

## **The IMF Loan – Its Implications for the Sri Lankan Economy**

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In so far as the economy was concerned the IMF loan of \$2.6 billion (Rs 300 billion) that was approved on July 24<sup>th</sup> dominated the economic news in the month of July. In the February 2009 Economic Review we noted that the Central Bank was asserting that the country had “adequate” reserves. We also noted that it was trying to raise \$500m from the Sri Lankan Diaspora and was making arrangements for currency swaps in order to “avoid having to go to the IMF for assistance that invariably comes with conditions attached that may be unacceptable to the government.” A month later in March the government applied to the IMF for a loan of \$1.9b.

The IMF is controlled by the powerful western nations. US controls 17% of IMF “shares” and an equal percentage of the vote. EU countries together have 23%. Sri Lanka’s share of the vote is a mere two-tenths of one percent. The IMF delayed the final decision on the Sri Lankan loan owing to pressure from USA and some EU countries. The reasons were political and not economic. Western countries disapproved some aspects of governance in Sri Lanka, most notably, the government ignoring western pressure to stop the war against the LTTE and commence negotiation, the holding of about 275,000 IDPs in camps in the north and the culture of impunity that prevails in the country undermining the rule of law. When the IMF Executive Board eventually took up the loan application for review in July, USA, UK and France abstained from voting on it. This was a clear signal to the country from the west that in the coming months their donor assistance, GSP+ and other trade and investment decisions will be influenced by governance issues as much as economic issues.

First, the essentials of the loan. The total loan of \$2.6b is 37% higher than the \$1.9b that was originally requested. It is a sign that the foreign exchange crisis was even more serious than originally projected and the need was greater. The current loan exceeds the total of \$1.5b that Sri Lanka raised from the IMF in a thirty year period between 1977 and 2008. It is a 20 month loan that will be released in quarterly tranches with the final due in March of 2011. The loan is repayable in four years starting in April 2012. There is a service charge of 0.3%. The loan is four times the size of Sri Lanka’s IMF quota. On the first 300% the rate of interest is 1%. On the last quarter of the loan there is a surcharge of 2%. This loan is far cheaper than the commercial loans we raised in 2007 and 2008 at about 7.5% interest. The loan is not for development projects. It is only to augment the country’s foreign exchange reserves.

To avoid the adverse political fallout from the loan request President Mahinda Rajapakse publicly claimed that Sri Lanka would not agree to any conditions when borrowing money from the IMF. The Central Bank governor boasted that Sri Lanka could do without the IMF loan. In July the Acting Finance Minister and the Governor of the Central Bank signed a Letter of Intent agreeing to several conditions that we must adhere to receive the loan. In late July the IMF approved the loan and sent the first installment of \$322m. Now some government ministers are hailing the loan as a stamp of approval of government economic policy. In reality it is not so much a stamp of approval as much as a stamp of redirection of economic policy that tells the government what it has got wrong in its recent policies and how to put them right.

The main reason for taking the loan is the balance of payments crisis that the country faced in 2008. The current account balance ballooned from \$1,401m (4.3% of GDP) in 2007 to \$3,719m (9.4% of GDP) in 2008 (See Table 1). Hit by the world recession the growth in the value of exports declined from 11.0% in 2007 to 6.5% in 2008. In contrast the value of imports grew from 10.2% to 24.0%. Gross official reserves at the end of 2007 stood at \$3,063m (2.4 months of imports). In 2008 it was down to \$1,580m (1.6 months of imports). Public dollar commercial debt rose from \$1,659m in 2006 an average of \$2,700m in 2007/08. At the end of 2006 such commercial debt was 66% of gross official reserves. In 2007 it was 90% and 2008 168%. This was a classic foreign exchange crisis that required major economic surgery.

The cause for the crisis was partly external and partly internal. The principal external factor was high commodity prices, energy prices in particular. The main internal factor was the high and unsustainable budget deficit that was fuelled by war spending – Rs 177b in 2008 – and some government spending that was wasteful. A large pool of ministers created for political expediency is costing the treasury heavily. In addition the duplication and inconsistent allocation of ministerial tasks makes the administration less efficient. Poorly designed and targeted subsidies such as the fertilizer subsidy and economically unviable state enterprises such as the new budget airline Mihin Air also add to the budget deficit. Two state enterprises, Ceylon Electricity Board and the Ceylon Petroleum Corporation reported a combined loss of Rs 50b at the end of 2008. The budget deficit in turn spills over to the balance of payments particularly in the form of higher demand for imports.

