# Spotlight: Econ Op-eds in Summary

Week ended 3rd March '21

## In Summary

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

**Budgetary pressures restrict monetary policy space**
**By: Professor Sirimevan Colombage**

- The government has had to excessively rely on the Central Bank to finance the growing fiscal deficit in recent months, resulting in a rapid increase in money supply. This has been done through the purchasing of Treasury bills in primary auctions, where the CBSL would then issue an equivalent amount of currency in return, leading to a 23.7% YoY increase in money supply over the last 12 months.

- Critics would argue that money printing amounted to Rs. 650 Bn in 2020. However, this figure was wrongly arrived at by computing the difference between the CBSL's Treasury bill holdings over the year. The correct computation, which takes into account the changes in the monetary base, shows that the actual amount of currency issued by CBSL or newly printed money was only Rs. 31.8 Bn in 2020.

- Despite the correct computation being lower than critics say, currently, the ability of the Central Bank to control inflation has been constricted by the debt burden faced by the government. Although the Fiscal Management Responsibility Act (FMRA) introduces strict fiscal rules to maintain fiscal discipline, authorities have failed to comply with these rules. It is thus prudent to reactivate the FMRA to enhance fiscal discipline and free the CBSL from political pressures.

The Government has been increasingly depending on borrowings from the Central Bank (CBSL) and commercial banks to finance its growing fiscal deficit in recent months. This has resulted in a rapid increase in the country's money supply.

The excessive accommodation of fiscal requirements has weakened CBSL's monetary management to a large extent. Hence, fiscal discipline, coupled with central bank independence, is essential to put monetary management on the right track.

**Fiscal dominance**

The budget imbalance has led to a situation of "fiscal dominance" in which CBSL tolerates expansionary fiscal policy by accommodative monetary policy. In contrast, "monetary dominance" prevails when monetary authorities focus entirely on controlling inflation, irrespective of budgetary requirements.

The CBSL has directly accommodated the budgetary requirements by purchasing Treasury Bills in recent primary auctions. In return, CBSL usually issues an equivalent amount of new currency (notes and coins).

However, the decline in CBSL's foreign reserves and other domestic assets largely offset the impact of government borrowings on currency issues, and therefore, the actual amount of money printed was much less than the exaggerated figures quoted by some critics.

Strangely, CBSL has not rectified such widely-circulated misleading information. Overall, the decline in foreign reserves and slow private sector credit growth have provided leeway to the Government to borrow excessively from the banking sector which is likely to disappear in case of a reversal of those two factors.

**Budget pressures across the world**

In the backdrop of the COVID-19 pandemic, budgetary difficulties of governments across the world have prompted central banks to suppress monetary dominance. The government debt in advanced economies is projected to increase rapidly during this year, according to the International Monetary Fund (IMF). The projected scenarios for developing countries are even worse.

As in the case of Sri Lanka, many emerging economies have been facing a new wave of sovereign debt rating downgrades in the backdrop of the pandemic. Central bank accommodation of governments' credit needs in several countries has further worsened the credit ratings.

Remittances from citizens of developing countries working abroad are expected to drop by more than 20% this year, according to IMF reports. Simultaneously, borrowing needs have gone up in developing countries, as they struggle with severe budgetary stresses and balance of payments difficulties.

**Composition of money supply**

A country's total stock of money in circulation among the public at a particular point of time is called money supply. It can be categorised as (a) narrow money [M1] consisting of currency and demand deposits with commercial banks, and (b) broad money [M2] consisting of M1 plus time and savings deposits with commercial banks.

**Credit creation**

In Sri Lanka, the broad money supply (M2) rose by 23.7% on Y-o-Y basis during the last 12 months.

This monetary expansion was largely due to a substantial increase in bank credit to the public sector. The outstanding amount of net credit to the Government rose by 63.1% to Rs. 4.8 trillion in January 2021 from Rs. 2.9 trillion a year ago. Of this amount, net credit provided by CBSL increased almost three-fold to reach nearly Rs. 1 trillion by last month.

Net bank credit to public corporations rose by 29%, and stood at Rs. 1.1 trillion in January.

