

# Spotlight: Econ Op-eds in Summary

Week ended 19<sup>th</sup> August '20

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## In Summary

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

### 1. Urgent economic challenges for the new government

**By: Nimal Sanderatne**

- The government needs to urgently adopt policies to stabilise the economy while addressing rising unemployment and poverty in Sri Lanka. Even so, the economy's dependence on trade, tourism and foreign remittances indicates Sri Lanka's recovery depends very much on the global economic recovery.
- Sri Lanka's economy faces pressing issues, foremost of which are the ballooning fiscal deficit and the deteriorating balance of payments. These have resulted in significant economic instability and critically low foreign reserves, compounded by debt service obligations
- In order to remedy its BOP woes, it is essential that Sri Lanka seek debt moratoria and aggressively seek bilateral and multilateral foreign assistance. Solving the fiscal imbalance will require a two-pronged strategy of revenue enhancement through tax reform and fiscal consolidation through expenditure changes.

Mitigating the external financial vulnerability, reduction of the large fiscal deficit, reducing the growing unemployment in the country and alleviating poverty are challenging tasks in the current inhospitable global economic environment. However, their resolution is vital to usher in economic growth in the medium and long run.

#### Weak economy

However, the country's weak macroeconomic conditions and the recessionary global economy make the economic recovery difficult. The containment of the world-wide COVID-19 pandemic is a precondition for the global economic revival. In turn, the trade, tourist and foreign remittances dependent Sri Lankan economy is dependent on the global economic recovery.

#### Immediate problems

The new Government has to resolve several economic problems before embarking on an economic growth strategy. These include the need to address the country's external financial vulnerability and reduction of the large fiscal deficit by enhancing government revenue. These have to be achieved while addressing the problems of growing unemployment and poverty in the country that requires additional expenditure for immediate relief measures.

#### Twin problems

The twin problems of the deteriorating balance of payments and external finances and the destabilisation of the economy by the large fiscal deficit require immediate remedial measures.

#### External finances

The dire state of external finances in the current inhospitable global conditions necessitates foreign assistance. In the case of the public finances, a U-turn in fiscal policies is needed to enhance government revenue. At the same time prudent management of government expenditure too is needed to reduce the ballooning fiscal deficit.

### **External vulnerability**

The external reserves of the country that were US\$ 7.5 billion at the end of last year have fallen to US\$ 6.5 billion by the end of June this year. The likely continuing balance of payments deficit in the second half of the year and debt repayment obligations of about US\$ 1 billion this year would result in a critically low level of foreign reserves at the end of the year.

The adverse balance of payments would be despite the stringent import controls, due to the fall in exports, reduction in workers' remittances and negligible earnings from tourism.

### **Low reserves**

The danger with the low reserves is in 2021 when debt service obligations of about US\$ 4 billion have to be met. It is imperative that Sri Lanka obtains moratoria on debt repayments as proposed by the IMF. The Government must also aggressively seek other multilateral and bilateral international assistance to overcome the external financial vulnerability.

### **Fiscal imbalance**

The other serious problem is the burgeoning fiscal deficit that is a root cause for economic instability. The fiscal deficit is likely to reach double digit proportions this year and need to be halved in 2021. This is an immediate problem that the Government must resolve.

### **Strategy**

A two-pronged strategy is needed to reduce the fiscal deficit: an increase in Government revenue and a containment of expenditure. Revenue enhancement is the more important and pragmatic course of action.

The Government should reverse the tax exemptions and tax reductions it implemented and revive the tax reforms that attempted to achieve fiscal consolidation through a revenue enhancing strategy.

In the long run further progressive tax reforms and expenditure changes are needed to achieve fiscal consolidation.

[For the full article – refer the Sunday Times](#)

## **2. New Govt. should take the foreign debt crisis seriously and stop playing popular blame game**

**By: W. A. Wijewardena**

- Due to both government and private sector foreign borrowings, Sri Lanka is now facing a debt crisis where the country's foreign currency reserves are insufficient to repay the loans while also financing the necessary imports.
- These high borrowings are a direct result of lack of savings on the part of the government as well as people. While foreign borrowings are justifiable for development purposes, a crucial requirement in doing so is the adoption of prudential measures to use such borrowings and ensure their repayments.
- As such, the government should immediately start negotiating with the creditors to have the current loan repayments postponed at least for two years, while also developing a medium to long-term strategy, for improving its foreign earning capacity by promoting the export of goods and services.

### **Per capita debt is a fallacious indicator**

Per capita debt will become a real burden if and only if the entirety of foreign debt is to be repaid in one year. In that case, each citizen has to make a sacrifice immediately at the cost of his personal consumption or investment today. But Sri Lanka's debt maturity profile is long term and the actual burden falling on each citizen is only the share of debt servicing – that is, commitment to repay the principal and pay interest on the debt – and not the total debt stock. In Sri Lanka's case, that is about 10% of the total debt stock.

