

Economy Waits for Politicking to Finish

By Dr. Stanley W R de A Samarasinghe

There were no surprises on the economic front in March. The politicians were consumed with the parliamentary election. However, as the relatively low voter turnout of about 56% showed almost half of the voters did not show much appetite for exercising their so called sovereign right to elect lawmakers. The operative term in economic decision making for the month was “postponed until after the election.” The government said that it would present the 2010 budget after the election. The IMF said that it will revisit the issue of the suspended third tranche of \$326m of the \$2.6b standby loan also after 2010 budget is presented following the election. A delegation of senior official that visited Brussels to persuade the EU to withdraw the suspension of the GSP+ tariff concession due to go into effect in August of this year returned without a firm commitment from EU, presumably because it also wants to see what the Rajapakse administration would do after the election. In March reinsurance premium and terrorism policy premium were cut down but Lloyds Registry of UK said that a full review will also have to wait until after the election.

This mood of waiting until after the election was nicely captured by the Colombo All Share Price Index (ASPI) that reflects the mood of the investors who also hedged their bets waiting for the election to be over. At the beginning of March ASPI stood at a little over 3,800. Over the month it fluctuated and closed at the end of the month down by about 2.5%.

However, what could not wait for after the election was the need for funds to meet government fiscal obligations. The 2009 budget was almost totally off target. The Treasury announced that the 2009 budget deficit (excluding grants) was a whopping 10.2% of GDP that was way above the originally estimated 7.0%. The actual revenue collected was below estimate and actual spending was above. The drop in revenue is largely attributable to a drop of Rs 100b in export income that would have cut into corporate and profit taxes and a Rs 400b drop in imports that would have cut import tariff revenue.

On the spending side the usual story was repeated. Recurrent spending, most notably interest on the public debt and wages and salaries, were above estimate by 7.4% and capital spending was below by 15.1%. However, the latter was not sufficient to offset the former in absolute rupee terms. A reduction in capital spending is not good for job

creation and growth. To the government's credit some projects such as the 900mw Norocholai coal-fired power plant that will make a significant contribution to growth are on track. The second stage of Norocholai to produce 300mw was inaugurated in March. However, low productivity ventures such as Mihin Air get scarce tax rupees from the capital budget that calls into question the economic judgment of the Rajapaksa administration.

The government that was desperate for funds issued Sri Lanka Development Bonds (SLDBs) worth \$ 100m in March. Foreign and local commercial banks took \$45m in two-year bonds with an interest rate of US dollar six month London Inter Bank Offer Rate (LIBOR) +3.80% and \$55m in three year bonds with an interest rate of six months LIBOR plus 3.95. The LIBOR rate when the bids were accepted was 0.4%. That means the government will pay 4.2% for the two year loan and 4.35% for the three year loan.

Borrowing short term at commercial rates is becoming a part of Sri Lanka's fiscal scene. In March 2007 before the onset of the global financial crisis the government borrowed \$215m from commercial sources at less than 2.0% interest when credit was easy and Sri Lanka's sovereign credit rating was better. Two years later in March 2009 it borrowed \$184m, when global credit was tight and Sri Lanka's sovereign credit rating was down, at an interest rate that exceeded 7.0% largely to repay the 2007 loan. In June and August of last year it borrowed \$116m and \$190m respectively paying over 5% in interest at a time when credit markets continued to be tight.

In March the Colombo Consumer Price Index rose 6.3% year-on-year down from 6.9% in February. Sri Lanka's year-on-year inflation rate hit an all time high of 28.2% in June 2008. The rate remained above 20% until October of that year and began to decline thereafter. The Central Bank with the help of a sharp drop in oil prices and strict monetary management has succeeded in squeezing out inflation from the economy in the past eighteen months. The Bank announced in March that it will hold its "policy rates" unchanged. However, market rates, as reflected in the three month Treasury bill rate has been rising since last November reflecting the demand for funds from the government. The private sector loudly complains that it is being crowded out by government borrowing.

In January 2010 Sri Lanka's apparel export earnings totaled \$167m compared to \$232m, down 28%, in the same month last year. Exports to EU were down 22% and to USA 36%. The recession is probably one reason for this drop. This is a matter for concern because tens of thousands of jobs are at risk. The situation will become worse if the EU carries out its suspension of GSP+ effective August of this year.

The government has made extravagant promises to the electorate to please the voters. For example, wage hikes are promised to public sector employees. Seventeen thousand unemployed graduates have been promised government jobs. Sales taxes have been cut. Thus the government won't find it easy to present the next budget in late April. It is true that China that accounted for about 50% donor assistance – mostly loans - in 2009 does not impose conditions the way that IMF and western donors do. However, as the IMF standby loan demonstrates Sri Lanka cannot afford to ignore western countries and their markets. The latter group will demand fiscal discipline as a condition for assistance. Western donors will pressure the government to stop the financial bleeding that occurs in state corporations such as the Ceylon Electricity Board and the Ceylon Petroleum Corporation. Cutting the fiscal deficit by increasing taxes and pruning spending is deflationary and politically difficult to do.

In principle private investment spending, which is generally productive can be encouraged with low interest rates and holding steady if not cutting down corporate taxes. However, that won't help government politicians to give jobs to party supporters that were promised during the election campaign.

There are some hopeful signs for the economy that will help the government. The price of natural rubber reached a record high of \$3.50 per kg in early April, the highest price since the days of the Korean War in the early 1950s. The tea crop affected by draught last year is returning to more normal levels. February 2010 output was 23.5m/kg compared to 12.9m/kg in the same month last year. Tourist arrivals have been steadily increasing since the end of the war. The reintegration of the northeast to the country's mainstream economy is steadily happening. In addition to government investment in infrastructure private banks and private companies are moving into the area. Even the anticipated revaluation of the Chinese Yuan against the dollar should help because whatever exports from Sri Lanka that compete against Chinese exports will become more competitive.

Now that the government has a comfortable majority in parliament it is in the fortunate position of being able to send the right signals to western governments whose cooperation is needed to get the economy on the right track. For example, EU may well decide to continue GSP+ if the government makes some good faith moves toward improved governance. The re-poll ordered for Nawalapitiya and Trincomalee is a good start. If the cabinet is right-sized and the tasks allocated more rationally to the different ministries it will be a signal that the government is making a serious effort to reduce wasteful spending and rationalize ministerial governance. The rupee can be depreciated a little as an incentive to exports and the tourist industry.

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 an expanded version of that report. Global Vision thanks CHA for granting permission to reproduce the article