Spotlight: Econ Op-eds in Summary

Week ended 27th January '21

In Summary

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

1. Sri Lanka facing 2021 with reckless MMT, stimulus mania
By: Bellwether

- Sri Lanka is heading for one of the biggest economic challenges in its history in 2021, with reserves falling due to severely eroded confidence, from the tax cuts in 2019 and rate cuts and injections from January onwards as well as due to building upon REER targeting, call-money-rate targeting implemented by previous regimes.

- To overcome this issue the Central Bank had resorted to printing money which had created excess liquidity. This is acceptable in an instance where the interest rates are hiked, and the currency is allowed to float. However, currently the government is trying to keep interest rates low and currency steady in conjunction with money printing, which could lead to a crisis.

- With a 'CCC' credit rating it is very difficult to recover from the crisis of falling reserves and high debt repayment. That is where an IMF program with a debt workout if possible, will help. As such, What Sri Lanka needs now is a complete reversal of policy towards sound money, strong property rights, and policy stability.

Sri Lanka is heading for one of the biggest economic challenges in its history in 2021, as the central bank prints money. Meanwhile the state sector is being expanded. The state expansion and stimulus mania is coming after slashing value added tax at the beginning of the year. By August 2020, 74% of tax revenues were being used to pay salaries.

In most countries, currency collapses and also hyperinflation is triggered by money printed to pay salaries of state workers and the military. If taxes were slashed, then interest rates must go up as people's savings are borrowed to pay state worker salaries. But it has not happened. Instead, forex reserves are falling steadily.

The War and MMT

It is a telling factor that Sri Lanka managed to grow the economy despite a 30-year civil war with the central bank delivering some stability.

At the risk of digressing, it is important to lay the background.

In 2008/2009 Sri Lanka not only faced an internal war but the US monetary tightening that ended the Greenspan-Bernanke's mother of all liquidity bubbles and triggered the Great Recession.

But Sri Lanka survived with a temporary demand collapse despite higher interest rates. At the time the Governor Nivard Cabraal and Deputy Governor W A Wijewardene used multiple ruses to raise rates and avoid printing money.

The rupee was allowed to bounce back quickly to pre-crisis levels preserving domestic investible capital and the salaries of the working class. At the time a 'bills only' policy was in place for monetary operation and the central bank was prohibited from trading bonds.

Other than the late 2004 episode when the central bank was forced to print money under fiscal dominance, the rupee was kept stable and the country saved from a meltdown. Wijewardene left a little after civil war ended in 2009.

Worse than War

When the war was on, people blamed the war for the country not progressing. But policy worsened after the end of the war, becoming severely pro-cyclical.

In 2011/2012 Sri Lanka hit a balance payments crisis, because liquidity was injected pro-cyclically from around mid 2011 after a pro-cyclical rate cut around April.

In 2015 liquidity was also injected and there was a pro-cyclical rate cut.

The 2015/2016 crisis was arrested partly with the help of the policy corridor, when then Governor Arjuna Mahendran suddenly called a halt to reverse repo injections and overnight rates hit the policy ceiling without a rate hike.

Since the Monetary Board is notoriously unwilling to raise rates, a wide policy corridor can save the country, the people and any economic program the incumbent administration cares to run.

Without a policy corridor (a currency board has no ceiling rate), the country is completely exposed to the Monetary Board's wrong decisions. The currency collapses, exchange controls, import substitution are ample evidence of the Monetary Board's wrong decisions.

Two monetary policy changes were made after 2016 that put the country in worse danger than the 30-year a civil war.

- One was the abandoning of the corridor and the targeting of middle of the band. To target the middle of the corridor, large volumes of liquidity had to be injected. As a result, the central bank lost complete control of reserve money. This is why Argentina collapses without a civil war.

- If money is printed (reserve money is made through purchases of Treasury bills) a floating exchange rate is needed and foreign reserve collections has to be abandoned. There is no mixed-up system. A mixed-up system triggers balance of payments crises. Under a floating rate the complete responsibility of rolling over debt goes to the Treasury. The central bank cannot collect reserves under a floating or 'flexible exchange rate' to repay foreign debt.

Interest rates as a Final Target

Under then Governor Indrajith Coomaraswamy, the central bank also targeted the Real Effective Exchange Rate and a potential output as part of flexible policy. The International Monetary Fund gave technical support to Sri Lanka to print money and target a potential output, defeating their own economic program.

