Parliament and Cabinet Needs Reliable Economic Analysis

A regular feature of Sri Lanka's public debates and writing on economic issues is that they are infused with factual inaccuracies or claims that are quite misleading. This reflects poor political and public understanding on the real state of the economy and undermines sound economic decision making in the country. This *Insight* shows how pronouncements on the cost of international borrowing have been subject to just this problem. The problem is aggravated by the fact that Sri Lanka's parliamentarians don't seem to have access to reliable economic analysis.

How to assess the cost of borrowing?

The cost of borrowing, through international bonds, has two components. (1) The global rate which is the international risk free rate, determined by global factors. The standard measure is the US treasury yields on bonds of the same duration in the prior week; (2) The country cost which is the country risk premium. That is the extra yield that Sri Lanka pays for being considered a risky borrower. This is determined by the confidence of lenders in the future economic outlook of the country. Together these two rates give the total borrowing cost (yield) of the bond.

In assessing the cost of borrowing, Sri Lankan policy makers cannot take credit or blame for the changes in the global rate, over which it has no control. The country cost, however - the additional interest rate paid above the risk free rate - is what Sri Lankan policy makers can influence and take credit for, if it is reducing.

Previous Insight on cost of international borrowing

In a previous *Insight* titled: *Sri Lanka's borrowing costs are not declining,* Verité Research pointed out that in July 2012 Central Bank had issued a public media release that was severely misleading: It claimed credit for the fact that Sri Lanka had achieved the lowest cost of borrowing on international 10 year bonds. But on closer analysis, that particular bond issue in fact had the highest country risk premium Sri Lanka had faced on 10 year international bonds (see Exhibit 1).

The Central Bank statement though misleading the public, was not falsifying information, because the total cost of borrowing had indeed fallen. That is because the global rate had declined so much that it offset the increase in Sri Lanka's country cost.

A review of the numbers (see Exhibit 1) showed that the country cost, which is what Sri Lanka can influence, was increasing, and it had increased by more than 120 basis points from the previous 10 year bond issue in 2011, which meant that Sri Lanka was being assessed much worse than before. But the Central Bank statement misrepresented it as Sri Lanka being assessed better than in the past; and suggested that the government deserved credit, while the numbers suggested it deserved the opposite.

This same type of misinformation is currently being played out in the reverse, and this time it is parliamentarians and not the Central Bank that are misrepresenting information.

The first international bond issue since January 2015

Sri Lanka issued its first international sovereign bond, under the new presidency of Maithripala Sirisena and the new premiership of Ranil Wickremasinghe, on the 28th of May. It was a 10 year bond for LKR 650 million, and had a yield of 6.125%.

The commentary on this issue by opposition politicians serves as a further example of how politicians could mislead themselves and the public, when they are not informed by reliable economic analysis.

This bond issue came into criticism in the media by several politicians. One such politician was a prominent MP of the previous government, who has held ministerial portfolios of Trade, and then Education. He has also been a prominent teacher for A-Level students in Economics, and held the portfolio of deputy minister of Finance over a decade ago. This MP stated that the yield of 6.125% was "excessively high and the highest since the end of war". He further reiterated that the previous government sold bonds to raise 1.5 billion USD at a yield of 5.125% in 2014.

The three lies of the bond price criticism

The above response by the prominent MP had three criticisms: One, that cost was increasing, two, that it was the highest ever since the end of the war, and three, that the total cost of borrowing had gone up by at least 100 basis points from 5.125% to 6.125%. The following analysis, with relevant numbers shown in Exhibit 1, shows that all three criticisms are incorrect.

Did the cost increase? Exhibit 1 shows that the country cost of the bond - Sri Lanka's risk premium - has in fact declined, not increased, since the previous 10 year bond issued in July 2012. The substantial decline of 41 basis points suggests an improved international outlook on Sri Lanka for the longer term. The total cost of the bond has increased, but this is driven by the increase in the global rate, which has been long expected, and is not in Sri Lanka's control.

Was it the highest ever since 2009? It was not. Exhibit 1 shows that both in 2010 and 2011 Sri Lanka issued 10 year international bonds at a yield of 6.25% which is 12.5 basis points above the current issue. To state that the current issue was at the highest rate since the end of the war is a factual mistake.

Has borrowing rates gone up by 100 basis points? This case is made by the MP by pointing to previous bonds issued at 5.125%. But the lowest ever that a 10 year bond has been issued at is 5.875%. So the increase in total cost since 2012 is only 25 basis points. The factual mistake is probably rooted in a misunderstanding. In the past, bonds with a 5 year maturity have been issued at this rate of 5.125% (see Exhibit 2), once in 2014 for 500 million USD (all previous issues of 5 year bonds were at much higher rates). Apart from the selectivity of the comparison, comparing the yield of 10 year bonds to the price of 5 year bonds shows a deep lack of economic understanding. It is akin to complaining that a 10 year old car didn't fetch the same price as a 5 year old car. Credit over a longer term is generally considered more risky than credit over a shorter period.

