Spotlight: Econ Op-eds in Summary

Week ended 24th June '20

In Summary

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

1. Accelerating credit flows Address structural issues first
By: W.A. Wijewardena

- Recently, the Central Bank decided to take measures to strengthen the recovery of the economy. The first of which was to cut the SRR to 2% and the second was to top up the special refinance fund to bring its balance up to Rs. 150 bn. These were taken to improve credit flows to the weakening Sri Lankan economy, both being measures to increase liquidity.

- However, Sri Lanka's commercial banks are already running on excess liquidity which they park in the Central Bank, to earn a relatively risk-free interest compared to lending. This ultimately would prompt the Central Bank to bring down policy interest rates, affecting the interest rate structure of the country where depositors stand to lose.

- Low credit flows, therefore, occur not as a result of liquidity concerns, but structural issues in the system. Complex risk mitigation systems prevent large scale disbursement of funds, especially when the CRIB is used as an eliminator rather than an indicator in providing credit. Addressing these concerns with proper credit guarantee will be more prudent to bring funds to the ailing economy.

Cutting SRR and flooding the banking sector

One of the decisions made by the Monetary Board was to inject additional liquidity to banks amounting to about Rs. 115 bn by cutting the Statutory Reserve Ratio or SRR from 4% to 2%. SRR is a legal requirement under which all commercial banks have to make a special deposit with the Central Bank based on the deposits they have accepted from their customers. Under the previous requirement, if a bank had accepted a deposit of Rs. 100, Rs. 4 had to be kept as a reserve with the Central Bank and that money was not available to the bank for lending. Under the revised ratio, only Rs. 2 has to be kept with the Central Bank and the additional Rs. 2 is now available for the bank to lend to its customers.

Creation of a refinance fund without supporting reserves

The other policy measure was to top up the special refinance fund of Rs. 50 bn already set up in the Central Bank to provide relief to businesses affected by COVID-19 pandemic with an additional sum of Rs. 100 bn.

The Board has to print money for this purpose because the Central Bank's free reserves that are available for this purpose is just Rs. 41 bn, much less than the Board's total commitments.

Increasing cash when banks have enough unused cash balances

Both measures will increase the cash availability to commercial banks for lending – known as liquid funds. Hence, in the opinion of the Monetary Board, pumping liquidity to the

banking system amounts to removing the most pressing stumbling block that has constrained credit flows. But this diagnosis of the Board appears to be ill-conceived.

Parking excess cash with the Central Bank

Sri Lanka's commercial banks are at present in a state of a massive excess liquidity. They are sitting on a huge amount of cash but there are no matching loan applications to dispense it. Hence, on a day to day basis, they have been parking their excess cash in an interest earning deposit with the Central Bank under its Standing Deposit Facility or SDF at 5.5%. At the time the Board decided to cut SRR by 2%, the banking sector was with an excess liquidity of about Rs. 100 bn which they had deposited with the Central Bank under SDF. Hence, as expected, when another Rs. 115 bn was released to banks through this cut in SRR, the excess liquidity immediately shot up to Rs. 223 bn. Banks have deposited this excess cash with the Central Bank earning 5.5% as interest per annum. Of course, this will be reduced gradually when banks begin to entertain more and more loan applications but it would take time.

The immediate result has been the shrinkage of the daily volume in the interbank call money market from Rs. 12 bn to Rs. 100 mn and a reduction in the rates from 6.78% to 6.65%.

Hence, in the interim period, this has become a lucrative business for commercial banks to earn a risk-free income of about Rs. 12.26 bn per annum or Rs. 33 mn a day. As such, the longer they keep this money with the Central Bank without lending, the higher the addition to their profits by way of a windfall gain. Any smart banker would follow this strategy as long as it is possible to do so.

'Open Mouth Operations' by central bankers

In the past the experience had been that banks, out of respect for the Governor, may choose to keep their heads down but would do the minimum to translate Governor's OMO commands into practical action in the field. There are two reasons for this. One is that banks' prime responsibility is not to the Governor but to their depositors.

