Spotlight: Econ Op-eds in Summary

Week ended 12th August '20

In Summary

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

1. SLPP has creatively disrupted politics; now it has to do the same to the economy
By: W.A. Wijewardena

- The new government is taking over an economy marked by a number of challenges including a fiscal crisis, a debt crisis and a foreign exchange crisis. As such, the government should take disruptive steps to overcome these challenges given the hard times expected in the near future due to the economic impacts of the pandemic.

- Sri Lanka's debt crisis is mostly a result of its fiscal crisis which was aggravated by the tax concessions given during the end of last year. As such, the government on one hand could take a disruptive step to move to the previous tax regime while also reducing excessive government spending. The savings from such measures should be utilized in productive government projects.

- On the other had Sri Lanka's foreign exchange crisis is marked by high external debt repayments as well as a large import bill. While measures had been taken to restrict imports this itself may not be sufficient to overcome the crisis. As such, the government should focus on increasing exports and attracting non-debt sources of foreign exchange such as foreign direct investments.

For good results, disrupt the existing systems

It was a cakewalk for Sri Lanka Podujana Peramuna or SLPP, to seize power in Parliament. Within a matter of a few months of its formation as a political force, it has kept a record by rising to the pinnacle of the country's power cathedral. In the process, it has disrupted the two oldest political powers in Sri Lanka, namely, the United National Party or UNP and the Sri Lanka Freedom Party or SLFP. The emergence of a disruptor, though the name sounds something frightening, is a welcome development in any society. This is because it is disruptors, and not conventionalists, who have created a new world for the betterment of humankind.

Relating to economics, this was first presented by the 19th century French economist and statesman, Frédéric Bastiat when he said that breaking of windows even in acts of vandalism was to be welcome. That was because it enabled the world to go for new generation windows sustaining the window industry, on one side, and creating a new output for society, on the other.

In the early part of the 20th century, Bastiat's views were more formally and cogently presented in a positive way by two economists.

One was the Russian economist Nikolai Kondratieff who discovered through empirical research that capitalist societies had repeatedly undergone ups and downs in their economies – known as business cycles – but had managed to recover to a new position every time they had suffered from an economic downturn. Such business cycles had typically been experienced by Western economies for long periods of about 50 to 60 years which he designated 'long-waves' of business cycles. The reason for the recovery of a dying economy was the commercial adoption of scientific and engineering inventions by businessmen thereby taking an economy to a higher wave.

The other was the Austrian-American economist, Joseph Schumpeter who, countering the Marxian view of the self-destruction of capitalist societies from internal conflicts, presented the contrarian view that capitalist societies continued to sustain and prosper through the introduction of a series of new technologies to replace the worn-out old ones.

Sri Lanka's manifesting sickness from all sides

Sri Lanka's economy began to demonstrate signs of serious sickness from around 2013 when the growth rate began to decelerate. Immediately after the end of the war in 2009, the economy showed all signs of recovery to a high growth path recording growth rates of above 8% in the three succeeding years. These growth rates were attained basically by investing in capital infrastructure which could sustain the growth rate only for a limited number of years. That was because in the absence of the needed reforms in the capital markets, labour markets and the public sector, the rigidity of the economy could not be softened. Such growth has been designated by Nobel Laureate Paul Krugman as ones that are Along with the falling growth rates, the symptoms of other ailments from which the economy was suffering also became manifest.

Such ailments had taken the form of rising budget deficits, unmanageable public debt, rising inflation, deficits in the trade, services and the current accounts of the balance of payments or BOP. Since adequate capital flows could not be harnessed to meet the deficit in the current account, there were deficits in the overall balance of BOP too. It led to the peculiar situation in which foreign reserves had to be built only by making further borrowings. It led to two other basic ailments. One was the pressure for the exchange rate to depreciate in the market in the absence of adequate foreign exchange flows to the country. The other, arising from the inadequate foreign reserves, was the accumulation of debt by the government beyond manageable levels. As a result, repaying the maturing public debt has become a serious challenge for the new government.

No rosy picture about the economy in the next few years

Certainly, the new government has to worry about the frightening economic conditions in 2020 and in the next few years. It is facing an economy that has been virtually incapacitated by the disastrous economic fallout of COVID-19 pandemic towards the end of the first quarter of 2020. As a result, the first quarter of 2020, the size of the real economy, pulled down by a negative growth in agriculture and industry and a slow growth in services, became smaller by 1.6% in rupee terms. Its contraction was sharper in dollar terms at 5% because of the fall in the value of the rupee against the dollar from Rs. 176 to Rs. 190 per dollar in the period.

