Spotlight: Econ Op-eds in Summary

Week ended 25th November '20

In Summary

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

1. Sri Lanka seeking IMF bailout looks inevitable
By: Shihar Aneez

- If Sri Lanka cannot increase its foreign exchange revenue by an additional $4 Bn USD, the country will likely face a sovereign default for the first time in history. In line with this, 2021 will be the start of a series of the hardest years ahead in terms of economic management as foreign debt repayments amount to $4.5 Bn annually till2025.

- Rolling over debt at a lower cost could help sustain Sri Lanka's debts. However, the rating agency downgrades earlier this year would mean exorbitantly high borrowing rates in the future. Recent undersubscriptions of auctions also reflect Sri Lanka's inability to raise further debt to finance interest payments. In this backdrop, Sri Lanka's options to seek borrowing from international capital market remain limited.

- Other options for financing include syndicated loans or an RFI from the IMF. However, there currently is a delay on the existing IMF EFF arrangement due to COVID-19. The second COVID-19 wave puts further pressure on an economic slowdown, the worst since 2001. All these conditions could result in Sri Lanka's ability to service its debt falling to its weakest level historically.

The new Government is in the process of implementing its first full year Budget for 2021 announced on Tuesday. It will be one of the toughest budgets in the country's history given that Sri Lanka is facing the COVID-19 pandemic and a challenging budget deficit and external debt.

The bottom line is if Sri Lanka cannot increase its foreign exchange revenue at least by an additional $4 Bn either through exports, remittances and tourism or borrowings, the country is likely to face a sovereign default.

Many in the Government have followed an ostrich approach in not accepting the reality and recognising the truth on the challenging foreign debt repayments. But Sri Lanka facing a possible sovereign debt default is not completely ruled out given Sri Lanka's precarious finances.

Prime Minister Mahinda Rajapaksa, who is also Sri Lanka's Finance Minister, last week told Parliament that dire predictions about sovereign default had not happened.

"We were able to stabilise the exchange rate, which was steadily depreciating then at around the 185 Rs (per USD) and to service the foreign debt of USD 4,200 Mn averting the country being classified into a debt default status," he told Parliament while participating in the 2020 Budget debate.

Many economists who are backing the current Government's economic policies do not want to talk about how to face the debt crisis in the future. But the reality is Sri Lanka is inching toward a hard landing on the debt crisis. 2021 will be the start of the series of hardest years ahead in terms of economic management.

Looming sovereign default?

Sri Lanka has never defaulted on any foreign loans so far and successive governments have bragged about this. They also have repeatedly promised to maintain the Government's untarnished track record in the future as well. But the current reality threatens the $84 Bn economy's non-defaulting track record.

Let me explain it in simple words. Sri Lanka has to pay a total foreign debt which includes both principal and interest payments of around $ 4.5 Bn annually for the next five years through 2025.

The country has been rolling over many maturing International Sovereign Bonds (ISBs) and Sri Lanka Development Bonds (SLDB) except on one occasion before this Government came to power. Sri Lanka had to use its foreign exchange reserves in January 2019 as it could not borrow an ISB due to the coup attempt by former President Maithripala Sirisena. The current Government also repaid $ 1 Bn of matured sovereign bonds last month from the foreign currency reserves.

Rolling over debt and borrowing at a lower cost is not bad for the economy and in fact it could help sustain Sri Lanka's debts. However, Sri Lanka will not be able to borrow at a lower cost from the international markets after the rating downgrades by all three global rating agencies early this year. If the country still wants to borrow, then it will have to borrow at an exorbitantly higher rate compared to its emerging market peers due to higher risk premium and the country cannot afford to borrow at the level.

The last week's SLDB auction reflected Sri Lanka's extreme difficulty in borrowing. The Central Bank's effort to raise $75 Mn in four short term papers was heavily undersubscribed and the bank was able to attract bids for 33.4% of the total requited amount it wanted to raise. The Central Bank had no option but to accept 99.2% of the total bids at fixed rates ranging from 6.69% to 6.82% in this auction.

However, on Monday, the Central Bank in a statement said there was a renewed interest/investor appetite for SLDBs and it was able to raise further $62 Mn. Sri Lanka's 10-year sovereign bond sold in July 2016 priced at 6.825% was trading around 17.5% this week and that gives an indication of the borrowing cost Sri Lanka will have to pay if it seeks funds from international capital market.

Sri Lanka has also failed to attract foreign investors into Government bonds in rupees even after State Minister Ajith Nivard Cabraal in September offered to cap forex risks to reduce the country's dependence of international sovereign bonds. Since the announcement, foreigners have in fact withdrawn a net $22 Mn worth investments in Treasury bonds and bills.

