The Role of International Financial Institutions in Sri Lanka

Azra Jafferjee

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Azra Jafferjee is a Senior Professional at the Centre for Poverty Analysis and coordinates the Poverty Information and Knowledgment Management programme. She has a MPhil in Development Studies from the University of Cambridge, UK and a MA in Economics from the University of Colombo, Sri Lanka.

Foreword

This series of Poverty Briefs (No. 1 to 10) was produced for OXFAM Great Britain (GB) by the Centre for Poverty Analysis to provide a macro overview of key thematic areas relating to poverty, of relevance to Oxfam GB's work in Sri Lanka. They are specifically designed to provide Oxfam GB programme staff with insights into the major issues, concerns, and debates within these themes and their linkages and effects on poverty in Sri Lanka. They also aim to highlight potential areas for policy advocacy by Oxfam GB. This input was used in staff preparation for Oxfam GB's Strategic Review in August 2004.

Oxfam GB's mission is, to work with others to overcome poverty and suffering. Its current programme focus is on: Livelihoods and poor people's access to markets; Gender equality, empowerment and ending violence against women; Public health promotion and access to quality water and sanitation facilities; Emergency preparedness and response; Relationship building between and within communities; and Empowerment of the poor through building of Community Based Organisations.

The views and opinions expressed in the Poverty Briefs are those of the authors and do not necessarily reflect those of Oxfam GB or the Centre for Poverty Analysis.

This series of Poverty Briefs was prepared in mid 2004, prior to the events of the Tsunami on 26th December 2004. The context and issues discussed in some of the Briefs could have changed since then.

The Role of International Financial Institutions in Sri Lanka

1. Introduction

This Poverty Brief looks at the role and significance of International Financial Institutions (IFIs) on the poverty-relevant policy arena in Sri Lanka. It is beyond the scope of this note to look at the effects of projects and programmes financed by these IFIs. Instead, it highlights the policy agendas of IFIs active in Sri Lanka and attempts to define their policy priorities against a context of the external framework (the policy frameworks of the institutions) and the internal dynamics (the policy framework of the Government of Sri Lanka). In other words, it attempts to draw out 'supply side' and 'demand side' factors in the agenda setting of IFIs operating in Sri Lanka. The IFIs analysed in this brief are selected by their significance (financial volume, areas of intervention, degree of influence) and relevance to policy making in the area of poverty.

IFIs are defined as lending institutions that obtain their finances from a number of sources, thereby making them international, or multilateral. Through their involvement in stabilization and structural adjustment programmes; development policies, programmes and projects; as well as through their lending and grants policies, IFIs play an important role in the definition of domestic economic and social policies of most developing countries and economies in transition.

2. Overview of Foreign Debt and Sources of Funding

2.1 Debt position

In measuring the dependency of a country on external aid, three indicators are frequently used:

i. the foreign debt / Gross Domestic Product (GDP) ratio, which calculates foreign debt as a proportion of the country's GDP,

ii. the foreign debt / export earnings dependence and,

iii. the debt service ratio, which measures debt and its servicing (interest plus amortisation payments) as a percentage of the foreign exchange earned via exports.

As table 1 below shows, while Sri Lanka's total debt /GDP ratio has crossed 100% in recent years the main source of this debt is domestic borrowing (57.9% of GDP) as against foreign borrowing which constitutes 47.9% of GDP. On the second indicator, Sri Lanka's foreign debt /export ratio is less than the danger point of 150% (although it is getting close at 134% in 2003). A country is classified as 'highly indebted' if its external debt /export ratio is over 150%. Sri Lanka's external debt servicing ratio is on par with East Asia and the Pacific and European and Central Asian countries. Hence Sri, Lanka is not classified as a Highly Indebted Poor Country (HIPC).

