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Debt Crisis, Structural Adjustment and Trade Policy

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Two key issues

- How ‘anti-tradable’ bias in the incentive structure made the Sri Lankan economy vulnerable to the sovereign debt crisis

- How to redress anti-tradable bias as part of stabilisation and structural reforms

[Note

Tradables = exportables + importables

Exportables: actual exports and close substitutes for exports that are sold domestically.

Importables: imports and goods produced domestically that are close substitutes for imports.]

Structure

- Debt crisis: A primer
- Anti-tradable bias and vulnerable to the crisis
- Policies for redressing anti-tradable bias (as part of a structural adjustment program)

Debt crisis: A Primer

Debt crisis: loss of confidence in a country's ability to manage debt ('debt distress'), causing a severe disruption in the function of the economy.

What causes a debt crisis ?

Two alternative (but not mutually exclusive) views:

The *self-fulfilling panic* theory

The *vulnerability* theory

The *self-fulfilling panic* theory

A crisis is prompted by a sporadic event ('trigger'), striking both 'guilty' and 'innocent' countries alike.

Trigger:

An external shock: pandemic/epidemic, wrong government policy, an unexplained failure of a firm/bank

The *vulnerability* theory

A debt crisis is caused by a combination of 'vulnerability' and a 'trigger'

Vulnerability: an unsustainable macroeconomic condition.

'Vulnerability means that if something goes wrong, then suddenly a lot goes wrong' (Rudiger Dornbusch)

A trigger: a certain event, pandemic, wrong government policy, an unexplained failure of a firm/bank

A state of vulnerability by itself does not give rise to a crisis.

There needs to be a certain disturbance (a *trigger*) that will push a vulnerable situation into an actual collapse.

Anti-tradable bias and vulnerability to the crisis

- Debt-driven growth spurt in the post ethnic-conflict era.

- Growth spurt was underpinned by a massive non-tradable bias.

- Outcome: vulnerability to the 'COVID-19 shock'

