# Spotlight: Econ Op-eds in Summary

Week ended 23rd October '19

## In Summary

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

**1. Political uncertainty of presidential poll retards economic growth**
**By: Nimal Sanderatne**

- Political uncertainty in the run up to the presidential elections and beyond can slow down the economy. Therefore, a full economic recovery in 2020 after an expected slow growth in 2019 is unlikely. Until a stable government is made following the parliamentary elections, political stability and policy certainty cannot be established.

- Political stability after the presidential polls depends on if the new president is able to work with the current parliament. If not, a constitutional crisis like that of October 2018 is possible. If no candidate gets 50% majority even after second preference, any conflict over the final winner can still lead to political chaos.

- Lack of clarity on the constitutional powers of the new president under the 19th amendment further fuels this uncertainty. While most developed economies today are under political turmoil, their economies are not dependent on state policy unlike Sri Lanka that relies on the state for a stable economic and business environment.

The uncertainties of the presidential polls will retard economic growth. The adverse impacts could go to a post-election period of political confusion and even a constitutional crisis. Furthermore, once the presidential polls are over, the runup to the parliamentary elections would be another period of uncertainty for the economy.

This political uncertainty is not conducive for economic growth and resolving the massive financial problems the country is facing. They are likely to aggravate for quite some time till there is political stability.

**Economic slowdown**

Economic growth fell to 1.6% in the second quarter from 3.7% in the first quarter. It could fall further in the third and fourth quarters owing to political uncertainties. Consequently, the economy is expected to grow by less than 3% this year. The IMF estimates the economy to grow by only 2.7% in 2019: A substantial downward revision from the prediction made at the beginning of the year.

**Second quarter**

This low growth in the second quarter of this year was due to a significant slowdown in services owing to the setback to tourism due to the Easter Sunday attacks. Though there has been a slight improvement in tourism recently, its recovery too has been hampered by the elections. Agriculture and industry slowed down during the second quarter of 2019, compared to the previous quarter. Consequently the, economy is likely to grow slowly in 2019.

An economic recovery is unlikely in 2020 owing to the political confusion that may be created in the coming months and the run up to the parliamentary elections in 2020. The election will further slowdown the tardy economic growth this year. The presidential poll has slowed down the economy in diverse ways and may continue into 2020, as political stability and a certainty in economic policies cannot be achieved till a stable government is established following the parliamentary elections of 2020.

**Three scenarios**

The next four weeks till the results of the presidential poll are announced will be a period of economic neglect, political uncertainty and confusion. If that be all and a stable political situation is assured then the economy could revive. However, such political stability is possible only if the newly elected President is able to work with the Prime Minister and elected government that controls a parliamentary majority. The election rhetoric does not indicate such an understanding of the constitutional position of the new President.

**Second scenario**

A second scenario is that of no candidate obtaining more than the requisite 50% of the votes cast, even with the second preference. Such an eventuality would lead to political chaos with the main candidates claiming they have won or that their opposing candidates have not won. Such confusion and possible violence would certainly harm the economy. The Elections Commissioner should clarify the constitutional process in the event this happens.

**Third scenario**

The third scenario is that of the elected President not being able to work with the Prime Minister and government controlled by a majority in parliament. This third scenario would create a constitutional crisis like that of October 2018 and bring the government into a standstill. This would be a severe blow to the economy, especially the balance of payments and external finances.

**Confusion**

The presidential election has put the country into much confusion. It is not only the uncertainty of the nation's choice of the President, but whether the polls would elect a President. The second crucial confusion is as to what the function of the newly elected President would be under the 19th amendment to the constitution.

The presidential candidates are acting as if they would have the same powers as the current President. Some of the election rhetoric even suggests that the President will act with immunity to do whatever he wants. This confusion is a further factor for economic uncertainty. It would be salutary if the constitutional position is clarified and the candidates and people are made aware of the constitutional position and powers of the next President.

**Mature democracies**

Today even mature democracies and developed economies are in political turmoil. However, they have strong institutions and their economies are not much dependent on state policy or political stability. In contrast, the Sri Lankan economic performance is very much dependent on the role of the state for macroeconomic stability and a conducive environment for investment and growth.

For the full article – Refer The Sunday Times

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**2. Elections and economies: How will our economy deal with all this electing?**
**By: VLM**

- The upcoming presidential election and the subsequent parliamentary election is likely to add additional costs onto the economy. With both sides promising large expenditures, the fiscal deficit could expand, moving beyond 2019's expectation of 4.8% to well over 5%. Financing this could cause interest rates to rise for the whole country.

