NEWS ROUND UP

Tuesday,October 09th, 2018

Contents

Sri Lanka stocks end 0.41-pct higher, rupee weakens

Sri Lanka stocks closed 0.41 percent higher on Monday on buying interest in HNB, Hemas Holdings and Distilleries Company, while the rupee ended at a new low of 170.65/80 rupees against the US dollar and gilt yields edged higher, market participants said.

Colombo's All Share index gained 0.41 percent to close 24.29 points higher at 5,908.06, and the S&P SL20 of more liquid stocks ended up 0.91 percent, gaining 27.52 points to 3,038.12.

Market turnover was 265 million rupees with 63 stocks gaining during the day against 49 that declined.

HNB (up 7.80 rupees to 214.80 rupees), Hemas Holdings (up 5 rupees to 90 rupees) and Distilleries (up 60 cents to 17.50 rupees) contributed to the benchmark index gain.

Net foreign selling was 30.4 million rupees, up marginally from selling of 30.2 million rupees the previous day.

Foreign selling in Kahawatte Plantations was 20 million rupees, according to Asia Securities. The stock closed 20 cents lower at 38 rupees.

There was on crossing, or off-market negotiated trade, in Melstacorp for 100 million rupees, accounting for 38 percent of market turnover. Melstacorp closed 50 cents higher at 50.50 rupees.

The Sri Lanka rupee continued to weaken closing at a new low of 170.65/80 rupees in a wide spot market quote against the US dollar Monday, market participants said.

The rupee traded at an intraday low of 170.70 rupees against the greenback during the day.

The currency closed at 170.35/55 rupees last Friday.

Sri Lanka's currency depreciation is largely due to inconsistent central bank policy, analysts said.

Overnight money market liquidity was short by 10 billion rupees on Monday, down by 3.58 billion rupees on Friday.

The central bank injected 24.025 billion rupees via term and overnight repos including banks borrowing from its overnight window.

Gilt yields edged higher amidst thin trades in the secondary market.

A three-year bond maturing in 2021 ended at 10.85/95 percent in two-way quotes, up from the previous closing of 10.75/85 percent.

A five-year bond maturing in 2023 closed at 11.00/15 percent, up from 11.00/08 percent the previous close. (EconomyNext)

Sri Lanka July exports up 5.7-pct, tea, garments down

Sri lanka's earnings from merchandise exports surpassed a billion US dollars for the second consecutive month in July 2018, rising 5.7 per cent to 1,073 million US dollars from a year ago, the central bank said.

Expenditure on merchandise imports increased by 10.3 per cent to 1,754 million US dollars in July 2018 over the same period, a statement said.

The trade gap in July 2018 rose to 681 million dollars from 576 million dollars the previous year owing to higher imports.

"On a cumulative basis, the deficit in the trade account widened considerably during the first seven months of 2018in comparison to the corresponding period of 2017," the central bank said.

The trade balance in the January – July 2018 period rose to 6.4 billion dollars from 5.3 billion dollars the year before.

Earnings from industrial exports contributed to increased export earnings while agricultural and mineral exports recorded poor performance during the month, the statement said.
"Under industrial exports, earnings from export of petroleum products increased significantly due to higher export prices of bunker and aviation fuel despite reduction in volumes."

However, export earnings from textiles and garments declined marginally in July 2018.

This was due to the decline in demand from the USA and non-traditional markets such as Canada, UAE and Australia and the base effect which reflected significantly high export earnings in July 2017.

Earnings from agricultural exports reduced due to poor performance in almost all categories except vegetables and minor agricultural exports.

"While export earnings from tea declined due to the drop in both prices and volumes exported, earnings from coconut declined owing to the reduction in all kernel categories as a result of lower export volumes despite higher prices reported for these products," the central bank said.

Import spending rose because of the increased expenditure in all major import categories, as well as the effect of the low base in 2017.

Spending on fuel imports increased significantly during the month owing to higher import prices of crude oil and refined petroleum products.

Expenditure on textiles and textile articles imports increased in July 2018 due to higher expenses on yarn and fabric imports.

“Consumer goods imports increased mainly due to higher imports of personal motor vehicles, particularly cars with less than 1,000 cylinder capacity, hybrid and electric motor cars,” the statement said.