a debt overhang + debt service burden +
drying-up of foreign exchange reserves

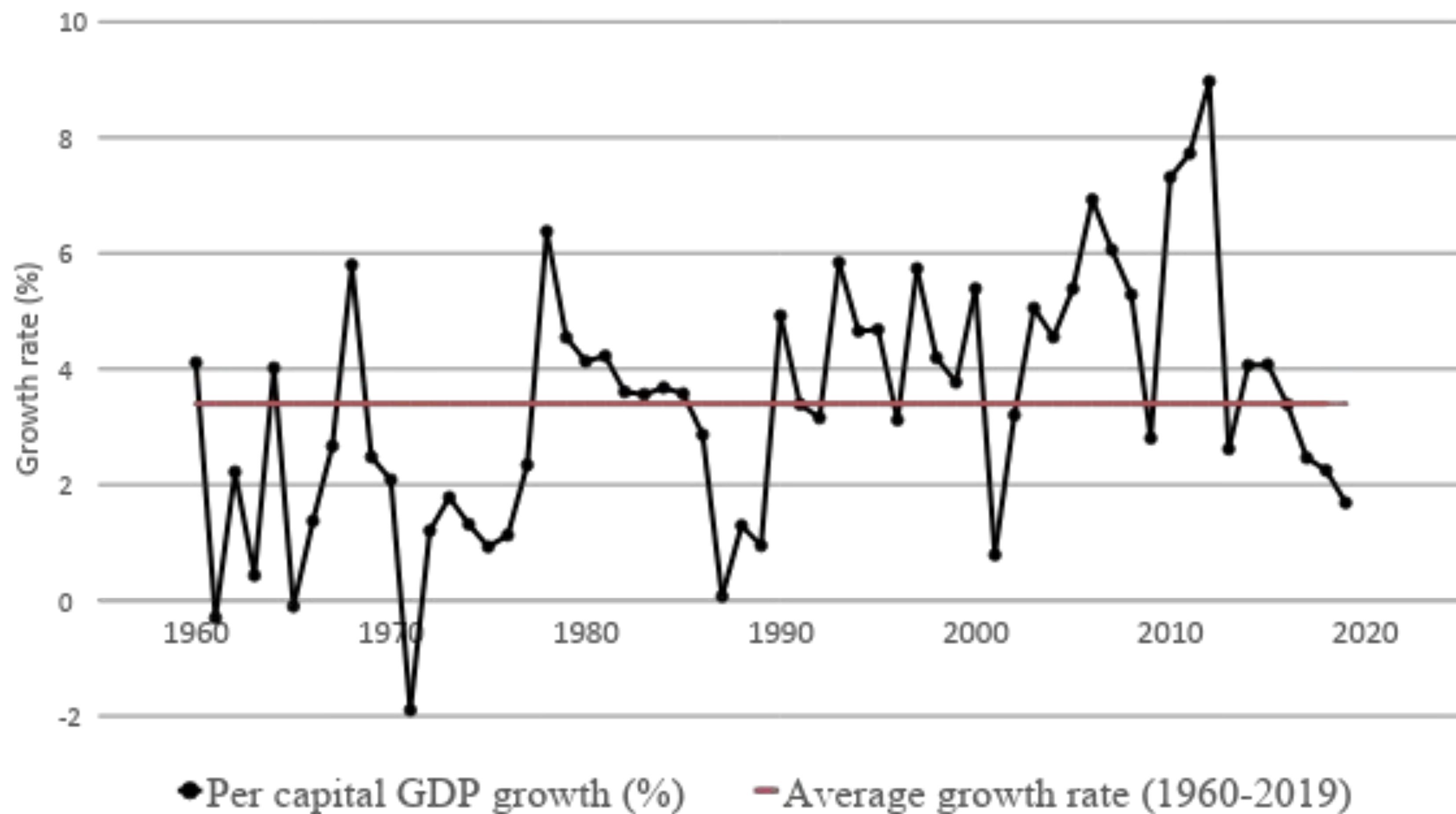


Figure1: Sri Lanka: GDP growth, 1959-2019 (%)
Growth rate (%)
10
8
6
4
2
0
-2
1960
1970
1980
1990
2000
2010
2020
Per capital GDP growth (%)
Average growth rate (1960-2019)

