

## **Global Crisis Begins to Impact on Sri Lanka**

The economy produced mixed news during the month. Almost all the disturbing news came from the external sector. It was reported that of the 350 garment factories in operation in 2007 about 60 to 70, mostly relatively small units, had been shut down in the past fifteen months reducing employment in the sector from 300,000 to about 280,000.

Sri Lankan financial institutions have not been exposed to the toxic assets in the global financial crisis. However, the crisis has produced a Sri Lankan variant of toxic assets. These are unrecoverable loans given to local industries that are suffering from the loss of markets. There is practically no market for the machinery that has been pledged as collateral. Real estate used as collateral can be seized but it is a cumbersome process. The banks would rather have money back.

The Central Bank continued to assert that the country had “adequate” foreign reserves. At the end of 2008 official reserves were \$1.8 billion – equal to six weeks of imports - and with unofficial reserves the total was about \$3.0. Central Bank’s effort to defend the rupee in the last quarter of 2008 is partly responsible for the drop in reserves. Falling import prices have helped to ease pressure on the reserves. But export earnings may fall. Tea and rubber prices are weak. Tourist arrivals plummeted 32% in January 2009 compared to the same month last year. Earnings remitted by our migrant workers may also decline. Foreign direct investment won’t improve in the near term and commercial borrowing is both difficult and expensive. The Central Bank is unlikely to raise the targeted \$500 million from “Diaspora Bonds” that it started selling last month. The Central Bank is also negotiating for currency swaps. The goal is to avoid having to go to the IMF for assistance that invariably comes with conditions attached that may be unacceptable to the government. The Central Bank also pegged the rupee-dollar rate around Rs 114 through the month.

Fitch Ratings downgraded Sri Lanka's long-term foreign and local currency issuer default ratings (IDRs) from stable to negative on the grounds that the foreign reserve position has weakened. The Central Bank publicly criticized the revision as unwarranted.

The loss of public confidence in finance companies following the collapse of Golden Key Credit Card Company persisted. Unconfirmed reports claimed

that some finance companies were losing deposits. The Central Bank announced a stimulus package that it said was worth Rs 4.25 billion to assist finance companies and leasing companies that required additional liquidity. Under the proposed scheme these companies have been permitted to "sell" the land they own in exchange for treasury bonds that can be discounted in the bond market.

The good news of the month was the decline in the annualized rate of inflation from 10.7% in January to 7.6% in February, the lowest rate in the last three years. The drop in oil prices and other commodity prices played a major role in this decline. Central Bank's tight monetary policy that held bank credit growth in 2008 to 6% compared to 20% in 2007 also helped.

Last month the government partially passed on to the consumer global price reductions in some products such as milk powder and gas. A part of the price reductions were retained by the government as tax revenue. This is good economic management to preserve macroeconomic stability.

The easing of inflation has allowed the Central Bank to relax its control on credit. To reduce interest rates it reduced the Reverse Repo rate from 10% to 9.5% and the statutory reserve requirement of commercial banks by 75 basis points to 7% which released about Rs. 9 billion that the banks can use to expand lending.

It was reported that in February business confidence was at a two year high. This is probably a response to the prospect that the twenty five year old war would soon end. However, during the month the Colombo All Share Price Index declined by about 7%.