NEWS ROUND UP

Tuesday, 26thMarch, 2019

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Sri Lanka rupee closes weaker, stocks fall

Sri Lanka's rupee closed slightly weaker at 10.15/25 to the US dollar in the spot market after opening at 178.10/15 to the US dollar Monday morning, while bond yields were stable and stocks fell 0.19 percent, brokers and dealers said.

The rupee closed at 178.00/15 to the US dollar in the spot market on Friday.

At the Colombo Stock Exchange, the All Share Price Index closed 10.38 points lower at 5,529.67, continuing a retreat seen since last Tuesday.

All Share reached an intra-day high of 5,543 in the morning session, before turning volatile and falling towards the latter part of the day.

The more liquid S&P SL20 Index closed 7.34 points lower at 2,717.60.

Market turnover was 268.5 million rupees.

There was high foreign participation with a net outflow of 53.9 million rupees from the market,

The All Share was weighed down by Asiri Hospital Holdings which closed 1.40 rupees lower at 20.10 rupees per share, Cargills (Ceylon) which closed 4.50 rupees lower at 195.50 rupees and Sri Lanka Telecom which ended trading 60 cents lower at 22.10 rupees per share.

John Keells Holdings was the most traded, generating a turnover of 74 million rupees, and closing 50 cents lower at 150 rupees per share.

Dealers said the bond market was dull on Monday with limited trading, while yields were mostly stable, with upward pressure on some maturities.

The Central Bank's decision to move a Treasury Bond auction a week earlier to April 2 has seen slight selling interest, dealers said.

Twelve month bills closed at 10.35/45 percent on Monday, unchanged from Friday.

A bond maturing on 01.08.2021 closed at 10.65/75 percent, slightly higher than 10.63/66 percent.

A bond maturing on 15.07.2023 closed at 10.85/95 percent, easing from 10.87/95 percent.

A 5-year bond maturing on 15.03.2024 closed at 11.00/05 percent on Monday, stable from Friday's close of 11.00/03 percent.

A bond maturing on 01.08.2026 closed at 11.10/20 percent, up from the previous close of 11.05/12 percent.

A bond maturing on 15.06.2027 closed 11.25/35 percent, up from 11.20/30 percent.

A bond maturing on 01.09.2028 closed at 11.30/40 percent, stable from the previous 11.30/50 percent.

A bond maturing on 01.05.2029 closed at 11.40/45 percent, unchanged from Friday. (EconomyNext)

Sri Lanka imposes power cuts after failing to build thermal plant

Sri Lanka has started cutting power after failing to award a contract to build a 300 MegaWatt power plant for over three years amid corruption allegations and also cancelling coal plant that was about to be built, making a reality of warnings given by analysts, engineers at the state-run power utility and industry analysts.

State-run Ceylon Electricity Board said up to four hours of power cuts will be imposed on consumers in all parts of the island with one hour in the day time and the rest in the day time. (link to load shedding times)

Three years ago CEB's engineers union, industry analysts and the power regulator had warned that power cuts were likely in 2018 as the government failed to award a 300 MW thermal power plant to a private firm which was to tide over the country until the coal plant came on line.

But there were no power cuts in 2018 amid better rainfall and slower demand growth.

"We can expect a government announcement by 2018, when indications of the crisis become apparent - typically (during the hot months from) February to April," power sector analysts Tilka Siyambalapitiya said in 2016 shortly after President Maithripala Sirisena cancelled a coal power plant which was about to be built. (Sri Lanka faces power shortage with coal plant delay)

"The government will say ‘we will pay the bill for diesel and customers would not be burdened’. There will be load shedding (power cuts)."

The government also failed to award a stop gap 300 MegaWatt thermal plant for around three years amid allegations of corruption.

CEB's engineers union had also warned that the scrapping of the coal plant will push up power costs and if the tariffs are not raised taxes charged from other goods will be used to cover losses in power.

"If the CEB makes losses, the costs will eventually have to be recovered from the public with taxes on food or value added tax," then CEB engineers union chief Athula Wanniarachchi said. (Sri Lanka consumers warned on impending 'electric shock' after coal plant scrapping).

In 2018 the CEB lost 25 billion rupees and losses could worsen in 2019.

The Public Utilities Commission of Sri Lanka has also given similar warnings.

