An Analysis of the 2009 IMF Loan Facility to Sri Lanka

Pathfinder Foundation
Colombo

Introduction

A seminar was organised by the Pathfinder Foundation on 26th of August 2009 at the Galle Face Hotel, Colombo, on "the International Monetary Fund (IMF) Loan Facility: Challenges and Opportunities" to critically examine the IMF assistance to Sri Lanka, aiming at making suggestions for effective utilisation of the loan facility for the development of the country. Some leading professionals, namely Dr. Saman Kelegama, Executive Director, Institute of Policy Studies, Dr. Anura Ekanayake, Chairman, Ceylon Chamber of Commerce, Dr. G. Usvatte-Aratchi, former chief economist, UN system and Prof. W. D. Lakshman, Prof. of Economics and Senior Economic Advisor to the President, made presentations, and discussions were followed. At this forum, following a brief review of the recent IMF assistances to Sri Lanka, a detailed discussion on the current assistance was held to make suggestions to the government to face the challenges that would be anticipated in achieving the targets of the loan facility:

This article is based on the presentations and deliberations of this seminar, and is organised into five sections. The second section briefly presents the global role of the IMF and reviews its recent assistances received to Sri Lanka. Section three explains the 2009 loan facility, and its opportunities and challenges are presented in the fourth section. The recommendations proposed as guidelines in planning and formulating various measures aiming at accelerating economic growth and development of the country are presented in the final section.

International Monetary Fund and Its Recent Assistances to Sri Lanka

The IMF is the key international organisation that observes the macroeconomic policies and monitors the global financial system, tracking movements of exchange rates and the Balance of Payments (BOP) of its member countries. The primary mission of the IMF is to provide financial assistance to countries experiencing BOP difficulties.

In the past, Sri Lanka has received IMF assistance on a number of occasions to tide over periods of foreign exchange difficulty. Sri Lanka's formal exchanges with the IMF date back to the late 1970s when the IMF extended a Stand-By Arrangement (SBA) facility to implement liberalisation policies. Sri Lankan governments continued to obtain such credit facilities in 1977, 1979, 1980, 1981, 1982, 1983, 1988, 1989, 1991, 2001, 2003 and 2005. A brief description of the most recent assistance received by Sri Lanka from the IMF is given below as a preamble to the current loan facility:

SBA in 2001

The SBA made in April 2001 by the IMF, offered US$ 274 million to strengthen the economy and build up foreign exchange reserves, when gross official reserves had fallen to US$ 906 million which was sufficient to cover only 1.3 months of imports. The programme was meant to be completed by June 2002, but it was thrown off course by further economic and political shocks, such as the LTTE attack on the international airport and political uncertainties due to a new parliamentary election in October 2001. Thus, the SBA conditions laid down by the IMF could not be met on time. Eventually, the new government elected in December 2001 re-negotiated the programme, and it was completed in September 2002.

Poverty Reduction and Growth Facility (PRGF) and Extended Fund Facility (EFF) in 2003

In the IMF's agreement with Sri Lanka in 2003, it agreed to provide two credit facilities for a total value of US$ 567 million, equivalent to 100 per cent of Sri Lanka's IMF quota. Of this, US$ 369 million was offered under the Fund's PRGF and the balance under the EFF which helps countries overcome BOP difficulties. The funds were available to be drawn in seven tranches over three years. The assistance was intended to support the government's medium-term programme presented in a Poverty Reduction Strategy Paper (PRSP) called "Regaining Sri Lanka: Vision and Strategy for Accelerated Development" (RSL). The IMF decision was seen as a vote of confidence in the policies being followed by the government to restore the health of the economy.

However, only the first disbursements of this fund went through. The first reviews of the programme were initially delayed owing to the lack of progress on key structural reforms, particularly in areas of tax administration and the restructuring of the state-owned People's Bank. In 2004, macroeconomic conditions also deteriorated, although toward the end of the year, steps were taken to strengthen the macroeconomic policy framework. Accordingly, the PRGF with the IMF was not seen through to its completion.

