# Spotlight: Econ Op-eds in Summary

Week ended 26th February '20

## In Summary

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

**1. Sri Lanka battered by unceasing 'regime uncertainty'**
**By: Bellwether**

- A country that lacks certainty in policies makes it difficult for businesses to operate within it, leading them to lag behind countries with policy certainty. This is often the case with Sri Lanka. Taxes and duties are often changed, along with mandated wage hikes and price controls which ends up affecting business confidence.

- Policy instability is closely connected to monetary instability. Higher budget deficits resulting from these policy changes often create more uncertainty over interest and exchange rates and weaken economic stability. Sometimes, such policy changes made to stimulate the economy often end up delaying economic recovery.

- Even with a change in regime, Sri Lanka has not been able to avoid this uncertainty. In fact, continuous change in regimes causes even more uncertainty. Especially where there are midnight gazettes, sudden import bans, and price controls, this kind of effect is increased. Hence, the country remains under a state of overall economic uncertainty.

When the government changes ground rules and conditions or the operating regime suddenly, like in Sri Lanka, it is very difficult for ordinary people or businesses to operate and survive. Countries that suddenly up-ends policies cannot grow fast and their people would be poor. Sri Lanka can change taxes suddenly without going to parliament and debating about it. While cutting taxes may increase the freedom of citizens, certainly raising taxes doesn't.

Virtually no certainty can be given about any policy, tax or any other rule, or its continuity, in countries like Sri Lanka.

**Fluid Regime**

Sri Lanka has a habit of suddenly raising import duties by midnight gazette. Markets have all kinds of uncertainties. But when governments add to this uncertainty, individuals and businesses in that country have to bear higher risks than a person or enterprise in countries with stable policies. Such countries will lag behind, relative to others were individuals and businesses face no such risks.

In 2015 there was an outcry by people who had ordered cars after taxes were suddenly raised when the car had already arrived in the country. Then a policy was evolved that cars already ordered would be allowed to be imported at the old tax rate if the letter of credit was opened before the tax was announced.

While a duty cut can be said to be beneficial, it can also cause losses because the value of all existing stocks fall. The man who cleared a stock the day before will face a substantial loss.

**Executive Power, Royal Prerogative**

President Gotabaya Rajapaksa suddenly ordered by decree that plantations sector wages would be raised to 1,000 rupees, while a collective agreement was in force. An unexpected wage hike suddenly hit plantations companies which were already facing low global tea prices. Any enforced wage hike ends up expropriating the cashflows of a company, like a new tax imposed to finance a subsidy.

Before 2015, personal income taxes were brought down to 16% as part of efforts to create a competitive playing field for a highly skilled services-based economy. It was suddenly changed to a progressive tax rate with the highest rate at 24% by the last administration under an International Monetary Fund program.

Personal income tax has now been brought back down to 18% – without going to parliament. The PAYE tax threshold has also been raised – without going to parliament. Value-added taxes have been cut from 15% to 8% – without going to parliament.

This may increase the freedom of citizens, but with budget deficit expected to grow, it has generated more uncertainty over interest rates, exchange rates and economic stability itself.

European-style governments publish budgets to give certainty, recognising that government taxes and spending are a source of instability as the single largest player in an economy with coercive power.

More than the income tax, the VAT cut has fundamentally altered the 2020 mini-budget up to April, which has already been presented and ratified in parliament.

**Monetary Instability**

The taxes were cut as a 'stimulus' after economic growth slowed in the wake of a currency collapse in 2018.

What happens to car taxes from time to time is symptomatic of the overall problems facing Sri Lanka. Sri Lanka's car taxes are suddenly jacked up usually 'to reduce imports' after the central bank generates pressure on the currency by printing money to reduce short term interest rates. In countries with monetary stability, such changes do not occur.

Government policies, involving 'stimulus' and other interventions rapidly increase after a currency, credit and economic collapses, delaying an eventual recovery by heaping more uncertainty and risks.

