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The Sri Lankan economy:

Hope, despair and prospects

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Abstract

This paper provides an interpretative survey of economic policy and performance of the Sri Lankan economy during the post-independence era with a focus on the sources of the country's vulnerability to the unprecedented economic crisis in the wake of the Covid-19 pandemic and prospects beyond the crisis. The analysis infers that, contrary to the popular perception that the crisis was caused by the COVID pandemic, the crisis is the culmination of debt distress that has been building for over two decades aggravated by more recent policy blunders. Recovery from the crisis and placing the economy on a self-sustained growth path requires combining the standard IMF approach to macroeconomic stabilisation with coherent structural adjustment reforms to redress the long-standing anti-tradable bias in the incentive structure that was the root cause of the vulnerability to the crisis.

Key words: Sri Lanka, IMF, sovereign debt crisis, dependent economy model, debt restructuring

JEL codes: F41, H63, O10, O53

The Sri Lankan economy: Hope, despair and prospects

Introduction

Sri Lanka achieved independence in 1948 with high hopes for economic achievement. The country was favoured with many early advantages not shared by most other Asian countries: a strategic location in the Indian Ocean; an open economy with a vibrant export sector; a relatively good standard of education; well-developed physical infrastructure; and a broad-based and efficient administrative apparatus staffed largely by locals. The balance of payments position was healthy, backed by large foreign exchange reserves and a sound b\udgetary position. It was 'an oasis of stability, peace and order, set against the contemporary catastrophes in the rest of the British possessions' in the region' (de Silva 1974: 1). It was 'Britain's model commonwealth country, carefully prepared for independence' (Lee 2000, p. 461). These initial conditions justified the expectation that Sri Lanka would prove 'the best bet' among all post-colonial nations in Asia' (Jiggins 1976: 26).

At the time of independence, and well into the 1950s, Sri Lanka ranked as one of the most prosperous Asian countries, with per capita income and other development indicators placing it well above its South Asian neighbours and even much ahead of countries such as Thailand, South Korea, and Taiwan in East Asia (Athukorala et al 2017). Sri Lanka's standards of living measured by the usual indicators, such as adult literary, life expectancy, infant mortality remained well above those of other developing countries. During the ensuing seven decades, growth of Sri Lanka's per capita income fell way behind the fast-growing East Asian economies, rapidly converging to the levels of its South Asian neighbours. From the late 1960s even the vaunted basic need achievements have become relatively less impressive through time (Dunham and Jayasuriya 2000, Osmani 1994). Given the failure to find a way to make the economy grow fast enough to sustain social progress, Sri Lanka has become a vivid illustration of the limitations of direct approach to problems of social equity: 'a tale of missed opportunities' (Snodgrass 1998: 89). Eventually the country ended up in an unprecedented sovereign debt crisis that culminated in April 2022.

This chapter undertakes an interpretative survey of economic policy and performance of the Sri Lankan economy with a focus on the economic underpinning of the country's vulnerability to the unprecedented crisis in the wake of the COVID-19 pandemic, and prospects beyond the crisis. The chapter begins with an overview of policy-making during the post-independence era. The next section discusses economic performance with emphasis on how debt-fuelled growth and the resulting debt overhang made the economy vulnerable to the COVID19- shock. The following two sections examine the unfolding crisis, policy responses and prospects for economic stabilisation and structural adjustment. The final section offers some concluding remarks.

Historical Perspective

Policy regimes

Sri Lanka inherited from the colonial past a classical *export economy* with a system of government, which could already lay claim to being a welfare state (Wriggins 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. Export earnings from the three crops covered over 95% of the country's imports that accounted for over three fourths of the 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 from primary through to the university level, free medical care, and subsidised public transportation. During the colonial era, the thriving export industries generated ample surpluses for the state to finance these schemes.

The colonial welfare orientation became the precursor of an extensive welfare system in the post-independence period as the government passed into the hands of leaders with popular mandates. A population boom that began in the late 1940s following a highly successful malaria eradication campaign added to the pressure to widen and deepen the welfare state. The rapid expansion of the welfare state occurred against the backdrop of gradually diminishing fortunes of the traditional export industries because of both supply-side and demand-side reasons. The successive governments of independents Sri Lanka largely failed to match the 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 1966,1998; Athukorala & Jayasuriya 1994, 2015).

In the first decade of independence, policy makers perceived periodic export shortfalls as cyclical phenomenon and maintained the status quo of the colonial economy by financing balance of payments deficits with foreign exchange reserves accumulated during the boom years. There was no coherent strategy to restructure the economy other than continuation of a colonization scheme in the dry zone of the country, which specifically focused on expanding paddy cultivation (Snodgrass 1966).

From the late 1950s, a combination of change in political leadership and balance-of-payments difficulties led to the adoption of a state-led import-substitution industrialization strategy. By the mid-1970s, the Sri Lankan economy was one of the most inward-oriented and regulated economies outside the communist bloc with pervasive state interventions in all areas of economic activity. Widespread nationalization measures, coupled with various economic controls, had effectively marginalized the private sector in the economy. The policy stance during this period vividly demonstrated that a small country was not able to achieve self-sustained growth through the import-substitution development strategy, given the obvious limit to economic expansion within its national boundaries (Snodgrass 1989,Wriggings 2011).

In 1977 Sri Lanka embarked on an extensive economic liberalization process that marked a decisive break with decades of protectionist policies. The reforms, implemented in two stages (during 1977-80 and in the early 1990s), included lifting almost all quantitative import restrictions and substantially reducing tariffs, opening the economy to foreign direct investment and abolishing export duties.

The reform process was, however, incomplete in terms of the standard prerequisites for a market-oriented economy (Levy 1989, Athukorala and Jayasuriya 1994). First, most state-owned enterprises (SOEs) set up during the preceding three decades continued to operate with heavy dependence on budgetary transfers. Second, the promised reforms to achieve greater labour market flexibility were abandoned in face of widespread opposition by the trade unions. Third, and perhaps more importantly, the complementarity between macroeconomic management and trade liberalization required for maintaining competitiveness of ‘tradable production’, that is, production of exportable and import-competing goods and services, which are capable of being traded among countries , was missing in the liberalized economy. 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 and 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 because the government embarked on a massive public investment program side by side with opening the economy. Consequently, the real effective exchange rate (REER)[1] appreciated, eroding competitiveness of tradable production in the economy.

Reaping gains from liberalization reforms was also seriously hampered by the escalation of the ethnic conflict from the early 1980s (Arunatilake et al 2001). 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 percent of the population, from the national economy. Even in the rest of the country, the lingering fear of sporadic attacks by the Tamil militants hampered the prospects for attracting foreign investment, particularly in long-term ventures. Massive military expenditure jeopardized macroeconomic instability.[2] The government's preoccupation with the civil war also caused delays and inconsistencies in the implementation of reforms.

Despite the incomplete reform agenda and the debilitating effect of the civil war, the reforms significantly transformed the economic landscape of Sri Lanka as discussed in the the 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 (Panagariya 2002).

From about the late 1990s, the reform process suffered a setback because of the pressure for raising additional revenue from import tariffs and a plethora of surcharges on the existing customs duties on imports ('para tariffs') to finance the ballooning war budget. The protectionist tendencies soon received added impetus from the growing discontent amongst the electorate propelled by the crisis economic conditions as the civil war accelerated. The anti-liberalization lobby begun to portray the failure of reforms to elevate the country to the league of dynamic East Asian economies as an intrinsic flaw of liberalization reforms, while ignoring the constraining effects on the reform outcome of the incomplete and staggered nature of the reform process and the prolonged civil war (Athukorala and Jayasuriya 2015).

