Spotlight: Econ Op-eds in Summary

Week ended 13th October '21

In Summary

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

1. Economic instability likely to prevail despite Central Bank's Road Map
By: Professor Sirimevan Colombage

- The 6-month Road Map presented by the CBSL goes beyond a monetary policy framework. However, it fails to address concerns about the fiscal sector. The rate of money printing has also continued to rise, despite yield caps being removed in the face of undersubscribed T-bill auctions. The roadmap also points to maintaining the exchange rate stable at the current rate, despite a fall in foreign reserves.

- Banks are seemingly complying with the stipulated exchange rate, although foreign currency problems in the sector still persist. However, a higher Real Effective Exchange has been recorded given higher inflation, disadvantaging exporters. As such, certain exporters have opted to not convert export proceeds in the stipulated time frame, as they believe the current exchange rate is not sustainable, which the road map tries to address through a higher tax.

- Given macroeconomic concerns, Citibank believes that there is higher risk that Sri Lanka would need to restructure its debt with IMF assistance. Given this, Sri Lanka needs to take measures to bolster its debt sustainability before it is too late.

The six-month Road Map for Ensuring Macroeconomic and Financial System Stability presented by Central Bank Governor Ajith Nivard Cabraal early this month contained a long "to-do-list" that goes beyond the scope of monetary policy.

Economic imbalances disregarded

The monetary policy would be futile unless it is tied up with strict fiscal targets. The Government's borrowing requirements are continuing to rise depending heavily on Treasury bills and bonds and foreign commercial loans. The Treasury bill auctions have been under-subscribed although the yield caps have been removed recently. Purchasing of the unsold portion of Treasury bills by the Central Bank causes an increase in its monetary base, and in turn, the money supply. The resulting inflationary pressures are already evident.

The exchange rate remains fixed as stipulated in the Road Map, despite the severe foreign exchange shortage exacerbating the anti-export bias. The foreign reserves are down to minimum levels as against the upcoming external debt commitments.

Monetary expansion continuing

The rapid money supply growth propelled by substantial bank lending to the Government since last year has been a major cause of economic instability. The Central Bank has no policy space to mop up such excess liquidity, in the absence of fiscal discipline.

Immediately after the presentation of the Road Map, the Central Bank's holdings of Government securities rose by 8% from Rs. 1,336 bn to Rs. 1,443 bn. This raised the monetary base (adjusted for net foreign assets) causing an expansion in the money supply.

The balance portion of the Treasury bills was to be purchased by the Central Bank causing a rise in its monetary base, and in turn, the currency issue, commonly known as money printing. The aggregate money supply rose by 10 times the monetary base due to the money multiplier effect.

Inflationary pressures

The year-on-year inflation, measured in terms of the Colombo Consumer Price Index (CCPI) rose to 5.7% last month from 4.0% a year ago. The maximum retail prices of several essential goods including rice, wheat flour, milk powder, and LP gas were removed last week, and therefore, inflation will accelerate further in the coming weeks.

The monetary expansion has resulted in excess market liquidity pressurizing aggregate demand. These adverse trends clearly show the imminent danger in adopting the so-called Modern Monetary Theory-styled policy by the Central Bank to meet the fiscal shortfalls by printing currency.

In the backdrop of the supply shortages due to the pandemic and import restrictions, inflationary pressures are intensified further. The depreciation of the rupee is another factor that has led to push up inflation from the cost side. With the rupee depreciation, imports are getting costlier and as a result, the prices of consumer goods that form a significant portion of the consumer basket will continue to rise thus, accelerating inflation.

Apart from such direct effects of currency depreciation, further rounds of monetary expansion are going to take place as a consequence of possible increases in the budget deficit due to rupee-depreciation-led Government expenditure hikes.

Exchange rate distortions

Higher domestic inflation vis-à-vis the inflation of trading partners causes an appreciation of the Real Effective Exchange Rate (REER) putting exporters in a disadvantageous position. Hence, it calls for a depreciation of the rupee to sustain export competitiveness.

However, the Road Map envisages, "Considering the REER, maintain the Rupee at the very competitive level of Rs. 199 to Rs. 203 against the US dollar over the next three months, and review thereafter." Commercial banks have been adhering to the fixed exchange rate rule despite the severe shortage of dollars in the market.

Meanwhile, the CBSL allows paying an extra Rs. 2 per dollar remitted and converted by workers abroad. This discriminates against other foreign exchange earners, particularly exporters. This type of dual exchange rate system was in force during the pre-liberalisation period.

The fixed exchange rate system prevents market adjustments needed in the backdrop of the overvalued rupee. The unrealistic exchange rate has led to the development of a parallel black market, as admitted by the CBSL itself in its recent press notice.

The attractive black-market rates tend to divert foreign exchange earnings including worker remittances away from the official channels to Informal Money Transfer Schemes (IMTS) such as 'Hawala' and 'Unidyal'.

It would be difficult to keep the fixed exchange rate for long, as the Central Bank does not have sufficient foreign reserves to defend the rupee. Hence, substantial rupee depreciation is inevitable, which would be more painful than gradual adjustments reflective of market conditions.

Exporters discontented

It is reported that some exporters have decided not to bring the export proceeds to Sri Lanka defying the Central Bank's export proceeds conversion rule. They are of the view that it is profitable for them to pay tax at 28% instead of 14% as warned by the Central Bank Governor, rather than converting the export proceeds at the unrealistic fixed exchange rate.

Exporters also have expressed their displeasure over the Governor's statement that they are hoarding foreign exchange abroad.

Investors unconvinced

Global financial giant Citi has indicated that the downward risks are higher despite the Central Bank's Road Map, as Sri Lanka would not be in a position to restructure her debt obligations without IMF assistance. Citi feels that the Road Map contains somewhat less clarity and longevity than some investors sought. In the circumstances, Citi has decided to remain credit neutral on Sri Lanka.

