Account.

Erosion of the revenue base

The objective of the government by offering these tax concessions was to reduce tax rates and relieve the taxpayers, catch more potential individuals to the tax-net and rely on large taxpayers for generating revenue for the government in the long run.

Though it might help the government to establish a viable tax regime in the country in the long run, immediately, it would eat into the revenue base of the government. My prediction at that time, based on the revenue generation in 2019, was that the government would lose between Rs. 650 billion and Rs. 680 billion in 2020. This is a significant income loss amounting to about 4-4.5% of GDP. What it meant was that in 2020, tax revenue would fall to about 8% of GDP from around the historical average of 12% during the preceding four-year period.

Since it would take time for the new tax regime to get established and fully operational, it was predicted that the government would have to live in a low-revenue regime in the next few years too. This was to adversely affect the government programs, especially those

targeting higher public sector investments in infrastructure, human capital advancement and research and development.

The option available to the government was to borrow more money, both from domestic and foreign sources, and increase the stock of public debt further to unaffordable levels.

An alarming fiscal situation in the first four months of 2020

These fears have now been confirmed by mid-year Fiscal Position Report 2020. The fiscal position during January-April 2020 has been alarming. The tax revenue has fallen by Rs. 143 billion from what the government had raised during January-April 2019. Government's consumption expenditure – known as the recurrent expenditure – has increased by Rs. 80 billion.

The reduction in revenue and the increase in the expenditure have caused the government to run a bigger deficit in its revenue account making dissaving in its financial operations. This deficit amounted to Rs. 344 billion in the first four months of 2020 compared to Rs. 152 billion in the corresponding period in 2019. It is an unaffordable 7% of GDP projected for 2020. Consequently, the budget deficit too has shot up to Rs. 452 billion amounting to about 9% of GDP.

This deficit has been financed by borrowing, on a net basis, Rs. 26 billion from foreign sources and Rs. 426 billion from domestic sources. These new borrowings have increased the debt stock of the government from Rs. 13,031 billion at end-2019 to Rs. 13,483 billion at end-April 2020. This is a further increase in the debt stock as a ratio of GDP from 87% to 90%.

A flattened U-shaped recovery

Thus, the budgetary outcome in 2020 and in the next few years will not help the government to undertake the needed expenditure programs to realise a quick economic recovery. Contrary to the prediction of the Central Bank that the economy would grow at a reduced rate of 1.5% in 2020, the available information point to a negative growth of about 6% in 2020 followed by a slow recovery in the next few years. Economic growth would become slightly positive only after 2024 due to the prolonged effect of C-19 pandemic. Accordingly, it would be a flattened U-shaped recovery and not a quick V-shaped recovery which Sri Lanka would realise in the post C-19 period.

Need for postponing tax reforms

Noting these adverse developments, and the need for introducing measures to have a quick economic recovery, I argued that the present state of the economy does not support trying out costly economic reform programmes. They should be postponed for implementation until the economy returns to normalcy and it would be after 2024.

Difficulty to borrow from external sources

As it is, the government itself has created a huge budgetary gap which has to be funded by resorting to borrowing. Its ability to borrow from foreign financial markets has been impeded by the eroding confidence which the investors have about the bonds to be issued by Sri Lanka. This is evident from the deep discount at which the bonds already issued by Sri Lanka is trading in the secondary markets for same. Before March, these bonds were traded at a premium. But today, they are traded at $ 94 per $ 100 bond in the case of those maturing in October 2020 and at $ 66 in the case of those maturing in 2030.

The other bonds maturing in between are traded at prices within this range. What this means is that if Sri Lanka goes to the market now to raise funds for undertaking C-19

recovery programmes, it has to offer those bonds at a relatively higher yield. Hence, the government has resorted to other tactics like getting a SWAP facility from India or entering into a REPO with the Federal Reserve Bank. Both these measures would help the Central Bank to boost its foreign reserves but not the government to finance the budget.

As a result, the increased expenditures have been funded by borrowing from domestic sources. There-again, these borrowings have been made principally from the Central Bank and commercial banks – two inflationary sources of financing.

In these circumstances, it is a flattened U-shaped recovery that Sri Lanka could bargain for at the present moment. If it desires to have a quick V-shaped recovery, its government has to put its house in order by attaining a sufficient fiscal space to undertake expenditure programs.

For the full article – Refer the Daily FT

2. A return to import substitution won't deliver rapid growth
By: R.D.R. Jayampathi

- The import restrictions put in place in March in Sri Lanka were not only aimed at managing a Balance of Payment crisis but also promoting domestic industrialization. While this is possible due to the reduction in the import trade in the short run, there are questions on the ability of domestic industry to stand up beyond this.

