

# **Sri Lanka: Economic collapse and the post-IMF crisis**

Friday 1 April 2022, by [GUNAWARDENA Devaka](#), [KADIRGAMAR Ahilan](#) (Date first published: 1 April 2022).

**Sri Lanka is quickly becoming a poster child for the sovereign debt crisis, much like countries before it such as Lebanon, Greece, and Argentina. While the consequences may appear similar, it is critical to understand the specific characteristics of the unfolding crisis in Sri Lanka. For many, the solution was always the same: go to the IMF. Meanwhile, the Government wasted precious time by failing to actively prioritise imports and rebalance the economy toward domestic production. Because many within the opposition were convinced that the IMF was the answer, they too failed to pressure the Government to change its economic policies to address the crisis.**

As a result, an IMF agreement has apparently become inevitable, while the Government has become delegitimised because of the economic collapse. But the social costs are and will continue to be abysmal. Sri Lanka's bargaining position has eroded significantly over the last two years. Its leverage for negotiating a bailout with external actors, including the IMF, is practically non-existent. Meanwhile, the current economic crisis is being analysed with extremely flawed assumptions.

Above all, by conflating the fiscal deficit with the current account deficit, neoliberal experts have managed to confuse the public about the central challenge. They avoid focusing on the central problem of the external sector, including the trade deficit and foreign borrowings. Their free market ideology and prescription of trade liberalisation masquerades as an objective description of the economy. To the extent that this ideological distortion shapes the choices of those in power, it will have disastrous consequences for the country, in addition to bringing tremendous suffering for the people. In this regard, the current economic depression will only be exacerbated by a post-IMF crisis.

## **Economic tropes**

Over the last few decades, mainstream economists have proposed trade and financial liberalisation as the way forward for Sri Lanka's economic prosperity. Their analysis of the economy has shifted from celebrating its initial opening in 1977, to criticising the continued absence of macroeconomic stability. Their basic assumption remains that if Sri Lanka embraces free trade, it will attract investment that could stimulate growth. State investment in industries and, for that matter, an industrial policy were discouraged because it was assumed that the market would ensure investment, growth, and ultimately an increase in State revenues.

Instead, the country has experienced a secular decline in Government expenditure and revenue as a proportion of GDP. State expenditure has hovered around 20%, while State revenues have fallen from 14% to as low as 9% in 2020. In this context, even amidst the pandemic the Government has not offered much in the form of fiscal stimulus, having avoided an increase in State expenditure. The increase in the fiscal deficit is mainly due to the tax cuts after the elections in 2019. In any event, the fiscal deficit is not necessarily an issue during a crisis, because every Government must spend

when the private sector withdraws investment, which again became evident over the last two years. Indeed, Sri Lanka can engage stimulus spending – like what Western countries pursued during much of the COVID-19 pandemic – provided it were to engage in domestic borrowing in rupees.

Neoliberal experts argue, however, that stringent fiscal standards are necessary to guarantee the value of its currency and ensure the inflow of foreign capital. Such capital flows either increase the foreign debt stock or are portfolio investments that fly out just as quickly as they enter, making the external sector crisis prone. This process begs the question: What does money purchase?

If Sri Lanka was consuming what was produced within the country, then the question of foreign exchange would be irrelevant. But because it must purchase imports, it must be able to cover the cost through exports and other foreign earnings such as from the tourism sector and migrant workers remittances. In this way, experts conflate the fiscal deficit with the balance of payments. Instead, the fiscal deficit can and should be de-linked from the external sector. In other words, it should not be financed through foreign borrowings, and in the medium term it should be balanced by redistributive taxation.

The problem is further compounded by the fact that trade liberalisation never appears alone. Instead, it reflects the broader dynamics of globalisation, in which financialisation has become the most entrenched aspect. Anything that impinges on the free flow of capital itself is considered a violation of the sacred concept of the free market. In the case of Sri Lanka, from 2007 onwards the country issued sovereign bonds and became further integrated into global financial markets.

