CHAPTER 22
SRI LANKA

Introduction. If it weren't for the crippling effects of the 18 year-old civil war, Sri Lanka would likely be one of Asia's top performers. But it's tough to run a successful economy when people are shooting at each other.

War's Economic Impact

In April and May of 2000, the Liberation Tigers of Tamil Eelam (LTTE) inflicted a series of defeats on the Sri Lankan armed forces. President Chandrika Kumaratunga and her Peoples Alliance (PA)—which had recently won a narrow political victory—sharply increased military spending.

- The military budget was lifted from 52B rupees to a record 83B rupees ($1B) for purchase of new warplanes, rocket launchers, and other hardware.
- Other government spending was cut and development projects put on hold.

Over-borrowing. Unfortunately, spending cuts were not deep enough. So the government opted to borrow the money for the plus up in defense spending.

- Consequently, domestic government borrowing rose to 8.5% of GDP in 2000 even though the target was 3%.
- Repayments on state borrowings consume 32% of government revenue.
- Total public debt rose to 97% of GDP.

On the Brink. Increased military spending, subsequent over-borrowing, and higher oil prices led to an exchange crisis in late 2000.

- The central bank faced an overvalued currency, capital flight, and low reserves.
- Foreign reserves ($950M) covered only six weeks of imports.

IMF to the Rescue. Lacking any other solution, the government turned to the IMF.

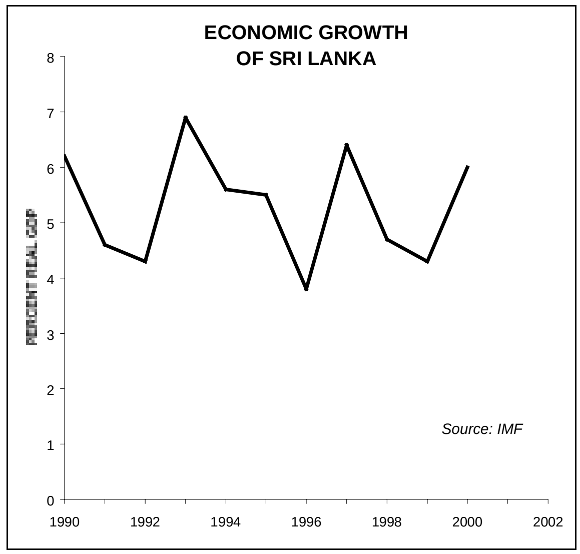
- In return for a $253M IMF loan, Colombo had to implement market reforms—formerly delayed by popular opposition.
- The IMF released $131M, with the remainder conditional on performance.

Figure 22-A. Selected Historical Data

$ Billions (or %)	'97	'98	'99	'00
Gross National Income	14.8	15.2	15.7	16.4
Purchasing Power	46.0	51.2	58.0	67.8
Real Growth (%)	6.4	4.7	4.3	6
Inflation (%)	9.6	9.4	4.7	6.2
Exports	4.6	4.7	4.5	5.4
To U.S.	1.7	1.9	1.9	2.1
Imports	5.6	5.7	5.4	6.2
From U.S.	0.2	0.2	0.2	0.2
FDI from U.S.	0.022	0.024	0.029	0.032
In U.S.	-.002	-.001	-.001	0.002
Cur Account /GDP %	-2.6	-1.4	-3.6	-6.0
Fiscal Balance /GDP %	..	..	-7.5	-9.9
External Debt /GDP %	52.1	56.0	60.3	..

Sources: IMF, ADB, World Bank, U.S. Commerce

Figure 22-B



A War-Ravaged Economy

By all accounts, Sri Lanka's economy is in trouble, with no immediate prospect of getting back on an even keel.

Slower Growth. According to the Central Bank, the growth rate for 2001 will be 4.5%, or 1.5% lower than 2000. But private analysts predict a far lower rate amid concerns over a global slowdown.

Stocks Crash. Share prices are trading at their lowest level in more than ten years.

- Share prices in 2000 were 50% below the peak of two and a half years ago.
- Since then the share index has slumped further from 449 to 419 in June 2001.

- In 1999-2000, foreign investors were the net sellers in the Colombo share market. The situation in 2001 may remain as is.

Opportunity Costs. Most development spending is suspended as the government buys more planes, artillery, and tanks with cash that might otherwise be used to narrow the fiscal deficit or improve infrastructure.

Budget problems. Given the state of the government's finances, there is little hope that it will achieve fiscal goals.

- These goals are a budget deficit of 8.5% of GDP and 25% growth in revenue.
- It is doubtful that the government can realize its long-term target commitments.

Weak Economic Fundamentals. Political uncertainty and low consumer and business confidence paint a gloomy economy.

- *Huge National Debt.* The country's total national debt reached 1.2 trillion rupees ($13.9B) at the end of 2000, an amount which is expected to come close to the value of GDP for the same year.
- *Foreign Exchange.* The rupee initially fell to 93 rupee to the U.S. dollar after it was floated, but is now 87 rupee per dollar.
- *Foreign Reserves*, however, are down to 3.4 months of imports.
- *Trade Deficit.* The trade deficit stands at $216M, down from $387.1M a year ago.
- *Textile Woes.* The U.S. economic downturn is hammering the textile industry.

