World Bank places Sri Lanka among the "highly vulnerable" countries

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30 October 2008

A World Bank report published just prior to a joint International Monetary Fund-World Bank meeting on October 10 included Sri Lanka among 28 countries that are judged to be "highly vulnerable" to the ongoing global financial crisis and credit crunch.

The countries listed were mainly small, impoverished and economically backward countries, including Eritrea, Ethiopia, Tajikistan, Madagascar, Nepal, Rwanda, Malawi, Ivory Coast, Fiji, Haiti, the Seychelles and Mauritania. The Seychelles declared on October 1 that the country was in default and could not pay interest on its foreign loans.

Speaking in New York prior to the October 10 meeting, World Bank President Robert Zoellick acknowledged that the international finance crisis was hitting many countries hard. "The events of September could be a tipping point for many developing countries. A drop in exports will trigger a fall-off in investments. Deteriorating financial conditions combined with monetary tightening will trigger business failures and possibly banking emergencies. Some countries will slip toward balance-of-payments crises," he said.

In order to forestall defaults, the World Bank and International Monetary Fund (IMF) are demanding the reining in of budget deficits through cutbacks to government expenditure, including to subsidies and social spending, and an acceleration of privatisations. All of these measures will fall most heavily on those who can least afford it—millions of urban and rural poor in economically backward countries.

In Sri Lanka, Central Bank Governor Ajith Niward Cabral attempted to play down the World Bank report. In a press conference on October 24, Cabral was at pains to emphasise that the situation was not so bad. But the picture he painted was far from reassuring: rapidly draining foreign reserves, an unstable rupee and a flight of investment.

Cabral admitted that Sri Lanka's foreign reserves had plunged by $US800 million, or more than 30 percent, in just three months. The reserves stood at $2.6 billion last week, down from $3.4 billion in early August. "[The] balance of payments problems this year seems to have been triggered by [a] withdrawal of foreign money brought into the country during the past two years to fill the ballooning budget deficit," Cabral said.

The main drain on the treasury has been the government's renewed communal war against the Liberation Tigers of Tamil Eelam (LTTE) as well as the high cost of fuel and food imports. Since President Mahinda Rajapakse restarted the war in mid-2006, defence spending has jumped from 96 billion rupees for 2006 to 167 billion rupees for 2008—a rise of more than 70 percent.

Since last year, the government has borrowed $800 million at high interest rates from the international money markets. Earlier this month, it called for proposals to obtain another $300 million. According to a 2007 Central Bank report, the country's overall debt stood at 85.8 percent of gross domestic product (GDP). Foreign financing of the budget rose from 2.5 percent of GDP in 2006 to 3.7 percent in 2007.

To plug the holes in the treasury, the Central Bank has issued treasury bills and securities and taken out loans. For the first time, the government allowed the sale of 10 percent of treasury bonds to foreign investors. However, foreign investors are now selling off rupee-denominated securities in line with the scramble internationally out of so-called emerging economies.

Cabral pointed out that at the peak the bank had $600

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million worth of foreign investment in government securities, but by last August $200 million had been withdrawn. He warned that in the coming months at least another $200 million would be pulled out.

In recent years, the Sri Lankan rupee has fallen sharply, contributing to an inflation rate that is currently hovering around 28 percent. Confronting a wave of strikes and protests over pay demands, the government pressed the Central Bank to take action to reduce inflation. The floating exchange rate was abandoned at the beginning of the year and replaced with a managed rate of 108 rupees to the US dollar.

The pull-out by foreign investors increased the demand for US dollars, forcing the Central Bank to repeatedly intervene in the market to defend the rate of 108 rupees. The result has been a huge strain on the Central Bank, which spent $202 million in September and another $150 million in the first three weeks of October.

Big business has expressed fears over the continuing drain on foreign reserves as a result of the managed exchange rate. *Lanka Business Online* wrote recently that “soft pegs and sterilised intervention of currencies eventually lead to steep currency falls, which can result in banking sector and economic collapse as has happened in East Asia, Sri Lanka in 2000 and is now happening in Iceland, Ukraine, Belarus and Pakistan.”

In 2000, the value of the Sri Lankan rupee plunged and foreign reserves fell dramatically, creating an acute balance of payment crisis. The IMF forced the government to implement a floating exchange rate, cut subsidies, and increase taxes including a defence levy, all of which hit working people and the poor.

While not as volatile as other share markets, the Colombo stock market has been falling amid global financial instability. The all share price index (ASPI) dropped by 8.4 percent and the blue chip Milanka index fell by 7.8 percent in the week from October 17 to October 24. In the year to September, the ASPI has dropped by 25 percent.

Sri Lankan exports are also suffering. Tea is the country’s third largest foreign exchange earner, employing half a million workers in the tea plantations. Tea prices and sales are both falling. Sri Lanka Tea Board chairman, Lalith Hettiarachchi, told the media last Friday: “All the stake holders are worried about the functioning of tea auction. In the last few weeks almost 65 percent of tea stocks were withdrawn from the auction because of the low demand and the prices.”

Along with other commodities, prices for tea had been rising since late last year. The Sri Lankan government had projected $1.5 billion in foreign exchange earnings this year from tea, but this target is no longer realisable. Plantation employers recently met President Rajapakse to request a financial bailout amounting to six to seven billion rupees. The Central Bank governor has since been ordered to devise a plan.

There are also concerns that the garment industry, another major exporter earner, will be badly affected by recession in US and Europe. Anura Ekanayake, deputy chairman of the Ceylon Chamber of Commerce, warned that any recession or growth slowdown in these two markets would have a “definite and significant” impact on demand for Sri Lankan products.

Mahesh Amalean, chairman of the major apparel exporter MAS Holdings, explained: “The impact of the US recession will hit us in the first half of next year. The whole of next year will be difficult, but the first half will be really tough.” The garment sector directly employs about 270,000 workers, mainly female, and makes up 10 percent of GDP.

The full impact of the global economic turmoil crisis is only beginning to hit countries such as Sri Lanka. Millions of workers will be affected as factories are shut down, the production of tea and other commodities is wound back, and the government imposes the burdens of the economic crisis and its war through further cutbacks to subsidies and social services.

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