To curb imports of small vehicles, taxes applicable on these categories were revised upward with effect from 01st August 2018 and a 100 per cent margin deposit requirement against letters of credit on non-commercial vehicle imports was imposed with effect from 19th September 2018.

Expenditure on food and beverages declined in July 2018 as a result of lower rice imports owing to the healthy harvest obtained during the Maha season. (EconomyNext)

Sri Lanka minister breaks with Erdogan, Trump over rates

A minister in Sri Lanka has taken a radically opposite approach from Turkish President Recep Erdogan and President Donald Trump by urging a central bank not to give weapons to undermine a national currency by printing money at low rates.

Sri Lanka's central bank had intervened heavily to protect its unstable peg with the US dollar in September, after allowing excess liquidity to build up in the weeks before, including with some swaps of the style that are used by speculators to attack pegged exchange rates.

When a central bank intervenes in forex markets, unlike the Treasury or any other entity, a liquidity shortage is created as rupees disappear in to the monetary authority, which tends to tighten the credit system and contract base money (unsterilized intervention) automatically protecting the peg.

Printing Press

But because the soft-pegged central bank has a policy rate or interest rate target, it will ten print large volumes of money (to sterilize or fill the intervention) in a bid to keep rates down, giving more ammunition for speculators to hit the currency and take away forex reserves.

Money is printed through overnight auctions of cash, term auctions, outright purchases of securities, non-transparently purchasing Treasury bills at auctions, at rates unknown to the public or through forex swaps.

When rates are raised, the volume of new money needed to be injected falls ((sterilization is reduced), as banks also restrict credit or raises new deposits both of which tends to reduce imports and consumption.

"In fact I have always argued for CBSL (central bank of Sri Lanka) to let rates rise in such situations and not sterilize interventions," Harsha de Silva, State Minister of National Policies

and Economic Affairs, wrote in a facebook.com post, responding to question by a follower, which referred to a story on EconomyNext.

When interest rates are closer to market, the sterilization is progressively less than 100 percent, as credit systems adjust faster.

Over the longer term when central banks follow consistent policy (either pure float or fixed peg) nominal interest rates plunge and economies take off.

China is the most obvious case in recent decades.

Those that don't end up with both high interest rates and currency collapses, a situation which EN's economy analyst Bellwether calls 'rawulath ne kendath ne."

Quick rises in market rates are followed by a fast return to normal.

Last week the central bank bought Treasury bills for up to three months, at a little over the overnight 8.50 percent ceiling policy rate giving subsidized printed money to speculate against the rupee, when banks were raising money from depositors at around 11 percent.

However after weeks of excess liquidity which sent the rupee sliding, the central bank kept overnight markets short for more than a week, which also helped, while the rate at which new money was printed overnight was raised up to 8.19 percent after keeping it down to 7.95 percent up to the third week of September. Most of the liquidity shortage is sterilized short term by term repo injections, which also helps.

The higher bank deposit rates mean that the credit system is tightening and pressure on the rupee is reducing, despite central bank attempts to stop the correction by printing more money.

Though money is still printed below that rate, overnight market rates are also now close to the 8.50 policy ceiling. Prolonged liquidity shortages, however can have a shock on output, unless a float re-stablishes credibility of the peg quickly after the system has tightened.

Confusion

But last Monday the central bank said bought dollars, just as exporters began to sell, signaling that it was happy at the exchange rate of around 170 to the US dollar.

Central Bank Governor Indrajit Coomaraswamy expressed satisfaction that a Real Effective Exchange Rate Index, which had risen to 104 was now back near 100 after the latest collapse further, confusing exporters who were beginning to sell at a little over 169 thinking the rupee had overshot.

If the central bank was so happy with the rupee at 170 to the US dollar or weaker, it is not clear why the Treasury was pushed to slam trade controls, leaving the administration's entire trade agenda in tatters and advocates of free trade with egg on their faces.

Analysts had warned that the central bank and its contradictory monetary and exchagne rate policy was a threat to free trade (Sri Lanka central bank has to be restrained for free trade to succeed: Bellwether).

Economic analysts have said that Sri Lanka's 8.50 percent policy rate which is three times that of the US is enough to keep a peg, if the central bank does not switch from pegs to floating regimes suddenly, maintains consistent policy and does not print money in unorthodox ways at the drop of a hat to expand base money.