“PUCSL envisages an energy shortage in years 2018/ 2019 unless the plants identified in the approved plan relevant to the period are implemented on time, the regulator said in 2016. (Sri Lanka regulator stresses urgency of new power plants to ward off shortage.)

“The real challenge is to get these plants implemented," PUCSL director general Damitha Director General Damitha Kumarasinghe told a news conference in 2016.

"We have only one and a half to two years. We’re looking at very quick implementation."

There was also a tug-o-war between the regulator and the CEB after amid allegations that data in a power plan was mis-represented to show that long term costs of coal was higher than liquefied natural gas.

In Sri Lanka power supply is a state monopoly and the people themselves cannot set up a power plant and even sell to a neighbor, which generates shortages.

Power cuts are commonplace all over South Asia except in Mumbai, India where electricity is provided by Tata, a private firm, which escaped expropriation by then Prime Minister Nehru. (EconomyNext)

Sri Lanka bondscam suspects remanded

Suspects in Sri Lanka's largest securities scam who were arrested Monday were remanded till April 05 by a magistrate.

Sri Lanka's police arrested Retired Deputy Governor Pathinige Samarasiri, and directors of Perpetual Treasuries Chithra Ranjan Hulugalle, P Gunewardene, Muthuraja Surendranwere and Chairman Geoffrey Aloysius arrested by the criminal investigation department.

Perpetual Treasuries was involved in securities scams involving bidding at rigged bond auctions, where larger than announced volumes were sold when Arjuna Mahendran, the father of Perpetual Treasuries chief Arjun Aloysius was the governor of the Central Bank.

Deputy Governor Samarasiri was in charge of debt sales in 2015 and 2016 when the scams took place.
Perpetual Treasuries then dumped the bonds taken at low prices (high interest rates) on the Employees Provident Fund, which was also managed by the central bank at high prices (low interest).

The EPF itself had stayed out of key rigged auctions, the auditor general said. (EconomyNext)

Sri Lanka goes from boom-bust to bust-bust with soft-peg

Sri Lanka is going from boom-bust to bust-bust in this credit cycle despite the injection of excess demand into the economy by the central bank, with currency depreciation and capital outflows taking their toll and a Weimar Republic style default looming due to the soft-peg.

Sri Lanka has had boom-bust cycles in the past primarily due to the Central Bank's failure to allow rates to rise as credit demand picked up in the recovery period. The Federal Reserve, however, is raising rates as the economy is picking up.

But the Fed has a floating rate and does not intervene in forex markets and print large volumes of money (like quantity easing) even if it did cut rates because the US has a floating exchange rate with no convertibility undertakings, explicit or otherwise. As credit recovered, the Fed in fact has been reducing excess liquidity created during quantity easing after credit collapsed.

Booms

Sri Lanka's budgets have been blamed for generating boom-bust cycles by the Central Bank. It has accepted no culpability. But Boom-bust is an inherent side effect of all credit cycles. This belief that budgets are a source of excess demand is a dangerous misconception. A budget cannot infuse a lot of excess demand unless the credit system is contracting and the excess liquidity it uses comes from a private credit contraction.

A budget will simply transfer spending power from buyers of bonds to the Treasury. If at all, state spending, which may involve putting other people's money in low return projects, will reduce long term growth.

The Central Bank has to avoid firing any recovery with new money to make the boom worse with pro-cyclical policy (through open market operations or purchases of Treasury bills at auctions) and allow market rates to take care of the problem and minimise its effects.

Having said that, there is evidence that some Central Banks have been able to reduce the boom quickly (Canada, Australia, New Zealand) as the Fed is trying to do now. The secret may be a good consumer (headline) inflation index that does not hide inflation.

Even in free banking days, there have been credit cycles around the world, though they were not as bad as the ones that came after the creation of the Federal Reserve.

However, there is no point in comparing the Fed to the Central Bank; they operate regimes which are polar opposites.

Sri Lanka is operating a soft-peg with explicit and implicit convertibility undertakings. In such a regime, any money created from domestic asset purchases, which has no foreign assets to back it, and make good the CU (convertibility undertaking) is printed money.

Last year, the Central Bank loosened policy and injected cash into money markets just as the economy was recovering.

"Sri Lanka is at the bottom, and was just starting to recover from 2016 bust when the depreciation hit again," this column said last year in Sri Lanka and Ecuador; a cautionary tale of the Rupee and Sucre.

