Spotlight: Econ Op-eds in Summary

Week ended 11th September '19

In Summary

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

1. Sri Lanka's challenging debt outlook
By: Prof. Lalith Samarakoon

- Public debt in Sri Lanka has been rising over the past years to 83% of GDP in 2018. This is even more alarming because around 50% of this debt is foreign debt, requiring Sri Lanka to either earn foreign currency or borrow more from abroad to finance the payment of interest and principal obligations, making the country more vulnerable to external shocks.

- Such a rise in debt could be a huge burden on the budget balance as it limits fiscal space and flexibility for development, while lowering the resources available for fiscal stimulus. It also risks deteriorating the country's credit quality resulting in a higher risk premium being required by investors. This could increase an already high borrowing cost.

- Ultimately, the country could fall into debt distress, if public debt continues to grow unguarded at the current rate. Thus, the country would require a strong policy framework for fiscal consolidation and achieving sustained economic growth in high single digits to mitigate the risks created by the country's debt.

Public debt has continued to increase at a higher rate

Sri Lanka's public debt amounted to Rs. 12tn at the end of 2018. In fact, according to the Central Bank of Sri Lanka, the total debt was Rs. 12.6tn as of June 2019.

In terms of growth, debt has more than tripled growing at about 13% per year over the 10-year period from about Rs. 3.6tn in 2008. At this rate of growth, debt will double to Rs. 24tn in about six years. Clearly, such an explosion of debt at the current economic growth rate of about 3-4% is not sustainable.

Public debt is 83% of the economy

In relation to the 2018 nominal GDP of Rs. 14.5tn, debt stands at 83% of GDP. The debt-to-GDP ratio was 86% in 2009, the final year of the civil war.

Although the debt-to-GDP ratio declined in the subsequent years, reaching 69% in 2012, it has continued to increase since then, with the exception of a small dip in 2017. Two of the largest increases in the debt-to-GDP ratio occurred in 2015 and 2018 when it jumped up by six percentage points in each of the two years.

This amount of public debt and its rate of recent increase sound an alarming bell. Although there is no agreement on the optimal level of debt, a debt level of 60% of the GDP can reasonably be sustained.

While Sri Lanka might justify a ratio higher than the 60% level given the large financing needs necessary for economic development, its current rate of economic growth and fiscal capacity to pay cannot justify the current level and growth of public debt.

Foreign debt is now half of the total public debt

As of the end of 2018, Rs. 6tn of Rs. 12tn – 50% of total debt – was foreign debt. As of June 2019, Rs. 6.3tn of Rs. 12.6tn debt is foreign debt. As a result, foreign vs domestic debt is now 50/50. How did we get to this point? Foreign debt was 42% of the total debt in 2009 and rose to 46% of debt by 2012. Although foreign debt declined to 42% by 2014, since then it has increased continually, resulting in a share of 50% of debt now.

On the flip side, while foreign debt has increased from 42% to 50% between 2014 and now, the share of domestic debt has decreased from 58% to 50%. This 8% shift from domestic to foreign debt over a four-year period is quite alarming.

Thus, not only has the total public debt reached high levels, but also more and more debt are now foreign-denominated debt, which requires Sri Lanka to either earn foreign currency or borrow more from abroad to finance the payment of interest and principal obligations on such debt.

Foreign debt represents 41% of the economy

As a percent of GDP, foreign debt declined from 37% of the GDP in 2009 to 30% in 2014. Since then, foreign debt-to-GDP ratio has increased by 11% percentage points to 41% as of the end of 2018.

In 2018, total debt as well as foreign debt recorded one of the largest increases in recent years.

- Total debt grew by 16%, representing the second highest increase in the past 10 years.

- Foreign debt rose by 26%, making it the largest increase in the past 10 years.

At these rates of growth, foreign debt could easily overtake domestic debt as the largest financing source in the Sri Lankan economy, making Sri Lanka highly vulnerable to external shocks.

Burden on Government budget

Economic implications of high levels of debt are well known. First and foremost, interest payments on debt have created an enormous burden on the government budget. Interest cost alone was

- Rs. 852bn in 2018
- 42% of Government revenue and
- 6% of the GDP

With rising debt, the interest burden will only continue to grow. The 2019 government budget envisages a total interest burden of Rs. 913bn for 2019 and Rs. 1,000bn for 2020.

Limited fiscal space and flexibility for development

As seen from the above numbers, higher interest costs severely limit the availability of financial resources for the government to spend on other recurrent expenses and public investment.

In 2018, the interest cost represented 31% of the total expenditure. The negative impact on the development expenditure is very visible. Since 2016, interest costs exceed the amount of funds spent on public investment.

Lower resources for fiscal stimulus

Furthermore, revenue drain through interest costs severely limits the government's ability to respond to economic slowdowns, such as the one we are in now, in terms of fiscal stimulus either through tax cuts or increased government expenditure. That can lead to prolonged downturns which will in turn exacerbate budget deficit and debt problems.

Deterioration of credit quality

Economic and financial consequences of debt build-up could ultimately lead to a deterioration of the country's credit quality and the sovereign credit rating. Sri Lanka's credit quality is already weak. All three major credit rating agencies downgraded Sri Lanka's sovereign rating to the 'B' (S&P B, Fitch B, Moody's B2) due to refinancing risks and uncertain policy outlook.

This rating indicates highly speculative debt where capacity for continued payment is vulnerable to deterioration in the business and economic environment. Further, the build-up of debt without improvement in budget deficit, economic growth, foreign currency reserves etc. could further weaken the sovereign credit quality.

