



Sri Lanka's Economic Crisis

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This case study examines the causes, structural and proximate, of the ongoing economic crisis in Sri Lanka. It draws important policy lessons from this episode for developing economies – diversification of debt, industrialising the economy and managing government finances. It finally looks at implications of the crisis and the way forward for Sri Lanka.

Executive Summary

The Sri Lankan economic crisis, which began in 2019, worsened in 2022 culminating in protestors storming the presidential palace in Colombo. The agitation of the people stems from acute shortages of food, fuel and other essential items, galloping inflation, long power cuts, and a collapsing economy with no avenues for employability.

This case study examines the crisis by looking at the fundamental causes that date as far back as Sri Lanka's independence— the lack of industrialisation, the economic price of the prolonged civil war, and the majoritarian leanings of policy. Terror attacks and the pandemic only exacerbated the crisis. globally, travel bans were introduced, and Sri Lanka's tourism sector suffered a huge setback.

More importantly, Sri Lanka's debt portfolio has undergone a substantial change with the tipping of balance towards costly external debt. This crisis carries important lessons for developing economies – diversification of debt, industrialising the economy, avoiding populist tax cuts that hurt the government's balance sheets, and cutting unnecessary public expenditure.

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1. Introduction

Sri Lanka's current economic crisis began in 2019, though structural deficiencies in the economy have existed for a long time. The ongoing crisis entails record levels of inflation, a depletion of foreign reserves, rapidly depreciating currency, inability to pay for imports, and increasing interest rates by the central bank. In May 2022, Sri Lanka defaulted on its debt for the first time in its history. Consumer price inflation rate breached 50 per cent and there is a stark shortage of basic goods such as food, medicine, and fuel.

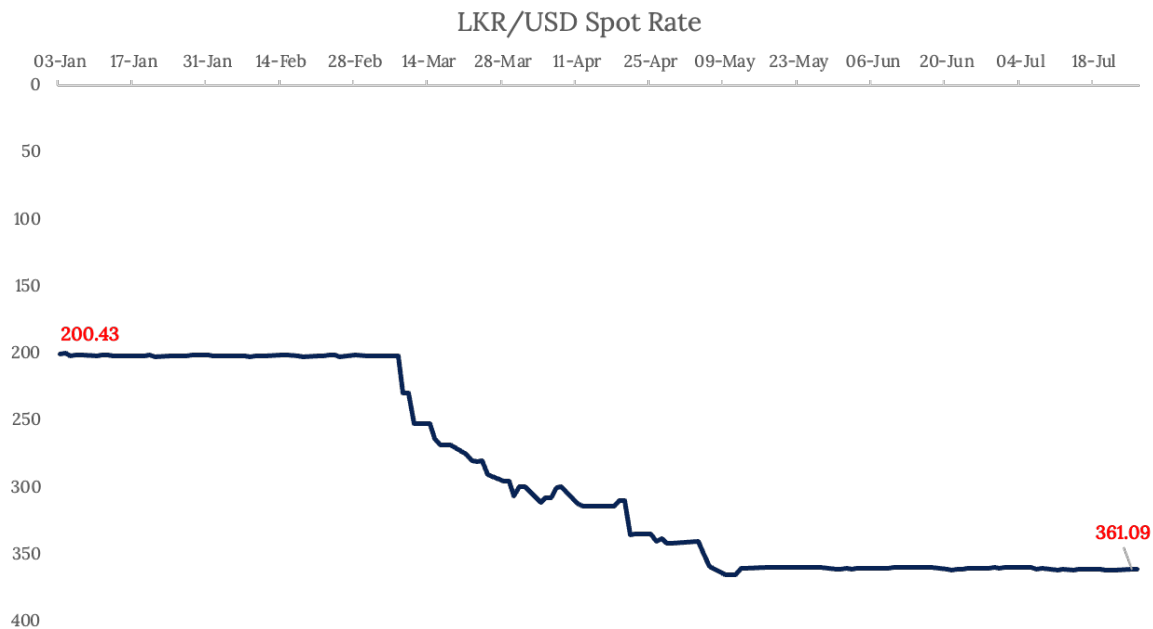
Fuel shortage has resulted in the stoppage of essential services such as buses, trains, and even medical vehicles. The shortage has also resulted in a sharp spike in prices and the government has had to resort to drastic measures to conserve the remaining fuel, such as closing schools and offices, instituting work from home, and banning the sale of petrol and diesel for non-essential vehicles for a period. The government had declared that it didn't have the necessary foreign exchange reserves to import more and the national Ceylon Petroleum Corp. was \$700 million in debt.

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Sri Lankan Rupee (LKR) lost its value dramatically since March 2022. The exchange rate depreciated from LKR 201.09 per US dollar in the beginning of March to LKR 361/\$ in July 2022, amounting to a staggering depreciation of 79 per cent.

Sri Lanka is not alone here. The dollar has strengthened against most currencies, as indicated by the dollar index reaching a 20-year high. The Euro fell below parity for the first time in 20 years. Many emerging countries with weak macro fundamentals, like Pakistan, Sri Lanka and Turkey, witnessed sharp depreciation of their currency.

Figure 1: Sri Lankan Rupee/ USD spot exchange rate



The crisis is a result of various economic and political factors building up over time. There is macroeconomic instability, economic stagnation, and a non-conducive business environment. Continued large scale protests across the island nation resulted in the resignation of President Gotabaya Rajapaksa on 15 July 2022. The crisis has a chance of spilling beyond Sri Lanka's national borders.

This document looks at the causal factors behind Sri Lanka's economic crisis, followed by a discussion on the policy lessons and finally touches upon the implications for Sri Lanka and way forward.

2. Causal Factors

1. Tax Cuts and Expansion of Money Supply
2. Pegged Exchange Rate and External Debt
3. Import Ban on Fertilisers leading to Agricultural Crisis
4. Fall in Tourism
5. Structural Patterns

2.1: Tax cuts and expansion of money supply

Sri Lanka's government revenue has steadily declined, from LKR 1,932 billion in 2018 to LKR 1,373 billion in 2020. In November 2019, President Rajapaksa announced tax cuts, following up on his election pledges. This includes cutting the value added tax (VAT) by almost half to 8% from 15% and abolishing pay-as-you-earn (PAYE), nation building (NBT), withholding tax, capital gains tax, and bank debit tax.

When Rajapaksa made tax cuts an electoral issue, it was largely considered a campaign gimmick. However, the elected President followed through with rare alacrity and the tax cuts were passed in the first cabinet meeting itself (Schultz 2022). The tax cuts were meant to stimulate the economy, which did not happen.

Less than 2 percent of government revenue comes through direct taxes and only 1 percent of the population come under the requirement to pay income taxes. Sometimes, a tax cut is justified as a mechanism to increasing the tax base. That did not materialise either as Sri Lanka lost over 1 million taxpayers since these tax cuts. From

approximately 1.56 million taxpayers in 2020, Sri Lanka had only 0.41 million taxpayers in 2021 (ET 2022). This is largely attributed to be a consequence of the pandemic that resulted in widespread unemployment.

