Spotlight: Econ Op-eds in Summary

Week ended 13th January '20

In Summary

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

1. Would lower interest rates spread perform favourably to recuperate the Sri Lankan economy
By: W.N.P. Surawimala

- Given the economic crisis brought on by the pandemic many big players in the global economy had resorted to reducing interest rates in order to create liquidity and induce a recovery. Sri Lanka too had promptly followed these countries and had reduced interest rates of the country throughout 2020.

- However, the policy is faced by few barriers given that the economic crisis is brought forward by a pandemic. Firstly, it is unlikely that rate cuts will generate productive investments at a time when business entities prefer to save rather than to invest not due to high costs of borrowing but because of the uncertainty associated with the pandemic.

- On the other hand, low interest rates, by spurring the growth in consumption, reduces national savings. In turn, in the long run the reductions in national savings directly root to the current account imbalances. However, in this circumstance, lower interest rates would be a favorable factor in improving bank balance sheets and banks' capacity to lend, but should be implemented with thorough monitoring.

The movement of interest rates spread led by the pandemic in world economy

When compared to other countries it has been observed that the interest rates spread for Sri Lankan commercial banks are much higher reflecting high intermediation cost incurred by local commercial banks. The banking sector has been developing gradually over the years in terms of number of banks, number of branches, assets and in terms of the usage of technology in customer service.

However, banks so far have been unable to reduce considerably their intermediation costs, and hence the problem of high interest rates spread exists. Gaining a clear understanding about the factors that influence the interest rates spread would help effective policymaking.

Global economy landscape has reshaped with an everlasting impact with the surge of COVID-19 pandemic. It is anticipated that most of the developed and emerging economies will plunge into a recession in 2020 and beyond, contracting major portion of GDP ever since 1870s.

The reduction of interest rates, stimulus packages backed by respective governments together with unconventional monetary policy measures have been included to the day today vocabulary. It has been envisaged a 5.2% contraction in global GDP in 2020, the deep recession ignited in global economy with the pandemic across the world.

In response to the pandemic-induced global recession, monetary authorities across the world have commenced to introduce lower interest rates – with Eurozone, Switzerland,

and Japan already in the negative interest rates zone and the US Federal Reserve seemingly heading in the same direction. Global stock markets tanked in March 2020.

For a time even US Treasury bonds, the world's safest asset, fell in price amid a scramble for cash and turned into dysfunctional money markets. The Federal Reserve in USA cut interest rates and unleashed a torrent of liquidity to keep dollar markets functioning, preventing a credit crunch, mass bankruptcies and lay-offs.

Other central banks followed suit. From the beginning of year 2020, Central Banks in the US, UK, Japan and the European Banking sector have created new money worth of $ 3.8 tn, much of which have kept yields on long-term Government debt close to zero.

Navigation of interest rates in Sri Lankan context amid COVID-19

Considering the necessity to further support the economy to endure the adverse economic impact caused by the COVID-19 pandemic, given subdued inflationary pressures, the Central Bank of Sri Lanka (CBSL) has decided in addition to the other measures taken to ease monetary conditions in the market, to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank.

Additionally with the objective of revamping the affected businesses by the COVID-19 pandemic, the CBSL, in consultation with the Government of Sri Lanka, implemented Saubagya COVID-19 Renaissance Loan Scheme Facility in three phases to provide working capital loans at a lower interest rate of 4% p.a., with a repayment period of 24 months, including a grace period of six months and subsequently granted extension period of repayment considering the turbulent situation and constraints of repayment arisen with the second wave of the pandemic.

Further backing lower interest rates as the best growth formula, the CBSL last week decided banks would change 7% p.a. on mortgage-backed housing loans and would introduce lending targets to selected sectors to counter the second COVID-19 wave. The Monetary Board at its last monetary policy announcement for this year kept policy rules unchanged and decided to introduce two new measures to complement the concessional loan scheme proposed by the Budget 20/21.

Yet fulfilling its national duty as the regulator of the economy, the CBSL has decided to reduce the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks (LCBs) by 200 bps to 2.00%, with effect from the reserve maintenance period that commenced on 16 June.

This reduction in the SRR injected around Rs. 115 billion of additional liquidity to the domestic money s market, enabling the financial system to expedite credit flows to the economy, while reducing the cost of funds of LCBs.

The financial sector is expected to pass the benefit of the high level of liquidity and the reduced cost of funds to the economy without delay, by increasing lending to businesses and households at low cost. The Monetary Board will continue to monitor economic and financial market developments and will take further policy and regulatory measures to support a sustained revival of economic activity in the period ahead.

Monetary policy and control its money supply, often mandated with maintaining low inflation and steady GDP growth. On a macro basis influence interest rates and participate in open market operations to control the cost of borrowing and lending throughout an economy. Thus, the regulators extended their duty to the interest of the nation in relaxing monetary policy guidelines with the objective of infusing additional liquidity to the economy during this strenuous situation.