They make a solemn promise each time they accept a deposit that those moneys would be used by them prudently earning an income and sharing that income with depositors by way of paying interest to them. This prudence does not allow them to waste the depositors' money by lending to unworthy customers.

The other reason is that if borrowers are not of good quality, banks would not put their money at risk by lending to them. Hence, whether the credit flows would increase or not would depend on how many of the borrowers knocking at the door of the banks are worthy customers. If they are scanty, however much the Governor would open his mouth, credit will not move at the rate expected by the Monetary Board or the government. When there is a lucrative business without risk is available under Central Bank's monetary policy windows, nothing can prevent banks from using it. Another unintended consequence is that banks, filled to the brim with excess cash, would refrain from canvassing for deposits at least in the immediate period.

CB will have to cut its policy rates to dissuade banks from parking excess cash with the bank

To dissuade banks from keeping excess money with the Central Bank without lending, the Central Bank has to cut its policy rates drastically once again. This applies to both the Standing Deposit Facility Rate or SDFR and the Standing Lending Facility Rate or SLFR. SDFR, as explained above, is the rate at which commercial banks can keep their excess cash temporarily with the Central Bank.

In the opposite, SLFR is the rate at which commercial banks can borrow money from the Central Bank to meet their urgent cash requirements. SDFR at present is 5.5%, while SLFR is 6.5%. Since banks can earn a minimum of 4% under Central Bank's special refinance facility, SDFR should be brought below that rate. A possible SDFR is 3% and SLFR, 4%. But this would cause the entire interest rate structure in the country to move downward producing gainers as well as losers.

The biggest losers are the depositors who have kept their savings in bank deposits to earn a comfortable income for their living. When the actual income they get declines due to the interest rate cuts, they will experience a deterioration in their living standards. This is particularly applicable to senior citizens and those who depend on interest incomes. This will certainly be the cause of social chaos. The gainers are the borrowers, the government and those in the private sector. Both parties will find a fall in interest payment commitments leaving a sizable cash savings which they can use for other purposes. A likely unintended consequence is the development of an informal financial services market that would lure depositors of banks on the promise of higher interest rates. These are not the developments which the Monetary Board may have anticipated.

Address the structural issues

Thus, the blockage of credit flows is not a liquidity problem but a structural problem. Banks in the exercise of their prime responsibility to the depositors may not want to put the depositors' money at risk. Presently, the risk mitigation involves getting suitable collateral for loans, limiting loans to a single customer to a maximum, adopting a multi-tier loan approval process within banks and building capital within banks to provide a minimum protection to depositors. In an emergency in which both the government and the Monetary Board want to promote credit flows, these structural problems certainly stand in their way.

To take the fear of lending out of the mindset of bankers, it is necessary to provide a comprehensive credit guarantee scheme to bankers. That could be funded out of a seed capital to be given by the government initially and out of subscriptions of the banks that would get the benefits from the scheme. An automatic subscription flow can be generated by charging a premium of 1% annually from the loans granted out of the refinance funds of the Central Bank.

CRIB reports are just indicators and not eliminators

The other structural problem is the overreliance on the reports from the Credit Information Bureau, known in its acronym as CRIB, when sanctioning loans. As the founding General Manager of CRIB, I could say that the objective of these credit reports was not to eliminate borrowers. They were simply an indicator of the likelihood of habitual loan default by prospective customers which the sanctioning bank could take into account when assessing the credit risk involved. Then, like good bankers, they could take measures to mitigate the risk through additional collateral or charging a higher interest rate. Instead of assessing loans appropriately, the bankers are in the habit of rejecting those whose names are in the CRIB register. There are small as well as large borrowers in this category. Some have got their names into CRIB register simply because they have failed to pay credit card instalments or they have guaranteed a loan which has been defaulted by the original borrowers. There are also non-executive company directors whose names have been reported to CRIB because the company concerned has defaulted payments.

It is of importance that the Central Bank should issue guidelines to banks as to how they should rate those whose names are there in the CRIB register and assess the risk involved in accommodating such borrowers.

A cure worse than the disease

Therefore, simply increasing the liquidity in the system will not improve credit flows unless these structural issues are addressed. The excess liquidity created by the Monetary Board will remain within the system as a virus for which there is no effective vaccine.

