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Pathfinder Economic Flash

IMF, World Bank and other Donor Support: *Should not be a pretext for avoiding economic reform*

The IMF tends to be the refuge of countries that have mismanaged their economic affairs. In this context, it is important to recall that Sri Lanka has had to obtain balance of payments support from the IMF on a number of occasions. Each time, the causes have had more to do with domestic policy weakness rather than external shocks. On previous occasions, IMF support, combined with the assistance of the donor community, has enabled Sri Lanka to get over its problems without undertaking the necessary economic reforms, particularly in relation to the budget and to structural weaknesses related to low productivity and competitiveness. It is important that this should not happen yet again. It is the responsibility of both the Sri Lankan authorities and multilateral institutions to ensure that the country embarks upon a medium-term program of reforms which increases the growth potential of the economy and generates higher value employment. Some critics allege that the Fund and the Bank apply lenient conditionality when new governments of their liking are in power. Nevertheless as final outcomes of direct or indirect incentivising of the adoption of bad economic policies and neglecting fundamental economic reforms, countries have been trapped into vicious cycles of stop-go policies.

There has been considerable interest in Sri Lanka since the recent election. Relations with India, the US and Europe has been reset. Japan has made a strongly supportive statement. Visits to China by the President and Foreign Minister also signal that relations with China will continue to be of high priority. This pragmatism is very much in the country’s interest.

The importance the government attaches to bilateral relations with India was amply demonstrated by President Sirisena’s first overseas trip being to Delhi. The Pathfinder Foundation (PF) has repeatedly emphasised that perceiving India as an economic opportunity rather than a threat can have a positive impact on the development prospects of the country in terms of trade, investment, tourism, technological transfer and training.

In addition, the PF has also highlighted that the proposed FTA with China will, above all, provide a framework for attracting Chinese FDI to generate competitive exportable supplies at a time when Chinese enterprises are being encouraged to go ‘abroad’ due to rising domestic costs and the strengthening of the Yuan. Tourism from China has the potential for exponential growth provided bilateral relations remain sound.

Japan was, for many years, Sri Lanka's largest bilateral donor. Now that Sri Lanka is a lower-middle-income country, which is ineligible for ODA, it can be a source of FDI, including for infrastructure projects. Linking Sri Lankan enterprises to the supply chains of the many Japanese companies operating in Asia is another opportunity worthy of consideration.

The US and Europe are Sri Lanka's two largest export markets. Early restoration of GSP+ and a settlement of the European fisheries ban will serve to boost exports. US fund managers account for about ¾ of the foreign holdings of Sri Lankan dollar bonds and rupee securities. An improvement in the bilateral relationship will provide additional comfort for such portfolio investors.

The Finance Minister's recent visit to Washington also marks a change in Sri Lanka's approach to its relations with IMF and World Bank (WB). In understanding the attitude of these institutions, it is important to realise that the US and Europe have dominant voting shares in them. Both institutions claim that they treat all member countries equally. However, in practice the degree of empathy shown to specific country conditions (politics and economics) can be strongly influenced by the US and Europe which have controlling voices on the Executive Boards of the IMF and World Bank. Equally, Japan, along with the US and Europe, is very influential at the Asian Development Bank (ADB). This needs to be factored in when assessing the leverage the traditional donors have in terms of the degree of sympathy and support a country can expect from these multilateral institutions, which continue to be key sources of foreign financing for development.

According to statements made in media, Sri Lanka will be able to mobilise sufficient amounts of foreign assistance. This will be very timely as the relief measures contained in the November 2014 and Interim Budgets will exert considerable strains on both the fiscal outcome and the balance of payments. It will also facilitate the restructuring of some of the existing high interest borrowings. Some analysts argued that the relief package was justified on social (declining real incomes); political (reduced disposable incomes in a society recently characterised by fault lines along ethnic, religious and class lines), and short term economic (boost to domestic demand to support growth until conducive conditions are created for export-led growth) factors. Hence, attracting the financing to support these measures is a positive development.

However, the PF would like to strike a note of caution. Time and again, Sri Lanka has been able to postpone the structural reforms that are essential to break out of the current repeating cycle of stop-go policies and place the economy on a path of sustained growth and development. A recent IMF study established that the potential rate of growth for the Sri Lankan economy was 6.8%. It is, however, clearly feasible to achieve sustained growth of 8% - 10%, for a decade or more, as countries in East and South East Asia have done. It is not enough to dodge the bullet and revert to 'business as usual'. This is s model which has seen Sri Lanka go from second in Asia to Japan, in 1947 to a relative laggard today.

In the last decade, there have been two previous occasions where Sri Lanka has been bailed out by generous foreign inflows. The country's external finances were in difficulty in 2004/5 a crisis was avoided due to the large scale foreign inflows and foreign debt relief provided as Tsunami assistance. The Tsunami had a devastating impact on the lives of about a million Sri Lankans the rest of the population was able to avoid the tough austerity measures that would otherwise have been inevitable to stabilise the balance of payments.

Similarly, in 2008/9, there was another impending balance of payments crisis. Sri Lanka was able to dodge the bullet again as the Global Financial Crisis (GFC) led to the international community using the IMF to infuse large scale liquidity into the system. As it's share, Sri Lanka received a grant of SDR 250 million (about $300 million) as part of a global SDR allocation by the Fund. In addition, the IMF changed its focus from a preoccupation with stabilisation/austerity to growth to push back against the strong deflationary pressures in the world economy following the DFC. This meant that Sri Lanka was able to obtain a Stand By facility with relatively low conditionality to avoid a balance of payments crisis.

On both occasions, the external assistance received to stabilize the economy was not used to initiate structural reforms to strengthen its growth framework i.e. increase productivity/competitiveness. The PF has set out a blueprint for reform in its 'Charting the Way Forward: Prosperity for All' (see www.pathfinderfoundation.org). It's of paramount importance that yet another opportunity is not lost. Once the political compulsions of the 100 Day Program and the electoral calendar are behind us, the focus should be on breaking out of the mediocrity imposed upon the economic performance of the country by populist policies rooted in political expedience over the last 60 years. The pain associated with reforms will be mitigated if they are undertaken at a time when the country can mobilise generous support from all its partners. ***At the same time it is important that the country should not be encouraged to adopt bad policies for short-term political gains by those who understand very well the necessity of reform.***

This is the Sixty First Economic Flash of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org