Spotlight: Econ Op-eds in Summary

Week ended 13th May '20

In Summary

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

1. Sri Lanka growth stalls, GDP drops US$200 in 2019 after monetary instability
By: Bellwether

- Sri Lanka's 2019 per capita GDP (in USD terms) has seen little improvement over the 2015 figure. The key factors behind the stunted growth is monetary instability and weak policy that led to a vicious cycle amidst external sector developments. On the policy side, a focus on the state sector and fiscal dominance of monetary policy stand out.

- Instability has also come from Sri Lanka's soft peg commitment, Real Effective Exchange Rate (REER) targeting and call money rate targeting, necessitating IMF assistance. As credibility of the peg deteriorated, there was capital flight considering the depreciatory implications of REER targeting.

- Liquidity shocks from call money rate targeting resulted in a currency collapse since May 2018, with excess liquidity putting depreciation pressure on the LKR. However, a steep LKR depreciation has been held at bay by the collapse of consumption amidst the COVID pandemic.

Sri Lanka's per capita GDP in 2019 was USD 3,852 after the latest currency collapses as well as bad economic policies, including trade restrictions and price controls, which expanded to credit markets. This is almost the same as USD 3,842 in 2015.

Sri Lanka's economy grew rapidly in US dollar terms after the war. The post-war period was also helped by Chinese debt-funded projects.

During this period, fiscal dominance of monetary policy had been resisted to avoid an external meltdown in the latter stages of the war by raising rates to near market levels, as deficits rocketed.

Though the 2008 crisis still occurred, its effects were reduced by allowing the rupee to bounce back from 120 to 113 as private credit fell, allowing growth and domestic consumption to resume. Financial capital was also preserved from depreciation.

However, from 2012 greater monetary instability set in with liquidity injections made to suppress rates when domestic private credit picked up, shortening the growth cycle and driving the credit system towards the balance of payments crises quickly.

In 2011 Sri Lanka also passed an expropriation law, worsening regime uncertainty, in a repeat of a key policy in the immediate post-independence period that made the island lag behind most of Asia.

Monetary Instability

From around 2011 Sri Lanka's monetary policy framework also started to deteriorate. The issue of central bank securities which helps build up forex reserves was discontinued, which made it less easy to collect forex reserves by mopping up (sterilizing) inflows.

When the rupee fell in the 2011/2012 crisis it was not allowed to bounce back, amid complaints that greater exchange rate stability was responsible for low export growth, ending one of the key economic planks that had helped maintain growth and living standards.

Without monetary stability as a foundation, even a strong economic framework in other ways would not deliver sustained growth.

Weak Policy

In Sri Lanka, the overall policy framework was also weak and generally tilted towards state and enterprise. The economy was also stifled with renewed import duties and import substitution which seen during the 1970s.

New loss-making state enterprises were also built with Chinese loans.

Previously privatized firms went back to state hands through different means, leading to mal-investments, corruption, and losses.

Anti-private sector biases would reduce tax revenues to service infrastructure loans in the future.

Most of the foreign infrastructure loans, sovereign bonds and also domestic road loans are now maturing.

Bad Policy

In 2015, in the same lines as the expropriation law, retrospective taxes were slammed on private companies in more regime uncertainty.

State worker salaries and subsidies were ratcheted up and more money printed as private credit recovered.

The currency started to collapse in the second half of 2015 as the soft-peg was floated without first taking out excess liquidity in money markets.

Sri Lanka's soft-peg has driven the central bank to seek support from International Monetary Fund programs 16 times.

Instead of cutting expenses in the classical economic tradition, and privatizing state enterprises that were pushing up debt, the IMF came up with a program called 'revenue-based fiscal consolation' aimed at taxing the private sector to help maintain a bloated state.

Monetary Instability Worsens

Monetary instability sharply deteriorated after 2015, under flexible inflation targeting, where authorities aimed to target inflation (a domestic anchor) while targeting the exchange rate or soft-peg (an external anchor) to collect forex reserves under an IMF program.

REER targeting meant that the external anchor would be downward driven as the index followed the worst central banks in the basket to the bottom.

Increasing forex reserves (and increasing dollar cover of the monetary base) required a peg where reserve money had be slightly under-supplied compared to the balance of payments.

The administration gave the central bank full independence to ratchet up monetary instability.

There was no fiscal dominance to print money and avoid taxes, placing a higher value added tax regime and also market price fuel in politically costly reforms.

Operationally the new monetary regime involved keeping the REER index below 100, by depreciating the currency to destroy real wages of export workers, lowering living standards of not only export workers but all workers.

The REER is now 90 by March 2020, over-achieving the target, but growth had fallen to low single digits helped by currency crises which were coming rapidly due to call-money rate targeting-with-excess liquidity.