"It is one thing to have a boom-bust. It is quite another to have a bust-bust."

"If the Vietnam Dong collapses in the next year, despite rocketing exports, their people would have got many benefits during the decade-long boom."

Bust-bust

In 2018, as the rupee came under pressure from excess liquidity, and credibility in whatever convertibility undertakings was lost, the recovery stalled and growth slowed.

In the 2011/2012 balance of payments crisis, there was strong growth as money was injected through terminated term repo deals (a bit like Central Bank of Argentina creating a secondary market for its own sterilisation securities to generate the latest Peso collapse).

The Yellow GDP growth went up sharply with the printed money growth (net credit to govt).

Growth was strong for two reasons. One was that the currency peg was kept until 2012, preserving the real value of the current for people to invest or consume most of the printed money.

The other reason for stronger growth was that foreign investors in bonds such as Templeton did not sell.

Foreign bond holders held back because the rupee was allowed to appreciate during the 'bust' period (credit contraction) that followed the liquidity injections in the 2008/2009 crisis.

However, after the rupee fell to 131 to the US dollar in the 2011/2012 crisis and it was not allowed to appreciate, foreign investors had second thoughts. Plus the UNF administration also got into some public spat with Templeton, which may have sent bad signals.

In both the 2015/2016 crisis and 2018 runs on the rupee, foreign investors sold out strongly. Using the printed money from open market operations banks then bought the bonds sold by foreign investors instead of giving credit, reducing the resources available for domestic players.

Currency depreciation also destroys real purchasing power. For example, it costs more to build a house as building material prices go up due to depreciation. Meanwhile potential buyers of houses or any other good will also find less money available as fuel or other costs go up.

Growth is now slow, around 3 percent. Sri Lanka's growth may look slow due to the changes made in the way it was calculated after 2015, when GDP was estimated to be bigger. But over time they should balance out (items like revenue to GDP will be lower).

If the Census Department consistently undercounted GDP, eventually total GDP will be low and GDP growth will show the 'correct' number because the same assumptions or errors will be made consistently.

However, bust-busts have many other implications. If not for the halting of mopping up auctions in February and rate cuts and cash injections in April, Sri Lanka would be on a strong recovery cycle, backed by the end of the drought.

However it was not to be, due to capital outflows and the currency collapse. But a more deadly result of a bust-bust cycle is that killing domestic demand with currency depreciation leads to business failures, resulting in bad loans. That is also why this columnist advocated open market operations or unsterilised defence to generate a liquidity short, hiking rates, and quickly floating to re-establish confidence in the peg.

Prolonged liquidity shortages have severe consequences. This is another problem with soft-pegs. Hard pegs, which have credibility, rarely have such problems.

While Hong Kong's peg was hit by speculators in the 1997 crisis, the confirmation of its credibility resulted in excess liquidity during the 2008 global crisis, as resident firms and banks brought funds back home.

Sri Lanka's rupee peg is non-credible. A REER target is going out of its way to undermine its credibility. Therefore it is better to hike rates, allow the liquidity shortage to spread through the banking system and then float, and 'get it over' as the saying goes each time a monetary policy error is made.

Multiple Runs

In February 2018, there were strong signs that the second run on the central bank had ended and the rupee was stabilising.

However, emerging data showed that even in January, the Central Bank had bought dollars. It is a mistake to buy dollars too soon. The rupee should have been allowed to appreciate like in India.

The marginal cut in the money printing auction from 9.0 percent to 8.75 percent in recent days is also extremely premature. It is premature because 2019 has a lot of debt repayments. For the same reason, the rupee should be allowed to float cleanly and appreciate before the Central Bank purchases dollars.

In 2018, the Central Bank generated the second run after the rupee stabilised in August.

Weak private credit allows the credit system to stabilise faster than in earlier crises, when business confidence was stronger and the rupee had been stable for longer periods before that, preserving purchasing power.

What is happening now is that borrowers are getting more acclimatised to higher rates. To fix the next run, even higher rates may be required.

Data seems to show that liquidity shortages are developing again in February, which is not a good sign.

Debt Repayment

What is happening to Pakistan should be a warning. It is a wrong strategy to repay foreign loans purely with new borrowings with a depreciating currency.