Table 1: Key foreign debt indicators

Indicator (%)	1999	2000	2001	2002	2003
Total debt / GDP	95.1	96.9	103.2	105.4	105.9
- Domestic debt/GDP	49.1	53.8	58.0	59.8	57.9
- Foreign debt / GDP	45.9	43.1	45.3	45.6	47.9
Foreign debt / export earnings	129.1	110.1	115.5	126.4	133.7
Foreign debt service / export earnings	7.7	6.6	6.8	8.3	7.3
Total debt service / government expenditure	31.3	38.7	38.0	49.8	54.1
- Domestic debt service / government exp.	22.2	31.6	30.0	41.5	46.9
- Foreign debt service / government exp	9.1	7.1	8.0	8.3	7.2

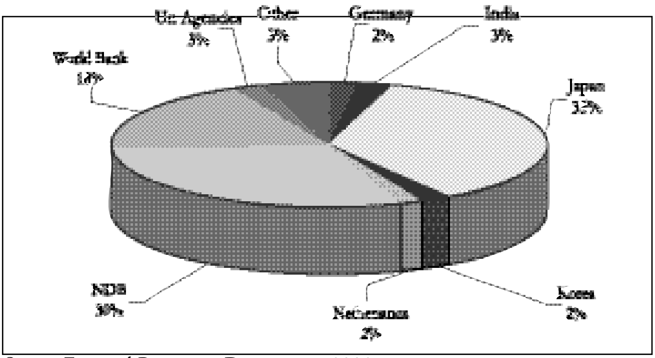
Source: Central Bank of Sri Lanka, Annual Report, 2003

As shown in Table 1 the cost of servicing domestic debt (46.9%) is far greater than that of servicing the foreign debt (7.2%). The major reason for this is the different borrowing terms and conditions. Due to Sri Lanka's position as a low-middle income country (GDP per capita less than US$1,000) most of its foreign assistance comes through grants and loans granted at highly concessionary terms. Of the US$8.7bn foreign debt stock in 2003, 98% was made up of concessionary loans for which repayment periods averaged at 10 to 20 years and carry interest rates of 0.5% to 2%. In contrast, domestic borrowing is done at interest rates of over 15%, although recently this has dropped to around 8-9% p.a.

2.2 Sources of financing

Foreign financing of the budget deficit takes three forms: outright grants, concessionary loans, and market borrowings. Grants do not add to the country's debt, as they do not have to be repaid. Concessionary loans are repayable on easier terms and market borrowings are repayable on commercial terms (the latter is less than 2% of Sri Lanka's total foreign debt). In general grants are provided by bi-lateral donor agencies although multilateral agencies also provide some grant aid. The top providers of grant aid to Sri Lanka presently are the governments of Japan, the Netherlands and Germany.

As Table 2 shows, the bulk of external government debt is made up of long-term concessionary debt. Of this long-term debt, annual aid commitments by bi-laterals (mainly Japan) have seen their share exceeding that of multi-laterals by an average 11/2 times (average 1997 to 2002: grants US$361m, loans $266m).



Source: External Resources Department 2003

The chart below shows the aid disbursements (loans and grants) in 2002 by the major bi-and multi-lateral donors. The top lenders in 2002 were Japan, the Asian Development Bank (ADB) and the World Bank (WB). The International Monetary Fund (IMF) is not represented in this chart as its lending comes under balance of payments support rather than for financing of domestic spending.

The remainder of this note analyses the multi-laterals or IFIs as referred to in this brief namely, the WB, ADB and IMF as they are the most significant in volume terms. Table 2 sets out the share of debt owned by the three main IFI's.

Table 2: Selected items of total outstanding debt and ownership (US$m)

Item	1999	(%)	2003	(%)
Total Outstanding Debt	9,973		11,689	
Long term government debt	7125	71.4	8723	74.6
- Multilateral	3,225	45.3	3,524	40.4
- ADB	1,449	44.9	1,695	48.1
- IDA*	1,656	51.3	1,751	49.7
- Other	120	3.7	95	2.7
- Bi-lateral	3,707	52.0	3,675	42.1
- Japan	2,286	61.7	2,639	71.8

Source: Central Bank Annual Report 2003

Notes: *The International Development Association (IDA) is the part of the World Bank and lends to poorest countries on highly concessionary terms

**IMF comes under a special category

Of the three IFIs, the ADB has tipped the WB (IDA) to become the largest IFI lending to Sri Lanka. The IMF is a relatively minor player in value terms, accounting for just 4% of long term debt.

3. Country Strategy of Key IFIs

The central theme underlying the lending strategies of the international financial institutions that grew out of the post World War 2 Bretton Woods Conference is a strongly held belief in the market as the most efficient allocator of scarce resources. This forms the essence of neo-classical economics. Stemming from this central principle, all the IFIs advocate a minimum role of government restricted to that of providing the necessary frame conditions for the functioning of market forces. The decades since the establishment of the WB and IMF have seen policy shifts and changes, but this fundamental tenet of the supremacy of the market in resource allocation - including for poverty alleviation - remains unchanged.