- Domestic industries that export products could continue to be negatively affected, if imports of their inputs are restricted. Problems may also arise for intermediate industries using these as inputs if the quantity of output ends up being inadequate or is of low quality.

- Such weaknesses in domestic industry could also mean that the related service industries as well as government revenue could too suffer. If domestic industry doesn't take off, it could also result in shortages in the local market. Such a situation might even result in social unrest, as Sri Lanka's past proves. Such factors need to be considered within these policies as well.

Sri Lanka has imposed increasing levels of controls on imports since March. While this was partly a reaction to a balance of payments crisis, the restrictions are also intended to promote domestic industrialization.

A strategy of import substitution based on setting up domestic trade barriers can lead to a number of pitfalls resulting in grossly uneconomic practices. If such a policy is to be counted a success it must increase both economic output and productivity.

The inevitable result of protectionist policies is that it can lead to the formation of small-scale, inefficiently operated firms that survive only as a consequence of the prohibitive barriers imposed against competing imports. The inefficient firms become a drag on the economy causing long term harm. The more widely applied the policy, the greater the potential damage.

If we examine the impact of trade restrictions in terms of output, it initially causes a contraction in the import and distribution trade, hence a reduction in the output of that particular sector. The impact is not solely on the trade in goods however, the multitude of support services associated with imports will also face a decline including finance (banking, insurance), logistics (transport, warehousing), retail distribution and local ship/clearing

agents. Even government revenue will suffer as imports slow; customs contributes a little over half of all revenue so other taxes will need to rise to compensate.

For the import substitution strategy to benefit there needs to be a net increase in economic output; the contraction in import related activities must be offset and result in a net increase in activity.

The decline in the import trade following the imposition of controls in April is slowly taking effect but it will take time for any offsetting impact of local production to take place.

Where the protected industries produce intermediate goods, further problems may arise. If the quantity of output is inadequate or is of low quality, industries that depend on these for inputs will suffer, leading to a loss of output, markets or both.

The full impact of these measures will only be evident in the longer run. As similar policies were used extensively between 1956 and '77, reflecting on the past will be useful.

One objective of these measures is to prevent the erosion of foreign exchange. In the short run this will be achieved due to the reduction in the import trade but will this be sustained if domestic production takes off? In instances where domestic production is not possible the saving will be sustained, but at a price: shortages in the local market.

Where domestic production of finished goods is possible, it may nevertheless be dependent on imported capital goods, intermediate products and raw materials. In such instances the net savings in foreign exchange may be small. Sri Lanka's past experiments with import substitution encountered this problem.

As per Central Bank statistics food imports in 2019 made up around 10% of total imports while imports of other manufactured goods made up approximately 34%. The bulk of the imports are made up of intermediate goods (including fuel) and capital equipment (including vehicles). This indicates a high dependence on imported inputs which means a widespread ban will choke local industry.

This is happening, for example Harischandra Mills an exporter of processed foods has said production is down 90% due to the lack of the key raw material, ulundu. The drought has affected local harvest and no imports are available so production is curtailed. Local liquor producers have complained that there is a 40% shortfall in the local production of ethanol, compared to market needs. Nor is it only businesses that will be crippled: the CEO of DIMO said that four ambulances were currently out of service – due to the lack of tyres.

Another objective of import substitution is to diversify the structure of domestic production and reduce dependence on foreign sources of supply and demand. Sri Lanka small domestic market imposes a limitation on this strategy, a problem that was recognized as far back as 1965, which lead to attempts to promote export oriented production – Sriyani Dias, 1987.

"The potential for import substitution is already largely exhausted, and although there is scope for widening the product range, the small size of the domestic market will severely restrict demand prospects, even if rapid economic growth is sustained" – WB 1979.

Although tax concessions and a relaxation of foreign exchange restrictions were offered for export-oriented foreign ventures in 1966 (and reaffirmed in 1972) it was unsuccessful due to the unfavourable policy environment for private sector activities. The rapid increase in investment and exports only took place after various restrictions were removed in 1977.

The small market size also impedes achievement of scale economies which may mean that industries suffer structural inefficiencies necessitating long-term protection which is

detrimental to productivity: "Limited market size means that the unit cost of production for the local market alone is unavoidably high for many products."(WB, 1979).

It is rather ironic that yet another balance of payments (BOP) crisis has brought the country a full circle: to solutions that were tried in the 1960s. At that time there was no clear experience to draw on, many countries experimented with import substitution but the East Asian countries quickly abandoned them-and prospered.