The backlash against reforms gained momentum after the country returned to a state of normalcy after the three-decade old civil war ended in May 2009 (Kelegama 2017). The government begun to emphasize the role of the state in 'guiding the markets' to redress perceived untoward effects of market-oriented reforms. 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 became the key priority under the new policy. The emphasis on infrastructure development received added impetus from China's geopolitical ascendency marked by its signature 'Belt and Road' initiative (Drehar and Fuchs 2022). Of course, there was a clear need for large-scale reconstruction effort with substantial public sector involvement after a quarter century of destruction, neglect, and decay of essential infrastructure. The program of public investment was. However, not geared to island-wide infrastructure rehabilitation. Many government infrastructure projects, such as a modern port, airport and other facilities (built with Chinese assistance), are located in the Southern regions of Sri Lanka—the heartland of the electoral support base of the president Rajapaksa. The massive construction projects also became the focal point of widespread financial excesses and rampant corruption. Even through mostly foreign-funded, these projects required substantial domestic counterpart funding and contribute to widening fiscal deficits (Kelegama 2017).

Public investment program was implemented in the context of a policy backlash against liberalisation policies in line with the government's nationalist-populist policy trust. During the ensuing years, there were many case-by-case adjustments of duties for manufacturing imports, which directly competed with domestic production. The foreign investment approval procedure became interventionist and opaque. The Central Bank commitment to maintain the 'dollar value of the rupee by resisting any pressure for nominal depreciation. As the Central Bank managed to maintain a stable nominal exchange rate as an inflation anchor and monetary policy excesses continued to fuel domestic inflation, the real exchange rate appreciated raising concerns about the widening of the current account deficit (Pursell 2011, Athukorala & Jayasuriya 2016, Athukorala 2022,

The post-civil war period until about 2013 was notable for rapid growth (see below), predominantly driven by massive infrastructure investment. However, the growth spurt dissipated in the subsequent years with the completion of the massive debt funded construction projects followed by the government's preoccupation with the impending repayment of accumulated debt. By the time of political regime shift in early 2015, the dark clouds of the economic storm were already gathering on the horizon. In 2016 the new government entered a four-year Extended Fund Facility (EFF) program with the IMF, with a reform programme specifically focussed on fiscal consolidation (Coomaraswamy 2017). The revenue-enhancing fiscal consolidation reforms under this programme managed to reverse the dwindling tax-revenue to GDP ratio in the economy and achieve a modest surplus during 2018-19 in the primary balance of the budget after several decades. The implementation of the program abruptly terminated with the regime change in 2019, and the policy pendulum begun to shift in favour of 'guiding the markets' by the state' (CBSL 2020).

Economic Performance

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% (Table 1)[3]. Given a population growth rate of 1.4%, this translated into a per capita income growth rate of 3.4 percent, apparently an impressive achievement by 'developing-country' standards. However, annual growth rates have been rather uneven throughout this period. 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 rate of less than two percent. Diminishing fortunes of the traditional export industries, and import compression that constrained the expansion of the new import substitution industries, swapped growth dynamism. The economy entered a respectably rapid growth path after the liberalization reforms began in the late 1970s, albeit growth occurred in fits and starts owning to escalation of the civil war and the Southern youth uprising during the late 1980s. The five years following the ending of the civil war were notable for rapid growth, predominantly driven by debt-funded massive infrastructure investment. However, the growth spurt dissipated in the subsequent years with the completion of the construction projects and preoccupation of the government with the impending repayment of the accumulated debt.

The structure of production of the economy 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. Manufacturing continued to account for less than 10 percent of GDP, in spite of the emphasis on import-substitution production, with state-owned enterprises (SOEs) playing a dominant role.[4]

Table 1: Key economic indicators, 1960-2021

	1960-2019	1960-69	1970-77	1978-94	1995-04	2005-09	2010-14	2015-19	2020	2021
GDP growth (%)	4.8	4.7	3.1	5.0	4.7	6.0	6.8	3.7	-0.4	3.7
Per capita GDP growth	3.4	2.3	1.1	3.6	4.0	5.3	6.1	2.7	-4.4	3.0
Gross national saving (% of GDP)	18.3	12.2	12.3	16.2	21.2	22.2	29.6	26.9	23.6	23.8
Private	19.0	11.4	12.0	15.8	24.3	24.6	30.7	28.5	31.5	32.9
Gross domestic investment (% of GDP)	23.5	20.4	16.5	25.3	24.5	27.0	33.7	29.4	25.1	27.7
Private	15.4	8.2	9.4	12.2	18.8	21.0	28.6	24.3	21.8	24.3
Government expenditure (% of GDP)	26.2	27.9	31.4	31.3	25.6	26.4	27.0	35.3	35.4	34.0
Govern Revenue (% of GDP)	18.4	21.8	25.4	20.6	17.3	18.8	21.0	28.6	24.3	21.8
Primary budget balance[1]	-3.1	-4.7	-4.6	-5.3	-2.1	-2.3	-1.2	-1.2	-4.6	-6.0
Overall budget balance (% of GDP)	-7.8	-6.1	-6.0	-10.4	-8.3	-7.6	-6.0	-6.7	-11.1	-12.2
Government debt (% of GDP)	77.9	52.6	63.0	87.1	97.1	86.3	71.3	81.3	101.0	104.6
Debt service/government revenue (%)	20.5[2]	---	---	25.0	28.9	25.5	32.9	45.0	63.7	61.4
Current account balance (% of GDP)	-4.0	-2.7	-1.2	-6.9	-3.1	-4.5	-4.1	-2.5	-1.5	-4.0
External debt (% of GDP)	42.8	6.6	19.5	59.7	57.1	42.7	50.0	59.3	60.3	60.1
Debt service ratio[3] (%)	16.4	4.8	20.5	19.0	13.8	14.8	19.6	27.3	35.2	30.0
Foreign exchange reserves (US$ bn)	2.0	0.1	0.1	0.6	1.8	3.4	7.4	7.2	5.7	3.1
Import months equivalent	3.1	2.1	2.0	2.8	3.6	3.8	5.0	4.2	4.2	1.7

Notes: (1) The difference between government revenue and expeditor excluding interest payment on public debit; (2) Average for 1978-2019; (3) Amortization of, and interest payment on, external debt as a percentage of earnings from goods and services exports; --- Data not available.

