Spotlight: Econ Op-eds in Summary

Week ended 14th July '21

In Summary

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

1. MMT-styled fiscal and monetary policies inject liquidity into market, creating demand pressures
By: Professor Sirimevan Colombage

- Sri Lanka laid the foundation for Modern Monetary Theory (MMT) to be implemented after the change in the political regime in 2019, given the proposals of sweeping tax cuts at the time. This is in line with the current policy agenda being followed, where low taxes are maintained, and money is printed to meet the budget deficit.

- The CBSL Governor dismissed concerns on the ability of the government on repaying it's domestic debt and ruled out negotiations of an IMF program. Raising domestic debt however, has become more difficult given the country's sovereign downgrading's and has resulted in auctions being persistently undersubscribed. This has led the CBSL to seek bilateral funding from different countries to help manage debt repayments.

- The use of MMT has affected the macroeconomic environment through a sharp increase in market liquidity, putting pressure on inflation to rise and weakening export competitiveness. This in turn will cause a widening of the trade deficit and puts additional pressure on the currency to depreciate. These impacts are already being felt by the country, with lower income earners being disadvantaged the most due to higher inflation.

There is widespread criticism levelled against the authorities of the Central Bank of Sri Lanka (CBSL) in recent weeks alleging that they have printed large quantities of money since early last year. While such criticisms cannot be totally ignored, the money printing numbers quoted by some critics are overestimated.

Nevertheless, the fact remains that increased lending to the Government by the CBSL since last year, seemingly following the so-called Modern Monetary Theory (MMT)-styled monetary policy, has led to a rapid increase in the issue of notes and coins, defined as currency. Such currency issues by a monetary authority are commonly known as money printing.

CBSL's net lending to the Government rose by a whopping 176% year-on-year basis by January this year, resulting in a 31% increase in currency in the hands of the public. The outstanding stock of CBSL's net credit to the Government now exceeds Rs. 1 trillion.

Apart from being a component of the aggregate money supply, currency functions as the monetary base for commercial banks to create credit by multiple times. Hence, the increase in currency issues in recent months has significantly enhanced market liquidity, and thereby created demand pressures fuelling price hikes and rupee depreciation.

What is MMT?

The notion that a sovereign government can print money to repay its debt without any financial limit has gained increased popularity in recent times in the US and in a few other countries, based on a new obscure approach to macroeconomics, known as Modern Monetary Theory (MMT). Money printing, rather than taxation, should be used to meet government expenditure, according to MMT proponents.

They argue that a government can never run out of cash, as it can repay its debts without any limit by getting the central bank to print new money, instead of resorting to taxation for revenue mobilisation.

This idea was developed by a few academics who broke away from mainstream economics. It became famous when some US politicians endorsed it, reinforcing their own accommodative monetary policy viewpoints. MMT is now gaining attention of the policymakers in some developing countries including Sri Lanka, as money printing is a convenient way to finance the budget deficits in the context of expenditure overruns and revenue shortfalls, amidst the COVID-19 pandemic.

SL moving towards MMT

In Sri Lanka, the policymakers seem to have moved towards MMT-type macroeconomic management in recent times. A few months ago, Central Bank Governor Prof. W.D. Lakshman mentioned that domestic currency debt is not a huge problem for a country with sovereign powers of money printing as prescribed in MMT.

State Minister Ajith Nivard Cabraal stated at a recent news briefing that money printing is permissible due to the drop in Government revenue. He pointed out that a new deal with the International Monetary Fund (IMF) would mean hiking taxes, apart from various other hostile conditionalities such as increasing interest rates, devaluing the Rupee and cutting the number of state sector employees. CBSL Governor too ruled out any negotiation with the IMF at the Monetary Policy Review meeting held last week.

Thus, the policy stance preferred by the Government and the CBSL is to maintain a low taxation regime, and to meet the resulting budget deficit and debt obligations by printing money. This is exactly the policy mix suggested by MMT promoters.