The interest payments which the Board has to make to absorb that excess liquidity will be extremely costly for the Bank. To soften it, the Board can reduce SDFR and SLFR. But that cure will be worse than the ailment since the across the board decline in the whole interest rate structure will create many long-term macroeconomic issues.

Some undesirable outcomes would be the dwindling of the savings flows, rising savings-investment gaps, need for borrowing abroad to fill the gap, trapping the country in an external debt trap and above all, pressure for the rupee to depreciate in the market. These costs would have been avoided by the Board if it had gone for a credit guarantee scheme and streamlined CRIB reports when assessing loan applications.

For the full article - Refer Daily FT

2. National debt status and future directions for raising debt in international markets

By: Shamika Ramanayake

- While advanced economies following principles of 'Modern Monetary Theory' can take on sovereign debt comfortably due to negative interest rates and low interest regimes, this is not a viable path for emerging economies. Factors such as currency weakness, higher interest rates and intricacies in capital flows inhibit this.

- Sri Lanka is no exception, and persistent fiscal and current account deficits have resulted in spiralling national debt levels. This has necessitated Sri Lanka seeking debt assistance to manage its obligations. Despite seeing relatively moderate growth in recent years, the country's debt obligations have risen to more dangerous levels.

- While it is important to attract investors through structural fiscal reform in the long run, Sri Lanka must also look to raise debt sustainably in the near term. To this end it can help to target Sovereign Wealth Funds (SWFs), Non-USD based bond issuances, tap into the green bond market and establish a National Investment Authority.

Global overview

As governments all around are stretching their balance sheets to accommodate various economic stimulus to salvage national economies and avoid damaging spill-over effects, especially on vulnerable sections such as small and medium business holders, entrepreneurs, labour markets etc., such measures are invariably linked to national debt and fiscal ability.

To complement the above cause, advanced economies have leveraged their persistent sub-zero or negative interest rate and low inflation regimes to comfortably raise more debt resulting in widening Fiscal gaps. That is, 'monetising debt' by way of Treasury and Central Bank collaboration (e.g.: The Federal Reserve buying Treasury issued bonds in US).

Underlying economics

To the aid of such measures, economists argue that countries like US, UK and Japan which command high capital mobility and ability to raise debt (via bonds) in respective reserve

currencies, may continue to fund such increased crisis-spending without having to increase follow-on fiscal costs (i.e. raising taxes) to the economies. Essentially not triggering a hyperinflationary environment as well.

This school of thought is widely popularised lately under the 'Modern Monetary Theory' (MMT) concept. Japan stands as a typical example for these results whilst running the highest debt: GDP ratio (which is currently in excess of 220%) in the world for the longest period and yet been unable to push-up the inflation for decades. Similarities can be seen in the US and UK.

Further, it is said that advanced economies which carry persistently lower risk-adjusted interest rates (e.g.: Treasury Inflation Protected Securities – TIPS in US) than respective growth rates (i.e. nominal GDP growth) remain in a better position to do the debt rollovers (issuance of incremental debt) without resorting to a public tax-increase regime. This has been extensively reviewed by the renowned scholarly Professor and former IMF Chief Economist, Olivier Blanchard in his research published in early 2019 at the Peterson Institute for International Economics.

To put this in US context, this can be pointed to the fact that 10-year nominal bond rates (safe or risk-free rate) hovering near 3% which is lower than the country's nominal GDP growth forecast of around 4% (2% real growth + 2% inflation) during Q1-2019.

In essence, as the debt servicing cost (interest) is cheaper than the earnings return (growth) in the economy, debt created by the State is bound to be self-liquidating in nature, provided that rest of the conditions remain unchanged. In turn, this provides an incentive for such governments to be more fiscally expansive without the fear of adverse spillover effects in later periods.

Even though the above basis is largely valid with respect to developed economies, the viability of such rationale in emerging markets remain highly constrained by factors such as currency weakness, higher interest rates and intricacies in capital flows. Due to these reasons, even during current crisis times where little or no push-pull inflationary pressures are present, the headroom for monetising debt by developing economies remain largely restrained. In other words, Fiscal expansion or government spending to support various stimulus measures in the economy are limit-bound and require close reviewing.