Emergency assistances for natural disasters (Tsunami) in 2005

Sri Lanka's BOP was again adversely affected by the impact of the December 2004 Tsunami on tourism and the resulting escalation in imports for reconstruction. The BOP was further weakened as a result of the oil shocks and drought in 2005. In this context, to support Sri Lanka's effort to meet the immediate financing needs without seriously depleting its external reserves, the government requested a loan from the IMF for the equivalent of SDR (Special Drawing Rights) 103.35 million (25 per cent of the quota) under the Fund's policy on Emergency Assistance. In line with the Fund's policy on providing Emergency Assistance for Natural Disasters to PRGF-eligible countries, the IMF offered SDR 103.4 million at an interest rate of 0.5 per cent per annum to support meet immediate BOP financing needs, and to restore macroeconomic stability. Whilst there were no direct macroeconomic policy conditions attached to the emergency assistance funding, the IMF directors encouraged the government to move forward with the re-structuring of key loss-making State-owned enterprises and to continue pursuit of the policy reform agenda, including improvements in tax administration and fiscal reform in line with the Fiscal Management Responsibility Act.

The Current Loan Facility: Stand-by Arrangement in 2009

Economic fundamentals of Sri Lanka had been improving until the third quarter of 2008 with strong GDP (gross domestic product) growth, decreasing rate of inflation from a peak in July 2007, improving level of exports, steady growth of remittances along with rising investments. Hence, the country did not feel the need of the support from IMF or any other institution. However, during the fourth quarter of 2008, the external sector was adversely affected by the global financial downturn which resulted in a sudden withdrawal of investments in Treasury Bills and Bonds by foreign investors, swift claims on short-term credit facilities that were freely available for petroleum imports, drying up of commercial financing required for counterpart funds for the implementation of foreign-funded projects and severe valuation losses arising from the sharp depreciation of major international currencies against the US dollar. Foreign Reserves which were at US$ 3.5 billion in July 2008 declined to US$ 1.2 billion by March 2009. Consequently, in March 2009, Sri Lanka applied for a SBA facility with exceptional access from the IMF amounting to US$ 1.9 billion, 300 per cent of the country's current quota in order to overcome the BOP difficulties and other macroeconomic instabilities.

The Letter of Intent was signed by the Sri Lankan authorities on 16th July, 2009 and the Executive Board of the IMF approved the SBA facility on 24th July, 2009. The key objectives under the SBA Programme are to rebuild external reserves further, strengthen the fiscal position, domestic financial system, safety net and resettlement programmes, and maintain monetary stability. The programme was designed to help Sri Lanka re-build its reserves to about US$ 3.5 billion or equivalent of 3.5 months imports, within a period of 20 months.

The facility amounts to SDR 1.65 billion (approximately US$ 2.6 billion), which is equivalent to 400 per cent of the country's current quota with the Fund, and it is the highest ever facility offered by the IMF to Sri Lanka. The first tranche amounting to SDR 206.7 million (approximately US$ 322 million) was made available immediately. The remaining amount will be disbursed in seven tranches, subject to the quarterly reviews on economic performance, and the final tranche will be disbursed in March 2011. The loan is repayable within 4 years, commencing April 2012. The rate of interest is in two components: Service charge: calculated weekly, based on the SDRs rate (current rate: 0.3 per cent per annum) and Fixed margin: 1 per cent per annum for the outstanding loan amount. Moreover, a surcharge of 2 per cent per annum will be added when the outstanding loan amount exceeds 300 per cent of the quota, and when the outstanding loan amount exceeds 300 per cent of the quota for more than 3 years, a surcharge of 3 per cent per annum will be added. The second review took place in mid September 2009.The completion of the review enables the immediate disbursement of an amount of US$ 329.4 million bringing total disbursement under the arrangement to an amount of US$ 658.8 million.

