Slow Economic Recovery in the First Half of 2002

06/10/02
Island.

by Kanes

The economic performance in the first half of 2002 though better than in 2001, was still below par. Economic Growth — GDP — in the first quarter was a marginal 0.1 per cent and in the second quarter 1.0-1.5 per cent. These are very low figures, and in fact, some do not expect overall economic growth for the year to exceed 2.0 per cent. The IMF, however, predicts a more optimistic growth of 3.5 per cent to 4.0 per cent in 2002. Industrial production actually declined in the first half — by 1.5 per cent in the private sector and by 5.0 per cent in the public sector (major industries). Tea production increased only marginally — by 0.3 per cent — and rubber production by 6.6 per cent but coconut production dropped by 10.1 per cent. No figures are available for paddy production, but the import of 60,300 metric tons of rice in the first half seems to indicate that the Maha crops was not a bumper. The only redeeming feature is the rise in the all share price index from 399 in August 2001 to 730 or by 83 per cent in August 2002, reflecting increasing investor confidence.

The most disturbing factor is the marked fall in our exports by 17.3 per cent in dollar terms in the first half of 2002 from the corresponding period in 2001. Both agricultural and industrial exports declined. All agricultural exports declined by 3.5 per cent in value — dollar terms; tea by 7.5 per cent, rubber by 10.0 per cent and coconuts by a massive 26.2 per cent. Only minor agricultural exports, such as spices, showed an increase of 27.5 per cent. Even gems exports dropped in value by 4.6 per cent.

Both tea and rubber experienced a fall in world market prices: tea export price in dollar terms dropped by 5.3 per cent and rubber prices by 18.2 per cent. Rubber exports volume actually increased in the first half by 11.8 per cent but the greater fall in price resulted in lower export earnings. Tea export volume fell by 2.7 per cent simultaneously with the decline in prices, but coconuts show a different picture. Export volume of coconuts dropped drastically by 55.0 per cent but the export price in dollar terms shows a sharp rise of 71.4 per cent.

A matter of serious concern is the drop in exports of packeted tea to Libya and Russia and CIS countries. In the first seven months of 2002, value added tea exports formed 36 per cent of total tea exports as compared to 41 per cent during the corresponding period in 2001. Exports to Libya have recorded a decline of nearly 50 per cent but the drop in sales to Russia — the largest export market — caused by penal import duties imposed on value-added teas, is of greater concern.

Industrial Exports

Industrial exports have dropped in value (dollar terms) by 20.1 per cent. All industrial exports have dropped: Food, Beverages and Tobacco by 27.0 per cent, Leather and Rubber products by 26.5 per cent, Textiles and Apparel by 21.9 per cent, Petroleum Products by 8.4 per cent and the balance by 6.9 per cent. The drop of the country's principal export — textiles and apparel — by as much as 21.9 per cent is no doubt, alarming, particularly as it dropped in 2001 too. The drop in textile and apparel exports in 2001 was about 15 per cent and it has continued in 2002, reflecting the downturn in the US and EU — the largest export markets for textiles and apparel. Economic growth for 2002 is now estimated at 2.8 per cent for US and 1.2 per cent for KU. To make makers worse, tourist earnings, in dollar terms, had fallen by 23.8 per cent in the first half on account of the fall in tourist arrivals by the same percentage and net migrants remittances had dropped by 2.5 per cent.