Cutting the budget deficit from the 7.7% of the GDP in 2008 to 5.0% by 2011 is a major condition that the government has accepted as a condition for obtaining the loan. (The 2009 budget deficit is likely to be higher than 7.7% making the task even more daunting.) The Central Bank will try to build its foreign reserves while permitting the exchange rate to be determined by market forces. In keeping with this principle, in the past few weeks the Bank has purchased dollars to prevent the rupee from appreciating. If there is a dollar shortage the Bank will not sell dollars as it did from about November 2007 to September 2008 to defend the rupee. The Central Bank will allow the rupee to depreciate. We should not be surprised if the rupee falls to Rs 120 against the dollar in the coming months.

The IMF has explicitly stated that the government must protect its social spending, especially on education and health and transfers to protect the poor who are about 15% of the population. The point is that the much needed economic adjustment must not be at the expense of the most vulnerable in the population. This condition makes it hard for the government to blame the IMF for welfare cuts.

In 2008 prices the government must reduce the budget deficit by about Rs 120b to meet the IMF target of a 5% budget deficit in 2011. In 2008 total tax revenue was Rs 586b. If tax revenue is to be raised to eliminate the budget deficit taxes have to go up by 20%. If the VAT alone is to be increased to raise the additional revenue it will have to go up by as much as 59%, not a practical proposition. The government has appointed a tax commission to make recommendations for tax reform. It is likely to recommend some tax increases, abolition of tax holidays and a greater effort to collect taxes from readily identifiable tax evaders such as businesses and professionals such as doctors, tuition masters and lawyers.

Additional tax revenues alone won't help to reduce the budget deficit. The government will also have to cut spending. The government announced a few weeks ago that it has cancelled an import order worth Rs 23b for military equipment. The government's intention to recruit an additional 100,000 soldiers will add around Rs 40.0b to Rs 50.0b in wages and related personnel expenses to the military budget. Thus, we may not see a substantial fiscal saving from the military budget on account of the end of the war.

Untargeted and inefficient subsidies are more politically sensitive, especially with parliamentary elections and a possible presidential election looming in 2010. In 2008 current subsidies and transfers totaled Rs 171b. Of this amount Rs 131b. went to households. The income supplement called "Samurdhi" designed for low income households living below the poverty line accounted for Rs 10b. Around 15% of the population live below the poverty line. But 33% receive Samurdhi. If the scheme is strictly targeted about Rs 5b can be saved. However, it is unlikely that any such attempt would be made on account of the political sensitivity of the issue.

Another prime candidate for pruning is the fertilizer subsidy for paddy that cost Rs 26b in 2008. Agricultural experts generally consider this to be a highly inefficient scheme that needs radical reform. It leads to both waste and corruption and is not a significant contributor to higher yields. However, it personally benefits rice farmers and officials that indulge in corrupt practices. It also has the support of politicians in the governing party from paddy growing.

The losses that the Ceylon Electricity Board and the Petroleum Corporation incur can be rectified only if the two institutions are streamlined. This calls to stopping the recruitment of refinement workers for political reasons, more efficient management and a rational price structure for the products that they market.

The government and the IMF hope that the IMF loan and the connected reforms, if made, would provide a framework for other donors to step in help Sri Lanka reconstruct its economy following the end of the war. In theory this could happen. The government swallowed its pride and signed the Letter of Intent with the IMF agreeing to the IMF conditions. The government's strategy is to make an economic trade off. It is willing to undertake economic reforms in exchange for financial assistance, It remains to be seen whether the government will have the political will to effect the requisite economic reforms. Even if that happens, as the negotiations for the IMF loan amply demonstrated, donor assistance is not devoid of politics. Sweden, a long standing donor of Sri Lanka, terminated its assistance recently. It gave the unconvincing excuse that Sri Lanka has fully graduated from being a country that needs its assistance. The real reason appears to be Sweden's dissatisfaction with governance in Sri Lanka. The continuation of GSP+ tariff concession from EU also depends on governance issues. Thus the government will come under pressure from donors to make concessions on the governance front as much as on the economic front if it wants large scale western donor assistance.

