

## **Budget and Trade Dominate Economic Discourse**

The much delayed budget for 2010 and issues concerning two of Sri Lanka's major trading partners, European Union and India dominated the month's economic news.

Sri Lanka's annual rate inflation slowed to 4.8%. This was one good piece of macroeconomic news for the government although the seasonal increase in food prices, especially those of vegetables, conveyed the impression that inflation was out of control in the economy. The official figures suggest that foreign exchange reserves also remained at a comfortable level above \$5.0 billion.

Usually relative price stability and a substantial foreign reserve allow a government a little more leeway to have an expansionary budgetary policy to cut taxes and expand spending. This option, however, was not available to the government for one major reason, the high budget deficit that has reached close to 10%. Last February. The IMF suspended the disbursement of the third tranche of \$408m of the \$2.6 billion stand-by loan to express its disapproval of the large budget deficit. The government has funded a substantial part of the deficit with Chinese loans that also help build high profile infrastructure projects ranging from power plants and the Hambantota harbor to a National Performing Arts Centre in Colombo. Some of these projects yield medium term benefits that boost output. Others will take a long time to yield an economic return but will eat up scarce economic resources.

There is not much of a cyclical component in the deficit. Part of it can be attributed to structural factors such as pensions and servicing the national debt (Rs 787b for 2010) that are unavoidable. The rest of the deficit is caused by discretionary spending ranging from defense to consumer and producer subsidies. The government has taken a deliberate decision to increase military spending by over 13% from Rs 178b in 2009 to Rs 202b in 2010. This together with the need to cut the deficit has negated any possibility of a peace dividend by way of boost in welfare spending for education, health and IDPs and the Rs 2,500 wage increase that candidate Mahinda Rajapaksa promised in his presidential campaign last January.

The government plans to issue a ten year bond worth \$500m later this year to raise funds from the internal market. Sri Lanka currently has a long term foreign currency debt rating of B to B+ that is four to five grades below the investment grade rating level. In October 2009 the country sold \$500m in bonds due to mature in January 2015 at a rate 7.4%, about 5.0 percentage points above similar US bonds. What this means is that countries like Sri Lanka, Kenya, and Ukraine that have similar ratings can sell bonds in the global market but only at a heavy discount (high interest) that attracts investors.

The government is optimistic about the near term and long term prospects for the economy. The GDP growth rate for the first quarter was 7.1%. Tourism is rapidly picking up and the government is targeting for 2.5 million tourist arrivals by 2016. This may be too ambitious unless there is a construction boom in hotels and guest houses.

The proposed Comprehensive Economic Partnership Agreement (CESPA) between India and Sri Lanka was not signed during President Rajapaksa's visit to Delhi. The government has not released the official draft agreement. Some note that even the twelve year old Free Trade Agreement (FTA) with India has not benefitted Sri Lanka much. In particular they note that India uses non-trade barriers to discourage exports from Sri Lanka. They also criticize the failure of Sri Lankan authorities to issue certificates of origin in a timely manner. Critics also note that Indian investors have failed to use Sri Lanka as a manufacturing platform to export to India making use of the duty free concession. On the other hand those who favour CESPA note that Sri Lankan business must be more dynamic and creative to exploit the large and growing Indian market. The manner in which a few Sri Lankan companies such as Damro the furniture manufacturer, have carved out a market niche for themselves are cited as examples. If the playing field is level –the government alone is responsible for that – what matters is not the size of the country but the quality, price and marketing of a good or service. That is how countries ranging from Belgium, Switzerland to Singapore and Malaysia have succeeded. Sri Lanka can learn a lesson from them.

---

***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. Global Vision thanks CHA for granting permission to reproduce the article***