Sri Lanka's rating is at now at 'B', which is too close to 'CCC' for comfort. Going for large borrowings at one go will spook investors. It is better to go for usual volumes and go to markets a second time, even at a higher rate, after investors get comfortable.

Ever since the last regime ended privatisation, then re-nationalised agencies like SriLankan, expropriated others, bought back Litro Gas and generally had an unfriendly attitude towards free enterprises, and the backing of crony businesses with protectionism, this country had been going down the low growth-default path.

The infrastructure drive with Chinese loans would have made sense if more private investors were allowed to come in. Even on expressways built with people's money, private buses were not allowed.

A Fool's Paradise

The REER pegging depreciation will also contribute to debt default pressure. It is a completely wrong claim made by the Central Bank and other official commentators that depreciation brings more revenues to the state.

Depreciation expands the budget. It is simply not shown as an expense despite depreciation being a cash flow rupee item. Why it is not done is not clear.

During the British period, when Sri Lanka had currency board, depreciation was not a factor.

Even after the Central Bank was created and money was printed, the exchange rate was maintained with trade and exchange controls. It may have contributed to the way budget numbers are calculated. The IMF, which also tends to depreciate soft-pegs to re-establish credibility, would prefer not to take into account depreciation.

A similar strategy is followed with the so-called Primary Deficit. It is a target that keeps policy rate hikes off the table. It may make sense since policy rate hikes are needed to fix problems. But like depreciation, the interest cost is there.

There is no path to prosperity through depreciation.

Monetary Stability

The first priority in debt repayment is to re-establish confidence in the peg.

Borrowing more dollars to repay debt is not the only answer. It is also a mistaken idea to think that there is some shortage of 'foreign currency'.

There is no shortage of foreign currency to repay debt if the Central Bank maintains monetary stability and mops up a part of the inflows and avoid debacles like in April and August.

Such a strategy requires a slightly higher interest rate than the market clearing rate (the currency board rate say) that allows the domestic banking sector to lend all the money it raises as deposits or loan repayments.

A sale of sterilisation securities into the banking sector at the required domestic interest rate will generate 'forex savings' by keeping imports and the so-called current account below full potential.

It is not possible to shrink the entire external current account to repay all the foreign debt in one go and convert them to rupee debt. It may generate negative growth. But it can be done to some extent. Sri Lanka has been doing it for decades.

After all, in the old days the IMF loan was given for just that reason. IMF loans would re-build reserves and give immediate confidence, allowing reserves to re-built slowly without shrinking the current account too much.

But the IMF programs have, in recent years, institutionalised the contradictory policy of soft-pegs with an inflation target coupled with a forex target.

This column said at one time before the 2015 liquidity injections that Sri Lanka cannot afford to take monetary risks with commercial foreign debt. It is even more so now. Trigger-happy domestic operations are even more dangerous with a B credit rating.

It is perfectly acceptable to have another quarter of low growth if the result is to push the peg to the strong side of the convertibility undertaking. Borrowing abroad will not help, if the Central Bank's Domestic Operations Department keeps injecting new money for whatever reason, belief, ideology, or theory.

There have been some claims made that budget deficit injects excess demand. The Treasury cannot print money. It can only transfer purchasing power from purchases of bond holders to itself. Excess demand comes if the Central Bank accommodates the deficit with printed money.

No Fiscal Dominance

2018 proved beyond doubt that political pressure was not the reason for monetary instability. State Minister for Finance Eran Wickremaratne publicly said the Central Bank was independent.

Finance Minister Mangala Samaraweera slapped import controls despite getting egg on his face and undermining the entire free trade strategy of the administration just to contain the negative effects of monetary instability.

And Sri Lanka had the extraordinary spectacle of Harsha de Silva, the State Minister of the ministry to which the Central Bank is assigned, pleading to allow rates to go up to the 8.5 percent policy ceiling.

Subsequently policy rates were raised to 9.0 percent.

It is not clear whether any politician of a developing country had ever urged a Central Bank to tighten instead of loosening.

Having said that, 2019 is an election year. So the budget will not be helpful. It is imperative that monetary stability is restored soon as possible and rates match the deficit.

More Chinese loans are not the answer to foreign debt repayment. The Dawes plan did not help the Weimar Republic.