Source: Compiled from CBSL (various years)

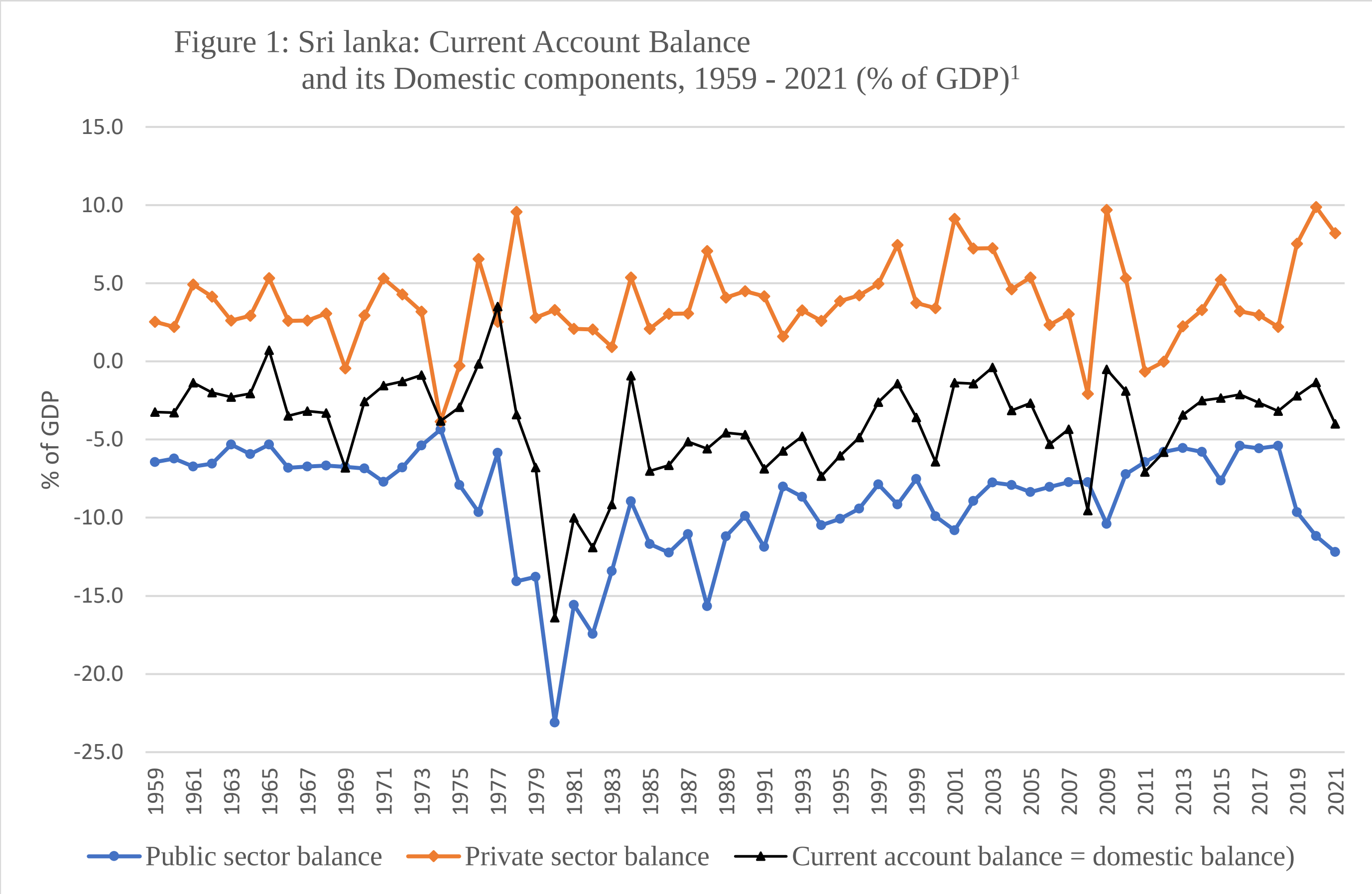
Following the liberalization reforms initiated in the late 1970s, there was a notable increase in the share of manufacturing in GDP (from 14% to 18-20% by the mid-2000s). In a notable structural transformation of the economy, the share of manufacturing in GDP begun to surpass that of agricultural from about 2005. With the gradual erosion of the role of state-owned enterprises (SOEs), the private sector was largely responsible for economic dynamism in manufacturing (and other sectors) of the country. Disaggregated data (not reported here for brevity) indicate significant export orientation of manufacturing. The share of manufacturing in merchandise exports increased from less than five percent in the 1970s to over 65 percent 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, and also in sport and travel goods, cutting and polishing imported diamonds, and in 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).

The increase in manufacturing share in GDP has not continued into the post-civil war period: it remained virtually unchanged around 20 percent. The data point to a significant shift in the production structure towards nontradable sectors reflecting massive investment in infrastructure development and government services. Nontradable production[5] contributed to over 70 percent of the increment in real GDP between 2005-06 and 2018-19. The relative importance of non-tradables in the economy is relevant for the ensuing discussion on debt servicing capacity of the country. Shifts in the domestic production structure towards nontradable production results in a compositional shift in domestic aggregate demand towards imports and/or a contraction in exports. This, in turn, contributes to widening of the balance of payment deficits and accumulate of foreign debt.

On the expenditure side of the economy, there was a rapid expansion of government expenditure compared to government revenue throughout this period (Table 1). Government saving — the difference between government income and current expenditure—turned out to be negative in most years. Government investment was, therefore, financed by relying on capital inflows (foreign aid and borrowing), domestic borrowing, mostly 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 face of rapidly increasing government expenditure. Tax revenue as a percentage of GDP declined from over 20 percent in the 1960s to less than 10 per cent at the end of 2010s, which was one of the lowest in the developing world (Moore 2017).

Private consumption accounted for a disproportionate share of income (Table 1). The private savings rate hovered in the range of eight percent to 15% until about the late 1980s. It increased to only about 24% during the ensuing years, which is much lower than the average saving rate of the high-performing East Asian countries (about 35%). The private sector balance —the difference between private expenditure and income, which is equal to the private 'saving – investment' gap— remained positive in most years. However, unlike in the East Asian economies, and also India and Bangladesh in recent decades, the private sector did not generate a substantial surplus to counter balance the ballooning public sector deficit (Athukorala and Suanin 2022).

In sum, the upshot of the development strategy of Sri Lanka during the past eight decades has been a 'twin deficit economy', an economy that has both a current account deficit and a budget deficit (*a la* Streeten 1987) (Figure 1). 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 public sector deficit (budget deficit) that overwhelmed the modest private sector surplus. During 1960-2021, Sri Lanka's current account has been in deficit throughout other than in 1965 and 1977 when there were small surpluses. External deficit has closely mirrored the public sector deficit (the budget deficit).

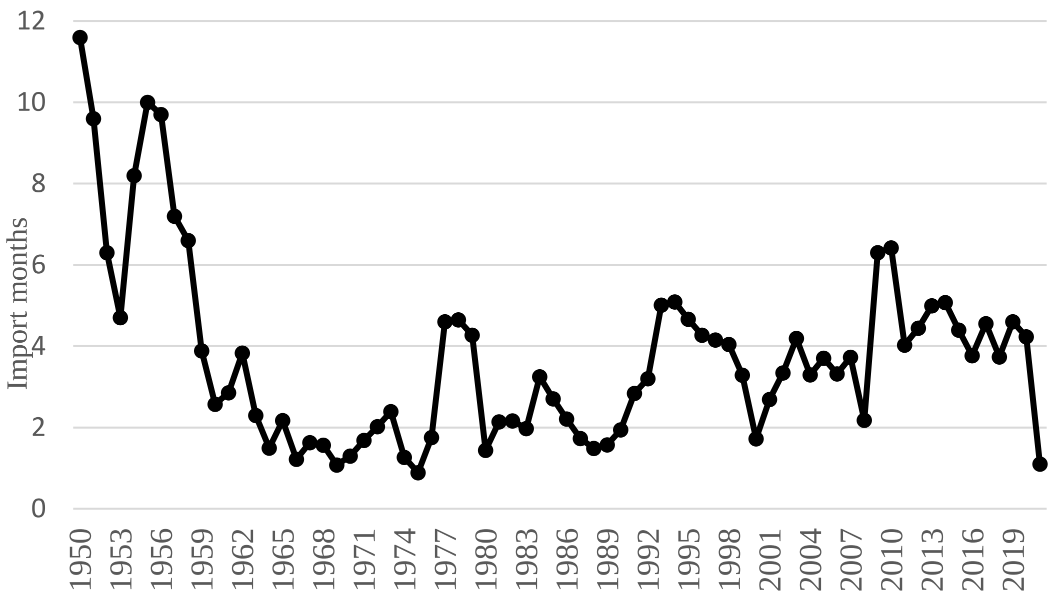


Note: (1) By definition, the current account balance (external balance) is equal to the internal (domestic) balance, which is the sum of the public sector balance (budget balance) and private sector balance.

