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POLICY PAPER

THE SOVEREIGN DEBT CRISIS IN SRI LANKA:

CAUSES, POLICY RESPONSE AND PROSPECTS

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Abstract

During the Covid-19 pandemic, there has been a dramatic increase in national debt levels across the world, with reported cases of downgrading sovereign debt ratings and difficulty of fulfilling debt obligations ('debt distress') heavily concentrated in low and middle-income countries. In this context, the unfolding sovereign debt crisis in Sri Lanka has attracted worldwide attention as the canary in the coal mine for what could become a global 'development' crisis. This paper examines the Sri Lankan crisis encompassing both the sources of vulnerability to the Covid-19 shock, and debt structuring and stabilisation reforms after the debt default. When the Covid-19 shock triggered the crisis, the Sri Lankan government treated it as a simple balance- of-payments disturbance that would dissipate together with the pandemic, while ignoring the systemic 'solvency' challenge of dealing with the massive debt overhang evolved over the previous two decades. After the default, Sri Lanka's policy challenge is to transform the 'twin deficit' economy, characterized by 'stop-go' growth cycle, into a dynamic, outward oriented economy that can deliver sustainable, equitable growth. The prime focus of the standard IMF approach to economic stabilization is on fiscal consolidation. It is necessary to combine fiscal consolidation with coherent expenditure switching policies to redress the long-standing anti-tradable bias in the incentive structure that has underpinned vulnerability of the economy to external shocks.

Author of the publication
Prema-Chandra Athukorala, Australian National University
Swarnim Wagle, UNDP Regional Bureau for Asia and the Pacific

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United Nations Development Programme
Regional Bureau for Asia and the Pacific
One United Nations Plaza
New York, NY, 10017, U.S.A.
Tel: +1 212 906-5000
Fax: +1 212 906-5898

THE SOVEREIGN DEBT CRISIS IN SRI LANKA: CAUSES, POLICY RESPONSE AND PROSPECTS

PREMA-CHANDRA ATHUKORALA
Australian National University

SWARNIM WAGLE
UNDP Regional Bureau for Asia and the Pacific

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1 INTRODUCTION

The Covid-19 pandemic has brought into sharp relief the subject of sovereign debt management in the international development policy debate. While the pandemic has led to a dramatic increase in national debt levels across the entire world, the reported cases of downgrading sovereign debt ratings and 'debt distress'—difficulty of fulfilling debt obligations—are heavily concentrated in low and middle-income countries (*The Economists* 2022, Reinhart 2022, Bulow et al. 2020, Kose et al. 2021). Managing unsustainable sovereign debt to restore access to capital markets is a vital policy priority for sustained and equitable economic recovery from the Covid-19 shock in these countries.

The policy debate and the related literature have so far focused predominantly, if not solely, on managing sovereign debt to free up resources for recovery in countries with debt distress and a high risk of debt default. An important issue that has not received due attention is the vast differences among these countries relating to the impact of the Covid-19 shock on debt distress. There is indeed evidence that a sizeable number of countries that require post-pandemic debt restructuring or debt service suspension support that entered the pandemic with elevated levels of public debt and debt distress (World Bank 2022, IMF 2020). Understanding the nature and sources of unsustainable debt build-upthat contributed to the vulnerability to the pandemic shock is vital for policy guidance for national sovereign debt management beyond the pandemic.

The purpose of this study is to contribute to the pandemic-propelled literature on sovereign debt crisis by undertaking an in-depth study of the experience of Sri Lanka, the third country to default on sovereign debt after Zambia and Lebanon in the Covid-19 era. The unfolding crisis in Sri Lanka has attracted international attention a 'warning sign' for policy strains faced by 'countries with high debt levels and limited policy space' (Georgieva 2022).

During the post-independence era, the Sri Lankan economy experienced several balance of payments crises. However, the current crisis is unique as it is centred on a massive external debt overhang: a toxic combination of a 'liquidity' crisis and a 'solvency' crisis. Managing a 'twin crisis' of this nature is much more challenging because replenishing foreign exchange reserves to maintain import flows has to go hand in hand with the arduous task of achieving debt sustainability, and stabilizing debt to a level consistent with maintaining the development progress of the country.

Sri Lanka entered the pandemic with a huge debt overhang built up over the previous two decades. Some significant policy initiatives of a new government that came into power in November 2019, which were not congruent with the needed reform priorities of a country with an elevated level of public debt, added to the 'debt distress'. This worsened when the government pursued a 'muddling through' approach to responding to the immediate impact of the pandemic on the balance of payments without paying attention to the impending debt servicing burden. When the government eventually went to the IMF in April 2022 after defaulting on foreign debt, the crisis-propelled socio-political instability had further complicated the process of debt restructuring and negotiating a stabilisation and structural adjustment program. The country is now in the unchartered territory of post-default economic adjustment and restructuring. Sri Lanka, therefore, presents a case study of a debt crisis encompassing both the sources of the country's vulnerability to the Covid-19 shock, and issues of post-covid-19 sovereign debt management and its implications for economic performance.

The rest of the paper is structured in four sections. Section 2 examines the origins of the debt overhang and the mounting debt service burden from a historical perspective. Section 3 discusses the onset of the debt crisis, and the initial 'muddling through' policy response that ended up with declared default on foreign debt. Section 4 discusses debt structuring and stabilisation cum structural adjustment reforms under the ongoing crisis resolution policy negotiations with the IMF. Section 5 undertakes a speculative discussion on economic performance in the post-default economy against the backdrop of experiences of sovereign debt default episodes in other countries. Conclusions and policy inferences close the paper.

2 BACKGROUND TO THE CRISIS: A HISTORICAL PERSPECTIVE

2.1 POLICY CONTEXT

Sri Lanka became independent in 1948 with a strong foundation and high hopes for economic achievement. It was endowed with what appeared to be a combination of several prerequisites for economic take-off: strategic location in the Indian Ocean, a literate, relatively well-educated population increasingly concentrated in working ages ('demographic dividend'); a competent public administration; well established smoothly functioning export economy; and well-developed economic and social infrastructure. At the time of independence and well into the 1950s, Sri Lanka ranked as one of the most prosperous countries in the region, with per capita income and other development indicators placing it not only above its South Asian neighbours but also ahead of economies such as the Republic of Korea, Taiwan (Province of China), and Thailand (Athukorala e al. 2017, Table 1.3). However, during the ensuing eight decades it has fallen behind the fast-growing East Asian economies and instead converged to the levels of South Asian neighbours. It took almost six decades since independence for Sri Lanka to move from the 'low-income' status to middle-income status (2007), and another twelve years to become an upper-middle income country (2019), in the World Bank's per capita income based country classification. Eventually the country has ended up in an unprecedented sovereign debt crisis that culminated in April 2022 with the stigma of becoming the only country in Asia to officially default on foreign sovereign debt over the past five decades.[1]

Sri Lanka inherited from the colonial era a classical *export economy* with a system of government that could already lay claim to being a welfare state (Jiggins 1960, Snodgrass1966). The economy was heavily dependent on three agricultural export commodities (tea, rubber and coconut), which directly contributed to nearly a third of GDP. In addition to its direct contribution to the economy, a host of activities in the services sector depended on the plantation sector. In the early 1950s, export earnings from the three crops covered over 95% of the country's imports that accounted for over three-fourth of total domestic absorption of goods. The period of political transition from colonialism to self-rule in the three decades leading up to independence saw the introduction and gradual expansion of a wide range of welfare measures including subsidised food, free education through to university level, free medical care, and subsidised public transportation.

The colonial welfare orientation became the precursor to the extensive welfare system that developed in the post-independence period as the government passed into the hands of leaders elected with a popular mandate. A population boom that started in the late 1940s added to the pressure of widening and deepening the welfare state. During the colonial era, the thriving export industries generated ample surplus for the state to comfortably finance these schemes. However, the rapid expansion of the welfare state during the post-independence era occurred against the backdrop of diminishing fortunes of the traditional export industries that underpinned past economic growth, for both supply-side reasons (gradual depletion of cheap land) and demand-side reasons. The successive governments of independent Sri Lanka largely failed to match welfare orientation with a coherent strategy to find new sources of growth through structural diversification of the economy, refurbishing existing export industries or diversifying into new areas in either agriculture or industry (Snodgrass 1966 and 1998, Athukorala & Jayasuriya 1994 & 2016).

In the first decade of independence, policy makers perceived periodic export shortfalls as cyclical phenomenon and maintained the *status quo* by financing balance of payments deficits with foreign exchange reserves accumulated during the boom years. From the late 1950s, following the depletion of foreign reserves, successive governments embraced import substitution in both agriculture and manufacturing. This protectionist policy stance continued until the late 1970s, belying an emerging academic consensus that a small country cannot hope to expand production without having to pay a price in terms of efficiency and market constraint.

In 1977, Sri Lanka embarked on an extensive economic liberalization process that marked a decisive break from the decades of protectionist policies (Rajapatirana 1991, Cuthbertson and Athukorala 1991). The reforms, implemented in two stages (during 1977-80 and in the early 1990s), included lifting almost all quantitative import restrictions and substantial reduction of tariffs,

[1] During this period, there have been some cases (in Indonesia, the Philippines, Pakistan and Vietnam) of restricting of international debt 'in the shadow of default' (that is pre-emptive restructuring of debt to avert a looming default) after incurring arrears on debt.

opening the economy to foreign direct investment and abolishing export duties. However, the reform process was incomplete in terms of the standard prerequisites for a market-oriented economy. First, most state-owned enterprises (SOEs) set up during the dirigiste era continued to operate with heavy dependence on budgetary transfers. Second, the promised reforms to achieve greater labour market flexibility were abandoned in the face of widespread opposition by trade unions.

Third, and perhaps more importantly, the complementarity between macroeconomic management and trade liberalization required for maintaining competitiveness of tradable production in the liberalized economy was missing. The dual exchange rate system, which had been in operation since 1968, was abolished and the new unified exchange rate was allowed to adjust in response to foreign exchange market conditions. However, from about 1979, the Central Bank began to deviate gradually from the original plan to intervene in the foreign exchange market to use the nominal exchange rate as an 'anchor' to contain domestic inflation. The policy emphasis on fiscal prudence, too, was short-lived. The main source of macroeconomic instability was a massive public-sector investment program that included the Mahaweli river basin development scheme, a large public housing program, and an urban development program. The real exchange rate (RER) (the standard measure of international competitiveness of an economy), which significantly depreciated showing improved international competitiveness during the first few years following the economic opening, tended to appreciate during the ensuing years (Athukorala and Jayasuriya 1994 and 2016).

Reaping gains from liberalization reforms was also seriously hampered by the escalation of the ethnic conflict from the early 1980s (Kelegama 2008, de Silva 1998).[2] The conflict virtually cut off the Northern Province and large parts of the Eastern Province (which together account for one-third of Sri Lanka's total land area and almost 12% of the population) from the national economy. Even in the rest of the country, the prospects for attracting foreign investment, particularly in long-term ventures, were seriously hampered by the lingering fear of sporadic attacks by rebels during the during the 25 years of the ethnic conflict. The government's preoccupation with the civil war stymied efforts to capture the full benefits of economic opening through delays and inconsistencies in the implementation of the reforms.

Despite incomplete implementation and the debilitating effects of the civil war, the reforms significantly transformed the economic landscape of Sri Lanka (next section). The gains from reforms were substantial enough to set the stage for the continuation of outward-oriented policy orientation well into the early 2000s despite political regime shifts (Moore 1997). By the mid-1990s Sri Lanka ranked amongst the few developing countries that had made a clear policy transition from inward orientation to global economic integration (World Bank 2004, Panagariya 2002).

However, as early as the late 1990s, the trade liberalization process suffered a setback because of the pressure for raising additional revenue from import tariffs to finance the ballooning war budget. The planned reduction of tariffs into a single band was abandoned and from then on tariffs were adjusted frequently in an *ad hoc* manner. The protectionist tendencies soon received added impetus from the growing discontent amongst the electorate as the civil war worsened.

The backlash against reforms gained added impetus after the country returned to a state of normalcy after the ending of the civil war in May 2009 (Kelegama 2017). The government began to emphasize the role of the state in 'guiding the markets' with a view to redressing perceived untoward effects of market-oriented reforms. During the ensuing years, there were many case-by-case adjustment of duties for manufacturing imports which directly competed with domestic production (Athukorala 2012). The new development strategy, labelled 'a new vision for achieving balanced growth', emphasised the role of the state in 'guiding the markets' with a view to redressing untoward effects of economic globalisation and privatization of key state enterprises (Government of Sri Lanka 2010). Rapid infrastructure development and the promotion of small and medium enterprises were the key priorities under the new policy. Sri Lanka's emphasis on infrastructure development received added impetus from China's geopolitical ascendency marked by its signature 'Belt and Road' initiative (Drehar and Fuchs 2022).

The period from 2015 to 2019 was an era of policy inaction. In spite of the promised commitment an outward-oriented development strategy, few attempts were made to redress policy reversals. With the regime change in 2019, the policy pendulum swung in favour of combining import substitution with export orientation while 'guiding the markets' by the state (CBSL 2020).

[2] Whether the liberalisation reforms contributed to the escalation of the ethnic conflict remains a debatable issue. On this issue, which is beyond the scope of this paper, see Abeyratne (2004) and Venugopal (2018) and the works cited therein

2.2 ECONOMIC PERFORMANCE

The key performance indicators of the economy for the period since 19603 are summarized in Table 1. The data are arranged by sub-periods to help analyse economic performance in terms of policy regime shifts. During the six decades prior to the onset of the COVID-19 pandemic, the Sri Lankan economy grew at an average annual rate of 4.8%. Given a population growth rate of 1.4%, this translated into a real per capita income growth rate of 3.4%, an impressive achievement by developing-country standards. However, annual growth rates were uneven throughout this period. Therefore, it took almost six decades since independence for Sri Lanka to move from the 'low-income' status to middle-income' status (2007), and another twelve years to become an upper-middle income country (2019), in the World Bank's per capita income based country classification.

During the 1960s and 1970s, per capita income grew at a modest annual rate of less than 2%. Diminishing prospects of the traditional export industries and import compression that constrained the expansion the new import substitution industries sapped growth dynamism. The population boom that began in the 1940s also continued apace.