A 'bills only' policy was abandoned, allowing the central bank to buy long term bonds and target longer tenors of the yield curve. Under Governor Coomaraswamy, not only the gilt yield curve, but lending rates and also deposit rates were also controlled.

It is now evident that while paying lip service to inflation targeting, Sri Lanka was basically targeting interest rates as a final target through multiple means. That is why there is monetary instability.

The 2018 currency crisis was an important milestone because there was no fiscal dominance. Finance Minister Mangala Samaraweera raised taxes to reduce the budget deficit. Oil prices were also market priced. In 2004 and 2008, credit taken for oil subsidies were a key problem. In 2018 there were no fiscal problems.

The central bank created the entire debacle by targeting call money rates on its volition mis-using the central bank independence given by that administration. In order to target interest rates as a final target, the monetary authorities were willing to sacrifice stability, inflation and eventually growth itself.

Modern Monetary Theory

Modern Monetary Theory is much more dangerous and the loss of control of reserve money is even greater.

In 2018 April excess liquidity injections under Call Money Rate targeting was about 60 bn rupees or about 5% of reserve money.

If credit was stronger then more money would have been required to keep call rates in the middle of the corridor.

All available tools were deployed to create the 2018 monetary instability: Overnight reverse repo, the term reverse repo, the buffer strategy (rejecting bonds auctions and overdrawing state banks who in turn to go the window).

Dollar/rupee swaps of the style used by speculators to hit East Asian pegs were also used to create liquidity and hit the peg.

It is all happening again under Modern Monetary Theory.

In 2020 under MMT excess liquidity is about 20% or more of reserve money, defined with or without excess liquidity. This is much worse than the reverse repo and dollar swap injections made in 2018. Bond and bill auctions are being rejected.

There is nothing modern about any of these theories. MMT and output targeting dates back to John Law. The entire Cambridge economics debacle is also a type of John Law operation. It is all 'stimulus' in refurbished clothes.

The 2015 and 2018 money printing for 'stimulus' or to 'target an output gap' triggered crises and killed output.

Then taxes were cut in 2019 by the new administration. So, things are even worse now.

Money is printed to cover lost taxes. And import controls have been placed while money is being printed.

MMT in 2021

Treasury bill auctions are being oversubscribed but bids are being rejected.

The central bank has recently made a public statement that it wants the rupee at 185. That is perfectly fine as long as the monetary policy is there to support the rate.

In fact that is how most of East Asia ran in their growth phase, China did from 1993 to 2005, Taiwan and Hong Kong still do, the high performing GCC countries still do and so on.

Sri Lanka is having a soft-pegged exchange rate. The wild variations of domestic and foreign assets show that very clearly. Now domestic assets (representing printed money) are rising fast. Meanwhile foreign asset growth is negative.

Interventions will push foreign assets faster into negative territory. Interventions (unsterilized) will also kill some of the liquidity.

But what about MMT? Can MMT be done with a peg? Governor Lakshman had said that under MMT debt is being rolled over.

That is precisely the problem. Debt is not rolled over.

Debt securities are being turned into reserve money, which are exchangeable for goods and dollars. If bids to bill auctions are being rejected, and money is being printed, it is not possible to hold the exchange rate at 185 to the dollar without losing more reserves.

However, it is also wrong to print money and not defend the peg.

That is the fast track to a meltdown.

In 2020 reserves were draining mostly because of government debt repayments and also private banks finding it more difficult to roll over foreign credit lines.

Reserve losses are accelerating under MMT. But it was Call Money Rate targeting that put country on an almost irreversible path to doom.

Reserve backing of the rupee has not recovered to 100% of the monetary base after call rate targeting.

The numbers are overstated because in Sri Lanka excess liquidity is not considered part of reserve money.

The credit system was put in on an irreversible downward track by a combination of call money rate targeting, 'operation twist' and term reverse repo injections.

The steady pressure on reserves and the inability to mop up inflows is the reason that foreign debt suddenly ballooned under REER targeting/call money rate targeting.

Now claims are being made that foreign debt is falling and domestic debt is rising.

While it is true that not much new foreign debt is being raised, most of the debt is being repaid through reserve losses and selling bills to the central bank.

