Spotlight: Econ Op-eds in Summary

Week ended 30th September '20

In Summary

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

1. Financial institutions under pressure to lend: A dangerous trend
By: Rienzie Wijetilleke & Kusum Wijetilleke

- The combined impact of the Easter Attacks and COVID-19 pandemic has resulted in many consumers resorting to debt to make ends meet. Rising levels of credit card debt and other unsecured personal debt may result in a snowballing effect, posing a major systemic threat.

- Against this backdrop, banks must lend with caution, taking into account their funding structure and capital adequacy. They also face the difficult task of determining the risk profile of borrowers and taking steps to mitigate risk, which remains a challenge given the present economic environment, moratoriums ending in September and non-performing loans on the rise.

- Bank financing remains especially important to Sri Lanka as a growth driver, given constrained FDI. However, policy consistency, stability of currency, multi-stakeholder planning of key industries and attracting both FDI and foreign talent to the country must first be addressed prior to enhancing lending portfolios to spur economic growth.

Sri Lanka was spared the worst effects of the 2008 financial crisis primarily due to the regulatory structure which restricted exposure to high risk financial assets. The financial crisis did create issues for Sri Lanka's exports, and, generally speaking, there was a drop in both the prices of and demand for commodities. Sri Lanka nonetheless survived the financial crisis and even thrived for a few years following the defeat of terrorism.

Sri Lanka may however face more severe issues in the near future with the level of personal debt that many Sri Lankans have taken on. From the point of view of the financial institutions, unsecured credit card debt is perhaps the major threat to the stability of the system. As per a report from October 2018, Sri Lanka's total credit card debt stood at Rs. 101 Bn. A report in April 2019 showed that total credit card debt had increased further to Rs. 109 Bn, which is an Rs. 8 Bn increase in 7 months. Since April 2019, the overall economic performance of Sri Lanka has suffered at least two major setbacks. First, the Easter Sunday Attacks, which created a dramatic drop in tourist arrivals, a major income earner for Sri Lanka and an industry that employs millions directly and indirectly. Second, just as the country's economy seemed set for a revival, the Covid19 pandemic struck, affecting tourism specifically but virtually every other industry as well.

Many Sri Lankans had no choice but to resort to utilising any debt instrument available to them in order to make ends meet. There is little doubt that many Sri Lankans would have opted to utilise the available balances on their credit cards, plunging them further into debt with even higher interest rates and expensive penalties and charges.

Even if we assume that credit card debt in total would 'only' be around Rs. 120 Bn at this point in time, we have to also consider other forms of personal debt. Most mortgages are well secured due to the discounting requirements from the CBSL; thus, even in the unlikely event that there would be a crash in the property market, most lenders will be well

collateralised. This is not the case with credit cards, and exposure to the credit card sector is significant across banks of all sizes at all tiers.

Yet, this still only part of the problem. Consider personal loans, though quantums are smaller, the risk is high for the lending institutions as more often than not, personal loans are unsecured and usually borrowed for consumerist purposes. Most people in Sri Lanka buy durables on consumer finance schemes, and again some of this risk is taken by banks and other lending institutions. The durable item will often be obsolete in a year or two, so any default is unlikely to be covered by the value of the goods. Education loans are another instrument which many consumers use to fund their educational pursuits or those of their children. Often these too are unsecured and only linked to monthly income. Thus, considering credit card debt plus other forms of unsecured personal debt, both Sri Lankan borrowers and the lending institutions might well be engaging in an unstoppable 'snow-ball' effect.

The Minister of Industries recently stated that the banks in Sri Lanka were less interested in lending to industries. What he perhaps meant to say was that lending on industrial projects was restricted. However, economists agree that many of Sri Lanka's major industries; tourist hotels, hydro-power, garments and other manufacturing related projects have all been heavily backed by bank finance. Banks are run through depositors' funds and the depositors are Sri Lankan citizens; it is their money that the banks lend with margins under strict guidelines.

Veterans of the banking industry are well aware that banks are one of the key drivers of economic activity in any economy, but more so in Sri Lanka where FDI has been lagging for many years.