The Good News: Teas and Remittances. Tea prices have firmed, production is stable, and profits made in 2001. Further, Sri Lankan domestic workers in the Mideast earned $1B in remittances.

IMF Strings

Now let's turn to IMF's tough conditions for its financial assistance. A key question: Will IMF and World Bank's tough medicine cure the patient or kill it?

- Samurdhi, a limited poverty alleviation program under which a family receives 500 to 750 rupees per month ($5.5 to $8.25), is to be pruned back. The World Bank has plans for further cutbacks.
- Far-reaching restructuring or privatization of state enterprises is proposed. In all, 35 enterprises will be closed or sold off. About 14,000 jobs will be slashed at the Ports Authority.
- Proceeds from the privatizations will be used to repay huge government debts.
- Civil servants will receive no pay rise during 2001. There will be a freeze on hiring civil servants and the government pension scheme will be "reformed" to make the "civil service more affordable."

Financial Liberalization. In addition, the IMF has been urging the Central Bank to liberalize financial markets.

- In January 2001, the Central Bank free-floated the rupee in an attempt to stabilize soaring interest rates and protect foreign reserves.
- While imports fell and reserves were protected, interest rates remained high.
- With commercial banks' prime lending rates running at over 22%, the private sector is finding little room to breathe.
- The skyrocketing interest rates threaten the survival of many businesses.
- The float and the subsequent free fall of the currency contributed to higher inflation. The consumer price index has already risen by more than 4%.

IMF Sets Targets

The IMF has set tough government targets.

Higher Energy Prices**.** A timetable has been set for abolishing price controls on energy. By the end of 2001, all oil prices (including diesel) will be determined by the market. Already the price of diesel has doubled since early last year. Higher fuel prices will inevitably impact on the cost of transport and send the price of basic commodities soaring again.

A Smaller Current Account Deficit. The current account deficit is to be reduced from 6% of GDP in 2000 to 3% this year. As announced in the budget, the government will reduce its deficit from 9.9% of GDP in 2000 to 8.5% in 2001 and 7.5% in 2002. These targets will mean a drastic cut in government spending on basic services such as education and health.

Flexible Labor Market. Changes are required to end the rigidity of the labor market, including a hire-and-fire policy to allow enterprises to determine appropriate staffing levels. One piece of legislation to be abolished is the Termination of Employment Act, which requires an employer to obtain the written consent of the employee or the Labor Commissioner before any dismissal.

Higher Tax Revenue. The general sales tax (GST), which by November will incorporate the existing National Security Levy, is to be extended to all sectors. When the National Security Levy was originally imposed, the government claimed that it was only a temporary measure while the country's civil war continued. Now the levy is to be made permanent through the GST.

Smaller Defense Budget. The government plans to reduce defense spending, but if it cannot, then "any overspending on security-related expenditure will be offset instantaneously by further measures." In other words, increased spending on the army will automatically result in cuts to further government services or higher taxes. Defense spending in 2000 was 5.6% of GDP.

Open Door to Foreign Direct Investment (FDI). In a further concession to international capital, the remaining limitations on FDI will be phased out in 2001.

Other Items. The Central Bank's report also reiterated the necessity of implementing the IMF's program, calling for the restructuring of the public sector, a reduction in the number of public holidays, more "labor reforms" and the tying of wages rises to productivity increases.

A Domestic Backlash

Implementing IMF and World Bank agreements is unpopular at home.

- Restructuring programs could well wipe out tens of thousands of jobs at the Sri Lanka Ports Authority and in the country's financial sector.
- These measures could erode working conditions for the remaining workforce.

Poverty May Worsen. Meanwhile, Sri Lanka still suffers from high levels of poverty throughout the country. Excluding the war torn northern and eastern provinces, the indicators show an average of 30% of the population living in poverty. A key question therefore is, "How will the IMF and World Bank programs affect poverty?"

- Once the IMF measures are implemented, however, the gulf between rich and poor will widen even further.
- Moreover, those hit by higher prices and the lack of jobs will also find it increasingly difficult to get access to basic services (education, health and welfare) as the government slashes spending in these areas to meet the IMF's budget targets.

Conclusions

The military escalation in 2000 and the subsequent foreign exchange crisis are part of a classic case study that shows the seamless web between military security and economic security.

- A military victory is unlikely if the economy is collapsing.
- Economic security is unlikely in a war zone.
- Any strategy that successfully addresses the economic and military instability in Sri Lanka must creatively harmonize all the instruments of power.
- In this regard, a negotiated settlement of the long-running civil war with the separatist Tamil Tigers is needed to help Sri Lanka dig itself out of its economic hole.
- The government needs to redouble its efforts to shape the conditions necessary to rebuild economic and military security in Sri Lanka.