

Financial Situation Deteriorates

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In April the Sri Lankan economy exhibited more signs and symptoms of a deteriorating financial situation that has the potential to reach crisis proportions if some of the remedies that the government is attempting such as the application to the IMF for a \$1.9b loan fail.

Before the onset of the global financial crisis in the middle of 2008 the government was quite successful in borrowing from the international market at relatively modest and affordable rates. But the crisis increased the rates to unaffordable levels. The situation was made worse when foreign investors exited from Sri Lanka's domestic bond market. Sri Lanka went to the IMF against such a financial backdrop.

Negotiations on the technical issues concerning the IMF loan were completed towards the end of the month. In Sri Lanka the government boasts publicly that it will accept a loan from IMF only if it comes without any conditions being attached. Such statements may go down well with a gullible Sri Lankan electorate although even among them those who have borrowed money by pawning family jewelry would wonder why a lender is so keen to give a loan to Sri Lanka without any conditions being attached. Be that as it may Sri Lanka will have to provide the standard "Letter of Intent" that the IMF requires for any loan from it. This will spell out the conditions that the government will have to adhere to get the loan which usually comes in several tranches. In the last few weeks the rupee has depreciated against the dollar. This is partly explained by the lack of foreign reserves for the Central Bank to sell dollars to defend the rupee. But it is also one way of that the government is accepting the inevitable and signaling to the IMF that it will accept some stringent conditions to the economic house in order including the depreciation of the rupee to a more realistic level, especially to help exporters.

Sri Lanka should have no difficulty in getting IMF assistance if it was purely a matter of economics. In addition to the depreciation of the rupee it will also

ask the government to cut wasteful spending and unsustainable subsidies. But there are some economic factors that strengthen the government's bargaining position. Economic growth has been relatively strong in the past few years. Unemployment too has fallen and so has the poverty rate. The fiscal deficit relative to GDP has been modest and public debt as a percentage of GDP has declined in the past four years.

Perhaps the biggest success was in reducing inflation. What is known as headline inflation fell for the tenth consecutive month in April to 2.9% on an annualized basis. In July of 2008 it was 28.2%. Analysts believe that roughly about 25% of Sri Lanka's inflation is attributable to what are called "external shocks." That means high oil prices and high commodity prices last year made a significant contribution to inflation. By the same token the fall in oil prices and the price of other imported commodities partly explain the fall in inflation. Credit must also be given to the Central Bank for its tight monetary policy that helped moderate inflation. However, the falling rupee is likely to push up inflation in the coming months.

If media reports are to be believed it is not economics that is delaying or blocking the IMF loan but politics and international diplomacy. On account of the situation in the north the IMF is under pressure from detractors of the government to delay or deny the loan.

The government is also negotiating for a \$500m loan from Libya.

The government that is desperate for revenue increased the Nation Building Levy (NBL) introduced in the 2009 budget from 1% to 3%. The government is increasingly resorting to ad hoc adjustments in taxes. To appease the public that complains of high prices it reduces tax rates but only to increase them in some other form to keep revenue flowing in. Businesses are complaining that the government is delaying the refund of VAT that it owes them.

The talks between the government and the five commercial banks that were involved in the oil hedging deal with the Ceylon Petroleum Corporation (CPC) broke down when the two foreign banks in the group, Citibank and Deutsche Bank, decided to file action for international arbitration through the International Centre for Settlement of Investment Disputes (ICSID). The full amount that the state-owned CPC owes the banks under the agreement is

\$810m plus interest on the overdue amount. This amount possibly is well over half of the entire foreign reserves of the country at the end of last month. Thus having to pay this sum would have a devastating impact on the shaky finances of the country.

The Central Bank, confident of low inflation, has been trying to ease bank liquidity to encourage bank lending. In April the Bank lowered the repurchase rate to 9% from 10.25% and also cut the penal rate to 13% from 14.75%. The state banks have reduced lending rates by 2 or 3 percentage points to "priority" sectors. But the prime rates of the commercial banks that averaged a little over 19% in mid April have been sticky.

To help private borrowers who are increasingly hit by the recession the Treasury requested the Central Bank to extend the period when a bank loan is considered a "non-performing" loan from the current three months to six months.

In April the Asian Development Bank approved two loans totaling \$160m to rehabilitate and expand the electricity generating and distribution capacity of the island where an estimated 20% of houses do not have electricity.

The informal arrangement that existed for the last several months in many businesses between employers and employees to cut down on work hours or temporarily lay off workers to cope with shrinking order books for exports was formalized in April. The government agreed to permit such practices subject to mutual agreement between employers and workers.

The two-year collective wage agreement between plantation workers and employers ended in April. The JVP which is trying to get a toe hold in the sector announced that it would demand a Rs 500 per day wage for plantation workers.

Share prices alone do not tell the full story of an economy. However, their movement gives an indication of investor expectations. In April the feeling that the end of the war would create new business opportunities would have helped move up the All Share Price Index by about 10%.

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.