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

During the 1950s, the twin deficits were filled largely by foreign exchange reserves accumulated during export booms of tea and rubber (Figure 2). From then on reliance on foreign capital inflows[6] to fill the deficits became as enduring feature of the economy, as the levels of foreign exchange had reached alarmingly low levels. In the absence of adequate foreign exchange reserves to face external and internal economic shocks, Sri Lanka because a 'repetitive' client of the IMF. Daring 1965-2019, it was under 16 stabilization and structural adjustment programs with the IMF (CBSL 2022b). Six of the 16 terminated before the 'official' competition dates because of the country's failure to meet conditionality relating to structural adjustment. Overall, the country was under the IMF programs for 30 years during this 54-year period. A simple analysis of the data relating to the relevant key macroeconomic valuables (in particular the current account deficit, foreign exchange reserves, budget deficit, inflation and the real exchange rate) suggest that even the completed programs have not had a lasting effect on the economy beyond providing balance of payment support during the program period (Athukorala 2021).

Figure 2: Import moths equivalent of foreign exchange reserves

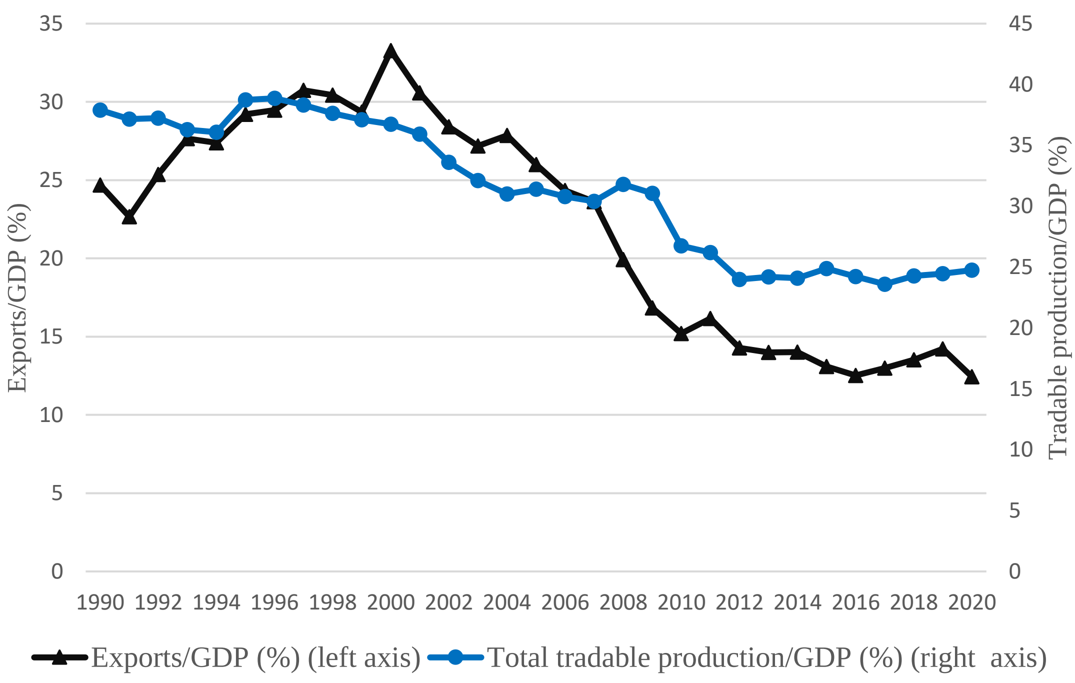


Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues).

Debt-driven growth and vulnerability to the COVID-19 shock

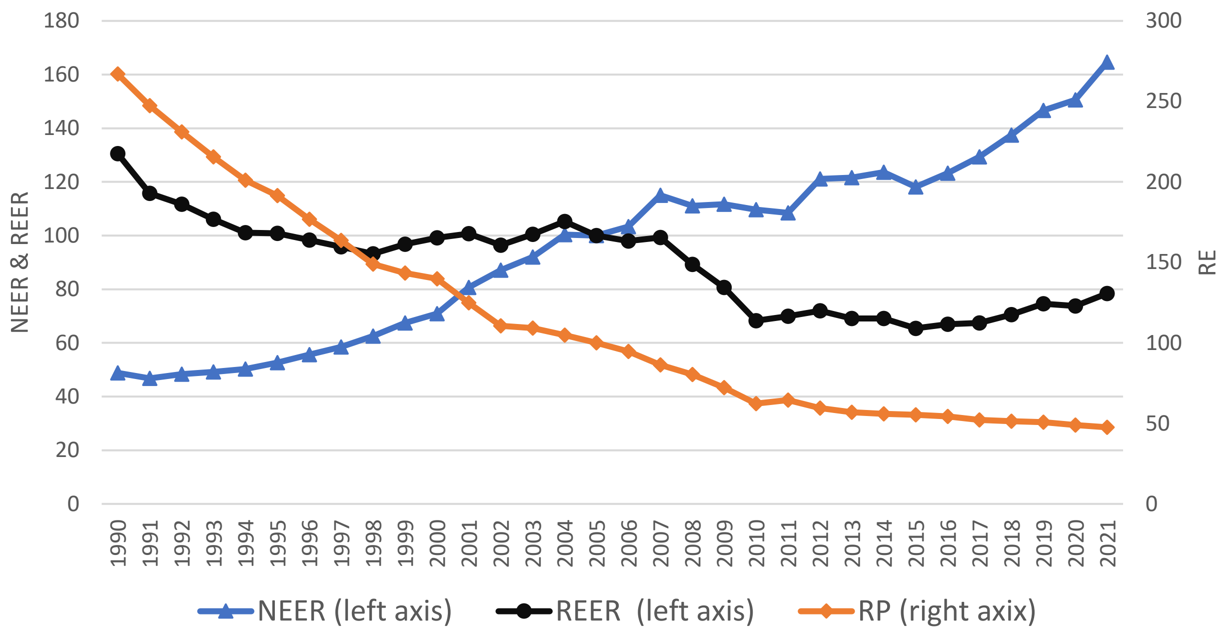
During the five years following ending of the long civil war in May 2009, the Sri Lankan economy grew at an average annual rate of 7.0 percent, the fasted average growth rate for any sub-period in the country's post-independent history (Table 1). However, the growth spurt dissipated in the subsequent years with the completion of the construction projects and given the preoccupation of the government with the impending repayment of the accumulated debt. Nontradable sectors (construction, transport, utilities, trade and other services) contributed disproportionately to the 2009-2014 growth spurt, driven largely by the major public sector infrastructure development projects. Over 70 percent of the total increment in real GDP during this period originated in these sectors. The share of tradable sectors in GDP shrank to less than 20% during 2009-19, compared to over 30% during the preceding decade (Figure 3).[7] The export-GDP ratio, which is relatively more precise indicator of the relative importance of tradable production in the economy, declined from about 30% in the early 2000s to about 10% by 2019.

