Spotlight: Econ Op-eds in Summary

Week ended 29th July '20

In Summary

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

1. Sri Lanka's economic consequences of the peace; monetary instability and trade lockdown
By: Bellwether

- Sri Lanka faces risks of severe monetary instability and balance of payments issues due to high volumes of money printing by the CBSL, and the trend does not show signs of ceasing. While a sovereign rating downgrade was carried out following the latest tax cuts and liquidity injections, rate cuts in 2018 resulted in the slump in 2019.

- This was due to targeting the call money rate and the output gap. REER targeting by depreciation was also based on claims that East Asia undervalued its currency. Economic nationalism also ignores monetary instability as the cause of foreign exchange shortages, and Sri Lanka must also auction debt domestically if it is to retain the ability to pay foreign debt.

- Sri Lanka is currently facing a external lockdown with import and exchange controls and the inability to rollover bonds. Further money printing in a low rates environment would lead to BOP issues and inflation. Sri Lanka needs to shift away from policies that would intensify monetary instability, economic nationalism and regime uncertainty and expropriation that holds the country back.

Economic consequences of the peace

Sri Lanka's monetary policy has progressively deteriorated after the civil war; starting from 2011/2012 balance of payments crises.

As a result, the country is now in severe monetary and balance of payments problems it did not suffer even during the height of the war.

As this column is written more than 220 billion rupees has been printed and 1.3 billion US dollars have been lost.

Amid currency falls in 2018 despite severe fiscal corrections, the sovereign rating had been downgraded to B- due to the country's obsession with low non-market interest rates.

If Sri Lanka is to progress it has to follow the German policies after World War II, followed by the Ordoliberals, which led to the German Economic Miracle.

Of ÖFFA bills and Contractor bills

Sri Lanka's Central Bank is set to monetize billions of contractor bills, after monetizing over Rs100 billion of private bank loans with bank re-finance – money printing.

The contractor bills would be monetized with 1 percent money from the Central Bank in a scheme similar to that hatched in Nazi Germany to circumvent budget and Central Bank rules.

In fact, Sri Lanka's Central Bank has much more leeway to create money than the Reichsbank.

Deferred

Germany resorted to MEFO bills because the Reichsbank law prevented direct financing of the deficit. Under John Exter's Monetary Law no such prohibition exists and the discounting of contractor bills and the re-financing of COVID-19 loans comes on top of direct financing of the deficit of hundreds of billions of rupees.

On available data over 400 billion had been injected to the banking system so far, and 1.3 billion US dollars had been lost up to June.

The central bank is engaging in swaps like the Philippines central bank to boost reserves. About 150 billion in re-finance is to be issued. The exact volume of contractor bills has not been disclosed.

In Sri Lanka contractor bills would be immediately discounted, not five years down the line.

By issuing bills which can be discounted though the central bank budget rules were circumvented.

Budgetary Control

There are other troubling facets in recent data released by the Central Bank. The agency had printed Rs50 billion for an 'energy stabilization' fund. This fund was supposed to be built out of taxes.

Why is printed money needed? Also how legal are these funds outside of the consolidated fund?

Sri Lanka has made a game of presenting a non-credible budget to parliament and then finding ways to undermine it especially after the war. These include funding the Road Development Authority and the National Water Supply and Drainage Board with guarantees.

The RDA funding tends to understate the deficit in the year debt is incurred. The money is later paid out of capital spending because the agency has no revenue.

Sri Lanka is now under budget problems also due to the lack of elections. That is probably why contractor bills are not settled by selling government bonds which is the simple solution, but a subterfuge like the MEFO bills is resorted to.

However, it may also be due to the desire for 'stimulus' or the obsession with low interest rates that had led to high interest rates and a slump later.

Keynes Haunts through REER Targeting, Stimulus

Sri Lanka's latest downgrade came in the wake of a fiscal 'stimulus' in the form of tax cuts and monetary 'stimulus' in the form of rate cuts and liquidity injections.

