# Spotlight: Econ Op-eds in Summary

Week ended 24th March '21

## In Summary

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

**1. What does a challenging economic environment facilitated by low-interest rates mean for corporates?**
**By: Charith Gamage**

- Sri Lanka is currently in a low rates environment amidst the COVID-19 pandemic. In such an environment, corporations can enhance their funding by either issuing new stock or borrowing funds from lenders. The total level of corporate borrowings can be ascertained from the Debt-to-Asset and Debt-to-Equity Ratios. These ratios measure a firm's borrowings relative to their equity or asset base respectively, with a higher value indicating that a firm has a higher reliance on debt compared to its equity or asset base.

- In general, a firm's total financing will be procyclical and is consistent with the idea that firms reduce investments during economic downturns and vice versa, optimising their debt-equity choice accordingly. Studies show that firm size is a key consideration for firm financing over the business cycle, with funding needs and capacity differing across firms. Regardless of the business cycle stage, large firms find debt financing attractive, as economic downturns will have less of a detrimental effect on large firms' credit quality than smaller firms.

- Bank credit plays a crucial role in firm financing in recessions, particularly in Sri Lanka as the corporate bond market is illiquid. This means that firms must heavily rely banking channels for debt financing. An article from Global Finance demonstrates that low rates don't mean that funds are accessible to all firms, given tighter lending standards for banks amidst COVID-19. Rather, a wave of mergers acquisitions which favour larger corporations have emerged. However, to mitigate adverse effects arising from excessive lending of regulatory measures must be in place.

With last year's deep dive into monetary easing amidst the COVID-19 initiated economic slowdown, Sri Lanka is still experiencing an environment of some of the country's lowest interest rates in recent history.

A more recent development is that the Central Bank of Sri Lanka reaffirmed its commitment to maintaining a low-interest-rate environment at a policy meeting held earlier in March. Lower policy interest rates theoretically translate into lower borrowing costs and boost the credit flow towards firms. Hence, it is expected to create a feedback loop of growth that boosts economic activities by encouraging borrowing and investing.

However, it is also possible that the outcomes of these measures would deviate from the expectations, with unproductive effects on the economy. This article views this paradigm from the perspective of firm financing, an essential integrant in the recovery process. By weighing risks and potential benefits, it will discuss how to guide developments on a productive trajectory.

**What does an economic slowdown mean with respect to firm financing?**

In general, an economic slowdown slumps consumer spending. Fear and uncertainty begin to grip the consumer market, and lenders tend to pull back their money and become more selective with their lending criteria. Firms, those who depend on external financing to finance ongoing operations, get caught between both declining sales and tightening credit conditions.

The idea of monetary easing during an economic slowdown is to lower borrowing costs and increase the money supply; as the monetary authorities open the monetary floodgates, this financial pressure on firms is expected to decline. However, how long this should last and at what level it is appropriate is debatable.

Nevertheless, such measures expect firms to maintain their operations and, during the economic recovery cycle, permit them to invest in new projects and machinery; therefore, they catalyse the overall economy. Lower policy interest rates affect the borrowing costs of two main types of companies; public and private.

However, comparing public and private firms, the former has two options for raising capital: issuing new stock to the public and borrowing funds from lenders. By contrast, private firms have to depend on existing shareholders and borrowings. These corporate borrowings are measured through leverage; in some contexts, this is also called financial "gearing".

Debt-to-Asset Ratio and Debt-to-Equity Ratio are the main measures of leverage; as the names imply, these ratios measure a firm's borrowings relative to their equity or asset base. A higher value indicates that a firm has a higher reliance on debt compared to its equity or asset base.

**Firm financing over the business cycle**

In general, firm financing studies imply that a firm's total financing is procyclical either through debt or equity. Procyclicality (opposite: countercyclicality) means that they are either positively or negatively correlated with cyclical economic fluctuations and therefore react to economic variations. This is in line with the idea that firms reduce investments during economic downturns and accelerate investments once they see the light at the end of the tunnel, thereby optimising their debt-equity choice accordingly.

Although equity is one option for public firms, bank credit as the monetary transmission mechanism plays a crucial role in firm financing during economic downturns to support these firms. For example, discussions of former Federal Reserve chairman Ben Bernanke (with Mark Gertler) support this idea [1]. A recent study by scholars from Stanford University and the University of Minnesota explains how small and large firms finance through debt and equity in the different phases of the business cycle [2].