This is in contrast to the slower pick up of private sector credit only by 6.9% during the last 12 months, as I explained in a previous Daily FT column (http://www.ft.lk/columns/Bank-credit-to-private-sector-picking-up-at-slow-pace-in-response-to-monetary-easing/4-712502).

The monetary expansion was due to credit creation by commercial banks by multiple times of the reserve money. The money multiplier, which measures the link between the money supply and reserve money, is around 10 now. This means that commercial banks have created money in the form of bank deposits as much as 10 times of reserve money.

**Money printing exaggerated in media reports**

In recent media reports, it is alleged that CBSL prints truckloads of money week after week to meet the budgetary needs.

Top CBSL officials themselves have fuelled the sensations by bringing the phenomenon of 'money printing' into the limelight by way of making some irrelevant references to the nonsensical Modern Monetary Theory (MMT), which asserts that public debt commitments can be easily met by printing money instead of mobilising tax revenue. The very same concept of money printing, which is not a legitimate term used in monetary policy or monetary economics, has boomeranged the CBSL with a barrage of criticism, which seem to be unfair to a large extent.

**Critics' figures of money printing too high**

According to some critics, the amount of new money printed by CBSL in 2020 was around Rs. 650 billion and yet another Rs. 50 billion was printed in the first two weeks of this month.

The above figure of Rs. 650 Bn seems to have been derived by computing the difference between the CBSL's Treasury bill holdings which rose from Rs. 75 Bn at the end of 2019 to Rs. 725 Bn at the end of 2020. Similar exercise must have been done to derive the figure of Rs. 50 Bn for this month as well.

Methodically, these computations are wrong, as Treasury bill holdings are only one component of the money supply process, as explained below.

**Actual amount of currency printed is much less**

In terms of the Monetary Law Act No. 58 of 1949, CBSL has been empowered as the sole authority to print money or what is called currency (notes and coins) on behalf of the Government. This component of money supply is the one that has been subject to much controversy these days. In contrast to arbitrary increases in the printed money stock as alleged by several critics, CBSL uses changes in the monetary base or reserve money as the basis for new currency issues (Table 2).

The monetary base consists Net Domestic Assets (NDA) plus Net Foreign Assets (NFA). NDA includes Net Credit to the Government (NCG) and other domestic assets/liabilities.

NCG rose by Rs. 506 Bn in 2020. This means that CBSL bought that amount of Treasury Bills and Bonds during the year. Theoretically, CBSL should have issued an equivalent amount of new currency. But such impact of NCG was largely offset by a decline in NFA by Rs. 369 Bn and other domestic assets by Rs. 104 Bn in 2020.

Hence, the actual amount of currency issued by CBSL or newly printed money was only Rs. 31.8 Bn in 2020 reflecting only 3.4% increase over 2019. This is much lower than the exorbitant numbers quoted by some critics.

**Monetary policy space restricted**

Following its monetary policy framework, the CBSL adjusts NCG from time to time by using Open Market Operations (OMO) so as to achieve its monetary policy targets. For instance, when there is a substantial increase in NFA, the CBSL can sterilise the resulting excess liquidity to avoid inflation by selling a part of Government securities in its hand through OMO, and vice-versa.

However, CBSL would not be in a position to mop up excess liquidity in such manner, when it is compelled to hold excessive Government securities, as experienced at present.

In addition, excessive Government borrowings prompts CBSL to maintain low interest rates to avoid aggravation of debt commitments. The CBSL continues to keep its policy interest rates down in recent months, on the grounds of low inflation figures drawn from the Colombo Consumer Price Index (CCPI). However, the Producer Price Index (PPI) reflects inflationary pressures, as explained in my earlier Daily FT column (http://www.ft.lk/columns/Inflationary-pressures-on-the-horizon/4-712891).

Hence, in time to come it might be necessary mop up excess liquidity by selling CBSL's holdings of Government securities and raising policy interest rates. This would not be feasible, if the Government continues to depend on bank borrowings.