Banks must be cautious about lending funds even on a short-term basis if their funding structure is tilted towards demand deposits. Capital adequacy will not be anywhere near enough if ad hoc lending strategies are given priority. A lender's major task is to identify the borrower and their risk profile verses the steps that can be taken to mitigate risk. The important term here is to mitigate risk, not to altogether absolve yourself from the risk.

Once you identify your customer and what category he falls into, you must then take a view on the risk proposition versus the profit motives and act accordingly. This is no easy task. At this current stage in our country's recovery from the Easter attacks and the pandemic, increased lending even at lower interest rates can lead to serious instability in the system. In fact, the worst is likely still to come, considering that moratoriums are expiring at the end of September and the country's economy has yet to show signs of a sustained recovery. Wages have fallen due to the lack of business activity, disposable incomes are non-existent, personal debt is on the rise, and non-performing loans are also increasing.

Yes, the banks in Sri Lanka have been very successful in the past and the industry is perhaps one of the most stable and dynamic in the country's history. However, this is as a result of very carefully crafted policy and strict regulations. If anyone goes back a few decades to the height of terrorism in the nation, it is the banks that guaranteed some form of economic progress to the country's people and its industry. The state and its institutions should provide a framework for success, beyond tax holidays and low interest rates. Consistency of policy, stability of currency, multi-stakeholder planning of key industries and attracting both FDI and foreign talent to the country are just some of the facets that must all come together before we start looking at enhancing lending portfolios to spur economic growth.

For the full article – Refer The Island

2. Role of Special Economic Zones in development of Sri Lanka
By: Utthara Wanigasekara

- Sri Lanka, which occupies a strategic geographical location close to major global sea lanes, has long aspired to be a regional trading and services hub in the Indian Ocean. Taking its location as an advantage, the country can establish special economic zones (SEZs) to attract FDIs, create meaningful jobs for younger generation and help Sri Lanka to be competitive in the global market.

- Sri Lanka in fact, already has significant experience of SEZs in the form of Export Processing Zones (EPZs), which are a subset of SEZs focused primarily on manufactured exports. These zones have played a crucial role in the development of Sri Lanka's exports, particularly the apparel sector, which today continues to account for around 50% of the country's goods exports.

- Taking the current economic disruption caused by the pandemic as an opportunity, Sri Lanka can use Special Economic Zones as an economic tool, which can play an important role in attracting FDI, creating more employment opportunities in order to achieve industrial development in a sustainable, efficient and effective manner.

Special Economic Zones (SEZs) can be defined as 'geographically delimited areas within which governments facilitate industrial activity through fiscal and regulatory incentives and infrastructure support'. These zones are widely used in most developing and many developed economies.

In these geographically delimited areas, governments facilitate industrial activity through fiscal and regulatory incentives and infrastructure support. For an example, in 1988 Hainan Island was made a separate province and a special economic zone, and by 2005 in India there were eight special economic zones in states like Kerala and Gujarat. By 2019, there were about 5,383 SEZs across 147 economies worldwide.

SEZs have become increasingly popular mechanisms to promote economic development. Over the last two decades, in particular, SEZs have significantly increased in number in emerging and transition economies. States promoting zones have sought to stimulate economic development both within and outside the zone. Within the zone, states aim to attract investment that will lead to new firms and jobs, and to facilitate skills and technology transfers. Outside the zone, states aim to generate synergies, networks, and knowledge spillovers to foster additional economic activity.

SEZs are typically designed to achieve the following four policy objectives:

(i) Attracting foreign direct investment and promoting exports and industrialization.

(ii) Serving as 'pressure valves' to alleviate large-scale unemployment.

(iii) Supporting wider economic reform strategy.

(iv) Acting as experimental laboratories for the application of new policies and approaches.

The rationale for establishing Special Economic Zones in any country is the realization that existing general infrastructure conditions and regulatory frameworks are not ideally helpful for attracting Foreign Direct Investment (FDI) or relocation of industries from excess capacity economies. In order to overcome these constraints, host countries need to establish specially designated zones with liberal policies, minimum bureaucratic processes and improved infrastructure facilities.

