Spotlight: Econ Op-eds in Summary

Week ended 10th March '21

In Summary

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

1. Central Bank needs to tackle macroeconomic challenges instead of piecemeal solutions
By: Prof. Sirimevan Colombage

- At last week's Monetary Policy Review meeting, Officials emphasised the CBSL's commitment to keep interest rates down and to avoid exchange rate depreciation. However, it is impossible to achieve this without allowing capital outflows according to the theorem of policy trilemma. In trying to achieve this impracticle goal, the CB has confined its policy stance to specific industries and, in the process, has failed to tackle economy-wide challenges.

- The Governor has stated that the CB is using an alternative economic model, which is not yet revealed. However, this model seems to carry some of the pre-liberalisation period policies, which hadn't worked for Sri Lanka and other developing countries in the past. In one of these measures, for example, the government had turned to financing the budget deficit through bank funding, thus adversely affecting the banking environment.

- It had also refused to obtain IMF support, despite the fact that doing so would reduce pressure on the BOP and would improve the country's sovereign debt rating. Thus, the CBSL, as an autonomous body by statute, needs to urge the Government to improve fiscal discipline by eliminating its dependence on bank credit to finance the budget deficit, which is the root cause of current macroeconomic imbalances.

At its monthly Monetary Policy Review (MPR) meeting held last week, the Central Bank of Sri Lanka (CBSL) announced that the policy interest rates will be kept at the same low level considering the lack of demand-driven inflationary pressures.

Unquestionably, the country has been facing unprecedented economic difficulties emanating from the COVID-19 pandemic. In this background, it is quite challenging for the CBSL not only to provide monetary stimulus to revive the pandemic-hit economy under political pressure, but also to address the longstanding economic imbalances facing the country.

Low interest rates and rupee strengthening

At the MPR meeting, the officials emphasised CBSL's commitment to keep interest rates down and to avoid exchange rate depreciation. The CBSL expressed its firm intention to maintain these two crucial rates within the desirable ranges, rather than leaving them to be determined by free market forces. It was mentioned that "guided yield rates" are given prior to Treasury bill auctions.

But it is not viable to fix both the exchange rate and interest rates by CBSL at the same time without allowing capital outflows, in terms the theorem of "policy trilemma" or "impossible trinity"

Industry-level solutions impracticable

The CBSL is not yet ready to tackle the economy-wide challenges. Instead, its policy stance is confined more or less to offer piecemeal solutions to selected sectors, based on the old-fashioned credit rationing approach. While noting the slowdown in commercial bank credit disbursements to the private sector, the need to direct bank lending to productive sectors was stressed. It was revealed that the necessary regulations are being formulated by CBSL to direct credit to the priority sectors.

The Governor indicated that he had a series of successful meetings with the stakeholders of different sectors including apparel, tea, rubber, coconut, gem and jewellery and IT to identify industry-specific challenges.

While the financial difficulties faced by such sectors amidst the pandemic cannot be underestimated, there does not seem to be any necessity for the CBSL to intervene at micro-level, as there are a plenty of dedicated government organisations such as the Tea Board, Board of Investment, Export Development Board, Tourism Board, etc. to deal with such industry-specific challenges.

Moreover, it is not practicable for the CBSL to deal with each and every industry without discrimination. Much greater responsibility entrusted to the CBSL, as the apex financial body, is to ensure macroeconomic stability so as to facilitate smooth functioning of business activities of different sectors.

Alternative development model yet to be unveiled

The Governor has reiterated in several public forums during the past couple of weeks that the Government is adopting an alternative economic development model that deviates from mainstream economics.

This alternative model is yet to be unveiled. Bits and pieces of the new model seem to include import restrictions, less-flexible exchange rate, non-engagement with IMF, non-adoption of structural reforms, less dependence on foreign debt and increased reliance on domestic borrowings.

Most of these policy measures were fashionable more or less during the pre-liberalisation period, and they proved to be unsuccessful to a large extent in Sri Lanka, as in the case of many developing countries.

Excessive bank financing of budget deficit downplayed

At the MPR meeting, CBSL officials seem to have downplayed the major economic challenges facing Sri Lanka – excessive bank financing of the budget deficit, balance of payments difficulties, foreign debt burden, capital outflows, slow economic growth, underlying inflationary pressures – which are bound to exert severe economic difficulties in weeks to come.

The MPR made no reference to excessive financing of the budget deficit through bank credit, which is the root cause of many of the current economic ills. Net bank credit to the Government rose by as much as 63% in January this year on YoY basis, and credit to public corporations rose by 29%.

In contrast, bank credit to the private sector rose only 6.9% on YoY basis. Thus, monetary easing has not helped much to reactivate the private sector during the pandemic, as envisaged by CBSL. Of course, the CBSL cannot be blamed for slow private sector credit growth, as factors affecting such credit are beyond its control.