Capital Flight, Dollar Debt

In the eight-year from 2011 to 2018, three currency crises had occurred, killing credit cycles just as they began.

Unlike the 2011 crisis, foreign investors began to flee under REER targeting as credibility of the peg was weakened. As the understanding of the consequences of the new monetary regime grew among foreign investors, capital flight worsened.

Capital flight from rupee bonds has the same effect on the credit system as the inability to roll over dollar debt.

From 2015 about 450 billion rupees in bonds held by foreign investors had dwindled to about 20 billion by April 2020.

REER targeting and general monetary instability also bloated the foreign debt of the central government and also state enterprise, many of which had dollar loans, driving national debt towards 100 percent of GDP.

Liquidity Shocks

In the most severe deterioration of policy, the call money rate was targeted to keep it at the middle of the policy corridor, by helicopter dropping large volumes excess liquidity into money markets and de-stabilizing the peg.

Call-money-rate-targeting with excess liquidity lost the economy and the rupee the protection of a policy corridor. In another deterioration the policy corridor was cut from 150 to 100 basis points.

Call money rate targeting with excess liquidity was seen in action in April 2018 where LKR 60 Bn of excess liquidity was dumped on the credit system to enforce a rate cut.

The LKR 60 Bn far exceeded real money demand, leading to currency collapsing from May 2018 onwards just as private credit picked up.

The crisis was also worsened by liquidity generated from rupee/dollar swaps with the central bank.

Speculators who broke pegs in East Asia had also used similar swaps with the central banks to generate liquidity and hit the peg.

Ironically in Sri Lanka, the counterparty to the rupee generating was not a foreign speculator, but the Treasury.

Under call money rate targeting with excess liquidity, reserve money growth was not only out of line with the balance of payments (and the foreign reserve target set under an IMF program) but the central bank lost complete control of reserve money growth.

Under a ceiling policy rate, where just enough liquidity is given to target a policy rate, some control of the expansion of reserve money can be maintained to slow or delay currency crises or limit the loss of forex reserves in defending the currency.

With a wide enough policy corridor, linked to the US Fed, currency collapses can be almost eliminated.

When the credibility of the peg is lost, massive output shocks (low or negative growth, consumption killing, lower living standards) are required to correct monetary instability.

In 2020, excess liquidity had jumped LKR 160 Bn. The central bank is now not only targeting the call money rates, but the 3, 6, and 12-month rates by printing money.

Dropping a prudential rule set previously, the central bank has also got back the powers to print money and target long term bond rates.

In the 2020 liquidity injections, the rupee fell to 200 to the US dollar and has since been brought back to 190 levels, partly helped by a consumption collapse driven by coronavirus curfews.

Dollar Inflation

In the immediate post war period Sri Lanka's dollar GDP growth was also helped by the post-2009 quantity easing of the Federal Reserve which reflated the US dollar, with commodities and precious metals rising partway towards levels seen in the 2008 bubble.

From September 2014 the Federal Reserve reversed quantity easing pushing down commodity prices including oil. Fed rate hikes began in 2015.

But Sri Lanka cut rates in 2015 triggering the 2015/2015 crisis where the rupee fell from 131 to 151 to the US dollar. In the 2018 crisis the rupee fell to 182.

Measured in ounces of gold, Sri Lanka's 2019 per capita GDP of 3,852 dollars is around 2.5 ounces of gold, the same as in 2002, when egged on by Ben Bernanke, the then US Fed Chairman Alan Greenspan started the money of all liquidity bubbles.

In 2002 Bernanke in a speech spoke why the Fed should print money to avoid deflation.

"The Congress has given the Fed the responsibility of preserving price stability (among other objectives), which most definitely implies avoiding deflation as well as inflation," Bernanke said.

"As I will discuss, a central bank, either alone or in cooperation with other parts of the government, retains considerable power to expand aggregate demand and economic activity even when its accustomed policy rate is at zero."

The rest is history. Less than years later as the bubble he fired collapse the Fed had to do the very thing he predicted.

For the full article – Refer EconomyNext

2. Quo Vadis Sri Lanka's economy: An appeal to President Rajapaksa
By: Raj Gonsalkorale

- It is clear that Sri Lanka's economic fundamentals were deteriorating even prior to the pandemic. Thus, it is opportune to discuss whether we travel down the same failed path and fall into the abyss below us or whether we look at fundamentals that might help.

- Sri Lanka's main issues are broadly related to two main accounts: rupee denominated Fiscal account and largely dollar denominated Balance of Payments. These issues are often related to the inability to maintain a balance in these accounts due to the mismanagement of income and expenditure included in them.