Stephanie Kelton, a leading proponent of MMT, in her recent book titled 'The Deficit Myth: Modern Monetary Theory and How to Build a Better Economy' asserts that the way monetary sovereign governments should actually conduct expenditure is by simply creating the money for its spending by "a few key strokes" and not by using tax collections.

Revenue shortfalls due to tax cuts

The Government knowingly or unknowingly laid the foundation for MMT-type fiscal policy by curtailing taxes in 2019. Immediately after the victory of the Presidential election in November 2019, the newly formed Government took steps to revise the Inland Revenue Act so as to provide a wide range of concessions to tax payers, without considering their adverse fiscal implications for monetary stability.

Accordingly, personal income tax rates, tax-free thresholds and tax slabs were relaxed significantly with effect from 1 January 2020. Also, Pay-As-You-Earn (PAYE) tax on employment receipts, withholding Tax and Economic Service Charge were removed effective from the above date. Downward revisions were made to the Value Added Tax and Nation Building Tax to stimulate business activities.

As a result of these tax cuts, the tax revenue declined by Rs. 518 billion or by 30% from Rs. 1,735 billion in 2019 to Rs. 1,217 billion in 2020. It resulted in an expansion of the budget deficit by Rs. 229 billion from Rs. 1,439 billion in 2019 to Rs. 1,668 billion in 2020.

Limited foreign borrowings

As the borrowing requirements of the Government rise continuously to meet the widening budget deficit, the authorities have been experiencing difficulties in mobilising borrowings from both foreign and domestic sources.

On the foreign front, the country's sovereign rating downgrades effected by several international rating agencies have weakened the investor confidence in Sri Lanka's bonds. This is reflected in substantial undersubscriptions in recent sovereign bond auctions. In the circumstances, the authorities have turned to obtain foreign loans in the form of swaps from China, Bangladesh and India.

Heavy reliance on CBSL's lending

Amidst foreign capital constraints, the Government started to raise more borrowings from the domestic money market through Treasury bills and bonds. It was reported that the Government intends to restructure public debt so as to change the domestic to foreign debt component from 55:45 in 2020 to 60:40 in 2021.

However, continuous increase in borrowings from the domestic market tends to raise interest rates causing difficulties in selling Treasury bills at lower rates. This is reflected in the recent Treasury bill auctions which were undersubscribed.

The total outstanding amount of Treasury bills stood at Rs. 1,759 billion by the end of April 2021, nearing the Treasury bill limit of Rs. 2,000 billion. This limit was raised to Rs. 3,000 billion last month so as to mobilise more Treasury bill borrowings.

The CBSL usually calls bids for Treasury Bills at weekly auctions. Treasury bills amounting to Rs. 56 billion are to be issued at the next auction to be held on 14 July. It is higher than the amount of Treasury bills issued at previous weekly auctions which amounted to around Rs. 40 billion. This reflects the increasing reliance on domestic borrowings.

The CBSL has been compelled to purchase the unsold Treasury bills at primary auctions. As a result, the CBSL now holds around 40% of the total outstanding amount of Treasury bills. This has resulted in a significant increase in currency issues.

Monetary base

The CBSL's credit to the Government raises the money supply through its influence on the monetary base. It is also known as high powered money, since increases in the monetary base supports larger expansion of credit and money through the money multiplier.

On the liabilities side of the CBSL's balance sheet, the monetary base comprises liabilities that support the expansion of credit and broad money. It includes currency outstanding and commercial bank deposits with CBSL. On the assets side, the monetary base consists of CBSL's Net Foreign Assets (NFA) and Net Domestic Assets (NDA).

The monetary base rose from Rs. 932 billion in 2019 to Rs. 964 billion in 2020, resulting in an increase of Rs. 32 billion. On the liabilities side, currency issues rose by Rs. 156 billion while commercial banks' deposits with the CBSL declined by Rs. 124 billion in 2020 due to a drastic reduction of the Statutory Reserve Ratio from 5% in 2019 to 2% in 2020.