### **Government is a net beneficiary of currency depreciation**

As for the depreciation of the currency, the government is a net beneficiary of falling exchange rates. Though it is true that the rupee value of the annual debt servicing increases after the currency is depreciated, the additional amount it has to pay in rupee terms is much less than its gain due to the valuation of imports and government's foreign borrowings at a higher exchange rate. For instance, in 2019, if the rupee depreciates against the US dollar by Rs. 1, the rupee value of the debt servicing would go up by Rs. 4 bn. But the government's additional rupee income by way of import duties and loan proceeds had amounted to Rs. 6 bn, making the government a net beneficiary of the depreciation of the rupee.

### **Need for taking a realistic view of the burden**

The longer a country postpones introducing necessary remedial measures, the much deeper it would find itself in the crisis at hand, making it difficult for the country to escape the hard realities of being indebted to other nations.

### **Foreign debt involves a resource inflow and outflow whereas domestic debt doesn't**

This is because in the case of foreign debt, a country gets a benefit when it receives the proceeds of a loan. People in the rest of the world have sacrificed their current consumption, saved money and enabled the borrowing country to have a higher consumption or investment in the current period. But when the debt is to be repaid or interest on it has to be paid, the borrowing country has to make a similar sacrifice. If this sacrifice is too much, then it becomes a burden. However in the case of domestic debt, a country does not face a similar situation. At the time of borrowing, savers give their savings to the government which in turn gives it back to people by way of government expenditure. Hence, there is no change in the country's total consumption levels. At the

time of repayment or payment of interest, people pay taxes to government that causes a reduction in their consumption. But the society as a whole gets this back, when the government spends that money,. Hence, domestic debt is normally categorised as 'We owe it to ourselves' meaning there are no outside creditors holding their guns at our throat to get their money back.

### **It is the total country debt that matters**

Many tend to attribute the debt crisis to only the foreign debt owed by the government. In public discussions, the reference is usually made to the foreign debt contracted by the government of Sri Lanka. But this is only a part of the story. That is because there are private companies, banks, etc. which also have borrowed from foreign sources. Hence, what matters for debt resolution is not the government's debt per se, but the total country debt.

### **Total debt in 2019**

For instance, at end-2019, the government had borrowed a sum of \$ 35 bn from foreign sources. As at the same date, the private sector had borrowed \$ 21 bn, making the total country foreign debt a staggering US\$ 56 bn which amounted to 66% of the country's GDP. Sri Lanka has to repay all these loans as and when they mature and pay interest on them annually. For this, it needs foreign exchange. Since there is a deficit in the current account of the balance of payments of the country, foreign exchange for debt repayment should be found by making further foreign borrowings or using the country's existing foreign reserves. In the next twelve-month period, the total debt repayment commitment of Sri Lanka will be \$ 5.6 bn. Since the available liquid foreign reserves amount only to \$ 6.6 bn, the only option available for Sri Lanka to meet its debt repayment obligations is resorting to further borrowing. But it would worsen the country's woes and will snare it in an inescapable debt trap.

### **At independence, foreign debt was insignificant**

All Sri Lankan governments since independence have contributed to the build-up of foreign debt by the country. In 1948 when it gained independence, Sri Lanka's foreign debt was negligible at 4% of GDP. This was not a problem at all because when the British left the country, the country inherited a massive amount of foreign assets sufficient for paying for 17 months of imports in the following year. But over the years, foreign debt has increased both in amount and as a share of GDP, while the foreign assets have fallen sharply making the country vulnerable to unexpected external payments.

In some years like early 1970s, 1989 and 2007-8, foreign asset adequacy was as low as having less than two months of future imports. Today, Sri Lanka's average foreign asset level is about four months of future imports, but it has basically been built by borrowing from abroad rather than earning via the export of goods and services. If foreign assets are used to meet these obligations, the country will not have enough foreign exchange to buy oil, medicines and raw materials for industries. This is the nature of the crisis which the country is facing today.

### **Borrowings are needed when savings are paltry**

Sometimes, the question is posed why Sri Lanka should borrow abroad to finance its domestic development works. Why can't Sri Lanka do without it? If for example King Parakramabahu I could build giant reservoirs and other irrigation schemes without borrowing from abroad, why Can't Sri Lanka could do the same today? Surely, Sri Lanka can finance its domestic development works without borrowing from abroad if it makes enough savings locally. The problem with Sri Lankans is that they are notorious spenders and poor savers. For instance, on average, a Sri Lankan spends about Rs. 80 out of an

income of Rs. 100 on consumption and saves only Rs. 20. This Rs. 20 is insufficient for it to meet the high investments that would generate prosperity to Sri Lankans. The **problem is further worsened because the government is a dissaver**. When it receives Rs. 100 as income, it normally spends Rs. 102. Hence, it has to necessarily use the savings made by foreigners to meet the gap between the required investments and available local savings.

