Spotlight: Econ Op-eds in Summary

Week ended 31st March '21

In Summary

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

1. Government pushes panic button on FDI?
By: Indika Hettiarachchi

- Sri Lanka recorded a 33% decline in FDIs up to the third quarter of 2020 compared to only a 4% decline experienced by Asian peers. The country also has been seeing a trend of declining 'new foreign cash inflow' - a big concern for the government, as FDI has been identified as a main source of foreign cash inflow to bridge the current account deficit.

- Despite having a low score in the Ease of Doing Business index, which had been quoted as one of the main barriers for FDIs in the past, Sri Lanka has been able to attract FDIs mainly through substantial policy interventions targeted at specific industries and by putting in place initiatives to encourage local entrepreneurs to act as catalysts.

- In order to absorb productive FDI, there must be a healthy local industrial base, supporting infrastructure and a foundation to develop value chains. Hence, it is vital to develop the local businesses as a catalyst. In order to do so, there have to be programs to boost local entrepreneurship and the capital market ecosystem.

Recently, the government announced a plan to obtain the services of a foreign constancy firm to promote foreign direct investment (FDI). This development comes as FDI has reached a negligible level, in comparison to the size of Sri Lanka's GDP. However, this plan appears to be an attempt to address the inefficiencies in the FDI process, rather than a policy intervention for a sustainable FDI growth.

Sri Lanka lags behind other Asian counties

Global FDI fell sharply by 42% in 2020, due to the COVID-19 pandemic. While the developed countries experienced a major 69% decline in FDI, the developing countries in Asia only experienced a marginal 4% decline. However, Sri Lanka recorded a 33% decline up to the third quarter of 2020, compared to the same period in 2019.

Up to the third quarter of 2020, Sri Lanka has received US $ 350 mn total FDI, compared to US $ 523 mn for the same period in 2019. Another trend seen in Sri Lanka's FDI is declining 'new foreign cash inflow'. Out of the total US $ 350 mn FDI, the actual new foreign cash inflow into the country was US $ 191 mn.

New equity investment for the period was a negligible US $ 11 mn, indicating very little new venture activity. This trend is probably a big concern for the government, as FDI has been identified as a main source of foreign cash inflow to bridge the current account deficit.

SL's existing FDI ventures appear to be little impacted by COVID-19

Interestingly and on the positive side, data shows that for the first three quarters of 2020

(which includes almost the two-month COVID-19 lockdown), Sri Lanka's existing FDI ventures have not experienced a significant decline in earnings. As evident from the available data, the FDI ventures have reported only a 10.8% decline in earnings compared to last year.

Moreover, the existing FDI ventures have taken US $ 302 mn out of the country as dividends during the first three quarter of 2020, compared to US $ 312 mn for the same period in 2019.

Slower replacement of maturing FDI ventures

High profit repatriation and low new FDI inflows are clear indications that a large share of Sri Lanka's existing FDI stock is reaching last (maturity) phase of the FDI cycle. Unless fresh FDIs are attracted (to new ventures), it is inevitable that FDI-related cash flows are going to be a burden on the current account. Sri Lanka has been experiencing negative FDI-related cash flows for several years.

SL attracted productive FDI in past

Sri Lanka attracted productive FDIs in the past for industries such as garments and textiles, information technology (IT) and telecom. When we analyse these successful industries, we can observe substantial policy interventions (often associated with reforms) targeted at these industries.

Also there were initiatives to encourage local entrepreneurship to act as the catalyst. A good example is the programme to encourage local entrepreneurs (mostly at regional level) to venture into garment manufacturing through the 200 garment factory programme. This programme put in place a good foundation for the garment industry to develop where it is today.

Another example is policy initiatives to develop the IT industry in early 2000s through programmes such as popularising IT education, creation of IT parks, etc. The telecom sector reforms in the late 1990s are another example of industry reforms leading to high FDI. The telecom industry continues to attract a good level of FDI, even at present.

