Spotlight: Econ Op-eds in Summary

Week ended 23rd June '21

In Summary

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

1. Fiscal policy corrections postponed until 2030, defying IMF support
By: Professor Sirimevan Colombage

- The government recently took actions to defer the fiscal rules introduced in the Fiscal Management Responsibility Act (FMR) to 2030 and while also introducing relaxations to the current fiscal rules. In conjunction to which, the debt to GDP target outlined was shifted to 2030. Given these changes, the budget deficit is expected to be approximately 12% by end 2021- a clear sign of refusal of IMF support.

- Such deferments is not surprising given that that the non-adherence to fiscal targets outlined in the FMR in the past had let to a growing of the debt burden to unsustainable levels. The amendments made to the Monetary Law Act in the past on inflation targeting being abandoned, in combination to the credit expansion undertaken by the CBSL recently, has led to a rapid rise in the money supply.

- The effect of rupee depreciation coupled with rising inflation had led to poorer consumers suffering a greater impact on their purchasing power. The delaying of policy adjustments in effect will pass it on to the future generation, and the government must ensure that it has strict budget targets and sound structural reforms to ensure price and economic stability in the country.

Neglecting the urgent need to reduce the budget deficit so as to restore economic stability, a few days ago, the Government decided to defer the fiscal rules that were introduced way back in 2003 until the year 2030.

The budget deficit rose to 11.1% of GDP in 2020, and it is most likely to be over 12% of GDP this year in the backdrop of revenue shortfalls caused by pandemic-hit economic activities. The fiscal deficit, compounded by the tax cuts effected in 2019, is the root cause of excessive money supply growth and debt accumulation in recent times aggravating macroeconomic instability, as I reiterated many a times in this column previously.

Distancing itself from the International Monetary Fund (IMF), the Central Bank has turned to international capital markets to raise borrowings. Since last year, even such borrowings have been constrained by the country's weak debt sustainability. Therefore, foreign loans through bilateral swap arrangements with China, India and Bangladesh have become the next choice, as I explained in last week's column.

Shying away from IMF

The Government, on the advice of the Central Bank, is determined to avoid seeking financial assistance from the IMF to overcome the balance of payments difficulties.

The irony is that the Government is now compelled to adopt bits and pieces of IMF's policy prescriptions, even without any financial agreement with the Fund.

A good example is the recent fuel price increase. Regular fuel adjustment is a usual conditionality in IMF policy packages. With such conditionality Sri Lanka could have realised better budgetary management uplifting her credit worthiness in foreign capital markets.

Central Bank still in search of an alternative policy approach

The Central Bank continues to deny assistance from the IMF arguing that the conditionalities attached to such assistance are not compatible with the Government's home-grown alternative economic policy strategy.

At his very first Monetary Policy Review meeting held in December 2019, Central Bank Governor Prof. W.D. Lakshman stated: "In the present context of subdued growth and development, continuing poverty pockets despite poverty alleviation policies of several decades in the past, and prevalence of unemployment and underemployment at worrying levels, fiscal and monetary authorities and decision makers in different sectors of the economy are confronted with the challenge of searching and identifying alternative policy sets of greater efficacy than the neoliberal policy sets we have been working on so far. I hope to be able to make my contribution on this search for this alternative, working together with the other authorities."

He further mentioned: "This is the time of important changes in Sri Lankan development policy and practice. Questions are being raised extensively about the validity and relevance of 'Washington Consensus'-type or neoliberal-type of policies to achieve the desired goals of inclusive, sustainable and shared development. This questioning may also apply to central banking nowadays. I am extremely excited about the opportunity I have gained at a time like this to make my active contribution to Sri Lanka's search for an alternative policy approach to achieve the desired development objectives."

Many moons have passed since the above declaration, but the alternative policy set is yet to see the light of day.

EFF agreement abandoned

The Yahapalana Government entered into a three-year Extended Fund Facility (EFF) arrangement with the IMF in June 2016 for an amount equivalent to SDR 1.1 billion (around $ 1.5 billion, or 185% of the country's quota) to support Sri Lanka's economic reform agenda.

The present Government abandoned the EFF arrangement in 2019 without drawing its last tranche amounting to around $ 200 million.

EFF agenda

Fiscal consolidation targeting a reduction in the overall fiscal deficit was the linchpin of the EFF program. Rebuilding tax revenues through a comprehensive reform of both tax policy and administration were key in this regard. These were to be supplemented by steps toward more effective control over expenditures and putting State enterprise operations on a more commercial footing.

It was also expected that a clear commitment to exchange rate flexibility would improve the external payments position while allowing the Central Bank to rebuild foreign exchange reserves and focus more closely on its key mandate of price stability.

Fiscal deterioration

The fiscal and monetary situation worsened by 2020, The budget deficit widened to 11.1% of GDP in 2020, in comparison with the much lower deficit of 3.5% envisaged in the EFF programme.

This was largely an outcome of the significant decline in tax revenue in 2020. Following the Presidential election in November 2019, the Inland Revenue Act was revised so as to provide a wide range of concessions to tax payers, without considering the adverse fiscal implications for economic 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.