Parliament and cabinet need reliable economic analysis

Much of the country's economic debates are driven by the press and media statements of parliamentarians and senior government officials. Universities and academic economists in Sri Lanka provide only minimal commentary. On a plethora of issues ranging from the cost of living to cost to the cost of borrowing, the pronouncements of parliamentarians are quite often significantly at odds with facts and reliable analysis.

The fact that most parliamentarians in Sri Lanka have only a scanty knowledge of economic principles and concepts means that they can be easily misled. That government institutions such as the Central Bank have also been politicised over time and participate in providing misleading information, compounds the problem. Even government ministers are not able to exercise proper judgement on important issues in such a context.

These observations suggest that the lack of reliable information and analysis on economic issues is weakening the quality of economic debate and policies, and undermining economic decision making in Sri Lanka. A mechanism to provide parliamentarians and cabinet with independent and reliable economic analysis can be important for Sri Lanka's future.

Exhibit 1: Yield cost-breakdown of 10 year international Sri Lankan sovereign bonds

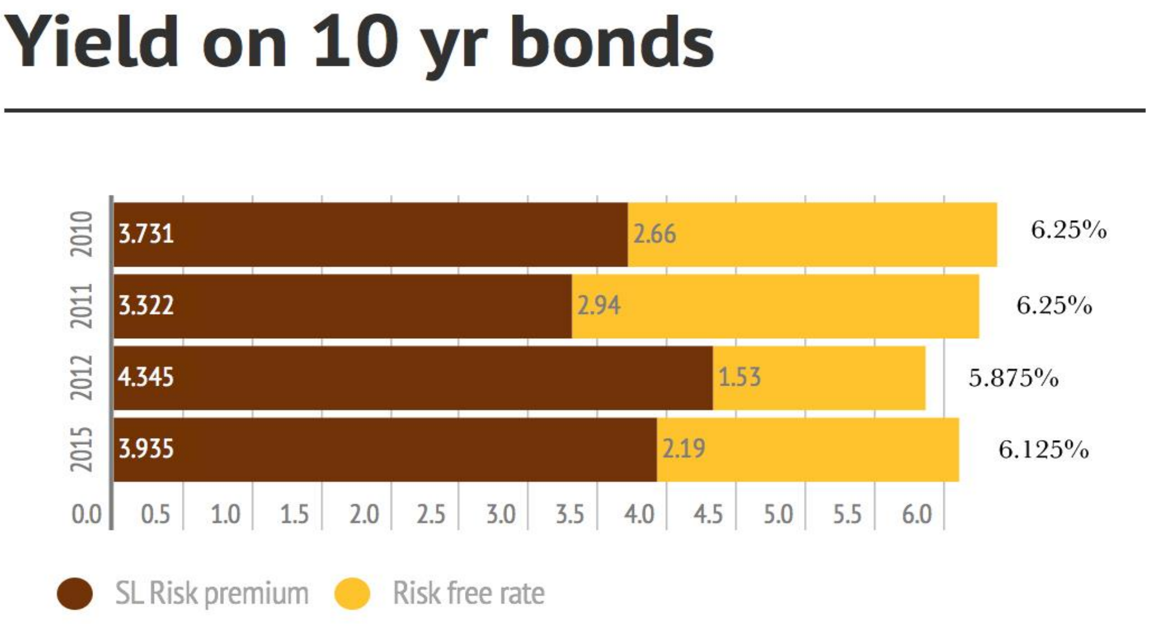

Exhibit 2: Details of international sovereign bonds issued by Sri Lanka

Year	Amount	GOSL, bond issue date	Yield (total interest paid)	UST Yields 1 week prior	Sri Lanka country risk premium
5 Year bonds					
2007	500 mm	17-Oct-07	8.25%	4.37	3.88
2009	500 mm	15-Oct-09	7.4%	2.26	5.14
2014	1 bn	6-Jan-14	6.00%	1.73	4.270
2014	500 mm	7-Apr-14	**5.125%**	1.74	3.385
10 Year bonds					
2010	1 Bn	27-Sept-10	**6.25%**	2.66	3.731
2011	1 bn	21-Jul-11	**6.25%**	2.94	3.322
2012	1 bn	17-Jul-12	5.875%	1.53	**4.345**
2015	650 mm	28-May-15	**6.125%**	2.19	**3.935**