Figure 3: Tradable production and exports relative to GDP,1990-2021



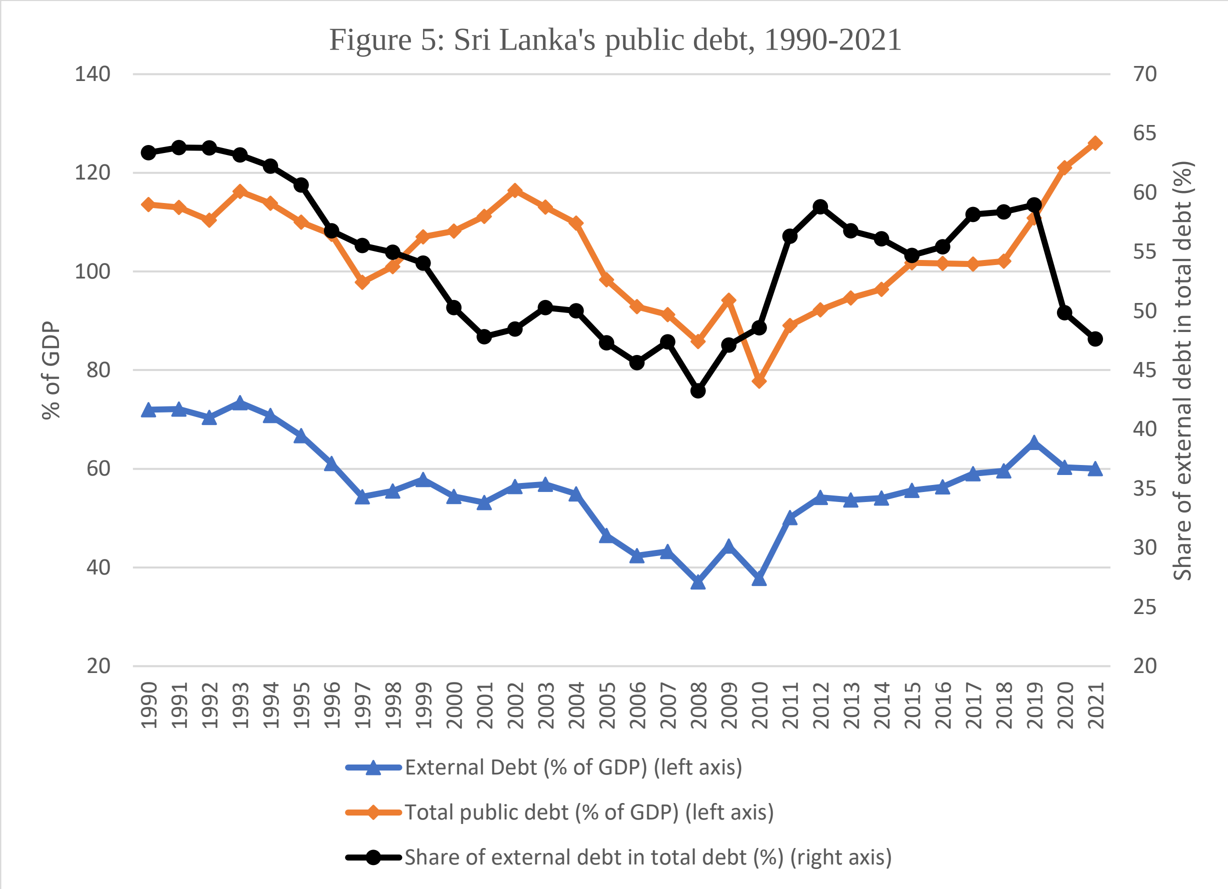
The non-tradable bias in the economy was underpinned by significant appreciation of the real effective exchange rate (REER). The REER appreciated by about 20% during 2009-19 compared to the previous five years, eroding relative profitability of tradable goods production (Figure 4).[8] Massive debt-fuelled infrastructure investment tilted domestic price structure in favour of prices of non-tradable production as predicted by the dependent economy model of economic adjustment to an investment boom in a small open economy (Corden 1994). The non-tradable bias was compounded by the Central Bank's 'leaning against the wind' foreign exchange market intervention to use the nominal exchange rate as an inflation anchor.

Figure 4: Sri Lanka: Real exchange rate and its Component[1] 1990-2021 (2005 =100)



Note: 1. Nominal effective exchange rate (NEER) is export-weighted bilateral nominal exchange rates (measured as rupees per foreign currency unit) relating to Sri Lanka's top six export destination countries (which together account for over 90% of the country's total manufacturing exports). Real effective exchange rate (REER) is NEER adjusted for the relative price (RP), which is measured using the export-weighted producer price indices of the six countries and the domestic price level of Sri Lanka measured by the GDP deflator. An increase (a decrease) in the REER shows an improvement (a deterioration) in international competitiveness.

The post-civil war growth spurt was underpinned by a massive build-up of public debt, with external debt accounting nearly 60 percent of total debt. The end-of-year stock public debt had reached 125 percent of GDP in 2019, up from 78 percent in 2008. The stock of external doubled from about 30 percent of GDP to 61 percent between these two time points. In calculating the external debt, the Central Bank has valued international sovereign bonds (ISBs), which accounts for over a third of total debt, at market price.[9] When the data are adjusted by including ISBs at face value, the external debt to GDP ratio in 2019 increases to about 66%.

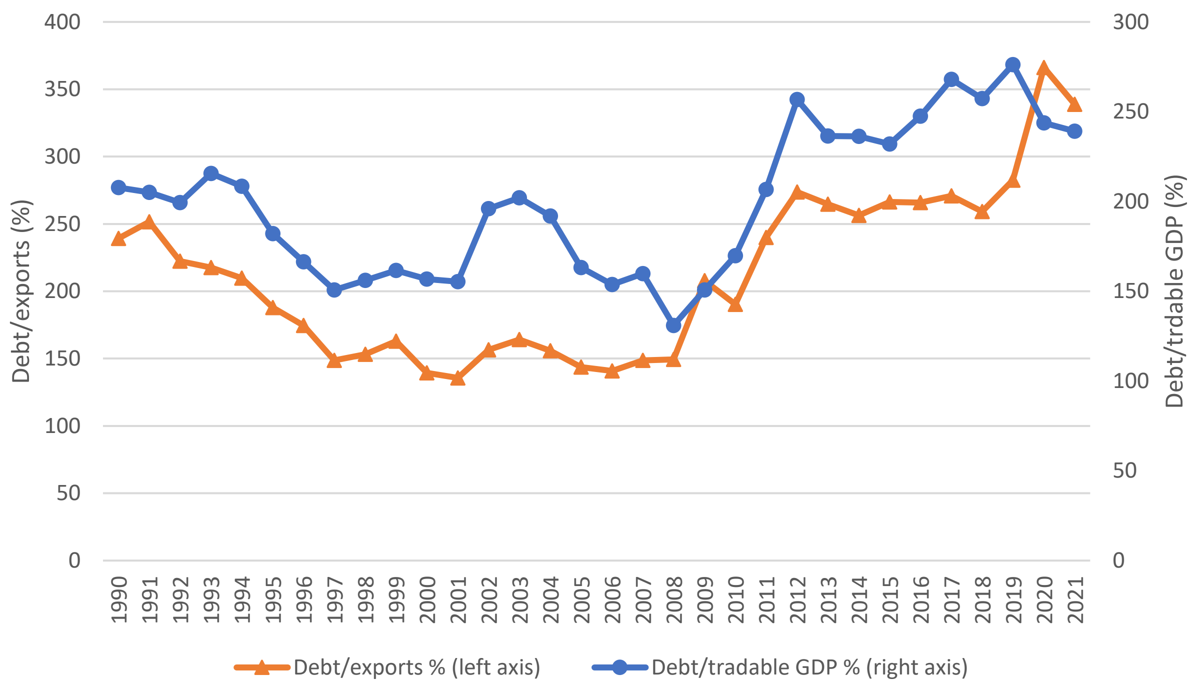


Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues).