- Sri Lanka is already likely to have to pay around US$ 4 bn every year until 2022 in debt servicing costs. Further fiscal deficits, and borrowings to finance such deficits, would only worsen the country's already precarious debt position. The possibility of rising imports after the election and subsequent BOP worries are also likely to add pressure to the country's debt.

- These factors are likely to negatively impact Sri Lanka's economic growth. The country has already been seeing a slide in GDP growth since 2012 (except for a spike in 2014), and the country hasn't been able to grow its exports to its fullest potential. Unless proper and comprehensive economic reforms are undertaken, any economic recovery in 2020 is likely to be short lived.

There are three main impacts onto our economy from this election season.

**The fiscal impact: To spend their way to our hearts**

Whatever side ends up winning the Presidential Elections, it's squaring up to be a close fight. With a Parliamentary Election just around the corner as well, a close presidential vote is going to make things very messy.

The two main sides have already made their stance on this matter clear. Once they get into power, they are 'going to develop' the country, and they are willing to spend in order to do so.

The Government is already expecting a budget deficit of 4.8% of GDP for 2019, and with how all governments in recent years have severely under forecasted their own deficits, it's quite reasonable to expect the deficit to actually be above 5%.

With all the talk about lower tax revenue so far (and the possibility of tax cuts after a new president comes in), we might even end up with a budget deficit for 2020 well above 5%, maybe even reaching 6%!

The Government has to borrow to bridge the fiscal gap from domestic sources, we might see interest rates rise for the rest of the country as well. The IMF might also not like it very much, and whoever comes into power will sorely need the money that they will give us. But of course, the biggest problem is how it will affect our debt.

**The debt impact: The burden is on our shoulders**

The story of our public debt being above 83% of our GDP became quite popular in the recent past, and with good reason.

The country is probably going to have to pay at least US$ 4 bn in debt repayments every year until 2022. So in addition to all the budget financing, there's all that to be paid off as well. And with imports this year being pretty weak, 2020 could see a massive growth in imports, and even create a large Balance of Payments deficit.

One idea that both sides have talked about is simply borrowing more! With global interest rates being very low, that might not be such a bad idea for next year. Of course, the problem is when we have to pay that money back as well.

**The economic growth impact: Can we get bigger again?**

Ever since 2012, we've been on a bit of a slide, and although there was a one-year recovery in 2014, our GDP has missed out on growing every year after 2012. This year is probably going to be even worse, with last year's political situation and this year's terrorist attacks.

Things might look a little better next year, with people already fattening their pockets to spend. But will that last?

Sri Lanka has talked about improving exports for quite some time, but it hasn't really happened in the way we talked about. Sure, apparel hit $ 5 billion and tourism did well until Easter, but there's so much more that hasn't happened.

If the country is to truly bring the story of growth back to where it once stood at, whoever comes into power needs to do some quality reform work. Reforms that Sri Lankans haven't really heard of before. Without these reforms, any pickup in growth is likely to be just a stutter.

For the full article – Refer Daily FT

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**3. Fixing lending rates and waiving farmer loans two policies that do not augur well for borrowers**
**By: W.A. Wijewardena**

- Recently, there were two policy announcements relating to lending to support faster economic growth. One was made by the presidential candidates, where a promise to write off debt was given to the farmers. The other was a lending rate cap by the CBSL with the hopes of getting banks and financial institutions to lower their lending rates.

- Low interest rates are expected to ease the working capital constraints of businesses and encourage them to go for permanent investments. Thus, when the banks and financial institutions did not lower their rates, despite lower policy rates, the CBSL ordered commercial banks to cut their lending rates by at least 2%, using the powers it possessed under the Monetary Law Act.

- However, policy makers have failed to realize that SMEs are indebted not to the formal banking institutions, but to the informal money lenders. Thus, the need of the hour is for the formal banking institutions to change their lending behavior and emulate informal money lenders when they meet the financial requirements of SME borrowers.

**Central Bank's requests going unheeded by commercial banks**

The Central Bank, earlier in April, requested commercial banks and non-bank financial institutions which are mainly made up of finance companies to cut deposit rates to be in line with the Central Bank's borrowing rate to accommodate excess liquidity of commercial banks, known as Standing Deposit Facility Rate or SDFR, and one year Treasury bill rate.

The objective was to reduce the cost of funds of these financial institutions so that they could in turn bring down the lending rates, especially those applicable to the Small and

Medium Enterprises or SMEs. Since this measure did not bring in the expected results on the lending rates, later in July, the Bank provided a further boost to this by getting non-bank financial institutions to cut deposit rates again. The Bank once again requested these lending institutions to cut lending rates to facilitate economic growth. But the lending institutions were still stubborn.