Continuing the downward trend, the tax revenue is likely to be even lower this year which would widen the budget deficit to around 12% of GDP.

As a result of the larger borrowing requirements to finance the widening budget deficit, the Government's debt to GDP ratio rose to 101% in 2020, and when the Government guaranteed loans are included the ratio goes up to 108% of GDP.

Fiscal targets postponed until 2030

Making matters worse, a few days ago, the Parliament approved an amendment to the Fiscal Management (Responsibility) Act of 2003 to further relax the fiscal rules. Accordingly, the Treasury guarantees provided for bank loans to state-owned enterprises and private entities are to be raised from 10% to 15% of GDP.

Also, the ratio of debt to GDP target envisaged in 2013 is now shifted to year 2030. When the Act was initially approved in 2003, it was targeted to reduce the gross Government debt to 85% of GDP by the year 2006, and reach 60% by 2013. It was also expected to maintain the budget deficit at 5% of GDP.

The successive Governments have never attempted to achieve the stipulated fiscal targets during the last 18 years since the enactment of the Act. As a result, the fiscal situation has deteriorated over the years aggravating the debt burden to unsustainable proportions by now.

Excessive money supply growth

The broad money supply rose by 22.9% in 2020, as against the EFF target of 12.5%. Direct purchase of Treasury bills by the Central Bank owing to undersubscribed auctions led to increase reserve money (notes and coins), which provides the monetary base for commercial banks to create credit by multiple times.

A major reason for the excessive money supply growth is the rise in bank credit to the Government and public corporations. Net bank credit to the Government rose exorbitantly by 62.7% in 2020, as against the EFF target of 4.5%. In the backdrop of difficulties encountered in raising foreign loans in the capital markets, domestic bank credit has been extensively used to finance the budget deficit.

On the contrary, private credit slowed down partly due to the pandemic-affected economic setback.

The amendment to the Monetary Law Act, which was in the EFF agenda with a view to provide greater independence to the Central Bank by permitting it to adopt inflation targeting monetary policy, is abandoned now.

Energy price increase without a reform package

In an effort to strengthen governance and transparency of state-owned enterprises (SOEs), the energy pricing reform was a key policy component of the EFF programme which was abandoned in 2019. A fuel pricing formula, linked to a 3-month average of the Singapore Platts index, was introduced with a view to reduce the losses of the Ceylon Petroleum Corporation (CPC) caused by administratively determined prices. This fuel adjustment formula was scrapped in 2019.

It is reported that the Energy Ministry has obtained Cabinet approval last week to raise foreign loans amounting to $ 1 billion in order to repay CPC's local debt to State-owned banks. This will further worsen the foreign debt situation.

IMF's rapid financing instrument untapped

Contrary to official claims defying IMF assistance, the Fund's Director of Communications, Gerry Rice announced in May last year that they had received a request from the Sri Lankan Government for emergency financial support, under the rapid financing instrument to replace the EFF. He confirmed that the IMF was having discussions with the Government in this regard. These discussions do not seem to have brought fruitful results yet.

However, Sri Lanka is likely to receive $ 800 worth reserves under a new allocation of Special Drawing Rights (SDRs) from the IMF without any conditions.

Little hope for economic stabilisation

Given the postponement of fiscal adjustments until 2030, economic stability seems to be a distant reality for Sri Lanka. In effect, the much-overdue fiscal adjustments are conveniently passed down to the next generation.

The money supply has already been rising at a rapid pace owing to Central Bank's easy credit policy characterised by fiscal dominance over monetary policy threatening price stability. The resulting deterioration of the rupee value is reflected in the depreciation of the currency vis-à-vis US dollar in recent months.

The adverse effect of rupee depreciation is already felt in the energy sector which led to raise retail fuel prices last week. This will have spillover effects on the entire economy spiralling cost-push inflation. The poorest are going to be the worst hit by impending consumer price increases.

The Central Bank, which is responsible for sustaining price and economic stability, should insist that the Government ensures fiscal discipline adhering to strict budget targets, instead of lavishly accommodating the Treasury's cash requirements and ridiculing the much-needed structural reforms as neoliberal nonsense.

For the full article – Refer Daily FT

2. Growing concerns in external finances
By Nimal Sanderatne

- Sri Lanka's external finances had become a serious matter of concern with a USD 4bn debt repayment falling due this year, especially as exports fall due low production and a significant decrease in raw material stocks. Adding on to the pressure are the rising import prices.

- However, there has been a significant increase in workers' remittances in the first few months of the year. Information Technology (ICT) services earnings have been increased compared to last year. These inflows along with a possible IMF SDR allocation of around USD 800mn this year could positively affect the balance of payments.

- Given these conditions Sri Lanka is most likely to meet its foreign debt repayment obligations this year with multilateral and bilateral support contributing towards this. In the long run however, country needs to make its policies right to increase imports, reduce the trade deficit and increase capital inflows. Neither import restrictions nor excessive creation of money is a sustainable solution.

The external finances of the country are in a perilous state. External reserves have fallen, the trade deficit is widening, the balance of payments deficit is increasing and there are foreign debt repayments of about US$ four billion during the rest of the year.