In this backdrop, Sri Lanka's options to seek borrowing from international capital market could set higher benchmark rates for Sri Lanka's five-year and 10-year sovereign bonds. For its smooth sailing of the economy, Sri Lanka needs to borrow at least around $6 Bn in 2021 including to bridge its current account deficit, with all its tight import controls. The import controls are expected to compensate the loss of country's foreign revenue from tourism and remittances in the face of COVID-19 pandemic.

Out of this $6 Bn, analysts say Sri Lanka should be able to manage to borrow around 2.5 Bn from currency swaps from China and India as well as from Panda bonds from China.

The next option is going for syndicated loans, especially with some Middle Eastern markets. That will help, but the borrowing cost will be still high.

Debt moratorium

In the event of Sri Lanka failing to raise the required amount of foreign loans to pays its debt servicing, it has the option of debt moratorium.

A debt moratorium is a delay in the payment of debts or obligations. It may take the form of a complete cessation of debt repayments, or a partial cessation. However, Sri Lanka cannot decide the debt moratorium on its own. Its past deeds with its lenders and diplomatic relations with the rest of the world will matter a lot if Sri Lanka needs a debt moratorium.

President Gotabaya Rajapaksa in March through the Director General of the World Health Organization requested all the international donor agencies, both multilateral and bilateral lending agencies, to provide a debt moratorium or debt deferment facility to all COVID-19-hit vulnerable developing nations

Prime Minister Mahinda Rajapaksa has directly requested a debt moratorium from India. Strangely, Sri Lanka is yet to request a debt moratorium from China, Sri Lanka's largest lender at the moment, and Japan, the country's long-term lender.

"The President, Prime Minister and I have been saying there must be a universal moratorium; not an individual moratorium for Sri Lanka," Ajith Nivard Cabraal, State Minister of Money and Capital Markets and State Enterprise Reforms, says.

"No requests for moratoriums have been made from China and Japan. A possible moratorium had only been discussed only with India." In the event Sri Lanka is forced to request a debt moratorium, which cannot be ruled out in the current context, the island nation will have to agree to certain conditions of financial discipline.

Sri Lanka could get the best out of a debt moratorium when all its lenders agree to defer the repayment of loans and interest payments. The negotiations will take a long time and be very tough.

Sri Lanka will have to go through a hard time in managing its debt and it is likely go to the extent of compromising its sovereignty which could be in the form of lands or fiscal/monetary policies.

The longer term solution is sustainable debt management while encouraging more exports through trade agreements and foreign investments. That could only happen when Sri Lanka genuinely deals with its international partners with consistent foreign and prudent economic policies. Unfortunately, Sri Lanka has been unable to deal with nations like Japan and Singapore which have the least political agenda in their dealings. And Sri Lanka's last option is likely to be the International Monetary Fund (IMF).

Discussions with IMF

When the Sri Lankan economy has faced crises, the country has turned to the global lender regardless of which party has been in power. However, governments led by centre-left ruling parties have been shy of dealing with the IMF throughout post-independence history.

The IMF has assisted Sri Lanka soon after the end of the 26-year war in 2009 and when the country first started to realise the extent of debt crisis in 2016. The IMF gave money in much-needed US Dollars to boost the country's foreign currency reserves on both occasions.

There is a delay on the seventh review of the $ 1.5 Bn existing IMF Extended Fund Facility (EFF) arrangement with Sri Lanka due to the COVID-19 pandemic, postponed General Election, and the Government's failure to present a National Budget for 2020, which was only presented last week.

Government authorities started discussions with the IMF for a Rapid Financing Instrument (RFI), a facility made available by the global lender for the countries to face the pandemic. However, Sri Lanka failed to secure the facility.

"In April, we received a request from the Sri Lankan authorities for emergency financial support under the Rapid Financing Instrument (RFI)," the global sender said in an emailed response when asked about the discussion between it and Sri Lanka.

"Assessing relevant conditions for the RFI has taken longer than for other countries, due to Sri Lanka's daunting economic challenges, high public debt, and Parliamentary Elections in August."

The IMF said it had yet to reach understanding on how to fulfil key requirements for the RFI, "which include policies to continue ensuring debt sustainability".

"The authorities have a range of options to ensure debt sustainability and the IMF stands ready to discuss all options with the authorities."

With the Budget presentation this week, the discussions with the IMF are likely to start based on the Budget document, a top Government official said.

More worries

Sri Lanka's economic growth is expected to see its worst performance since 2001 when the country saw a 1.5% contraction after the terrorist attack on the only international airport hit the economy. Though the Central Bank has said the contraction would be 1.7%, independent economic analysts estimate the contraction to be between 7%-10% depending on the recovery in the last quarter.