Largely as a result of the increased credit to the public sector, the money supply rose by 24% in January this year on YoY basis. CBSL claims that such high money supply growth is warranted to meet the government debt obligations as long as inflation is subdued. It was noted that demand-driven inflationary pressures have not emerged, as the country's actual output is less than its potential.

Nevertheless, the underlying inflationary pressures as reflected in alternative price indicators such as the Producer Price Index need to be recognised.

Operating environment of banks weakening

Heavy credit disbursement to the public sector by banks, particularly the state-owned Bank of Ceylon and People's Bank, has led to deteriorate the operating environment of the banking sector, according to a recent report by the rating agency Fitch.

It notes that the two banks have greater risk exposure than the private banks, given their high loan-book concentration and unsustainable balance sheet expansion.

Question on money printing unanswered

At the MPR meeting, a question raised from the audience to clarify the quantity of money printed by CBSL was left answered.

The CBSL has not responded to the critics who continuously alleged that truckloads of money were printed in recent months. In the circumstances, I had to point out on behalf of CBSL that the actual amount of money printed was much less than the exorbitant numbers quoted by the critics.

The reason being that the net outflow of foreign reserves and decline in other domestic assets siphoned-off the impact of CBSL's substantial purchases of Treasury Bills on new currency issues.

Shying away from IMF

The country is facing severe balance of payments difficulties in the backdrop of the shortfalls in earnings from exports and tourism. World-wide, worker remittances are expected to go down by 20% this year. The projected rise in crude oil prices in the coming weeks is likely to aggravate foreign exchange difficulties. To make matters worse, Sri Lanka has to meet external debt commitments over $ 5 bn this year.

As claimed by CBSL, it is a fact that Sri Lanka has an unblemished record of honouring her debt obligations. Nonetheless, foreign debt commitments exert considerable burden on the balance of payments.

Given the above difficulties, it would be appropriate to have a stand-by arrangement with the International Monetary Fund (IMF) to overcome the balance of payments difficulties and to ease the debt burden. That would have improved the country's sovereign debt ratings paving the way to obtain foreign credit with favourable terms and conditions.

It would also provide opportunity rectify the macroeconomic imbalances with stipulated deadlines. However, such arrangement is unlikely to take place in the near future, according to official announcements.

Import substitution creates anti-export bias

The Government's preferred policy option to face the balance of payments difficulties appears to be import substitution (IS) strategy. This strategy was in vogue across developing countries in the 1950s and 1960s. IS policies, however, ran out of steam in the 1970s and 1980s mainly due to their adverse implications for the export sector and economic activity.

In Sri Lanka, IS strategy was experimented from time to time since the latter half of 1950s without much success. Imports were restricted by using import bans and quotas, exchange controls, import duties and non-tariff barriers during the periods of 1957-1967 and 1970-1977. This strategy has been adopted in different forms even during the post-liberalisation era since 1977 obstructing export-oriented growth.

Recognising the shortcomings of IS strategy long ago, the CBSL's Annual Report of 1964 stated, "… there is certainly little room left for further curtailment of imports without affecting production and development activities adversely."

A major disadvantage of IS strategy is its tendency to create anti-bias environment due to exchange rate over-valuation, price distortions, black markets, corruption and shortage of raw materials and equipment.

CBSL to act as economic advisor to Government

The CBSL, as an autonomous body by statute, needs to urge the Government to improve fiscal discipline by eliminating its dependence on bank credit to finance the budget deficit, which is the root cause of current macroeconomic imbalances.

For the full article - Refer Daily FT

2. Increasing exports vital to improve 2021 trade balance and balance of payments
By: Dr. Nimal Sanderatne

- A significant improvement in export earnings is required to bolster Sri Lanka's trade balance, given that import expenditures are likely to rise due to numerous factors, including a recovery in oil prices and the revival of the manufacturing industry. The EDB targets $12 Bn in export earnings, with increased demand in apparel and rubber manufacturing contributing positively to this forecast.

- Although demand for exports is expected to grow given the global recovery, two threats to growth would be in the form of possible trade sanctions imposed by the EU and a failure in the revival of agricultural exports due to current disruptions in estates. These disruptions outline the need for a long-term strategy to increase production for agricultural exports.

- Workers remittances which were $7.1 Bn in 2020 are unlikely to remain at this level for 2021, given the repatriations of migrant workers back to Sri Lanka. Whether the rest of the year faces high levels of BOP pressure is dependent on whether the tourism industry can recover sufficiently and whether the $1.5 Bn provided by China is large enough to meet debt repayments.