This shows that monetary instability and overall policy instability is closely connected. In 2018 rates cuts and injections from April, plunged the country into a new currency crisis, as it was recovering from an earlier one, triggering two busts in a row. That is the cost of sacrificing stability for monetary stimulus.

Now banks are being asked to give debt moratoriums, reduce credit standards by ignoring credit information bureau data. The list of interventions can go on. The entire misguided approach dates back to the Great Depression in particular and Keynesianism in general.

**Regime Uncertainty**

Economists called this fluid and operating environment, Regime Uncertainty. In Sri Lanka regime uncertainty is ever-present, with or without an economic collapse. But most 'developed countries' have lower levels of regime uncertainty and more certain policy for several years. A key reason for their prosperity is the lack of regime uncertainty.

When developed countries change policies suddenly or adopt policies, their effects have also been devastating. Britain became a shadow of its former self after World War II, pursuing Keynesian interventionist policies and socialist expropriation. But Germany and Japan, which were occupied by the US, and the American military allowed German-like policies to be followed, zoomed head.

Hong Kong, which also eschewed stimulus through its 'positive non-interventionism', placed stability before interventions, allowing it to power ahead. America's economy is now being buffeted by President Trump's antics, though his party is for low direct taxes and de-regulation. But his capricious policies will reduce the benefits of the better ones. The US was also severely hit by policy instability during the Great Depression.

Policy uncertainty is linked to business confidence, and property rights. Narrowly the concept of business confidence, can be interpreted that business people may be more or less "uncertain about the regime". Investors' private property rights in their capital and the income it yields will be attenuated further by government action.

**Expropriation**

In Sri Lanka, the threat of expropriation is ever-present. Expropriation can be outright – like the nationalisation of businesses and land reforms. Indirectly private property can be expropriated through high taxes, price controls or mandated wage hikes.

Under the last administration, with an International Monetary Fund program, all sorts of new taxes were slapped. There were also retrospective taxes. Former administration also blasted big businessmen, who had previously backed the preceding regime. Price controls were imposed money was effectively expropriated from diary and gas companies. An entirely new price control agency was established for pharmaceuticals.

**Same Old, Same Old**

The current administration is perceived as being more business-friendly. But midnight gazettes, sudden import bans, price controls are continuing unabated. The last administration also expropriated depositors, first by depreciating the currency and then by slapping price controls on deposits.

The public service is going to be expanded by 10%, with 100,000 ill-educated persons and 50,000 graduates who are ill-suited for productive work and cannot get jobs being absorbed and to be paid by taxpayers to 'reduce poverty'.

The uncertainty from budgets is also very present. As the Great Depression showed, monetary instability is a great driver of state interventions and stimulus. There is also no real prospect of monetary instability ending either.

Under 'flexible' inflation targeting, there is a high degree of bureaucratic discretion. In January the central bank cut rates as inflation was spiking up and the threat of a higher deficit.

**Executive Power**

Through his executive orders, Trump, is creating Regime Uncertainty around the world, destabilizing the global economy. In Sri Lanka, Regime Uncertainty is ever-present though a cyclical recovery is underway from the last balance of payments crisis.

On top of that, many policies are New Dealer-like in Sri Lanka, and have been for decades, which undermines both economic freedom and the rule of law. The threat of expropriation is ever present.

Monetary instability is always over the horizon with a soft-peg, threatening both the currency, which is the economic foundation of the poor, and debt repayment, regardless of the party or the leader in power.

For the full article – Refer EconomyNext

**2. Guarded optimism of economic recovery in 2020**
**By: Nimal Sanderatne**

- Despite Sri Lanka recording one of the lowest growth rates in 2019, the IMF expects a revival in 2020. This revival, however, depends on an improvement in tourism as well as a pick up in the manufacturing sector, both of which are strongly linked to international developments.

- However, it is unlikely that tourist earnings will reach the level achieved in 2018, and the impact of the coronavirus could even weaken this. The growth in the manufacturing sector would also depend on global trading prospects related to the virus. Thus, the country's economic growth would depend on the capacity to attract foreign direct investment in to export manufactures.