The economy entered a respectably rapid growth path after the market-oriented reforms began in the late 1970s, albeit growth occurred in fits and starts owing to escalation of the civil war and the youth uprising during the late 1980s. The five years following the ending of the civil war were notable for rapid growth, predominantly driven by massive infrastructure investment. However, the growth spurt dissipated in the subsequent years with the completion of the debt funded construction projects and given the preoccupation of the government with the impending repayment of accumulated debt.

The structure of production changed little during the 1960s and 1970s other than a modest increase in the share of domestic agriculture (mostly paddy production) in the face of a faster decline in the share of plantation agriculture (Table 2). Much of the growth came from the services sectors dominated by public sector services. Manufacturing, other than factory processing of plantation produce, continued to account for less than 10% of GDP, in spite of the emphasis on import-substitution production with state-owned enterprises (SOEs) playing a dominant role.

Following the liberalization reforms initiated in the late 1970s, there was a notable increase in the share of manufacturing. Disaggregated data (not reported here for brevity) indicate a significant export orientation of manufacturing (Athukorala 2022). With the gradual erosion of the dominant role of state-owned enterprises (SOEs) the private sector was largely responsible for economic dynamism in manufacturing (and other sectors) of the country. The share of manufacturing in merchandise exports increased from less than 5% in the 1970s to over 65% by the late 1990s. Foreign direct investment, mostly in joint ventures with local entrepreneurs, begun to play a pivotal role in export-oriented manufacturing. FDI attracted to Sri Lanka during this period was, however, heavily concentrated in standard light consumer goods industries, predominantly in garments, sport and travel goods, cutting and polishing of imported diamonds, and in some natural rubber-based industries such as rubber bands, gloves and automobile tyres. There is evidence that FDI could have played a much more important role in export expansion in labour-intensive assembly activities in high-tech industries (such as electronics and electrical goods) if it were not for the political risk resulting from the ethnic conflict (Snodgrass 1998, Athukorala 2022).

[3] National accounts data are available on a comparable basis only from 1959. For an analysis of economic performance prior to that year see Snodgrass (1966)

Table 1: Key economic indicators, 1960-2021

	1960-2019	1960-64	1965-69	1970-77	1978-94	1995-04	2005-09	2010-14	2015-19	2020	2021
GDP growth (%)	4.8	4.5	4.8	3.1	5.0	4.7	6.0	6.8	3.7	-0.4	3.7
Population growth (%)	1.4	2.4	2.4	2.0	1.4	0.7	0.7	0.6	1.0	0.8	0.7
Per capita GDP growth	3.4	2.1	2.4	1.1	3.6	4.0	5.3	6.1	2.7	-4.4	3.0
Gross national saving (% of GDP)	18.3	12.4	11.6	12.3	16.2	21.2	22.2	29.6	26.9	23.6	23.8
Government	-0.7	0.8	0.7	0.3	0.3	-3.2	-2.5	-1.1	-1.7	-7.9	-9.1
Private	19.0	11.7	10.9	12.0	15.8	24.3	24.6	30.7	28.5	31.5	32.9
Gross domestic investment (% of GDP)	23.5	15.2	15.4	16.5	25.3	24.5	27.0	33.7	29.4	25.1	27.7
Government	8.1	6.9	7.2	7.1	13.1	5.8	6.0	5.1	5.1	3.3	3.4
Private	15.4	8.3	8.2	9.4	12.2	18.8	21.0	28.6	24.3	21.8	24.3
Government expenditure (% of GDP)	26.2	28.0	27.7	26.0	32.0	25.6	23.0	18.3	20.1	20.2	20.9
Govern revenue (% of GDP)	18.4	22.1	21.5	20.0	21.6	17.3	15.4	12.3	13.4	9.1	8.7
Budget deficit (% of GDP)	-7.8	-5.9	-6.2	-6.0	-10.4	-8.3	-7.6	-6.0	-6.7	-11.1	-12.2
Government debt (% of GDP)	77.9	43.3	61.9	63.0	87.1	97.1	86.3	71.3	81.3	101.0	104.6
Debt service/government revenue (%)1	20.5				25.0	28.9	25.5	32.9	45.0	63.7	61.4
Exchange rate, LKR2/US$	55.0	4.8	5.3	6.9	30.1	75.9	107.7	122.2	155.1	184.9	199.0
Real exchange rate RER2 (2005 = 100)	103.0	93	101	87	139	99	93	70	69	74	75
Trade balance (% of GDP)	-8.7	-1.9	-3.5	-2.4	-12.8	-9.1	-11.1	-11.6	-10.7	-7.4	-9.7
Current account balance (% of GDP)	-4.0	-2.2	-3.2	-1.2	-6.9	-3.1	-4.5	-4.1	-2.5	-1.5	-4.0
External debt (% of GDP)	42.8	4.9	8.2	19.5	59.7	57.1	42.7	50.0	59.3	60.3	66.0
Debt service ratio3 (%)	16.4	1.8	7.7	20.5	19.0	13.8	14.8	19.6	27.3	35.2	30.0
Foreign exchange reserves (US$ billion)	2.0	0.1	0.1	0.1	0.6	1.8	3.4	7.4	7.2	5.7	3.1
Import months equivalent	3.1	2.6	1.5	2.0	2.8	3.6	3.8	5.0	4.2	4.2	1.7

Notes:

(1) Average for 1978-2019; (2) Trade weighted real effective exchange rate estimated covering bilateral exchange rates relating to the 20 major trading partner countries of Sri Lanka. An increase (decrease) indicates real exchange rate deprecation (appreciation); (3) Debt repayment and interest payment as a percentage of export earnings (goods + services)
(2) LKR Sri Lankan rupee.

Source: Compiled from Central Bank of Sri Lanka, Annual Report (various years)

Table 2: Sectoral composition of gross domestic product, 1950-2021.

	1960	1965	1970	1975	1980	1985	1990	2000	2005	2010	2015	2020	2021
1 Agriculture, forestry and fishing	32.5	31.4	30.7	27.6	28.1	25.9	23.2	19.9	11.8	12.8	8.8	9.1	9.5
of chic plantation agriculture	17.1	14.7	11.7	10.3	7.3	6.8	5.4	2.8	3.0	3.2	1.8	1.8	2.0
2. Industry	23.3	21.3	28.6	25.9	29.3	25.6	28.5	27.3	30.2	29.4	29.3	27.8	27.5
2.1 Mining and quarrying	0.4	0.3	0.5	1.8	2.6	2.3	3.0	1.9	1.5	1.6	2.5	2.3	2.3
2.2 Manufacturing	14.9	16.0	17.9	16.0	15.3	14.8	17.4	16.8	19.5	18.0	17.5	17.1	17.1
of which processing of plantaion crops	7.2	4.6	5.4	4.5	3.5	2.9	2.7	2.4	0.7	0.8	0.0	0.0	0.0
2.3 Construction	7.7	6.1	10.3	7.8	10.4	7.4	6.8	7.3	6.8	7.6	8.2	7.2	7.2
2.4 Electricity gas and sanitary services	0.5	0.6	0.8	0.8	1.1	1.2	1.3	1.2	2.4	2.3	1.1	1.2	0.9
5 Services2	43.2	44.8	43.3	45.9	49.0	48.5	48.3	52.8	58.0	57.8	61.9	63.1	61.0
GDP (1 + 2 +3)	100	100	100	100	100	100	100	100	100	100	100	100	100
Nontradable production3 (2.3 + 2.4 + 3)	51.3	51.5	54.4	54.5	60.5	57.1	56.4	61.4	67.2	67.6	71.2	71.4	71.1

Notes:

(1) Tea, rubber and coconut cultivation (includes palm oil cultivation since 2018).
(2) Sum of value added in (i) Transport storage and communication; (ii) wholesale and retail trade, (iii) Banking, insurance and real estate; (iv) Ownership of dwellings; (v) Public administration and defence; (vi) other (unclassified services)
(3) Based on the classification system in Goldstein and Officer (1979)

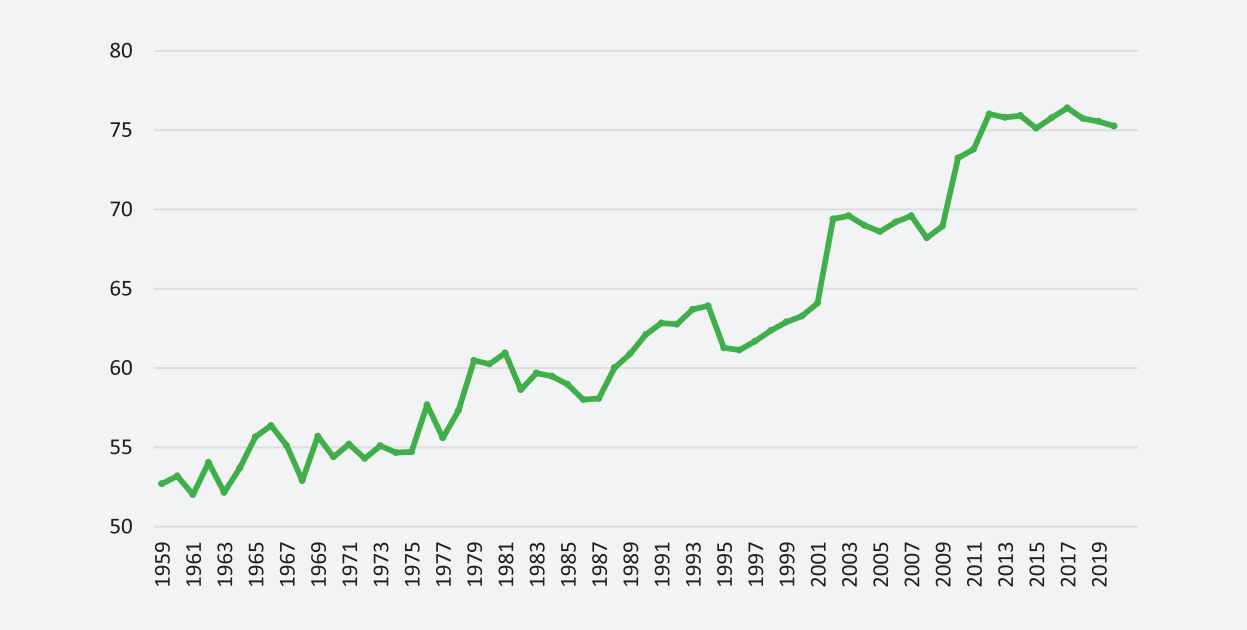
Source: Compiled from Saundranayagam (1983) for 1950-59 and Central Bank of Sri Lanka, *Annual Report* (various issues).

The increase in manufacturing share from about the late 1980s has not continued into the post-civil war period: it delined from about 20% in 2005 to around 17% by the end of 2010s. The data point to a significant shift in the production structure towards nontradable sectors reflecting massive investment in infrastructure development and government services from about the early 2000s. Nontradable production accounted for over 70% of the increment in GDP between 2009 and 2021 (Figure 1).[4] The relative importance of nontradable and tradable production in the output (GDP) composition is relevant for the ensuing discussion on the debt servicing capacity of the country. Shifts in the domestic production structure towards non-tradable production could result in a compositional shift in domestic aggregate demand towards imports and/or contraction in exports.

On the expenditure side of the economy, there was rapid expansion of government expenditure compared to government revenue throughout this period (Table 1). Government savings, the difference between government income and current expenditure, turned out to be negative across most years. Government investment was therefore mostly financed by relying on capital inflows (foreign aid and borrowing), domestic non-bank borrowing and borrowing from the central bank ('money financing'). The government failed to diversify the revenue base inherited from the colonial past and to improve the efficacy of the tax administration in the face of rapidly increasing government expenditure (Stern 2002, Moore 2017) (Figure 2). Tax revenue as a percentage of GDP declined from over 20% in the 1960s to less than 10% at the end of 2010s, one of the lowest ratios in the developing world (World Bank 2022).

Private savings rate, hovered in the range of 8% to 15% until about the late 1980s and increased to about 24% during the ensuing years, compared to around 40 percent in the high-performing East Asian countries (Athukorala and Suanin 2022).The private sector balance (the difference between private expenditure and income, which by definition is equal to the private 'saving – investment' gap) remained positive in most years. Unlike in the East Asian economies, and also India and Bangladesh in recent decades the private sector has not generate a substantial surplus to counterbalance the ballooning public sector deficit.

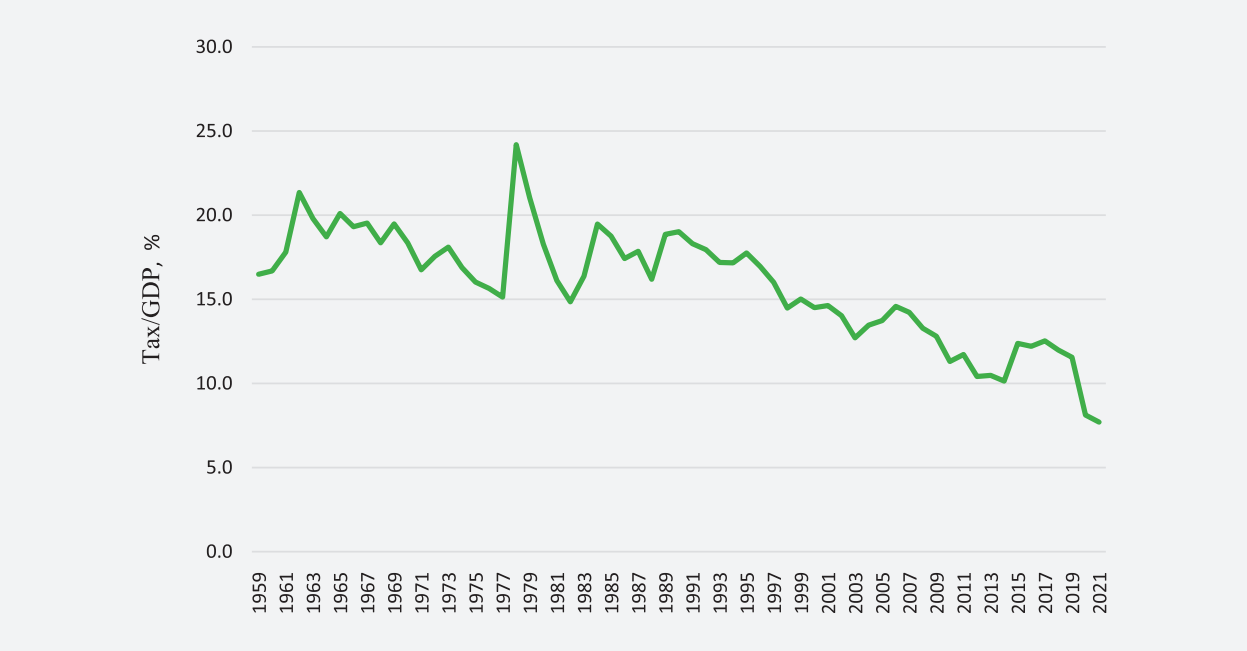
Figure 1: Sri Lanka: Share of nontradable sectors in GDP, 1959-2020 (%)



Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues)

[4] The tradable–non-tradable disaggregation used here is based on the methodology of Goldstein and Officer (1979). It is important to note that the available two-digit level GDP data do not permit a precise disaggregation. Some quasi-tradeable agricultural products are treated as tradables, whereas tourism related services are scattered across a number of services categories, which are treated as nontradable.