Once yields collapsed and interest rates started rising, new sovereign bonds could not be floated to roll over previous loans, and Sri Lanka depleted the foreign reserves it had accumulated. In his paper evaluating the global context, “The Social Cost of Foreign Exchange Reserves,” Harvard economist Dani Rodrik has argued that countries accumulate foreign reserves to compensate for short-term liabilities. But by focusing on the former instead of reducing the latter, countries end up taking away from the amount that can be invested in their economies. Meanwhile, as Rodrik, among others, pointed out after the East Asian Financial Crisis of 1997-98, Malaysia’s experiment with heterodox policy, including capital controls, allowed it to weather the most severe effects of the crisis, as opposed to other Asian countries that experienced a far more uneven recovery.

The crisis is even deeper and more severe in Sri Lanka today, because its economic foundations are weaker. Yet rather than questioning the bias toward the free flow of goods, our experts assume that because the current account deficit is worsening, it requires regaining access to international capital markets. Unsurprisingly, this process is driven by the assumption that public finance must be pruned to please global financiers.

Or as Rodrik put it in, “Who Needs Capital-Account Convertibility?”, a paper he presented in 1998: “The greatest concern I have about canonising capital-account convertibility is that it will leave economic policy in the typical ‘emerging market’ hostage to the whims and fancies of two dozen or so thirty-something country analysts in London, Frankfurt, and New York. A finance minister whose top priority is to keep foreign investors happy will be one who pays less attention to developmental goals. We would have to have blind faith in the efficiency and rationality of international capital markets to believe that these two sets of priorities will regularly coincide.”

## **The IMF Staff Report**

Enter the IMF and its latest Article IV Staff Report, released on March 25<sup>th</sup>. The IMF offers several recommendations, including raising indirect and direct taxes, cost-recovery energy pricing, fiscal consolidation, and devaluation of the rupee. Because Sri Lanka’s neoliberal experts have shaped the

dominant thinking among political actors, they have encouraged them to view the IMF as the solution to the country's problems. Everything that pushed Sri Lanka further toward the edge is redeemed in this narrative because finally, at last, the country has come to its senses and recognises that there is only one answer.

Unlike the progressive image the IMF has attempted to cultivate over the past decade or so, the recommendations are a reversion to the historical meaning of its thinking. First, "Reforms should focus on strengthening VAT and income taxes, through rate increases and base broadening measures" (p.1). While the IMF mentions direct taxes, the reality is roughly 80% of Sri Lanka's tax revenue already consists of indirect taxes, such as taxes on consumption, which inevitably burden the poor. Accordingly, the IMF's recommendation to strengthen VAT in particular means further raising the cost of essential goods.

Next, the IMF proposes that "Fiscal adjustment should be accompanied by energy pricing reforms to reduce fiscal risks from loss-making public enterprises" (p.2). What this means was perfectly captured by no less than Ajith Cabraal. CNBC reported on March 7<sup>th</sup> that "To address the country's acute fuel shortages, Cabraal said the central bank has made a 'very clear appeal' to the Sri Lankan Government to make a 'sharp increase' in fuel and electricity prices, so there would be a 'natural reduction' in demand." This strategy in effect means destroying demand. If people can no longer afford electricity, for example, then they simply will not have lights in this scenario.

The logic is not only that of privatisation, but the core belief that State institutions must be profitable, rather than guarantee essential services for people. Every other country around the world effectively operates loss-making institutions, yet because of the nature of the crisis the IMF proposes these as an example of where fiscal stringency must be applied, even if it means a disastrous regression in people's living standards. Rhetoric about the rich enjoying the lion's share of benefits of energy subsidies aside, the solution appears to be making sure only the rich can have lights because only they can afford such high electricity costs in the future.

Finally, in addition to fiscal consolidation, in its Staff Report the IMF recommends "a gradual return to a market-determined and flexible exchange rate to facilitate external adjustment and rebuild international reserves" (p.29). If the entire crisis was generated because of the build-up of Sri Lanka's foreign loan obligations, then the solution to take money out of the country's budget to offset risks perceived by investors is simply another turn on the rack. In this way, the country can become an attractive magnet for speculative capital inflows, and the cycle begins all over again. Meanwhile, the worst depression since the 1930s will be compounded by an IMF program that turns the crisis into permanent dispossession for the working people.