If CBSL's NFA goes up in the near future by any chance, as predicted by the authorities, it would be essential to reduce NDA through open market operations so as to sterilise excess liquidity to avoid inflation. This again will be unviable due to CBSL's current accommodative monetary policy.

**Fiscal-monetary policy mix**

It is widely recognised that freeing central banks from political interference is essential to conduct monetary policy to achieve price stability.

However, worldwide empirical evidence suggests that central bank independence is only a necessary condition, but it is not a sufficient condition to attain price stability. The reason is that the Government's budgetary constraints might bind the monetary authority to exercise accommodative monetary policy, and thereby limiting its ability to control inflation.

Hence, it matters how fiscal and monetary policies are coordinated compromising the monetary dominance vis-à-vis fiscal dominance.

**Fiscal responsibility imperative**

In an effort to arrest fiscal dominance in Sri Lanka, the Fiscal Management Responsibility (FMRA) Act was enacted in 2002 with a view to introduce strict fiscal rules. The two prominent objectives stipulated in the Act were (a) to reduce the government debt to prudent levels by ensuring the budget deficit does not exceed 5% of GDP from the year 2006 onwards, and (b) that total government liabilities (including external debt) do not exceed 60% of GDP commencing 2013.

Since then, however, the fiscal authorities have failed to comply with the rules pertaining to the budget deficit and debt as stipulated in the FRMA. This was due to the rise in expenditure for infrastructure development, social welfare, salaries, debt repayments, interest payments and transfers to loss-making state enterprises. The revenue shortfalls that arose from the arbitrary tax cuts in recent times have aggravated the budget deficit.

Thus, legal (de jure) fiscal targets enforced by the Act have little meaning in actual practice (de facto).

In view of the above analysis, it would be prudent to reactivate the FRMA to enhance fiscal discipline so as to insulate the CBSL from political pressures.

For the full article – Refer The Daily FT

**2. Cabraalnomics: 'No default because we have enough forex inflows to pay ISBs'**

**By: W.A. Wijewardena**

- Standard Chartered Bank and Barclays Bank, had recently shown concerns about Sri Lanka's debt repayment capacity, downgrading Sri Lanka's ISBs to underweight status advising to reduce exposure to the bonds. According to them, due to fast draining foreign exchange reserves, things would be critical for Sri Lanka unless the country goes for an IMF-backed debt restructuring.

- The state minister Ajith Nivard Cabraal argues that the percentage of ISBs of total external debt is quite small, meaning there should be no worries about repayment. While his numbers are different to actual numbers, his arguments aren't invalidated based on 'flows of foreign exchange inflows' rather than the 'stock of foreign assets'. The argument is based on the simple premise that the debt repayment capacity depends both on the annual income and the amount of assets held by the borrower.

- The argument, however, has two caveats. One is, while the inflows would strengthen the repayment ability, cash available for debt repayment will depend on how much of net cash is available after paying out normal bills. The other is trying to achieve the impossible trinity. Given these caveats, the country is expected to take a hit in the form of making foreign exchange available for debt repayment by cutting domestic consumption which carries social, economic and political consequences.

**Challenging doomsayers**

State Minister Ajith Nivard Cabraal in a statement reported in the press had challenged the 'doomsayers' who had been pronouncing from time to time the perilous path which Sri Lanka's economy was taking toward an ultimate self-destruction

He had confidently said that those doomsayers will be disappointed when the Government would repay in full the International Sovereign Bonds or ISBs amounting to $ 1.5 bn coming up for repayment in July this year. He is correct and Sri Lanka will pay this $ 1.5 bn in July out of the country's existing foreign reserves.

**Multiple doomsayers at work**

There had been many doomsayers in the past, but the latest addition to the list has been the Standard Chartered Bank (SCB) and the Barclays Bank (BB) which had functioned earlier as issue managers of those ISBs now out in the market. Both banks had downgraded Sri Lanka's ISBs to 'underweight status' advising the investors to reduce their exposure to the bonds. The reasons for this bleak investment advice have been clearly articulated by the two banks in the titles they have selected for their respective reports.