Neither will new Chinese loans help Sri Lanka or Pakistan. China itself will learn the mistakes of those who had to engage in gunboat diplomacy. It seems that the People's Bank of China and China itself is having higher interest rates after the strong peg was broken.

Let's face facts. Keynes was wrong. Bertil Ohlin was right. Later on, Robert Mundell was right. Marcus Fleming was right.

There is no transfer problem. Economic Consequences of Peace may have been a runaway success with English readers, buts its core argument was flawed. Similar arguments are repeated in Sri Lanka. Foreign debt repayment will slow domestic economic activity, but export surpluses are not a requirement.

Bretton Woods collapsed with the Fed's own peg collapsing. So did the sterling. Little wonder that the rupee collapses.

But a mountain of debt denominated in a stronger currency was not a problem for the US. But it was a problem for the Weimar Republic. And it is a problem for Sri Lanka and also fore regional soft-pegs like Pakistan which is having problems now.(EconomyNext)

Growth fears pressure world's stock markets

World stock markets were pressured Monday, with Asia taking the heaviest hit, as investors worried about signs of a sharp global economic slowdown.

Traders shrugged off news that an investigation found no evidence of collusion between US President Donald Trump's election campaign and Russia.

The pound gave up earlier gains to trade lower against the euro and the dollar after Prime Minister Theresa May admitted Monday she still had not secured the votes needed to get her Brexit deal through parliament, again raising the prospect Britain could crash out of the European Union in two weeks' time.

Dealers have been spooked by growing evidence of a slowdown, after a broad-based rally since the start of the year that was built on hopes for China-US trade talks and a more dovish Federal Reserve.

"Concerns over the health of the global economy heat up at a rapid pace," said analyst Jameel Ahmad at traders FXTM.

In Europe key stock markets were lower at the close, with London the weakest performer.

Wall Street finished a choppy session little changed, with little impact from the conclusion of Special Counsel Robert Mueller's report which failed to tie Trump and his campaign to conspiring with Russia to influence the 2016 US presidential election.

"We have rarely if ever commented on the investigation as it has never been seen as a market moving event," said Art Hogan, chief market strategist at National.

"We do not see that changing with the release of the findings."

Apple declined 1.3 percent after product launches that included a game subscription service and a news service, in addition to a subscription streaming service to compete with Netflix, Amazon and other tech giants.

- Nikkei slumps -

Tokyo's main stock index was hammered 3.0 percent, while Hong Kong and Shanghai each dived two percent, as concerns festered also over a possible recession in the United States, dealers said.

US and European equities had tumbled Friday as the yield on 10-year Treasury bonds fell below those for three-month bills -- for the first time since before the global financial crisis.

This so-called inverted yield curve shows investors are more willing to buy long-term debt -- usually considered higher risk -- as they consider the short-term outlook more risky.

"This development will psychologically encourage further anxiety and rocket fears that the global economy is heading for another downturn, if recent economic releases across the globe have not already provided indications that the downturn has arrived," said analyst Ahmad.

The yield curve is closely watched since it has inverted prior to recessions in recent decades.

- Key figures around 2100 GMT -

New York - DOW: UP 0.1 percent at 25,516.83 (close)

New York - S&P 500: DOWN 0.1 percent at 2,798.36 (close)

New York - Nasdaq: DOWN 0.1 percent at 7,637.54 (close)

London - FTSE 100: DOWN 0.4 percent at 7,177.58 (close)

Frankfurt - DAX 30: DOWN 0.2 percent at 11,346.65 (close)

Paris - CAC 40: DOWN 0.2 percent at 5,260.64 (close)

EURO STOXX 50: DOWN 0.2 percent at 3,300.48 (close)

Tokyo - Nikkei 225: DOWN 3.0 percent at 20,977.11 (close)

Hong Kong - Hang Seng: DOWN 2.0 percent at 28,523.35 (close)

Shanghai - Composite: DOWN 2.0 percent at 3,043.03 (close)

Pound/dollar: DOWN at $1.3198 from $1.3209 at 2100 GMT on Friday

Euro/pound: UP at 85.71 pence from 85.59 pence

Euro/dollar: UP at $1.1313 at $1.1302

Dollar/yen: UP at 109.96 yen from 109.92 yen

Oil - Brent Crude: UP 18 cents at $67.21 per barrel

Oil - West Texas Intermediate: DOWN 22 cents at $58.82 per barrel. (AFP)