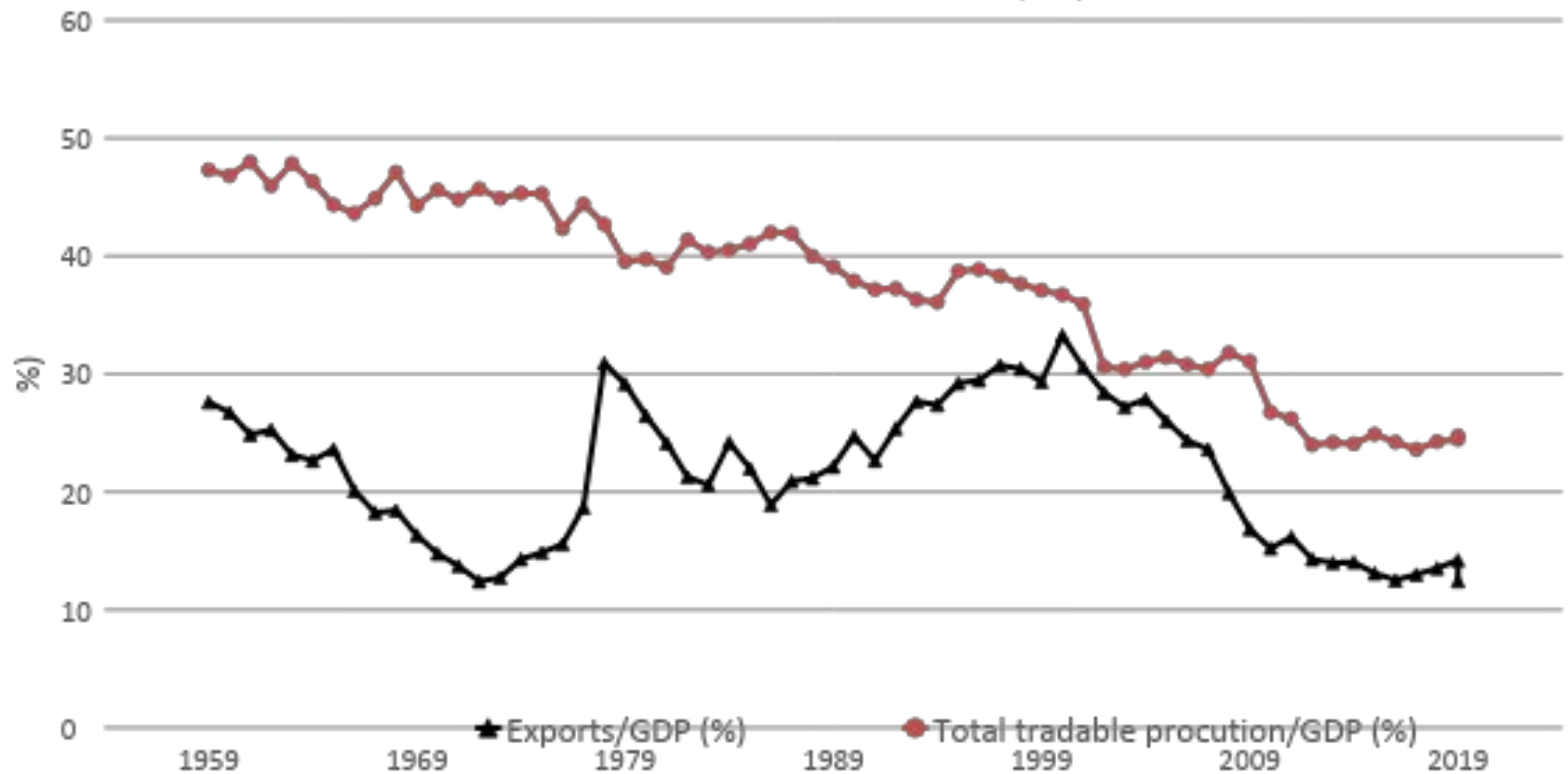


Figure 2: Total tradable production and exports relative to GDP, 1959-2022 (%)
60
50
40
30
20
10
0
%)
Exports/GDP (%)
Total tradable procution/GDP (%)
1959
1969
1979
1989
1999
2009
2019