Both of them have opined that unless Sri Lanka goes for an IMF backed debt restructuring, the things would be critical for the country. Before SCB and BB, there was Citibank, another ex-ISB issue manager, which had issued a report on Sri Lanka warning the Government that 'denying the problem was not a strategy'.

The fast-draining foreign exchange reserve of the country had been the contentious issue for all these investment advisors. Citi had even recalculated the country's available foreign exchange reserves for debt repayment by taking out the short-term foreign liabilities on account of SWAPs, etc. According to them, that net amount was a dismal figure at about $ 2.5 bn. Before these investment advisors, all the three rating agencies, Fitch, Standard and Poor's, and Moody's, had downgraded Sri Lanka's sovereign risks from B category to CCC category.

**Is the market driven by doomsayers?**

It is quite clear that the whole international community of worth is seeing a 'doomsday' event regarding Sri Lanka's ability to repay maturing ISBs at least in the near future. International investors who have taken a serious view of the emerging situation have begun to reduce their exposure to Sri Lanka's ISBs by selling them in the market. As a result, ISBs which had been traded at a premium, that is, above the par value of $ 100, in February 2020 began to lose their glamour and consequently traded at a deep discount, that is, below $ 100.

However, to its credit, Sri Lanka disappointed doomsayers in October 2020 by fully repaying the maturing ISBs by using its foreign exchange reserves. Reserves fell drastically but Sri Lanka managed to maintain its unblemished credit record in the eyes of external lenders. Now with another set of ISBs maturing in July, suspicion has been cast about the country's ability, in a greater vigour and rigour, to repay its external debt.

**Cabraalnomics: Rely on flows and not on stocks**

But this has been hotly denied by the Government. Central Bank Governor Deshamanya Professor W.D. Lakshman even went to the extent of castigating those 'doomers and gloomers' as not understanding the alternate economic policy being pursued by the Government. But State Minister Cabraal has been more confident. He had argued that there should not be any fear of Sri Lanka's defaulting its external debt by taking a different line of argument. In a nutshell, his argument is as follows.

He says that Sri Lanka's outstanding ISBs amounting to $ 14 bn is only 16.7% of the total external debt and the balance debtholders accounting for 83.3% have no fear of loan default by the Government. But the actual numbers are different from these percentages. ISBs account for 40% of the Central Government's external debt portfolio of $ 35 bn and 25% of the total country portfolio of $ 56 bn. However, this discrepancy does not invalidate his argument which is based on 'flows of foreign exchange inflows' rather than the 'stock of foreign assets' which the alleged doomsayers, according to him, have been using.

In 2021, Sri Lanka would get a foreign exchange inflow of about $ 32 bn and it would be augmented by about $ 2-3 bn every year thereafter. Given this high foreign exchange inflow, repaying ISBs of $ 1 to 1.5 bn is nothing for the country, he concludes. He had therefore questioned, "Will the authorities be so foolish as to default on a payment of around $ 1 to $ 1.5 bn per annum and risk its entire economy and impeccable credit history?"

**A numbers game?**

State Minister Cabraal has a point, and it can be illustrated as follows. The debt repayment capacity of a borrower depends on both the annual income he gets which is a flow and the amount of assets he has which is a stock. In the case of a country, the flow relating to foreign exchange is simply the credit side of its balance of payments. The $ 32 bn he had talked about is the total inflow of foreign exchange to be received by Sri Lanka in 2021 as recorded on the credit side of BOP. When one looks at a commitment of $ 1-1.5 bn against this massive inflow, there is nothing to fear, even though the stock of foreign assets is 'draining faster than expected' leaving everyone in 'suspense until the last minute arrives'. He had, therefore, confidently said that doomsayers who will rely on stock figures will be disappointed.

**Two caveats, one practical and the other theoretical**

This is new economics, and it can be safely termed 'Cabraalnomics'. It is the foundation of the alternate strategy which the present Government is following. Its main features are 'no to IMF, control prices, interest rates and the exchange rate, no risk in financing the budget through bank funding, not to worry about fast draining foreign reserves, rely on flows rather than stocks, have import substitution, restrict imports to contain the debit side of BOP, and have FDIs in large volumes to augment the credit side of BOP'.

