Economic pressure mounts to end the war

Sri Lankan rupee plunges following currency free float

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Two weeks ago the Sri Lanka government deregulated the rupee in a bid to avert the country's growing balance of payments crisis and shore up its low foreign reserves. Since then the currency has fallen sharply, adding to the pressure on the government to accelerate market reforms, cut its expenditure and negotiate an end to the country's protracted civil war.

The Central Bank of Sri Lanka announced the free float of the rupee on January 23, ending the existing managed exchange rate and indicating that it would only intervene under exceptional circumstances. To stem a drain on foreign reserves, the bank announced a series of currency measures, including a 90-day deadline for the remittance of export earnings, and lifted interest rates to commercial banks from 20 to 23 percent.

Within two days, however, the currency slid rapidly from around 85 rupees to the US dollar to reach 99 rupees at one point—an effective devaluation of about 17 percent. In the midst of the slide, the Central Bank warned that it would be compelled to intervene to defend the rupee and take action against speculators. At the end of last week the rate had stabilised, temporarily at least, at around 89-90 to the US dollar.

The Central Bank has predicted that the currency deregulation will bring down the trade deficit, increase exports by 10 percent and put the country's balance of payments in surplus by the end of year. Private analysts are more pessimistic, however, saying that high interest rates, the effects of the devaluation on consumption, the high cost of war and a downturn in the US economy will result in a slump in Sri Lanka.

The state media quoted a number of businessmen welcoming the deregulation. Ceylon Chamber of Commerce chairman Chandra Jayaratna said, “the ultimate beneficiaries will be the private sector if it is properly implemented”. The Hatton National Bank managing director commented that it “would prevent spurious dumping” and “encourage exporters”.

Others were not so enthusiastic, complaining about the confusion caused by the uncertain exchange rate. The Colombo stockmarket continued to stagnate. One stockbroker commented to the media: “We are playing in a dead stock market.” The Central Bank's capital and currency controls have also provoked protests from businessmen.

The instability of the rupee and the decision to float the currency highlight the country's underlying economic and political crisis. By the end of last year, Sri Lanka's foreign reserves had fallen to just $US950 million, or only enough to cover about six weeks of imports. It was a fall of 45 percent over the year, mainly due to higher oil prices and a dramatic increase in military spending.

Last May the Sri Lankan army suffered a series of major defeats including the loss of the strategic Elephant Pass base to the separatist Liberation Tigers of Tamil Eelam (LTTE). In a bid to stave off further losses, the Peoples Alliance (PA) government went on a spending spree, buying new military aircraft, patrol boats, artillery and multi-barrel rocket launchers. The defence budget skyrocketted by more than 50 percent from 52.43 billion rupees ($728 million) to 83 billion rupees ($1,152 million).

The military purchases, combined with an extra $400 million on the country's fuel bill, lifted the trade deficit to $1.3 billion and the balance of payments deficit to $516 million for 2000. The Central Bank has carried out four piecemeal devaluations since last June totaling 10 percent and originally proposed a free float of the rupee for June 2001. But as the economic situation continued to worsen, the PA government was forced to advance the plan by six months.

The International Monetary Fund had been pressing for the deregulation of the rupee for some time, and had a team headed by Asia Pacific regional chief Jeremy Carter in Sri Lanka at the time of the announced float. An IMF statement backing the decision commented: “The new exchange arrangement is in keeping with the broader reform agenda... The Central Bank's discontinuation of the band was... timely and well received by the market.”

The government is in desperate need of IMF funds. The high level of public borrowing to pay for military purchases has dried up the financial markets and created a liquidity crisis in recent months, forcing up interest rates over the last year from 13 to 24 percent. Without IMF backing and loans the government will have difficulty presenting its next budget, propping up the country's foreign reserves and getting further loans from other sources.