**Making a final assault on stubborn commercial banks**

Then, the Central Bank in September ordered commercial banks to cut their lending rates by at least 2%, by using the powers it possessed under the Monetary Law Act. The Bank may have felt that this is an unwarranted order which has a place only when the country is faced with a national emergency. Hence, it has promised to review it in March 2020. However, by way of justification, the Bank tagged this order as a way to ensure that its monetary policy measures aiming at making credit cheaper for borrowers are more effectively implemented through the financial system.

This is the first time, that the Central Bank has used its powers to order commercial banks to cut lending rates. In the past, the Bank had got commercial banks to cut interest rates not by ordering them, but by using other tactics. For instance, it got the Ministry of Finance to direct the two State banks to cut lending rates, so that other banks too had no option but to follow suit. This was criticized by many as an 'arm-twisting method', converting the Bank's normal 'moral suasion' to 'immoral suasion'. As such, the present management in the Ministry of Finance or the Central Bank would have chosen not to tarnish its image by resorting to such arm-twisting methods.

**Gotabaya Rajapaksa's promise to farmers**

The SLPP presidential candidate, Gotabaya Rajapaksa, addressing the nation from Anuradhapura, promised that if he is elected to power, he would take the farmers out of indebtedness, by writing off farmer loans granted by banks. Rajapaksa did not give details of how it would be implemented, but going by the past practices of politicians, the promise can be construed as directing banks to write off the existing bank loans given to farmers for agricultural purposes, mainly for cultivating paddy.

In 1994, Chandrika Bandaranaike Kumaratunga too made such a promise. But what was delivered was not an across-the-board loan waiver. It was applicable to loans in default, provided the defaulter agreed to repay 25% of the amount in default. Thus, without offering a general loan write-off, the Ministry of Finance and the Central Bank managed to maintain credit discipline among the farming community.

**Lowering inflation when growth is slowing down**

Both the Central Bank and the candidates may have gone for these two options with good intentions. The Central Bank has been able to keep inflation below 5% in most the years since 2009. This is in fact maintaining virtual price stability by the Central Bank, since an annual inflation rate of 4-5% is considered a rate that would not adversely affect people's decisions on earning, consumption, saving or investment.

However, this price stability is irrelevant if the economy does not wake up from the low growth slumber which it had been happily devouring in the last 6-year period. The best projections made for the next 4 years too show that growth will be only marginally better than the low rate it had recorded in the past. As a result, to boost the economy, the Central Bank has been relaxing monetary policy, by way of reducing interest rates and releasing a significant part of the money belonging to commercial banks that had been kept with it as compulsory deposits, known as statutory reserves. This would increase the supply of money to the market, and in any other market where supply has exceeded the demand, the price would have fallen.

**Cheap money to promote investments**

Similarly, the expectation of the Central Bank had been that these monetary policy relaxations should lead to a downward adjustment of the whole interest rate structure in the country. Such a low interest rate regime would ease the working capital constraints of businesses on the one hand, and encourage them to go for permanent investments, on the other.

In economic terms, the resolution of the working capital problem of businesses will enable the economy to produce and maintain its current production level, which in turn will help it to use resources unimpeded and employment undiminished. The permanent investments are to help the economy to use more resources, employ more people, and produce more. It will ensure that the economy will accelerate to a higher growth path, the need of the day.

Hence, if interest rates do not fall in line with Central Bank's relaxed monetary policy measures, the expectation of moving from the current low growth to high growth will simply be a non-event. It is an outcome which the Central Bank cannot afford to have at this juncture of prolonged low growth.

**Ignored SME borrowers**

The reality is that SMEs are indebted not to the formal banking institutions, but to the informal money lenders who operate as solo lenders or organized fake microfinance institutions.

The behaviour of these borrowers is not different from that of the Sri Lanka Government which has borrowed partly for consumption and partly for investment, mostly in unproductive projects. Since the economic growth has not been adequate for it to earn sufficient income, every year, it had to borrow more to repay the maturing loans and pay interest on the existing debt stock. Fortunately, it could still access global financial markets to do so. However, those borrowers in the SME sector cannot reach a commercial bank and raise a bridging loan to refinance what they have borrowed from informal money lenders. Their choice is to abandon business, and it is happening now.

**Two policies that have gone wrong**

Hence, the Central Bank's well-intentioned measure of fixing a ceiling on lending rates of commercial banks and finance companies is not of use to many SME businesses. Similarly, the promise to write off farmer loans by Rajapaksa, and other presidential hopefuls who would follow him, will not help the economy at large. What is needed is for the formal banking institutions to change their lending behavior and emulate informal money lenders when they meet the financial requirements of SME borrowers. Since possibly they could lend below 10% per month, their loan schemes will not drag the borrowers to eternal indebtedness, as is the case with informal money lenders.

For the full article - Refer Daily FT

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