It has two caveats, though.

- One is practical and relates to the numbers quoted.

  First to numbers. It is true that cash inflows will strengthen a borrower's capacity to repay his loans. But how much of that cash is available for debt repayment will depend on how much of net cash is available after paying out normal bills. In the case of a country relating to foreign payments, this is determined by the magnitude of the debit side of BOP. That consists of imports, payments for services, factor service payments like interest payments and profit transfers, remittances out and above all, foreign exchange outflows on account of share and debt market transactions. If these are more than the foreign exchange inflows, there is a deficit, and the deficit must be financed by drawing on foreign reserves. In other words, the deficit or surplus in BOP is exactly identical with the decrease or the increase in the net foreign assets of the Central Bank.

  Hence, a country experiencing a deficit in BOP cannot use the foreign exchange inflows to repay debt. In the case of Sri Lanka, this is the normal situation, a deficit in BOP, unless the country borrows a massive amount from abroad. Hence, to rely on foreign exchange inflows to repay any debt is a non-event. In that sense, it is correct for the doomsayers to base their analysis on the foreign asset stock of Sri Lanka to determine its ability to repay foreign loans.

  To prevent a foreign exchange outflow on account of imports, Sri Lanka has clamped selective import controls. As a result, imports fell in 2020 sharply by 20% to $ 16 bn. But the trade deficit narrowed only from $ 8 bn in 2019 to $ 6 bn in 2020 due to a fall in exports by 16% to $ 10 bn. Hence, Sri Lanka's foreign exchange numbers are not that favourable. A further unsalutary development has been that import crunching by $ 4 bn due to import controls has taken place mainly in raw materials and capital goods. This affects the future growth prospects of the country. What it means is that import controls has had only a limited success so far. They have not been able to generate a surplus in the foreign exchange cashflow of the country.

  Sri Lanka's debt problem is not related only to ISBs. In addition to the central government's foreign debt of $ 35 bn, non-central government sector that includes private entities as well has borrowed $ 21 bn. The total known debt repayment obligations during the next 12-month period are about $ 6.4 bn. In addition to this, there are other short-term obligations and REPOs amounting to $ 2.3 bn. So, the total country obligations during the next 12-month period amount to about $ 8.7 bn. Hence, even if ISBs are paid in July, Sri Lanka has to find foreign exchange to meet all these obligations.

- The other is theoretical which is concerned with trying to attain what is known as 'the impossible trinity'.

  The impossible trinity also called policy trilemma, is that policymakers cannot fix the exchange rate, have free forex movements, and conduct independent monetary policy at the same time. When translated into laymen's language, what it means that the Central Bank cannot have a stronger rupee, induce foreign inflows in FDIs, remittances and flows into share and debt markets, and control prices and interest rates. When these policies are set at the corner of a triangle, only two could be attained at a time.

The signs are visible that the Central Bank has failed in resolving the impossible trinity. When it has fixed the exchange rate and interest rates, foreign inflows and prices have flown out of the window. Then, instead of abandoning the impossible policy, it has started making mistake after mistake in the form of micromanagement of the economy.

- First, it invited Sri Lankan diaspora to send in their dollars into special bank deposits in the country. This did not generate a sufficient inflow.
- Then, it went for a dual exchange rate system by offering a premium of Rs. 2 over the official exchange rate to those Sri Lankans who send in remittances to the country.

**Nation should be ready to take a hit**

Sri Lanka's external debt problem is not a problem of State Minister Cabraal alone. It is a problem faced by the whole nation. What should be done today is to find a quick solution for the problem without defaulting the obligations. It requires the whole country to take a hit. The hit comes in the form of making available the necessary foreign exchange for debt repayment by cutting the domestic consumption. We are heading toward that position fast and the present problem is how to manage it without causing social, economic, and political disorder in the system.

**Avoid anti-IMF rhetoric**

Cabraalnomics should take note of this and have a backup rescue plan. That may include giving up the anti-IMF rhetoric because circumstances would force Sri Lanka to eat the humble pie eventually.

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