

Review of the Sri Lanka Economy: March 2009

Impact of the Global Economic Meltdown Felt in Sri Lanka

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The negative consequences of the global economic crisis aided and abetted by homegrown economic mismanagement took centre stage in Sri Lanka's economic news in March. But first some context. The latest IMF forecast is that the global GDP will shrink by about 0.5% to 1.0%. The OECD forecasts that the output of advanced countries will decline by 4.3% this year and possibly stagnate in 2010. This is bad news for Sri Lanka that relies heavily on exports, foreign direct investment and donor assistance.

The good news in March was the drop in the annualized rate of inflation to 5.3% from 7.6% in the preceding month. In addition to falling global commodity prices and tight monetary policy the *Maha* crops reaching the markets also helped to hold down inflation. The higher taxes on tobacco products and alcohol that the government imposed a few weeks ago are not reflected in the price index because they have been dropped from the computation of the official consumer price index. The consumer price index is not a moral compass of the nation. Neither are alcohol and tobacco banned substances. Excise taxes earned Rs 97 billion (17% of total tax revenue) for the government in 2007. The government should stop manipulating numbers for political reasons.

The Financial Times (FT) of London announced that two Sri Lankan banks Hatton National and DFCC were among 22 banks worldwide that have entered the FT/IFC Sustainable Banking Competition 2009 for the Bank of the Year award. In a situation where many financial institutions the world over have earned the wrath of the public for irresponsible behavior and Golden Key in Sri Lanka has undermined confidence in Sri Lanka's private financial institutions, this is a compliment to Sri Lankan banking.

The fiscal situation showed signs of further deterioration. The government conceded that pension anomalies of retired government employees must be rectified but did not fix a date for action because it could not raise the Rs 15 billion required to implement the scheme. The Deputy Minister of Finance publicly complained that there were about 100 state agencies that should be able to pay their way but have come to rely on treasury subsidies to pay the wages of their workers. However, the "prodigal son" of government enterprises, Mihin Air got another Rs 400m from the Treasury to settle a loan taken from the state-owned Lankaputra Bank.

Iran has promised \$1.5b for infrastructure projects including for expansion of capacity of the Sapugaskanda oil refinery and for construction of the 100MW Uma Oya hydropower project. The Sapugaskanda project is in jeopardy because Sri Lanka has failed to raise \$350m as its share of investment.

The government announced its intention to get parliamentary authorization to raise the limit on treasury bills from the existing 600 billion to 750 billion.

The LMD-Nielsen Business Confidence Index (BCI) registered a two-year high of 122 in February compared to 96 in January, perhaps because an end to the protracted ethnic war appears to be in sight. But it is not clear how long this sense of optimism would last because the economic realities associated with the global economic crisis are making the situation difficult.

Tourist arrivals to Sri Lanka declined by 25.5% in January-February 2009 compared to the same two months in 2008.

A survey of garment factories in seven provinces including the Western province that has the most revealed that 75 factories had closed down between mid 2005 and early 2009. Of these only 24 had closed down in the last six months of the survey period. The balance 51 had closed earlier. The survey also found that the number of steady garment buyers operating in Sri Lanka has dropped from about 50 in 2005 to about 30 today. The main reasons include the higher cost of production in Sri Lanka and the bad security situation in the country. The government policy to keep the rupee against the dollar steady despite high domestic inflation was a major reason to make Sri Lanka a high cost producer.

The tea industry is facing mixed prospects. Sri Lanka is the world's top tea exporters. In 2007 we took 20.2% of global exports with China (18.5%), Kenya (17.5%), India (14.1%) and Viet Nam (6.8%) being the other major exporters. On the one hand world tea prices have been up on account of drought hitting three major producers, Sri Lanka, India and Kenya. Sri Lanka's tea production fell by 7.9m kg (23.5%) to 25.6m kg in 2008 over that of 2007. FAO reports that global tea consumption increased to 3.85m tons in 2008, a rise of 4.8% over that of 2007, while production increased only 1.2% to 3.78m tons. This supply deficit boosted prices. The deficit is expected to continue in 2009 as the drought continues to affect Sri Lanka, as well as Kenya and India.