External reserves

External reserves that were US$ 4.47 billion at the end of April have fallen to US$ 4.02 billion at the end of May. The trade deficit expanded at the end of the first quarter and is expected to widen further. This is in a context when foreign debt repayments are about US$ four billion during the rest of the year.

Trade deficit

The trade deficit is widening owing to a decrease in exports and an increase in import expenditure. The country was poised for an increase in merchandise exports as global demand was reviving when the resurgence of the COVID in May disrupted production of export manufactures.

Exports

Exports that were poised to increase owing to a revival of global demand are experiencing a setback owing to the resurgence of the COVID. Last Sunday's column spotlighted factories working at low capacities or closed down owing to the spread of COVID among workers and travel restrictions.
This was an unexpected turn of fortunes as export industries, especially apparel, were poised to expand to cater to the growing global demand. Garment factories were affected the most by COVID.

Reduced production

There is growing evidence that manufacturing activities have contracted from May onwards owing to the spread of COVID and restrictions. According to the Central Bank of Sri Lanka there was a "significant contraction in production, employment, new orders and stock of purchases."
Furthermore, "production, especially in the manufacture of food and beverages and textiles and wearing apparel sectors, declined significantly together with the decline of employment." This was mainly "due to a significant reduction of availability of employees amidst the mobility restrictions imposed in mid-May."

Raw materials

It is also significant that there was a "deterioration in accumulated stocks of raw material" according to CBSL. It also notes several other constraints to industrial production such as increased freight rates that have increased the cost of imported raw materials.

Expectation

Although there are expectations of increased manufacturing activities in the next three months, if there is a normalisation of economic activities, at the time of writing, it is unlikely.

Revising targets

Recognising this, the Export Development Board (EDB) is revising its export target downwards from US$ 15 billion. Exports would probably be around US$ 10.5 billion this year.

Threats

There are several serious threats to the country's exports on the horizon. The foremost is the European Union's (EU) likely withdrawal of the GSP plus status soon. This would make our exports to the EU less competitive. This is a repetition of the earlier experience when GSP Plus was withdrawn and export growth was stifled till it was revived after the restoration of GSP plus.

Other markets

More threatening is the prospect of other western countries like the UK, Canada and the US imposing trade restrictions or higher tariffs. This would be a disaster as these countries and the EU account for 70 percent of our exports.

Sea food

A ban on our sea food imports is an imminent threat owing to the ocean around the country being poisoned by chemical and oil spill of the burning and sinking of the Xpress Pearl.

Reduced agricultural output

A third threat to exports is from reduced output of tea due to the unavailability of chemical fertilisers, weedicides and pesticides. The impact on coconut production would be from next year. Reduced rubber production would necessitate imports of natural rubber for rubber manufactures like gloves and tyres.

Import increase

Import expenditure is increasing. This is primarily due to increasing prices of oil internationally. Oil prices have increased by as much as 75 percent. Consequently, fuel imports would make a big dent on import expenditure.

Oil imports

The increase in price of petroleum products would ease the public finances somewhat, but will not reduce petrol imports by much due to the inelastic demand for petrol and petroleum-based products.

Food imports

The trade deficit would expand due to increased imports of food either later this year or in 2022. Rice production is expected to fall drastically in Yala 2021 owing to the lack of fertiliser, weedicides and pesticides. The Maha 2021/22 drop in production would be larger, unless there is a reversal of import policy on fertiliser, as discussed in the June 6 column.

Silver linings

Amidst these dark economic clouds, there are a few silver linings in the balance of payments. Workers' remittances that has increased in the first few months are likely to be around US$ seven billion and there is aprospect of an increase in earnings from information technology (ICT) services. In the first quarter of this year, these earnings increased compared to last year.

IMF grant

Another favourable prospect to the balance of payments is the IMF grant of about US$ 800 million in an additional issue of Special Drawing Rights (SDRs) that is expected during the course of the year.
While these earnings would narrow the balance of payments deficit, they are not likely to wipe it out completely.

Summing up

While the country's export capacity is hampered by the spreading COVID and travel restrictions, import expenditure is increasing. This widening of the trade deficit is likely to continue owing to increased import expenditure and the setback to exports due to production constraints.
Last year the trade deficit was US$ six billion. With an increase in the trade deficit in the first four months of this year, the trade deficit may expand to about US$ eight or nine billion. This may lead to a balance of payments deficit this year.

Conclusion

The country is likely to meet its foreign debt repayment obligations this year by further foreign borrowing, development assistance from multilateral agencies and loan facilities from friendly countries in various forms and the IMF grant. These are temporary means of getting over the severe crisis in the external finances. A crucial determinant of the country's economic performance is the elimination of COVID.
In the medium and long run the government must get its policies right to increase exports, reduce the trade deficit, enhance earnings from services and increase foreign capital inflows.
The expansion of import restrictions is not a feasible option as it affects production and exports adversely. The adoption of pragmatic economic policies rather than fanciful policies like organic agriculture, excessive creation of money and arbitrary import restrictions are counterproductive for external financial stability.

[For the full article – Refer Sunday Times]