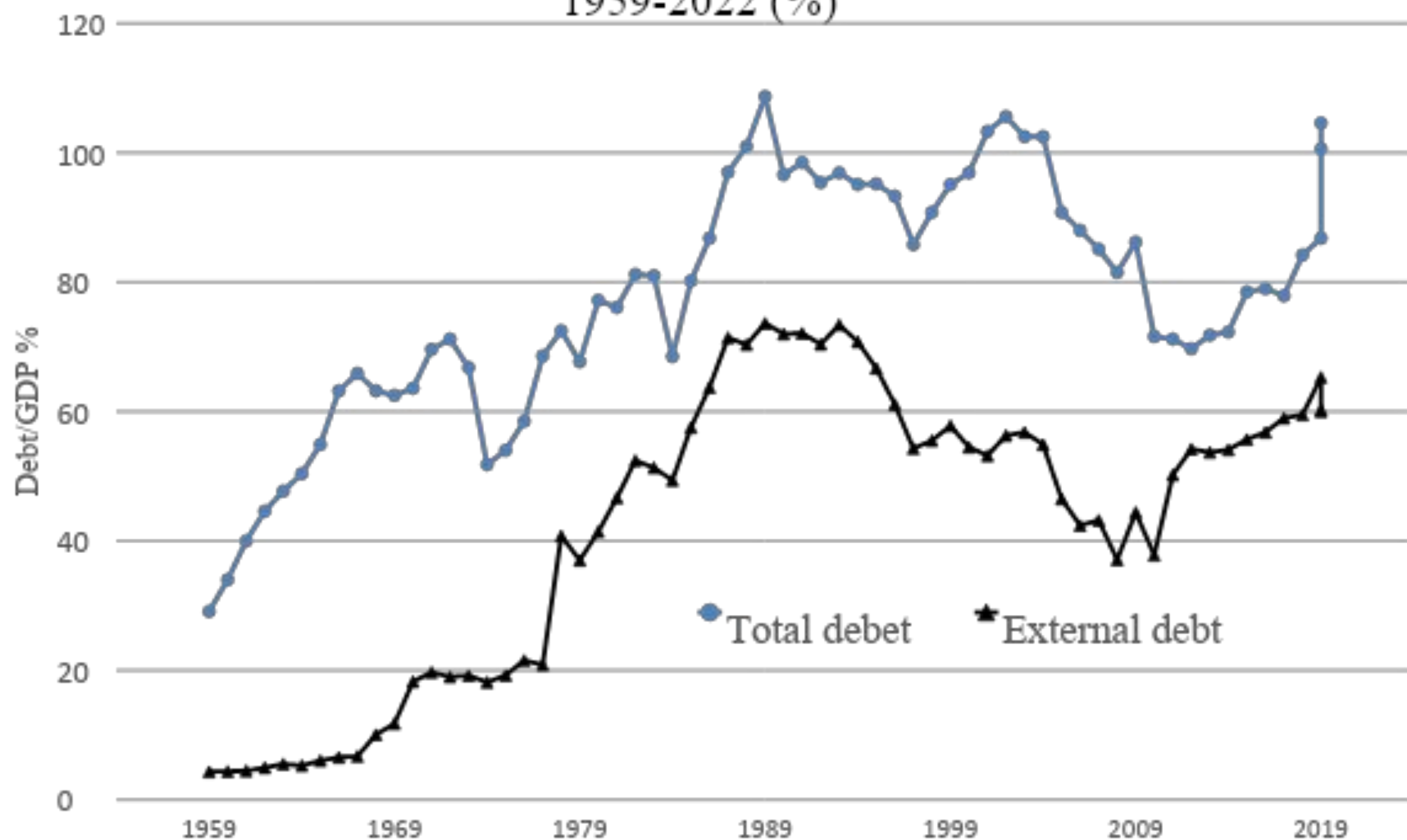