According to the study, firm size is a key consideration for firm financing over the business cycle. Two considerations distinguish small and large firms: funding needs and funding capacity. Small, growing firms are firms with high funding needs but often constrained by their debt capacity. By comparison, large firms are particularly well established. They do not have strong investing requirements as small firms, but they also have a higher debt capacity.

Regardless of the business cycle stage, large firms find debt financing attractive, as economic downturns will have less of a detrimental effect on large firms' credit quality than smaller firms. This implies that large firms also become attractive for lending institutions during economic down cycles as they are well established and less risky. In contrast, small growing firms become riskier for those institutions to lend to. Therefore,

economic downcycles can increase the disparity between lending rates that lenders offer to large and small firms.

Overall, small and large firms' drift apart in the lending markets during the economic downcycles is against the policymakers' expectations. Through policy measures such as low-interest rates, policymakers expect growing firms to invest more and help the economy recover fast.

When it comes to debt instruments, firms have two options for debt financing, i.e. issuance of corporate bonds or borrowing through the banking system. However, due to the country's less-developed corporate bond market, Sri Lankan firms rely more heavily on the banking channel for debt financing. This in turn can act as a headwind towards economic recovery, as had there been liquid and deep corporate bond market options available, the firm financing process would have been more effective, subject of course, to the risks attached to corporate bonds.

Improving the corporate bond market has the effect of somewhat reducing the pressure on the banking system. It provides an alternative risk measure for banks and prevents the banking system from being saturated by large firms. It also provides the central bank with an additional tool; the monetary authority can directly purchase corporate bonds to backstop corporations; this is a strategy adopted in most developed economies. If this is done with proper risk assessment, it provides confidence to those firms and the economy.

**Global trends**

In line with the theoretical framework discussed above, a recent article from Global Finance shows the low-interest rates does not necessarily mean funds are accessible to all the firms.

As banks started to tighten lending standards with the rising expectations of pressures caused by COVID-19 on the business environment, corporates also started firming up their balance sheets and strengthening their market position to face this battle.

As the article shows, this created a wave of worldwide Mergers and Acquisitions (M&A), including in Asia, and the trend is expected to be stronger this year. Therefore, the article supports the idea that during these turbulent periods, it is possible for the market to reach an equilibrium where lenders favour lager and strong institutions to mitigate risk, while large firms also expand their institutions to become more attractive, increasing the inequality between large and small borrowers.

Altogether, by considering the theory and recent evidence, it is clear that the mechanism by which lower interest rates propagate into the corporate sector is not as straightforward as it seems. Instead, it is an outcome of a complicated process wherein both lenders and borrowers act strategically.

**Knock-on effects on the stock market, lending institutions and the macroeconomy**

When considering economic developments, there is a higher tendency that lower borrowing costs would increase the overall leverage of the market. Corporate leverage is helpful for firms up until a certain point; after that, it works adversely on firms and the economy. Excessive corporate leverage affects stock market volatility as well as exerting pressure on lending institutions.

On the one hand, a paper by the University of Rochester Professor Schwert William mentions that corporate leverage affects stock market volatility. On the other hand,

studies support the idea that high corporate leverage could also be harmful to lending institutions.

For example, a study by Saibal Ghosh explored this in the context of India and found that high corporate leverage is a determinant for predicting banks' non-performing loans. When considering the impact of financial leverage on the macroeconomy, potential risks with respect to the macroeconomic stability caused by high-level corporate debt should be taken into account.

However, it is important to note that an overregulated approach would offset its potential efficiency benefits. Instead, policy measures should constructively steer these new developments in a progressive direction.

**Policy considerations**

From the perspective of economic policy, the ongoing low-interest-rate environment is relatively new to Sri Lanka. Policymakers can deploy new tools and strengthen macroprudential measures, including active supervision and macroprudential oversight. It is also important to analyse highly leveraged and unsustainable borrowers separately with prudential tools as their knock-on effects could cause adverse consequences for the rest of the economy.

In addition to this, targeted stress tests at banks' loan portfolios would be another way of identifying the impact. However, most are not regulatory, but measures that encourage equal access to funds during the recovery process. Also, policymakers can encourage and support improved corporate governance measures; therefore, firms themselves can better manage market dynamics by identifying risks and prospects.

For the full article – Refer The Daily FT

**2. Sri Lanka import controls and their impact**
**By: Asanka Wijesinghe**

- Sri Lanka had recently imposed a wave of import restrictions with the aim of boosting domestic production and avoiding re-exporting substandard products and foreign exchange leakage. However, protectionism has costs. One of the main concerns is the possibility of trade retaliation where import controls could lead to long lasting and damaging tariff battles with key trade partners, which could in turn hurt the country's exports.

