Spotlight: Econ Op-eds in Summary

Week ended 01st February '22

In Summary

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

1. Sri Lanka use of reserves for imports is a deadly false choice
By: Bellwether

- An IMF program will be accompanied by a debt restructuring, rate and tax hikes. They will not permit the usage of reserves for imports as Sri Lanka would otherwise default on the restructured debt. Given this, imports need to be financed by inflows into the country, and can only be done at the correct interest rate. However, the country doesn't have a working currency regime and the LKR needs to be floated.

- Central bank dollar sales, if unsterilized, create liquidity shortages in the interbank market, which will lead to further imports and loss in reserves. Although financing from India has helped alleviate short term pain, an IMF program is needed for the economy to correct itself. If more money is printed for the relief package announced earlier this year, it would only put more pressure on rates to rise.

- Problems faced in recent months are, similar to Latin America, as Sri Lanka faces power cuts, food shortages and a pegged currency. Given this, current import controls will hurt businesses in the long run, and may even result in bank runs and the debt to GDP ratio skyrocketing. Sri Lanka is heading for more pain, and the sooner it goes for a correction, the less painful it will be for the economy.

Sri Lanka should not use foreign reserves for imports, because under a 6.5% policy rate an equal amount of money will be printed, which will prevent a contraction in credit and reserve money, encourage imports, perpetuate forex shortages and bring the country closer to default.

There has been flurry of calls to use reserves for imports rather than repaying debt.

No person who advocates Sri Lanka going to the International Monetary Fund can also advocate using reserves for imports with a straight face.

The first step the IMF takes is to hike rates (if they are too low) and force a float of the currency to stop 'reserves for imports' and implied sterilization of such reserve sales with printed money.

Such a float – at an appropriate interest rate that is sufficient to finance the residual deficit after a tax hike – will stop the currency crisis in its tracks within a few weeks. IMF will not make any disbursements unless 'reserves for imports' are stopped.

The agency gives money to boost reserves, improve confidence and give a breathing space, not to bust them up on import consumption.

If reserves are given for imports, how will any debt, re-structured or otherwise be repaid? As long as reserves for imports are given, Sri Lanka will then default on the re-structured debt.

Any imports have to be financed by inflows only. Not only that, there has to be a little left over to re-build reserves. At the correct interest rate, that can be done.

So giving reserves for imports vs debt is a false choice and a deadly one.

That reserves can be used for imports as domestic credit picks up is a myth. It is a naked Mercantilist myth. Countries that do so, including those with budget surpluses have come to grief.

For 70 years Sri Lanka has been using reserves to repay debt. Reserves are needed for debt because payments are lumpy. While it is beyond this column to explain the exact mechanism suffice to say, it can be done without altering reserves of multiple banks almost similar to an IMF transaction with the central bank.

However, Sri Lanka now does not have a working currency regime. Sri Lanka neither has a credible pegged regime nor a floating exchange rate.

To balance imports with inflows, to repay debt, one or the other is needed. The surrender rules prevent any peg from operating, because they create new money.

Sri Lanka now does not have reserves. The central bank foreign liabilities exceed assets by a big margin.

To say reserves must be used for imports is a statement that has no basis with reality.

Sterilized Currency Defence

When a pegged exchange rate central bank sells dollars to an importer, it is not the same as an exporter selling a dollar or even the Treasury selling a dollar.

A central bank dollar sale reduces liquidity in the banking system and shrinks the monetary base. A $100 mn dollar sale of reserves for fuel by the central bank leads to a 20 bn rupee liquidity shortage in the interbank market at the current rate.

This reduction in rupee reserves in the banking system (as long is it is unsterilized) also kills off credit that the 20 bn would have generated keeping the external sector and the exchange rate in balance. An unsterilized currency defence immediately deducts the outflow of real wealth from the banking system as a fall of rupee reserves of banks.

However, if this rupee shortfall is pumped backed into banks to maintain the policy rate, re-expanding reserve money, banks do not have to collect new deposits to replenish rupee reserves. It prevents the correction in the credit system that is required to stop the currency crisis.

It is not relevant whether money is printed to finance the deficit or sterilize reserves given for imports in an economic recovery. The effect is the same.

The injections will will completely mess up the prices in the economy, trigger further imports and reserve losses, even if there is no overt excess liquidity seen in the banking system, like now.

In a clean, 'fixed' exchange or credible peg rate there is no sterilization. An outflow of dollars leads to an equivalent fall in the local money, just as if the money supply was dollars.

In consistent peg, net foreign assets (NFA) will move parallel to the growth in reserve money.

In a float net credit to government (NCG) will go in parallel to reserve money.

In a (soft) pegged country, the intervention is sterilized with new money. In a soft-peg prone to crises, the two will go in opposite directions creating crises when NCG goes up (sterilizing reserve sales), and re-building reserves when it goes down (sterilizing purchases of dollars).