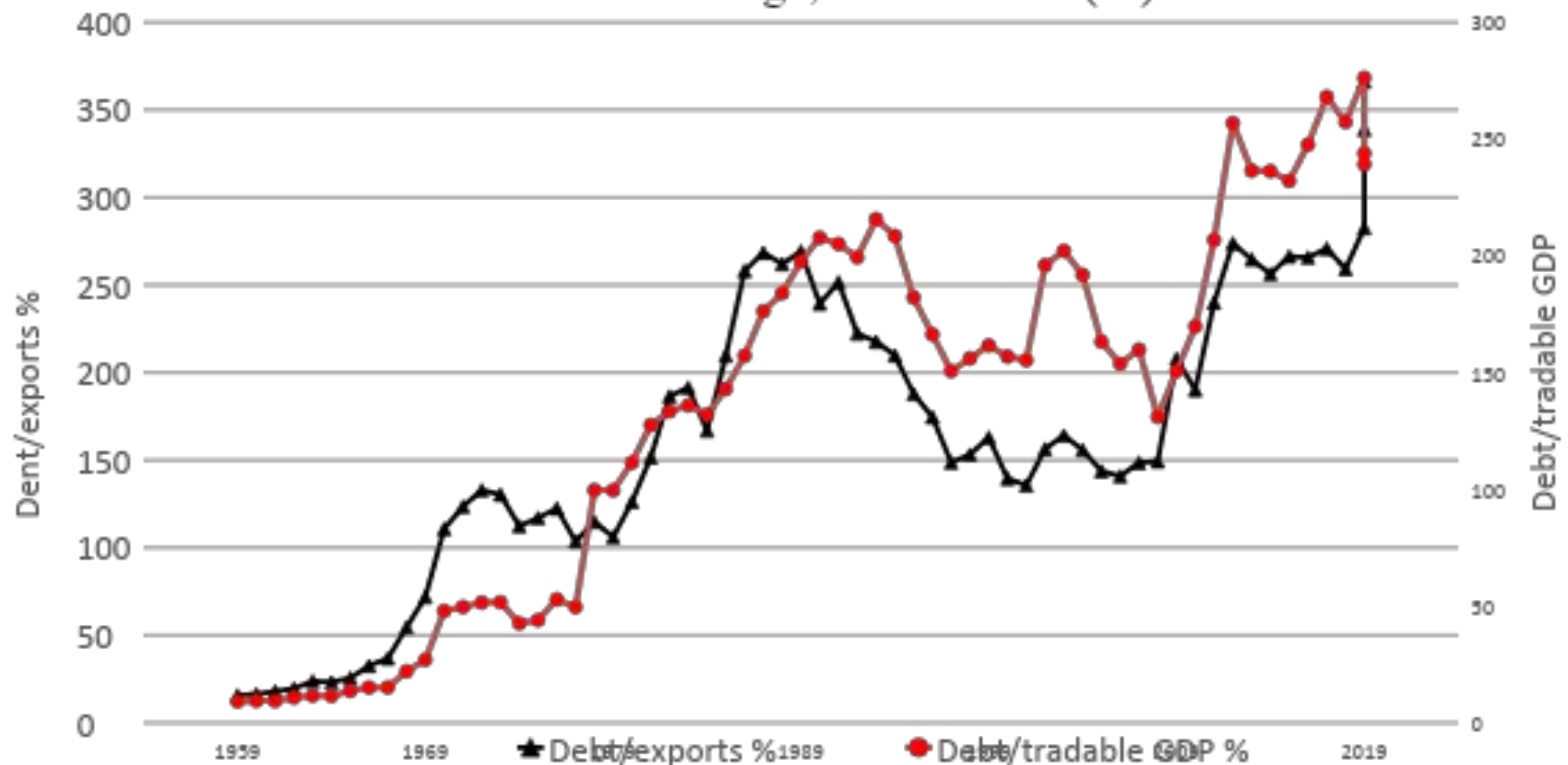