### **King Parakramabahu I and his surplus budget strategy**

As for King Parakramabahu I, there was no need for borrowing abroad to finance the local development works for two reasons. First, the **budgetary policy adopted by all Sri Lankan kings was that of surplus budgeting**. Kings were advised to build treasuries full of resources because that was a symbol of his power. To build such treasuries, they should spend less than what they have got as revenue, gifts or expropriations. The resultant surplus enabled them to undertake massive development projects or meritorious works.

### **Inclusive tax policy of ancient Sri Lankan kings**

The second reason was the **high and inclusive taxation policy adopted by all ancient kings**. People had to pay income tax not by using money which was in short supply at that time but by providing free labour services to the king under a system called Raajakaariya or compulsory royal service. This is similar to the polls taxes which some governments impose on their citizens today. Under the polls tax, all able-bodied persons have to pay a tax to the government simply because they have a body. Similarly, under the Raajakaariya system, all able-bodied people had to provide free labour to the King for three months and it was similar to an income tax of 25% levied on people. In addition to this, taxes paid by farmers were even higher than 25% of their annual crop values. Overall, people were paying taxes of more than 50% of their income to the king and therefore, kings did not have to borrow abroad to finance domestic development works.

Therefore, in today's context, **there is nothing wrong in borrowing abroad to finance local development works if the available domestic savings are inadequate. However, a crucial requirement in doing so is the adoption of prudential measures to use such borrowings and ensure their repayments.**

### **Financing Sri Lanka's railway system by borrowing**

A good example is the financing of Sri Lanka's railway system by the colonial masters. Many in Sri Lanka who use the railway services today are unaware that **almost entirety of the capital cost of the development of the system was financed by tapping the savings of British savers by borrowings from the London capital market by issuing Sterling debentures at interest rates ranging from 3% to 6%..** In addition, to meet the local expenses, a small sum was borrowed from local sources too. Altogether £ 3.4 mn from London and Rs. 2.5 mn locally were raised by railway authorities to finance this project.

However, the **Colonial Secretary had imposed two conditions** for these borrowings. One was that the **loan proceeds should be used only for the railway project and nothing else**. The other was that to **ensure repayment of these debentures, the railway authorities should build up a sinking fund out of the annual surpluses** in the railway system. Accordingly, as reported by Indrani Munasinghe in her Colonial Economy on Track, by 1905, the total value in the sinking funds amounted to about Rs. 41 mn. The outstanding loans as at that date were only Rs. 39 mn. What this meant was that the burden of repaying loans raised for the railway project was shouldered by the users of the system, mainly British planters who used it to transport their produce to Colombo for exportation and passengers of the railway system who used it.

### **The abolition of the sinking fund system**

During the colonial times, even the government borrowings were supported by the building-up of sinking funds in this manner. After independence, Sri Lanka government continued with this prudential practice till 1984 and its objective was to get the current taxpayers to bear the burden of repaying government's borrowings. But this required the government to allocate every year a sufficient amount out of its budget to the sinking funds maintained in the Central Bank. However, by mid 1980s, the government had considered it as an additional burden and therefore decided to abolish the sinking fund scheme. As a result, today, the burden of repaying the country's foreign (as well as local) borrowings are being passed on to the future taxpayers. It amounts to the present generation selfishly passing the burden of their high borrowings today on to their children and grandchildren.

### **The growing debt crisis**

Since Sri Lanka does not have enough foreign exchange to repay these borrowings, it has to borrow more and more funds to gain capacity for same. As a result, the outstanding borrowings have been rising year after year making it more and more difficult for servicing them. The total country debt to foreigners as at end-2019 amounted to 66% of GDP. When one adds the local borrowings of the government too to that figure, the total borrowings will rise to a staggering 111% of GDP.

There are some Sri Lankans who have been arguing that this is not a burden compared to countries like USA and Japan whose borrowings have been more than Sri Lanka's debt to GDP ratio. This is a fallacious argument because all these countries have borrowed in their own currencies and therefore are in a position to repay those borrowings by printing their own currencies just like Sri Lanka government can print rupees and repay domestic loans if the tax revenue is not sufficient to repay the same.

### **Repudiation of debt is unwise**

Some others also suggest that Sri Lanka should default on these loans at this stage. This is also not a prudential strategy. Countries like Vietnam, Cambodia and Laos wrote off their foreign loans in early 1970s but it caused these countries to be isolated from the rest of the world. Only after three decades they have corrected their previous mistake and became respectable members of the global economic community.

Sri Lanka should indicate to the rest of the world that it will be with the rest of the economic community. As an indicator of its good intentions, it should immediately start negotiating with the creditors to have these loan repayments postponed at least for two years as Ecuador has done recently. Then, as a medium to long-term strategy, it should go for improving its foreign earning capacity by promoting the export of goods and services through the introduction of high technology. Sri Lankans are presently sitting on a volcano that might erupt at any time. To evade the inevitable calamity, they should work hard, create wealth and be ready to make the maximum sacrifice possible. That is the responsibility of Sri Lankans today.

Political leaders should tell this truth to the people instead of playing the more convenient blame game on their political rivals.

[For the full article – Refer the Daily FT](#)

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