China's experience in SEZs

China has successfully leveraged SEZs for economic transformation. Initially SEZs were used to experiment with market-oriented economic reforms and build experience, before reforms were implemented more widely. Now, a wide range of SEZs have been established to take advantage of local conditions. These encompass large national zones (whose objective is to foster broad-based, comprehensive economic development), high tech industrial development zones, free trade zones, and export processing zones, as well as others at both national and regional levels. Although there is no single model, all successful Chinese SEZs are supported by conducive government policies and commitments. Some of the features of successful economic zones are as below.

Features of successful SEZs:

- Geographically delimited area
- Single management or administrative structure
- Strong linkages with domestic industries
- Attractive FDI and diaspora
- Technology learning, innovation and upgrading
- Separate and efficient custom provisions

The case for Sri Lanka

Sri Lanka, which occupies a strategic geographical location close to major global sea lanes and near the coast of dynamic Indian economy, has long aspired to be a regional trading and services hub in the Indian Ocean.

Sri Lanka has significant experience of SEZs in the form of Export Processing Zones (EPZs), which are a subset of SEZs focused primarily on manufactured exports. The first EPZ in Sri Lanka was established in Katunayake in 1978 under the authority of the Greater Colombo Economic Commission (GCEC), which was later renamed Board of Investment. Today, there are 12 EPZs in Sri Lanka concentrated in the Western and Southern Provinces, and an additional three are planned. These zones have played a crucial role in the development of Sri Lanka's exports, particularly the apparel sector, which today continues to account for around 50% of the country's goods exports.

Sri Lanka's geographical position is ideal to become a regional manufacturing and shipping hub. Taking this as an advantage, it is important to establish special economic zones in order to attract FDIs, create meaningful jobs for younger generation and help Sri Lanka to be competitive in the global market. It is the responsibility of the Government to take necessary action by promoting FDI and providing an environment conducive for investors to consider Sri Lanka as a suitable place for investment. In this regard, the Pathfinder Foundation had recommended in 2015 the following key actions, which are still valid:

(i) Identify the needs of both the host country and the investor and design SEZs

(ii) Adopt transparent and consistent pro-business, especially pro-FDI policies, and regulations.

(iii) Administrative processes must be streamlined and bureaucratic red tape in granting approvals must be minimised.

(iv) Policies and regulations must welcome technology transfers, innovations and technology know-how while protecting patent rights, trademarks, etc.

(v) The consistency of policies, irrespective of changes of government or political systems, must be guaranteed.

Sri Lanka had considerable potential for FDI four decades ago. In the early 1980s, companies like Motorola and Harris Corporation had plans to establish plants utilizing facilities offered by the GCEC. Other companies, such as Marubeni, Sony, Sanyo and several foreign banks had investment plans in the pipeline. However, the 1983 race riots and the separatist war put an end to that nascent potential.

With the end of the conflict in 2009, Sri Lanka began to attract attention once again and by 2013 received approximately $ 1.4 bn as FDI. However, by that time, countries like Malaysia and Vietnam, which suffered from decades' long war, had taken giant strides by attracting FDI. As a percentage of GDP, FDI currently stands at mere 2% and lags behind Malaysia at 3-4% and Vietnam at 5-6%. Rate of FDI since 2013 has been disappointing. The major reason for the decline has been attributed to geopolitical risks and policy uncertainty for investors.

This situation could be seen by looking at the cumulative employment of BOI projects. As at December 2013, textile accounted for 60%, knowledge services for 4% and 12% for manufacturing. Disappointingly, the numbers were the same three years later, when it came to the apparel sector, which accounted for an unchanged 60%, manufacturing halved to 6.6% and there is no data available for knowledge services.

The outbreak of COVID-19 has severely impacted the apparel sector making it more difficult for the Sri Lankan economy. Taking this challenge as an opportunity to change the apparel dependent economy to more diversified export generation, Sri Lanka can use Special Economic Zones as an economic tool, which can play an important role in attracting FDI, creating more employment opportunities in order to achieve industrial development in a sustainable, efficient and effective manner.

For the full article - Refer the Daily FT

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