The same point is very much valid for Sri Lanka who has been persistently running a Fiscal deficit averaging to 6.3% for the last decade. This is in addition to the deficits maintained in country's Current account. Owing to such reasons, it is needless to mention that Sri Lanka's national debt has spiralled over the years leading to its current state of boiling point.

On top of such existing debt backlog, the additional cost created to the State by the current pandemic are expected to put further strain on the Fiscal status for foreseeable periods unless drastic reforms are expedited.

National debt burden

It is no secret that Sri Lanka is overwhelmed by a debt cycle spinning one fiscal period to another. In the face of continuous deficits carried in both fiscal and current account balances which respectively accounted for 6.8% and 2.7% against the GDP in 2019, had naturally forced the country to seek debt assistance for managing its affairs and recurring debt repayments.

As per the CBSL records in 2019, the country's total debt comprising of both domestic and foreign stood at Rs. 13.03 trillion. Comparatively this figure in 2015 was Rs. 8.7 trillion. For the same period, total debt: GDP increased to 86.8% from 76%. On an aside, whilst

the country's GDP or national output grew by mere 4.2% during 2015-2019 period, the corresponding debt burden has outgrown by almost 50%.

Over the above period, Sri Lanka has been more reliant on raising its debt internationally than domestically. As figures indicate, the foreign debt component which stood at 42% in 2015 against total national debt has gradually increased to 49% by 2019. More of a natural phenomenon for a country which simultaneously carries a weaker trade balance putting pressure on the primary source of net foreign income.

Whilst 51% of total foreign debt in 2015 attributed to non-concessionary loans obtained on commercial terms, this figure has climbed to 57% by 2019. This is in turn points to the increasing incremental debt servicing cost (i.e. interest) associated with the foreign borrowings.

Ironically, the fact that Sri Lanka was elevated to the 'upper middle income' status during 2019, consequently took away the country's eligibility to obtain foreign denominated loans/grants by supranational entities like IMF under concessionary schemes at reduced interest rates. Instead, now Sri Lanka is compelled to avail those loans at a relatively higher cost owing to the country's elevated per capita income status as per the World Bank classification.

As a result of above developments, the issuance of foreign currency denominated bonds out of total foreign debt has been gradually increased to 43% in 2019 (i.e. $ 4.4 billion) compared to 27% reflected five years ago (i.e. $ 2.15 billion). Realistically, as this trend is expected to be continued for the foreseeable future, Sri Lanka's creditor status or sovereign risk rating becomes one of the critical yardsticks dictating the country risk premium involved with foreign borrowings.

In view of recent Issuer Default rating downgrades by both Fitch and S&P Ratings, the bonds issued (i.e. borrowings) by Sri Lanka falls six notches below that of 'investment-graded' bonds traded globally. In other words which continues to categorise country's issued and proposed debt under 'junk' investments.

Therefore, speedy reforms to prop up the country's external and fiscal sector performances in the long run remain a critical task in order to improve Sri Lanka's credit worthiness in the eyes of international investor community. Sri Lanka is already facing constraints in international debt markets as evidenced by the recent undersubscribed SLDB issuances during March and April this year. In addition, the existing USD bonds issued by Sri Lanka which are currently trading considerably lower than their par (face value) despite the higher coupons, suggests the aggravated risk-on status of country's debt instruments as perceived by international investors. Hence, the failure to expedite corrective economic reforms may lead to more stress and further investment appeal deterioration in coming periods. As CBSL annual data suggests, total foreign debt as a percentage against country's exports as of 2019 FYE posted at 184.4% which accumulates to a USD figure of 22.02 billion. Moreover, total foreign debt service (annual principal + interest) as against the exports in 2019 has spiked to 23.7% from reported 16% in 2018. Similarly, the interest service alone has climbed to 7.2% from 6.5% for the same periods. Sustainable way out from this chronic problem lies with the strengthening of country's External sector for persistent periods. This leads to the major improvements in key sources of foreign inflows to the country which stand under exports, tourism, worker remittances and FDIs.