The three IFI's relevant for Sri Lanka, the WB, IMF and ADB have poverty alleviation as a core objective in their programmes. In keeping with their basic neo-classical principles, the route to poverty alleviation is through a growth-based strategy underpinned by macro, meso and micro level policy reforms to remove structural impediments to growth. Structural impediments are interpreted as those that keep the poor from fully participating and benefiting from economic growth. Hence, the IFI's have moved away from the explicitly growth-based assumptions of poverty alleviation, known infamously in the 1970s and 1980s as the 'trickle down' theory, to more 'pro-poor' growth strategies that aim to bring the poor into the growth process. The basic assumptions of market-led growth, however, remain unchanged.

The following section provides an overview of country strategies of the three IFIs. Since the latest available documents reviewed in this section were produced prior to the change of government in April 2004, they do not reflect potential changes - in substance or emphasis - that might be taking place at the time of preparation of the brief.

The International Monetary Fund

The IMF lends to Sri Lanka under its Poverty Reduction Growth Fund (PRGF) and Extended Fund Facility (EFF). In a recent press release the IMF states its "core agency mandate [as providing] advice, dialogue, and financial support to member countries including Sri Lanka. The focus in Sri Lanka will be on macroeconomic stability, combined with reforms and improvements in the public administration, financial sector, as well as removal of impediments to growth...No specific funding has been ear marked for conflict-related districts. Disbursements and possible changes to the program will be evaluated based on the ongoing dialogue, and the performance of the government".

Its most recent country update (IMF March 2004) highlights 4 areas of action as agreed to by the government of Sri Lanka (GOSL) under the PRGF arrangements.

i. Fiscal measures: this involves further rationalisation/streamlining of the tax system including the continued shift to indirect taxation, reducing import taxes and setting up and implementation of the Revenue Authority to enforce fiscal discipline.

ii. Financial sector reform: this essentially involves restructuring of the two state banks and easing of capital account restrictions.

iii. Public enterprise reform: continuation of the privatisation process and reform of the Samurdhi programme to enhance targeting.

iv. Labour market reform: to increase flexibility of the labour market through retrenchments schemes

The core of IMF reforms target macro-economic policies to restore fiscal stability. Through a combination demand and supply side adjustments the reforms are intended to create the necessary conditions for growth.

The World Bank

In comparison to the IMF, the WB country assistance programme has more significant implications for poverty reduction policies. The Bank builds its strategy on the GOSL's Poverty Reduction Strategy (PRS) and the six pillars identified in it (see Poverty Brief on PRS). Within this, the Bank identified three core themes: Peace, Growth and Equity, for which the Bank has identified targets. The poverty relevant targets are identified under all three themes, and include the following areas.

i. Peace: restore health, education and irrigation access to conflict affected areas

ii. Growth: this involves legal reforms to create flexible labour and land markets, implementation of a consistent and transparent tariff policy for agricultural products, improved water resource management by enacting a National Water Policy, facilitating access to safe and efficient planting materials and methods and increasing the share of rural households with electricity

iii. Equity: focuses on increasing investment in health and education for the poor and generally improving the access of services in poor areas

Much of the WB target areas are contained within the PRS, which is not surprising since the PRS was based on the framework provided by the WB. Similar to the IMF, the WB focuses on facilitating a process of macro-economic reforms, but goes further, encompassing a series of reforms aimed at the welfare sector and the rural economy. Welfare sector reforms target the Samurdhi programme and proposes transparent and means tested systems for beneficiary selection. Reforms in the rural economy aim at increasing productivity and creating a more efficient market for agricultural produce.

The Asian Development Bank

While also an IFI, the ADB unlike the WB and IMF is not a product of Bretton Woods. The ADB was established 22 years later in 1966 with a focus on Asia and the Pacific. In recent years it has overtaken the WB to become the largest IFI lender to Sri Lanka.

The ADB Country Strategy and Programme Update 2004-2008 published in September 2003 points to a number of mutually reinforcing causes of poverty that need to be addressed by poverty reduction strategies. These are: inadequate growth and significant inequality; the civil conflict; lack of integration and access of physical and social infrastructure; slow growth in agriculture and productivity; lack of clear land tenure; environment degradation and; social exclusion and powerlessness felt by many of the poor. Accordingly, the ADB identifies its strategic priorities to be:

i. Promoting pro-poor economic growth

ii. Advancing social development; and

iii. Supporting improved governance.