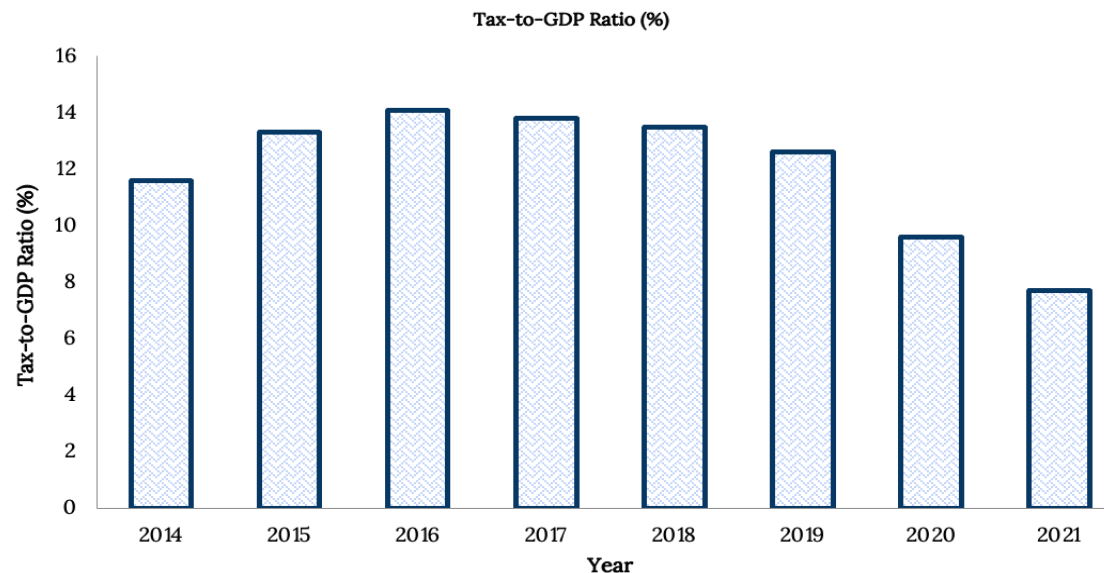
BOX 1: Direct and Indirect Taxes in Sri Lanka

The PAYE tax is a method of collecting taxes at source from those engaged in gainful employment; the employer makes a deduction based on the tax rate and remits it directly to the tax authority. This tax ranged from 0 - 18% depending on the income bracket (SLIR 2021). The NBT is imposed on persons, companies, and partnerships who import articles into Sri Lanka, manufacture articles, provide a service, and partake in the wholesale or retail business of articles. This was fixed at 2%. Withholding Tax on individuals is based on their income levels and charged on winnings from lotteries above 500K LKR and gambling (14%), non-employment sources like rent, royalty and annuity, insurance premium (14%), interest payments (5%).(PwC 2020) A Capital Gains Tax is the tax applied on gains realised on the transfer of ownership of an investment asset. This is fixed at 10% (SLIR 2019). A Bank Debit tax is levied on 0.1% of the total debits (exceeding 20k LKR) made during a calendar month from any current and savings accounts maintained with a commercial bank (Trade Chakra 2010).

The Laffer curve didn't materialise either as overall tax collections reduced after a cut in tax rates. Even before the tax cuts, Sri Lanka had one of the lowest revenue-to-GDP ratios. Sri Lanka's revenue-to-GDP ratio was at 7.6% in 2021, while it was 29.3% for Bhutan, 34.3% for Tunisia, 15.5% for the Philippines, and 9.38% for Angola. By reducing government revenue, the government's capacity to repay debt denominated in foreign currency weakened significantly.

The idea behind the Laffer curve is that higher tax rates reduce people's incentives to work and make investments, as they have to give a higher proportion of it to the government. According to the hypothesis, at some level, increases in tax rates lead to a decrease in total revenue collected. This results in a U-shaped curve when we plot total tax collection against tax rates. Though this may sound intuitive, empirical evidence has failed to consistently demonstrate this effect.

Figure 2: Tax to GDP Ratio (%) is low and declining in Sri Lanka



Data Source: Statista

In desperate times, governments often resort to coercing the central banks to infuse liquidity into the system (printing money).

Governments also resort to borrowing from the central bank, for its expenditure like paying salaries. Printing money builds inflationary pressure in the market by accelerating aggregate demand in the market. However, the supply of goods and services unchanging means there will be a sharp increase in prices. The Lankan government pursued this strategy despite the advice of the IMF which suggested raising interest rates and reduced spending instead of printing money.

Sri Lanka printed about 588 billion rupees in the first quarter of 2022, taking the total money printed since January 2020 to 2.3 trillion rupees, according to official data (News18). From January 2020 to March 2022, reserve money grew 49 per cent, broad money by 52 per cent and the food price inflation rose to 80 per cent (News18 and The Economist). On April 6, 2022, the Central Bank printed 119.08 billion rupees which is the highest amount printed in a day in 2022 (NewsWire 2022).

This can be attributed to the Central Bank not being independent: “the coalition had barely started to implement the reforms that

would...provide greater Central Bank independence...before political instability set in” (Arudpragasam 2022).

The Rajapaksa government passed the 20th Amendment which undermined the independence of crucial institutions. This was a move to consolidate power in the President's hands. Independence of a central bank guarantees insulation from short-term political pressures and allows them to maintain low inflation rates (ECB 2021). In 2015, another controversy surrounding strong independence measures – the central bank accepted a debt amount greater than communicated and issued a 30-year bond with a higher interest rate than communicated (Samarasinghe 2015). Therefore, the independence of the central bank has been questionable without enough safeguards to protect the Sri Lankan economy. The rationale behind printing so much money was presented as a way to kickstart Sri Lanka's production driven economy. Additionally, the printed money was being utilised to meet the finances for state expenditure by buying government securities (Gunasekara 2022).

There is also a general-equilibrium explanation for the rapid rise in inflation (Marshall 1890). Sri Lanka was not a well-connected market.

