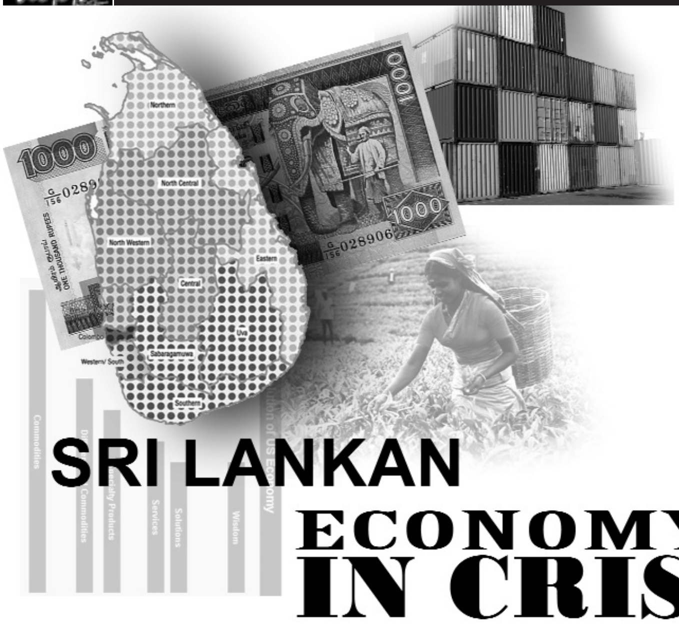

SRI LANKAN ECONOMY IN CRISIS

Whatever you and I may consider to be good news about Sri Lanka in this time and era, statistics relating to economic fundamentals, on which everything else eventually rests, does provide a grim picture of an economy in serious crisis. Yet, our political leaders and their bureaucratic collaborators have been presenting a different picture to the public. Governments, like magicians, live on creating illusions.

The Central Bank has willingly come to the aid of the politico- economists. Doing away with the long tradition of independence, expertise, and excellence of this great institution President Rajapakse made a political appointment to the Governor's position and this is paying dividends for the government if not for the country. The once sacrosanct apex-level institution of Governor is now playing poodle. See the difference in the Australian Federal Reserve Bank which refused to keep interest rate rises on hold despite the Howard Government's overtures during election time. Such independence and expertise is crucial if the Central Bank is to carry out its constitutional responsibility.

The Central Bank claims that the country is enjoying an impressive growth rate indicative of a "resilient economy". This claim hides the very important fact that the Sri Lankan economy is growing in debt at a faster rate than the growth rate. Since the 12 months beginning November 2006 public debt has grown by 16 per cent while the GDP (growth rate) has grown by 7 per cent. The real growth rate (eg taking Public Service salaries and payments which have been ballooning annually, out) is even less.

Shyamon Jayasinghe

The huge debt burden is a result of the large budget deficits (fiscal deficits). The deficit in the last budget was announced as Rs 293 billion. This is "not the whole truth" says Dr Harsha De Silva analysing the budget in the Sunday Times of 8/11 because it "leaves out the large amount of direct charges on the Consolidated Fund…… which includes repayment of foreign debt". Furthermore, in the Budget speech the President announced that expenditure on supply services had since gone up by Rs 119 billion. Reckoning these factors, the actual fiscal deficit should be around Rs 884 billion according to Dr de Silva.

Miltary expenditure is not the only reason for this shortfall. A wasteful and unchecked expenditure spree is also responsible according to Dr De Silva. Almost the entirety of government revenue now goes to pay debts and the government does not have money for other expenditure that is vital for the economy. "The government is not truthful about the reasons for the USD 500 million bond issue" says Dr De Silva "all indications are that there will be no money left from that issue for any developmental work; they have all been used up for settling debt". The only way that government can meet this debt repayment obligation is by further borrowing thus creating a spiralling debt burden and leading the country into a debt trap.

Backed by the Central Bank, politicians these days are bragging about Sri Lanka's Balance of Payments (BOP) surplus and foreign exchange reserves. The BOP surplus at the end of the year 2007 has been estimated to have increased to US $550 million compared to US $ 204 million in year 2006. The official reserves are estimated to have increased to US $ 3080 million at the end of 2007 compared to US $ 2526 million at the end of 2006. However, the flip side of the equation is that the apparent good position of exchange reserves was due to the increased foreign debt that had been incurred. What would you say if I were to claim that my bank balance is in big surplus after I get a big loan?

MAKING SENSE

The country's foreign debt had reached Rs 1353 billion at the end of same period. This was 29 per cent higher than the previous year. This means that while the official reserves were higher, the country's foreign debt was nearly 30 per cent higher than at the end of October last year.

Furthermore, the trade deficit reached a massive US $ 2846 million at the end of last October. This means that trade has contributed negatively to the BOP and that the main contribution have been capital inflows, the large inflows of foreign exchange, particularly higher remittances of employees abroad, loans and other debt and capital inflows. Several types of such inflows, like investments in the stock exchange and bonds, could well reverse into outflows of capital in the event that business confidence erodes. In other words, the high dependence of BOP on financial inflows rather than trade surpluses renders the BOP position very vulnerable.

The chronic trade deficit has also caused a sharp deterioration of the exchange rate because it means that more rupees are now required to buy foreign goods and services. The arrest in the flow of funds to pay for Colombo stocks and bonds have also contributed.

The unprecedented rise in the inflation rate also impacts negatively on the exchange rate. Latest official data shows that Sri Lanka's inflation has hit an all time high of 26.2 per cent last November. Inflation occurs when the rate of money growth in an economy is higher than the rate of growth in real GDP, hence more money is chasing fewer goods, and this in turn drives up the prices of these goods. Since exchange rates are an expression of one unit of a currency in terms of another, inflation essentially changes the relative value of this relation. For example, with Sri Lanka experiencing higher inflation than the US the SLR/AUD ratio decreases to represent the increased value of USD relative to SLR. Inflation increases costs of production and labour and this makes our exports uncompetitive thereby increasing our trade deficit which in turn impacts on the exchange rate and creates a spiral effect on inflation. The huge budget deficit also triggers inflation.

Thus inflation is caused by deep imbalances in the economy that have to be corrected in a systemic way. Perhaps ignorant of this, our Trade Minister once said that the cost of living is caused by the nattamis of Pettah! Politicians also blame the COL on the loka welenda pola. Although there is some truth in this, it is not the whole truth since world prices of commodities inevitably increase when our exchange rate drops. We are back with our imbalances.