- Another concern with regards to import controls lies in the manufacturing sector's heavy dependence on imported raw materials. In such a situation import controls disrupt the input supply and may harm the export performance of industries that use foreign raw materials.

- Historically, governments had resorted to import controls when there was a balance of payment crisis. However, the trade deficit's temporary shrinkage may not be sustainable if there is no increase in exports. Instead, Sri Lanka needs to remove hurdles on input supply, exploit market opportunities under the rule-based free trade system, and in the long run, improve the country's global value chain participation.

**Beyond Turmeric: How Import Controls are Impacting Sri Lanka's Economy**

Raw turmeric roots on the shelves of roadside vendors is a frequent sight nowadays. Thanks to the import controls, turmeric now fetches a higher price domestically; prices having soared by as much as 275% from Rs. 80 per kilo to Rs. 300 per kilo.

The turmeric shortage, reports of adulterated turmeric powder, the ceiling price, black-market sales, and sensational stories of busting smuggling attempts are the manifestations of the impact of import controls.

The recent waves of import restrictions imposed by the Sri Lankan government have different justifications such as boosting domestic production and avoiding re-exporting substandard products and foreign exchange leakage. However, protectionism has costs. The significant costs are:

1) possibility of tariff retaliation by the trading partners;
2) impact on domestic manufacturing for exporting; and
3) resource misallocation.

These costs will have a severe impact on the recovery of the COVID-19 affected economy.

**Possibility of Trade Retaliation by Trading Partners**

Trade is no longer a one-way street. The EU, in a statement on Sri Lanka's new import controls, points out that "a prolonged import ban is not in line with World Trade Organization regulations."

Returning to the turmeric story, Sri Lanka's primary turmeric import source was India. In 2017, 97% (USD 7 million) of Sri Lanka's turmeric imports came from India. Media reports show that Indian farmers and merchants have raised concerns over Sri Lanka's turmeric ban.

While these concerns have no immediate damage on the country's exports, Sri Lanka should still be cautious to avoid the Trump administration's blunder of getting into a series of tariff battles with crucial trade partners.

**Impact on Domestic Manufacturing**

Nowadays, the vertically linked manufacturing process through global value chains (GVCs) is the norm. Manufacturing in Sri Lanka is no exception. Around 49% of Sri Lanka's imports are intermediate goods, and 14% are capital goods.

Import controls disrupt the input supply and may harm the export performance of industries that use foreign raw materials. One significant China-US trade war harm was on the US manufacturing sector. Comparably, Sri Lanka's import controls in April 2020 seriously hurt the sectors which used imported raw materials.

It is, however, commendable that the government relaxed some of the import controls in June to ensure an uninterrupted supply of raw materials.

**Resource Misallocation**

Economic theory dictates that a country should produce and eventually specialise in products for which the country has a relative productivity advantage (production patterns correlate with predictions from Ricardo's comparative advantage theory). Import controls distort production and induce the allocation of scarce resources to relatively unproductive sectors.

Sri Lanka imported around 75% of the turmeric requirement, and 97% of imports came from India. The Revealed Comparative Advantage (RCA) index for turmeric shows that India has a superior export performance.

Sri Lanka traded turmeric following the “revealed comparative advantage” logic, but the import controls distorted it. The prospect of exporting domestic turmeric is not promising. India dominates the global turmeric market currently and has a cost advantage. It is doubtful if Sri Lanka can grab a sizeable chunk of world trade through protectionism. However, now the resources are diverted to the protected sector, and domestic consumers pay an exorbitant price.

**A Way Forward**

Historically, the government resorted to import controls when there was a balance of payment crisis. The current import controls have the same underlying rationale.

However, the trade deficit’s temporary shrinkage may not be sustainable if there is no increase in exports. To increase exports, Sri Lanka needs to remove hurdles on input supply, remove distortionary tariffs, exploit market opportunities under the rule-based free trade system, and in the long run, improve the country’s GVC participation.

Sri Lanka successfully realigned the production process to produce widely demanded COVID-19 related medical supplies showing the benefits and opportunities of free trade. The high demand may continue to another year, and countries have removed tariffs on medical supplies. Some countries have banned the exports of medical supplies like PPE opening substantial market opportunities for Sri Lanka.

Increasing GVC participation by producing products closely related to the current competitive sectors but have higher complexity, is a practical approach. Sri Lanka may not make the final good within the country, but the country may process the materials it currently exports by a little. Participation in downstream, as well as upstream GVCs, makes countries better off.

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