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Sri Lanka's crisis of legitimacy

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Author: Dushni Weerakoon, IPS

Sri Lanka's slide into political instability since April 2022 culminated in the resignation of former president Gotabaya Rajapaksa following public protests on 9 July 2022. The government's policy blunders and resistance to course correction were blamed for unleashing the harshest economic crisis on the Sri Lankan population in recent history. The former president's resignation paves the way for the formation of an interim all-party government.

Gotabaya Rajapaksa leaves behind an economy ravaged by shortages of essential goods, spiralling inflation and a historical-first debt default. Much of the blame for this sorry state of affairs can be placed on policy hubris.

The election-driven tax cuts and the stubborn resistance to reverse them were economically disastrous as COVID-19 pandemic-related spending pressures mounted. The central bank was made complicit in a money printing exercise that drained investors' faith in the currency — which lost more than 80 per cent of its value. This was coupled with an overly ambitious pursuit of environmental goals namely the banning of chemical fertilisers which devastated agricultural output in the process.

There is no doubt that the COVID-19 pandemic magnified Sri Lanka's economic problems, but plenty of other countries have emerged from the pandemic relatively unscathed. For a country with a large exposure to foreign commercial debt that is vulnerable to market volatility, the most credible move would have been to embrace sound macroeconomic policies out of its own understanding of the many risks involved.

Yet flawed policies and a refusal to redirect course narrowed the country's options. In April 2022, Sri Lanka finally declared itself unable to service foreign debt and approached the International Monetary Fund (IMF) for a deal. Negotiations with the IMF on a staff-level agreement and separate debt restructuring talks with creditors had to proceed simultaneously.

Political stability is essential to such negotiations. IMF negotiations are centred on returning to a sustainable debt path and Sri Lanka will have to promise that it will run a primary fiscal surplus (before interest payments) within a specified period. This means that significant tax hikes across the board and spending cuts or freezes are expected.

Unlike IMF negotiations with which Sri Lanka has plenty of experience, debt restructuring is unchartered territory. Such negotiations are not easy given the current complex creditor landscape where each creditor wants an assurance of comparable treatment. Sri Lanka's bonds are held primarily by a private-creditor base in the United States while its large bilateral lenders include non-Paris Club members like China and India.

China has already signalled a reluctance to an IMF-aligned debt restructuring of its loans, preferring instead to refinance rollovers. Among bondholders, potential holdout creditors need to be corralled to avoid costly lawsuits.

The timeline threatens to undermine economic stability further. Sri Lanka must present its debt restructuring plans for the IMF Executive Board's approval on the bailout program. In the interim, the country will continue to struggle in securing the foreign currency inflows necessary to overcome import interruptions that have fuelled much of the public dissent.

Sri Lanka desperately needs a strong and stable government that can get things done. That will still be months away as a transitional arrangement is put in place. The proposed all-party consensus appears to suggest appointing an acting president and a prime minister who have the majority support of parliamentarians by 20 July 2022.

The new governing arrangement will have more legitimacy than the ousted regime, but it will still be beholden to narrow party interests present in such coalitions. In these circumstances, the new leadership must reassure the IMF and Sri Lanka's creditors of its legitimacy to negotiate and its commitment to implement the terms of the agreement in the event of fresh elections and another change of leadership.

A fresh election that truly reflects the public mood holds the key to Sri Lanka's future. The country needs a strong and stable government to see through painful economic adjustments. The required fiscal changes will stop any government from spending its way out of the current crisis, limit help for the poor and restrict public investment.

Forcing a recession through tight monetary policy is necessary to tame the rampant inflation — currently at over 50 per cent — even if much of it is due to supply-side factors. Despite the obvious drawbacks on jobs and employment, building credibility by implementing the promised reforms is critical considering the magnitude of Sri Lanka's political and economic crisis. Once the economy is put on a sounder financial footing, a cautious policy shift to emphasise growth will be needed. It will demand more flexibility on macroeconomic policy and investor-friendly reforms without throwing fiscal targets into reverse.

In this period of national trauma, all is not lost to Sri Lanka. The political and economic upheavals may yet usher a renewed commitment to strengthen political and economic institutions to prevent similar episodes of avoidable policy errors with serious social repercussions.

As a starting point, Sri Lanka's political class must now resist the temptation to engage in short-run political battles and focus on building critical consensus to restore political stability. If politicians and the parliamentary system come to be seen as ineffectual, then Sri Lanka will truly be caught up in a vicious crisis of legitimacy.

Dushni Weerakoon is Executive Director and Head of Macroeconomic Policy Research at the Institute of Policy Studies of Sri Lanka.