Credit agency rates Sri Lanka “very high risk”

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Global credit ratings agency, Standard & Poor’s (S&P), has classified Sri Lanka as a “very high risk” (a risk score of 8) for economic resilience and credit risk, and a “high risk” (a score of 7) for economic imbalances.

On a scale of 1 to 10 (lowest risk to highest risk), S&P placed Sri Lanka in group 8 of its Banking Industry Country Risk Assessment (BICRA) along with countries such as Nigeria, Tunisia, and Kazakhstan. Within Asia, Indonesia and Philippines are in group 7, Cambodia and Mongolia are in group 9, and Vietnam in group 10.

S&P became the second agency to warn of Sri Lanka’s economic problems and exposure to the deepening financial crisis unfolding in Europe. Fitch Ratings recently stated Sri Lanka, among Asian countries, was “most at risk” from any disruption to global funding markets.

The S&P report pointed to the country’s weak external liquidity “in the context of low income levels, relaxed lending practices and underwriting standards, as well as a weak payment culture and rule of law.”

The country’s Central Bank dismissed the report as “factually incorrect, illogically analysed, and highly contradictory.” S&P, however, rejected the criticism and reaffirmed its statement. It reiterated that Sri Lanka’s “structural weaknesses and underdeveloped institutions” made it vulnerable to “adverse developments such as external shocks or internal imbalances.”

A major economic imbalance is the trade deficit, which grew by 32 percent compared to the same period last year, to $US3.3 billion in the first four months of 2012. Over the same period, the budget deficit reached 285 billion rupees ($US2.1 billion), badly exceeding International Monetary Fund (IMF) directives. This means that the second half of the year will see deeper attacks on social conditions, in order to reach the IMF target for the budget deficit of 6.2 percent of GDP for 2012.

The government’s external debt reached $18.6 billion at the end of 2011, up 13 percent over the year. By the end of April, the total had risen by another $300 million. External debt service payments reached almost $1 billion in 2011. This burden is set to increase. On June 25, the Central Bank issued $229 million worth of Development Bonds, and a $1 billion bond issue is pending, mainly to cover maturing bonds.

The government is also seeking a further IMF loan, having just received the last $400 million tranche of a $2.6 billion loan approved in 2009. Central Bank governor Ajith Nivard Cabraal told Reuters: “It is not a bailout package. The area (we’re) looking at is the extended fund facility.”

Cabraal’s terminological distinction cannot disguise the fact that the government has been forced to apply for further IMF borrowing, which will necessarily involve even harsher austerity measures than those already imposed under the 2009 package.

S&P’s report drew attention to economic imbalances produced by the annual 28 percent growth in credit during the past two years. The government of President Mahinda Rajapakse has resorted to credit expansion to develop infrastructure projects, and attract local and foreign investment.

While this credit boost generated a short-term lift in the gross domestic product, signs of a debt crisis are emerging. It was revealed in parliament last month that the biggest state bank, Bank of Ceylon, had written off 11.3 billion rupees ($80 million) worth of bad loans last year. During the past 10 years, two state banks, Bank of Ceylon and Peoples Bank, wrote off 125 billion rupees, with the loan defaulters mostly backed by government politicians.

Foreign Direct Investment (FDI) has largely been limited to luxury hotels and other tourism related projects. According to *Sunday Times* economist Nimal Sandaratne, writing on June 24, foreign investment is being deterred by perceptions of corruption and arbitrary governance, as well as "continuous protests and violence" and "issues in media freedom that are highlighted around the world."

These remarks point to concerns in financial markets about the capacity of the Rajapakse regime to implement the IMF's dictates and provide stable conditions for corporate profit. Faced by rising unrest among working people over its austerity program, the government increasingly depends on repressive methods. Three years after the end of the brutal war against the separatist Liberation Tigers of Tamil Eelam (LTTE), a military occupation continues in the North and East.

US-based investment group, Bespoke Investment Group, recently ranked the Colombo Stock Exchange (CSE) the world's fourth worst performing share market this year. The CSE's All Share Price Index was down 18.95 percent in the first four months of 2012, with only three countries having a poorer result—Greece, Spain and Ukraine. Annual CSE turnover to the end of April 2012 declined by a staggering 59 percent, to 91 billion rupees, and its share price index declined by 26 percent.

The S&P report also voiced concerns about government manipulation of the stock market, through pension funds controlled by the Central Bank. "[W]e see a potential conflict of interest in the central bank's role," it stated. "In addition to policy formulation and supervision of banks, the monetary board of the central bank also oversees Employees' Provident Fund (EPF) investments. The fund is a large investor in Sri Lankan banking stocks."

The IMF team that visited Sri Lanka before approving the final tranche of the $2.6 billion bailout accepted the government's assurances that it would deliver the further austerity measures required. Yet, the IMF also reduced its economic growth estimate for Sri Lanka from 7.2 percent to 6.75 percent and predicted that the annualised inflation rate would rise to 9.5 percent, the highest level since the end of the civil war.

A recent report by a local think tank, Pathfinder concluded: "[U]nfortunately, the combination of adverse global economic trends and the policy induced imbalances in the balance of payments means that there are no easy options. The authorities need to persist with contractionary policies to stabilize the economy (i.e. to live within one's means)."

In other words, Rajapakse's government will deepen its "contractionary" measures, such as scrapping fuel and other subsidies, driving down real wages and cutting public sector jobs and services, leading to even greater social and political discontent.