Higher prices are good for the producers. However, Sri Lankan producers have to contend with higher cost of production. Moreover, labour productivity in the Sri Lankan tea industry is about two-thirds that of India and only about 55% of that of Kenya. As a result of these unfavourable conditions Sri Lanka tea has lost market share in, among others, Egypt, Pakistan, UK and Afghanistan mainly to Kenya. The over-valued rupee makes our tea even less competitive.

The export sector welcomed the stimulus package that the government has announced but complained that it should cover all the export products. This is a valid criticism. In picking some export industries for assistance but not others, the government gets into the business of picking winners and losers. Or it may reflect the relative clout of lobbying of the different export industries. In any event stimulus assistance is constrained by availability of funds. More fundamental policy changes such as depreciating the rupee to compensate for high inflation in the recent past and reigning in the budget deficit that is pushing up interest rates are required.

The government's attempt to revive the negotiation of the comprehensive economic partnership agreement (CEPA) with India to replace the existing free trade agreement has run into opposition from the local business community who allege that India uses non-tariff barriers against Sri Lankan exports.

The government repealed the import tax on liquid petroleum gas (LPG) that it imposed last December to provide relief to industrial users such as ceramics that complained that the tax added an additional cost that made them uncompetitive in export markets. This is an example of *ad hoc* taxes that are imposed by a cash-strapped government without giving full consideration to the broader consequences of such taxes.

The Employers Federation of Ceylon asked the government for permission to curtail the work week from 5.5 days to 5.0, add one hour of work to each week day but without extra pay. It also wanted permission to lay off workers temporarily claiming that its members faced reduced export orders. The trade unions officially oppose both moves. The government has not formally responded to the request. However, reports from workplaces suggest that employees and unions also understand the problems that the recession has created for businesses and generally agree to some changes in work schedules to cut cost to keep the factories running and protect jobs.

In March the foreign exchange situation of the country deteriorated further. The Central Bank has been not entirely forthcoming on the foreign reserve

position of the country. The Bank spent about \$200m to \$250m in each of the past several months to defend the rupee against the dollar. In early January the gross reserves were \$1415m and net reserves owned only by the Bank were \$1150m, around 40% of the level in early August. By late March the amount of treasury bills that the Bank held had increased by almost \$200m suggesting that there was an equivalent loss in foreign reserves that would have gone down to about \$900.

Sri Lanka attempted to raise \$200m from a two year dollar denominated bond but managed to get only \$185m despite paying a premium interest rate. This would not have added to the foreign exchange reserves because a \$215m bond matured during the month and had to be paid off.

The government – or more specifically the Governor of the Central bank – that boasted a few months ago that Sri Lanka had sufficient reserves to face the global financial meltdown decided to request the IMF for a stand-by loan of \$1.9 billion. This was an admission of the fact that the nation's foreign reserves were precariously low.

An IMF team was in Sri Lanka for over one week in late March to discuss the terms of the loan. The government said that the IMF loan would be accepted only if it came without conditions. The media reported a minister citing “a new loan facility” – presumably the so-called “Flexible Credit Line” that the IMF established in late March to lend money to members with “very strong fundamentals” – that would enable Sri Lanka to borrow from the IMF without conditions. This is most unlikely to happen. The evidence is that government will depreciate the rupee, freeze hiring to an already bloated civil service, not give wage increases for the rest of the year, agree to at least make a half hearted attempt to restructure the CEB and contain the budget deficit. As far as one could see most of these are sensible steps that must be taken with or without IMF intervention. IMF loans come in several tranches. This allows government wiggle room to get out of the loan if the economic conditions turn favorable so that it can escape making policy changes that are politically unpopular.

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