Imports

Sri Lanka's imports too declined in the first half — by 10.5 per cent in dollar terms. All categories of imports had declined — consumer goods by 10.0 per cent, intermediate goods by 6.3 per cent, investment goods by 13.5 per cent and others by 48.9 per cent. The fall in imports was due to the decline in international prices — the unit import price declining by 11 per cent — for the import volume actually had increased by about 9 per cent between May 2001 and May 2002. In the first half of 2002, imports of petroleum, rice, wheat and sugar increased in volume but their dollar prices declined: Crude Oil by :12.6 per cent, Rice by 36.9 per cent and wheat by 10.7 per cent. Only sugar price shows a marginal increase of 1.8 per cent. (Between June 2001 and June 2002, dollar prices fell by 11.1 per cent in Crude Oil, 50.4 per cent in Rice, 12.1 per cent in Sugar and 24.1 per cent in Wheat.) As exports declined in value - 17.3 per cent — more than imports - 10.5 per cent — the country's trade deficit in the first half of 2002 amounted to $ 863 million or 10.8 per cent more than in the first half of 2001. The rise in the trade deficit was in spite of an improvement in the terms of trade. Import prices fell more than export prices but the increase in import volume in contrast to a fall in export volume resulted in a larger deficit.

External Assets

The large trade deficit had not resulted in a fall in the country's foreign reserves. On the contrary, the country's gross official reserves in dollar terms rose by 7.6 per cent between the end of 2001 and June and 2002 and its total reserves increased by 3.7 per cent. This was the result mainly of the release of foreign exchange by the IMF under its Stand-by Arrangement. The country's total external assets had fallen from $ 3132 million at the end of 1997 to $ 2131 million at the end of 2000 equal to 3.5 months of imports. With the release of $ 131 million by the IMF under the Stand-By Arrangement of $ 266 million, total external assets rose to $ 2238 million at the end of 2001 equal to 4.5 months of imports. With further release of funds by the MF they increased to $ 2320 million at the end of June 2002 equal to 5 months of imports.

The Sri Lanka rupee continues to depreciate. The exchange rate in the week ending August 30 was US$ 1 = Rs.96.25 as compared to US$ 1 = Rs.89.91 a year ago and US$ 1 = Rs.93.16 at the end of 2001. The rupee has thus depreciated by 6.6 per cent in the 12 months to August and by 3.2 per cent since the end of 2001.

Inflation

The average annual increase in July 2002 of Colombo District Consumer Price Index was 8.8 per cent, of Colombo Consumers Price Index 11.1 per cent and of Greater Colombo Consumer Index 12.3 per cent. While the first two were marginally lower than a year ago, the third was higher: 12.3 per cent as compared to 8.1 per cent. The annual increase in money supply — MI — in June 2002 was 15.6 per cent in contrast to a decline of 0.2 per cent a year ago. Nominal wages of workers in Wages Board Trades appear to have risen by 1.6 per cent between June 2001 and June 2002 but their real wages would have declined on account of the higher increase in consumer prices.

Bank Credit and Interest Rates

Interest rates were generally lower in the first half of 2002 than a year ago. The Commercial Bank Prime Lending Rate for example, in the week ending August 30 was 12.63 per cent as compared to 18.23 per cent a year ago and Call Money Weekly Average 10.78 per cent as against 17.10 per cent a year earlier. Central Bank's Overnight Repurchase Rate fell from 15.0 per cent. to 10.50 per cent and the Three Month Treasury Bill Rate declined from 16.85 per cent to 10.99 per cent in the 12 months to August. The curious thing however, is that the drop in interest rates does not seem to have led to an expansion of borrowing by the private sector. On the contrary, total loans and advances of commercial banks outstanding are reported to have fallen marginally by 0.6 per cent from Rs. 370.7 billion in June 2001 to Rs. 368.5 billion in June 2002. This reflects the showdown in economic activity, as illustrated earlier, by the marked fall in industrial production, exports, tourist earnings and net migrants' transfers. The sole purpose of lowering interest rates by the monetary authorities was to stimulate private investment and economic activity, but this objective does not appear to have been achieved. The lower cost of credit apparently was not adequate to offset the adverse market prospects, particularly of exports. This is a matter, which merits investigation and research by the monetary authorities. On the other hand, commercial banks investments in Treasury Bills and Government Securities seem to have increased substantially in this period.