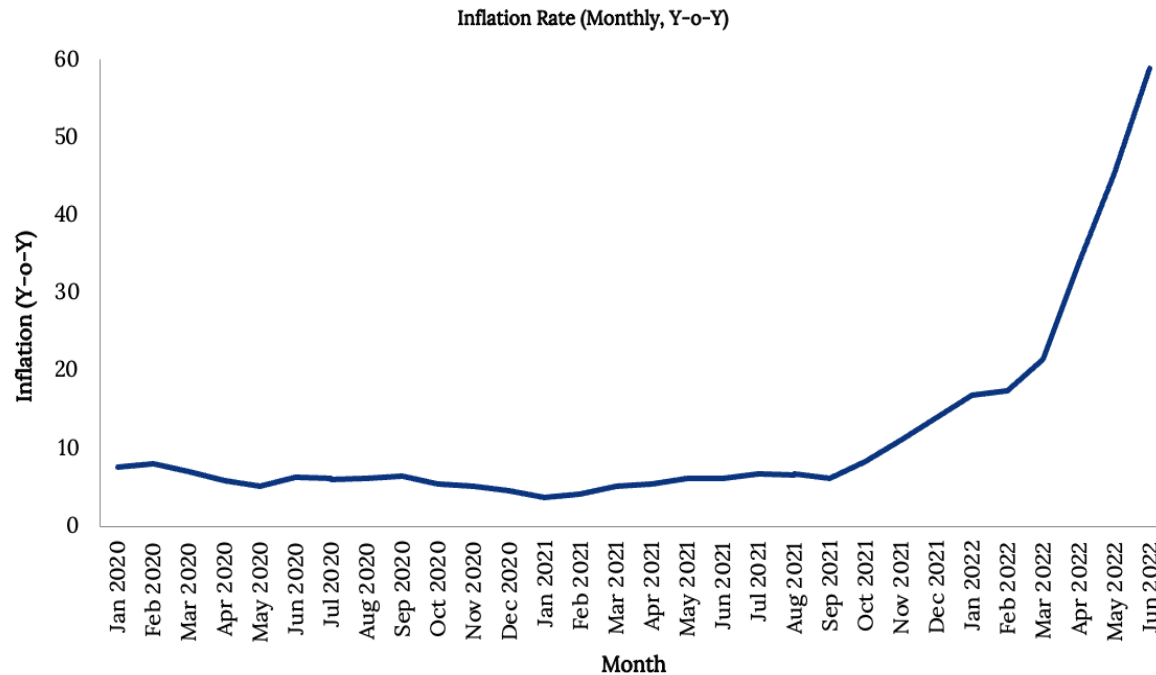
A wealth of economic literature establishes the negative and strong relationship between central bank independence and inflation. Countries with high central bank independence has lower average levels of inflation.

The tendency of governments to force their central banks to print excessive amounts of money (presumably in exchange for nominal economic growth) is termed as the “inflation bias” of discretionary monetary policy.

Trade as a percentage of GDP has fallen from 89% in 2000 to 52% in 2019 to 39% in 2020 (World Bank 2021). Since 2018, the imports have been declining due to Sri Lanka's dwindling foreign reserves. This means lower priced goods from international markets will not flow into the country and the Sri Lankan market is left with costlier domestic products.

As the economic crisis was worsening and Sri Lanka was on the verge of defaulting, the president announced a 229 Billion LKR economic relief package in January 2022 (Deccan Chronicle 2022). This was to provide 1.5 million government employees, pensioners and differently-abled soldiers with a special allowance of 5000 LKR per month. Farmers who were to see a reduction in their harvest by 25 to 30% would be offered subsidies along with 10,000 LKR being provided to cultivators owning less than one acre of land. Plantation sector employees' families would be provided 15kgs of wheat a month. The relief package was supposed to supplement the incomes as inflation hit 14.2% in January 2022.

Figure 3: Inflation is galloping in the recent months in Sri Lanka

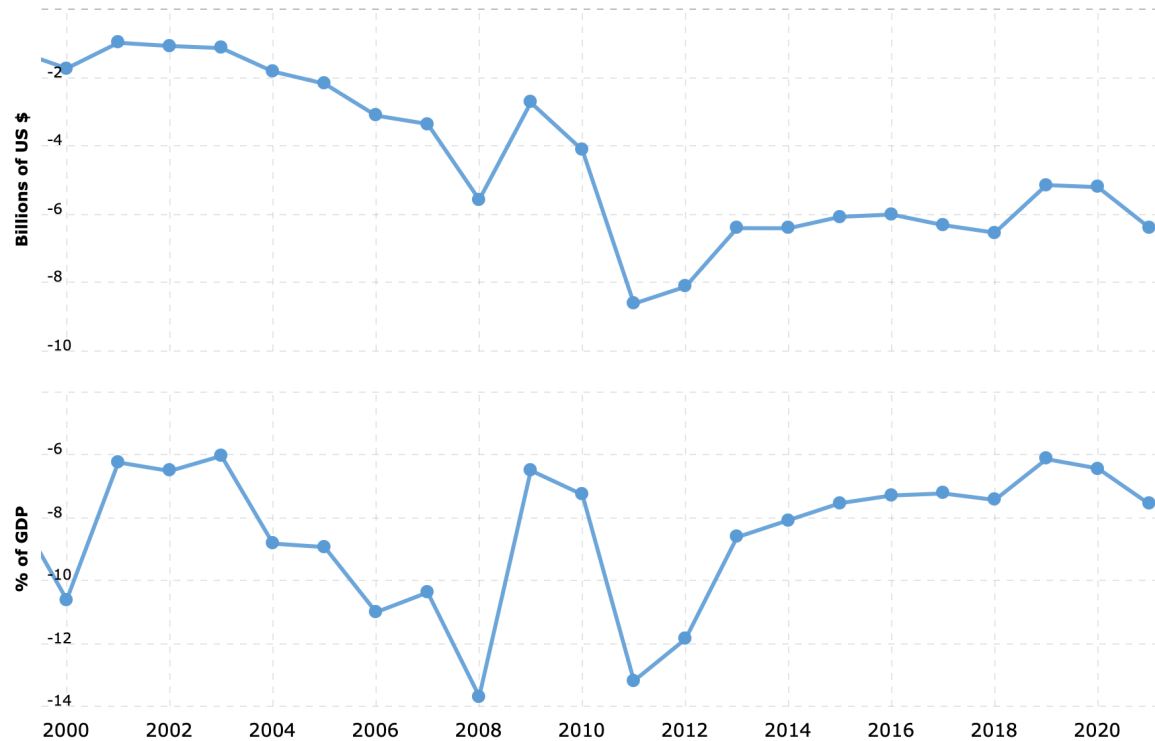


Data Source: CBSL

2.2: Rising Debt, Falling Reserves and a Broken Peg

Sri Lanka is heavily dependent on imports for almost all of its basic needs. Food and fuel are on top of the import list. An average Sri Lankan household gets 22% of its caloric consumption through imported food items.

Figure 4: Sri Lanka has a persistent trade deficit.



Source: Macrotrends

Poor urban households consume more imported calories (Wijesinghe and Yogarajah 2022). While Sri Lanka exports textiles and garments and tea and earns foreign exchange from tourists, it is not enough to offset their import bill. Therefore Sri Lanka runs a persistent trade deficit, as Figure 4 shows.

The Pegged exchange rate:

Like many big importing countries, Sri Lanka tried to minimise its import bill by pegging its exchange rate to the dollar at slightly overvalued terms. The Central Bank of Sri Lanka has maintained the exchange rate in a narrow band around LKR 200/\$. An overvalued exchange rate gives more dollars per Sri Lankan rupee, which allows them to import more. While this may work in normal times, it is a risk that can unravel in spectacular fashion.