The State-run Department of Census and Statistics has delayed the April-June quarter growth data, citing more data needed for compilation. The negative growth would be bad news for a new Government which had many ambitious plans to revive the economy. The pandemic has aggravated the situation.

Job losses, fall in exports, loss of foreign revenue from tourism and remittances, and lack of purchasing power of the general public are likely to make the situation worse than what it is now. And above all else, now the uncertainty of the second COVID-19 wave threatens a further slowdown of the economy. All these conditions could result in Sri Lanka's foreign borrowing ability falling to its weakest level in its history.

For the full article – Refer Daily FT

2. Budget 2021 in the context of the COVID-19 pandemic
By: Prof. Sirimevan Colombage

- The Budget 2021 focuses more on growth and maintaining policy consistency. This has the effect of not having direct action proposed to deal with the country's debt issues. Thus, the budget deficit in 2021 is likely to be much higher than what is given in the official projections due to inevitable revenue shortfalls and expenditure overruns amidst the pandemic.

- In financing the widening budget deficit, increased reliance on bank borrowings results in liquidity injections, and consequent pressures on the money supply, inflation and balance of payments. On the other hand, the import restrictions imposed recently to arrest the balance of payments deficit could also have adverse consequences on competitiveness, productivity and export-led growth in the long run.

- Meanwhile, the response of the private sector to monetary easing seems rather weak due to structural factors while cheap credit has encouraged extravagant consumption, speculative asset holdings and risky financial dealings. Thus, a systematic growth strategy, backed by a realistic macroeconomic framework, is essential to recover the economy.

The Budget speech 2021 was presented at a time when the country is being severely hit by the COVID-19 pandemic. GDP growth is projected to be down to negative 2% this year. Despite this economic setback, the Government envisages to maintain an inclusive GDP growth rate of 6% per annum over the medium-term while containing inflation to around 5%, according to its macroeconomic program, 'Vistas of Prosperity and Splendor'.

Less emphasis on COVID-19

Given such optimistic targets, it is somewhat puzzling that the Budget speech does not pay much attention to the COVID-19 pandemic which has paralyzed virtually all economic activities by now. Reflecting mixed-up priorities, the Budget has given undue resource allocations at this difficult juncture to some arbitrarily selected projects such as urban townships, sports, road construction and walking paths, which have no direct relevance to revive the pandemic-hit economy, though they may have their own merits during normal times.

A coherent economic recovery strategy, apart from the fiscal and monetary stimulus already granted is the need of the hour to revive the economy from the fallout. The pandemic has severe consequences on the Sri Lankan economy, which had already encountered multiple economic setbacks including low economic growth, fiscal disarrays, balance of payments deficits and foreign debt burden even prior to the health crisis. The pandemic has adversely affected the export sector, domestic production, inward remittances and distribution network. Poor households who are mostly working in the informal sector with irregular income sources have become extremely vulnerable in the present crisis situation.

Escalating fiscal imbalance

The budget deficit is projected to rise by 24% from Rs. 1,266 bn (7.9% of GDP) in 2020 to Rs. 1,565 bn (8.9% of GDP) in 2021, reflecting a severe deterioration of the fiscal position. It is expected that the total revenue would rise by 28% in 2021 as against 26%

increase in total expenditure. Such exorbitant revenue growth cannot be expected for a single year even during normal times.

The projected increase in revenue is said to be based on the assumption of 5% growth in GDP in 2021. This assumption seems to be over-optimistic considering the negative impact of COVID-19 in years to come, and the country's limited growth potential experienced even before the outbreak of the pandemic. Slower GDP growth in 2021 means low level of Government revenue, and consequent expansion of the budget deficit much higher than what is expected. Thus, the budget deficit is likely to be 10% of GDP or more in 2021.

Monetary implications of fiscal imbalance

With the rise in the budget deficit, the Government is compelled to rely increasingly on the banking system to finance the deficit. Net bank credit to the Government rose by 46% from Rs. 2,732 bn in September 2019 to Rs. 3.980 bn in September 2020.

The Central Bank has accommodated Government finance requirements by directly purchasing Treasury Bills at primary auctions. The Central Bank's net credit to the Government rose by 50.8% from Rs. 383.2 bn in September 2019 to Rs. 577.7 bn in September 2020.