The large trade deficit had not resulted in a fall in the country's foreign reserves. On the contrary, the country's gross official reserves in dollar terms rose by 7.6 per cent between the end of 2001 and June and 2002 and its total reserves increased by 3.7 per cent. This was the result mainly of the release of foreign exchange by the IMF under its Stand-by Arrangement. The country's total external assets had fallen from $ 3132 million at the end of 1997 to $ 2131 million at the end of 2000 equal to 3.5 months of imports. With the release of $ 131 million by the IMF under the Stand-By Arrangement of $ 266 million, total external assets rose to $ 2238 million at the end of 2001 equal to 4.5 months of imports. With further release of funds by the MF they increased to $ 2320 million at the end of June 2002 equal to 5 months of imports.

Inadequate Public Investment

One major reason for the slow progress in the economy is the inadequate level of investment. Public investment has suffered a gradual reduction over the years reflection trend towards downsizing the government's role in economy activity. It was 6.7 per cent in GDP in 1998, 6.5 per cent of GDP in 1999 as well as 2000 and 5.9 per cent of GDP in 2001. The budget estimates for 2002 show public investment to be 5.1 per cent of GDP — the lowest in recent years. In addition to being inadequate, capital expenditure for public investment is being under spent. In the first half of this year, government's revenue was 5.7 per cent higher and current expenditure 12.8 per cent higher than in the first half of 2001 but capital expenditure was 5.6 per cent lower. Under-expenditure on capital votes has been a regular feature every year and 2002 is no exception. Under expenditure may be due to delay in formulation of projects, selection of tenders, inflows of foreign aid but the most plausible reason appears to be deliberate cuts in spending to reduce the budget deficit. The government has promised the IMF to reduce the budget deficit to 8.5 per cent of GDP from 10.9 per cent of GDP in 2001.

The reduction of public investment has far reaching effects on economic activity, especially by limiting infrastructural improvements — roads, railways, harbours, airports, telecom, transport, power, irrigation, schools and hospitals — which are indispensable for economic and social progress. Increase of public investment tends to increase private investment as contracts for building and construction are normally given to the private sector. The construction industry had recently complained to the government that it was in the doldrums for lack of contracts from the government. Besides, improved infrastructural facilities are needed to stimulate investment in general and to attract foreign investment. Few investors would like to invest if the country suffers from frequent power failures, bad roads, airports, telecommunications and sick and unskilled manpower.

It is necessary to recall our experience of 1978-1981 in this connection. In the four years 1974-1977 public investment was 7.8 per cent of GDP and in the four years 1978-1981 it rose to 14.4 per cent of GDP or nearly doubled, mainly on account of the massive investment in the accelerate Mahaweli Development Scheme. Private investment, which was 7.8 per cent of GDP in the earlier period then rose sharply to 11.6 per cent of GDP in the later period. The rise in public investment instead of "crowd ing out" the private sector, boosted i and private investment increased by about 50 per cent. It is hoped that th authorities would take appropriate measures to accelerate the rate of public investment. Those who maintain that the government lacks funds to do this fail to see that the government lacks funds because it has delib erately reduced its revenue by lowering taxation — surcharge on company tax, import duties, National Security Levy, etc., — when the desperate situation demands higher taxation to finance rapid economic growth. It is not too late for the government to take measures to raise public investment — both by higher taxation and foreign borrowing — for that is the best method, as proved by East Asia, of increasing gross domestic investment, attracting more FDI and achieving high economic growth.

There is another important reason for increasing public investment at this particular time. When the economy is virtually stagnant mainly as a result of the fall in demand for its exports, attempting to revive the economy through export expansion is unlikely to be helpful. The economy can be revived to some extent at least by increasing public investment through a programme of public works as is being done in Singapore and Malaysia. Both these countries are badly hit by the reduced demand for their electronics exports on account of the US recession and they have consequently launched public works programmes to stimulate domestic economic activity. Public investment could also focus on an area which has been long-neglected-import substitution. Export-oriented development is all right when there is a demand for the exports.

Sri Lanka benefited all these yea from the consumer boom in the US but as that is getting weaker, it is n essary to explore the potential of import-substitution and provide encouragement and incentives for those investing in them.