Spotlight: Econ Op-eds in Summary

Week ended 6th November '19

In Summary

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

1. Post-election political stability crucial for economic recovery
By: Nimal Sanderatne

- Political stability is vital for economic recovery. Any conflicts between the newly elected president and the existing government, alongside the upcoming parliamentary elections are likely to delay political stability. A single party government that implements clear and certain economic policies and reforms, and also maintains ethnic harmony, is vital for economic development.

- This is especially important since Sri Lanka's economic recovery was delayed by external incidents like political anarchy and the Easter Sunday attacks. Economic reforms, pragmatic policies and fiscal consolidation needs to be re-established. Such political and economic stability is vital for future Balance of Payment surpluses enabling us to service the mounting foreign debt of the country.

- Such economic reforms are further valuable looking into the future, as an ageing population means that transformative 4th Industrial Revolution technologies are a key driver of future Sri Lankan economic growth. However, the current political agendas lack plans to address above issues and are full of promises that would worsen the country's economic problems involving low growth and high foreign debt.

In two weeks', time a new President will be in office. Even a short period of political anarchy could aggravate the nation's economic problems.

Political stability after the election is an immediate requirement for economic recovery. This is only possible if the newly elected president is able to work together with the Prime Minister and the rest of the government. If the new President attempts to act as an executive president, then there could be a constitutional crisis similar to the one in October 2018. Such a chaotic state of affairs would cripple the economy once again.

Whoever wins the Presidency, there is a likelihood of an early dissolution of parliament and a fresh election. Then the country would once again be plunged into another wave of preoccupation with the elections and a neglect of the economy.

Coalition

Furthermore, if the results of the parliamentary election do not give a single party a majority in parliament and the President is of another party, then there could be political instability despite the powers of the new President being reduced under the 19th Amendment.

Another impotent coalition would be the worst option for economic growth. A government formed by a single party with a clear economic vision and certainty in economic policies is vital for economic development.

Prerequisite

While political stability is crucial it is not sufficient. A number of other conditions are essential to move the economy forward. Foremost among them are sound economic policies and their effective implementation, a multiplicity of reforms, and ethnic harmony.

Neither of the two presidential front runners has disclosed a credible economic policy or programme. Their plethora of promises would worsen the economic crisis rather than lead to an economic recovery and economic development.

Formidable challenges

The economic challenges facing the country are formidable. The revival of the economy after a stable government is established is an enormous task. As the Institute of Policy Studies (IPS) has pointed out in its latest State of the Economy report, the country has had 10 consecutive quarters of below 3.5% growth and the prospects of economic revival is dim during the remaining months of this government's tenure.

What are the prospects in the next five years? Each time there was a prospect of economic revival, it has been cut down. The political anarchy last October, the Easter Sunday bomb blasts in April this year, the crippling strikes and obstructionist actions of the opposition have deterred economic growth.

Policies

While in the short term, an element of political stability could revive some sectors and turn the stock market to be bullish, an economic recovery would require not only political stability, a multiplicity of economic reforms, pragmatic economic policies and their effective implementation. The process of fiscal consolidation needs to be revived after the fiscal slippage this year. The politically difficult reform of the massive lossmaking state enterprises would require to be addressed.

Foreign debt

Servicing the foreign debt of US$ 54bn is onerous unless there is a significant balance of payments surplus. There is a glimmer of hope that there would be such a surplus this year, but it could be enhanced in the next few years only if the recent export growth accelerates, imports are contained, tourism revives and foreign investment increases. Political stability and economic policies will determine these.

State of the economy

The IPS states that "The Sri Lankan economy is making a slow recovery after a series of setbacks – a devastating terror attack in April 2019, preceded by a political crisis in the third quarter of 2018. With sluggish GDP growth of around 3% and high foreign debt settlements, the overall positioning of the economy in 2019 is weak.

This is despite significant gains from macro reform measures in fiscal, monetary and exchange rate policy management from mid-2016."

The IPS goes on to say: "As Sri Lanka prepares the groundwork for a fresh phase of economic growth and development on the back of decisive elections in 2019-2020, new tools to assess and understand competitiveness must be heeded. Transformative technologies such as artificial intelligence (AI), robotics, and 3D printing – under the banner of the Fourth Industrial Revolution (4IR) – are proving to be invasive, complex and disruptive. For countries with ageing populations like Sri Lanka that must rely on

productivity as a key driver of future growth the challenges need to be understood and opportunities grasped".