However, it is a mistake to blame the troubles only on the most recent 'stimulus'.

The reason for the 'Keynesian stimulus' was the slump in 2019, which was created by liquidity injections and rate cuts in April 2018, the so-called 'buffer strategy' and also the July Soros-style swaps in the form of a monetary stimulus.

The reason such a monetary stimulus was done was due to targeting the call money rate and also targeting the potential output gap.

The bloating of the debt and the slowing economy is due to currency collapse.

A real effective exchange rate (REER) was targeted by depreciation amid claims that East Asia 'undervalued' their currencies – a false charge frequently leveled by US Mercantilist in Western media which was taken to a new level by Trump in a trade war.

Economic Nationalism

Depreciation and REER targeting is a problem with Keynesianism and so-called Lost Generation of economists that follows the Cambridge dons' teaching.

Despite lessons from East Asia's best performing nations including Singapore, Taiwan, Thailand, Korea (and Japan earlier) that strong currencies create stability and preserve domestic capital, facts are ignored in favour of ideology.

Each time the rupee collapsed other Central Bankers, have also claimed it made Sri Lanka more 'competitive', while Singapore's exchange rate appreciated from 3 to 1.2 from the collapse of the Bretton Woods, Hong Kong fixed it though a currency board.

Spurious Transfer Problem

Sri Lanka not only believes in devaluation to promote exports, but also believes that their foreign exchange shortages are caused by the lack of exports or imports or both, rather than monetary instability.

To retain the ability to pay foreign debt, Sri Lanka's government must sell debt domestically at auctions (which is a type of default of domestic debt) without the Central Bank printing money to take up a part of the issue or the whole of it as has happened recently.

Whether the money is taxed or borrowed, the private citizens will be crowded out and imports will be reduced and there will be a surplus of dollars to buy. If it is borrowed rather than taxed, the rationing is done through the credit system via interest rates.

External Sector Lockdown

Sri Lanka is now in an external lockdown with import and exchange controls and unable to rollover bonds.

If money is printed to boost credit and rates are kept low, not only will there be balance of payments problems but prices will also rise or inflation in current terms – in classical terms inflation was an inflation of the money supply.

Recent currency collapses did not lead to proportionate rises in prices partly due to negative dollar inflation at times (falling commodity prices) but also due to private sector productivity gains made in the years prior to deprecation.

Unlike in the past the component of food has been reduced in the Consumer Price Index following basket changes made over the last decade, which tends to keep prices low as private sector productivity absorbs part of the depreciation.

A part of the deprecation was also absorbed by falling margins of private firms. But now firms can hardly pay salaries, much less absorb more losses.

Import controls will not only strangle the economy, but it will also lead to losses of revenue. Import substation tax arbitrageurs will, in the meantime, have a field day collecting taxes that would have gone to the state.

In 2008 foreign financing was a negative -Rs4.4 billion when the entire deficit was financed domestically for the first time in post-independence history. Not even in 1955 when there was a budget surplus was foreign financing negative.

That was the year direct placements were started outside of auctions after giving high rates of interest to savers and the EPF, which came under fire after the bond scam.

Direct placements made in 2008 helped avoid money printing and probably headed off an even severe external meltdown.

Sri Lanka needs to radical shift away from the policies involving monetary instability, nationalism (economic and otherwise) and the regime uncertainty of pulling the rug from under the private sector with fluid policies and expropriation which has kept the country back from independence.

For the full article – Refer Economy Next

2. Can Central Bank initiate a V-shaped quick recovery by printing money and lending to businesses

By: W.A. Wijewardena

- With the disrupted global economic conditions affecting the country and a lack of 'fiscal space', Sri Lanka could only expect a prolonged economic recovery. This however could be turned into a V-shaped recovery by getting the Central Bank to print new money and make it available to businesses and exporters at low interest rates and avoiding a hard-landing of the economy in the process.