Last Friday 5.4 billion rupees of overnight money was auctioned at 8.25 percent where the maximum, minimum and weighted average yield were the same raising questions whether it was a coincidence or a result of deliberate action.

Soros Swaps

De Silva, an economist, was also a former Head of Treasury of a Colombo-based bank, and is familiar with money, bond and forex markets.

But now as a State Minister in the ministry that was overseeing the monetary authority, he appeared to be struggling to protect credibility of agency, while pushing it to adopt prudent, consistent policy.

"And yes, I agree with the EconomyNext piece that CBSL providing cash advances to Treasury against dollars is not helping the situation," de Silva wrote.

"While crediting the CBSL with managing the current situation well this is one area I am not in agreement with them."

The central bank had been a counterparty (with the Treasury) to the type of forex swaps that offshore speculators had used to break East Asia central bank pegs in their latest attempt to print new money and bring rates down just as the economy was recovering.

It is not clear who advised the Treasury and central bank to enter into Soros-style swaps, but such deadly practices have to be nipped in the bud, long term watchers of the central bank say.

The forex swaps had since been reversed. The Bank of Thailand had entered into longer term swaps. The forward legs were eventually paid off during an IMF program. Central bank forex swaps have been halted under the current IMF deal with Sri Lanka and it is not clear why there were revived.

Sri Lanka's central bank, which is under an IMF program also paid off a 379 million dollar swap originally entered in 2013 in September, which led to severe liquidity shortages and forex reserve losses last month.

In 2017, many such deals had been unwound, when the peg was on the 'strong side' with steady permanent mopping up of inflows by selling down securities held by the central bank.

While selling securities out of the balance sheet of the central bank (or unwinding swaps without causing large shocks which require sterilization) helps squeeze outflows, buying securities into its balance sheet, or initiating swaps, injecting new money (loanable rupee reserves) into the banking system makes dollar outflows exceed inflows.

George Soros, the-man-who failed-to-break the Hong Kong currency board, lost money when swap rates jumped in the territory during the East Asian crisis, whose monetary authority does not sterilize interventions and interest rates float. The peg did not break, unlike in Thailand.

The Hong Kong's hard peg at 7.8 to the US dollar had not moved since 1983, when it was created. Sri Lanka had become a lagging nation since a hard peg was abolished in 1950 to create a money printing, soft-pegged central bank.

Analysts say China's speculative pressure and volatility including in economic output had increased after the firm peg was broken in 2005 under US pressure.

"…[U]nder pressure from the United States and on the advice of the International Monetary Fund (IMF), China dumped its embrace of exchange-rate fixity and adopted a flexible exchange-rate arrangement," economist Steve Hanke wrote in a column on two months ago in Forbes.com (President Xi's Nightmare)

"We anticipated that instability would accompany the introduction of exchange-rate flexibility. Never mind, the U.S. and IMF ruled the day."

"Their thinking was that, if flexibility was introduced, China would be forced to adopt an ever-appreciating renminbi policy.

"Well, contrary to what Washington wished for, the renminbi has been up, down, and sideways in the era of flexibility."

'Exchange rate flexibility' is an amorphous term where no consistent policy can be found backing it.

Central Bank Independence

De Silva was critic of the central bank before 2015. His criticism helped it do tighter policy, and also helped create wide public understanding about the danger of buying Treasury bills and creating new money to manipulate rates.

The current administration had promised central bank independence, but there is no accountability.

While ordinary people are have their salaries and savings destroyed and foreign investors run amid when currrencies collapse in one direction, central bankers get inflation protected salaries and pensions.

Turkey's Erdogan threatened the Turkish central bank which had also erred in generating double digit inflation, when it was hiking rates to protect a plunging lira. In September the central bank raised rates from 17.75 percent to 24 percent despite criticism from the President Erdogam.

"Here you go, have your independence. We will see the results of the independence," he was quoted as saying later.

President Donald Trump had also criticized the Fed for raising rates.

De Silva has also been pushing central bank independence, though a REER peg, involves importing the monetary policy of the worst central banks in the region and generating instability like the current situation, is directly undermining his own plans to build a financial centre in the island.

Politicians like de Silva however are accountable and will get their reward at the elections from an angry public who are struggling to feed their families as sugar, milk, tea, fuel, gas, go up in price.