Collectively these sources have contributed to $ 23.47 billion in 2019 which is in fact down from $ 25.42 billion reported a year earlier. Whilst annual inflows from tourism and worker remittances will remain more susceptible for external factors, as proven during current crisis times, greater emphasis should be given to drive the country's exports and FDIs in the long run which are relatively less cyclical and complementary in nature (as 37% of FDIs has flown into exports led economic zones during 2019).

In view of current developments and future reliance on issuing debt internationally by the country, the following captures some of the important directions which Sri Lanka can explore both internally and externally in terms of better approaching the international debt markets;

Targeting of sovereign Wealth Funds (SWFs): As per the latest SWFI (Sovereign Wealth Fund Institute, USA) ranking, Norway SWF with $ 1.186 trillion assets ranks as the first whilst China remains in the second position globally. Interestingly, out of the top 15 global SWFs, almost half of the largest asset pools are domiciled in the Middle East (ME).

Sri Lanka should drive a focused and professional approach to pitch its International Sovereign Bonds (ISB) and Sri Lanka Development Bonds (SLDB) propositions to federal authorities based in the ME to tap these investment pools effectively.

In addition to the large investment pools held by these SWFs and diversified investment mandates, persistent lower interest rate regimes prevalent in these economies probably might help the Sri Lanka's cause of raising future bond issuances cost-effectively (in the event of competitive bidding) and with possible higher allocations.

Non-USD based bond issuances: The country made its intention public for the first time to issue bonds denominated in YEN (Samurai bonds) and YUAN (Panda bonds) during 2019. However due to the long-drawn formality issues and follow-on presidential election, the plan was shelved.

Japan persistently runs negative interest rates and sub-zero inflation levels. Having the world's third strongest economy and its safe haven currency status make the country one of the best-suited and less-volatile financial markets to raise non-USD debt by the GoSL.

Similarly, China remains as a compelling alternative as a strong-defender of its currency ably supported by the large wealth. China's interests in Sri Lanka being a benefactor of the Belt & Road initiative validates the rationale for a national strategy to raise non-greenback international bonds in these markets.

Sri Lanka can better leverage on the historical ties with Japan and China to tap these debt markets, possibly more competitively compared to more risk-driven markets in US or Europe.

Additionally, prospects in financial markets like Norway (largest SWF and stable currency status) and Singapore (strong economy and safe haven status) also to be explored by Sri Lanka in its endeavour to raise non-USD debt in future.

Tapping into green bond market: The option should be actively explored for future project financing in renewable-energy initiatives or possibly towards a national project for waste recycling plants etc. whereas the cost (i.e. coupon rate) will be relatively lower than that of conventional vanilla debt instruments.

Being a country majorly reliant on fossil fuel and running an annual bill of $ 3.9 billion (almost one-third of annual exports in 2019), Sri Lanka can purposefully explore this alternative to raise capital for future greener development projects. India is actively pursuing this option and has reportedly raised $ 10.3 billion worth of debt during 1H-2019, becoming the second largest emerging green-bond market after China.

Tax benefits availed for investors on green bond investments which are in compliant with the Sustainable Development Goals (SDG) may provide a viable cost-effective route for Sri Lanka to actively strategise a national policy to raise foreign debt through this option in the future.

Establishing a National Investment Authority: The country should ideally form/develop a standalone national body comprising of bankers/financial market professionals with international expertise and networking to liaise with the CBSL in strategising future ISB, SLDB or structured debt issuances intended for international debt/capital markets. Realistically speaking, as Sri Lanka is compelled to issue more debt internationally in order to manage the rollover risk of existing debt, this will be a prudent move towards country's readiness for foreseeable future.

Conclusion

Whilst it is paramount that the country uplift its investor appeal in the long run through fiscal and external sector corrections and new reforms, similar emphasis should be given to explore the above ways to raise foreign debt sustainably in future periods. Such strategies can be looked upon in tandem with the CBSL's ongoing efforts to raise foreign flows by way of SWAP arrangements with fellow Central Banks, syndicate debt (where all-in price might be cheaper than bonds), etc. to manage existing debt repayments and future rollovers.

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