Figure 2: Sri Lanka: Tax revenue as share of GDP (%, 1959-2021)



Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues)

2.3 TWIN DEFICITS, DEBT OVERHANG AND VULNERABILITY TO THE COVID-19 SHOCK

The upshot of the development strategy of Sri Lanka during the past eight decades as surveyed in the previous section has been a 'twin deficit economy', an economy that has both a current account deficit and a budget deficit. (*a la* Streeten 1987)[5] Put simply, the country experienced a persistent deficit in the current account of the balance of payment because domestic expenditure continuously exceeded domestic production underpinned by a budget deficit that was overwhelmed by a modest private sector surplus. As Figure 1 depicts, during 1960-2021, Sri Lanka's current account has been in deficit throughout other than in 1965 and 1977 when there were small surpluses. When the counterpart domestic balance is decomposed into government and private balances, the dominant role played by fiscal operations in the twin deficit economy is vividly illustrated: thexternal deficit has closely mirrored the public sector deficit (the budget deficit).

Until the late 1970s, the government managed to keep deficits within a manageable range with grants and concessional institutional borrowing through recourse to import compression (Corea 1971). Substantial accumulation of external debt gained momentum after the liberalisation reforms initiated in the late 1970s and gained added impetus from the new- found emphasis on infrastructure investment following the end of the civil war.

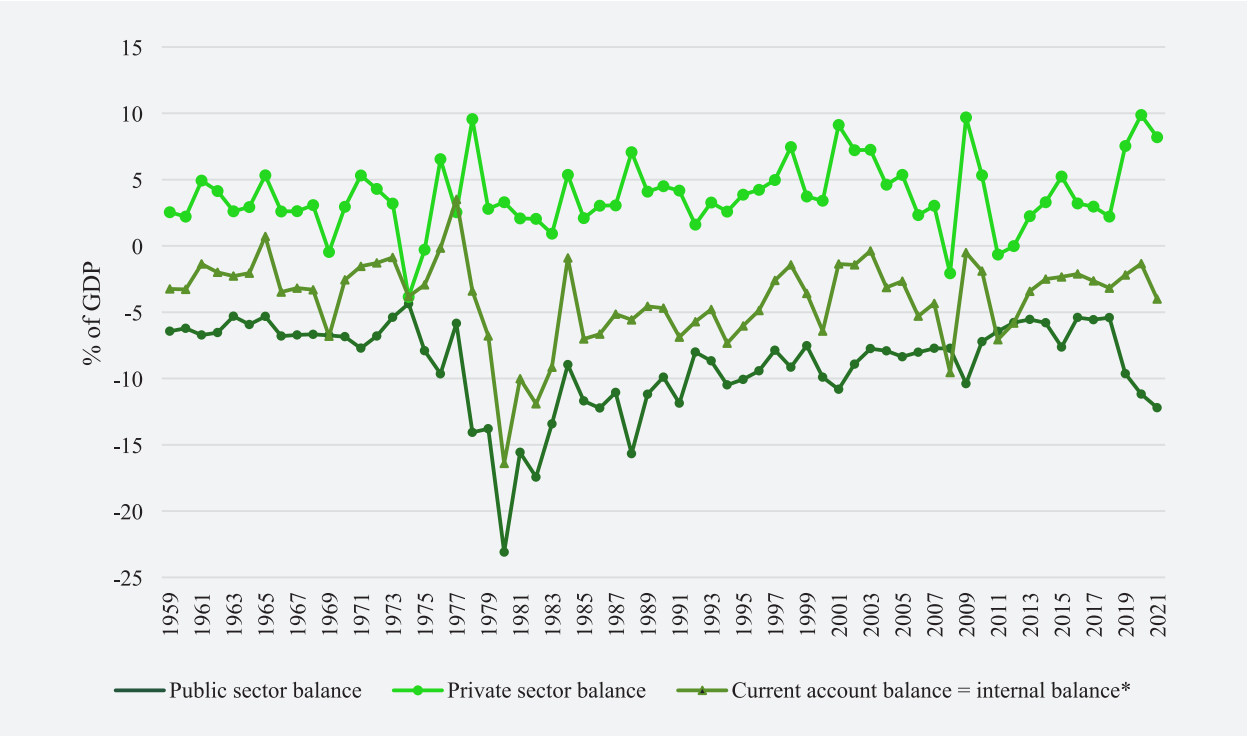
Figure 4 depicts total public debt and external debt of Sri Lanka during 1959-2021. The data indicate significant accumulation of external debt during the period from the late 1970s compared to the previous years. The external debt levels peaked at about 70% in the early 1990s and declined to 40% by the time of the end of the civil war. Then it increased continuously, reaching 61% in 2019 before the onset of the COVID-19 pandemic. In calculating the total debt figure from 2007, the Central Bank has valued international sovereign bonds (ISBs), which accounts for nearly a half of total debt, at market price.[6] When the data are adjusted by including ISBs at face value, the external debt to GDP ratio increases to about 66%.

Even after making this adjustment, the debt burden was not excessively high by Sri Lanka's own past record or compared to the widely accepted global norm (of about 60% of GDP) (Reinhart and Rogoff 2009). However, the debt-to-GDP ratio understates the debt burden of Sri Lanka because the composition of the denominator

[5] For a simple mathematical exposition of the relationship between the two deficits within the national account framework, see Appendix.

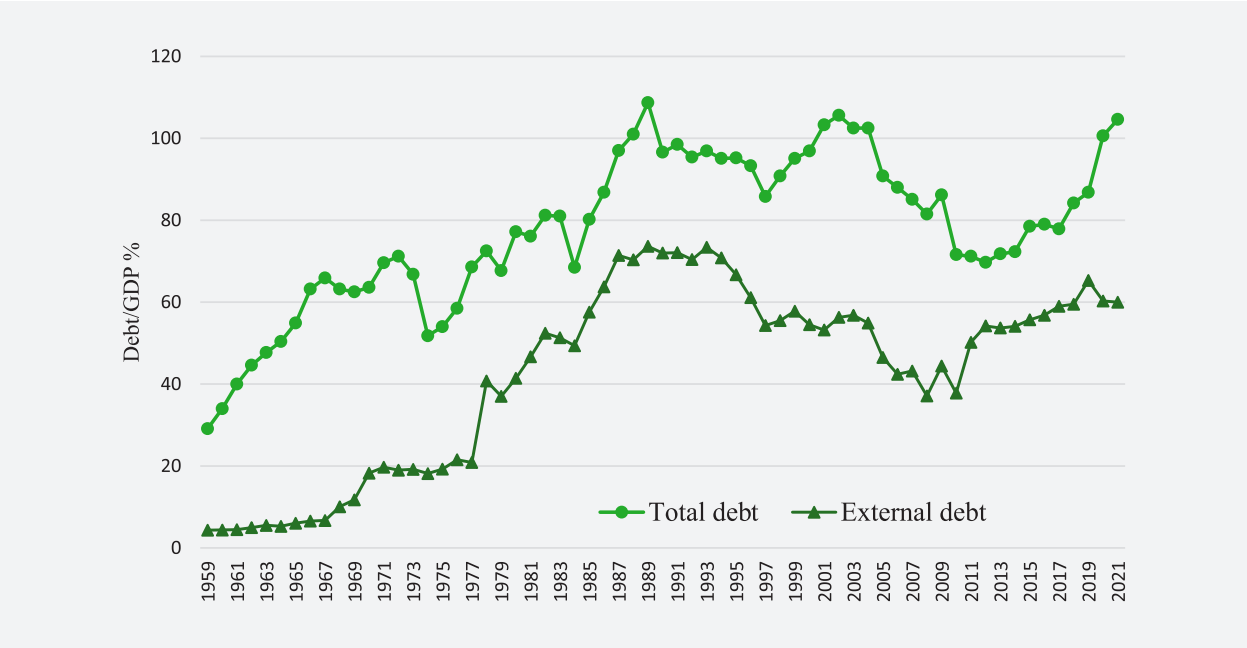
[6] See Chapter 5, Table 5.12 in the CBSL 2020 Annual Report. At the time market price was much lower than the 'face value' of ISBs, which is a true indicator of the country's actual debt obligation.

Figure 3: Sri Lanka: Current account balance and its internal components, 1959-2021 (% of GDP)



Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues)

Figure 4: Sri Lanka: Central government debt, 1959-2022 (% of GDP)[1]



Note: (1) Currency composition of debt (as of 31 April 2021): US$, 64.6%; SDR, 14.4%; Euro, 3.0%; Japanese Yen, 12.5%; Chinese Yen 2.6%; other currencies, 2.4% (DER 2022).

Source: Data compiled from Central Bank of Sri Lanka, Annual Report (various issues)

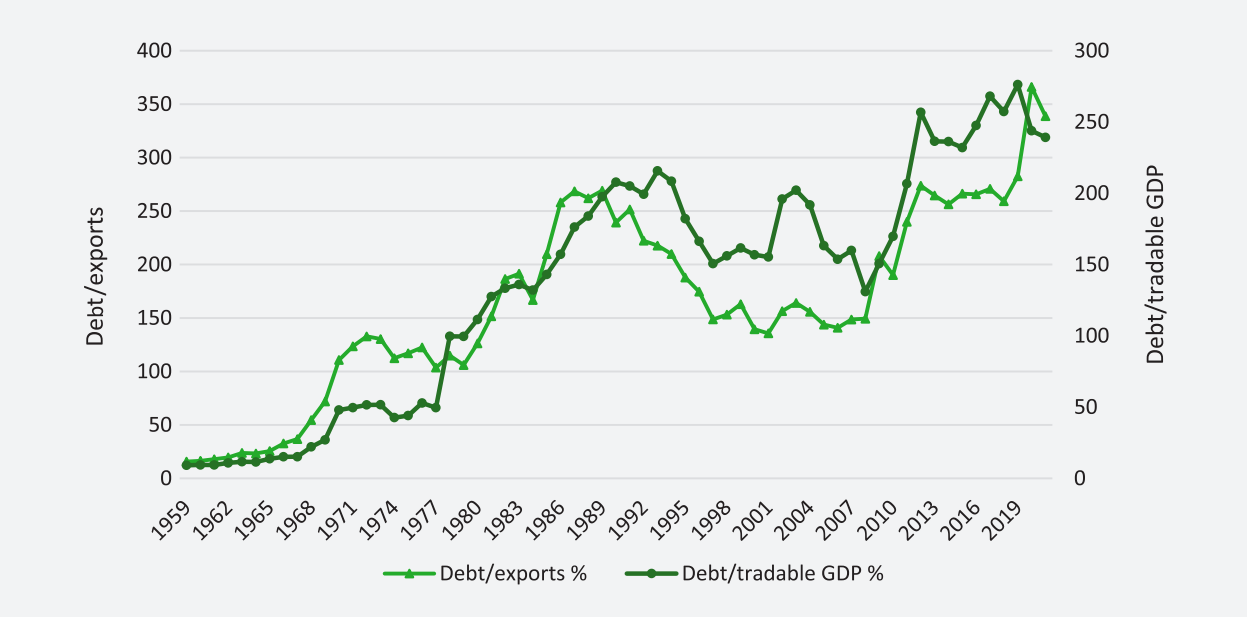
of this indicator (GDP) has dramatically changed by the debt-driven construction boom during the past two decades. As noted, non-tradable production that does not directly contribute to improving debt repayment capability of a country, has accounted for the lion's share of increment in GDP during the post-civil-war period.[7] Therefore, it is important to assess the debt burden by allowing for non-tradable bias in national output.

Two alternative indicators that measure the external debt burden after allowing for the non-tradable bias are plotted in Figure 5. The first is the debt to export ratio. It is a better indicator of whether debt accumulation has been consistent with the growth of export earnings (defined here as the sum of merchandise and services exports) over time (Dornbusch 1984, Dias-Alejandra 1986, Tanzi 2018). The other indictor is the debt to total tradable GDP ratio. Tradable production encompasses both import-competing and export-oriented production in the country. Therefore, this is an indicator of a country's debt servicing capacity rooted in both import substitution and export production capabilities. Interestingly, both indicators clearly show a dramatic increase in debt accumulation in the one-and-a-half decades prior to the COVID-19 pandemic.

The composition of Sri Lanka's external debt has undergone a dramatic change over the past two decades, a shift from multilateral and bilateral debt to more costly private market debt. From about the early 1960s (Table 3, Figure 6), the twin deficits were financed mostly through foreign grants and concessional loans. In particular, starting with the debut ISB issue of US$500 million in 2007, the share of ISBs in total external debt increased nine-fold from under 4% in 2007-2009 to about 36% in 2020-2021 (Table 1, Figure 6). The share of multilateral and bilateral loans, which are generally at much lower interest rates, declined from 43.2% and 42.8% of total government external debt during 2005-09 to 26.5% and 28.1% in 2019, respectively.