Suspension of Convertibility

A float will prevent a further erosion of reserves as money will neither be taken out of the banking system.

However, a float will not work if the interest rates were too low, and money was printed either to finance the government through failed bill auctions, or banks were finance through the reverse repo window.

However, if interventions are made for imports, and they are sterilized, a total currency collapse and an economic collapse comes closer.

Reserves as the foregoing shows foreign reserves are not there for imports as claimed by Mercantilists.

Reserves are there in a peg as a restraining influence or in technical terms to anchor the monetary base and prices by triggering a tightening of the quantity of money which in turn will trigger a rise in rates and savings and a reduction in credit.

Conserving reserves for imports will not help.

A rate rise will help. However with the credibility of the peg being lost now, and a very large parallel premium having emerged a very high rate is required to maintain the current exchange rate.

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However a float will not work if the interest rates were too low, and money was printed either to finance the government through failed bill auctions, or banks were finance through the reverse repo window.

Interventions are made for imports, and they are sterilized, a total currency collapse and an economic collapse comes closer. And its effects will be made worse.

Reserves are there in a peg as a restraining influence or in technical terms to anchor the monetary base and prices by triggering a tightening of the quantity of money which in turn will trigger a rise in rates and savings and a reduction in credit.

Conserving reserves for imports will not help. It is a road to nowhere.

Painful Correction

Liquidity injections made to outright finance the deficit such as in 2020 or to mis-target reserve money in both 2015/16 and in 2018, eventually reduces growth and also generates inflation due to the liquidity injections made in the run up to the crisis.

"The structure of prices that existed during the period of sterilized intervention contains mistakes that must now be corrected, perhaps at the cost of a recession," explains the congressional report.

"Mistakes in targeting the real supply of money create opportunities for arbitrage in foreign-currency markets and elsewhere: the bigger the mistakes, the bigger the opportunities. Monetary authorities that in effect target the real supply of money by maintaining pegged exchange rates encourage speculative pressure to build until it forces a devaluation."

"Currency crises can be viewed as the foreign-exchange market's way of forcing adjustment of the real supply of money to the real demand when the monetary authority is trying to prevent it.

Déjà vu

Sri Lanka is heading for more pain.

In 2018 when the central bank embarked on a similar escapade this column warned that Sri Lanka was not Greece where inflation was stable, bank deposits and pensions and salaries retained value and there was no shortages of goods.

At the time the Fed had already tightened policy and oil prices were falling and there was also good rain, which reduces losses and credit pressure from energy utilities. Now a drought is on. Fed tightening is ahead.

But budget are already in dis-array due to the 2019 tax cuts though some new taxes are coming in.

If the 229 bn rupee 'relief package' is printed, and more money is printed, things will get worse. At the moment with the rise in Treasuries rates, most of the deficit is financed.
However large volumes of money are printed at 6.5 percent to sterilize interventions. It cannot continue. (When this column was originally published in December, the rate was 6.0 percent)

Earlier the correction, the lesser the pain.

This administration has done well to get finances from India. However they can be frittered away in imports. The credit lines can be effectively used to finance the budget, as long as goods are market priced. Using the fuel credit lines on a loss – making CEB is not a good idea. The food and medicine credits can also be used to finance the budget.

But for this an overall program is needed. This is where the IMF will come in useful. (Click here for other elements of an overall program – Sri Lanka has to hike rates, tourism recovery will not help end forex crisis).

Sri Lanka is not Greece, It is Latin America

Many of the problems seen in recent months, the goods shortages, the price controls (now abandoned in an improvement in policy) fuel shortages had been predicted in these columns, when disastrous monetary policy was followed in 2018, after budget corrections had been made.

"It is not possible to import goods freely when a soft-peg collapses because there will be forex shortages due to sterilized intervention. Import controls may also come," this column warned at the time.

“As the cost of fuel or electricity goes up if prices are not raised, more money will be printed to subsidize energy, pushing the currency down.

“In Latin America, energy price controls have led to money printing and rationing. There can be power cuts and fuel shortages.

“In Sri Lanka because of price controls of the National Medicines Regulatory Authority medicines, drugs can go off the shelves.

“In Latin American soft-pegs many price controls were imposed. Instantly goods go off the shelves and black markets appear.

“With import controls more businesses will fail. People will be laid off as revenues fall. Banks will make more losses. Rates will rise eventually. More businesses can fail.

“If this situation continues for several months, there may be runs on banks. If money is printed to bail them out, the currency falls even more. This phenomenon was seen in many Latin American soft-pegs and also Indonesia during the East Asian crisis.

“Debt to GDP will explode until inflation catches up. The share of foreign debt will also increase.

“This is what happens in Latin America. It is not Greece.”

Sri Lanka is not Greece where the anti-austerity brigade created mischief misleading politicians backed by Western financial media. The pain of depreciation, high inflation, un-affordable food and energy shortages are real.

It is Latin America. It is Ecuador before dollarization.

For the full article – Refer Economynext

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