A central bank manages the peg by announcing its desired rate and using its foreign exchange reserves to maintain that peg. Usually, the knowledge that a central bank is willing to defend the peg makes traders follow the peg. When the exchange rate deviates from the peg, say starts to appreciate or depreciate, the central bank will intervene in the market to restore the exchange rate by selling dollars and buying the currency or vice-versa.

However, in times of a crisis, when traders suspect that forex reserves are running low, they will try to “break the peg” by selling rupees and buying dollars. At this point, either the central bank gives up the fight and allows the currency to depreciate sharply or it loses an

There are different types of exchange rate regimes in the world, as classified by the IMF. While some countries, like the US or New Zealand, choose to have the exchange rate determined purely by market forces (free float), other countries like India prefer to intervene periodically (managed float).

In some other cases, like Sri Lanka, the central bank tries to fix the value of its currency against the dollar. Over the years, the exact classification has changed from stabilised arrangement to crawl-like peg, but, the exchange rate has been maintained around LKR 200/\$

enormous amount of its forex reserves by trying to gradually allow the currency to depreciate.

Simultaneously, as confidence in the economy weakens, many people try to move their money out of the country and into safer havens (usually, the United States). This capital flight will further weaken the currency.

In the case of Sri Lanka, the Central Bank in March 2022 first devalued the currency (perhaps at the insistence of the IMF) from 200–203 rupees per dollar band to around 230/\$ (Jayasinghe 2022). After the devaluation, traders started selling rupees. The Central Bank tried to stop the capital flight by using some of its reserves. However, when it realised that reserves were inadequate to maintain the exchange rate, the peg broke and there was a sudden depreciation. It is quite apparent to see when the peg was broken (refer Figure 1).

While a pegged exchange rate allowed Sri Lanka to import more for the same amount of rupees, it still needed to pay for these imports. Exports would pay only for a portion of the imports. The bigger portion would come from external borrowing.

External debt

Apart from pegging their currency, Sri Lanka had made yet another risky gamble – borrowing in foreign currency. Since Sri Lanka was importing a lot more than exporting, it had to borrow to pay the difference. The borrowing could have either been in Lankan rupees or in a foreign currency, which dictates who would take the exchange rate risk. Borrowing in rupees means that the lenders take the exchange rate risk (if the rupee devalued or crashed in value, they get less). In order to cover for that they charge a much higher risk premium (interest rate). On the other hand, borrowing in dollars or another foreign currency is cheaper, but Sri Lanka would have to bear the exchange rate risk. If the rupee crashed or lost value against the dollar, they would have to give up a lot more rupees to make the same dollar payment. Sri Lanka chose the cheaper, but riskier option of borrowing in dollars (and a part in Chinese Yuan).

On April 12, 2022, Sri Lanka announced that it was going to default on all external debt obligations after running out of its foreign reserves (ET 2022). In late April 2022, India urged the IMF to reclassify Sri Lanka as a lower-income country so that it could restructure its debt. As a low income country, Sri Lanka has access to

Sovereign Bonds are essentially government securities issued to finance the fiscal deficit. These can be denominated in domestic or foreign currency. International sovereign bonds are those issued in foreign currency. These attract lower interest rates but are more exposed to exchange rate risk. These securities are also highly sensitive to global interest rates.

Such bonds are settled in international clearing houses, such as Euroclear.

concessionary funding from organisations like World Bank and ABD. These have low interest rates (usually below 1%) and a long repayment horizon.

Sri Lanka had initially graduated from the low income status to lower middle income status in 1997 (Wijewardena 2020). This meant that the country could no longer avail fresh concessionary funding and had to rely on commercial sources. This altered the debt structure for the economy. Commercial loans have higher interest rates and shorter repayment horizons. Between 2004 to 2019, commercial loans increased from 2.5% of foreign loans to 56% (Bhowmick 2022). This has increased macroeconomic instability.

Between 2006 and 2020, Sri Lanka's debt rose from USD 11.85 billion to USD 56.83 billion. This is attributed to the country funding debt through International Sovereign Bonds. 47% of Sri Lanka's debt, as of April 2021, came from market borrowings. Its second largest lender is the Asian Development Bank at 13% followed closely by China at 10% (See Figure 5). This debt is equivalent to 104% of Sri Lanka's economic output (Gordon 2022). This is way above the World Bank warning of 77%. When a country exceeds 77% for a

prolonged period of time, its economic growth is adversely affected – every additional percentage point of debt above 77% leads to a 1.7% decrease in annual real growth (CFI 2021).

High ratios need not always signal defaults – the US was at 105% in 2017 and Japan has been over 200% for years, but these are developed economies with good economic prospects in the future. Siddique and Selvanathan (2016) find that high levels of external debt has negative capital and labour productivity and crowding out effects (Siddique, Selvanathan 2016, 38).

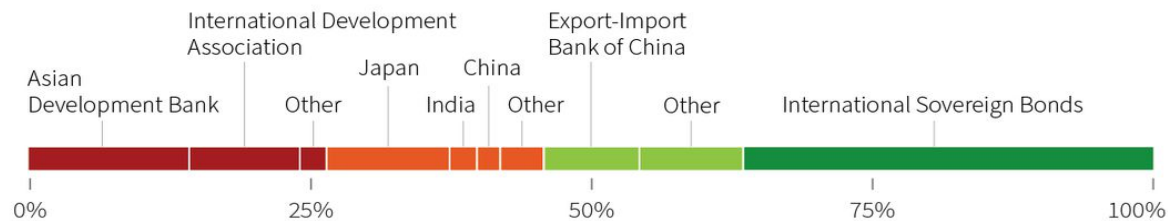
Figure 5: Increase in the share of International financial market borrowings

Sri Lanka's foreign debt

Repeated cycles of borrowing from capital markets, including the International Sovereign Bonds, have made them the largest source of foreign funding for Sri Lanka.



