

Fiscal Deficit Causes IMF to Delay the Standby Loan

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The IMF mission that visited Sri Lanka in February concluded that Sri Lanka has failed to keep to its fiscal target of keeping the budget deficit for 2009 to 7.0% of the GDP to qualify for the third tranche of \$322m from the 20 month/8 tranche \$2.6b IMF standby loan. The actual budget deficit for 2009 is estimated to be 10.3%. The government itself originally estimated that it would be as low as 7.0% but failed to keep to that target. Unless the IMF agrees to an upward revision of the permitted deficit target in 2010 the government will have a very difficult choice. Either it will have to abandon the rest of the standby loan or will be compelled to increase taxes and cut spending in the 2010 budget due in late April. The former will have serious repercussions for Sri Lanka's credit worthiness in the international financial markets because IMF imprimatur is essential to maintain a high credit rating for Sri Lanka's sovereign debt. The latter would have serious domestic political and social consequences.

In February with the parliamentary election looming, politics trumped economics in news coverage. However, economics and politics are two sides of the same coin. Political parties compete with each other to offer to the voter higher wages and subsidies, lower taxes and lower consumer prices. Some of these such as controlled price of rice and cuts in taxes on cooking gas are likely to be temporary. Some others are cynical inducements to voters, especially the poorer ones, that are not meant to be kept. The fiscal trends confronting the government are such that, no matter who wins, Sri Lankans can expect tax increases and cuts in spending in the next budget scheduled to be presented after the election.

The Rajapaksa administration did not present a regular budget for 2010 to parliament. Instead it shrewdly presented a Rs362b vote on account for the first four months of 2010 on the grounds that the new parliament should pass the 2010 budget. Parliament is parliament and the old parliament had every right and indeed an obligation to pass a proper budget. A new parliament could have passed a revised budget if it so wished. The real reason for postponing the budget was the government got a virtually blank cheque for Rs 362b that it could spend as it wished during a four-month period when presidential and parliamentary elections were being held. The IMF that is supposed to be a stickler for fiscal discipline and good economic governance fell for the ploy and gave its blessings.

In 2009 the Central Bank was successful in curbing inflation. But in the last three months the consumer price index rate has been an uptick in inflation, by 4.8% in December, 6.5% in January and 3.1% in February.

In monetary policy the Central Bank held steady its policy interest rates at 7.5% (repurchase rate) and 9.75% (reverse repurchase rate). A year ago these rates stood at

10.25% and 11.75%. The bank is cautious because of the possibility of inflation rate rising again. The average weighted fixed deposit rate of commercial banks in February 2010 was around 11%. One year ago it was around 17%. The prime lending rate was also down from about 19% in 2009 February to around 11% in February this year.

Bank lending to the private sector is still sluggish. Between November and December 2009 bank credit increased from Rs 1.18 trillion to Rs 1.19 trillion. However, in December 2008 it was Rs 1.26 trillion. This drop over 2009 partly reflects the Central Bank's successful squeeze on credit to control inflation and partly the slowdown in economic activity associated with the global recession and uncertain investment climate in Sri Lanka. Now the Central Bank wants private business to borrow more to accelerate growth. However, that is unlikely to happen until the economic climate and fiscal policy become clearer after the April poll.

According to the Central Bank, official foreign reserves grew by 198.2% to US\$ 5.2b by end November 2009 from US\$ 1.7b as at end December 2008. The former amount was enough to finance imports for more than six months. Given the very low interest rates in US and elsewhere in western capital markets short term capital is flowing into emerging markets such as Sri Lanka to exploit the relatively high interest rates paid on government bills and bonds. At the end of November 2009 the three month Treasury bill rate was 7.25% and at the end of January 2010 7.95%. About \$1.3 b or 25% of the reserve consisted of investment in short term securities. In February \$26m had come from abroad to purchase Treasury bonds. The downside of this is that the rupee is under pressure to appreciate harming exporters. On February 01, 2010 the dollar rate was around Rs114.50 and at the end of February/early March it was Rs around Rs 114.15.

The All Share Price Index (ASPI) rose by about 3.6% over February to reach an all time high by the end of the month. In the first two months the inflow of foreign funds to the share market amounted Rs 8.2b and the outflow Rs. 11.5b recording a net loss of Rs 3.3b (\$29m). This partly reflects profit taking and partly the withdrawal of investment by the troubled US hedge fund manager Raj Rajarathnam.

The dire fiscal situation in countries such as Greece and Ireland has focused global attention on unsustainable budget deficits and large public debt. The Central Bank of Sri Lanka reported that Sri Lanka's outstanding debt stock has reached Rs. 4.1 trillion by end October 2009, an increase of more than 20 percent year-on-year. About Rs 2.3 trillion is rupee (domestic) debt and the balance Rs 1.8 trillion (\$15.6b) is foreign debt. As a percentage of GDP the total public debt is around 115% and the foreign debt 50%. By global standards these are not very comforting numbers. The government now pays about one-third of its revenue as interest payment to service the debt. This is one reason for the severe cash shortage the government is currently experiencing. That in turn makes the government borrow even more from the banks making it a vicious circle and crowding out the private sector.