Meltdowns

When countries run out of reserves either the rates are raised or the currency falls when it is finally floated. Already net foreign assets are about US$ 3.1 bn.

At some point either rates will have to go up or the currency will have to be floated. Usually both happen in Sri Lanka.

If excess liquidity remains and the currency falls further, credit tends to move up.

This is not because there is any new business, but because prices go up and businesses need more money to hold on to their existing stock.

It is the first step in a meltdown.

Economic growth falling to 2% or 3% a year after a 10% fall in the currency like in 2018, is nothing compared to what may happen in a total meltdown.

When currencies fall and stock holding costs go up, credit will move up and more money will have to be printed even as people buy less goods.

If people demand their deposits (run on banks), more money will be injected through lender of last resort windows.

The central bank will then find it difficult to control reserve money. Then people will try to buy dollars with the printed money withdrawn from bank bailouts.

This is why it was difficult to control the currencies of Indonesia during the East Asia crisis (unlike in Malaysia and Thailand and Korea) and also more recently in Lebanon.

Then regulators will place withdrawal limits.

Already there is capital flight in several ways. The rupee bond holders are gone, stock investors are going, bond holders are demanding high yields and banks are finding it difficult to extend foreign credit lines.

In such countries it can become difficult to even get imports.

Eventually such a country will be dollarized involuntarily.

Confidence Killer

The 'flexible exchange rate' which gave absolute discretion to the central bank killed all credibility and destroyed confidence.

When there is no credibility of the peg, serious problems occur, including default.

Foreign investors fled rupee bonds from around the time of REER targeting, call money rate targeting.

There was Rs. 450 bn or US$ 3 bn of foreign investments in rupee bonds.

In the past balance of payments crises in Sri Lanka have happened in times of strong economic growth, strong credit, and strong imports fired by printed money from a central bank unwilling to allow rates to move up.

It was also partly due to a closed capital account.

But now reserves are falling depressed conditions due to severely eroded confidence, from the tax cuts in 2019 (fiscal stimulus) and rate cuts and injections from January onwards (monetary stimulus) and building upon earlier REER targeting, call-money-rate targeting.

Unfortunately, with confidence at a 'CCC' credit rating it is very difficult to recover. That is where an IMF program with a debt workout if possible, will help.

Sri Lanka has had several serious economic crises in the past. Unfortunately, they have not led to a re-setting of policy.

What Sri Lanka needs is a complete reversal of policy towards sound money, strong property rights, and policy stability. Less nationalism the better.

For the full article - Refer EconomyNext

2. Sri Lanka's Post-COVID-19 Recovery: The Need for Inclusive Economic Growth By Wimal Nanayakkara

- Sri Lanka was only at Upper Middle-Income Country (UMIC) status for a year before being revised downward due to stagnating economic growth and a revision of the threshold for UMICs by the World Bank. This, compounded with the impact of COVID-19 and high levels of inequality makes the task of achieving UMIC daunting.

- COVID-19 affected key sectors in the economy, including tourism, remittances and exports. The number of individuals indirectly affected by COVID-19 in the tourism estimated to be at 1.5 million. Although remittances were negatively impacted over the first half of 2020, remittances hit a historic high in December 2020.

- Future growth strategies need to be inclusive, with equitable and quality education and skills development. In terms of the development of the agricultural sector, modernisation and guidance to increase productivity are required to minimize post-harvest wastage. Targeted social safety nets and the encouragement of female labour force participation are also important policies needed to be highlighted for inclusive growth.

High levels of inequality impede sustainable growth and development of a country. Sri Lanka made impressive strides to reach an upper middle-income country (UMIC) status in July 2019, only to slip back a year later. The COVID-19 crisis, amid growing inequities, is likely to make the task of regaining UMIC status even harder.

The present health pandemic is exerting significant adverse impacts across many sectors of the Sri Lankan economy. In particular, economic activities related to tourism and travel and associated activities of hotels and restaurants are struggling. So too are apparel exporters, small/medium-scale enterprises, and construction related activities. Many of these economic activities are dominated by the self-employed and daily wage earners. COVID-19 in particular has been especially harsh on the poor, running the risk of widening existing socio-economic inequalities. Indeed, any further increase in income inequality, which is already high in Sri Lanka (Figure 1), could lead to social unrest.