The outstanding amount of currency rose by 23% from Rs. 678 billion in 2019 to Rs. 834 billion in 2020 (Chart 1). In other words, the CBSL issued new currencies amounting to Rs. 156 billion in 2020. This is the popular notion of money printing.

Monetary expansion

The broad money supply (M2), defined as narrow money supply (currency and demand deposits) plus time and savings deposits held by the public with commercial banks rose by 23% in 2020. This was due to a 117% increase in the NDA of the banking system mainly caused by the rise in Net Credit to the Government (NCG).

Around 98% of the increase money supply was on account of the substantial increase in NCG; net credit provided to the Government by CBSL and commercial banks accounted for 28% and 70%, respectively.

The Government obtained as much as Rs. 1,560 billion of net credit from the CBSL and commercial banks during the last 12 months. This reflects the extent to which liquidity is injected into the market by way of bank lending to the Government.

Adverse implications of MMT policies

As a result of the monetary expansion, the market liquidity, which can be measured in terms of the ratio of broad money supply (M2) to GDP, rose by 11 percentage points from 46% in 2019 to 57% in 2020. This is an unprecedented increase in market liquidity. Demand pressures emanating from the excessive liquidity escalate inflation, weakening export competitiveness and encouraging imports, thereby widening the balance of payments deficit. This calls for further depreciation of the rupee giving rise to cost-push inflation.

The unprecedented rise in M2/GDP ratio also indicates that the country's productivity growth is on a downward path. The higher the ratio the lower the productivity. This means that the country's productivity does not grow proportionately to money supply increases. It is understandable, as bank credit is used to meet the Government's debt obligations, rather than to fund efficient investment ventures. The lower productivity further widens the output gap in the backdrop of liquidity injections, and escalates demand pressures.

The adverse implications of MMT-styled fiscal and monetary policies are already reflected in price increases, income downfalls and rupee depreciation, which cause severe hardships for the people who are in the bottom of the income pyramid.

For the full article – Refer Daily FT

2. Remittances from around the world strengthen balance of payments
By Nimal Sanderatne

- Remittances has been on rise during past couple of years. During first five months of this year remittances has grown by 18pc compared to last year same period. Majority of these remittances are from Middle East and the rest are from all over the world including countries from North America as well as South Asia. These remittances are the main strength in offsetting the trade deficit of the country.

- Usually remittances are for varied reasons. Some are as support for their dependents, some for property purchases for retirement, some prefer the higher interest rates as well as to make gains out of depreciating rupee. It's not only Middle East workers who remit money to Sri Lanka, Tamil diaspora consists of a large number of professionals who have left the country are some who remit money inwardly. Apart from that social services organizations, schools and NGO receive regular remittances.

- Finally considering the above, it is not suitable to use the word "workers' remittances" for the funds Sri Lanka receive. It should be corrected as foreign remittances. Also it is a misconception that if middle east workers fail to remit it will severely impact the total remittances. Middle East workers' remittances are only a part of the total foreign remittances Sri Lanka receive.

Remittances that are the main strength of the balance payments, have been increasing in recent years. They increased from US$ seven billion in 2019 to US$ 7.1 billion in 2020. In the first five months of this year, remittances increased by a further 18 percent compared to the same period last year to US$ 2.8 billion. If this increasing trend in remittances continues, they may exceed US$ seven billion this year.

From around the world

Although a little over one half (52 percent) of these remittances are from the Middle East, there are significant amounts of remittances (48 percent) from many countries. There are remittances from North America, Europe, Australia and the Far East, among others.

BOP strength

Remittances have been and are the main source of strength for the balance of payments. For many years, either a large proportion of the large trade deficits or even the entirety of large trade deficits have been offset by remittances.