The debt service burden (repayment of principal plus interest) remained modest until the early 2000s (Figure 7). However, reflecting the cumulative effect of debt accumulation coupled with the significant compositional shift in favour of private market borrowing, the debt service ratio increased continuously from about 2010.. In 2020, debt repayments and interest payments accounted for over a third of total earnings from goods and services exports; and external debt servicing absorbed about 60% of total government revenue. There has been some decline in the share of government external debt with the increase in the share of the banking sector dominated by the state-owned banks. This, however, does not have a notable impact on the burden of external debt management because banking sector debt is *de facto* government debt.

Figure 5: External debt relative to tradable GDP and export earnings, 1959-2021 (%)



[7] Of course, increase in domestic production, regardless of the tradable-nontradable composition, enhances the domestic tax base and thus helps reduce the debt dependence of the government, depending on the efficacy of tax administration. However, in a country where external debts are denominated in foreign currency, it is eventual improvement in the balance of payments that matters in determining debt sustainability.

Table 3: Sri Lanka: key indicators of external debt

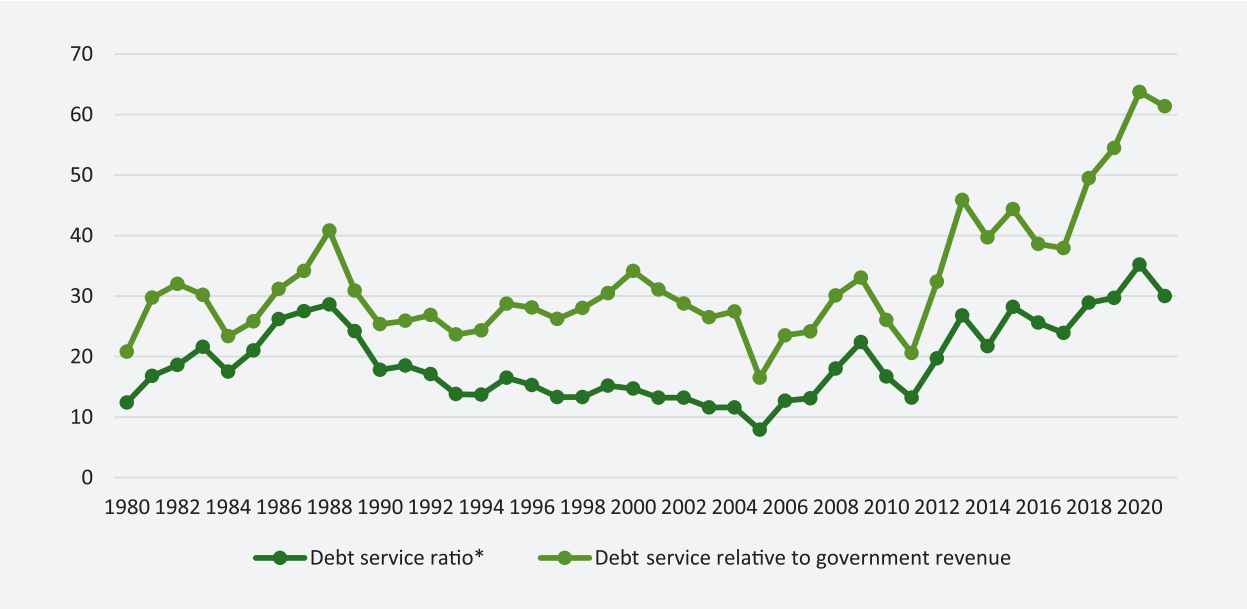
	2005-09[1]	2010-14[1]	2015	2016	2017	2018	2019	2020	2021 May
Total external debt (US$ billion)[2]	14.2	34.8	44.8	46.4	51.6	52.4	54.8	49.2	49.3
Government external debt (US$ billion)[3]	12.4	21.5	26.1	27.8	30.9	36.7	34.6	32.6	33.2
Government share in total external debt (%)	88.1	63.9	58.1	59.9	60.0	70.0	63.3	66.3	65.0
Composition of government external debt (%)									
Multilateral loans	43.2	30.8	28.1	26.6	25.4	24.4	23.7	26.5	27.5
Bilateral loans	42.8	33.2	32.0	31.2	30.1	23.0	24.6	28.1	27.9
Commercial loans	13.3	33.7	36.9	39.8	42.8	50.1	50.3	45.0	45.6
International sovereign bonds (ISBs) [3]	3.4	16.0	27.0	30.2	31.3	37.3	40.8	36.4	35.9
Other	9.9	17.7	9.8	9.6	11.5	12.8	9.5	8.6	9.6
External debt/GDP (%)	42.7	50.0	55.7	56.8	59	59.5	65.3	60.6	60.0
External debt/Export (%)	158.1	245.0	266.3	265.8	270.8	259.2	282.6	366.1	338.7
Debt service ratio (%)	14.8	19.6	28.2	25.6	23.9	28.9	29.7	33.5	32.3
Debt service/government revenue (%)	25.5	32.9	44.4	38.6	37.9	49.5	54.5	60.9	60.2

Notes:

(1) Five-year average.
(2) Total external debt including banking sector external liabilities and government guaranteed debt of sate-owned enterpises.
(3) Creditor composition (as of 31 April 2021): Commercial borrowing, 46.7%; World Bank, 9.2%; Asian Dvelopment Bank, 12.6%; China, 9.7%; Japan, 9.6%; India, 2.5%; other (mostly other bilateral creditors), 9.8 (DER 2022).(4) Sri Lanka debut sovereign bond issue was in 2007. The figures reported here for all years are at the market value of bonds. From 2019, ISBs held by domestic institutions are classified as domestic debt.

Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues).

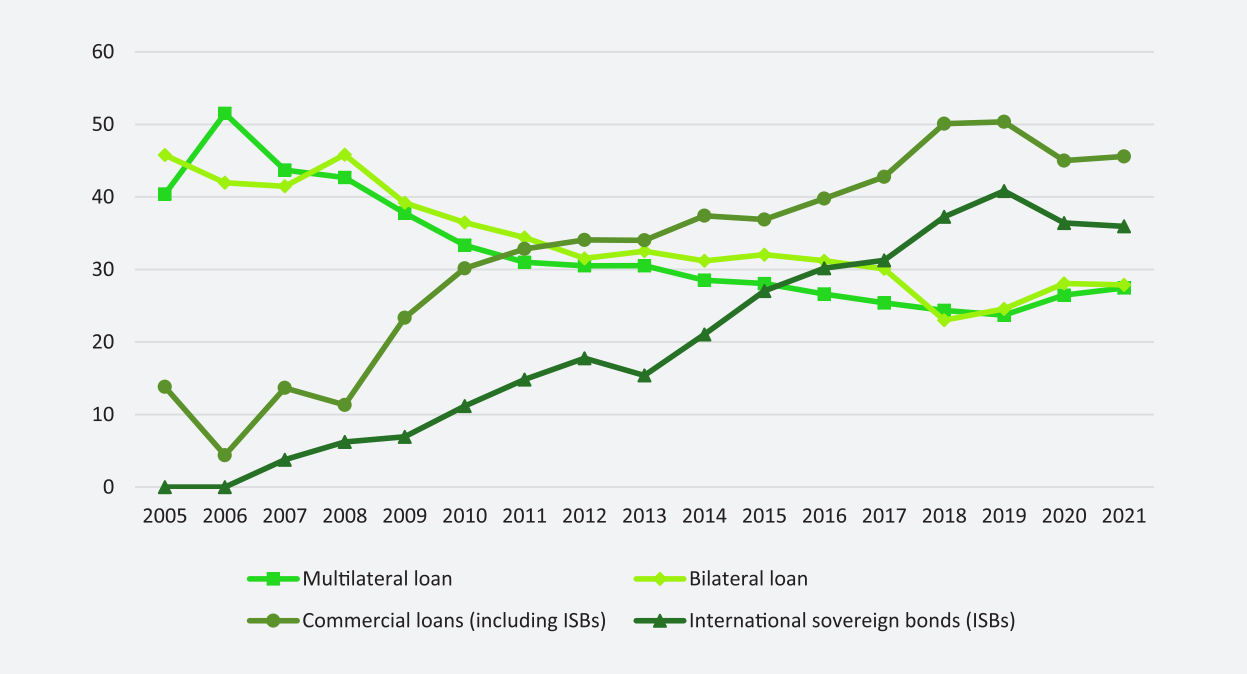
Figure 7: Sri Lanka: External debt servicing, 1980-2021 (%)



Note: *External debt repayment and interest payment as a percentage of total export earnings.

Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues)

Figure 6: Sri Lanka: Composition of external government debt (%)



Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues).

By the late 2010s, there were clear signs of debt distress in the economy. A tentative estimate based on the time profile of total external debt suggests that, on average, debt repayment of the country in the coming five years would be around US$4.5 billion per annum. The government in preparation for these impending debt repayments made two bond issues. In 2016 the government embarked on fiscal consolidation under an Extended Fund Facility (EFF) program (2016 June 31- 2019 May 1)[8] of the IMF. At the time of the change of government in November 2019, Sri Lanka was on a revenue-enhancing fiscal consolidation program registering surpluses in the primary account of the budget after several decades. In the sixth review under the EFF undertaken in December 2019, the IMF reported that Sri Lanka's external position was broadly in line with economic fundamentals, but a strong commitment to fiscal consolidation was needed to achieve debt sustainability over the medium term (IMF 2019).

There was a major policy shift following the change of political leadership in November 2019: a massive tax cut combined with filling the resultant budget deficit through money financing. It went against the fiscal consolidation program.[9] The tax cut wiped out almost a third of government revenue in 2020 compared to the previous year, resulting in a historically high budget deficit, which was financed by printing money. Given the severe vulnerability of the country's ability to continue servicing its debt, the three leading sovereign credit rating agencies immediately revised downward Sri Lanka's outlook, virtually cutting off the country from global capital markets. Since then, Sri Lanka's ISBs have been trading at just 40% of face value. Short-term investors did not come to the country in spite of significant relaxation of restrictions on such investment.

[8] Extended to June 2020 following the economic disruption caused by the Easter Day terrorist attack (2019) in Colombo.

[9] Apparently, this policy was based on a misinterpretation of the so-called Modern Monetary Theory (Kelton 2020). This theory postulates that a country that borrows in its own currency in a floating exchange rate regime has no effective limit on its central government debt. It reaches the limit of its ability to spend when the rate of inflation rises; the size of its budget deficit and public debt is irrelevant.

3. THE COVID-19 SHOCK, POLICY RESPONSE AND ECONOMIC COLLAPSE

As discussed, Sri Lanka entered the COVID-19 pandemic with a significant external debt overhang. The onset of the pandemic in March 2020 compounded the debt distress. Merchandise exports declined by about 20% in 2020 from the previous year (from US$12 billion to US$10 billion) but recovered well in 2021. The biggest blow to the balance of payments was the collapse of tourism inflows: total estimated earnings dwindled from about US$4 billion in 2019 to US$606 million in 2020 and US$500 million in 2021 (Table 4). Merchandise exports declined by about 20% in 2020 from the previous year (from US$12 billion to US$10 billion). Inward remittances by Sri Lankan workers significantly increased in 2020, reflecting intensified family support money transferred during the height of the pandemic. However, 'formal' remittance inflows tended to decline subsequently reflecting diversion to informal channels because of foreign exchange restrictions and fixing of the exchange rate at an overvalued level for several months (see below).

In March 2020, the government approached the IMF for financial assistance under the rapid financial instrument (RFI) facility. RFI financial assistance is available to all IMF member countries facing urgent balance of payments needs. Under the regular window of the facility[10], financial assistance is provided subject to an access limit of 50% of the member's quota for any 12-month period and 150% of the quota on a cumulative basis. However, Sri Lanka's request was unsuccessful because Sri Lankan's massive tax cut was not consistent with the IMF's assessment of Sri Lanka's external debt sustainability. At the same time, the IMF terminated the 2016 EFF program, and the government was not able to withdraw the final instalment of SDR 118.5 million (about US$155 million) under that program.

The negative response of the IMF was a strong signal for the government to enter into a stabilisation program to achieve debt sustainability and become eligible for IMF balance of payments support. However, the government decided to manage the crisis on its own. The government likely viewed the crisis as a temporary liquidity shock resulting from the COVID-19 pandemic while ignoring the systemic 'solvency' challenge—the arduous task of dealing with the debt overhang. Consequently, the government's crisis response turned out to be tinkering with symptoms, rather than addressing the root cause, hoping that the economy would be able to pull itself out of difficulty and regain access to global financial markets when the COVID-19 shock dissipated.

Entering into an IMF-supported stabilization and structural adjustment program is the common path followed by almost all IMF member countries in response to sovereign debt crises of this nature in recent decades (IMF 2009, Manasee and Roubeni 2009, Mitchener et al 2021, Dvorkin et al 2020). The resistance of the Sri Lankan government to follow this well traversed path was presumably driven by ideology. The widely held misconception that such a program would inherently be anti-welfare oriented figured prominently in the policy debate on the crisis response. The policy requirement of fiscal transference as part of IMF conditionality would also have closed loopholes in fiscal operation that has become a source of political patronage.

It is important to note that Sri Lanka has been a 'repetitive client' of the IMF, having entered into 16 economic stabilization programs during 1965-2020 (Athukorala 2021). The governments in both political camps have obtained IMF support. The resistance of the Sri Lankan government to follow this well traversed path this time was presumably because of the concern that fiscal reforms as part of IMF conditionality could close loopholes in fiscal operation that had become a source of political patronage. The populist concern propagated by the government at the time that an IMF program could involve sacrificing equity and fairness in development policy appeared a step behind the IMF's emphasis in recent decades on more inclusive approach to stabilisation and structural adjustment reforms (Boughton 2009, Georgieva 2019). The clean record of the country in dealing with the IMF, and, in particular, the absence of any previous default could have been in Sri Lanka's favour in pre-emptive debt restructuring and negotiating a stabilisation program with the IMF. All else qual, countries have never defaulted are much less likely to run into default than countries with high default possibility ('serial defaulters') (Reinhart *et al.* 2003, Asonuma and Trebesch 2016).

[10] There is a second window to assist countries that face large natural disasters.