To achieve this strategy, the ADB supports six core sectors: (i) agriculture and rural development, (ii) transport, (iii) energy, (iv) financial sector and SMEs, (v) education and, (vi) water supply and sanitation. In addition, three underlying themes run through its sectoral strategy. These are, private sector development (accent on job creation), governance (accent on the quality and effectiveness of the public sector) and gender considerations (accent on mainstreaming gender in all its programme implementation).

The ADBs lending programme for 2004-2006 devotes 46% to 'poverty interventions' of which the bulk is allocated on 'core' poverty interventions. They comprise projects related to improvements in social infrastructure, education, water supply and sanitation.

4. Policy Implications

The previous United National Front (UNF) government had defined its economic strategy in a document titled "Regaining Sri Lanka (RSL) Vision and Strategy for Accelerated Development". The core objectives and development strategy outlined in the RSL, which was also the government's Poverty Reduction Strategy, were closely aligned to those of the IFI's and reflect their neo-classical character. In fact it could be fair to say that the RSL document in tone, was even more stridently neo-classical than the IFI policy documents.[1] In this sense, therefore, there was a good match between the policy agenda of the host country and those of the IFI's and made for more consensual decision making at the policy level.

This picture changed with the election of the new United Peoples Front Alliance (UPFA) on 2nd April 2004, with its red-blue coalition signalling a return to confrontational policy making between the donor and recipient.

Criticism of the IFIs, especially the WB and IMF centres on their promotion of a world order based on a particular understanding of history as defined by the 'Washington Consensus'. IFIs are criticised for imposing 'one-size-fits-all' prescriptions on borrower countries that are insensitive to their specific conditions. These standard prescriptions are based on the central underlying assumption that economic growth is a panacea for all ills and that economic growth is best ensured by removing impediments for operation of market forces.

Balancing the reform agenda with a social agenda

Inspite of consistent lip-service over many years to concepts of 'ownership' and 'consultation, all IFI strategies are essentially similar. The neo-classical policies of increased property rights, trade liberalisation and privatisation have been accompanied by more 'holistic' approaches to development involving safety nets, poverty, health, education, environment rural economy and gender considerations. The World Bank's World Development Report (WDR) 2000, 'Attacking Poverty', reflects this struggle of ideas. WB President James Wolfensohn in his introduction to this report says, the Bank "now also recognises the need for much more emphasis on laying institutional

1 See Poverty Brief No. 3 on 'Poverty Reduction Strategy'.

and social foundations for the development process and on managing vulnerability and encouraging participation to ensure inclusive growth", while also insisting that "macro-economic stability and market friendly reforms remain equally essential for reducing poverty".

In principle the two approaches are not in contradiction and remain equally valid. The contradiction comes in its translation into policy strategies, where more emphasis is given to the latter set of doctrines than the former. The review of IFI strategies in Sri Lanka supports the idea that the thrust of policy is towards a reform agenda aimed at removing obstacles to market forces, be it at a macro or sectoral level.

Some of the specific areas where IFIs standard prescriptions have been criticised include; macro-economic reforms, the emphasis on trade liberalisation and particularly the liberalisation of the capital account (Peet 2003). While the positive correlation between trade and growth is well researched it is also well established that in low-income countries the benefits of trade unequally benefits the rich. The equitable distribution of benefits of trade and foreign direct investment depend on a number of variables, not least the willingness and ability of recipients to direct the flows to sectors that benefit lower income groups.[2] On liberalising the capital account pushed for by the IMF, recent crises in East Asia and Latin America have only too well established the dangers of exposing a country to volatile and footloose capital flows without pre-conditions of economic and political stability - which Sri Lanka also lacks. To its credit, the GOSL has thus far resisted such moves thanks in part to a healthy balance of payments position and a lower dependence on the IMF.

Assessing poverty and social impact of reforms

Another area of agitation in Sri Lanka has been the privatisation of public utilities and the emphasis on increased private sector participation in the public realm. Policies such as the entry of private service providers in health, education and the introduction of user fees for these services has raised the ire of the public who fear the access of the poor to affordable services would be disproportionately reduced. The latest WDR 2004, Making Services Work for Poor People describes the need to facilitate an accountability relationship between (a) poor people, (b) policymakers and

2 See Poverty Brief No. 9 on 'Trade and Poverty'.

(c) providers. Accountability is a crucial determinant of development, particularly in nations such as Sri Lanka, ridden as they are with corruption and a civic culture that relies on political patronage to 'make services work'. For it to be effective, however, such accountability relationships should include the IFIs, which are notorious for circumventing the channels of accountability that they prescribe for others.[3] Instances of IFI projects where negligence, wastage, and mismanagement are rife are frequently documented by newspapers and serve to erode their credibility in the eyes of an already disenchanted public.