- Central Bank's offer of a stimulus to the economy had been done in the past by transferring a part of its profits to a fund called the Medium and Long-term Credit Fund or MLCF. However, as the MLCF saw a natural death in the early 2000s, the Central Bank is left with the option of printing money to finance a major part of the liquidity fund of Rs. 150 bn created recently to support the economy.

- Such printing of money is advocated by Modern Monetary Theory (MMT) which argues that governments' printing money has a favourable impact on economies because people will get encouraged to work harder due to what's called the 'wealth effect'. This however, comes with it's own pitfalls including higher inflation. Thus, a cautious approach is needed when using newly printed money for attaining a quick V-shaped recovery.

Sri Lanka could bargain for only a prolonged economic recovery

Given the disrupted global economic conditions affecting the country and a lack of 'fiscal space', Sri Lanka could only expect a flattened U-shaped recovery.

But with the onset of the second and third waves of Covid-19, the expectation has been that the global economic recovery would be zigzagged moving from recovery to depth and back to recovery and so on, dubbed as a W-shaped recovery. Sri Lanka cannot avoid

undergoing these ground realities irrespective whether the recovery program is tax-financed or bank-financed.

Print money and go for a quick recovery

In this background, one might suggest that Sri Lanka could still attain a V-shaped quick recovery by getting the Central Bank to print new money and make it available to businesses and exporters at low interest rates. The underlying rationale for the Central Bank to print new money is the presumption that such money printing is virtually costless.

One could also say that the projected hard-landing of the economy, could be softened if appropriate cushions are laid on the floor to facilitate a soft-landing. A hard-landing would have crushed the economy but a soft-landing would have enabled it to escape without injuries.

Both these suggestions are not without precedents.

An economy can avoid a hard-landing through appropriate policies

Making an economy soft-land when it is about to hard-land was exactly what China did in 2010s. When USA threatened to cut its lifeline by imposing restrictions on its exports, China intensified its economic relations with more lucrative South Asian and South East Asian countries and managed to escape even a soft-landing.

Therefore, as suggested, Sri Lanka's policy makers should start strategizing right from now to prevent the imminent hard-landing of the economy due to the Covid-19 menace. It requires the adoption of immediate to short term to medium term economic policies to take the economy out of the slow growth mode and place it on the targeted growth path.

The way out

Several strategies could be presented for Sri Lanka to place its economy on a viable growth path.

- In the case of agriculture, paddy farmers should be given access to new technology enabling them to increase yields and reduce the average cost of production.
- Exporters should be encouraged to join the global production sharing networks by adopting advanced technologies.
- Public service should be reformed with capacity improvement via new technologies.
- The loss-making state-owned enterprises should be converted to efficient production units to free the taxpayers of having to bear the burden.
- The current consumption-oriented budget should be transformed to an investment oriented one allocating more funds for human capital improvement and technological advancements.

MLCF: Use of Central Bank profits to fund medium to long-term lending

The Central Bank's offer of a stimulus to the economy had been done in the past by transferring a part of its profits to a fund called the Medium and Long-term Credit Fund or MLCF. The transfer to this fund was done annually after the Bank had ascertained its profits but before transferring the surplus to the government. Hence, in effect, it was a fund created by the government but operated by the Central Bank. Thus, there was no new money printing involved. Money in the fund were lent to exporters and other entrepreneurs through participating commercial banks at concessionary interest rates. Commercial banks had lent money to borrowers after selecting them and claimed refinance from the Central Bank. To cover the credit risk, the Central Bank had operated a separate credit guarantee scheme to which the participating banks had to pay an annual premium.

Abandoning the MLCF

MLCF was in vogue in 1970s and 1980s when Sri Lanka's banks were short of liquidity, interest rates were high due to tight monetary policies, the country's savings were at a low level and those savings were kept outside the banking system. There are some success stories but many failures. Two factors caused MLCF to have a natural death.