- Thus, the government should look to adopt some underlying principles to manage these accounts. These principals include, adopting policy road maps, providing targets to be achieved by state organizations, having discipline in relation to foreign borrowings and facilitating the growth of the current account and foreign reserves.

'Quo vadis?' is a Latin phrase meaning 'Where are you going?' It is perhaps opportune now to ask this question about the Sri Lankan economy.

Some relevant information prior to the COVID pandemic are noted here. Before things get any better, they are expected to get worse.

How bad is worse going to be for Sri Lanka?

Government debt to GDP in Sri Lanka is expected to reach 92.50% by the end of 2020, according to Trading Economics global macro models and analysts' expectations.

Generally, government debt as a percent of GDP is used by investors to measure a country ability to make future payments on its debt, thus affecting the country borrowing costs and government bond yields.

It is time the President laid bare the bare cupboard of the Sri Lankan economy. No doubt the COVID catastrophe has made matters worse for the country, but in truth, it appears Sri Lanka was in dire economic straits even before COVID-19 hit us.

As the writer has no expertise in economics, this article is written from a prism of relative ignorance of economics. It is written to highlight a few points that might be relevant to the millions of ordinary people of the country.

No doubt there has been several laudable development activities, and we have had to endure a costly war and other challenges.

However, it does appear we have not operated within a sound economic structural framework.

What is this framework? Leaving aside a myriad of measures and indicators, there are two fundamental accounting operations to consider

(a) A rupee account and

(b) a foreign currency account

Since the Sri Lankan Rupee is not a free floating convertible currency, the two accounts mentioned have to be managed as if they were in separate cupboards although each has an impact on the other.

The rupee account of the country has two components, the current account and the capital account. The current account has an expenditure side and an income side. In a healthy economic situation, these two sides balance, and in a healthier situation, there will be a surplus in the income side.

To the best of the writer's knowledge, the country has not been able balance the current account, except perhaps during the very early days of independence when the healthy financial legacy left behind by the British colonialists allowed us to do so.

The main expenditure items in the rupee current account are broadly speaking, a huge component comprising of

- salaries of Government officials, both in Government offices and Government owned undertakings,
- rupee interest payments on rupee borrowings and
- other recurrent expenditure which is not regarded as capital expenditure.

The income side of this account comes from

- personal income tax receipts,
- corporate tax reports,
- GST proceeds and other rupee income streams.

It needs to be noted that this income stream does not bring much income as Government officials do not pay tax, and private sector employees pay tax if they are above an income threshold. It is likely that local rupee loans in the form of rupee treasury bills and borrowings from commercial and State Banks are also credited to this account as income. This does not seem correct as such borrowings cannot be considered income.

A confusion caused by a structural deficiency here is that most likely, the rupee income derived from capital projects which is funded not by rupees but with foreign currency loans is also included as income in the rupee current account. An example would be road toll income. The sole if not primary source of funding for all the highways subject to tolls have been funded with foreign loans where the capital and interest of such loans are payable in foreign currency. This is of course subject to correction if these receipts are treated differently.

The rupee component also has a capital account where rupees generated as income from any capital expenditure projects funded with rupees, should be credited to this account as income. In Sri Lanka, it is very likely that no significant capital projects, or very few of them, have been undertaken with rupee funding from this account. It is possible, and it should be the case that capital projects such as hospitals, schools, roads which are not regarded as national roads, bridges, etc. are funded through this account. It should be, if it's not. Sri Lanka should strive towards funding rupee projects with income generated form rupee capital projects and not through rupee borrowings at least in the longer term unless deemed absolutely necessary. It is agreed that in the immediate term, capital projects may have to be funded by domestic borrowings. These are however debts, and have to be treated as such and not income.

The foreign currency account perhaps is the most mismanaged account. It is common knowledge that we have been borrowing large amounts to fund development projects.

A gross simplification from the point of view of economic pundits, but probably a commonsense approach from the perspective of the simple minded majority of the country of the country might be the principle that:

a. Foreign currency borrowings should be for capital projects that cannot be funded with rupees as there aren't sufficient rupee funds to do so, or only to fund a component of the project that requires importation of machinery or equipment or foreign expertise. All such projects however should have a return on investment (ROI) computation in order to ascertain and decide on priorities as the country needs to make such choices.

b. If revenue from such projects is confined to a rupee revenue, the government should factor in the ability to repay such borrowings and interest payments in foreign currency that it earns from exports and other foreign currency earnings.

In times of low interest rate borrowings, one could make a judicious decision to borrow at low interest payments and favourable long term repayment conditions for specific projects which have a social responsibility bearing and which have a long gestation period, but this has to be accompanied by the building up of the country's own foreign exchange reserves with its export earnings and other foreign currency revenue streams so that the country would have enough savings to tide over unfavourable economic conditions as we are experiencing at present due to the impact of COVID.