Sri Lanka's exports declined by 12.7% from \$8.1b in 2008 to \$7.1b in 2009. Imports also declined by about 30% from \$14.0b to \$9.9b. As a result the trade deficit contracted from US\$ 5.9b in 2008 to \$2.8b by 52.5% in 2009. These are not economically healthy figures. The loss of export earnings means less income and fewer jobs. In principle lower imports may be substituted with higher domestic production. However, in a relatively open economy such as that of Sri Lanka the reduction in imports reflects a lower level of economic activity and less spending, smaller incomes and fewer jobs. For example, the import of building material, transport equipment and machinery fell by 29.9%, 18.9% and 30% respectively during 2009. These are key inputs for investment.

Global tea production in 2009 was down by about 100m kg as a result of draught in the top tea producing countries including Sri Lanka. The country exported 289 million kg last year, the lowest since 2000. But in commodity markets such shortfalls are typically offset by higher price. Last year the price of tea reached a record \$4.09 per kg. In rupee terms the 2009 export earnings of Rs 136b was only a mere 1% less than 2008 earnings. However, producers had to cope with higher cost of production, mainly on account of higher wages. In the first two months of 2010 also prices have help up but high cost of production is worrying producers.

Tourist arrivals in January grew by 31.9 percent to 50,757 from 38,468 arrivals a year ago. Earnings from tourism grew 20 percent year-on-year in 2009 to US\$ 450 million.

On the trade front the big though not unexpected news in February was the EU announcement that Sri Lanka would lose its GSP+ tariff concession in August of this year. The government is trying to put the best possible spin on this by claiming that it won't hurt exporters that much. The government has also promised exporters that it would assist those that are adversely affected. But it may not be able to deliver on that promise. As noted earlier the fiscal revenue is simply not adequate to pay additional subsidies. Exporters point out that the government has not paid in full for the first and second quarters of 2009 the money that they were promised under the Export Development Rewards Scheme and that practically no payments have been made for the third and fourth quarters. In the meantime a trade union leader is reported to have said that even if Sri Lanka convinces the EU that its human rights situation has been rectified to the satisfaction of EU, the country could still lose GSP+ because only "Four out of the 403 garment factories in the island actually comply with the core ILO conventions on Labour Rights" that the EU insists upon.

On the positive side there is increasing evidence that the east and especially the north that was longest under LTTE control is coming back to the economic mainstream. The opening of the main A9 highway to the north has helped. In Jaffna HSBC opened a branch in Jaffna this month, the British Council launched an English Language Teacher Training programme, and it was announced that an ICT exhibition in Jaffna was in the

works. The government also announced that it would establish free trade zones one each in the Killinochchi and Trincomalee districts.

In February there were two issues concerning good economic governance that were reported in the media although it is unlikely that they got the attention of the public that they deserve. The first concerned two media reports regarding economic data compilation by state agencies. The Central Bank has complained that the Treasury had failed, as of February 07th, 2010 to provide it with the government spending and revenue data for October and November 2009. Past practice has been to supply the data to the Bank with a time lag of about two to three months. Second, it was reported that the Department of Census and Statistics was leaving out price increases exceeding 5% on consumer items for which it believes there were close substitutes in the market. It is true that consumers substitute cheaper goods for more expensive goods when they shop. However, this particular maneuver, if true, appears to be more political than scientific. The motive is to show that inflation is moderate. One practical implication of this would be to weaken the wage bargaining position of trade unions. Sri Lanka has a good reputation for producing reliable economic and social statistics. If that process is also politicized it won't help economic governance.

The Securities and Exchange Commission of Sri Lanka (SEC) notified that the Colombo Stock Exchange must strictly comply with the rule that requires public listed companies to immediately disclose dealings by directors of companies under Continuing Listing Rules of CSE. The use of the term "strictly comply" implies that the rule is not strictly followed. This makes one wonder whether insider trading is going on without proper compliance and regulation. This is not a good advertisement for free markets and capitalism.

The economy will emerge to the forefront of public discourse only after the parliamentary elections poll scheduled for April 08th, 2010. In the campaign rhetoric the open economy and market may be vilified as the source of all evil. However, in the manifestoes private sector is usually described as the "engine of growth." This seeming contradiction is not to be taken seriously. J R Jayewardene's open economy is here to stay.

Dr. Samarasinghe writes a monthly report on the Sri Lankan economy for the Rapid Context Assessment (RCA) of the Consortium of Humanitarian Agencies (CHA), Colombo. This is a an expanded version of that report. Global Vision thanks CHA for granting permission to reproduce the article