Ownership of Sri Lanka's outstanding foreign debt in 2020



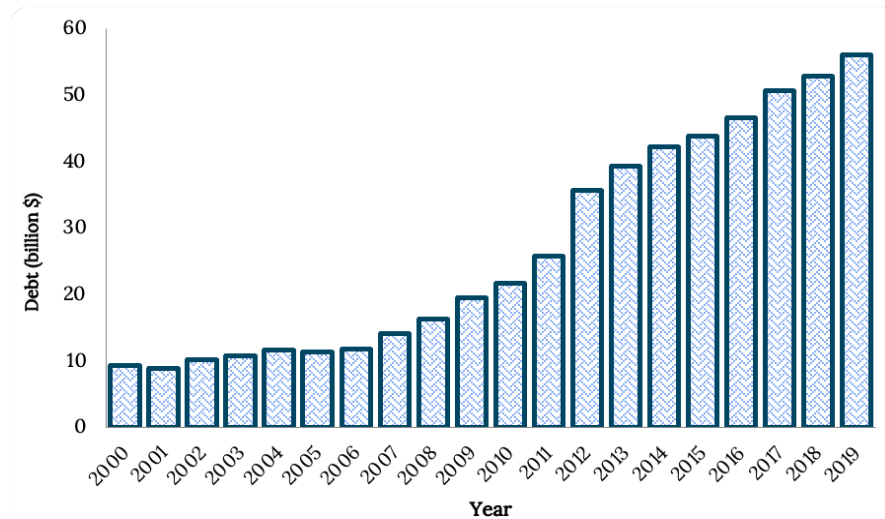
Source: Central Bank of Sri Lanka

V. Kawoosa, 17/01/2022



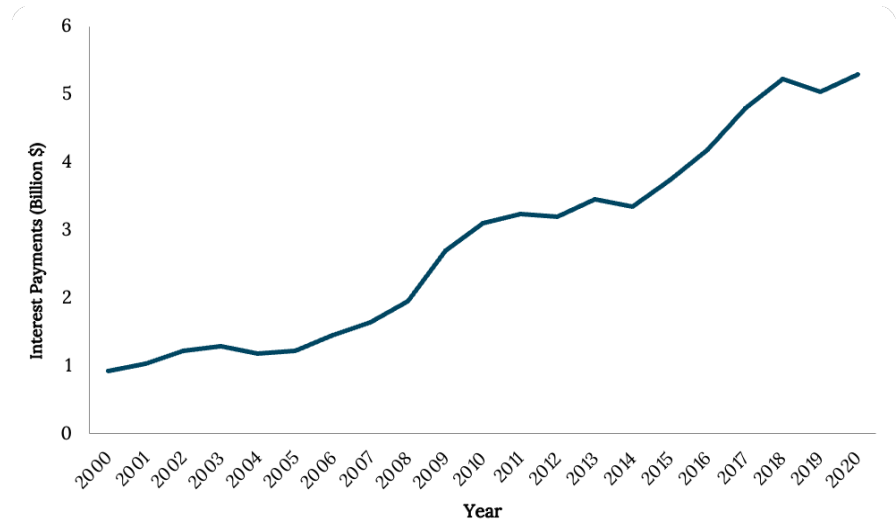
Source: Reuters

Figure 6: External debt of Sri Lanka (\$ billion)



Data Source: World Bank

Figure 7: Interest Payment for Sri Lanka (\$ billion)

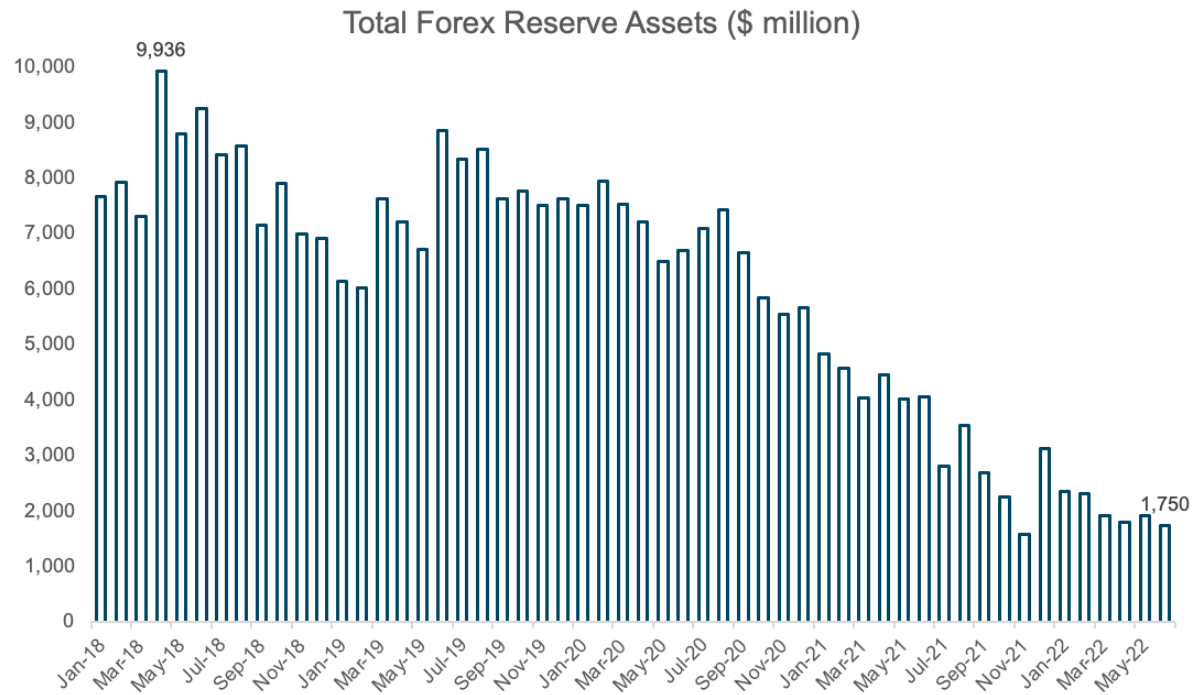


Data Source: World Bank

External debt of Sri Lanka has steadily increased since 2000 in both absolute terms and as a percentage of its GDP. The increase in debt leads to a corresponding increase in interest payments over the years, amounting to more than \$5 billion in 2020 (Figures 6 and 7).

Financing the interest payments and repaying the principle amount with declining foreign exchange reserves proved to be a problem.

