# Economic Blunders in Sri Lanka

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After reading Asoka Seneviratne's article published in Colombo Telegraph on 12 August 2021 (https://www.colombotelegraph.com/index.php/when-a-president-loses-peoples-respect-confidence/), I thought of adding to its long list five more economic blunders currently being committed by the Central Bank and the Finance Ministry.

The economy, that provides the livelihood, is the main concern of the people at present. Asoka has noted three main blunders committed by the Finance Ministry, The Central Bank and the Treasury: the massive loss caused to the government revenue by reduced Value Added Tax, increased income tax thresholds, and the reduction of import tax on sugar. In this rejoinder I would like to add five more blunders:

1. Calming that printing money (over 1600 billion Rupees in total) will not increase inflation.
2. Re-valuing US$ denominated government bonds using the currently depressed market prices to show a lower amount of foreign debt in the Central Bank report.
3. Payment of only US$ 800 million out of a total of US$1000 million of sovereign bonds and calling the amount which was not settled in US dollars to Sri Lankan institutions/residents as a 'net cash inflow'.
4. Attempts to hide the fact that the Sri Lankan government can no longer borrow money by issuing sovereign bonds in the international market.
5. Advocating outdated economic policies by the Central Bank.

**Printing money**

The central bank has printed (created) over 1600 billion Rupees during the last one and a half years. Most of this was lent to the government to fund its fiscal deficit or pay its outstanding debts which cannot be rolled over. Much has been already discussed in Sri Lankan media about this excessive money printing.

The State Minister for Finance and Capital Markets has discussed the 'merits' of such money printing. While money printing within limits is acceptable as a monetary stimulus it has its dangers, mainly the high probability of causing inflation. The state minister has argued that money printing does not lead to inflation. This is only true if the economy has the capacity to swiftly increase production to meet the excess demand stimulated by increased money supply. However, as a sensible observer would have expected, there are still no indications of any increase in productivity and production. Moreover, stringent import controls imposed by the government in the face of severe foreign exchange shortages prevent meeting excess demand through imports. According to the 'official' consumer price index, inflation rate in Sri Lanka is currently running at 7.5%, but it could be much higher if we allow for the artificial price suppression effect of controls on some products in the household consumption basket. In Sri Lanka excess money has caused to increase asset prices (such as shares and real estate), which generally benefit people in high income bracket. Easy money at low interest rates going into the hands of well-to-do people could add to income inequality in the country.

USA is one of the countries which added huge amounts of money to the economy through the Quantitative Easing program (money printing) of the Reserve Bank. There are constant worries about inflation in USA despite considerable productivity gains. Annual inflation of USA is currently 5.4%, while the policy rate (Reserve bank lending rate) is 0.06%. Inflation is far above the interest rate.

**Re-valuing of outstanding US$ bonds**

The latest (2020) *Annual Report* of the Central Bank of Sri Lanka has shown outstanding (still to be paid) US$ bonds (government borrowings by issuing sovereign bonds in the international market) as US$ 7,555 million **at market prices** on the date of data compilation. This is not the real extent of the liability of the government, because this valuation has been arrived at by using the deflated market values of these bonds. If the face values, i.e., the price at which these bonds must be paid off on maturity, were used the value would have been above US$10,000 million. For difficulty in finding specific detailed data in the CBASL report it was not possible for me to compute the exact liability.

In a context where bonds issued by the Sri Lankan Government are traded on the secondary market at a large discount because of the grave concern about Sri Lanka's country risk, this practice (i.e., valuing outstanding bonds at their market price) naturally leads to underestimation of the reported debt burden of the country and undermines the need for urgent reforms. It also raises doubts in international financial markets about the integrity of the Central Bank. This could have serious implications for raising funds by issuing sovereign bonds, or by any other means, at competitive interest rates.

As the face values of government bonds are usually repaid at the maturity, the market prices of these bonds at any point in time before their due date is considered irrelevant for the purpose of correctly showing the amount the government is owing at any point in time. This is (i.e., valuing sovereign bonds at their Face Value, despite their lower or higher Market Price) the internationally accepted practice. The US$ denominated bonds issued by the Sri Lankan government were selling at a discount of up to 50% in the international market due to the fear that the government would default paying-off these bonds. In other words, for example, a government bond with a face value of $100, was selling at $55 in the secondary market as they were considered to be junk bonds by the market. Investors believe these bonds are highly risky because there is a high probability that they will not get their money back. The Central Bank report has used these depressed market prices (for example, $55 instead of the face value of $100) in valuing the liability of the government. In accounting, mark-to-market is acceptable for valuing market-traded liabilities, if such liabilities can be redeemed at market prices as per the original bond agreement and if the company (the issuer) intends and has the capacity to redeem the bonds before their date of maturity. None of these are true in the case of Sri Lanka. By adopting this accounting practice relevant to business, the Central Bank has blatantly violated basic principles and underestimated and under reported the total liability of the government regarding its outstanding international bonds. By doing this, the Central Bank has misinformed people and lost its integrity in the eyes of the business and finance community.

According to the Central Bank *Annual Report 2020,* the nation's foreign debt burden measures as a percentage of gross national product (GDP) is 60.9%. This figure contains outstanding sovereign bonds incorrectly measured at the current market price. When these bonds are valued at 'face value' (which is the true indicator of the country's actual debt obligation), this figure is as high as 69.2%. Understating the nation's external debt burden by almost 9% is not a trivial manipulation when it comes to assessing the Central Bank's credibility!