Forward looking

IPS focuses on 'Transforming Sri Lanka's Economy in the Fourth Industrial Revolution (4IR)'. It examines many areas of the Sri Lankan economy – world of work, education, migration, gender, health, financial inclusion, trade, agriculture, and climate change, amongst others – where the 4th Industrial Revolution technologies will come into play as defining features of the country's future economic progress.

Short sightedness

In contrast to the IPS' forward looking perspectives, our political leaders are preoccupied in doling out money in numerous ways and making promises that would worsen the country's economic plight. There are no plans to reduce wasteful public expenditure and reduce the public debt. No mention of reducing the size of the cabinet or reducing the size of the bloated public sector employment, reforming the loss-making enterprises and fiscal consolidation.

Economic performance

This year's economic performance has been most disappointing. It is the lowest economic growth in the post-2015 five years — also much lower than the annual average growth from 1950 to 2018. It is less than half the economic growth of the South Asian region and almost the lowest economic growth in South Asia. The country's foreign debt has grown from US$ 21bn in 2015 to US$ 54bn this year and the servicing of the debt is a serious concern.

For the full article – Refer The Sunday Times

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2. Sri Lanka's killer 'flexible exchange rate' strikes again
By: Bellwether

- A modern central bank, as a state agency, has more power along with the ability to issue paper money and depreciate the currency. In such an environment, the planned monetary reforms should be viewed cautiously. While the Central Bank now promises to end money printing, they in turn engage in open market operations to increase liquidity, resulting in a sliding rupee.

- The central bank also tries to maintain a floating exchange rate that is biased towards depreciation. When it buys dollars from the domestic forex market, market liquidity increases further. Such liquidity is bearable because of the increase in international reserves, and the liquidity can be reduced when selling dollars.

- When the dollars are sold, the call money and repo rates should go up as excess liquidity is absorbed. However, things don't always happen in such a stable manner. The use of swaps to obtain reserves and the use of various ways to inject or drain liquidity affects market stability. This needs to be kept under control through strict policies and laws.

Monopoly Mercantilist Power

A modern central bank, by virtue of being a state agency with a monopoly, has powers drawn from the state which no ordinary Mercantilist has, except perhaps archetypical agencies like the British East India Company, which had its own army.

Sri Lanka's central bank and that of India is wielding its monopoly power, with the same ruthless discharge of the control mindset but with greater powers than any 17th century Mercantilist ever had with the ability to issue paper money and depreciate the currency at will.

The Bank of England for example had to get parliamentary approval to float the currency (The Bank Restriction Act) or depreciate.

With a collapsing currency, REER targeting, gold taxes, car taxes, LTV controls on three-wheelers no less, the planned monetary reforms should be viewed with the most considerable caution.

Monetary window dressing

What is confusing is that the central bank is now promising to end money printing, apparently genuinely. But is then printing money through open market operations and other means. It does not matter how the excess liquidity injections are made; the effects are the same.

If the promise to end money printing was genuine, what happened in August 2019, and the liquidity disruptions should not have taken place.

- July 2019 dollars were bought by the central bank to create base money but rupees were mopped up steadily by selling down Treasury bills. There were also overnight repo auctions to mop up cash. On July 17, Rs. 17 bn in excess money was deposited at the floor rate window.

  Then mopping up stopped and excess liquidity started to build up, probably from dollar purchases.

- On August 08, Rs. 20 bn was printed suddenly on top of unsterilised excess liquidity. There were also term injections and outright purchases around the time.

  These show that even if by law the central bank is stopped from taking large volumes of bills from the auctions, it will take them through other means and dump reckless quantities of liquidity on money markets. It will then be justified on the basis of conducting 'monetary policy'.

- Then on August 16, the central bank suddenly brought down its Treasury bill stock to Rs77.8 bn from Rs106 bn. Before that, up to Rs25 bn of money was printed overnight and also through term reverse repo contracts.

A few years ago, the bank stopped showing the total bills it takes against central bank credit to the public and understated the bill stock. The great window dressing exercise left Rs50 bn of excess liquidity in the banking system. The rupee went sliding.

Floating with excess liquidity: A crime?

A look at recent spikes in excess liquidity tells its own story.

The central bank also floats the rupee with excess liquidity, built up during the pegging period with the acquisition of foreign assets (dollars) or Treasury bills (domestic assets). Or both, as in the case of August 2019.