- Any cautious optimism also depends on policy measures. Thus, the government should focus on policy measures which could stop the country from another fiscal slippage and reduce the external vulnerability through accelerated export growth. Reforms in State owned enterprises would also play a vital role in achieving better economic conditions.

Although economic growth in 2019 was one of the lowest in recent years the International Monetary Fund (IMF) expects a revival in 2020. However, this recovery is dependent on an improvement in tourism and the manufacturing sectors both of which are interdependent on international developments.

The cautious optimism of the IMF is also dependent on appropriate policy measures and correction of fundamental weaknesses.

**Fiscal Deficit**

One of the fundamental weaknesses of the economy in 2019 was the fiscal slippage.

The fiscal deficit is estimated to be as much as 6.2% of GDP in 2019. This was one of the highest fiscal deficits in recent years.

It is a characteristic of the Sri Lankan economy to have large fiscal deficits in election years. In 2014 prior to the 2015 presidential election the fiscal deficit rose to 5.7% of GDP from 5.4% in 2013. Following the presidential election in 2015 the fiscal deficit ballooned to 7.6% owing to fiscal spending to gain votes at the parliamentary election of the same year.

There was an effort to achieve fiscal consolidation in 2017 and 2018 but the fiscal consolidation based on higher revenue collection was derailed by high public expenditure in 2018/ 2019. With the election of the new president in 2019 the new regime reduced a number of revenue measures as a fiscal stimulus to the economy. It also included a number of new welfare expenditure that increased government expenditure.

Consequently, the fiscal deficit is expected to be 7.9% of GDP in 2020 according to IMF estimates. Such a large fiscal deficit will destabilize the economy and create inflationary pressures. It is therefore imperative that the government takes measures towards fiscal consolidation soon after the political compulsion of the 2020 parliamentary elections is over.

**Fiscal Consolidation**

The policy requisites to improve the macroeconomic fundamentals are politically difficult. Correcting the fiscal slippage is a difficult challenge. One can only hope that the government will pursue measures to enhance government revenue that is a low proportion of GDP as well as reduce non development and wasteful expenditure.

**Balance of Payments**

Although the trade deficit was brought down significantly in 2019 from US$ 10.3 bn to around US$ 8 bn the balance of payments did not reflect this improvement. This was due to a decrease in tourist income, inadequate foreign investment and capital outflows. It should also be noted that the reduction in the trade deficit was brought about by a 10.3% reduction in imports and an export growth of only 0.4%.

The shrinkage in imports was also due to the slower growth in the economy. It is vital that export growth is accelerated in 2020 onwards to achieve a better balance of payments outturn.

**External Vulnerability**

The most serious problem facing the economy is the increased external vulnerability. The foreign debt increased to US$56 bn in 2019 and may exceed US$60 bn in 2020. The IMF estimates that the foreign debt in 2020 would be 62.1% of GDP. The consequent debt servicing obligations are estimated at over US$6.1 bn this year. Given the weak balance of payments position and low reserves of foreign exchange estimated at US$ 7.6 bn, the country's external vulnerability is high.

**State Enterprises**

In its staff appraisal statement, the IMF has once again pointed to the need for reform of state owned enterprises. Most of the over 300 state enterprises are making huge losses. The reform of these enterprises to reduce the burden on public expenditure is vital. Whether the government is able to improve the efficiency of state enterprises remains to be seen.

**Concluding Reflections**

Given the weaknesses in the country's macroeconomic fundamentals the task of reviving the economy and facing the challenges of external financial vulnerability is imminent. The IMF's expectation of an economic revival in 2020 to achieve a 3.7% growth is based on an improvement in tourism. The current setback to tourism owing to the novel coronavirus by the latter part of this year will hopefully materialize.

However it is still unlikely that tourist earnings will reach the level achieved in 2018. The growth in the manufacturing sector would also depend on global trading prospects. Another important factor that would determine the country's economic growth is the capacity to attract foreign direct investment in to export manufactures. These are all formidable challenges that the government and the nation must face during 2020.

For the full article - Refer The Sunday Times