**Settlement of $ 1 billion sovereign bonds by paying only $800 million**

On 27 July 2021 Sri Lanka settled a $1 billion international bonds that needed to be paid off to avoid defaulting. Sri Lanka paid only about $800 million in dollars, the rest was settled in Sri Lankan Rupees to Sri Lankan (national) bond holders (mostly banks and other national institutions) while arranging to add the dollar equivalent to Central Bank foreign exchange reserves through 'under the table' swap arrangements. According to the announcements made by the State Minister for Finance and Capital Markets, this non-settlement of $200 million debt in US Dollars, should be celebrated as a 'net cash inflow' to the country. The truth is that Sri Lankan residents (institutions and persons, if any) who had purchased bonds paying US$ were denied their right to receive their money back in US dollars. Taking such a desperate action, given the scarcity of foreign exchange, is understandable. However, framing and spinning it as a gain and a virtue is laughable. People, both local and international, who are literate in finance easily understood the truth. The credibility and integrity of Sri Lanka were adversely affected.

**Attempts to hide the fact that the Sri Lankan government can no longer borrow money from the international market**

Monthly Bulletin of the Central Bank for March 2021 (Table 32, P. 34) has shown the value of outstanding Central Government Debt as Rupees 15,754,375 million (Rs 15.75 trillion), Out of which Rupees 9,420,166 million (Rs 9.42 trillion) are domestic debt, while Rupees 6,334,209 (Rs 6.33 trillion) are foreign debt. Out of the foreign debt, international sovereign bonds denominated in US$ are valued at Rupees 2,293,750 million (Rs 2.29 trillion). As explained in section 2, the liability of international sovereign bonds would have been much higher had the **Face Value** of bonds been used to value them. The value of the total external debt, including the international sovereign debt will be much higher in Sri Lankan Rupees soon given the expected sharp depreciation of Sri Lankan Rupee against US$.

Based on the recent statements made by the State Minister for Finance, one might think that the government has made a prudent decision not to borrow from international markets in the future. The truth is that international markets are out of the question for Sri Lanka now. Sri Lanka cannot issue new sovereign bonds in the international market as it did a few years ago because there will be no demand for its bonds. Even if there is a demand, Sri Lanka will have to offer an interest rate of over 40% per annum to find buyers. Even if Sri Lanka is willing to pay an exorbitantly high coupon interest rate, it will be hard to find a Lead Manager (bookrunner) to organise, market and sell a new issue of sovereign bonds.

The interest rate to be offered in a new issue of bonds is reflected in the market yield (Yield to Maturity or YTM) of the outstanding Sri Lankan sovereign bonds. The outstanding sovereign bonds of Sri Lankan government were selling at a huge discount (around 50%) in the secondary market. For example, the YTM increased to 91% on 3 April 2020 and dropped to 39% on 30 April 2020. According to a Bloomberg publication on November 1, 2020, Sri Lankan bonds lost 15.5% of their value in September 2020 and further 20% in October 2020. The YTM of Sri Lankan sovereign bonds is somewhat settled down since the last-minute settlement of US$1 billion on 27 July 2021. This was achieved by printing Rs 213 billion and using part of this money to buy foreign exchange needed to pay off the $800 million worth of foreign-owned bonds in US dollars. The rest was used to settle $200 million worth of bonds in Sri Lankan Rupees to domestic (resident) holders. However, despite this settlement, the international markets remain doubtful about the ability of Sri Lankan government to settle all the remaining bonds on maturity. Because of this situation, issuing new bonds in the international market is not a possibly for Sri Lanka for the foreseeable future.

The government has also stubbornly taken a position not to borrow money from the IMF even at a rate less than 2 per cent per annum because of the conditions likely to be imposed by the IMF. Instead, the government seem to have decided to depend on loans and swaps arrangements with other countries (e.g., China, India, Bangladesh). While swap arrangements are short-term measures, loans from other countries would carry a much higher interest than the IMF rate. The interest rate on IMF program borrowing (under a Stand-by Agreement or the extended Funds facility) is normally less than 2%, whereas the government is currently paying 9.5% on national development bonds. It is important to note that unlike the money created by the central bank to fill the budget deficit, IMF loans are directly given to the central bank to be used strictly for external payments and hence do not add to domestic money supply that fuel domestic inflation. Moreover, entering into an IMF stabilisation program would help obtaining concessionary financing from donor nations by increasing the country's creditworthiness. For example, according to media reports, India has stipulated this as a condition for future financial support for Sri Lanka.

**Advocacy of outdated economic policies**

The Central Bank of Sri Lanka is currently advocating and promoting a pre-1978 economic policy which centres on import substitution and protective tariffs (import taxes). This policy is clearly outdated: very few isolated countries, such as North Korea and Cuba, seem to adopt such a policy today. Low productivity, persistent scarcity of essential consumer goods, and low per capital income are well known features of these countries. People of these countries have been at subsistence level for decades without any hope for enhancing their living standards. Although much has already been published in the Sri Lankan press and other media, demonstrating the inappropriateness of such a protective, antiquated, economic policy, the policy makers do not seem to listen. The case made by the Central Bank for this dramatic (and costly) policy reversal is simply based on slogans, not factual analysis. For instance, their reports says that the new policy will help 'resolve the numerous *legacy issues* that straddle the performance of the export sector' (Annual Report 2020, p. 20), without spelling out what the so-called 'legacy issues'. The report has completely ignored Sri Lanka's achievements under liberalisation reforms even under severe constraints imposed by the civil war for over two-and-a-half decades and the incomplete nature of the reforms. Moreover, the policy makers seem to be ignorant about the rapid economic advance that has already been made by countries such as Singapore, South Korea, and advances being made by Vietnam and Cambodia by adopting/adhering to economic policies appropriate for the 21$^{st}$ century.

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