However, instead of investing the funds which obtained at an incentive low rate, the manipulation and diversion of additional funds could be witnessed and thus a liquidity trap has awakened which hinders the normal function of spurring the economy to growth.

At this juncture the role of the regulator is vital to influence interest rates in the economy, affecting the behaviour of borrowers and lenders, economic activity and ultimately the rate of inflation.

However, the issue is not entirely above level of market liquidity. It is more about structural deficiencies within the banking sector such as high tendency for transferring facilities to Non-Performing (NPL) category since most of the businesses and individuals tend to exploit the incentive of low interest rate by acquiring more consumption rather than investing funds to the affected businesses.

Therefore, it is indispensable to identify the needy sectors and follow the end use of funds through a comprehensive monitoring mechanism. Also, it is prudent to manage moderate rate for consumption as such misappropriation of funds is expected to be minimized.

The reduction in interest rates will improve the repayment capacity of borrowers, strengthen licensed banks and address the challenges of rising NPLs. Also, the banks could establish Business Revival Units in order to reduce NPLs by granting additional loans on lower rates for the purpose of recovering hardcore facilities.

In today's global economic environment, it seems like conventional measures of monetary stimulus are not only sufficient to lead to greater economic growth; they are actually counterproductive and damage the economy by causing market concentration and unproductive investment and increasing trade deficits and debt.

Central Banks have already realized their importance in contemporary conditions and time to time in supervision, the Central Banks assess the risks that financial institutions pose to financial system stability and, where necessary, take actions to reduce them.

Despite the fact that the interest rate cuts should support economic growth, they alone may not be substantial enough to offset the impact of sluggish growth of economy. The cost of financing may not be the main factor deterring businesses from investing. Therefore, this should be a wake-up call for countries to take efforts towards diversifying their economic base to avoid daunting vulnerabilities of low interest rates and get benefited as expected by the policy makers.

Expectation vs. Reality

The conservative insight is that low interest rate is positive for economic growth because it paves the way for governments, businesses, and consumers to borrow hence spurring investment and ultimately increasing employment and GDP growth. However, it is ambiguous that current lowering of interest rates would boost investment and which in turn assist to revive the economy.

In spite of everything, the current issues in the world economy are the repercussions led by the pandemic, both on demand and supply, as it disrupted global supply chains, restricted people movement and closure of borders.

In this backdrop, it is unlikely that rate cuts will generate productive investments at a time when business entities prefer to save rather than to invest not due to high costs of borrowing and "high" interest rates but because of the uncertainty associated with the pandemic.

Also, particularly when the lower rates introduced for consumption loans such as housing, purchasing capital items, education etc, it is doubtful that funds would be utilized for the same purpose. Therefore, diverting funds will be a common lapse made by the borrowers with the financial constraints followed by the pandemic.

According to the latest research, it has been stated that low interest rates, instead of higher contribution towards the economic growth, have contractionary consequences due to increased market concentration and subsequent formation of monopolies.

As the authors of the research claim, "lowering interest rates have an expansionary effect on the economy through stronger productivity growth". However, although lower interest rates encourage all firms in a sector to invest further, the incentive has been grasped by market leaders than followers.

As a result, industries become more monopolistic over time as long-term rates fall. The various studies concluded that low interest rates would lead to monopolization of the economy, slowing growth in productivity, and rising inequality rather than stimulating the development of the economy.

However, it has been witnessed in today's context particularly in economies in South Asian Region which have low or moderate per capita income that traditional monetary measures are no longer assist in reviving the economy. They contribute to rising inequality for lower interest rates benefit mostly the wealthy, who possess large financial holdings, and hurt middle-class families and retirees who depend on their investments and savings for a living.

Low interest rates, by spurring the growth in consumption, reduce national savings. In turn, in the long run the reductions in national savings directly root to the current account imbalances, in particular, trade deficits and subsequent fiscal deficits.

At the instance of paying incentives of low interest rates to the economy, the banks and other financial institutions may overinvest in long-term assets, such as Treasury securities. If interest rates rise unexpectedly, the value of those assets will fall exposing banks to substantial losses.

However, it is affirmed that in this circumstance, lower interest rates would be a favourable factor in improving bank balance sheets and banks' capacity to lend. During the financial crisis, many banks, particularly some of the largest banks, were found to be undercapitalized, which limited their ability to make loans during the initial stages of the recovery. Therefore, in terms of augmenting the bank balance sheet at the turbulent economy, this would be a blessing in disguise.

Fiscal and monetary authorities in Sri Lanka have undertaken unprecedented steps to revamp the fragile economy during the pandemic situation through massive fiscal stimulus and easing monetary regulations to uplift the nation. Reaping the benefits is in the hands of all economic sectors and individuals in positive approach to recuperate the economy of the country.