Even after making this adjustment, the external debt-to-GDP ratio understates the debt burden of Sri Lanka because, as noted, the composition of the denominator of this indicator (GDP) has dramatically changed by the debt-driven construction boom from about the mid-2010s (Figure 3). Non-tradable production does not directly contribute to improving debt repayment capability of a country. It is important, therefore, to assess the external debt burden by allowing for non-tradable bias in national output. 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 (mostly in the US$), debt sustainability eventually depends on the improvement in the balance of payments. Investment in nontradable sectors, often financed by external debt, raises questions about the capacity to transform tax revenue they generate into dollars debt servicing (Diaz-Alejandro, 1984).

Two alternative indicators that measure the external debt burden after allowing for the non-tradable bias are plotted in Figure 6. The first is the debt to export ratio. It is an indicator of whether debt accumulation has been consistent with the growth of export earnings (merchandise and services exports) over time (Dornbusch 1983, Dias-Alejandra 1984, Tanzi 1987). The other indictor is the debt to total tradable GDP ratio. This is an indicator of a country's debt servicing capability 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.

Figure 6: External debt relative to tradable GDP and export earnings, 1985-2021 (%)



This increase in the stock of external debt was underpinned by a palpable shift in its composition from concessional loans from bilateral donors and international developmental agencies, to borrowings on commercial terms. 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(Table2, Figure 7). 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.

Table 2: Sri Lanka: key indicators of external debt

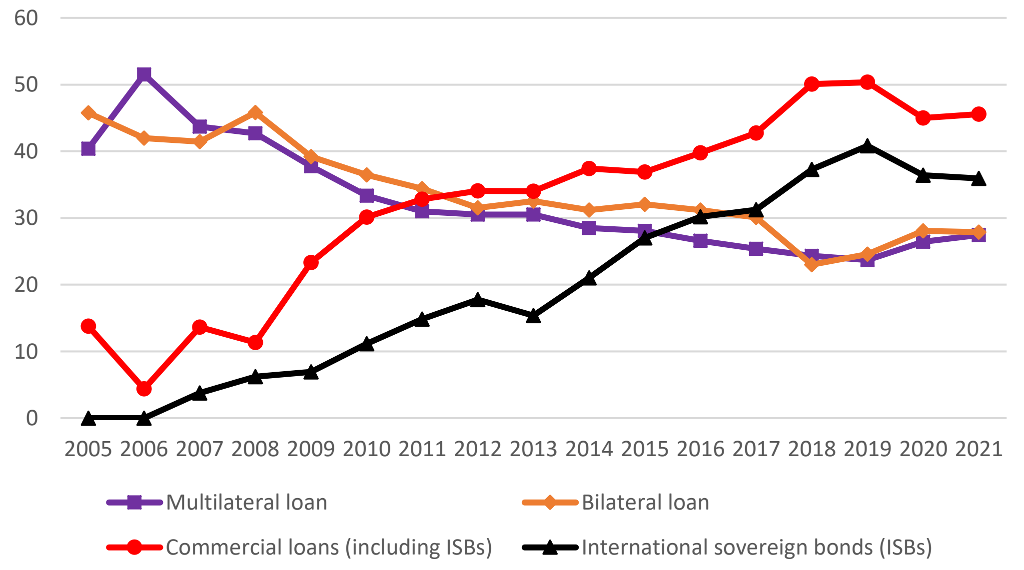
	2005-09[1]	2010-14[1]	2015-18[1]	2019	2020	2021
Total external debt (US$ billion)[2]	14.2	34.8	48.8	54.8	49.2	49.3
Government external debt (US$ billion)[3]	12.4	21.5	30.4	34.6	32.6	33.2
Government share in total external debt (%)	88.1	63.9	62.0	63.3	66.3	65.0
Composition of government external debt (%)						
Multilateral loans[4]	43.2	30.8	26.1	23.7	26.5	27.5
Bilateral loans[5]	42.8	33.2	29.1	24.6	28.1	27.9
Commercial loans	13.3	33.7	42.4	50.3	45.0	45.6
International sovereign bonds (ISBs) [6]	3.4	16.0	31.5	40.8	36.4	35.9
Other	9.9	17.7	10.9	9.5	8.6	9.6
External debt/GDP (%)	42.7	50.0	57.8	65.3	60.6	60.0
External debt/Export (%)	158.1	245.0	265.5	282.6	366.1	338.7
Debt service ratio (%)	14.8	19.6	26.7	29.7	33.5	32.3
Debt service/government revenue (%)	25.5	32.9	42.6	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 state owned enterprises; (3) Creditor composition (as of 31 April 2021): Commercial borrowing, 46.7%; Multilateral, 21.8%; Bilateral, 31.5; (4) Multilateral: World Bank, 42.2%; Asian Development Bank, 57.8%; (5) Bilateral: China, 52.1%; Japan 19.3%, India 12.1%; other 16.5%; (6) Sri Lanka's 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.

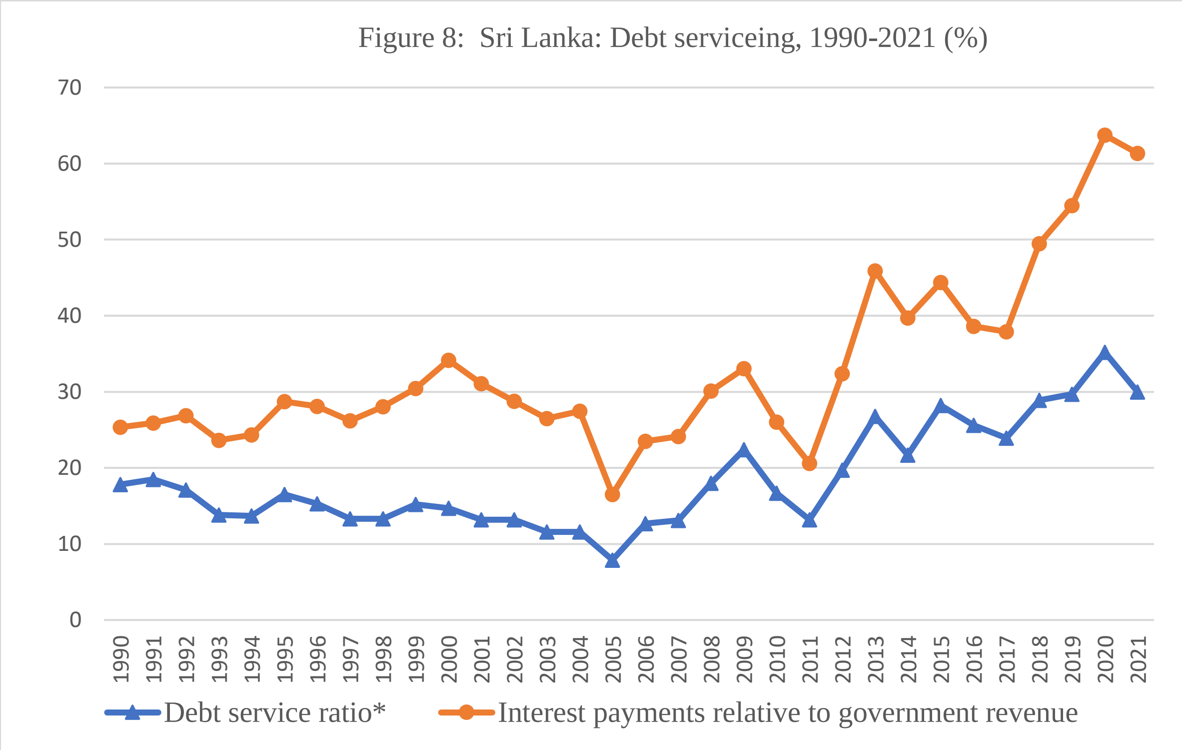
Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues).

