

Inflation is Down but External Outlook Not Favorable

In January 2009 the principal good economic news was a 28-month low of 10.7% in the year on year rate of inflation that was reported. The Central Bank's tight monetary policy and the fall in the price of oil helped. However, celebration is premature. The Oil prices will go back up when the global economy recovers. Fiscal stimulus may be needed to avoid the worst of the consequences of the global economic crisis. But the dwindling demand for Sri Lankan exports cannot be substituted with local demand. Sri Lankans can't drink more tea, or buy a lot more clothes if our usual foreign customers don't buy them. Given the global recession finding new markets in the short term won't be easy. Neither can resources be readily shifted, say, from garment production to infrastructure development. Thus there are serious limits to fiscal stimulus in the Sri Lankan economy. What is urgently needed is intelligent government spending concentrated on raising local productivity and elimination of wasteful spending such as the dubious effort to resurrect Mihin Air. But there is no such sign of fiscal discipline.

The Central bank reduced its penal rate of interest charged on reverse repurchase transactions by 200 basis points to 17% to ease bank credit. In any event, in 2008 prices rose by over 20%. That has reduced people's real wages and made the country's exports less competitive.

In January most attention was focused on the country's external finances. The Central Bank claimed that the country had foreign reserves worth about \$2.6b at the end of November 2008 that would finance about two months' imports of the country. However, official data that the Bank itself has released suggest that the reserves were a little over \$2.0 billion only. Today (end of January) reserves are likely be even lower.

Import restrictions of the 1970s type are not economically feasible today to conserve reserves. On the contrary last month two senior Central Bankers publicly advocated a liberalization of the capital account.

Depreciation of the rupee by about 15% to 20% to make a dollar worth about Rs130 is another option. Exporters want it but the Central Bank is resisting the idea because it will increase the cost of living. This is a shortsighted policy for two reasons. First, because sustaining the export sector is vital for long term growth. Second, postponing depreciation by supporting the rupee with short term measures such as foreign borrowing

only postpones the day of reckoning and makes adjustment both for the consumer and the producer that much harder.

Seeking IMF assistance will be a last resort because conditionalities such as deprecation of the rupee and eliminating wasteful spending such as the Mihin Air project would be anathema to the government.

The Central Bank launched a campaign with an ambitious \$500m target to persuade Sri Lankan expatriates to invest in government bill and bonds and offering a 20% premium on the interest income on their foreign currency deposits.

The Supreme Court decided not to proceed with the Ceylon Petroleum Corporation (CPC) hedging case because the government ignored the order of the court to reduce the price of petrol. Some saw this as a break down in constitutional governance. But it can also be seen as a necessary demarcation of responsibility between the executive and the judiciary.

The Central Bank claims that the oil hedging agreement is illegal. One of the five banks involved in the deal, Citi Bank, is seeking international arbitration to enforce it. The CPC may have to pay a sum in the range of \$300m to \$800m if the agreement is enforced. Last month Prima Flour Milling Company won an arbitration award of \$35m against the government.

The Finance Companies reported that their deposits were down following the collapse of Golden Key Credit Card Company where depositors have lost an estimated Rs14 billion or more. The Central Bank's claim that it has no responsibility for Golden Key has not helped the situation.

Total tourist arrivals to the country in 2008 were 438,475, down by 20% on the 2007 figure of 494,008. The government is creating a Rs 400m fund to help the industry in lean times. Bharti Airtel entered the local mobile phone market further intensifying competition.

In exports cinnamon, jewelry and rubber continued to report poor market conditions but Tea prices improved slightly.

The government launched an intensive lobbying campaign in Europe to get the GSP+ concession extended for another three years.

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 reproduction of that report with a few modifications, where appropriate. Global Vision thanks CHA for granting permission to reproduce the article.