The SBA programme aims at reducing the budget deficit from a target of 7 per cent of GDP in 2009 to 6 per cent of GDP by 2010 and 5 per cent of GDP by 2011 and enhancing the country's economic standing by boosting investor confidence, and the country's private sector's ability to attract local and foreign investment. Investments could be easily channeled for infrastructure development as well as for the post-conflict reconstruction, resettlement and relief effort. The conditions, as stated in the Letter of Intent and the Technical Memorandum of Understanding, are voluntarily and internally chosen.

Opportunities and Challenges of the IMF Loan Facility to Sri Lanka

Opportunities

Sri Lanka is about to enter a promising, but economically challenging era. One of the main opportunities, the IMF loan facility provides to Sri Lanka is an impetus to get the country's fiscal discipline in order and to rebuild foreign reserves. Under certain circumstances, externally-imposed discipline is an effective lever to drive policy reform. At the same time, strong political commitment is required to drive through difficult policy reforms.

The loan facility is also an opportunity to promote Public-Private Partnerships and to set a platform to restructure loss-making and inefficient enterprises. There is already a Strategic Enterprise Management Agency (SEMA) and Public Utilities Commission (PUC) functioning to cater to these purposes. Given the political stability enjoyed by the incumbent government, this is an unprecedented opportunity to reform loss-making institutions, such as the Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), etc. In fact, the Letter of Intent states that the government intends to make these two State-owned enterprises breakeven by 2011. The IMF loan facility is also a vital catalyst in rebuilding international investor confidence, as the government's understanding with the IMF signals a fundamental commitment towards fiscal discipline, the key for long-term macroeconomic stability. This improved confidence in the economy has resulted in the upgrading of Sri Lanka's sovereign rating and increased interest by investors.

The necessity to improve fiscal discipline would also set the platform to scrutinise the duplication of functions and thus expenditure incurred both within the central government and between the central and provincial governments. Whilst curtailment of government expenditure is a key step in improving fiscal balances, the sources of revenue also need to be reviewed, particularly in the context of the declining trend observed in the first half of 2009. For instance, the incentive scheme under the Board of Investments (BOI) needs to be revisited to minimise granting of costly fiscal incentives. The revenue position could also be enhanced by considering measures, such as widening the tax net to include hitherto exempted categories, while lowering the existing rates, and refining the Value Added Tax (VAT).

The SBA will enhance the confidence amongst other donors, lenders and investors, and Sri Lanka is expected to benefit from a few more windows through which the country can obtain funding more than what would have had without the SBA. If the government is able to effectively invest in key infrastructure, both in the North and East and in the rest of the country, there will be a rise in Sri Lanka's long-term production potential. In the short term, domestic demand will increase along with the reconstruction and development of post-conflict provinces, which will help expand domestic production and boost growth prospects despite a downturn in global economic activity. The steady accumulation of international reserves, the gradual reduction of the budget deficit and the consistent maintenance of stable monetary growth are possible as a consequence of a fully implemented SBA facility.

Challenges

One of the main challenges pointed out with regard to the recent IMF loan facility is achieving the fiscal targets; reducing the budget deficit to 6 per cent of GDP in 2010 and to 5 per cent of GDP in 2011 from the current (2008) level of 7 per cent of GDP. Meeting the fiscal deficit targets is a major concern at a time where the current and capital expenditures are rising due to massive development and resettlement programmes, large defence expenditures and increasing fertiliser subsidies. In the case of the defence budget, although capital expenditure may decrease, current expenditure is anticipated to remain at a higher level. Continuing recruitments to the forces, requirement for building and maintenance of several new army camps in the North and the East will keep recurrent defence expenditure high for another year or two. A framework related to this target was established in 2003 by way of the Fiscal Management Responsibility Act. However, in 2004 the tsunami disaster caused substantial departures and this pattern has continued since then.

Another challenge is the restructuring of the CEB and the

CPC and ensuring they breakeven by the end of 2011. There are concerns as to how this will take place and how long it would take. It should be noted that apart from these, there are many other loss-making State-owned enterprises such as SriLankan Airlines, Sri Lanka Railways, Sri Lanka Ports Authority, etc.