- First, when the liquidity position in banks improved, there was no necessity for cheap refinancing from the Central Bank.
- Second, the government very badly needed the Central Bank's profits to finance its ballooning expenditure programs.

As a result, by 2000s, most of the credit schemes got fizzled out.

Central Bank's dilemma with the new liquidity fund

In the current context, the Central Bank has created a liquidity fund of Rs. 150 bn at the instance of the government to provide short-term working capital to businesses affected by Covid-19. Of this, Rs. 60 bn is to be provided by the Bank by printing new money but even that amount has been a cause of concern for the Bank. That is because in terms of its existing capital funds, as revealed by the Bank's top officials, only Rs. 30 bn could be provided without endangering its inflation-targets.

Hence, the balance Rs. 90 bn is to be provided by commercial banks out of their own liquid funds and the Central Bank would support them by providing a credit guarantee to support their lending operations. In my view, this model is the best which the Bank can adopt at the present juncture without compromising its main objective of delivering an inflation-free world to Sri Lankans.

Modern Monetary Theory

Money printing for economic prosperity is being advocated presently by a new school of economics known as Modern Monetary Theorists or MMTs. MMT has a long history but the prominent current advocates are Warren Mosler and L Randall Wray of the University of Missouri – Kansas City, USA and Bill Mitchell of the University of Newcastle in Australia. They base their argument on the concept of a government token known as 'charta' through which the government can borrow from the private sector. In modern times, currency notes, Treasury bills or Treasury bonds are examples of chartas. Since the use of the last two add to the government's debt explicitly and they are governed by Parliamentary control, the issue of currency notes has been the easiest and most convenient charta for borrowing from the people. Hence, modern monetary theory is also called 'chartalism'.

MMT's argument: A bigger money packet makes you feel richer

Their main argument is that governments' printing money and financing budget deficits have a favourable impact on economies because people will get encouraged to work harder due to the feeling that they are now richer than before. It happens in the following way. Suppose that the government prints money and spends on people who now have a higher money income. But they do not have an obligation to pay back such money and even the government's obligation to pay the value of the money it has issued is just on paper and not in reality.

If the necessity for paying back the value arises, the government can easily meet its obligation just by giving out a new currency note. As a result, when people have a higher money income without a corresponding obligation to pay back, they have higher money on a net basis making them feel richer than before. Economists call this feeling of richness

the 'wealth effect'. This wealth effect will force them to consume more, invest more and work harder. The higher consumption will encourage an increase in supply, while higher investment and hard-work will raise the overall output and employment in the economy.

MMT's argument: Giving government jobs is building a buffer stock of consumers

MMT also argues that governments should guarantee jobs for the unemployed. Such job guarantees issued by governments, most often at minimum wages, will raise employment, give additional income to the unemployed who would use that income to consume more and encourage production. The increased production will raise output and supply in the market thereby stabilising the prices and killing inflationary pressures. They also argue that these newly employed people serve as a buffer stock of consumers who would automatically stabilise an economy in a recession. Thus, reducing the size of the buffer stock of added consumers will reduce the budget deficits, but it will eat out the booming economy as well.

Defects of MMT

MMT has therefore offered a dose of chartalism to people who have been frustrated by the failure of economies to give them jobs, incomes and means of enjoying a good life. But it ignores the possibility of creating inflation and the newly printed chartas becoming an obligation of the people due to a reduction in real living of people arising from inflation. It also ignores the possibility of raising prosperity in foreign countries through increased imports, on one side, and creating balance of payments difficulties, on the other. As Singapore's First Finance Minister Goh Keng Swee has said, financing government budget deficits through printed money is a recipe for economic disaster in an open economy and a country should not run the risk of compromising long-term economic growth by imposing import controls.

If people are to learn from past mistakes, a cautious approach is needed when using newly printed money for attaining a quick V-shaped recovery.

For the full article – Refer the Daily FT

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