But some of the best performing pegged central banks in the region were run by politicians with monetary knowledge, including in Singapore (Finance Minister Goh Keng Swee), and China (Vice Premier Zhu Rongji), who were in favour of sound money and used monetary policy for domestic stability and not for Mercantilist subsidies for industrialists at the expense of the working class.

After China fixed the peg in 1993, nominal interest rates collapsed.

Ironically, China came under fire from US Mercantilists for 'undervaluing' it currency when it stopped depreciating from 1993, though the US Treasury has never officially named it as having done so.

Policy Errors

Analysts had identified failed term repo auctions in the first quarter of 2018 in Sri Lanka - which may have happened due to the unwillingness of the central bank to pay market rates - as a contributory factor to the weakening of the peg in the first run as well as outright injections in April.

An unsterilized liquidity spike in August including Soros-style swaps led to the current run and the undermining of the administration's entire free trade agenda.

Critics say laws should be brought to limit the unorthodox avenues the central bank has to inject money including outlawing Soros swaps because it may become as big a source of instability to the country as is the direct non-transparent purchases of Treasury bills, where weekly auctions and the entire credit system is undermined by expanding base money.

Laws should also be brought to prohibit the central bank from purchasing bills at outright auctions below the Sri Lanka Interbank Offered Rate for the particular tenor, so that exiting bond

holders and other market participants do not get subsidized printed money to hit the currency and un-necessarily prolong speculative runs.

Reserve Bank of India has just announced 360 billion rupees of bond purchases to sterilize interventions made as the Indian rupee tanked, showing that it is also not free floating and is subject to contradictory policy.

Bond yields fell after announcement and the rupee fell further. India's policy errors however may provide temporary relief via imported food prices in Sri Lanka.

In Sri Lanka since the March/April policy debacle, bond holders have also exited steadily. In any case, it is now clear that under a REER peg, the rupee is a one way bet and not a 'flexible exchange rate', analysts say. (EconomyNext)

Scrapping trade barriers could double Sri Lankan exports to South Asia

Sri Lanka has the potential to more than double its exports to South Asia to $2.8 billion from $1.2 billion by overcoming trade barriers, a new World Bank report has said.

“Increased intraregional trade will provide a greater variety of goods and services at cheaper prices for Sri Lankan consumers, better access to inputs for producers and exporters, increased investment, export diversification and growth,” a statement said.

While South Asia is the world’s most rapidly growing region, it is also the world’s least integrated.

Man-made trade barriers have hampered intraregional connectivity and kept South Asian countries from maximizing their prospects, the World Bank said.

Trade within South Asia accounts for only 5 percent of the region’s total trade, compared for 50 percent in East Asia and the Pacific.

Sri Lanka’s exports to South Asia are equivalent to only 11 percent of its global exports.

The report, ‘A Glass Half Full: The Promise of Regional Trade in South Asia’, launched Monday, highlights four critical obstacles to regional trade - border tax distortions, nontariff barriers, connectivity costs, and trust deficits - and offers options for policymakers to address them.

The report helps to quantify commonly known benefits associated with a more integrated South

Asia, saying the $1.6 billion gap between the actual and potential value of Sri Lanka's exports to South Asia is equivalent to 15 percent of Sri Lanka's total global exports.

"Closing the gap will not only enhance but also help diversify Sri Lanka's trade," it said.

"There is evidence that Sri Lanka will benefit financially and improve its services sector and human resources if it removed trade barriers and invested in better connectivity," says Idah Pswarayi-Riddihough, World Bank Country Director for Sri Lanka and the Maldives.

In addition to tariffs, para tariffs such as port and airport development levy and cess create an anti-export bias.

"Para tariffs more than double the average import tariff in Sri Lanka," the report said.

Additionally, 44 percent of Sri Lanka's imports are not provided concessional treatment under the South Asia Free Trade Agreement (SAFTA).

About 23 percent of its exports to South Asia suffer from the same non-concessional treatment. Non-tariff measures further increase the cost of imports. (EconomyNext)

IMF cuts global growth forecast to 3.7-pct for 2018, 2019 as risks rise

An upswing in economic risks due to rising trade tensions and debt levels has prompted the International Monetary Fund to cut its forecast for world growth for this year and next.

With trade growth set to slow sharply amid a trade war between the United States and China, the IMF cut its outlook for global GDP by two-tenths to 3.7 percent for 2018 and 2019, according to the quarterly World Economic Outlook Report issued Monday.