Debt refinancing risks

Any further weakening of Sri Lanka's credit quality could elevate refinancing risks of foreign debt. To pay interest and principal obligations of the existing stock of foreign debt, Sri Lanka will need $ 5-6bn in each of the next five years. Any deterioration of credit risk could raise the country risk premium, thereby increasing the interest cost of future borrowings needed to rollover existing debt.

Currently, Sri Lanka's 10-year sovereign bonds yield is about 7.4% whereas the 10-year US Treasury yield is 1.6%, resulting in a country risk premium of about 5.8%.

Debt distress and restructuring

Ultimately, the country could fall into debt distress, if public debt continues to grow unguarded at the current rate of growth without material improvement in economic growth and fiscal deficit.

In conditions of debt distress and restructuring, countries implement economic austerity programs in which government budgets tighten, economic activity shrinks, creating difficult economic conditions for the people. Obviously, it is in nobody's interest to let the country slide into such as state of affairs.

Need to recognize the problem and implement a growth-focused economic plan

The high level of public debt is not sustainable in the long-run. Given the continued fiscal deficit, the Government will be forced to continue to rollover existing debt as they mature and, as a result, reduction of existing debt will be a significant challenge. The Government projects that debt will decline to 70% of the GDP by 2023.

Reducing debt will require a strong policy framework for fiscal consolidation and achieving sustained economic growth in high single digits for at least a decade. And that is possible. Sri Lanka can accomplish it with a strong economic vision and a long-term socio-economic development plan supported by professional economic management and political commitment.

For the full article - Refer Daily FT

---

2. A weakening global economy calls for a consensus on Sri Lanka's priorities
By: Dr. Ganeshan Wignaraja

- Weaknesses in the global economy are weighing down on the strength of markets all over the world. Slowing economic growth in China, India, and the US are combining with global recession worries to cause high levels of economic uncertainty. While central banks are looking more ready to ease monetary policy in response, it remains to be seen how effective and practical this would be.

- The precarious state of the global economy is likely to add risks to Sri Lanka as well. Sri Lanka is tied to the health of the global economy, with factors such as tourism and remittances facing possible risks from a global economic downturn. These external factors would be especially problematic given the country's issues with foreign debt.

- On the other hand, there are a few opportunities on the horizon as well. The global economic downturn could improve some business opportunities, with budget tourism being a prime example. Moreover, following the 2019/20 election cycle, the country could look towards a more stable economic outlook. Managing these possibilities will be crucial to the country's economic health.

The critical policy questions facing us today are whether fears of another global recession are being overstated by international financial markets, and how vulnerable Sri Lanka is to such a challenging economic event.

Intensifying global economic risks

This is not a new phenomenon but rather a continuing shift to a new normal world economy that evolved from the global financial crisis of 2008-2009. Advanced Western economies are experiencing what former US Secretary of the Treasury Larry Summers calls "secular stagnation" or a long-term economic slump. Chinese growth is also slowing faster than expected and could converge over time to levels seen in advanced economies. Indian growth has also slowed to a six-year low.

These changes in the pattern of global growth largely reflect underlying structural factors like low investment, a shortage of labour due to an ageing population and disruptive technological change. Lower consumer confidence and high levels of household debt have contributed to waning demand.

The tit-for-tat tariff escalation between the US and China, other countries' global interconnectedness with these two superpowers, and the prospect of a disorderly Brexit have probably made matters worse for the fragile global economy.

That said, the world's central banks and finance ministries are monitoring the situation closely, and still have some firepower for counter-cyclical monetary and fiscal policies. The Bank of Japan and European Central Bank recently confirmed that they would employ further monetary easing in an attempt to stimulate the economy should the need arise. The International Monetary Fund (IMF) and regional financial institutions are also gearing up. Whether there is scope for national action backed by international policy coordination on a scale seen during the 2008-2009 crisis remains an open question.

The independence of central banks in the US and the UK seem to be under threat, with political leaders criticising their actions on interest rates and quantitative easing. At the same time, the IMF is in a leadership transition and it will take some time for a new head to come to grips with the institution.

Implications for Sri Lanka

On the one hand, this could spell more bad economic news for Sri Lanka which is still in recovery mode following the Easter Sunday bombings and downturn in the second half of 2019. As a small open economy and a foreign borrower, Sri Lanka is intricately linked to the global economy. A global recession economy shock and economic downturn could hit the country's trade, tourism, and worker remittances. Inward foreign investment and domestic business confidence could also be affected.

Financial markets and exchange rate volatility may affect the terms of foreign borrowing, external debt repayments and the capacity to import. Indeed 2019 and 2020 could see tough economic times for Sri Lanka.

On the other hand, some of the disruptions in the global economy and price reductions in Sri Lanka means that some new business opportunities could come the country's way. For instance, the tourism sector could benefit from an influx of Chinese and Indian tourists seeking bargain-basement prices.

More generally, the silver lining for Sri Lanka is that an opportunity exists for a new economic agenda for inclusive growth after the cycle of Presidential and Parliamentary Elections in 2019-2020.

Sadly, there is no quick fix to the country's underperforming economic growth and lack of competitiveness. An agenda for long-term growth and competitiveness would need to effectively manage macroeconomic imbalances and the debt overhang, whilst doing some house-keeping work on the trade and investment regime.

For the full article – Refer Daily FT