The monetary easing policy adopted by the Central Bank to relieve the households and businesses adversely affected by Covid-19 also accelerated the annual money growth from 7.4% in September 2019 to 19.2% in September 2020. The monetary easing measures included sequential reductions of the policy interest rates and Statutory Reserve Ratio (SRR), which led to the injection of substantial liquidity into the market, and to reduce borrowing costs significantly. Concessional credit schemes were also introduced to facilitate the activities of Small and Medium-scale Enterprises (SMEs), alongside debt moratoria granted for businesses and individuals distressed by the pandemic.

Nevertheless, the annual growth of commercial bank credit to the private sector has remained stagnant around 5% reflecting the slow pick up of economic activities. In contrast, net commercial bank credit to the Government rose by 44.9% in the 12-month period ending September 2020. In this background, the excessive money supply growth is bound to create demand pressures augmenting inflation and imports in the coming months.

Inflation-targeting monetary policy missing

The Central Bank made concerted efforts about two years ago to launch the inflation-targeting monetary policy framework with the expectation of close coordination with fiscal authorities while regaining its independence.

It is evident by now that inflation-targeting monetary policy is a remote possibility, as such a policy is completely neglected not only by the fiscal authorities in the latest Budget Speech, but also by its architect, the Central Bank. Inflation-targeting monetary policy framework is not focused in the Central Bank's publication, 'Recent Economic Developments – Highlights of 2020 and Prospects for 2021'.

Understandably, it is not feasible to implement such rule-based policy amidst the current economic crisis, but the Central Bank should have displayed its long-term commitment to run the inflation-targeting monetary policy framework, which was declared with much grandeur not so long ago. That would strengthen the Central Bank's independence, which is vital to operate monetary policy.

Demand pressures mounting

The easy monetary policy implemented by the Central Bank under the Presidential directive following the pandemic is unlikely to boost production activities significantly as expected, given the inherent weaknesses of enterprises, uncertain macroeconomic environment and imperative health-related precautionary measures imposed by the government including curfews, lockdowns and travel restrictions. The global economic downturn resulting from the pandemic has dampening effects on the export sector.

Further, business decisions in the private sector are mostly based on comparisons of the expected rate of return on investment vis-à-vis opportunity cost of investment. Interest rates represent the opportunity cost while expectations are influenced by many factors including macroeconomic economic environment, technological changes, exchange rate volatility, capacity utilisation, export competitiveness, aggregate demand, fiscal stability, inflation, political stability, business confidence, and cost of production.

The present low interest rate environment encourages consumption, as savings yield low returns. Thus, low interest rates have negative effects on domestic savings. This is reflected in the downfall of domestic savings rate from 24.8% of GDP in the first half of 2019 to 20.8% in the corresponding period of 2020. Meanwhile, private consumption rose from 66.7% of GDP in the first half of 2019 to 70.5% in the same period of 2020. Given the low returns on savings, the surplus-fund holders tend to move to alternative assets such as commodities, real estate and risky financial instruments. Such fund diversions lead to distort investment decisions, and to create asset bubbles harming financial stability.

The rising consumption demand has spill-over effects on domestic production and imports exerting pressures on inflation and balance of payments deficits. Inflation, in addition to cheap credit, makes imports attractive and exports unprofitable, causing further deterioration of the trade balance. Unless the exchange rate is allowed to depreciate freely to achieve external equilibrium, import restrictions become imperative to avoid deterioration of the trade deficit.

This type of inward-looking foreign trade policy seems to be the Government's policy choice at present, as can be evident from several import controls imposed in recent times. Although such measures are inevitable amidst the pandemic, it must be noted that they have adverse consequences on competitiveness, productivity and export-led growth in the long run. Hence, it is important to phase out import restrictions and to allow free trade.

Policy concerns

Given Sri Lanka's long track record of low economic growth and macroeconomic imbalances, it is a major policy challenge to mitigate the economic fallout from COVID-19. Budget 2021 does not contain any coherent policy strategy to overcome the crisis. The budget deficit in 2021 is likely to be much higher than what is given in the official projections due to inevitable revenue shortfalls and expenditure overruns amidst the pandemic.

In financing the widening budget deficit, increased reliance on bank borrowings results in liquidity injections, and consequent pressures on the money supply, inflation and balance of payments. The import restrictions imposed recently to arrest the balance of payments deficit might give wrong signals to the market depressing outward-oriented growth. Meanwhile, recourse to foreign borrowings escalates the already heavy external debt burden.

The response of the private sector to monetary easing seems rather weak due to structural factors while cheap credit has tended to encourage extravagant consumption, speculative asset holdings and risky financial dealings. The neglect of inflation-targeting monetary policy launched by the Central Bank about two years ago is a matter of concern from the viewpoint of optimal monetary-fiscal policy mix. A systematic growth strategy, backed by a realistic macroeconomic framework, is essential to recover the economy.