Figure 8: Total Forex Reserve Assets have been steadily declining since 2019

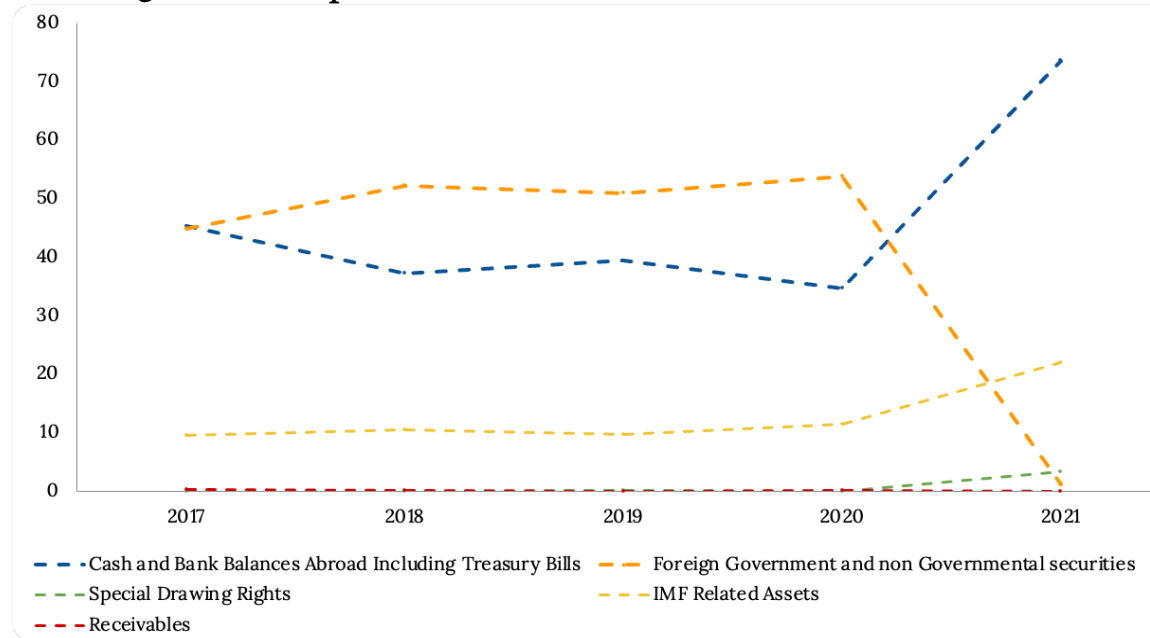


Data source: Central Bank of Sri Lanka; Bloomberg

Starting 2019, Sri Lanka used its foreign reserves to pay for debt obligations. This was mainly financed by selling foreign securities held by the Central Bank of Sri Lanka (CBSL) as seen by the sharp reduction in the Figure 9, where the proportion of foreign governmental and non-governmental securities held by the CBSL fell from 53.75% to 1.19%. This led to its foreign reserves plummeting

from USD 8,864 million in June 2020 to USD 2,361 million in January 2022.

Figure 9: Composition of Forex Reserve Assets



Source: Central Bank of Sri Lanka

Unfortunately, other sources of foreign exchange, such as FDI also fell during this period - from 1.6 billion USD in 2018 to 0.54 billion USD in 2020 (World Bank 2020). The net inflows of foreign investment as a percentage of GDP fell by more than half between 2018 and 2020 from 1.8% to 0.5% (World Bank 2020).

2.3: The drastic turn to organic farming

Table 1: Rice area, yield, output and imports in Sri Lanka

	Area (mn hectares)	Yield (tonnes/hectare)	Production (mn tonnes)	Imports (thousand tonnes)
2014-15	0.93	4.32	2.74	286
2015-16	1.23	3.95	3.29	30
2016-17	0.69	4.36	2.03	748
2017-18	0.77	4.30	2.25	249
2018-19	0.97	4.73	3.13	24
2019-20	0.97	4.85	3.21	16
2020-21	1.09	4.57	3.39	147
2021-22	1.10	4.91	2.92	650

Source: Indian Express

Over the last decade, agriculture has contributed between 7.4 to 8.8% to Sri Lanka's GDP. Agricultural earnings accounted for almost 16% of export earnings in 2019. The largest agricultural exports are limited to tea, coconut, and spices. They respectively account for 53.3%, 24.3%, 12.4% of agricultural exports. In 2019, tea and spices generated

USD 265.2 million but have an untapped potential of USD 1.2 billion (Dissanayaka 2021).

In his election manifesto titled “Vistas of Prosperity and Splendour,” Rajapaksa promised that Sri Lankans would be provided chemical-free food (Jayasinghe, Ghoshal 2022). After the election, Rajapaksa had outlined a 10-year transition period to complete organic farming.

However, in April 2021, Rajapaksa instituted a complete nationwide ban on the importation of and use of synthetic fertilisers and pesticides and ordered the country's 2 million farmers to go organic. While Rajapaksa claimed that “sustainable food systems are part of Sri Lanka's rich sociocultural and economic heritage,” and claimed that this move would reclaim this rich heritage, observers point to the other obvious reason for this drastic measure – Sri Lanka's falling forex reserves.

Despite claiming technical expertise, Rajapaksa's Vistas document did not feature any of Sri Lanka's leading experts on agriculture. The same members who had helped draft the agriculture section of the Vistas document then became members of Rajapaksa's government

Alternative agriculture aims at following the concept of agroecology and these kinds of systems seek sustainable performances while optimizing all agroecosystem resources. They employ “ways to preserve the environment and more precisely soil and water. They also seek to reduce or suppress the use of chemicals and mineral fertilizers, thanks to, respectively, biological control and organic fertilizers and amendments” (Kremsa 2021).

and went on to occupy the Agricultural Ministry. The Minister of Agriculture formed multiple committees on how to implement the organic farming dream, none of which contained agricultural experts. Instead, it mostly included representatives of the nation's small organic sector and academic advocates for alternative agriculture. It also paid heed to the advice of the Indian activist Dr. Vandana Siva, known for activism against modern agricultural practices (Nordhaus & Shah 2022).

The Sri Lanka Agricultural Economics Association (SAEA) pointed out the massive losses that would follow the ban. They categorically mention the fall in tea exports due to a 35% drop in productivity and an income loss of 84 billion LKR and a GDP contraction of 3.05% (Ramakumar 2021). This was duly ignored by the agricultural ministry, which set up a task force only in December 2021, nearly 8 months after the ban, to study the adverse effects of chemical fertilisers (Srinivasan 2021).

Organic farming comes with its limitations. The output from organic farming is lower than commercial farming done with fertilisers. Knapp and Heijden (2018) found that the temporal stability of per

“The farrago of magical thinking, technocratic hubris, ideological delusion, self-dealing, and sheer short-sightedness that produced the crisis in Sri Lanka implicates both the country's political leadership and advocates of so-called sustainable agriculture: the former for seizing on the organic agriculture pledge as a short-sighted measure to slash fertilizer subsidies and imports and the latter for suggesting that such a transformation of the nation's agricultural sector could ever possibly succeed.” (Nordhaus & Shah 2022)

unit yield from organic agriculture was 15% lower than conventional agriculture (Knapp, Marcel 2018). At the same time, Kirchmann (2019) found that yields from non-legumes were 35% lower in organic farming. A 35% yield gap implies Sri Lanka would require 50% more arable land to keep up with previous output levels. The reduced yields from organic farming meant that Sri Lanka should have either had a food surplus that could meet the supply shortage or had the means to import. Sri Lanka's staple diet is rice and its main export is tea. Rice yields fell by at least 30% nation-wide, requiring Sri Lanka to import rice (Jayasinghe, Ghoshal 2022) Due to the low output, export earnings fell exacerbating the falling foreign reserves.

Secondly, a policy that aims to transform the economy should be carried out in a phased manner to ensure minimal disruptions to livelihood. The fertiliser ban was put into effect without any discussion; the Cabinet Paper itself cites no justification except the President's election manifesto (Samarajiva 2021). The April 2021 chemical fertiliser ban was reversed in different stages but the recovery in food supplies hasn't been achieved.