In the next three quarters, the decline in the economy would be sharper due to a completely underperforming services sector. Unless an effective vaccine against the coronavirus is found soon, this negative economic performance is to linger into the next few years too. Such an adverse development would make Sri Lankans poorer and poorer year after year. This is what the new government should avoid and for that purpose, it has to creatively disrupt the economy too.

An aggravated fiscal crisis by a generous tax offer

Sri Lanka's present economic crisis has been aggravated by a fiscal crisis, debt crisis and a foreign exchange crisis.

In the case of the fiscal sector, the crisis took the form of an unwieldy budget. The government revenue in relation to GDP was falling, consumption expenditure rising, savings of the government becoming negative, having to borrow to finance both the consumption and capital expenditures on one side and pay interest and repay the maturing debt on the other. This resulted in an unwarranted rise in the public debt stock and by the time the new government came to power at end-2019, it was as high as 87% of GDP, up from 72% five years ago.

This frightening fiscal scenario was worsened by a generous tax cut offered by the new government to income tax and VAT payers. It resulted an estimated revenue loss of some Rs. 600 bn per annum. This was an unaffordable and unwarranted comfort which the new government had given to some section of the people in the country. The consequential rise in the gap in the government budget had to be financed by the government by borrowing from both the central bank and commercial banks. During the first six months of 2020, the government had borrowed, on a net basis, a staggering Rs. 1.22 tn from this source.

This is money printing which people in the street often talk about. Its inflationary pressure will have to be born especially by the low-income people. Hence, it is an iniquitous public policy since it favours the middle class and the high-income people, while passing the burden – called incidence of tax-financing versus inflation-financing – on to low-income groups. Hence, it is of utmost importance that the government revert to the tax system that prevailed prior to 2020 and save its budget.

Another important reform it can do in this context is to generate savings in the budget by placing the government's consumption expenditure – those expenses involving the day to day running of the government – below its revenue levels.

The curtailment of the benefits which many are enjoying today is a real disruption. Taking into account the current economic crisis in the country, they should go for a voluntary disruption. All other unnecessary expenses of the government should be cut, savings in the revenue account generated and those savings used for vital capital programs. In selecting those programs, those that would help the government to get more taxes in the future should receive priority. In this way, borrowings are directly linked to extension of welfare to people and gaining capacity to repay them on time.

External sector crisis needs reforms in all sectors

The crisis in Sri Lanka's external sector has been manifested by a need for borrowing for repaying the external debt and meeting the stubbornly high deficit in the current account of the balance of payments. The cause of the current account deficit has been the inadequate foreign exchange earnings by way of export of goods and services and remittances by Sri Lankans working abroad relative to the high import bill of goods and services and interest payments.

The government has recently clamped import controls on what it has termed inessential imports but the savings it could make through this measure is insignificant since the total such expenses are also a small fraction of the total bill. Sri Lanka spends massive amounts import crude oil, raw materials for industries, medicines and capital equipment. Any growing economy cannot curtail these items without compromising growth rates.

Hence, the way forward for the new government is to earn more foreign exchange in the medium to long run by increasing exports and attracting non-debt sources of foreign exchange such as foreign direct investments. To boost both these sources of earning, an essential requirement will be to introduce reforms to enable exporters to export more and attract more foreign direct investments into priority areas. Already, some of the reforms have been introduced to the goods market. But the labour, capital and land markets still remain untouched. It is necessary to shock these three markets through disruptive changes. Sri Lanka's archaic labour laws dating back to the colonial times need be revised protecting both the workers and producers.

For the full article - Refer the Daily FT

2. 4 critical steps for fighting a historic remittance decline in South Asia
By: Md. Shahidul Haque and Sheikh Tanjeb Islam

- Remittances account for more than 5% of South Asian countries' GDP. It acts as a key mechanism to boost consumption, making up the bedrock of financial security in South Asian Nations. However, remittances in South Asia are anticipated to fall by more than 20% in 2020 due to the pandemic's impact on economies and migration.

- While remittances are usually resilient to external shocks, the pandemic has affected the 3 critical drivers of remittances - economic opportunities in home countries; the international migration system; and the international financial system. The unemployment of migrant workers will deepen the economic downturn and result in social disruptions.