The independence of the Central Bank has to be restored. We simply cannot have a Governor of the Central Bank who had no credentials to hold such a vital position, including the citizenship of the country and a family member closely associated with key operational aspects of the bank, nor a Governor who also functioned as an Adviser to the President of the country.

In summary, it is opportune to discuss whether we travel down the same failed path and fall into the abyss below us or whether we look at fundamentals that might help us to save ourselves from the abyss below us.

In lay person's terms, these fundamentals may be listed as follows:

1. Balancing the Rupee Current Account

Develop a policy setting, a road map and a target to achieve a balanced rupee current account say within 5 years. Ensure that this current account is to meet only recurrent expenditure as described earlier, and the income side of this account is from local, non-capital revenue raising measures such as income taxes, corporate taxes, land taxes, GST revenue etc. It should not include any revenue such as earnings from road tolls or from any other capital project funded by foreign or local loans. During the five-year period, in order to balance this account, some unpalatable decisions will have to be made to reduce expenditure and to increase income. These will include reducing the Government's salary bill, which means reducing the numbers employed by the State, including a phased reduction of Armed Forces personnel, and reintroducing income tax to Government officials, and widening the GST coverage and enforcement mechanisms.

Such a plan should also be accompanied by a five-year development plan that must be based on the growth of the private sector which would have employment opportunities for those lost in the government service. Besides these, all government undertakings should be given targets to breakeven and start showing profits within five years or run the risk of closure or privatization.

2. Balancing the Rupee Capital Account

Achieving this will be different to balancing the current account, as expenditure items here will have longer investment yield periods, and some projects like building hospitals, school buildings, etc., will not yield a conventional rupee return. Balancing this account may need to be over planning period horizons such as five-year plans, 10 year plans, etc.

However, the principle that should underpin such planning horizons should be that one should not spend more than what is earmarked for the planning period, and income streams to meet this expenditure should equal the planned expenditure during that period. If rupee loans are obtained for some capital projects, the repayment of the loans obtained and interest on such loans should be factored into the account.

3. Managing the Foreign Debt Account

Foreign borrowings should be made only to fund capital projects that have a significant foreign currency component and where borrowings are justified from a ROI perspective. As proceeds from such projects are not realised in foreign currency, the ROI computation may have to be done in rupees in equivalent terms to the prevailing currency conversion rates.

However, the principle that should underpin foreign borrowings must be the ROI. If a government uses foreign borrowings say to pay salaries of Government officials, it defeats this principle.

4. Managing the Foreign Currency Current Account

The income in this account will include export earnings, foreign exchange remittances and income streams in foreign currency like tourism and the hospitality sector. This account should not include any foreign borrowings as income. The key expenditure items would be repayment of foreign currency borrowings and interest payments. A surplus in this account would signify funds that are available to augment the country's foreign exchange reserves.

The necessity of doing so will be paramount as that would be the cushioning needed to weather any future storms like the COVID-19 attack, a tsunami, or a global financial crisis. The criticality of exporting more in order to increase earnings, moving away from exporting low paid unskilled workers and increasing the export of better paid skilled labour, developing the country as an education and health hub for foreign nationals are some measures that would create increases in income streams.

Lowering expenditure on some items such as motor vehicle imports, plus non-essential imports would be avenues to move towards building surpluses in this account, and thereby increasing the country's foreign currency reserves.

Following is submitted for consideration as the principles that should underpin this simplistic model:

a. Foreign debt should only be incurred to fund capital projects that delivers a ROI. Such debt repayments should be made from the Foreign Currency Current Account.

b. Foreign Currency Current Account should have a target to achieve a surplus that increases the country's foreign currency reserves adequate to fund at least 12 months' imports.

c. Rupee proceeds from foreign currency-funded projects that have demonstrated acceptable ROI returns should be credited to the Rupee Capital Account.

d. Rupee Capital Account should be used to fund domestic capital projects

e. The Rupee Current Account should be balanced within five years, and all Government official's salaries and the entirety of the Government's recurrent expenditure should be met through this account.

f. All Government owned undertakings, including SriLankan Airlines and the Ceylon Petroleum Corporation that do not breakeven and start showing profits in five years should be either privatized or closed.

It may be well to remember the words of US President Herbert Hoover who said: "Economic depression cannot be cured by legislative action or executive pronouncements. Economic wounds must be healed by the action of the cells of the economic body, the producers and the consumers themselves."

The road ahead is full of mine fields, perhaps even deadlier than what was on the ground during the war. As was done then, an efficient, loyal team will be needed to take the country forward and get the fundamentals of the economy on a sustainable footing. However, as Bernard Baruch said, unfortunately, we tend to learn little from the experience of the past.

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