To their credit, IFIs in particular the WB, are increasingly applying tools such as 'Poverty and Social Impact Assessments' (PSIA)[4] to their policy reforms. The reforms identified for PSIAs include fiscal reforms, tax reforms, labour reform, public enterprise reform, privatisation and liberalisation, reform of the state banks, welfare and land reform. On the negative side, the PSIA process is slow, under utilised and overly directed by the WB, with inadequate demanding from the recipient side. As long as such processes are not conducted parallel to the approval process they remain as pro-forma, and not a determinant of decision-making. This can change with more effective lobbying by government and civil society to take advantage of these 'windows', so that PSIAs become as standard and important as Environment Impact Assessments.

On the welfare sector, the main focus of IFI induced policy reform is the Samurdhi Programme. The extreme politicisation of the programme has seen Samurdhi recipients rise to 50% of the population whereas the incidence of poverty is 25% of the population. The Welfare Benefits Act passed in 2003 aimed to introduce a new cut-off line for receipt for Samurdhi and transparent methods for beneficiary selection. However, the process is on hold since the change of government. In the event of a streamlining of Samurdhi, the impact on the poor is in fact likely to be positive as the reforms envisage a reduction of beneficiaries to those entitled and a doubling of the transfer amount.

3 The Bangladesh government recently was pressured to introduce legislation that provides for blanket immunity to the World Bank from any form of court ruling (IFI Watch, vol.1. no.1, September 2004, Unnayan Onneshan, Bangladesh).

4 The PSIAs receive support from the Department For International Development (DFID) UK.

Paying heed to safeguards

Most poor people in Sri Lanka live in rural areas. The policies of the WB and ADB are designed to stimulate productivity through agriculture and land reforms that allow for a greater play of market forces. The reforms involve creating 'entitlements' to factors of agriculture production such as land, water and raw material (e.g., seed material).

Most of these measures have come under fire from NGO / civil society activists who argue they will negatively affect the poor by depriving them of access to scarce resources. For instance, both the proposed Water and Land Acts seek to create entitlements in an effort to ensure more effective resource management. The principle behind this is to promote a more productive use of scarce resources. In particular, the land titling reforms are driven by the belief that ownership of land will lead to its more productive use or sale to allow others to make productive use of it. However, for such reforms to succeed, they need to be grounded in a proper verification of such hypotheses. They must be accompanied by adequate safeguards to prevent adverse effects such as creating a mass of landless poor. In general, critiques argue that the IFIs push through reforms, without checks and balances (for instance, the fact that PSIA's are not planned for the host of reforms aimed at the rural economy). This is blamed on an unwillingness of IFIs to engage with multi-stakeholders, preferring to forge a one-way relationship with the government. In Sri Lanka, accountability relationships between policymakers, clients, service providers are weak, therefore, donors need to pay heed to what they preach about consultation.

5. Summary and Implications for Oxfam Advocacy

The picture in relation to IFIs and their policies is not clear-cut. Unfortunately, the debate tends to be conducted as if it were. While a number of reforms linked to IFI lending require serious analysis, it is also evident that many of these reforms are indeed badly needed - and that IFIs are used as scapegoats for postponing much needed change. The challenge is rather to create space for critical reflection and analysis of the reforms on their individual merits and de-merits - and not on the basis of ideological posturing. In this task, organisations such as Oxfam are well placed to support this process due to their relative independence from the neo-classical camp and global reputation.

The recent election outcomes in Sri Lanka and India have called into question, once again the automatic links between economic growth and poverty reduction; and in particular the importance of perceptions of relative deprivation in the face of growth which favours a limited segment of the population. It also brought home the importance of communication and transparency. In the absence of effective communication of government policies, the stage is set for fuelling fear and uncertainty, with the discussion degenerating into rhetoric and sloganeering. Organisations such as Oxfam, with their track record in sponsoring high quality studies and promoting platforms for debate and advocacy can do much to facilitate this process of dialogue and exchange in Sri Lanka.

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