Figure 3: Sri Lanka: Central government debt relative to GDP, 1959-2022 (%)
120
100
80
60
40
20
0
Debt/GDP %
Total debet
External debt
1959
1969
1979
1989
1999
2009
2019

Figure 4: External debt relative to tradable GDP and export earnings, 1959-2021 (%)



* Amortisation of debt and interest payment as a percentage of goods and services exports

An important lesson

Be careful in comparing growth rates.

Look at the sectoral composition of underlying growth.

Think about the difference between a Sumo wrestler and a ‘real’ wrestler

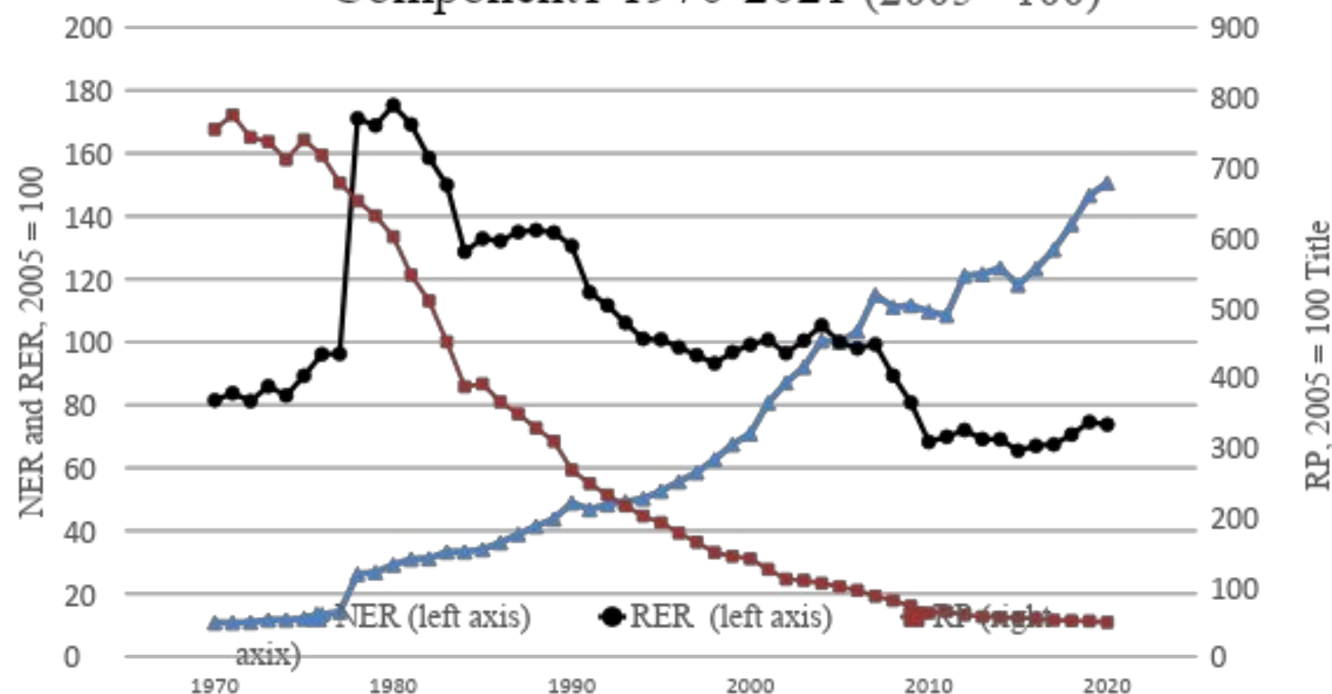
Sources of anti-tradable bias

Excessive focus on non-tradable sectors naturally tilted the incentive structure against tradable production (made tradable production less profitable) (the 'Dutch disease' effect)

The anti-tradable bias was compounded by:

- Exchange rate policy: using nominal exchange rate as an 'inflation anchor' (Figure 7)
- Tariff regime: 'import tariffs as a tax on export production' (the 'Lerner symmetry theorem')
- Policy backsliding in the area of promoting foreign direct investment (FDI)

Figure 6: Sri Lanka: Real exchange rate and its Component1 1970-2021 (2005 =100)



Note: 1. NER is export-weighted nominal exchange rate (measured as rupees per foreign currency unit) relating to Sri Lanka's top six manufacturing export destination countries (which together account for over 90% of the country's total manufacturing exports). RER is NER adjusted for relative price level of Sri Lanka (measured by the GDP deflator) and the six destination countries (measured by the producer price index) (RP).

An increase (decrease) in RER shows an improvement (a deterioration) in international competitiveness.

Reforms for redressing anti-tradable bias

IMF-supported stabilisation and structural adjustment reforms would specifically focused on fiscal consolidation through 'expenditure reduction' (contractionary fiscal and monetary policy)

(It's Mostly Fiscal)

Why?

Sri Lanka is a 'twin deficit' economy:

the current account deficit is approximately *identical* to the government balance (Figure 7).

(See next slide for national account identities)

Current account balance and domestic excess demand (domestic resource gap)

Gross national product (Y) on the demand side:

$Y = C + I + G + X - M$ (1)

Y is gross national product, C is consumption, I is investment, G is government purchases, X is exports, and M is imports

Total spending (absorption) of domestic residents (including the government), E, is defined as

$E = C + I + G$ (2)

Using (2) and (1) rearranging terms:

$\mathbf{Y - E = X - M}$ **(3)**

Current account balance (X –M) is *identically* equal to domestic excess demand (excess of national income over national spending), (Y – E).

On the income side:

$Y = C + S_p + T$ (4)

