

# Sri Lanka: Financialisation, foreign debt and crisis

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Since the end of the war, Sri Lanka's economy is being transformed through a rapid process of financialisation. Such widespread financialisation facilitated infrastructure development, a real estate boom linked to urbanisation and expansion of credit leading to increasing indebtedness of the rural population. In short, financialisation contributed to the geographical changes of the economy through beautification of Colombo and infrastructural connectivity of the country. Furthermore, it has changed the class structure of the society with increasing inequality leading to a new wealthy class and an increasingly indebted population.

In the context of such widespread political economic changes, this article addresses the impact of financialisation on the structure of the national debt. Finance Minister Ravi Karunanayake in a recent interview mentions seeking the assistance of the IMF to reduce the interest payments on the large national debt. Indeed, such concern is prudent, because according to the budget estimates, debt repayments totalled \$6.3 billion with an additional \$3.2 billion for interest payments, and together they are close to the total revenue of the Government in 2014.

There are other aspects to the character of the national debt, particularly foreign debt which are alarming. First, national foreign debt is characterised by increasing non-concessional loans as opposed to historically high concessional development loans. In other words, the structure of our debt has gained the character of shorter-term higher interest loans rather than longer-term lower interest loans. Second, foreign debt is increasingly dependent on market borrowings from the financial markets as opposed to loans from multilateral and bilateral donors, which can be negotiated and less susceptible to market forces. Third, there has been the promotion of foreign borrowings by state-controlled commercial banks and other private entities; these do not add to the fiscal deficit, however, they put pressure on the balance of payments.

## Structure of foreign debt

Sri Lanka's total foreign debt accumulated over the decades is changing drastically. According to the Finance Ministry Annual Report 2013, total foreign debt is \$22.3 billion of which multilateral and bilateral concessional loans was \$11.2 billion and non-concessional loans was \$3.5 billion. Market borrowing has increased considerably to \$7.6 billion. Thus market borrowings are now a third of foreign Government financing.

Next, financial flows from the capital markets outweigh foreign aid. The total disbursement of aid from the multilateral and bilateral donors in 2013 including the World Bank, ADB, Japan, China and

India was \$1.4 billion for public investment. However, the net flows after repayments amounted to only \$520 million. Such foreign aid should be compared with \$1.5 billion in sovereign bonds floated in 2014 pointing to the increasing reliance on capital markets.

There was a clear strategy to increase the flow of foreign funds few years back, according to several reports quoting former Central Bank Governor Ajit Nivard Cabraal.

The state-controlled Bank of Ceylon floated \$1 billion and the National Savings Bank floated \$750 million in euro dollar bonds, at very high interest rates in recent years. These are dollar denominated loans boosting foreign exchange reserves, but they also have to be returned in dollars. These massive bonds can create a crisis in the banking sector if the rupee depreciates, and also put pressure on Sri Lanka's balance of payments.

Foreign funds flowing into the stock market and the promotion of corporate bonds including a \$175 million by Sri Lankan Airlines in 2014 are contributing to further integration with the capital markets. In this way, global financial flows were encouraged through mounting foreign borrowing by the state, banks and companies.

### **Crisis tendencies**

Why should we be concerned about such financialisation? It is such financialisation that has been at the root of the recent Western financial crisis starting in 2008 and continuing to ravage Southern Europe. According to economist Dani Rodrik, with liberalisation of the global capital markets starting in the late 1970s, such crises have been widespread. His book, 'The Globalization Paradox: Why Global Markets, States and Democracy Cant Coexist' (Oxford University Press, 2011), provides a profound analysis: "The waves of financial crises that buffeted countries who left themselves at the mercy of international capital markets produced severe damage indeed. First was the Latin American debt crisis of the 1980s, which, aggravated by poor economic management engulfed the countries of the region and produced a 'lost decade' of economic stagnation. It was Europe's turn in the early 1990s... The mid-1990s saw another round of financial crises, the most severe of which was the "tequila crisis" in Mexico (1994) brought on by a sudden reversal in capital flows. The Asian financial crisis followed in 1997-98 which would then spill over to Russia (1998), Brazil (1999), Argentina (2000) and eventually Turkey (2001). These are only the better known cases. One review identified 124 banking crises, 208 currency crises, and 63 sovereign debt crises between 1970 and 2008."

Rodrik goes onto describe the common dynamics of these repeated crises:

"Most of these cases follow the same boom-and-bust pattern. First, there is the phase of relative euphoria during which a country receives a significant amount of foreign lending. This stage is fuelled by stories in financial markets that emphasise the bright prospects ahead. The country has reformed its policies and stands at the cusp of a productivity explosion. There is no need to worry about the debt build up because future incomes will be high and there will be ample capacity to repay the loans. The borrowers can be government, private banks, or corporate entities. In the end, it doesn't seem to make much of a difference. Then a bit of bad news, either domestic or external... The country's story in financial markets changes completely: the country has over borrowed, its government is acting irresponsibly, and the economy looks risky. Foreign finance dries up and in short order the economy has to go through painful contortions to adjust. Interest rates shoot up, the currency collapses, firms face a credit crunch, and domestic demand contracts, typically aggravated by tight fiscal policies aimed at restoring 'market confidence.' By the time it's all over, the economy will have forfeited, on average, around 20 per cent of its GDP."

These passages from Rodrik are quoted at length as a warning to the new Government which only sees the problematic impact of recent economic policies as relating to high interest payments on debt, bad investments not providing returns and corruption. Rater, the underlying problem as evident from numerous cases around the world is the process of financialisation. If such financialisation is not reversed, it might result in another financial crisis which devastates the Lankan citizenry through the loss of production and jobs and eventually further cuts to welfare including of healthcare and education.

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\*<http://www.sundaytimes.lk/150201/business-times/financialisation-foreign-debt-and-crisis-132297.html>

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