**TABLE 1**

**Sri Lanka: Selected Economic Indicators, 2006–2011**

Main exports (percent of total, 2008): garment (43), tea (16)

GDP per capita (2008, est.): US\$1,972

Unemployment rate (2008): 5.4 percent

Poverty rate (2007, incidence): 15.2 percent

FDI (2008, est.): \$691 million

Public debt (2008): 81.1 percent of GDP

	2006	2007	2008	2009	2010	2011
			Est.	Prog.		Proj.
<b>GDP and inflation (in percent)</b>						
Real GDP growth	7.7	6.8	6.0	3.0	5.0	6.5
Inflation (average)	10.0	15.8	22.6	4.6	13.0	9.6
Inflation (end-of-period)	13.5	18.7	14.4	8.0	10.7	8.6
<b>Public finances (in percent of GDP)</b>						
Revenue	16.3	15.8	14.9	14.8	15.4	16.0
Expenditure <sup>1/</sup>	24.3	23.5	22.6	21.9	21.5	21.0
Central government balance	-8.0	-7.7	-7.7	-7.0	-6.0	-5.0

<sup>1/</sup>

Consolidated government balance <sup>1/</sup>	-8.2	-8.0	-8.8	-7.7	-6.4	-4.9
Consolidated domestic financing	5.6	4.1	7.1	6.8	4.5	3.6
Government debt (domestic and external)	88.7	85.8	81.1	83.7	84.4	81.0
<b>Money and credit</b> (percent change, end of period)						
Reserve money	21.2	10.2	1.5	12.0	13.8	13.4
Broad money	17.8	16.6	8.5	14.9	20.2	20.8
Domestic credit	29.5	16.3	18.0	13.0	15.2	17.3
Private sector credit	24.0	19.3	7.9	10.5	17.4	21.4
Public sector credit	46.1	8.9	46.2	18.2	10.9	9.1
<b>Balance of payments</b> (in millions of U.S. dollars)						
Exports	6,883	7,640	8,137	7,098	7,559	7,949
Imports	10,254	11,296	14,009	10,015	10,552	11,368
Current account balance	-1,500	-1,401	-3,719	-478	-504	-929
Current account balance (in percent of GDP)	-5.3	-4.3	-9.4	-1.2	-1.3	-2.2
Export value growth (percent)	7.7	11.0	6.5	-12.8	6.5	5.2
Import value growth (percent)	15.7	10.2	24.0	-28.5	5.4	7.7
<b>Gross official reserves</b> (end of period) <sup>2/</sup>						
In millions of U.S. dollars	2,515	3,063	1,580	2,492	4,110	4,614
In months of imports	2.4	2.4	1.6	2.4	3.7	4.0
As a percent of short-term debt	71	60	29	45	71	79
<b>External debt</b> (public and private)						
In billions of U.S. dollars	14.2	16.7	17.6	18.0	19.1	19.6
As a percent of GDP	50.2	51.5	44.4	43.5	49.8	47.3
<b>Total stock of public dollar commercial debt</b> <sup>3/</sup>						
In millions of U.S. dollars	1,659	2,758	2,658	2,596	2,307	2,275

As a percent of GDP	5.9	8.5	6.7	6.3	6.0	5.5
As percent of gross official reserves	66	90	168	104	56	49

Sources: Data provided by the Sri Lankan authorities; CEIC Data Company Ltd.; Bloomberg LP.; and IMF staff estimates and projections.

<sup>1/</sup> Staff projections of domestic interest costs are based on a weighted average of yields on government paper. Actual interest payments have, however, averaged about 2 percent points of GDP lower in 2006-08. The consolidated government balance includes the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

<sup>2/</sup> Excluding central bank Asian Clearing Union (ACU) balances.

<sup>3/</sup> Staff estimates based on total stock outstanding of foreign exchange commercial debt plus nonresident purchase of rupee-denominated treasury bonds.

(Source: IMF <http://www.imf.org/external/np/sec/pr/2009/pr09266.htm>) Downloaded on August 01, 2009

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*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.*