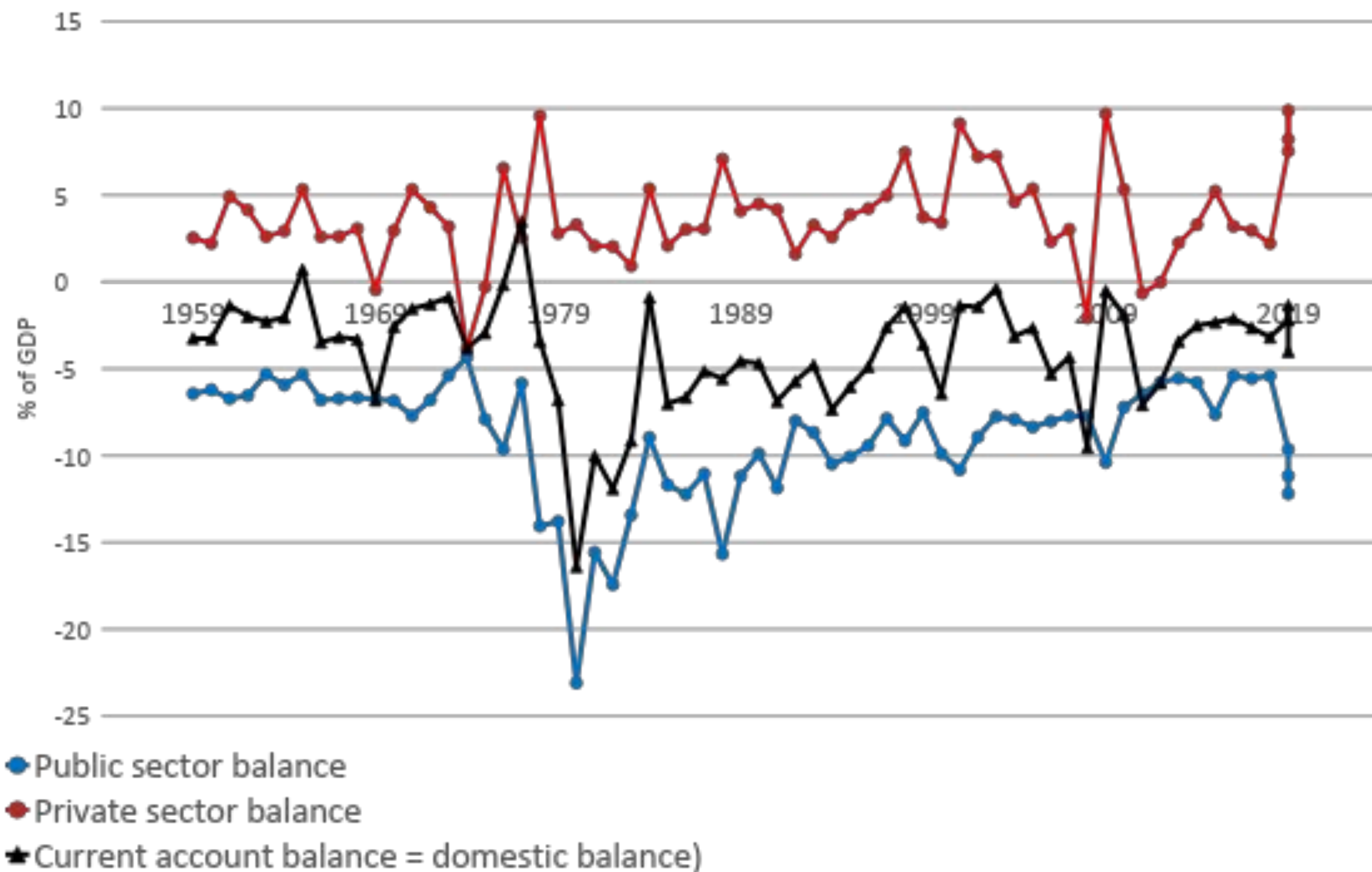
Where C is again consumption, S_p is private savings, T is government revenue.

By substituting (4) in (1) and rearranging:

$\mathbf{M - X = [I - S_p] + [G - T]}$ **(5)**

Thus, the excess of import over exports (the current account deficit) is *identically* equal the domestic excess demand, which is the sum of the excess of investment over private saving plus the excess of government purchases over government revenue (budget deficit).

Figure 7: Sri Lanka: Current account balance and its domestic components, 1959-2021 (% of GDP)



- IMF approach to reform, therefore, assumes a tight link between the budget deficit and the balance of payments deficit (operating through domestic money and credit that drive inflation).
- But the national account **identity** that links budget deficit to current account deficit does not necessarily imply **causation** running from the former to the latter.
- Taming domestic inflation through fiscal consolidation helps improving international competitiveness (through avoiding RER appreciation),
- But, anti-tradable bias depends on many other factors (as discuss, Slide 15)

- Therefore, in an economy where anti-tradable bias has underpinned vulnerability to the crisis by building up a massive a debt overhang, it is necessary to combine ‘expenditure-reducing’ policies with policies aimed at ‘expenditure switching’ from non-tradable to tradable production in the economy.

- Requires rectifying policy errors listed in Slide 15.

- Compare Sri Lanka’s own experience under IMF programmes with that of the other Asian countries

Why Sri Lanka has been a repetitive’ IMF client unlike the East Asian ‘miracle’ countries (and also India and Bangladesh over the past three decades)?