### **People's suffering**

There is more to dig into the IMF Staff Report, including its contradictory emphasis on "pro-poor" measures while simultaneously demanding punishing fiscal consolidation and austerity, which has denied State support, investment, and equitable recovery in so many other countries. But the biggest challenge is outlining the trajectory of the post-IMF crisis in Sri Lanka today. It is clear that because of a fatal misunderstanding of the economy that has become the dominant consensus, the IMF appears to be the only solution, thereby erasing other options. But now that we have reached this point, we must also be clear on what the picture of suffering will look like for most people.

If Sri Lanka is fortunate and agile, it may perhaps be able to cobble together financing from other donors. Already there are reports that it is seeking further funding from the World Bank. And it is not impossible that because of diverse and at-times contradictory geopolitical developments, the US, China, and India, among other hegemonic powers, see strategic value in rescuing the country. But it

is more likely that Sri Lanka, given its dependent economy, becomes further subordinated to the needs and interests of powerful actors, to the extent that we have already seen in the leasing and sale of public assets. The country is extremely weak, so its capacity to negotiate is marginal at best. The question will be what assets will be considered for a fire sale, and which assets will be salvaged by collective resistance.

In this context, further raising the prices of essential goods and effectively denying people access to basic services will extend the people's suffering and create the conditions for much greater social unrest. Meanwhile, businesses will also suffer. If demand collapses, who will purchase goods and services in the local economy? Comprador elites and rentiers may obtain benefits from international contracts, but for those who depend on the local market, we can only expect further pain, even if immediate shortages of items are resolved. Ultimately, local economic contraction will manifest in concrete measures of life such as increasing mortality. Sri Lanka is on the verge of experiencing a lost decade, if not more, much like the social disaster Greece experienced during the implementation of its austerity program.

For the neoliberal experts, of course, all this may appear as the necessary consequence of uncontrolled spending driven by politicians' promises to the people to win votes. But when we look at the actual statistics, we can see that so-called "handouts" were limited; COVID-19 related expenditure was a mere 0.8% of GDP in 2020. Furthermore, to the extent that there have been debt moratoriums, for example, it is big business that has benefited the most. Finally, the bugbear of corruption has been a convenient rhetorical device for many bereft of imagination, but it does not explain the dynamics of the economic crisis.

Ordinary people have been forced to consume less, not more, during the entire period in question. Accordingly, people understand the crisis is not their fault. And if they are vindicated in their ability to replace Governments, this realisation anticipates further rebellion as the post-IMF crisis deepens. We could even see events like the food riots and anti-austerity protests that have frequently occurred in other parts of the world.

### **Progressive alternatives**

For now, the opposition is content to ignore these issues and to ride the wave, convinced that the Government is on the verge of collapse and its own popularity is on the rise. But for the trade unions and other progressive actors who recognise the people's suffering, now is the time to question the logic of the IMF arrangement and its consequences for the people. If we know what the causes and effects of the crisis are, then it becomes easier to imagine solutions.

For example, given the logic of the foreign exchange crisis, Sri Lanka must prioritise imports, which inevitably involves a flexible determination of which goods are considered essential. But the most basic definition is food, pharmaceutical products, oil, and intermediate goods for production, including for exports. This choice will require a dramatic shift in our understanding of the economy, away from the assumption of a tourism "services-driven" economy that has only further entrenched Sri Lanka's dependency on the external sector.

In addition, progressive actors must be prepared to block the raising of prices. Rather than saying that the people must consume less, these actors must offer solutions that fundamentally re-envision the economy based on the goods and services people need to survive. For example, if energy consumption is an issue, then these actors must be prepared to make sure the rich pay first - for example, by means of a wealth tax to cover the cost of subsidies - rather than expecting most people simply to go without lights. Now is the time to articulate the genuine developmental tasks that require scaling up efforts to develop collective solutions to public problems. The battles will be

fought out on the street, but the onus is on progressive actors to demonstrate genuine leadership in consolidating the people's demands into workable alternatives.

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