Investors discouraged by Ease of Doing Business Indexes?

Sri Lanka's low scores in various (international) business indexes, including the Word Bank's Ease of Doing Business Index, are often highlighted as a barrier to attract FDI. However, many countries such as Nigeria, Ethiopia and Bangladesh, with much lower score than Sri Lanka, attract much higher FDI volumes (also as a percentage of GDP). This suggests that, in reality, FDIs are driven by factors other than what are often highlighted in academic-like analysis.

Building capacity to absorb FDI

An important determinant often ignored is Sri Lanka's capacity to absorb investment. In order to absorb productive FDI, there must be a healthy local industrial base, supporting infrastructure and foundation to develop value chains. It is possible to develop the FDI capacity by developing the local industrial base and developing a foundation for the value chain like the 200 garment factory programme. Absence of a scalable industrial base often diverts potential FDI into non-productive industries – like what Sri Lanka experienced in the post-war investment boom in the 2010-12 period, where lot of foreign investment went into real estate-related projects.

Moreover, when we analyse the FDI trend in Sri Lanka, we can observe that Sri Lanka attracts larger FDI through the merger and acquisition (M&A) route, compared to the

Greenfield route. Hence, it is vital to develop the local businesses as a catalyst. In order to do so, there have to be programmes to boost local entrepreneurship and capital market ecosystem.

For the full article - Refer The Daily Mirror

2. Currency swaps to boost foreign reserves
By: Dr. Nimal Sanderatne

- The government has a short-term strategy of using currency swaps to meet debt repayments for the year. The Central Bank of Sri Lanka will exchange up to $1.5 bn with China as a currency swap arrangement, and is able to repay obligations to China over three years, providing much needed support on immediate debt repayments.

- Given confidence based on expectations of currency swaps from China, Bangladesh and India, the Government expects foreign reserves to increase to increase to $5.5 Bn at the end of 2021. However, the request for a currency swap from India hasn't materialised yet. In order to obtain the swap, India would require Sri Lanka to negotiate an IMF arrangement, which the government seems unwilling to do.

- Although currency swaps will ease immediate debt pressure, they will increase the countries overall foreign debt burden. Despite import restrictions, import expenditure is likely to increase given higher oil prices. Given this, a favourable BOP balance is crucial in reducing external financial vulnerabilities. This, however, would depend on the speediness of the recovery from the pandemic.

The Government is confident that it could tide over the current foreign currency difficulties by obtaining currency swaps. Currency swaps are useful to reduce the looming external financial vulnerability and improve the balance of payments. They are a necessary palliative to tide over the current crisis. The government expects a favourable balance of payments outcome by the end of the year that would strengthen the reserves.

Currency swap with China

The Central Bank of Sri Lanka (CBSL) will exchange currency with China up to ten billion Yuan (about US$ 1.5 billion) in an agreement "aimed at promoting trade and investment between the two countries."

The Central Bank said that the currency swap allows it to borrow in any of the currencies involved. It is able to use these Yuan to repay obligations with China over a period of three years. This is of much relief due to the critical level of foreign reserves and large debt repayments this year.

Confidence

While most economists are of the view that Sri Lanka's external finances are in a perilous state, the government has been very optimistic of strengthening the foreign reserves and improving the balance of payments this year.

This confidence is based on the expectation of obtaining foreign currency swaps from China, Bangladesh and India and on their expectation of a favourable balance of payments outcome this year. The foreign reserves are expected to increase to about US$ 5.5 billion at year's end.

Currency swaps

A short-term strategy of the Government is to bolster international confidence by arranging currency swaps. It is an immediate relief to the critical level of foreign reserves. It is no doubt a desperate move, but a necessary one.