According to the media, Sri Lanka is currently negotiating a $450-500 million loan from the IMF and an IMF team has visited to review the government finances. At present an uneasy calm prevails in the country's financial markets, but that is mainly based on the hope that the IMF will grant the loan by March and that the Central Bank will be able to stabilise the rupee.

IMF loan conditions will have far-reaching implications, however. The IMF chief representative in Sri Lanka, Dr. Nadeem Ul Haque, told the *Daily Mirror* last week that the next budget “would focus on policies and measures ensuring further stability, reduce current and enhance capital expenditure and announce structural reforms that will further improve growth prospects”.

One of the IMF's main demands is for the government to cut its budget deficit, which soared to 9.7 percent of the Gross Domestic Product (GDP) last year. This will mean cutting back on military spending—which is only feasible if fighting is scaled back and a negotiated settlement reached. A Colombo-based diplomat quoted by Agence France Presse recently commented: “The economic picture must be a compelling reason for the government to move to the negotiating table.”

A report published by the Marga Institute, a private research organisation, last week highlighted the drain on the economy by the war, which, in human terms, has cost more than 60,000 lives and left many more disabled or homeless. According to the report, the direct cost of the war to the government over the period 1983-98 amounted to 295 billion rupees ($US4 billion) with additional military spending of 213 billion rupees. Another 40 billion rupees have been spent on law and order. The institute estimates that the LTTE's military spending over the same period has been 42 billion rupees.

The past year has seen a flurry of diplomatic activity aimed at pushing the PA government and opposition United National Party to work together to achieve a settlement. Only last week, Norwegian special envoy Erik Solheim left Colombo after the latest round of discussions with the government, opposition and other parties. All the major powers have been pushing for an end to the 17-year conflict, which constantly threatens to have a destabilising effect elsewhere on the Indian subcontinent.

Sections of big business in Sri Lanka have also been urging the PA and UNP to end the war, as it has become a barrier to attracting foreign investment. The leaders of the Business Forum, representing all the major business and financial organisations, are scheduled to meet the president on February 19 and are expected to renew their call for a settlement. The government, however, also faces pressures from Sinhala extremist groups that are bitterly opposed to any deal with the LTTE.

At the same time, the deregulation of the rupee will heighten discontent among workers and the rural poor, who have been hard hit by unemployment and inflation. Already prices have jumped. The Colombo Consumer Price Index for January rose by 104.5 to 2797.5—an increase of 16.2 percent compared to a year ago. Prices for essential goods such as rice, sugar, dhal, chilies, milk powder and medical drugs have soared by 15 to 30 percent. Market analysts predict prices could go up further as existing stocks are sold.

The Electricity Board has announced a 25 percent increase in charges from March. The Shell Gas Company has increased the industrial gas price by 35 percent, effective immediately. A Finance Ministry report obtained by the *Island* newspaper proposes to lift the price of kerosene by 40 percent and diesel by 20 percent, which will lead to higher transport charges. Health services and hospitals have been severely affected by the falling rupee as almost all medical drugs and equipment are imported.

Many families are barely coping at present. Half the population relies on the government's poverty alleviation program, under which they receive between 750 and 1,000 rupees ($US10-$14) a month. Officially 25 percent of people, excluding those in the war-torn North and East, live below the poverty line. If those in the war zones were included, the figure would rise dramatically.

Facing growing dissatisfaction among workers over rising prices, pro-government trade union leaders met President Chandrika Kumaratunga last week to urge a wage increase. They came away empty handed as Kumaratunga ruled out any pay rise in the near future. She emphasised the point during her Independence Day speech over the weekend when she said: “This is not a time to ask more and more. It is time for each one of us to give.”

Kumaratunga is well aware that any wage rise would only lessen her chances of obtaining international loans. The IMF is insisting that the government end price controls on basic commodities, step up privatisation, cut back social services and overhaul the country's labour laws for the benefit of private employers. If enacted, these measures will inevitably lead to a further sharp rise in unemployment and poverty.