Table 4: Sri Lanka: Key economic indicators surrounding the crisis

	2018	2019	2020	2021	2020				2021			
					q1	q2	q3	q4	q1	q2	q3	q4
GDP growth (%)1	3.3	2.3	-3.6	3.7	-1.9	-16.4	13.2	1.3	4.2	12.4	-11.9	2.1
GNP per capita (current US$)	3947	3734	3591	3722	---	---	---	---	---	---	---	---
Agricultural coproduction (2007-10 = 100)	126.2	126	129.4	133.3	79.9	92.9	73.4	95.1	94.6	105.9	97.6	91.4
Paddy	105.1	128.9	136	137.7	---	171	---	102.9	---	163.7		111.7
Industrial production (2015 = 100)	106.7	108.1	97.1	104.2	96.5	73.9	107.5	108.3	108.9	94.9	105.2	107.4
National consumer price index (NCPI) (2013 = 100)	125.2	129.6	137.6	147.2	136.4	135.8	138	140	142.3	143.8	147.1	155.6
Food (40% of the NCPI basket)	126.8	127.5	143.1	159.2	141.5	139.9	143.8	147.4	151.6	153.8	159.2	172.1
Merchandise exports (US$ billion)	11889	11940	10047	12494	2650	1763	3032	2602	2982	2717	3239	3560
Merchandise imports (US$ billion)	21947	19075	15584	20638	4503	3172	4107	4273	5041	4974	4923	5700
Tourist arrival ('000)	2337	1914	508	194	507	---	---	393	9	7	21	157
Gross tourist receipts (US$ million)	3897	3559	666	508	---	---	---	---	---	---	---	---
Migrant worker remittances (US$ million)	6707	6717	7104	5492	1600.3	1379.3	2069.2	2055.1	1867.1	1457.3	1253.1	914.0
Exchange rate, SKR per US$	182.7	181.6	186.4	200.4	188.6	186.2	185.5	186.4	199.3	201.3	200	200.4
Real exchange rate (RER) (2017 = 100)2	104.7	110.6	109.3	114.8	108.1	109.1	109.1	110.7	118.1	120.8	116.1	116.6
Gross official foreign exchange reserves (US$ billion)	6.1	7.6	5.6	3.1	7.5	6.7	6.7	5.6	4.1	4.1	2.7	3.1
Months of imports	4.2	4.6	4.2	1.8	4.6	4.5	4.7	4.2	2.9	2.6	1.7	1.8

Note:

--- Data not available (1) Quarterly growth is on y-o-y basis. (2) The Central Bank index has been inverted to make the index consistent with the nominal exchange rate (LKR per US$). An increase (decrease) indicates improvement (deterioration) of the international competitiveness of tradable production in the economy.

Source: Compiled from Central Bank of Sri Lanka, Statistical Bulletin and Annual Report (various issues)

The government's so-called 'home grown' response to the crisis was an *ad hoc* mixture of import restrictions, artificial fixing of the exchange rate and subsequent floating, and imposing restrictions on foreign exchange transactions on both current account and capital account transactions. The direct interventions were supplemented with swap agreements with the central banks of India (US$800 million), Bangladesh US$ 200 million) and China (US$1.5 billion), and financing facilities from the governments of India (US$ 1.5 billion) and China (US$ 1.3 billion) to meet debt service commitments and finance necessary imports.[11]

A rather incongruous element of import controls was a complete ban imposed on the import of two critical categories of agricultural inputs, i.e., synthetic fertilisers and pesticides. The stated objective of this ban imposed on 27 April 2021 was to convert Sri Lanka into the world's first country with pure organic ('green') agricultural produce to mitigate the adverse health implications of excessive use of inorganic fertilizer in domestic agriculture. The ban was finally revoked on 30 November 2021 in response to farmers' protests. However, this hasty decision to ban the importation of key agricultural inputs resulted in a harvest failure of crops in 2021 by a third or, in some cases half, depending on the crop (Marambe 2022). The need to import essential food items to fill domestic supply shortfall, in particular, rice, the main staple food of the country, added further pressure on the balance of payments; the country had to fill over 50% of the domestic rice requirement from imports during 2021-22 at an estimated cost of over US$150 million.

The debt 'rollover' strategy of refinancing existing debt by short-term borrowings helped reduce the cost of debt service burden because the new short-term loans are at a relatively low interest rate. Nonetheless, substitution of long-term debt with short-term borrowing further worsens the debt profile, making its term structure even more rigid. This tends to perpetuate the debt overhang and thus consolidate the case for continuity of stringent import controls.

Following the precipitous depreciation of the exchange rate of the rupee in response to the balance of payments shock, in September 2020 the Central Bank fixed the exchange rate at LKR 200 per dollar. This attempt, which was officially justified by the need to avert inflationary pressure of a free fall of the official exchange rate[12], set the stage for the emergence of a thriving black (curb) market for foreign exchange. By late 2020, the US dollar was exchanged in Colombo at a 25% to 30% premium over the official exchange rate. There was also anecdotal evidence of vibrant free market abroad involving the diaspora/migrant workers, where buying/selling deals occur with the corresponding rupee transactions effected in Sri Lanka without any cross border financial transfer.

The prevalence of a black market for foreign exchange, combined with import and capital flow restrictions, induced shifts of funds from the official market to free market. Such shifts increased in tempo as restrictions on transactions through the official market tightened, and thus worsened the official balance of payment position. Under-invoicing of exports and over invoicing of imports, smuggling and direct transfer through the black market channels by migrant workers and the diaspora are well-known tools of diverting foreign exchange from official to black market. Battling against the illicit movement of foreign exchange through law enforcement and by giving incentives for official transfers become futile when the black market premium is enormous and there are binding restrictions on formal foreign exchange transactions and imports.

The Central Bank abandoned the non-credible peg of LKR 200/US$ and allowed the exchange rate to float on 7 March 2022, with the expectation of the exchange rate would settle aroungd LKR 230/US$. However, because of the failure to sequence exchange rate adjustment as part of a comprehensive macroeconomic package (including relaxing of imports and foreign exchange restrictions), the official exchange rate of the rupee fell to LKR360/US$ by the April 2022. The floating of the official exchange rate failed to avert the diversion of foreign exchange into the curb market, binding import and foreign exchange restrictions, shattering business confidence, and aggravating political instability. Black-market rates moved in tandem with the official rate at a premium of over 10%.

On May 13, 2022, the Central Bank introduced a variant of 'target zone (band)' system of exchange rate determination with a view to limiting overshooting and excessive volatility. Under the new system, the Central Bank announced to the licensed commercial banks a 'middle' rate based on the rates determined in the interbank market on the preceding day advising the banks to maintain the buying and selling rates within a narrow two side band. This policy was also accompanied by some restrictions on open account imports with a view to

[11] In addition, South Korea signed a framework agreement with Sri Lanka in May 2021 for a concessional loan of US$500 million, with a repayment period of 40 years , to finance mutually agreed projects. The figure given here cover the two-and-a-half years ending July 15, 2022. (Source: Central Bank Annual Report 2020 and 2021 and press releases of the Department of External Resources and the Central Bank).

[12] Forcibly defending the fixed exchange rate was not just an economic choice, but perversion of justice and mal-governance too. There is anecdotal evidence that this enabled massive capital transfers overseas by the elite.

attracting remittances from the curb market to the banking system.[13] Following this, the exchange rate has moved in the narrow range of LKR/US$ 360 to 365. However, there are no indications yet of a noticeable decline in the curb market exchange rate premium.

Data are not readily available to measure the scale of capital flight propelled by import restrictions, fixing the exchange rate at an overvalued level (for over eight months) and the thriving black market for foreign exchange. However, the available data on merchandise imports and export indicates that import restrictions have not helped redress the widening of the trade deficit (Figure 8). There was a significant contraction in imports during the immediate aftermath of the introduction of quota restrictions in mid-2020. Since then, imports have increased continuously, reaching the pre-crisis level by the second quarter of 2022. This could reflect a combination of loopholes in the implementation of import restrictions, over-invoicing by importers, and imports under opening orders financed through the foreign exchange black market operation within the Sri Lankan diaspora.[14]

Formal emittance inflow increased almost every month in 2020 compared to the previous year reflecting family-support money trappers during difficult times. One would have expected continued increase in inflows in 2021 and 2022. But inflows in most months in 2021, and every month in the first four months in 2022 were significantly lower compared to the previous corresponding months. Total annual remittance inflows increased from US$6.7 billion in 2019 to US$7.1 billion in 2020. and then declined to US$5.5 billion in 2021 and amounted to a mere US$508 million (Figure 9)during the first four months of 2022. These patterns are indicative of the diversion of remittances to curb-market channels.

The Covid-19 shock and the uncertainty created by the 'muddling-through' response begun to stifle the economy. Investment approvals by the Board of Investment are at an all-time low: total envisaged investment in 'agreement-signed' projects in the first five months in 2022 is a mere US$55 million compared to a comparable annual figure of US$3.8 billion in 2020.

The year-on-year headline inflation rate based on the national consumer price index (NCPI) increased in 2020 and 2021 by 6.2% and 10.2% respectively, compared to 2019, driven largely by an increase in food prices. Comparable figures for food, which accounts for 44% of

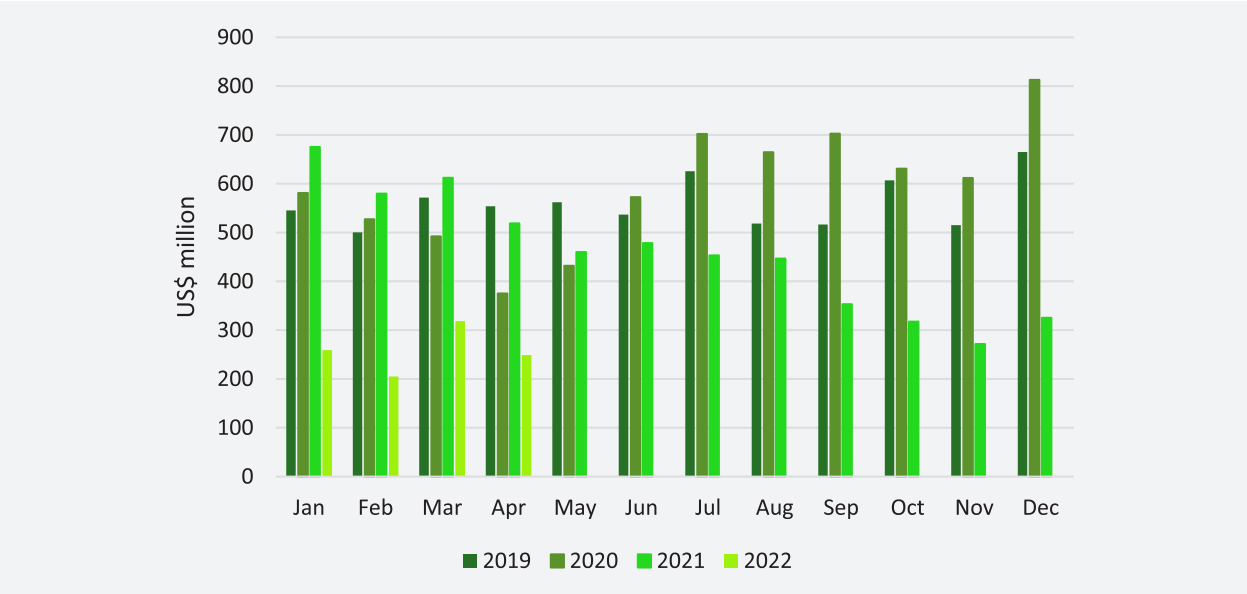
Figure 8 : Sri Lanka: Merchandise exports and imports (Jan 2018 to Dec 2021, US$ million)

Source: Data compiled from Central Bank of Sri Lanka, *Monthly Bulletin of Statistics* (various issues)

[13] An open account transition in international trade is a sale where the goods are shipped and delivered before the payment is due. Under an open account, the goods, along with all necessary export documents, are shipped directly to the importer, who has agreed to pay the exporter's invoice at a specific date. The alternative is a letter of credit transaction under which the buyer provides assurance to the exporter (seller) that the payment will be made by issuing a letter of credit through his/her bank.

[14] In 2021, the 'errors and omission' in the balance of payments, which is considered a rough indicator of capital flight, stood at US$ -711 million or 21.5% of the current account deficit of the year.

Figure 9: Sri Lanka: Officially recorded remittance inflows, 2019 -2022 (US$ million)



Source: Central Bank of Sri Lanka, *Monthly Statistical Bulletin* database

the NCPI basket, are 12.2% and 24.9%, respectively. It is widely believed that the NCPI significantly understates the degree of inflation because of the substantial presence of items subject to price control in the commodity basket.[15]

In 2020, the economy contracted by -3.6%. The level of GDP recovered to the pre-crisis level in 2021, but predicted to contract by 7.2% in 2022. In July 2020, the World Bank downgraded Sri Lanka's classification from upper-middle income status to lower-middle income status. According to World Bank estimates,in 2021 poverty (measured based on the US$ 3.20/day) had increased by about half a million since January 2020. This number would have swelled significantly because of the rapid rise in cost of living since early 2022. A tentative estimate made by combining data on household income distribution by quantiles from the recently released Household Income and Expenditure Survey (DCS 2022)[16] with NCPI data suggest about 60% of total household in the country are below this poverty line.

The decline in aggregate output appears to have been accompanied by changes in income and wealth distribution, although it is not possible to quantify these shifts. Producers of exportable and import competing goods and holders of net dollar assets would have reaped windfall gains from massive currency depreciation. Producers of nontradable goods, mostly wage earners, would have borne the burden of adjustment.

The IMF Article IV consultation report, published on 26 March 2022 (IMF 2022a), concluded that "Sri Lanka's public debt is unsustainable." The report stresses the urgency of implementing a credible and coherent strategy to restore macroeconomic stability and debt sustainability, while protecting vulnerable groups and reducing poverty through strengthened, well-targeted social safety nets. The authorities argued (in their response published as part of the IMF report) that the country's debt was sustainable and there was no need for rescheduling.

Using reserves to repay debt and to defend the pegged exchange rate (during September 2021-March 2022) caused gross foreign exchange reserves to deplete from US$7.6 billion at the end of 2019 to about US$50 million (equivalent to less than one-month of import requirement of the country) in early April.[17] The foreign exchange situation is even more alarming in terms

[15] According to the Bath Curry Indicator (BCI) compiled by the Advocata Institute, a think tank in Colombo, year-on-year food price inflation in Colombo in June 2022 was 61% (https://www.bci.advocata.org/). (The BCI tracks the prices of common food items that go into a ready-to-eat rice (bath) packet).