Indian swap

The request for a similar currency swap from India has not materialised yet. India's requirement that Sri Lanka comes to an arrangement with the IMF may stall this, as the government is unwilling to adopt the principles of good economic governance, especially fiscal consolidation and economic reforms that are conditions for an IMF facility. However, geo-political factors may make India drop this condition and lay down other conditions of advantage to India.

Help from Bangladesh

The country has turned to Bangladesh too for a currency swap that may be forthcoming. Bangladesh has foreign reserves of US$ 70 billion compared to our less than US$ five billion.

Palliative not solution

These currency swaps will bolster the foreign reserves and improve foreign confidence in our external finances. However, they increase the country's foreign debt and have to be repaid at the end of the agreed period. They are a useful palliative, not a panacea for the country's weak external finances.

Trade balance

An improvement in the trade balance and the balance of payments is the only real means of reducing the external financial vulnerability. The Central Bank expects this year's trade deficit to be moderate, as it was last year. Significant inflows of workers' remittances. as in the pre-COVID years, as well as in 2020, and increased earnings from tourism and higher earnings from ICT services are expected to result in a balance of payments surplus. The pertinent issue is whether these expectations are realistic and likely to be realised.

Imports

The Achilles heel in the trade balance is the value of imports. As pointed out in previous columns, despite even enhanced import controls, import expenditure is likely to increase owing to higher prices of fuel, fertiliser, raw materials and food imports. There is the likelihood that food imports would increase, if there is a shortfall of rice and maize production. The international price of wheat grain is also expected to increase. For these reasons, import expenditure is expected to increase significantly. Imports are likely to exceed US$ 18 billion.

Exports

On the other hand, there is every prospect of increasing exports this year. Merchandise exports could be higher than the EDB projection of US$ 12 billion for this year, as several of the country's pre-COVID industrial exports appear to be gaining ground, while the COVID induced manufactures of personal protective equipment (PPE) items are continuing to be demanded.

Furthermore, tea exports have increased in the first two months by two percent to US$ 213 million compared to US$ 207 million last year. Hopefully this trend would continue in

spite of the current disruption of production on the high grown plantations. For these reasons, merchandise exports of US$ 15 billion is not unrealistic.

If these expectations are realised, the trade deficit could be contained to between US$ three to five billion. However, merchandise exports fell short of a million dollars a month in the first two months of this year.

Balance of payments

The government expects the balance of payments to be in surplus as they expect workers' remittances to continue to rise as in 2020 to US$ 7.1 billion. There is considerable uncertainty in this as last year's increase is difficult to explain as workers were returning to the country.

One explanation is that returning workers are remitting their accumulative savings through official channels rather than informal channels. If this is so, we could expect remittances to decline as the number of workers abroad are declining. On the other hand, it is suggested that expats in developed countries have increased their remittances to help their relations in financial difficulties. Either explanation leaves some doubt on the expectation of remittances to reach over US$ seven billion this year. It is hazardous to make an estimate of remittances, but a fall in remittances would cause a serious dent in the balance of payments.

Tourist earnings

The official expectation is that tourism will bring in about US$ 1.5 billion. This is realistic, if the global pandemic is contained and international travel revives. Conditions in both the countries of origin and ours would matter. Hopefully, by the later part of the year there would be an increase in tourists and this target would be achieved.

Other services

Income from ICT services are likely to improve somewhat. These could be a useful contribution to the BOP, if the target of around US$ two billion is achieved.

Concluding reflection

Much of the balance of payments outturn would depend on the speed and extent of the global recovery from the pandemic and the consequent global economic recovery. There is much uncertainty, but expectations that at the end of the year, the global economy would be resuscitated.

If all goes well, we may have a balance of payments surplus that would enhance the foreign reserves. Meanwhile currency swaps from India and Bangladesh would strengthen the international confidence in the country's capacity to meet the large debt repayments. The currency swaps are much needed palliatives that increase debt and are repayable. Only an improvement in the balance of payments could really strengthen the reserves.

For the full article – Refer The Sunday Times

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