A brief glance at a study done in Bhutan, an economically similar country in terms of GDP, after it decided to become a 100% organic nation would show that there was a 24% yield gap, a fall in GDP, substantial welfare losses, and adverse impact on food security (Feuerbacher, Luckmann, Boysen, Zikeli, Grethe 2018)

Looking back at the Eswaran–Kotwal model, when there is an adverse shock to productivity in the farm sector, the number of people employed will reduce, if wages are kept constant. Generally, the non-farm sector protects those employed in the farming sector in case of an adverse shock to the farming sector, but tourism is the only robust non-farm sector and even that was collapsing. This meant that overall productivity of the economy was hampered as both the farm and non-farm sectors were in decline. The reduction in productivity in agriculture due to lack of fertilizers and the falling active employment in tourism meant declining incomes and an increase in unemployment. This is seen in the exponential rise of unemployment from 4.3% in 2019 to 5.9% in 2020 (World Bank 2020).

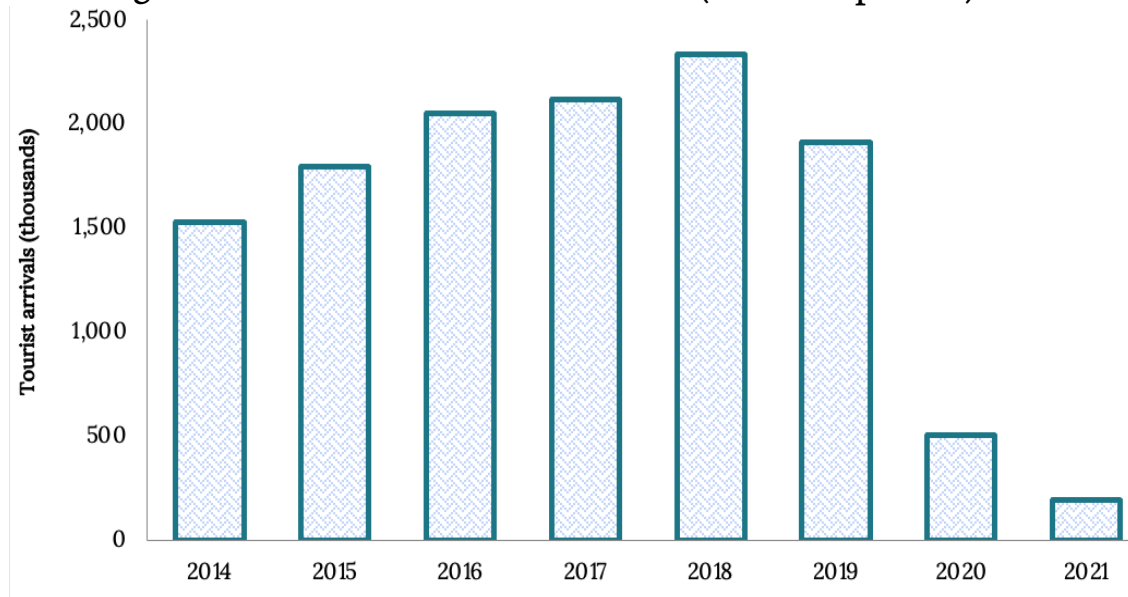
2.4: Terror attacks, pandemic, and the decline in tourism

In 2019, tourism contributed 10.4% to the GDP. This fell to 5.5% in 2020 during the pandemic. Over a million people directly depend on tourism for their livelihood; tourism contributes to 11% of total employment (Aneja, Shridhar, Maawi 2020). While the fall in tourism directly affected the inflow of foreign exchange into the

economy, tourism was already declining. It fell from 5.61 billion USD in 2018 to 4.66 billion in 2019 and 1.08 billion in 2020 (World Bank 2020). The fall comes after the stagnation between 2004 and 2009 and the steady rise post the Global Financial Crisis in 2009. Sri Lanka was hit by the tsunami in 2004 and has been marred in civil unrest, leading to a gradual decline in the tourist numbers. In 2019, bombings carried out by alleged Islamic State-linked militants killed more than 250 people in the Easter Sunday attacks. This led to a drastic fall in tourist numbers (Attanayake 2022). Two major employment sources in Sri Lanka are tourism (5.6% in 2018) and agriculture (8.02%).

The recent protests against the Rajapaksa government has further led to a drop in tourist numbers. The violence had led countries, including the United States and Australia, to issue travel advisories discouraging their citizens from visiting the nation. In May 2022, Sri Lanka recorded just 30,207 total international tourist arrivals, a 72 per cent drop compared to March 2022 (Attanayake 2022).

Figure 11: Tourist Arrivals in Sri Lanka (thousand persons)



Source: SLTDA

5: Structural Issues

Sri Lanka is composed of different ethnic groups. Three-fourth of the population is Sinhalese, while one fourth comprise Sri Lankan Tamils, Muslims, Indian Tamils, and other races. Ethnic tensions have been high between the Sinhalese and Tamils since 1948. In 1956, Sinhalese was declared as the official language and this relegated Tamil (and Tamils) to a secondary position. Over the years, as more

legal decisions disadvantaged the Tamils, resentment grew and culminated in the formation of the LTTE in the 1970s. LTTE is a militant group recognised as a terrorist organization. They have been a part of multiple peace talks with no fruitful results and have been in military conflict with the State for decades. LTTE was stopped in 2009 through army retaliation. While the violent conflict ended, power sharing has not been achieved. Sri Lankan governments have taken measures to concentrate power at the Center. For instance, institutions at the national level have been created to usurp provincial power (Deshal De Mel, Pathmalal 2009). Additionally, the President has authority over all provincial councils under Emergency Rule. Emergency has been used liberally by Sri Lankan leaders (Subramaniam 2022). This is just another example of authoritarianism in Sri Lanka that has been prevalent since Jayewardene's rule in 1979 (Gunawardena, Kadirgamar 2022).

Economically, the nature of political instability during LTTE's militancy, has kept Foreign Direct Investment (FDI) at bay. LI, Murshed & Tanna (2016) found that FDI can be reduced by 81-119% in the event of a civil war in developing countries. Therefore, as ISBs and other commercial borrowing matured and Sri Lanka's capital

The US State Department has noted that Sri Lanka is "a challenging place to do business, with high transaction costs aggravated by an unpredictable economic policy environment, inefficient delivery of government services, and opaque government procurement practices."

Investors are also concerned about contract repudiation, cronyism and expropriation. Sri Lanka's then Finance Minister Basil Rajapaksa gained the moniker of Mr. Ten Percent, for the alleged 10 percent commission demanded for every project.

outflows increased, the capital inflows were inadequate and the foreign reserves declined. Sri Lanka also witnessed trade as a percentage of GDP decline from 33% in 2000 and to 13% in 2019. Since 2008, government revenue as a percentage of GDP has been declining, which means the government expenditure could be financed only through further debt as expenditure was higher than government revenue (Deshal De Mel, Pathmalal 2009).

Other concerns include a protectionist import regime that is legally complex to navigate. The government takes unilateral decisions without consulting the private sector which further sours relations. While looking at Sri Lanka on the ease of doing business rankings by the World Bank, out of 190 countries, Sri Lanka comes 164th for contract enforcement, 142nd for paying taxes, 138th for registering property and 132nd for obtaining credit (Dietrich 2020). The political instability fuels the unpredictability of raising the transaction costs for companies which is only exacerbated by the cronyism within the government. Sri Lanka's largest trading partner, the United States, has repeatedly expressed concerns over Sri Lanka as an investment destination.