Reforms essential

A credible reform program is the need of the hour to rectify the macroeconomic imbalances and to win investor confidence.

In this regard, it is vital to improving the country's debt sustainability. In terms of the global Debt Sustainability Assessments (DSAs), Sri Lanka is identified in the "extremely speculative/substantial risk" category along with seven other countries – Angola, the Congo, Congo DRC, Gabon, Lao PDR, Mali, and Mozambique.

It would be impossible to improve debt sustainability without appropriate fiscal reforms geared to reduce the fiscal deficit.

For the full article – Refer Daily FT

2. Are we at a turning point in economic diplomacy and economic policies
By Nimal Sanderatne

- Visit of Indian Foreign Secretary, Japanese war ships in Colombo Port, review by EU team on country's effort to improve human rights, all seems to indicate a shift in Sri Lanka's foreign policy. Further with Adani group's investment in Colombo Port and New fortress investment in LNG gas project, Sri Lanka seems to be deviating from its dependence on China towards the west.

- It is vital that Sri Lanka is able to obtain foreign assistance and investments for economic sustainability. Thus, despite objections from the opposition and trade unions the government had moved to have agreements with these countries.

- Despite the assurance given to China that recent diplomatic developments will not be a threat to China, Sino-Sri Lankan economic dependence seems to be weakening. This is mainly due the developing financial crisis in China which limits

its capacity to assist Sri Lanka and Sri Lanka's significant dependence on Europe and North America as key export markets.

Recent events, diplomatic developments and foreign investments are indicative of a shift in the country's foreign policy, foreign economic dependence and perhaps of economic policies. The unfolding of events in the next few months will reveal whether there have been changes in these pivotal issues.

Important events

Several events that occurred last week were of significance for the country's economy. Among these were

- the visit of Shri Harsh Vardhan Shringla, the Indian Foreign Secretary, which was perhaps the most significant.
- The Japanese war ships in the Colombo port
- the European Union (EU) team to review the country's efforts to improve human rights in order to determine the continuation of the GSP plus concession.Advani group's 51% stake in the Colombo Port's West Terminal and
- the American company New Fortress investment of US$ 250mn in the Kerawalapitiya LGN gas project.

Shift in policies?

Are these developments indicative of a shift in foreign and economic policies towards India and the West? Has there been a tilt towards India and perhaps QUAD: The four-member alliance between Australia, US, Japan and India. Is the dependence on China diminishing?

Assurance to China

President Gotabaya Rajapaksa was quick to give China an assurance that these ties will not be a threat to the security of China.

Indo-Sri Lankan economic cooperation

The Indian Foreign Secretary's visit was not a courtesy call or a sightseeing visit of Colombo, Kandy, Trincomalee and Mannar, As Indian commentators have noted it has been to

- deepen Indo-Sri Lankan economic cooperation,
- revive Indian development projects in Sri Lanka that have made little progress,
- identify new economic opportunities and perhaps
- assist Sri Lanka's foreign currency reserves.

Foreign investments

The two recent foreign investments in the Colombo Port and the LNG gas plant have important implications. The Government has apparently decided that the country is in dire need of foreign investments from whatever quarter it comes and will face trade union and other political pressures to implement these two projects that are Indian and American investments.

The two projects

The Indian Advani Group of companies will invest US$ 500mn in the joint venture to develop the Colombo Port West Terminal and an American company, New Fortress will invest another US$ 250mn investment in the Kerawalapitiya LNG gas power plant. The interesting question is whether these are signs of other Indian and American investments.

Despite opposition

The Government faces severe trade union and other opposition to these projects. However, they are fait accompli and the Government is determined to resolve the opposition in their own way.

The Government appears to have taken the view that these foreign investments are vital of the country's development and cannot be blocked by opposition from even its constituent parties.

New approach

This new bold approach could result in many more foreign investments, especially from India. Has the Government's bias towards Chinese investments changed or is it that the weakening of the Chinese economy restrains their foreign investments abroad?

World Bank

The Government has also signed an agreement with the World Bank for US$ 500mn to improve rural roads and infrastructure. Although these funds would not be dispersed at once and there would be an import component when work begins, they would offer temporary relief to the low external reserves.

Reflections on these developments

The developments discussed above when taken as a composite picture indicate several significant changes in policy.

The Sino-Sri Lankan economic dependence appears to be weakening. Two factors are likely to have influenced this shift.

1. **China's capacity to assist Sri Lanka, especially her foreign currency problem, is limited by her own developing financial crisis.**

Its currency swap in Yuan was useful to import essential items, but limited in its use as a foreign reserve and had to be repaid in USD.

2. **Sri Lanka's markets were in Europe and North America.**

Any restriction in these markets would be suicidal. Therefore, there is a need to placate these countries.

The earlier approach by this Government was to ask the UNHRC to not interfere in Sri Lanka's internal affairs and that the country will ensure human rights by domestic instruments. The new approach was to assure UNHRC that weaknesses in human rights would be addressed in the near future. This was a reversal of the earlier haughty approach.

The reason for the change in approach was the belated realisation that the economy could not face the withdrawal of the GSP plus concession or trade sanctions by the EU or the US and North America that were the country's main export markets.

The decision to sign agreements with Indian and American firms was based on the conviction that the country's development was not possible without foreign investments and foreign technology. This implies that the Government would seek similar investments from India and western countries in the near future.

Final thought

Has the Government arrived at a turning point in its foreign investment policies that will shift its economic policies towards India and the West? Will the country drift away from her reliance on Chinese financial assistance and investments? Is there such a shift in economic policies? Only time will tell.

For full article – Refer The Sunday Times