To fix its economy, Lanka must make tough choices

The writing was on the wall. In 2021, Sri Lanka's foreign reserves barely covered two months of imports. In April 2022, Sri Lanka announced a default on its external sovereign debt. On December 5, the World Bank approved Sri Lanka's reverse graduation, allowing it to access concessional financing meant for poor or highly vulnerable countries that it graduated from in 2017. The fall was complete.

A country that was the first in South Asia to embrace outward-oriented policies, was among Amartya Sen's favourite examples of strong social and economic development, and one whose economy grew despite a 26-year civil war, Sri Lanka has now become a textbook case of how not to run economic policies.

Much has been written about how Sri Lanka came to be in this dire situation, especially the impact of the 2019 Easter bombings on tourism, untimely tax cuts, an unnecessary diktat on organic farming, the effect of Covid-19 and the Russian invasion of Ukraine. But, let's focus on two long-term policy errors that, over time, made Sri Lanka highly vulnerable to external and internal shocks.

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First, since about 2005, Sri Lanka became addicted to borrowing, especially external borrowing, to finance large and sometimes dubious infrastructure projects. This trend accelerated after the end of the civil war in 2009. As a result, Sri Lanka's external debt grew from 39% of the national income in 2010 to 72% in 2020. The comparable ratio for Pakistan — the other crisis country in South Asia right now — was 45% in 2020. In addition, with poor tax collections, Sri Lanka's total debt, a manageable 69% of the Gross Domestic Product (GDP) in 2010, soared to 131% by 2022.

Second, Sri Lanka's trade regime turned increasingly non-transparent and protectionist since the turn of the century -- a policy disaster in a small and import-dependent economy. As a result, trade fell from a high of 89% of GDP in 2000 to 54% in 2018 (pre-Easter bombings) and 43% in 2021. The anti-export bias and large fiscal deficits led to persistent current account deficits financed mainly by foreign borrowing.

To get out of this morass, Sri Lanka will have to make difficult choices that address its enduring policy mistakes. Here are a few of them. One, raise its paltry tax revenues through tax reforms. Two, improve public financial management and transparency to improve expenditure targeting and project selection. Three, impose a legal ceiling of 60-80% on the public debt-to-GDP ratio, to guard against any future government profligacy. Four, start a process of sustainable tariff reforms to correct the anti-export bias, beginning with a three year elimination of para-tariffs (disguised customs duties). Five, make better use of neighbourhood and location, starting with discussions on a deep trade and economic agreement with India (as Bangladesh is doing). Six, improve funding and targeting of the social safety net to protect people hurt by the ongoing economic crisis, and those likely to be affected by future reforms.

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As is normal in a crisis, Sri Lanka has asked the International Monetary Fund (IMF) for support (a long-delayed decision that has cost its people dearly). However, the IMF's Extended Fund Facility, worth $2.9 billion, requires a sustainable debt profile and financing assurances/debt relief from official and private creditors.

Unfortunately, debt restructuring is complicated, more so when China is involved. China is Sri Lanka's (and the world's) biggest bilateral creditor and was owed $7.2 billion by the end of 2021 — almost 20% of Sri Lanka's external public/guaranteed debt. China is not enthusiastic about global debt restructuring efforts, worried about a chain of debt forgiveness requests from borrowing countries. Also, multiple Chinese institutions lend to Sri Lanka, each with different terms and conditions, complicating possible debt restructuring. While China has made some supportive statements, it has been passive and non-transparent on Sri Lanka's requests for debt relief.

Unsurprisingly, China's position has made other bilateral creditors cautious. India, a large bilateral creditor to Sri Lanka (and unused to facing a debt default), while wanting to ensure that it gets the same debt deal as that offered to China, has, in a letter to IMF, expressed strong support for Sri Lanka. Japan, another significant creditor representing the Paris Club (a group of wealthy country creditors), is trying hard to play a constructive role. Private creditors are the other major holders of Sri Lankan debt. A debt restructuring agreement with them may be even more complicated than with official creditors.

Sri Lanka can only plead with its creditors to provide sufficient comfort to convince the IMF that its debt path, post-assurances and post-debt relief, will be sustainable. Unfortunately, the hopes of speedy IMF disbursement have already been pushed back by several months.

Sri Lanka has a long and challenging road ahead. After securing debt restructuring, it will need to make painful choices, tackle vested interests and undertake severe fiscal tightening. In addition, it will have to enhance and improve social protection to minimise the pain of the less fortunate. The beleaguered people of Sri Lanka can only hope that relief comes soon.

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The views expressed are personal