

External Reserves Grow but Fiscal Problems Remain

The macroeconomic numbers for the month of October 2009 were encouraging. The year-on-year rate of inflation was a modest 1.4%.

Low inflation put pressure on interest rates that is helpful to investment and growth. Treasury bill rates continued to decline. The state-owned banks cut lending rates to between 8% and 12% that put the private banks under pressure to do likewise.

The government claimed that it was comfortably meeting the macroeconomic targets that the IMF set as a condition for giving a standby loan of \$2.6b. in July 2009. Net international reserves were \$4.7m. at the end of September. Domestic bank lending and money supply levels were also within the range agreed upon with the IMF.

Fitch Rating raised Sri Lanka's B+ sovereign rating to "stable" from "negative." The government floated a USD-denominated international five year bond issue at a coupon rate of 7.4%.

While the monetary and international reserve situation improved the fiscal situation remained more problematic. Government spending continues unabated. For example, a supplementary military spending bill for Rs 33 billion was passed for the current fiscal year. The government has unpaid bills amounting to Rs 5 to 6 billion to the construction industry for work already completed. The Road Development Authority alone owes contractors over Rs 2b.

The prospects for containing government spending in the near term are not too good. Workers in the state sector, most notably, Petroleum, Railway and Electricity, are demanding higher wages to offset loss of income from high inflation in 2008.

The government decided to present a "vote on account" to parliament that will provide funding for government operations until regular budget is presented next year. Critics say that the government wants to avoid a regular budget because it fails to meet the IMF fiscal targets. Avoiding a regular budget also permits the government to avoid taking unpopular fiscal measures. It can also strategically select fiscal moves in the coming months that that may be politically popular in an election year.

Sri Lanka's international economic relations during the month of October showed a mixed picture. Donors announced \$196m in assistance to fund the IDPs. The Asian Development Bank announced that it will loan \$70m. for highway construction in the north and east.

Representatives from more than 40 American companies and 30 Indian and other Asian companies met with their counterparts and officials from the Sri Lanka government and US government to launch a "Public-Private Partnership" to explore business opportunities in Sri Lanka.

EU continued to warn that Sri Lanka will not get an extension of GSP+ tariff relief unless the government cooperates on human rights and a probe into the possible violation of international humanitarian law in

the last few weeks of the war. The government continued to insist that while Sri Lanka deserves to have the EU GSP+ privilege renewed, it will not agree to respond to any investigation on human rights that an EU appointed team conducts

Japan's new administration came under pressure for a group of human rights organizations to pressure Sri Lanka on human rights concern. Japan is a major donor to Sri Lanka. Thus the Sri Lanka government is bound to feel more pressure if the Japanese government decides to follow up on the request of human rights groups.

The Chinese and Indian governments signaled that they were ready to provide additional economic assistance to Sri Lanka.

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Tourism is steadily picking up after the end of the war. In October tourist arrivals were up 7.0 percent to 37,575 from a year earlier. However, major European countries, Japan and USA have not yet revised their travel advisories that were put in place when the war was on.

Share market fluctuated quite sharply during the month. The All Share price Index rose from around 3,000 at the beginning of the month to close to 3,200 by the middle of the month. Profit taking kept the index from rising higher. Then the news of the arrest of the Sri Lankan hedge fund executive Raj Rajarathnam who has a substantial stakes in some publicly traded companies in Sri Lanka set off a minor panic selling. By the end of the month the ASPI was slightly below 3,000.

The 2009 UNDP Human Development Report that was released in October revealed that Sri Lanka scored 0.759 in the Human Development Index (HDI) based on income, education and health status data for 2007. Thanks to our relatively better performance in education and health, our human development ranking is slightly better than what one could theoretically expect for a country that has a per capita income of just over \$2,000. But there is also bad news behind these numbers. In 1990 in the first HDI (1987) Sri Lanka scored 0.649 and was placed 47th out of 130 countries. That is 36% of the countries were above us. In the 2000 report our ranking was 84th out of 174 countries implying that 48% of the countries were ahead of us. In 2009 56% of the countries were ahead of us. Between 1987 and 2007 we have made some progress overall in income, education and health as reflected in an annual average increase of 0.59% in the HDI. However, many other countries have made much faster progress and gone ahead of us. Note that during this 20 year period the uncertainty that the ethnic war created and

the diversion of resources to the war jeopardized economic growth and constrained spending on health and education.

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.