[16] The survey was conducted in 2019/20.

[17] Over the preceding 12 months, the Central Bank had sold estimated US$ 382.2 million worth of the country's gold reserves. In addition, it used for debt repayment US$787 million the country received in August 2011 from the IMF (as part of its special drawing right (SDR) allocation of SDR 650 billion among member countries to address the long-term global need for reserves during the COVID-19 crisis). There is anecdotal evidence that the inflated rates offered on ISBs and their repayment in full as late as February 2022 disproportionately rewarded political cronies.

of the Central Bank's net reserve position. Until April 2021, the Central Bank reserve position was positive even though reserves had been rapidly depleting since 2019. But for the first time in the post-independence era the reserve position turned out to be negative (-US$ 4.1 billion).[18] More recent data are not available, but given the Central Bank's subsequent recourse to swap arrangements with other central banks and reliance on credit facility from the Asian Currency Union, the net reserve position could have worsened during the ensuing months. Much anticipated futher balance of payments support from China was not forthcoming. Coupon payments on ISBs amounting to US$125 million were due in the coming month.

On April 12, the government declared unilateral suspension of all external debt repayments with effect from 5PM that day, for the first time since independence. Addressing the nation on 16 April, the President revealed that the government had started discussions with the IMF. On April 23, IMF issued a statement after week-long meetings it had with the Sri Lanka delegation: "the authorities plan to engage in a collaborative dialogue with their creditors" reiterating the need for debt restructuring.

The forces unleashed by rampant scarcity and price increases of food, fertilizer, gas and fuel, and frequent power cuts, begun to threaten the constitutional order in the country. People had to stand in long lines for hours on end to purchase milk powder, kerosene, and cooking gas. Lack of fuel to power plants resulted in more than 12-hour long power cuts by late 2021. Fuel stations are either closed or have kilometres long lines to purchase rationed quantities for public and private transport as well as agricultural machines. Hospitals have stopped regular surgeries as they have run out of medicines. Protest rallies across the country saw record crowds, of all social classes. Thousands camped at the entrance to the Presidential Secretariat demanding the government to resign. Similar protests have started across all major cities. In response, the Prime Minister and the entire cabinet resigned and a new cabinet was formed with some multiparty representation. On July 9th, the protesters stormed the official president's residence. The president fled the country and tendered his resignation from sent resignation from Singapore on July 14th. On July 20th, a new president was appointed (for the remainder of the presidential term that ends in 2024) by a clear majority of the parliament. However, yet the political stability needed to make progress on an agreement with the IMF remain elusive.

[18] We are grateful to Dr. W.A. Wijewardena (former Deputy Governor of the Central Bank) for providing this figure and explaining how the next external position is calculated from the detailed Central Bank balance sheet data. The gross reserves comprise those held by the Central Bank and small credit balances held by the Treasury in accounts in foreign countries. Net reserves are gross reserves set against the Central Bank's foreign liabilities that consist of borrowings from other Central Banks under swap arrangements, IMF, and credit balances of foreign entities like the Asian Clearance Union that maintain accounts with the Central Bank.

4. STABILISATION AND STRUCTURAL ADJUSTMENT REFORMS

4.1 NEGOTIATION PROCESS

As a middle-income country, Sri Lanka is eligible for IMF support under a Stand-by Agreement (SBA) or an Extended Fund Facility (EFF), funded under the IMF's General Resource Accounts (GRA) on non-concessional terms (IMF 2021).[19] Of these two, EFF is the appropriate program for Sri Lanka in the context of the unfolding crisis. It is the main tool used by IMF to provide member countries experiencing protracted balance of payments problems with financial support over a period of up to four years. An EFF program aims to support an ex-post deep structural adjustment reforms. Access to funds is subject to the normal limit of 145% annually of a country's IMF quota and a cumulative limit in all-outstanding exposure to the GRA over the life of the program of 435% of its quota, net of scheduled repayments. Currently the basic rate is 1 percentage point plus a surcharge depending on the size and duration of the program (IMF 2021).

Amounts drawn under an EFF are to be repaid over 4½–10 years in 12 equal semi-annual instalments (IMF 2021). Sri Lanka, with its IMF quota of SDR 587.8 million and projected repayments of around SDR 580 million over the next four years should be able to obtain a 4 year EFF loan of around SDR 2 billion (US$2.8 billion).

In addition to the direct financial support provided at below market interest rate, the IMF endorsement can help a country improve its external finance position in multiple ways. First, the program sets the stage for the country to reschedule its debts with bilateral creditor nations who are members of the Paris Club[20] and the official export credit agencies of these countries. Paris Club rescheduling facility is available only for countries with IMF adjustment programmes. Second, reaching an agreement with the IMF can also facilitate new lending from the World Bank and the Asian Development Bank. In some cases, such as with loans from the World Bank, conditionality de facto requires that the country comply with an IMF program.

Third, an IMF program based on a credible structural adjustment policy package also would provide access to private capital markets and often necessary for attracting foreign direct investment by multinational firms. The domestic private sector would often feel less vulnerable and reassured if the reform process in the economy is under IMF surveillance.

An IMF team visited Colombo during June 20 to 30 for discussions with the Sri Lankan authorities on a reform program to be supported by an Extended Fund Facility (EFF). The IMF press release issued at the end of the mission confirmed 'commitment to support Sri Lanka… in line with the IMF's policies', and emphasized that 'because public debt is assessed as unsustainable executive board approval will require … assurances from Sri Lanka's creditors that debt sustainability will be restored' (IMF 2022b). The next step towards signing the EFF is reaching a staff-level agreement based on a comprehensive reform program formulated by the IMF based on discussions with Sri Lankan authorities.

The approval of a stabilisation agreement by the IMF Executive Board depends on bringing external debt to a sustainable level through restructuring. Unlike in the case of a 'normal' balance of payment (liquidity) crisis, in the case of a 'liquid' plus 'solvency' crisis of this nature, debt restructuring is a prerequisite for the IMF to sign a stabilization and structural adjustment program. In late May of 2022, the government appointed financial and legal consultants for debt structuring.[21] It is expected that the IMF will approve emergency financing and enter into a staff-level agreement with the government to work towards a stabilisation package by the fall of 2022. As part of this agreement, the IMF is expected to conduct a Debt Sustainability Assessment (DSA) based on the adjustment policy package proposed by the country and its own assessment. The negotiation process, including the cumbersome process of debt restructuring can therefore take six to nine months.

Multilateral creditors (the IMF, World Bank, ADB) are treated as 'senior' creditors and are normally excluded from the restructuring process. Bilateral debt needs to be restructured either through the provision of new financing or the rescheduling of existing debt in negotiation with creditor nations. The Paris Club provides an effective

[19] Only low-income countries are eligible for concessional stabilisation programs under the IMF's Poverty Reduction and Growth Trust (PRGT) introduced in June 2021.

[20] The Paris Club is a group of 22 creditor countries that have worked together since 1950 to find coordinated and sustainable solution to countries' debt problems. It undertakes non-concessional rescheduling of debt.

[21] The French firm, Lazzard, and the British firm, Clifford Chance, respectively. The agreed consultancy fee for Lazzard is US$5.6 million.

forum for negotiations with the conventional (Western) creditors. However, restructuring of bilateral debt can become a long-drawn process because China, the biggest bilateral creditor of Sri Lanka accounting for over US$6 billion of outstanding debt, is not a Paris Club member.

China's standard practice has been to agree on extending the period of repayment of existing debt rather than taking a 'haircut' on them or re-profiling with lighter repayment terms. However, in November 2020 meeting of the G20 Countries, China endorsed the Common Framework for Debt Treatments Beyond Debt Service Suspension Initiative (DSSI), which follows most of the fundamental principles of the Paris Club (Reiffel 2021). China participated in the Paris Club debt restricting negotiation with Zambia under this arrangement. On July 30, 2022, the Official Creditor Committee for Zambia announced its commitment to negotiate debt restructuring terms, enabling the IMF Executive Board to consider approval of the Fund-supported stabilisation program for Zambia (IMF 2022d).[22] This could set a precedence for China's participation with the Paris Club in Sri Lanka's bilateral debt restructuring too.[23]

Restructuring debt from private creditors, in particular sovereign bondholders, is normally a long-drawn, costly process. This would involve a mixture of 'haircut' on outstanding bonds, extension of maturities with a higher coupon rate. A country can restructure ISBs unilaterally (in an involuntary manner), but it could be messy and lead to depriving the country of accessing private capital market for a long period (Amo et al. 2020). The 'voluntary debt exchange' approach (under which the bond holders participate in negotiations with the debtor nation) first successfully implemented by Uruguay in 2003 has now become a standard practice (Ams et al. 2020, pp. 292/93). This is the approach Sri Lanka is likely to take. The Sri Lankan bonds comprise a very small percentage of assets of the funds that bought them. Therefore, the litigation risk is presumably negligible.

A major issue relating to debt restructuring is its implications for subsequent market access. The available evidence suggests that debt restructuring does not completely negate the opportunities; but higher haircuts are associated with significantly higher subsequent bond yield spread and longer periods of capital market exclusion (Cruces and Trehesch 2013, Meyear, Reinhart and Trebesch 2019).

4.2 STRUCTURAL ADJUSTMENT PROGRAM

Sri Lanka's policy challenge is to take this economic crisis as a springboard for lifting the country to a sustainable growth path and transforming the 'twin deficit' economy characterized by 'stop-go' growth cycle into a dynamic, outward-oriented economy. This requires achieving a sustainable fiscal position by undertaking government revenue and expenditure reforms, and redressing the anti-tradable bias by supplementing fiscal reforms with complementary monetary, exchange rate, trade and competition reforms. It is important to combine these initiatives with a comprehensive social protection package as an integral part of the reform process: 'Effective stabilisation is, above all, not a technical issue but a political issue' (Dornbusch 1983, pp.229)

Domestic demand management is the prime focus of the standard IMF-supported stabilisation reform packages. Given the fiscal operation is the key determinant of domestic excess demand, the IMF approach assumes a fairly tight one-to-one link between the budget deficit and the balance of payments deficit, domestic money and credit that drive inflation. Of course, aggregate-demand management is vital for any serious stabilisation plan, in the sense of seeking to eliminate domestic demand pressure on the external balance.

However, in the context of an economy where anti-tradable bias has underpinned vulnerability to the crisis (with a debt overhang), it is necessary to combine expenditure-reducing policies with those aimed at 'expenditure switching' (from non-tradables to tradables). Because of the strong complementarity between domestic production and imports (including oil), speedy and sustained recovery of the economy depends crucially on export expansion and efficient import substituting domestic production. Notwithstanding the national account identity that links the balance of payments and the aggregate domestic demand-supply imbalance, the equilibrium links between the two variables are complex (and the causation can run in both directions). The balance of payments situation of a country will depend on many domestic and external forces, which are not necessary within the domain of aggregate demand management.

Policy options for designing a stabilisation program are discussed below with emphasis on demand management, exchange rate adjustment, unshackling

[22] On December 3, 2021, IMF reached a staff level agreement with the Zambian authorities on an Extended Credit Facility (ECF) for 2022-2025 in the amount of about SDR 980 million ($1.3 billion). The approval of the agreement by the IMF Executive Board has been delayed because of the protracted debt restructuring process.

[23] It is important to note that the financial advisor that Sri Lanka has appointed for debt restructuring (Lazard) is also the advisor engaged in debt restructuring in Zambia.

the economy from direct government interventions, export development and reforming the social welfare system. Speedy recovery from the crisis calls for implementation of these reforms as one package given their interlocking nature in determining the reform outcome. It is necessary to remove controls on the flow of trade and production to reap the gains from exchange rate adjustment. Reforms on the exchange front may not wholly succeed without matching fiscal and monetary policies. If inflationary financing is not stopped, the benefit of other measures may be short-lived. Stabilisation and structural reforms are unlikely to be politically palatable and legitimate unless a cohesive initiative to protect the vulnerable groups become an integral part of the reform package

Demand management

Monetary and fiscal policies would need to be tighter. Fiscal reforms would focus on reducing the budget deficit through a combination of spending restraints and widening the tax base to provide fiscal space for social spending. There is ample room to strengthen the tax base. The tax to GDP ratio has plummeted to one of the lowest in the developing would (Section 2). There is a strong case to reintroduce the aborted revenue-based stabilisation reforms initiated under IMF's EFF reform package of 2016 (Coomaraswami 2017, IMF 2016). This needs to be combined with reforms to rewamp tax administration including introducing a pay-as-you-earn and withholding mechanisms and abolishing economically unjustifiable tax exemptions. On the expenditure side, it is neccesary to strengthen public investment management and increase transparency on where the borrowed money is being to spent in order to prevent politically-driven public investment spree.

A subsidized pricing mechanism for energy (oil, gas and electricity) benefits the rich disproportionately. A rational policy over the medium-term would aim to improve the government's budgetary position by cost-based pricing of these products and assisting the poor through direct cash transfers.

Fiscal policy could aim at achieving zero money expansion through the budget tap: borrowing from the Central Bank or commercial banks to finance any part of the payments for the government. An operating deficit financed by administrative borrowing, foreign loans and grants, and non-bank borrowing is clearly not expansionary. Foreign aid and grants add to the supply of imported goods (other than the counterpart funds contributed by the government for aid-funded projects), not to the supply of money.[24] Domestic non-bank borrowings merely shift funds from one set of pockets to another.

While complete denationalisation is politically impossible, SOE reforms would invariably be a prominent item on the reform agenda. Denationalisation of several prominent government undertakings would be desirable to eliminate the mounting fiscal burden involved in supporting loss-making SOEs and to release resources to sectors where the output per unit of capital is comparatively higher. When it comes to some SOEs (e.g., Electricity Board, Petroleum Corporation) that are engaged in providing essential goods and services, rationalisation of operation rather than privatisation is the only practical option. The reform of over 400 SOEs could release resources to sectors where output per unit of capital is comparatively higher to support social infrastructure development.