- 4 strategies are recommended to arrest this situation- Ensure all service providers facilitating remittances are allowed to operate as essential services; Provide fiscal and monetary incentives; Engage in multi-stakeholder dialogue in host countries; Leverage technology and ease regulations to facilitate remittances towards eliminating poverty.

As a result of disruptions caused by COVID-19, the World Bank predicts that remittance flows will face their sharpest decline in history, falling by an expected 20% in 2020 to $445 billion.

Understanding COVID-19's impact on remittances

Remittances are a key mechanism for boosting consumption in a migrant worker's home country. In 66 countries, remittances account for more than 5% of GDP.

In South Asian economies, however, remittances play an even more important role in countries' development roadmaps and comprise large shares of countries' gross domestic product (GDP). India, for example, is the single largest remittance recipient country in the world, receiving more than $ 80 billion in remittances in 2019. Remittances account for nearly 28% of Nepal's GDP and 8% of Pakistan's.

Remittances are highly dependent on three critical factors: economic opportunities in home countries; the international migration system; and the international financial system. The coronavirus pandemic has affected each of these three factors as it has created multifaceted human crises and disproportionately impacted the worlds' most vulnerable populations.

Although past remittance flows have been relatively resilient to external shocks, COVID-19 is different. The pandemic has already severely affected the 272 million international migrants by reducing their main source of income and job security. As a result, it has reduced remittance flows causing households to lose an economic lifeline. In South Asia, it is projected that remittances will fall by more than 22% in 2020 (marginally above the global trend the World Bank has predicted) before recovering in 2021. Figures released by their respective central banks show that, year-on-year, remittances for the month of April fell by 25% in Bangladesh and 14% in Sri Lanka.

Prolonged economic recession will force the return of a significant number of migrants to their countries of origin, aggravating the economic downturn and social disruption and resulting in gender-based violence and societal tensions. The effect of the projected sharp decrease of remittances on households in South Asia can potentially push back decades of progress made by the region on poverty reduction, income inequality, nutrition, health and education.

Measures for action

As with other sectors, public-private cooperation will remain key in mitigating the impact of COVID-19 on the remittances industry. Considering the importance of the remittance industry, a policy note highlighted four immediate steps that stakeholders in South Asia need to take to arrest the decline of remittances in the region.

1. Declare the provision of remittance services as an essential service to keep remittance service providers' outlets open to the public

There is a need to ensure that non-financial institutions that are also part of the ecosystem remain open – such as mobile operators, money transfer companies and post offices in both host and home countries. This will only be possible if countries declare remittances to be an essential service.

2. Provide fiscal and monetary incentives

Countries may consider providing 3%-5% cashback on certain corridors (e.g. high-volume corridors such as Middle East to South Asia) to waive transaction costs.

For example, for every $200 sent through a banking channel, $6-10 can be reimbursed in the bank account of the migrant/diaspora family member within 30 days. The ceiling for such transactions to receive the cashback incentive can be capped if necessary. Providing direct benefits to the end beneficiary also raises more awareness and opportunities for banking channels to be utilised for cross-selling opportunities. This will ensure that remittances flow through the formal banking channel leading to higher volumes for the operators and help to increase the foreign exchange reserve for countries.

3. Include remittances in the broader migration debate

Policymakers need to engage in dialogue with multi-stakeholder communities in host countries, which includes not just the government, but also the remittance service providers in the broader ecosystem. This may help to facilitate remittances through formal channels for South Asian expatriates with limited documentation, especially for low-value transactions. This could be done on humanitarian grounds and as a pilot for a period of six months at the least.

4. Reduce the average cost to achieve the United National Sustainable Development Goal (SDG) target

While the SDG target is stated for 2030, the pandemic offers the opportunity for South Asian countries to work with service providers as well as the host governments to achieve this target in the short term. This would require a fast adaption of technology products in both the host and home countries. Central banks in home countries should also look to ease know-your-customer (KYC) and regulatory requirements for both traditional service providers as well as fintech companies to help reduce the average cost.

The power of remittances lies in how they are invested by the families of migrant workers, helping them build up economic and social assets across generations. In South Asia, where social safety nets or weak or absent, remittances often form the bedrock of a family's financial security, on which generational resilience to economic shocks is built. Blindsided by COVID-19, many families have already consumed their private safety net of saved up remittances and they now risk falling back into poverty. It's time for both the public and private sectors to throw them a lifeline.

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