For the full article - Refer Daily FT

2. Containing COVID a pre-condition for economic revival in 2021

By: Nimal Sanderatne

- Sri Lanka faces numerous economic problems in 2021, primarily around its balance of payments and debt repayments. However, the immediate problem around Covid needs to be handled first and successfully in order to meet the issues surrounding the country's finances.

- With an economic recovery across the world, boosted by vaccines globally, there could be positive signs for our BOP that could surface later in the year. Exports and tourism could do well, although the markets that matter to Sri Lanka could shift away from the West and towards China and India.

- However, immediate problems still remain. Oil prices have already begun to rise, and would be detrimental to the country's import bill. The new strain of Covid will bring additional worries. Unless the immediate threat of Covid can be managed, the short-term negatives will outweigh the latter positives, and make the economic situation much harder to manage.

Multiple problems

Reviving the economy this year after two years of economic decline, a serious depletion of foreign reserves, large foreign debt repayments and inadequate finances, is a huge challenge. It is not clear how these difficulties would be overcome in the coming months of the year.

Priority

The containment of the COVID-19 virus globally and in the country would be an important determinant of the island's economic performance this year. In spite of several vaccines being available and used worldwide, the eradication of COVID-19 is many months away and global economic revival even further away.

Manufactures

The expansion of the country's manufactured exports and recovery of tourism would enhance the country's foreign earnings and would improve the trade balance and balance of payments. While there are strong expectations of containing the virus by the newly developed vaccines, the enormity of the needed coverage and the emergence of new strains, have dampened expectations of early success.

Global expectations

Global expectations of containing COVID-19 have been boosted by the availability of several vaccines. However, the light is at the end of a long tunnel. It may be at year's end, at best, that most economies will return to near normal virus free economies.

Increased demand

The use of the vaccine in the countries that are our main markets would hopefully revive demand for our exports such as apparel, tyres, rubber manufactures, ceramics and other goods that were the main manufactured exports prior to the pandemic. Hopefully, there would also be a continuation of the demand for PPE export items such as rubber gloves and masks too throughout the rest of the year.

Responsive

Industrialists would have to be receptive to the emerging new patterns of international demand and export possibilities and adapt their production capacities to exploit them. In as much as there may be changes in the demand for goods, there would also be changes in the markets for goods.

It is most likely that China and East Asia would emerge as more important markets for consumer goods than the traditional western countries that have been the main markets. A more eastward looking international demand is expected.

Import restrictions

The restrictions on imports should not hamper the availability of a large range of raw materials needed for export industries. On average the import content of exports is around 65 percent of export manufactures. At present even small manufacturers are having difficulties in obtaining required raw materials and have had to abandon their trade.

Disadvantages

The global economic recovery is not without disadvantages. While several aspects of global economic recovery, such as world travel and tourism, will take time and may benefit us at the year's end, there are developments that are immediately adverse. Most important of these is the rise in oil prices.

One of the important means by which the trade deficit was contained in 2020 was lower international oil prices. During the first nine months of this year fuel prices were at an average of about US$ 30 per barrel. Lower international prices of oil together with lesser imports due to subdued transport activity reduced oil import expenditure by about 30 percent in the first nine months of 2020.

Oil prices have begun to rise. At the time of writing the oil price is at US$ 52 per barrel, and climbing. This would make a dent in our trade balance and balance of payments.

Tourism and COVID

A matter of grave concern is the opening up of tourism to foreigners. Several plane loads of Ukrainian tourists have arrived in the country and are travelling to places of tourist interest like the Yala game sanctuary. At the time of writing, more than seven Ukrainians have been found to be infected with the virus. It is only a matter of time before locals in contact with the tourists will become infected.

Risk of spreading

These tourists are from one of the most COVID-affected countries. If COVID spreads in the country as a consequence of opening up tourism, the costs of containing the fresh wave of the pandemic and the consequent dislocation of production in the country could be a step backward in our quest of eliminating the virus, and it will be of little benefit economically.

The humanitarian losses could be incalculable. It may also taint the future image of the country as a tourist destination.

Other countries

In contrast to our opening up to tourism, other countries are expected to permit tourists from only countries that have eliminated the pandemic. This implies that normal tourist traffic will take some time to resume. The revival of tourism to any significant extent is unlikely unless we eradicate COVID. However, tourists from the region may in all probability come to the island. The main countries from which we could expect tourists are China, India and the Middle Eastern countries.

Concluding reflection

Containing the spreading of COVID is crucial for a sustained growth of the economy. However this is not sufficient. The resolution of the fundamental economic problems of repaying debt, improving the balance of payments and fiscal prudence are essential for economic stability.
Eradicating the several strains of COVID globally and locally is an urgent pre-condition at this moment in time.

For the full article - Refer The Sunday Times