For the full article - Refer Daily FT

3. Time to reset China-Sri Lanka relations for a Biden presidency?
By: Ganeshan Wignaraja

- With geopolitical considerations between the US, China, and India affecting Sri Lanka, there have been numerous concerns raised on Sri Lanka's ties to China. These range from economic costs of debt and investment, as well as questions of national security and political alliance.
- However, most investments in Sri Lanka by China have been generally positive. Investments in infrastructure have been especially helpful, as is the Colombo Port City project – which is expected to transform the services industries in Sri Lanka in the future.
- In order to continue receiving such benefits while also allaying concerns of allies like India and the US, Sri Lankan authorities will have to continue following a non-aligned path. This will help strengthen Sri Lanka's economy and also continue to get trade related benefits from the US, and help Sri Lanka get out of persistent macroeconomic pain.

Concerns about China ties

Several concerns have been expressed internationally about the state of China-Sri Lanka ties:

Sri Lanka is not in a Chinese debt trap. The latest available data suggest that Sri Lanka's external public debt owed to China amounted to $ 5 billion in 2018 (equivalent to about 6% of its GDP). Sri Lanka owes more of its external public debt to financial markets as well as multilateral and bilateral lenders than to China. Sri Lanka's generally high debt to GDP ratios over the past decade reflects the costs of a 30-year civil conflict which ended in 2009, lacklustre post-conflict growth and notable currency depreciation.

A second issue relates to the economic impact of China's signature Belt and Road (BRI) projects on host developing countries like Sri Lanka. Some analysts have labelled BRI investments as 'white elephant projects' which have contributed little or no economic benefits to host countries. The cumulative value of Chinese infrastructure investment to Sri Lanka was about $13 billion between 2006 and August 2020 (equivalent to 15% of Sri Lanka's GDP in 2019).

Many projects predate the BRI initiative which was formally launched in 2013. Clearly, some projects have brought greater benefits to Sri Lanka than others, such as the Colombo International Container Terminal (CICT), which has allowed the deep-water Colombo Port to become South Asia's premier transshipment hub. The adjacent Colombo Port City (CPC), built on reclaimed land from the sea, could be a game changer for modern service sector growth and post-COVID economic recovery.

The Hambantota Port, under new management, is likely to add to Sri Lanka's port capacity as Colombo Port is nearing capacity limits. However, the economic benefits of the Colombo Lotus Tower, a delayed telecommunications and leisure project, seem less clear.

Moreover, rising imported inputs from China for construction projects in Sri Lanka have widened the significant trade deficit between the two countries. There are also less visible economic spillovers from Chinese projects in terms of foreign investment from China into the Sri Lankan manufacturing sector, technology transfer and local job creation.

Third, is India's worry that a growing Chinese footprint risks violating Sri Lanka's sovereignty and threatens India's Southern flank and its national security.

Fourth, is the recent claim that China is using so-called 'pandemic diplomacy' to advance its interests in countries like Sri Lanka.

Balancing relations with the US and China

President Gotabaya Rajapaksa has congratulated President-elect Joe Biden and said that he looked forward to working with him. But, amid a likely continuation of US-China trade and technology rivalries in 2021 and beyond, the Biden administration may expect Sri Lanka to match words with deeds.

As a small state without a large military, Sri Lanka should adhere to a strict non-aligned foreign policy in its relations with great powers emulating the success of Singapore and New Zealand. Furthermore, Sri Lanka should pursue transparent, market-oriented policies to reassure US, India and other investors.

Export-oriented inward investment is critical to Sri Lanka's post-pandemic economic recovery. To ally India's security concerns, the feasibility of a maritime safety and security pact involving India, Sri Lanka and the Maldives may be explored. These policy steps could enable Sri Lanka to work more smoothly with the US in areas like trade and the regional maritime order as well as to leverage a recovering China as an engine for post-pandemic economic recovery.

In the case of China, this would require moving over time from foreign borrowing relationship to one emphasising trade and investment. The future agenda includes attracting Chinese investment into the industrial zone adjacent to Hambantota Port, concluding a bilateral free trade agreement on favourable market access terms for Sri Lankan exporters thereby reducing the trade deficit favouring China, and encouraging technology transfer from China to modernise Sri Lanka's lagging agricultural sector to ensure food security. Better infrastructure master planning and capacity building would enhance the gains from BRI projects to Sri Lanka.

To reduce any risk of a future Chinese debt trap, Sri Lanka should negotiate debt standstills with its creditors, improve its borrowing and debt management systems, and build its external reserve buffers by prudent macroeconomic management.

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