No attempt is made to withdraw the liquidity to make the monetary system ready for a float.

As a result, the currency slides, importers and foreign investors panic, then exporters hold back.

In August 2018 (last year), after the rupee stabilised the central bank again bought dollars at around 160 to the US dollar, and built up a liquidity spike.

In a tragic-comedy, the central bank also bought dollars through a swap

There are two reasons which make rupees created from dollars better than rupees created from T-bill purchases, but both have the same downward pressure on the peg.

- There are dollars in reserves to defend.
- When the dollars are sold, liquidity tightens and the overnight rates go up, to strengthen the peg.

But if dollars in a swap has to be retained to unwind the swap, the reserves cannot be used to sell and defend the currency.

It's the call money rate

It is not necessary to have substantial cash shortages to tighten the system. A cash short of about Rs.5-10 bn is enough. Then banks can borrow from the lending window at the ceiling policy rate, and the currency can be floated.

The greatest virtue of buying dollars to expand reserve money is that it can be sold, and when it does the call money and repo rates go up. In any case none of this will happen if the call money rate is targeted with new printed money.

Money Market Killer

In the July to August 2019 debacle the central bank completely killed the overnight money market.

In June there was a credit spike. A couple of weeks later repo and call money market became active as existing money was exchanged to clear transactions and keeping a reign on instability.

As rates started to edge up, massive liquidity injections were made to keep call rates low, expanding base money suddenly, taking away all restraints.

All activity is killed. During this time, primary dealers were out of the open market operations, which makes the effect more pronounced.

The targeting of rate below the window rate, with liquidity shocks, shows an unusual recklessness for any central bank, but particularly one that is trying to build a 'reserve buffer' and is facing problems repaying foreign debt.

State Failure

This country has suffered too long at the hands of soft-peggers. From 1951 to 2019. But there is no end in sight to this suffering and hardships. It seems, 'flexible exchange rate' is going to stay.

Sri Lanka's markets are working. In fact, the banking sector is competitive enough so that deposit rates are high enough to compensate poor savers as well as the less poor with financial savings when the currency collapses.

To compensate for its state failure, the central bank has hit depositors with price controls. Borrowers are now to get a subsidy, and banks are going to be hit with price controls. Not a single banker lifted a finger to stop deposit controls.

Now let them sell their soul.

The structurally high rates are a direct result of monetary instability. Banks are working to save the people from state failure.

Observers had assumed that the central bank was withdrawing liquidity at 7.70 percent above the 7.50 floor rate, out of an abundance of caution. The August debacle, where money was injected recklessly, shows that there was no such prudence at all. There is no point in talking about monetary reform if large volumes of money are printed to generate liquidity spikes.

Criminal Actions

Actions which caused the most significant damage in recent years which have to outlawed are as follows.

1. The buffer strategy (repaying long term bonds with central bank re-financed lender of last resort money injected to state banks).

2. Soros-style swaps. The damage is less if the dollars in reserves and they can be sold to mop up the liquidity.

3. Filling liquidity shortages after giving dollars for maturing 2013 swaps without allowing rates to hit the ceiling rate. A maturing swap is a capital outflow. Overnight rates have to rise after swap matures depending on the size.

4. Injecting cash after going without sterilising dollar purchases for more than 2 weeks. This is what happened in August 2019.

5. Operation twist (a two-leg operation that contributed to the 2015/2016 BOP crisis where long term rates are manipulated)

6. Floating without taking away excess liquidity and allowing rates to move up to the ceiling policy rate. This happens all the time under the deadly 'flexible exchange rate'.

7. Cover-up moves to delay rate hikes. Nixon shock style import controls, gold taxes are covering up for call money rate targeting or other policy errors and delaying corrections.

The following central bank actions cause less damage, but they should also be restricted.

1. Going for more than 2 weeks without sterilising inflows.
2. Going for more than 4 weeks with sterilising inflows – double the punishment for two weeks.
3. T-bill window dressing, like that seen in August.

The Rs. 50 bn liquidity bubbles that led to sharp downward pressure on the rupee in 2018 indicate that strict limits must be brought against excess liquidity to keep domestic operations on a tight leash.

It now turns out that most of these individual wrong policies have been undertaken to target the call money rate.

All this problems with contradictory central bank policies will become much more critical next year when private credit picks up on top of expanding state spending.

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