

## **Foreign Reserves are Up but Economic Fundamentals Remain Weak**

**In November 2009 the economy was upbeat especially in the buildup of foreign reserves that in April reached a low point posing a major threat to economic stability and forced the government to seek IMF assistance. However, this appearance of economic strength masked underlying structural weaknesses in the economy that remain to be addressed. The fiscal deficit remains unsustainably large, bank credit is still expensive and the political uncertainty associated with the January presidential elections have weakened business confidence.**

### **MACROECONOMY**

#### **External Economy**

One of the most striking changes that has occurred in the macro economy is the huge increase in the official foreign reserves of the country in the last seven months. In March reserves were down to a precarious \$900m (less than four weeks of imports in 2008) and the government applied to the IMF for a standby loan. It received a loan of \$2.6b. in July. Four months later the country's reserves exceed \$5.0b. But not all of these funds can be considered as coming from steady sources. Around \$650m of the reserves come from the first two tranches of the IMF loan. The government also borrowed about \$1,200 million by selling medium term bonds in the global market for which the country has to pay relatively high interest. Another \$1,000m are from hedge funds that have come to benefit from comparatively high interest rates in Sri Lanka. Only reserves that can be attributed to current account transactions and foreign direct investment can be attributed sound economic fundamentals.

High reserves have caused the rupee to appreciate from Rs 120 to the dollar in April 2009 to Rs114 at the end of November. This does not help exports although it helps the government to keep import prices in check.

The end of September Sri Lanka had 5.3 tons of gold worth around \$206m at early December 2009 market price for gold that stood at \$1,210 per ounce. On November 23<sup>rd</sup> the central Bank

purchased ten tonnes of gold from the IMF for \$375m paying around \$1,166 per ounce. Gold does not earn any interest income. This is speculative buying that can boomerang on the country if the gold price falls. Moreover, large reserves are nothing but frozen capital that the country can use for more productive purposes.

In November the Central Bank discontinued the 20% bonus on the interest rate that it offered some time ago to Non Resident Foreign Currency Account holders.

Taking into account the large foreign reserve the Central Bank announced that Sri Lankans would be free to take out capital up to a maximum of \$500,000 without obtaining Central bank permission to invest abroad. One cannot but wonder whether this relaxation is a device to allow money laundering by the rich and powerful.

### **Monetary policy**

The inflow of foreign funds and the maturing of public debt have increased liquidity in the financial sector. The Treasury Bill rate also declined. The Central Bank sold some of its own bonds to mop up some of the excess liquidity. The year-on-year inflation rate in November was 2.8%. Low inflation has allowed the Central Bank to cut its rates and encourage banks to lend more. The state-owned banks have cut lending rates. However, top clients still had to pay over 12% for private bank credit.

### **Fiscal Policy**

The government skipped the regular budget usually presented to parliament in November of each year on the grounds that a new parliament elected early next year should review and pass the fiscal 2010 budget. Instead it presented a Rs 362 billion "Vote on Account" to meet routine government expenses for the first four months of 2010.

By not having a regular budget government avoided for now having to show the IMF that it was on track to reduce the budget deficit to 5% of GDP by 2011. In 2007 it was 7.7%. Press reports based on government and opposition sources reveal that in the past 11 months supplementary appropriations totaling at least Rs 77 billion (6.5% of approved budget) and may be as much as Rs 135 billion (11.3%) were passed by parliament.

A report from the Department of Inland Revenue released in November revealed that in 2008 the amount in default was Rs 179b equal to 30% of the amount collected. Of this figure about half was categorized as “disputed” taxes. Fixing this problem requires a significant improvement in tax compliance and management.

The good news on the fiscal side is that the Treasury overdraft limit has been scaled down from Rs 60b to Rs 40b. In the first quarter of this year the limit was Rs 80b.

## **SECTOR ANALYSIS**

### **Business confidence**

The October 2009 LMD-Nielsen Business Confidence Index (BCI) at 145 is 11 points below the September figure but well above the average of 117 for the past 12 months. Business confidence appears to have softened a little owing to political uncertainty.

The share market was quite sluggish over the month. The troubled US investor Raj Rajaratnam and his Galleon Hedge Fund that had about \$107m invested in Colombo began to liquidate their holdings.

### **Agriculture**

The BOI announced that it has granted permission to a Norwegian company to invest in Maize, Sesame and Soya production using out growers and a 25 acre plantation. This project should be viewed in the context of rich countries moving to developing countries to produce food to improve food security in investing country.

Desiccated coconut growers warned that the industry is in danger of losing its export market owing to high cost of production and tax burden locally and the entry of low cost competitors such as Vietnam.

### **Trade**

The GSP+ issue with EU yet remains unresolved. The government handed over its observations on the GSP+ Report that the EU prepared without the cooperation of Sri Lanka.

In the early part of November tea prices in the Colombo auction were sluggish. The global tea market remains tight owing to the draught in Sri Lanka, Kenya and India that cut yield. From the beginning of this year world tea prices have steadily risen by about 80%.

## **Labour**

The president announced a pay hike for the armed services "with immediate effect." However, the demand for higher wages from other key public sector workers have not yet been granted. In response to pressure from unemployed graduates, the government announced that 17,000 graduates would be recruited to the state sector.

The Employees Provident Fund (EPF) since its inception has funded government budget deficits through bond purchases. This month the cabinet agreed to amend the EPF Act to use funds for investment in real estate and industry. It is not clear how the security of the funds would be guaranteed under the proposed change.

## **ECONOMIC GOVERNANCE**

This month the global corruption watchdog reported that Sri Lanka was 97<sup>th</sup> among 180 countries in public sector corruption. That is about the halfway mark on the global scale meaning about half of the public sectors surveyed are more corrupt than ours and the other half less corrupt. This is the position that the country has occupied on this index for the last ten 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 an expanded version of that report. Global Vision thanks CHA for granting permission to reproduce the article.***