Simplifying the tax system, strengthening the enforcement of tax collection, and improving tax auditing are key issues that require consideration. Pertaining to revenue enhancement, the government has already taken a short-term measure by introducing the Nation Building Tax of 3 per cent. It is necessary to revisit and rationalise the Sri Lankan tax regime as Sri Lanka has approximately 25 taxes whereas other developing countries have only 7 to 9 taxes. Thus, the imposition of new taxes will only result in reducing the incentives for private sector's investment rather than increasing tax revenue. Hence, the challenge is how to increase the tax base without further complicating the tax system and providing incentives for private sector investment. This challenge is being addressed by the newly-appointed (June 2009) Presidential Taxation Commission.

Management of the exchange rate is considered as a demanding task in the current context of increased flow of short-term foreign capital, direct investment as well as donor funding for reconstruction projects. Sri Lanka needs to ensure the competitiveness of exports by controlling pressures for appreciation of the currency. Though the country is expected to maintain a flexible exchange rate, the challenge is to maintain a rate that will ensure export competitiveness in a situation of large inflow of foreign currency.

Another challenge is the upcoming Presidential and Parliamentary elections and how it would affect national expenditure and adoption of a rational economic policy framework. Maintaining discipline in expenditure at a time of election was vital, yet, implementation of populist policies may become a possibility, and this can create further fiscal instability.

It is imperative that Sri Lanka meets the objectives as otherwise the withholding of the rest of the IMF loan would become a serious setback to the economy. The first tranche of the loan was only US$ 322 million dollars. It is the remaining US$ 2.2 billion that is of crucial importance. If under any circumstance, the IMF withholds the rest of the loan, it would result in a downgrading of the country's credit rating and any commercial borrowing even at considerably high rates would be difficult. Therefore, however difficult it may be and however unpopular, measures would have to be taken to adhere to the objectives of the loan.

Recommendations

During the open forum of the seminar, various measures to accelerate economic growth and development were deliberated. The following are some of the recommended measures which need to be carefully considered by the policymakers.

- Regain accountability and good economic governance for the purpose of rebuilding the fiscal discipline. It is also vital to assure a growing concern over a solvency certification subject to a post audit.

- Rationalise and widen the tax base and incorporate more of the informal private sector rather than solely burdening the formal private/ corporate sector, which is estimated as being only 40 per cent of the total private sector. Tax laws and tax administration must collect far more taxes from a very large spread of people. Make the tax file number a prerequisite for large purchases, over Rs. 5 million. Let the politicians and public sector employees pay tax to lead by example.

- Public–Private Partnership in State-owned enterprises and infrastructure investment should be given a priority. Such policies will help reduce the government public expenditure and release public funds for other purposes. In this respect, privatising only the management of State-owned enterprises would be more effective than giving up the ownership.

- Transparent bidding processes should be in place in order to attract investments.

- Mistargeting in beneficiary selection when allocating subsidies in welfare/ safety net programmes such as Samurdhi must also be revisited as a measure of reducing government expenditure and improving the economic and social impacts of these measures.

- Improving Sri Lanka's rank in terms of ease of doing business, global competitiveness, and tax regime can attract more foreign direct investment (FDI) into the country. Simplification of the existing institutional procedures, de-bureaucratisation and addressing corruption would help achieve the targets even without much State-led investment in infrastructure.

- Sri Lanka should move towards lower (single digit) interest rates as it will ensure the Sri Lankan diaspora with funds to invest in the country even without much improvement on the political devolution front.

- Security assurance and infrastructural developments, mainly road and air transport, in the war-affected areas in the Northern and Eastern Provinces should be highlighted and publicised with the intention of attracting the private sector investments for those areas where there is high potential for production expansion and to broaden the services sector. Thus, the psychological implications of the business environment should be cleared.

The IMF agreement to grant a loan facility to Sri Lanka should be considered as a challenge and opportunity. The recognition of Sri Lanka as a credit-worthy economy signals to the rest of the world that the country is still an attractive location for investment.