The revised estimates includes a worsening outlook for developing economies this year and next compared to the July report, as well as downgrades for the US and China in 2019.

The IMF warns that risks highlighted in previous reports "have become more pronounced or have partially materialized" in the real world.

The dominant US economy has been shielded from the ill effects so far due to the stimulus provided through tax cuts and spending policies but that will wear off by 2020.

Still, the trade disputes sparked by President Donald Trump that have led to tit-for-tat exchanges of tariffs among major trading partners are affecting China, other Asian economies and more vulnerable countries like Argentina and Turkey, along with Brazil.

Growth estimates for the euro area and Britain also was revised down.

The report warned that growth "may have peaked in some major economies."

- Rising protectionism -

"Downside risks to global growth have risen in the past six months and the potential for upside surprises has receded," the IMF said.

Rising trade tensions are a key challenge to the world economy as "protectionist rhetoric increasingly turned into action."

That includes President Donald Trump's imposition of tariffs on $250 billion in Chinese goods, as well as on aluminum, steel and other products worldwide.

The IMF warned the uncertainty caused by the trade disputes "could lead firms to postpone or forgo capital spending and hence slow down growth in investment and demand."

And if it continues, the "escalation of trade tensions to an intensity that carries systemic risk is a distinct possibility without policy cooperation."

Global trade is projected to expand by 4.2 percent this year, six tenths less than expected in July and nearly a full point lower than the forecast in April. For next year, trade is seen growing just four percent, a half point less than the prior forecast.

The IMF outlook already projects global growth will slow to 3.6 percent during 2022 - 2023.

However, the IMF cautions that it has a "poor track record of predicting recessions."

The fund urged governments to focus on policies that can share the benefits of growth more widely, helping counter the growing mistrust of institutions, and to avoid "protectionist reactions to structural change."

And it stressed "cooperative solutions" to help boost continued growth in trade "remain essential to preserve and extend the global expansion."

- US, China face challenges -

The IMF forecasts US GDP growth this year of 2.9 percent, slowing to 2.5 percent in 2019 -- which is 0.2 points slower than the July estimate -- and to 1.8 percent in 2020.

But the US tax cuts and rising spending that have boosted growth, helping compensate for the

impact of the growing trade conflict, could spark a sudden "inflation surprise," and in turn lead to faster-than-expected rise in US interest rates, according to the fund.

Already the Federal Reserve interest rates hikes are increasing pressure on emerging market economies by fueling an outflow of capital as investors seek higher returns, while increasing borrowing costs at the same time.

US stimulus also adds to the "already-unsustainable" debt and deficit that will undercut future growth, the report warns.

Medium term growth could drop below 1.4 percent.

The trade confrontation weighs on China in particular, where growth is projected to slow to 6.6 percent this year and 6.2 percent in 2019, a downgrade of 0.2 points.

However, stimulus measures by Beijing are likely to soften the impact of the tariffs.

Further out, China's economy is expected to slow gradually to 5.6 percent as the government shifts to "a more sustainable growth path" and addresses financial risks, the IMF said. (AFP)

China's Central Bank to cut reserve requirement ratio for fourth time

China's central bank announced Sunday it would reduce the reserve requirement ratio (RRR) for most banks by one percentage point, the fourth time this year the country has sought to free up credit for businesses as they face down $250 billion in US tariffs.

The move to cut the amount of cash which most commercial and foreign banks must hold in reserve, to repay loans obtained via the central bank's medium-term lending facility, will take effect on October 15.

The decision is intended to "further encourage the stable development of the real economy, optimise the liquidity structure of commercial banks and financial markets, lower financing costs, and to continue increasing the financial systems' efforts to support small businesses, private enterprise and innovation," the People's Bank of China said in a statement.

The move will be used to pay down 450 billion yuan ($65.6 billion) of medium-term lending facilities, it said, adding that it could also free up another 750 billion yuan in funds.

The move is not expected to put depreciatory pressure on the yuan, the statement said, adding that the bank would continue to maintain a "prudent and neutral" monetary policy.

It is the fourth such move this year, as China seeks to blunt the economic impact US President Donald Trump's imposition of $250 billion dollars of Chinese goods, roughly half of country's exports to the US.(AFP)