The SOE reforms ought to be part and parcel of a comprehensive public sector downsizing. By 2016, the public sector in Sri Lanka expanded to 1.1 million workers, excluding uniformed staff of the military (with 346,000 active and reserve personnel) (DCS 2016). The government becoming an *employer of last resort*, particularly for university graduates, is a poor strategy to absorb residual labor as it drains and abuses resources. A bloated military diverts human resources with alternative use; fuels corruption through an opaque web of lucrative contracts; and suppresses dissent, often weakening channels of accountability in fledgling democracies.

Over the medium-term, one new nature-related option for expanding fiscal space may be considered. Given the growing urgency posed by climate change, an innovative proposal to wed environmental challenges with the concerns of highly indebted countries is the adoption of 'Debt-for-Nature' swaps. This is an instrument through which a debtor country would make payments in local currency on terms agreed upon with creditors on projects in the country in line with the Nationally Determined Contributions (NDCs) pledged during the 2015 Paris Climate Accords, and/or national biodiversity strategies. The country would swap a promise (repayments on debt) with another promise (funding Sustainable Development Goals). This has been tried in small economies like Costa Rica,

[24] For most aid funded projects, the government has to provide counterpart (rupee) funds. This was a main source of inflationary pressure under the Mahaweli project. It attracted a massive amount of foreign aid and grants. At the same time the government has to commit a massive amount of counterpart funds to implement the project. This was the main source of macroeconomic instability during the period of implementation of the project, which was a big constraint on reaping gains from trade and FDI liberalisation.

Belize and Seychelles in recent years;[25] and in the aftermath of Sri Lankan default, a global financial firm expressed interest in restructuring US$1 billion of debt for environmental ends.[26]

Fiscal dominance of monetary policy has been a problem in Sri Lanka for decades. Bouts of high inflation and long-term loss of competitiveness can be directly linked to Central Bank printing money to accommodate the political objectives of the Treasury. The current crisis is a case in point. Institutional reforms based on an amendment to the Monetary Law Act to prevent unwarranted monetization of budget deficits by restoring Central Bank's independence is another policy priority. (centra bank independence)

As a general rule, the Treasury would refrain from dabbling in the field of monetary policy and central bank activity. Monetary policy needs to focus on both taming inflation and maintaining international competitiveness of the economy (as measured by the real exchange rate). It is important to avoid the temptation to use exchange rate policy as a fiscal tool to artificially lower the rupee cost of external debt servicing or for 'anchoring' inflation.

Exchange rate adjustment

So long as a thriving black market for foreign exchange exists, the balance of payments difficulties in the official market will persist. Eliminating the black market exchange rate premium by adjusting the exchange rate to the equilibrium level is vital for achieving external equilibria. It is difficult to ascertain the equilibrium exchange rate though simple 'desk work'. At the same time, the black market rates are an unreliable guide to the equilibrium rate. Black market quotations of course provide a rough guide to the order of magnitude of the degree of overvaluation, but there are wide margins between buying and selling rates that rule out their practical value. An initial failure to guess that equilibrium rate could necessitate repetitive exchange rate adjustments, resulting in diminished credibility of exchange rate management. The widely recommended and most expedient alternative is to identify the equilibrium level through a transitional phase of floating the exchange rate of the rupee and then stabilizing that rate at the market-determined level though Central Bank intervention in the foreign exchange market to redress erratic deviations of the exchange rate from that level (Corden 2004). It is important to emphasize, however, that floating the currency under this approach needs to be preceded by removal of foreign exchanges restrictions on current account transactions, quantitative import restrictions, building adequate reserves to support the currency and regaining market confidence by entering into the IMF program. Once the equilibrium rate is identified through floating, it is necessary for the Central Bank to resume operations in the foreign exchange market to smoothen erratic changes. This is to manage the floating rate to ensure exchange rate behaviour in line with the objective of achieving internal and external balance of the economy. Until these preconditions required for successful transition to a managed floating system are met, continuing with the target zone (band) policy recently introduced by the Central Bank seems the appropriate.

In foreign exchange market operations, the Central Bank would resist 'leaning against the wind', influencing the exchange rate against market forces with a view to taming domestic inflation or to cushion the budget against increase in the rupee value of the cost of debt servicing. Because real depreciation is the central instrument to promote medium-term growth and economic stability, averting the real exchange rate (RER) appreciation (maintain exchange rate broadly stable in real term at the equilibrium level) should be given priority over fiscal stabilisation and maintaining inflation targets. Put simply, the exchange rate should continue to function as a shock absorber while maintaining international competitiveness of the economy. In guiding the exchange rate, policymakers could err in the direction of undervaluation to buttress tradable production and to provide a favourable economic atmosphere for import liberalisation.

There is a strong case for giving priority to real depreciation of the exchange rate as the central instrument to promote medium term growth given that anti-tradable bias in the incentive structure has been at the heart of macroeconomic disequilibria. The non-tradable bias that underpinned the building of the debt overhang was underpinned by a persistent appreciation of the real exchange rate. Throughout the period, mild depreciation of the nominal exchange rate has been overwhelmed by the rate of domestic inflation, which continues to exceed (with a widening margin) that of trading partners (Figure 10). Given the recent significant upturn in inflation and the well-known pattern of market inertia, it is unlikely that the rate of inflation come down to the pre-crisis levels soon. Therefore, living with moderate inflation will be a more credible goal

[25] Belize bought back a $526.5 million bond with help from The Nature Conservancy (which has a much better credit rating) to fund a $23.4 million marine conservation trust that would help protect the world's second-largest barrier reef, damaged in the past by offshore oil drilling and overdevelopment (Maki 2021).

[26] https://www.ft.com/content/3e071d7a-2b6d-40a9-8aaf-a4fb3992d592

in the short- to medium-term in order to avoid a costly compromise between the objective of taming inflation and maintaining international competitiveness.

Unshackling markets

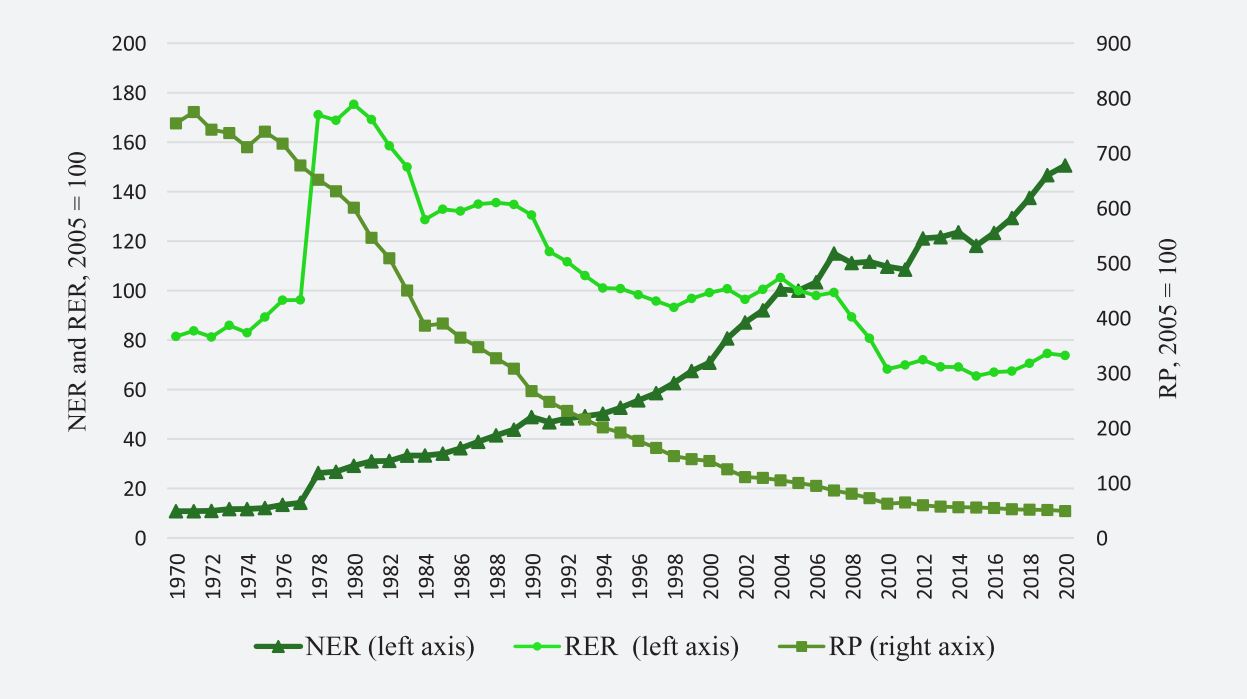
Lifting quantitative import controls (QRs), with the financial support forthcoming from the IMF, should be another key reform priority. In fact, IMF lending under an EFF specifically comes to the Central Bank as balance of payment support to restore import flows. Lifting QRs is vital to address the burning issue of shortages key imported goods in the domestic market: removal of QRs (even at high tariffs) would help win popular support for reforms by addressing the crippling supply shortages in domestic markets.

At the initial stage of managing the crisis, it would be necessary to retain import duties (tariffs) at reasonably high levels (consistent with bound rates at the WTO) as a 'first aid' measure, for two reasons. All-out import liberalisation (removing both quantitative restrictions and tariffs) could jeopardise the reform process though relentless pressure on the foreign exchange reserve of the country. Second, increased tariff revenue helps hedge against the inevitable pressure of the government budget resulting from exchange rate depreciation.

In Sri Lanka's tariff structure, among all tariff lines (6965, at the 8-digit level of HS) all agricultural tariff lines (1064) (other than whale oil and sperm oil) are bound at 50%; among the non-agricultural tariff lines (5901) only 22.3% are bound at rate between 50 to 75%, except textile which is bound at zero (WTO 2016). There is, therefore, ample room to increase tariffs without violating WTO commitment. Possible violation of WTO tariff commitments relating to luxury goods such as automobiles and liquor can be circumvented by imposing high excise duties along-side the new import tariff structure.

The crisis provides a valuable opportunity to revamp (simplify and rationalise) the overall tariff structure. The government could cash in this opportunity to abolish para tariffs, tariffs and other surges to introduce a transparent tariff structure with only tariffs applicable to all imports. Sri Lanka was one of the first countries to impose a complex set of 'para tariffs' or supplementary taxes which are not under the purview of the WTO

Figure 10: Sri Lanka: Real exchange rate and its Component1 (2005 =100), 1970-2021



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.

Source: Compiled from data extracted from World Bank, *World Development Indicator* database and Central bank of Sri Lanka, *Annual Report* (various years).

(Athukorala 2012). These tariffs were introduced during the civil-war years to raise more revenue. Various para tariffs combined with customs duties enforce effective protection rates of between 170% to 500% for some products and, overall, make production for the domestic market over 70% more profitable than production for export (Athukorala 2018). Much of this protection has been sought and obtained upon lobbying by parties politically close to the regime of the day. Some of the para tariffs amount to 'nuisance taxes' where the cost of collecting them possibly outweigh the benefit.

It is also desirable to supplant the prevailing 'specific' duties (that is, duties applied on a 'per unit' or 'weight' basis) on some imports with ad valorem (percentage on import value) duties. Specific duties are naturally unnecessarily regressive in their impact on market price depending on the quality of the products. They provide protection to low quality domestic producers and penalise consumers in lower income brackets.

It is important to carefully design the new tariff structure with the aim of gradually moving tariff rates towards a near-uniform structure in place of the current three-band structure, with lower tariffs for essential imports. There is ample evidence that a transparent tariff structure with relatively uniform low *ad valorem* tariffs help increase tariff revenue collection while improving the efficiency of custom administration (Corbo 1997, Subramanian 1994).

The proposed tariff reform/rationalization must be complemented with a comprehensive trade adjustment package to help local industries and entrepreneurs face foreign competition. This is because the reform will change the type of competition faced by industries and, in turn, change the labour market conditions faced by workers. While the goal of tariff rationalization is to catalyse the movement of a large share of Sri Lankan workers from lower paying jobs in traditional sectors to higher paying work in new industries, especially in the export sector, this desired transformation of the labour market will not benefit all workers equally. While some workers will see new opportunities emerge and willingly move between jobs, others may lose their job unwillingly, face unemployment, and possibly move to a lower paying or less desirable job. It is important to institute strong policies and tools that help workers adjust to the changing labour market. (elaborate)

Trade reforms would ideally combine the lifting of domestic price controls including government monopoly in certain imports (e.g., import monopoly of food commissioner and CWE). However, price guidelines could be established for imported inputs given that trading channels are far from competitive. If state trading is required for political/equity reasons, this could be on a competitive basis, private enterprises being allowed to participate side by side. It is important to ensure that agricultural inputs are distributed efficiently and priced 'right' to improve production of food and other agriculture products.

Capital flow management

Maintaining controls over most type of capital account transaction (while lifting restrictions of foreign exchange on current account transactions) is desirable during the reform period. To do so effectively may not be an easy task, but a reasonable exchange rate would help. Domestic policies targeting RERs will not be compatible with free or untaxed capital movements and unrestricted convertibility. In particular, a prudential regulation machinery is needed to discourage volatile international capital flows that rely primarily on taxes or tax-like instruments (that is, special reserve requirements) on short term capital inflows. So long as domestic currency balances may be burdened by an inflation tax (implicit tax on money holding) higher than that levied on foreign currencies, some limit on convertibility is widely perceived as a necessary part of transitional policy package. There is evidence from Sri Lanka's own past that in a period of economic recovery short term capital inflows put unnecessary pressure on macroeconomic management given that the Sri Lankan market for short term financial assets is shallow.[27]

Export promotion

With most (if not all) of its government debt denominated in foreign currency and with significant share of this debt held externally, Sri Lanka faces the dual challenge of raising sufficient fiscal revenues to service its debt and converting these surpluses into foreign exchange. Therefore, a strategy to reorient domestic resources from domestic production to export expansion (and efficient import substitution) production has to be an integral part of the structural adjustment reform package.