Sri Lanka's own experience was that ISI did not solve the foreign exchange crisis and actually lead to increased dependency on foreign inputs. Tight controls on exchange then strangled growth. The 1956-1977 era was characterized by a stagnant economy, unemployment, hardship and as a result; rising social tensions.

The pandemic is taking a heavy toll on the economy. The Government should not make matters worse by returning to policies that failed in the past.

For the full article – Refer the Daily FT

3. External reserves decline as strengths in balance of payments weaken
By: Nimal Sanderatne

- Sri Lanka's Balance of Payments is likely to be under stress this year due to the large trade deficit, and weak remittances and tourist income. This could diminish external reserves to a critically dangerous level by the end of the year and pose a severe threat to the economy.

- The trade deficit could be somewhat contained, as falls in imports keep up with the large decrease in exports. However, as more and more people return from overseas, remittances could decline further, and the closure of international travel can be very negative on tourism receipts.

- A reversal of these negative trends will only take place once the global economy has recovered, and international assistance is imperative to stave off a financial crisis in the meantime. This necessitates sound economic management and insightful international diplomacy.

Balance of payments

This year's balance of payments deficit is likely to be high owing to a large trade deficit, lower workers' remittances and insignificant earnings from tourism. It is likely to be over US$ 2 billion, one of the highest, owing to the precipitous decrease in tourist earnings and dip in workers' remittances that were two strengths in the balance of payments for many years.

Consequently, there will be a severe erosion of the country's foreign reserves to a critically dangerous level by the end of the year. Foreign reserves that were US$ 7.6 billion at the end of 2019 fell to US$ 7.2 billion by April and to US$ 6.5 billion at the end of May.

Trade balance

Despite the significant decrease in exports, the trade deficit may be contained at around last year's US$ 8.3 billion or less.

Imports of intermediate and investment goods are likely to decrease this year. Import restrictions and higher tariffs have reduced consumer imports as well. Exports are expected to increase during the second half of the year though this year's exports are

likely to be much less than that of last year. Nevertheless, the balance of payments deficit will widen this year owing to shortfalls in workers' remittances and much reduced earnings from tourism.

Remittances and tourism

In 2019 workers' remittances and earnings from tourism converted the trade deficit of US$ 8.3 billion into a surplus of US$ 772 million. These two strengths in the balance of payments have weakened significantly to cause a large balance of payments deficit.

Tourism

In the first five months of the year earnings from tourism have been negligible, while workers' remittances fell from US$ 2733 million in 2019 to US$ 2407 million in the same period of this year. The decrease in workers' remittances in May were higher than in the previous months and likely to decrease by higher amounts during the rest of the year.

Prospects

As these trends are likely to continue during the next six months of this year, the 2020 balance of payments deficit is likely to reach an unsustainable level and erode the external reserves to critical levels.

Earnings from tourism have fallen sharply in the first half of this year and at best is likely to recover partially only at years' end. This too remains uncertain as international travel is severely curtailed and the fear of the pandemic looms large in many parts of the world. Furthermore, loss of employment and lower income in countries of tourist origin would decrease the demand for travel. There is a chance that tourists from China and neighbouring countries may revive tourism. However, this too is dependent on the containment of the COVID-19 pandemic in those countries and ours and the lifting of travel restrictions.

Remittances

Large number of workers in the Middle East have lost their jobs, many have been infected by COVID-19 and most workers are clamouring to return to the Island. Workers' remittances that amounted to US$ 7 billion and US$ 6.5 billion may be halved this year.

Apart from the loss of remittances this year there is the likelihood of remittances drying up on the near future owing to much less migration of workers to many countries owing to lesser demand for such services and lesser number of persons willing to migrate.

Prerequisite

A global economic recovery is a prerequisite to a revival of international trade and travel. We may however be able to attract tourists from the Asian and Middle East regions and partially recover tourist earnings. Regrettably, there is little prospect of a reversal in tourist earnings and workers' remittances during the rest of the year. A global economic recovery is likely only after the containment of the COVID-19 pandemic and the wheels of industry and commerce revives. This is especially so with respect to international travel and tourism.

Imperative

In this perilous situation of external finances, international assistance is of utmost importance to stave off a severe financial crisis. Moratoria on debt repayments, assistance

from multilateral agencies, loans at low interest and long-term repayment conditions and foreign aid are needed to save the country from the impending financial crisis.

Sound economic management and insightful international diplomacy are needed to obtain such assistance. The Government must not "look at the mouth of a gift horse" given by donors and offend friendly countries that assist us.

For the full article – Refer the Sunday Times

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