Figure 7: Sri Lanka: Composition of external government debt (%)



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

The debt service burden (amortization of debt and interest payment) remained modest until the early 2000s (Figure 8). Reflecting the cumulative effect of debt accumulation and the significant compositional shift in favour of private market borrowing, the debt service burden of the country increased continuously since. The annual debt service ratio (amortization of debt and interest payment as a percentage of total export earnings), which remained at an average level of about 12 percent during 2000-08, increase to 33 percent in 2019. Interest payments on public debt (external and domestic debt) absorbed about 60% of total annual government revenue in 2019, up from an average of less than 30 percent 2000-2008.



Note: *External debt amortisation and interest payment as a percentage of exports of goods and services.

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

By the time of political regime shift in early 2015, the dark clouds of the impending economic storm were already gathering on the horizon. In 2016, the new government entered into a four-year Extended Fund Facility (EFF) program with the IMF, with a reform programme specifically focussed on fiscal consolidation, and a wide range of structural adjustment reforms to restore international competitiveness (Coomaraswamy 2017). The revenue-enhancing fiscal consolidation program of the reform package managed to reverse the dwindling tax-revenue to GDP ratio in the economy and achieve a modest surplus during 2018-19 in the primary balance of the budget after several decades.

However, the government, a coalition of disparate groups with divergent ideologies, did not have a steady hand on the policy leavers to successfully implement the proposed structural adjustment reforms. The implementation of the EFF program abruptly terminated with the regime change in 2019, begun to shift in favour of 'guiding the markets' by the state' (CBSL 2020).

There and the policy pendulum 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 though money financing. It went against the fiscal consolidation program.[10] 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. In response, the three leading international 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 the subsequent significant relaxation of restrictions on such investment by the government.

The Covid-19 Shock, failed 'home grown' response, and going to the IMF

As discussed, Sri Lanka entered the COVID-19 pandemic with a significant external debt overhang. The onset of the pandemic in March 2020 compounded debt distress. The biggest blow of the pandemic to the balance of payments was the collapse of tourist inflows: total estimated earnings dwindled from about US$ 4.5 billion in 2019 to US$ 606 million in 2020 and US$50 million in 2021. Merchandise exports declined by about 20 percent in 2020 from the previous year (from US$ 12bn to US$10bn), but recovered well in 2021. Inward remittances through the banking system by Sri Lankan migrant workers significantly increased in 2020, reflecting increased family support money transfer during the height of the pandemic. However, the 'official' remittance inflows declined from US$ 7bn to US$ 5.4bn in 2021 reflecting diversion to informal channels because of foreign exchange restrictions and fixing of the exchange rate at an overvalued level for several months.

In March 2020, the government approached the IMF for financial assistance under the Rapid Financial Instrument (RFI) facility. However, the IMF rejected the request because it had already assessed Sri Lanka's external debt as unsustainable.[11] 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 without seeking IMF support. Sri Lanka had been a 'repetitive' client of the IMF during the previous five decanted with a record of entering into sixteen stabilisation programs with the IMF; The governments in both political camps have obtained IMF support (Athukorala 2021). The resistance of the Sri Lankan government to follow the well-traversed path this time was presumably because of the concern that 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 was not consistent with the IMF's emphasis in recent decades on more inclusive approach to stabilisation and structural adjustment reforms

The government's so-called 'home grown' response to the crisis was an *ad hoc* mixture of import restrictions, artificially fixing the exchange rate, and subsequently floating it, and imposing restrictions on foreign exchange transactions on both current account and capital account transactions.[12] These direct interventions were supplemented with swap agreements with the central banks of India (US$800mn), Bangladesh US$ 200mn) and China (US$1.5bn), and financing facilities from the governments of India (US$ 1.5bn) and China (US$ 1.3bn) to meet debt service commitments and finance necessary imports .

The Covid-19 shock and the uncertainty created by the 'muddling-through' response begun to stifle the economy. In 2020, the economy contracted by -3.6%.[13] The level of GDP recovered to the pre-crisis level in 2021, but contracted by 8.7% in 2022. In July 2020, the World Bank downgraded Sri Lanka from upper-middle to lower-middle income status in its income-based country classification. According to World Bank estimates, between January 2020 and December 2021, population below the poverty line (measured at US$ 3.20/day) in Sri Lanka had increased by about half a million. A tentative estimate made by combining data on household income distribution by quantiles from the recently released Household Income and Expenditure Survey (DCS 2022)[14] suggests that about 60% of total households in the country are below this poverty line. By July 2022, the headline year on year inflation had reached 66.7%, with food, which accounts for 44% of the national consumer price index (NCPI) basket, recording a rate of 82.5%. The NCPI presumably understates the degree of inflation because of the substantial presence of items subject to price control in the commodity basket.

By early 2022, there was rampant scarcity and price increases of food, fertilizer, gas and fuel, and frequent power cuts. 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 had kilometres long lines to purchase rationed quantities for public and private transport as well as agricultural machines. Hospitals had to stop regular surgeries as they ran out of medicines. Protest rallies across the country saw record crowds of all social classes. Thousands camped at the entrance to the Presidential Secretariat for over two months demanding a change in political leadership and constitutional reform. Similar protests 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 president's official residence. The president fled the country and tendered his resignation from Singapore on July 14th, 2022. On July 20th, the parliament, the Parliament, dominated by the defected president's party, elected a new president (for the remainder of the presidential term that ends in 2024). However, the political stability needed to make progress on an agreement with the IMF remains elusive as the political status quo remain largely unchanged (Wickramasinghe 2023).

Foreign exchange reserves plummet from US$ 7.6bn at the end of 2019 to about a mere US$ 50mn (appropriately two-week import requirement of the country) in early April 2022. To make matters worse, a much-anticipated balance of payments support from China was not forthcoming. On April 12, the government declared unilateral suspension of all external debt repayments with effect from 5PM that day. On April 16, 2022 the government started discussions with the IMF.

Extended Fund Facility Programme

In late May 2022, the Sri Lankan government appointed financial and legal consultants for debt structuring and commenced consultation with the IMF. On July 31, 2022 the IMF and the Sri Lankan authorities reached a staff-level agreement for economic adjustment and reform policies with a 48-month Extended Fund Facility (EFF) with a requested access of about SDR 2.286bn (equivalent to US$2.9 bn) over a period of four years. The IMF Executive Board approved the staff-level agreement on March 21, 2023.

The key focus of the EFF programme is on near-term policy measures to restore macroeconomic stability and debt sustainability while mitigating the impact of the crisis on the poor and vulnerable (IMF 2023). Structural reforms [for long-term growth] are to be 'sequenced appropriately throughout the programme period, considering the authorities' capacity constraints' (IMF 2023: 26). The reform program has been structure under five key policy goals: fiscal consolidation accompanied by strong social safety net; public debt restoring to ensure stable functioning of fiscal operations; restoring price stability and rebuilding foreign exchange reserve buffers under flexible exchange rate; ensuring financial sector stability by addressing banking sector vulnerabilities; and reforms to address corruption vulnerabilities.