Avoiding RER appreciation (or perhaps, keeping it at a slightly undervalued level, as discussed), trade and investment policy reforms against the back drop of fiscal consolidation programs set the stage for export expansion by restoring international competitiveness of the economy and redressing anti-export bias in the economy. These reforms need to be supplemented with an endeavour, at the highest political level, to promote export-oriented foreign direct investment (FDI). Sri Lanka's own experience under liberalization reforms

[27] We owe this point to Indrajit Coomarasamy, a former governor of the Central Bank of Sri Lanka.

initiated in the later 1970s, the second-wave reforms in the early 1990s, have clearly demonstrated the complementarity of trade and investment liberalization in the process of export-oriented industrialization.

Restoring the Board of Investment (BOI) to its original 'one-stop-shop' status for promoting FDI could prove vital for linking Sri Lanka's manufacturing industry to the rapidly evolving global production networks. As part of BOI reforms, it is necessary to rationalize, rather than eliminate, the fiscal incentives offered to export-oriented investors. The very objective of giving incentives for promoting FDI is nullified if they are not made strictly time bound, performance based, and transparent.

To diversify exports, the government has rightly prioritized ICT-based services, including business process management (BPM). Before the crisis, the Sri Lanka Association for Software Services Companies (SLASSCOM) estimated that the industry could aim to generate US$5 billion in export earnings by 2025, creating 200,000 direct jobs.[28] While this prospect has dimmed since, in 2021, ICT/BPM sector was reported to have earned US$1.2 billion, marking a doubling of earnings within a decade.[29]

The pandemic has reaffirmed the feasibility and potential of IT-based remote work at a time when the world is on the brink of the fourth industrial revolution (4IR), characterized by a much more ubiquitous internet; smaller, cheaper and more powerful sensors; artificial intelligence and machine learning. Together they create new production possibilities because of speed and scope.[30] With one of South Asia's most educated workforce, Sri Lanka is well placed to leapfrog in this sector. However, additional investments are needed in digital infrastructure to narrow gaps in ICT coverage, quality and cost; train a critical mass of workers with skills that are *'future-proof'*, and pursue adaptive policymaking that proactively removes techno-regulatory hurdles in fast-growing industries.

The era of manufacturing a product from the beginning to end within national boundaries is ending. As countries are integrating globally and technological advances are creating previously impossible collaborations, rapidly evolving global manufacturing value chain (GMVC) is generating new opportunities for countries to participate in finer international division of labour than ever before.

These production processes with cross-border dispersions within vertically integrated global industries, with each country specializing in a particular stage of the production sequence, is becoming an increasingly important structural feature of economic globalization. Urgent action must be taken to integrate Sri Lanka into GMVC that would set the stage for rapid export expansions and creating create better employment opportunities.

Even though large electronics MNEs have shunned Sri Lanka because of the country risk during the three decades of civil war (Athukorala and Rajapatirana 2000), a sizeable number (over 30, according to Board of Investment records) of fully export-oriented medium scale foreign-invested enterprises (FIEs) (with full or partial foreign ownership have been successfully operating in electronics, electrical goods, and auto part industries in the country for many years now, suggesting ample opportunities for Sri Lanka in this new form of global engagement enduring the post-civil war era. These firms currently employ over 20,000 workers (Athukorala 2022).[31] According to a recent firm-level survey of 13 firms that produce (mostly assemble) a wide range of parts and components ranging from sensors for the Airbus and weighing components for baby incubators, availability of trainable labour and complementary supervisory manpower is the major attraction of Sri Lanka as a production location for these investors. Contrary to the popular perception among policy makers in the country, managers of none of these firms complained about a human capital constraint and labour shortages.

The survey found no evidence to suggest that the advent of the 4IR would put an end to the type of activities undertaken by these firms. In principle, almost all production processes could be robotised or automated, but, in reality, the actual replacement of labour with this 4IR technology depend on the relative cost of doing so, which depends on both complexity of the production process and the bulkiness of the given product. Automation or robotisation does not seem to be a cost- effective alternative for the human touch involved in intricate assembly processes undertaken by these firms. The firms involved in assembling weighing cells, auto wire harnesses, sensors for aircrafts and optical insulators have long-term plans to expand production. For a recent example, the UK-based major player in the global aircraft component industry bought a Sri Lankan

[28] https://slasscom.lk

[29] https://www.sundaytimes.lk/220206/business-times/exports-in-various-sectors-seen-increasing-in-2021-471218.html

[30] Industrial advancement based on the convergence of digital technology with breakthroughs in material science and biotechnology: artificial intelligence (AI), robotics, internet of things (IoT) 3D printing (additive manufacturing), autonomous vehicles and nanotechnology, according to Schwab (2016).

[31] Total exports of these products increased from US$247 million (6.1% of total manufacturing exports) in 2007-08 to US$95 million (10.3% of total manufacturing exports) in 2018-19. The annual growth rate of exports has been much faster in more recent years: an average annual growth rate of over 15% during 2015 -2019 compared 9% during 2007-2015.

US-Sweden-UK joint venture firm producing sensors for Airbus as part of its production expansion program. The new owner has plans to expand the Sri Lankan operation to a projected employment capacity of 2000 workers, up from the current employment of 60 workers.

Social Safety Nets

As discussed, the crisis has already had a crushing impact on low income families in Sri Lanka. A large segment of previously non-poor is now poor. Mass protests that initially spanned the cost of living pressure and scarcity of essential consumer items have morphed to threaten the constitutional order in the country. In this context, it is vital to design the stabilisation and structural adjustment policy package with a strong emphasis on social welfare. A pronged approach is needed: selective use of public expenditure and taxation to ensure both equitably the cost of adjustment (as discussed) and in tackling bottlenecks, and designing safety programs to help households at the bottom of the income scale who would become worse off owing to direct COVID-19 shock and stabilisation measures, in particular market-based pricing of electricity, gas and oil.

So far, no comprehensive assessment has been undertaken of the existing welfare (social safety) net in the country. There are around 30 programs (in addition to the long-running pension programs) under different ministries and departments (World Bank 2015). Of these, school meal program and Thriposha, and Samurdhi are the three biggest programs with island-wide coverage of households. The others are small programs well-targeted/tied to verified life status (pregnancy/age, health (kidney diseases, disability).

Samurdhi is the only poverty alleviation program involving a direct cash transfer coupled with a food stamp program, and saving/loan program for the needy. The total cost of the program was estimated to be about LKR 50 billion or 0.4% of GDP. The program seems to cover almost half of all households in the country. However, it misses a large share of (about 40%, according to some estimates) of households ranked in the lowest expenditure quintile, while a substantial number of households with higher income brackets receive a cash transfer and other forms of Samurdhi assistance. There is ample anecdotal evidence that 'political capture' has been an endemic feature in the implementation the program. Thus, the targeting outcomes of Samurdhi are inferior to the outcomes of targeted programs in other countries and not very different from the outcomes of untargeted systems covering the entire population (such as primary health care or primary education) (Glinskaya 2000). The administrative cost of the program seems to account for a significant chunk (over one-third) of the total cost of running the scheme (World Bank 2015, Madduma Bandara 2016, UNICEF 2020).

There may be a strong case to pivot away from Samurdhi towards a cash-transfer mechanism targeting the three bottom quantiles (60%), under which the payment is directly made into bank accounts of all households. Of course, targeted transfers are cost efficient by definition, but it is almost impossible to ensure totally efficient targeting, given the obvious possibility of 'political capture' and susceptibility to corruption and other malpractices. The inefficiency of no targeting is arguably offset to a significant extent by the ease and low administrative cost of providing a broader coverage to all households in the bottom three quantiles.

According to the IMF (2022), Sri Lanka's cash transfer programs such as Samurdhi have 69% of beneficiaries coming from the poorest 40% of households. However, there are large *exclusion* and *inclusion* errors in these schemes, with UNICEF finding that 58% of households who were entitled did not receive the benefits, and an identical share of households who were not supposed to receive benefits did. This requires that cash transfer schemes not only need to be better designed, but overhauled. UNDP (2022) has estimated that horizontally expanding the existing social protection programs to include newly vulnerable and poor households (such as the roughly 5.5 million informal sector workers of working-age, or the lower-middle-income households that have fallen into poverty) would require a minimum of US$75.8 million per month or US$682 million over nine months. This could be a time-bound experiment in quasi-universal basic income (QUBI).

A related issue is that in an inflationary situation, the value of cash grants rapidly erodes. So even a well-crafted cash grant programme could fail to meet the requirements of periods of deep crisis where acute food shortages are combined with the collapse of purchasing power. In such circumstances, one can make a strong case for an emergency food rationing scheme purely as a short term measure to address the crisis now and then move on to more 'efficient' cash grant schemes and other medium term measures. It seems worth looking at the war-time British experience of a successful good rationing scheme (Harris 1992). Perhaps policy makers can draw lessons from the administrative mechanism of the universal rice scheme in Sri Lanka that was in operation until the late 1970s. Of course, as that very scheme vividly demonstrated, there is the obvious risk that an emergency welfare scheme could become a perpetual drag on the government budget.

[32] We owe this point to Sisira Jayasuriya.

5. CONCLUDING REMARKS: RETROSPECT AND PROSPECTS

Sri Lanka is in the midst of an unfolding economic crisis, the depth of which is yet to be seen. During the post-independence era, the Sri Lankan economy experienced several balance of payments crises. However, this crisis is unique as it centres on a massive external debt overhang: it is a toxic combination of a 'balance of payments crisis' and a 'sovereign debt crisis'. Managing a 'twin crisis of this nature is much more challenging because replenishing foreign exchange reserves to maintain import flows has to go hand in hand with the arduous task of achieving debt sustainably, stabilising debt to a level consistent with maintaining development progress of the country.

Contrary to the popular perception that the crisis was caused by the COVID pandemic, it was the culmination of debt distress that had been building up for over two decades, aggravated by grave policy mistakes over the past few years. When the balance of payment shock emerged as a result of Covid-19, the authorities believed, as they had subsequently admitted, they could manage the crisis on their own without entering into a stabilisation arrangement with the IMF. Timely action with IMF support could have helped the government to manage the crisis as a lower economic socio-political damage while avoiding an ugly default. Understanding the real genesis of the crisis is vital for designing a coherent strategy for recovery from this human-made calamity towards an economy that is on a sustainable development path.

Following the unilaterally declared default on external debt on 12 April, 2022 without any agreement with the creditors, the credit rating agencies downgraded Sri Lanka to 'default' status and the country is severed from world capital markets. Given that possibility of mobilising bridging finance from friendly nations has virtually dried up, Sri Lanka has to manage import flows of essentials imports in line with current account receipts (export earnings, remittances, and tourist receipts). On the fiscal front, the default will provide breathing space for the government to expand social welfare, but this needs to be used cautiously. Future debt obligations require squeezing domestic absorption to generate necessary balance of payments surpluses.

Sri Lanka's policy challenge is to take the unprecedented economic crisis as the springboard for transforming the 'twin deficit' economy, characterized by 'stop-go' growth cycle, into a dynamic, outward oriented economy that can deliver sustainable, shared (equitable) growth. This requires achieving sustainable fiscal position by undertaking government revenue and expenditure reforms, redressing the anti-tradable bias by supplementing fiscal reforms with complementary monetary, exchange rate, trade reforms, and combining these policy initiatives with coherent social welfare as an integral part of the reform process. Given that the fiscal operation is the prime source of domestic excess demand, the IMF approach to economic stabilisation assumes a tight one-to-one link between the budget deficit and the balance of payments deficit, operating through domestic money and credit that drive inflation. Of course, aggregate-demand management is vital for any serious stabilisation plan, in the sense of seeking to eliminate domestic demand pressure on the external balance. However, in the context of an economy where anti-tradable bias has underpinned vulnerability to the crisis, it is necessary to combine expenditure-reducing policies with policies for 'expenditure switching' from non-tradable to tradable production. Because of the strong complementarity between domestic production and imports (including oil), speedy and sustained recovery of the economy depends crucially on export expansion and efficient import substituting domestic production.

While this paper focused on the *economic* causes, responses and prospects, Sri Lanka offers a stark cautionary tale of how flawed economic choices invariably originate in a weak polity characterized by pervasive venality, impunity and incompetence. This, centrally, is a political economy tale of bad governance. In this volatile socio-political setting, economic recovery and structural adjustment cannot proceed without political stability, and popular engagement and legitimacy. There is, therefore, a pressing need for forthcoming reforms to be underpinned by a broad social dialogue aimed at a robust 'listening campaign' behind the shared national objective of inclusive economic recovery (UNDP 2022b).

APPENDIX

CURRENT ACCOUNT BALANCE AND DOMESTIC RESOURCE GAP

Gross national product (GNP) can be considered from either the demand or the factor payments side (income).

On the demand side:

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

Y is gross national product (GNP), C is consumption, I is investment, G is government purchases, X is exports, and M is imports (with X and M both defined to encompass transactions in goods, services, factor payment and international transfers) . Here, M has negative sign because the sum of C, I, G and X is equal to GDP only after deducting imports embodied in them).

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

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

Using (2) and (1) rearranging terms:

$$Y - E = X - M \qquad (3)$$

Current account balance is *identically* equal to excess of national income over national spending by domestic residents.

On the factor payments (income) side:

$$Y = C + Sp + T \qquad (4)$$

Where C is again consumption, Sp is private savings, T is government revenue. The right-hand side shows that payments received by factors of production are exhausted by consumption, saving or payments to the government.

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

$$M - X = [I - Sp] + [G - T] \qquad (5)$$

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

This national account framework is helpful for analysing the impact of fiscal developments on the balance of payments. However, it is important to bear in mind that Equation 5 that depicts the relationship the budget deficit (for a given level of the private sector balance, I - Sp) and current account deficit depicted is an identity, not a behavioural equation. Of course, fiscal discipline is vital for maintaining a sustainable balance of payments position directly though domestic aggregate demand and indirectly through international competitiveness (captured by the real exchange rate. As regards international competitiveness, domestic inflation relative to that of trading partners determines RER for a given level of the nominal exchange rate. Nevertheless, in some cases, developments in the balance of payments do impact fiscal disequilibria. More importantly, trade patterns shaped by exogenous structural forces, or own historical policy mistakes of a given country, can have an enduring effect on the fiscal position. These considerations make a strong case to combine policies to achieve fiscal consolidation with structural reforms to strengthen the balance of payments position (Corden 1989, Tanzi 1987, Diaz-Alejandro 1984, Dornbusch 1982).

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