A significant increase in exports is vital to improve this year's trade balance and balance of payments, as imports that decreased significantly last year, are expected to increase substantially this year. Export earnings should exceed US$12 Bn to achieve a better balance of trade outcome than last year's trade deficit of US$6 Bn as imports would

increase to about US$18 Bn. This significant increase in import expenditure this year is despite import restrictions.

Economic context

Last year's trade deficit was reduced by US$2 Bn compared to that of 2019, owing to a large decrease in imports of about US$4 Bn. This reduction in imports was larger than the decrease in exports of about US$2 Bn.

The reduction in the trade deficit by US$2 Bn was due to a decrease in imports owing to import restrictions and low international prices of fuel. In contrast, this year's imports are likely to increase owing to higher imports of fuel, food and raw materials for industry. Imports could even exceed US$ 18 Bn projected for this year.

It is in this context that a substantial export growth is needed to offset the increase in imports. Providentially, such an increase in exports is possible owing to the gradual recovery of the international economy. However, there are some threats too.

Expectations

What are the expectations of the trade balance and balance of payments this year? The answers to three questions are pertinent for this year's trade performance. First, can the import bill be restrained to around last year's US$ 16 Bn? Second, could exports be increased this year to over US$ 12 Bn from US$ 10 Bn in 2020? Third, will the trade gap widen from that of last year and by how much?

Increase in imports

As discussed in last Sunday's column, there is no possibility of containing imports to last year's US$16 Bn owing to the rise in international fuel prices. Imports are likely to exceed US$17.5 Bn as fuel imports are likely to increase from US$2.5 Bn last year to US$ 4 Bn or more this year due to a doubling of international oil prices, the revival of manufactures requiring higher imports of raw materials for industry and a likely shortfall in paddy and maize production due to climate related reasons that may necessitate imports of rice and maize.

Exports

The answer to the second question as to whether exports could be increased this year, is an affirmative yes, as global demand for exports is increasing. Fortunately, the gradual revival of the global economy provides an opportunity to increase manufactured exports. In December 2020 exports increased to nearly US$1 Bn, due to a recovery from the disruption of manufacturing and increased international demand, due to COVID. Exports can exceed US$ 12 Bn if this momentum continues.

EDB expectations

The Export Development Board (EDB) has a merchandise export target of US$12 Bn for this year. However, the export performance of last December and information that there is increased demand for apparel and rubber manufactures, lends support to higher expectations of export earnings of about US$15 to 16 Bn.

Threats

However, there are threats to such an export growth. Foremost among them is the possibility of individual countries or group of countries, such as the European Union (EU)

imposing trade sanctions. The global containment of the pandemic and global economic recovery is also of significance to enhance exports.

Agricultural exports that have been declining are not likely to revive, especially due to the current disruption on estates. A long-term strategy to increase production is crucial to increase agricultural exports.

Trade balance

As to whether the trade gap would widen from that of last year depends very largely on whether the expected increase in exports would materialise. If exports could be increased to US$18 Bn, a smaller trade deficit or even a small trade surplus could be achieved.

Balance of payments

The containment of the trade deficit will have an important bearing on the balance of payments. A trade surplus, however small will ease the balance of payments pressure significantly. Three other factors will have a bearing on this year's balance of payments. These are whether workers' remittances that increased last year to US$7.1 Bn will be at about this level or if they were to decrease.

The government expects last year's increase in remittances to continue. If remittances are around US$7 Bn they would be a significant boost to the balance of payments. It is however unlikely. Remittances are likely to decrease by at least a billion or two as the migrant workforce is decreasing.

The second most important question is whether the tourism industry adversely affected by the COVID-19 pandemic last year will revive to contribute about US$2 to 2.5 Bn this year. While there has been a slight increase in tourist arrivals, in the first two months of this year, a significant increase could be expected only in the latter part of the year. A realistic estimate is around US$1.5 to 2 Bn. This too, will have a very favourable impact on this year's balance of payments.

Capital flows

The third vital issue is whether there would be capital inflows by way of foreign investments, loans and other foreign assistance. In fact, capital outflows are expected to be large. Debt repayments alone would absorb US$4.5 Bn. However, the extent of foreign assistance and investment remain shrouded in mystery with government spokesman being very optimistic.

Conclusion

The country's external finances are fragile with reserves falling to US$5 Bn at the end of last year. With debt repayments exceeding US$4 Bn, the performance of the trade and balance of payments is crucial.

The government has repeatedly assured us that a facility of about US$1.5 Bn has been negotiated with China and that the People's Bank of China (China's Central Bank) would provide this facility soon. Whether this is adequate depends on the earlier discussed prospects in the trade and balance of payments this year. If exports could increase to US$16 Bn, this year's trade deficit could be small and would help in the balance of payments outcome that is much dependent on workers' remittances, earnings from tourism and capital inflows.

For the full article – Refer The Sunday Times

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