The economy (measured by real GDP) is expected to contract by 3% in 202 and 1.5% in 2024, and gradually converge to an average annual rate of 3% by the end of the programme period (2027). According to these projections, real GDP in 2027 would be about 15% lower compared to the pre-crisis (2019) level. The estimated external resource gap during the programme period is estimated at $25.2 bn. of which IMF loan ($3bn) amounts to only 12%. Budget support from the World Bank and the Asian Development $ 3.8bn (15%). The government is expected to obtain raise 1.5bn (6%) by raising 1.5bn by issuing sovereign bond issue during the final year of the program. The lion's share of the resource gap (67%) is to come from debt relief obtained through restructuring of debts to bilateral creditors and private creditors (dominated by ISB holders). Multilateral creditors (the IMF, World Bank, ADB) are treated as 'senior' creditors and are excluded from the debt restructuring process.

The IMF issued the first instalment of the EFF loan ($ 330mn) immediately after signing the agreement to catalyse external funding from the ADB and the World Bank. The rest of the loan are to be distributed uniformly in four instalments over the period (2023-27) subject to an assessment of the progress on debt restructuring to restore debt sustainability and of meeting the performance criteria of the EFF program ('the IMF conditionality'). As noted, anticipated debt relief accounts for over two-thirds of the external resource gap during the programme period. Achieving debt sustainability is also vital for Sri Lanka to re-enter world capital markets.

The IMF Director Board approved the EFF program after obtaining assurance from the official (bilateral) creditors to bring debt to a sustainable level and expression of reediness a negotiate debt relief by a group of Sri Lankan ISB holders (holding about 60% of outstanding Sri Lankan ISBs). However, the possibility of completion of debate restricting within the one-year timeframe specified in the EFF agreement remains doubtful. The IMF has warned that 'risk to the program implementation are exceptionally high, given the complex restructuring process (IMF 2023: ii).

The Paris Club[15] provides an effective forum for negotiations with western government creditors. However, restructuring of bilateral debt can become a long-drown process because China, the biggest bilateral creditor of Sri Lanka, is not a Paris Club member. The Paris Club members would be reluctant to restructure debt before the Sri Lankan government comes to a negotiated settlement with China because of the concern that any prior concessions granted to Sri Lankan would unjustly benefit China. China's standard practice has been to agree on extending the period of repayment of existing debt rather than re-profiling debt with lighter repayment terms.

Restructuring debts to private creditors, in particular sovereign bondholders, is even more complicated. This would involve a mixture of a 'haircut' on outstanding bonds and the extension of maturities with a higher coupon rate, to be through voluntary negotiation of bondholders with the government. The experiences of other countries with debt restructuring suggests that the process of negotiating with IBS holders take between six months to over two years, with the time involved in post-default debt restricting episodes clustering at the upper end (Ams et a1. 2020, Asonuma and Trebesch 2016). In the Sri Lankan case, the major ISB holders have agreed to participate in restructuring debt subject to prior restructuring of the government's domestic debts, which account for over a half of its total debt, to their satisfaction. This could possibly prolong debt restructuring. A major issue relating to restructuring debt to private creditors is its implications for subsequent market access. The available evidence suggests that debt restructuring does not 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).

Concluding Remarks

The unprecedented economic crisis in Sri Lanka is the culmination of debt distress that has been building for over two decades aggravated by more recent policy blunders, contrary to the popular perception that the crisis was caused by the COVID pandemic. When the balance of payment shock of the pandemic triggered debt crises, the authorities believed, as they subsequently admitted, they could manage it on their own without entering into a stabilisation arrangement with the IMF. Timely action with the IMF support could have helped the government to manage the crises at a lower economic and socio-political cost and avoid sovereign debt default.

Sri Lanka's policy challenge is to take the unprecedented economic crisis as the springboard for lifting the country to a sustainable growth path, and to transform the 'twin deficit' economy, characterized by 'stop-go' growth cycle, into a dynamic, outward-oriented economy that can deliver sustainable and equitably shared growth. This requires achieving a sustainable fiscal position by undertaking government revenue and expenditure reforms, redressing the anti-tradable bias through monetary, exchange rate, trade and competition reforms, and combining these policy initiatives with a coherent social welfare net as an integral part of the reform process. Given the fiscal operation is the prime source of domestic excess demand, the IMF approach assumes a tight one-to-one link between the budget deficit and the balance of payments deficit, domestic money and credit that drive inflation. 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, it is necessary to combine stabilisation policies with policies to redress anti-tradable bias in the structure of the economy in order to set the economy on a 'new beginning' for a long-term self-sustained development path.

Notes

[1] The real exchange rate (*REER*) is the nominal effective exchange rate (NEER) adjusted for the domestic (Sri Lanka's) price level relative to the average price level of the trading partner countries (RP). NEER is the **(**NEER) is the trade -weighted bilateral nominal exchange rates (measured as rupees per foreign currency unit) relating to Sri Lanka's major trading-partner countries. Appreciation of the RER, that is an increase in NER adjusted for RP) reduces international competitiveness of tradable production in the economy.

[2] Military expenditure increased from 1% to 5% of GDP between 1984 and 2008 (CBSL 1985 and 1989).

[3] National accounts data are available on a comparable basis only for the period since 1951. For an analysis of economic performance prior to that year see Snodgrass (1966).

[4] The data used in this paper, otherwise specifically stated, are from the *Annual Report* and electronic data sources of the Central Bank of Sri Lanka.

[5] Sum of value added in transport storage and communication; wholesale and retail trade, banking, insurance and real estate; ownership of dwellings; public administration and defence; and other (unclassified services) in national income accounts.

[6] Foreign aid, concessional institutional loans and short-term commercial borrowing, with foreign direct investment accounting for only a small share of total inflows (on average less than 8% of total capital inflows during 1970-2018).

[7] Tradables are denied as actual exports and close substitutes for exports (exportable), and close substitutes for imported goods; nontradables are products that are not subject to international trade. Disaggregation of GDP into tradables and nontradables is based on the methodology of Goldstein and Officer (1979). The available two-digit level GDP data do not permit precise disaggregation. Some quasi-tradeable agricultural products are treated as tradables, whereas tourism related services are scattered across a number of services categories and hence treated as nontradable.

[8] The REER index reported here is presumably a better indicator of the competitiveness of tradable production vis a vis non-tradable production compared to the standard IMF REER index (reported in the Central Bank of Sri Lanka, *Annual Report*), which uses the consumer price index to measure both domestic and trading-partner price levels (Harberger 1989).

[9] See Chapter 5, Table 5.12 in CBSL (2020). 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.

[10] Apparently, this policy was based on a misinterpretation of the 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 until the rate of inflation become a serious policy consideration (emphasis added).

[11] According to its Charter, the IMF lends to a member country only if the country's external debt position is sustainable, that is, it has the capability to meet the existing debt servicing commitments.

[12] See Athukorala (2023) for details.

[13] This contraction was partly due to economic disruption caused by terrorist bombing of three churches and three luxury hotels in Colombo on the Easter Sunday (21 April 2019).

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

[15] The Paris Club is a group Western donor countries formed in 1950 to find coordinated solution to developing countries' debt problems. It undertakes non-concessional rescheduling of debt.

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