This blog highlights the main sectors and social groups that are adversely affected, and explains the need for inclusive economic growth (IEG) post-COVID-19 for Sri Lanka to emerge as a peaceful and developed country.

UMIC Status in 2019

Although Sri Lanka achieved UMIC status in July 2019 based on its gross national income (GNI) of USD 4060 per capita in 2018, the country was at the lower end of the threshold for UMICs. As predicted in an earlier blog, Sri Lanka slipped back to a lower-middle income country (LMIC) in July 2020. This was due to (1) the revision of the threshold for UMICs by the World Bank in 2020 and (2) Sri Lanka's poor economic performance in 2019.

A number of facts showed that Sri Lanka was not ready for UMIC status in 2019, such as declining gross domestic product (GDP) growth rates and relatively high levels of inequality. Sri Lanka's GDP had been declining from 5% in 2015 to 3.2% in 2018 and to just 2.6%, after the terror attacks in April 2019, and the country's GNI dropped to USD 4020 per capita in 2019, pushing it back to LMIC status.

Although Sri Lanka managed to bring down poverty to a satisfactory level as per its national poverty headcount ratio, according to UMIC standards, more than 40% of the country's population would be in poverty. This is based on USD 5.50 per person a day, the global poverty line for UMICs.

Another major issue is persistently high income inequality. When such a large proportion of the country's population is in poverty, with high income inequality, is it possible to consider Sri Lanka a UMIC? The policies implemented thus far have failed to reduce the gap between rich and poor. This gap could further widen due to the adverse effects of COVID-19, which impacts the poor disproportionately.

Setbacks and Opportunities

Following are some of the key sectors of the economy affected by COVID-19 which were earning much needed foreign exchange for the country.

Tourism: When the sector was gradually recovering after the April 2019 Easter Attacks, COVID-19 struck the country in March 2020 bringing the tourist arrivals to zero thereby affecting the livelihoods of more than 400,000 Sri Lankans who directly depend on the industry. The number of those indirectly affected could be as high as 1.5 million.

Migrant Workers: By mid-October 2020, over 54,000 migrant workers had returned and around 43,000 were still awaiting repatriation. However, there is an increase of 3.9% in worker remittances from January to November 2020 (USD 6.291 million), compared to the same period in 2019 (USD 6052 million). Encouragingly and defying expectations, remittances hit a historic high of USD 813 million for December 2020 reflecting a 22.2% year-on-year growth compared to December 2019. Therefore, the main concerns related to this sector at present would be the reintegration of the returnees and survival of the families who depend on remittances from their loved ones.

Exports: Due to the combined efforts of the government and the exporters, the overall export earnings which declined from USD 966 million in February 2020 to USD 282.3 million in April, managed to make a 'V' shaped recovery reaching USD 1.09 billion by July 2020 and then to remain around USD 1 billion until September 2020. Unfortunately, the second wave of COVID-19 has pushed export earning down to USD 848 million in October and then to 819 million in November. The EDB's revised target for 2020 is USD 13.4 billion, out of which 88.5% was achieved by November.

The remarkable performance in the export sector up to September 2020 clearly shows that possibilities exist for Sri Lanka to recover and move forward with new thinking, efficient planning, swift action and collaboration between public and private sector agencies. It is noteworthy that the government has given the highest priority to develop this sector which would create employment and economic opportunities at all levels, while earning much needed foreign exchange, at this difficult juncture.

Inclusive Economic Growth

For Sri Lanka to emerge as a peaceful and developed country, economic growth needs to be inclusive, though it is a significant challenge. Thus, any strategy for post-COVID-19 recovery should ensure IEG that would create economic and employment opportunities for all, including especially the poor and the vulnerable. For Sri Lanka's persistent high-income inequality to be bridged, the following categories of persons require special attention: (1) self-employed; (2) daily wage earners; (3) returning migrant workers and their families;

(4) tourism sector workers (5) socio-economic groups with a high incidence of poverty and (6) all others whose livelihoods have been hit.

Pro-poor and inclusive growth strategies should also include:

(1) coordinated and targeted social safety nets;
(2) equitable, quality education and skills development;
(3) agricultural sector development, including modernisation and guidance to increase productivity; ethical marketing facilities; and minimising post-harvest wastage; and
(4) increased female labour force participation, by creating decent employment opportunities closer to where they live, permitting working from home, flexible working hours, etc.

For the full article – Refer Lanka Business Online