Trade deficits

For instance, remittances offset the entirety of the trade deficit in 2020. The deficit of US$ six billion was wiped out by remittances of US$ 7.1 billion. In 2019 a high proportion of the trade deficit (83 percent), was offset by remittances. The trade deficit was US$ eight billion and remittances were US$ seven billion in 2019.

It is difficult to imagine the plight of the country's external finances without these earnings.

"Workers' remittances"

These remittances to the country are known as "workers' remittances". Undoubtedly, the remittances from the Middle East are the main component of remittances and these are from migrant workers. However, there is little awareness that nearly one half of these remittances are not from workers in the Middle East.

Many countries

While a little more than a half (51.5 to 51.7 percent) of these remittances are from workers in the Middle East, nearly one half (48 percent) are from other regions of the world.

Sri Lanka receives remittances from nearly all regions of the world. These include North America, UK, Europe, Japan, East Asia, South East Asia and Australia. We even receive remittances from South Asia.

In 2019, remittances from the Middle East accounted for 51.5 percent of total remittances. The other regions accounted for a significant 48.5 percent of remittances.

In 2020, the sources of remittances changed very little. Remittances from the Middle East accounted for 51.7 percent of total remittances, while other regions accounted for a significant 48.3 percent of remittances. The European Union (EU) and the Far East accounts for about 19 and 12 percent of remittances to the country.

Reasons

Many Sri Lankan expats send money to support their families. The extent of their support may have increased owing to the severe hardships of their dependents in Sri Lanka. Some of these remittances are for the purchase of property as expats expecting to retire in the land of their birth may be motivated to increase remittances owing to the higher interest rates and the gains from the continuous depreciation of the Rupee.

Diaspora

Furthermore, it is well-known that the Tamil diaspora sends significant amounts to their families in the North. These are from a large number of professionals who have left the country. They are doctors, engineers, accountants and technically qualified persons. Moreover, social service organisations, think tanks, schools and NGOs too receive regular remittances.

Bottom line

The bottom line is that so called "workers remittances" are not an accurate description of the remittances received by the country as a substantial amount of remittances are from varied sources in numerous countries. Although migrant workers do remit a high proportion of remittances to the country, these remittances are more accurately described as foreign remittances.

Increasing remittances

The increase in remittances after COVID-19 was unexpected, as a large proportion of workers from the Middle East had lost their jobs and were returning, it was feared that remittances would fall precipitously. However, it turned out that remittances increased from US$ seven billion in 2019 to US$ 7.1 billion in 2020.

The Increase in remittances has been explained as due to returning workers remitting their savings and such remittances being remitted through banking channels rather than through informal methods.

While these explanations have a validity, another reason is that the sources of remittances are not entirely from workers in the Middle East and remittances from other places did not decrease as the motives for their remittances were for various reasons as explained earlier.

Summing up

In brief, remittances are the strength of the balance of payments. They have increased from US$ seven billion in 2019 to US$ 7.1 billion in 2020.They have increased by 18 percent in the first five months of this year to US$ 2.8 billion compared to the same period last year.

A little over one-half of remittances are from the middle East, while almost one half are from the rest of the world. Middle Eastern workers have accounted for only a little above one–half of such remittances. In recent years they have been between 50 to 55 percent of remittances. In 2020, after COVID, they accounted for 51 percent of remittances that increased from US$ 7.0 billion in 2019 to US$ 7.1 billion.

Conclusion

Over one-half of the remittances received by the country are from countries in the Middle East. On the other hand, nearly one half of remittances are from other regions of the world. As the remittances come from all over the world and for a variety of reasons, they are a more stable source of foreign earnings than if they were from workers in the Middle East. It is the misconception that workers' remittances are overwhelmingly from workers in the Middle East that led to the anxiety that these earnings would drop sharply with workers returning to the country. Even if remittances from the Middle East falls, its impact on total remittances will not be that severe owing to the remittances from the rest of the world accounting for nearly half the country's remittances.

For full article – Refer the Sunday Times