Sri Lanka had initiated a programme of trade liberalisation in 1977 and gradually replaced quantitative restrictions with tariffs, reduced and rationalised the tariff rates and abolished forex restrictions on the current account. By 2000, average import tariffs were less than 10% and trade as a percentage of GDP was at its highest level.

However, the liberalisation process lost momentum due to a general economic downturn in the early 2000s and the escalation of the civil war. Domestic lobbies demanded and got protection from outside competition. As exports dwindled and loans increased, there was a pressure to save forex through curtailed imports – protectionism thrived and trade as a percentage of GDP steadily declined.

3. Policy Lessons

3.1: The Dependence on Foreign Capital

Sri Lanka was designated as a lower middle-income country in 1997 and an upper middle-income country in July 2019, but has again been downgraded to lower middle-income in 2020. Yet, despite being a middle-income country, the economic policies have not been structured to induce adequate domestic private investment or foreign direct investment. The growth of the economy has been fuelled through external debt which is often offered at very high interest rates. Another source of financing is International Sovereign Bonds (ISB), which are debt securities. These are used to finance the government's expenditure or repayment of loans. The excessive reliance on foreign capital can lead to unfavourable terms for Sri Lanka and can lead to sudden depreciation and loss of forex reserves. Foreign capital is at the mercy of international governments and subject to currency movements. Had the country had FDI, it would have been able to create industries and diversify its economy beyond agriculture and tourism. The additional effect of FDI could have been the creation of a comparative advantage in non-agricultural goods,

especially because of the low costs of labour in Sri Lanka. This could have reduced Sri Lanka's vulnerability. Therefore, economic policy should have been created to promote an inflow of FDI (like having an open-economy and improving the ease of doing business) and reduce the dependence on debt as a major source of foreign reserves.

3.2: Increasing Public Expenditure

The government pledged to hire 100,000 unskilled workers and 60,000 unemployed workers in 2020. This comes after the government spent approximately 50% of its revenue on salaries and pensions for public service employees (Public Finance 2020). The costs are bound to increase with employment of unskilled and unemployed individuals as they will require training, allowances, and have additional administrative costs. This announcement came after the Rajapaksas announced tax cuts and had already reduced the government revenue collection.

This fiscal profligacy overextends the government and in times of need, the government will be cash-strapped to supply essentials – like food, water, medicine, electricity – to the citizens. The obvious policy lesson for emerging markets is to maintain fiscal deficits in a

sustainable range. If the debt to GDP ratio is generally within sustainable ranges, countries will have higher leeway to spend during downturns and correct the business cycle swings. Sri Lanka, unlike most countries, wasn't able to announce any relief measures pertaining to food and health during the pandemic. Even the purchase of vaccines for citizens was through external funding from the World Bank.

3.3: Shifting Production Practice

Sri Lanka doesn't have a local fertiliser industry, which means it must import chemical fertilisers. It has been importing over USD 150 million worth of fertilisers. Since the late 1900s, governments have been providing subsidies to farmers on fertilisers. As of 2019, the rate of subsidy was 86% of the fertiliser price for paddy and between 50 – 90% for other crops. In 2020, the government provided fertilisers free of charge for paddy cultivation (Weerahewa 2021). The presence of fertilisers (and their subsidies) has increased yields, exports, and farming incomes.

Prior to the fertiliser ban, only 2.5% of agricultural land was under organic farming. The predicted yield losses from such a shift range

from 20 – 100%. The government shouldn't have created a dramatic shift overnight as it threatens the upcoming harvest, prices, and incomes. The shift to organic farming should have been the choice of farmers. A ban will probably create a shadow / black market for fertilisers where farmers will face even higher costs. A better move to dissuade the use of fertilisers would have been to decrease the subsidies on fertilisers or provide a conditional cash transfer if farmers opted for organic farming. In the Philippines, the government has abandoned subsidies and price policies, but instead set quality regulation and trained farmers. Other policy options include placing regulatory measures on the standards for imported fertilisers and soil or tariffs on chemical fertilisers or providing tax incentives / concessions as required when fertilisers are not used.

3.4: Populist Tax Structures

The tax cuts that were announced by the Rajapaksa government were populist in nature. In case of a macroeconomic shock – like the pandemic – if a nation has a manageable fiscal deficit or moderate taxation, it might be able to tide over. However, Sri Lanka had been witnessing a decline in economic resilience. The announcement of the tax cuts in 2019 was responsible for the widening of the fiscal deficit.

This tax cut was merely months before the pandemic hit Sri Lanka and dried up the largest sources of foreign exchange, remittances by labour and tourism. Given that the pandemic had already caused large scale disruptions in people's livelihoods, a leader that won a supermajority could not reverse the tax cuts. The lesson being that tax policies shouldn't be changed overnight, especially not if the country doesn't have adequate surplus accounts to shoulder a crisis. A more systematic approach would have been to quantifiably measure how much the tax base would increase by if there were tax cuts, and whether the increased tax base could ensure negligible change in taxation revenue.

4. Implications and the Way Forward

The parameters for Sri Lanka's fiscal health have been in decline for years. The economic crisis has been years in the making. Even after the new government has come to power in the place of the Rajapaksas, recovery will be slow and will not be achieved in a single term. This means that the hardship will continue, and the country will be increasingly reliant on external funding.

Additionally, till now, a majority of foreign exchange has been through external debt financing. As conditions in Sri Lanka hit a new low, countries will impose additional conditions for providing loans as Sri Lanka now poses a higher aggregate risk. Sri Lanka has been facing shortages of essential commodities and the citizens have deplorable living conditions due to a fall in incomes and inability of the state to provide the necessities. Neighbouring countries, like India, should expect an influx of migrants which will only further burden the public goods provision unless managed well. For instance, given the nature of the pandemic and the Russia-Ukraine war, India's buffer stocks are lower than previous years. The pandemic has also constrained employment generation and crumbled the health infrastructure. Lastly, Sri Lanka is strategically placed in the Indian Ocean. Commentators have attributed a part of the debt crisis to stem from China's infrastructure loans that haven't yielded any economic benefits. As China cancelled the setting up of power plants in Sri Lanka, India has signed a deal to do so.

Sri Lanka will have to rely on humanitarian aid to feed its population and fund its fuel for the foreseen future. The government in the

country will have to negotiate with its major creditors like Japan, China and the Asian Development Bank to restructure the repayment of its current debt and possibly be able to seek a write-off for a few loans. The paramount step for the country would be to negotiate a realistic bail-out package with the International Monetary Fund and ensure quick deployment of funds to source fuel and fertiliser for a decent harvest next season.

There are quite a few complications. China may not be willing to accept a “haircut” or incomplete payments, lest it sets a precedent for other countries to whom it has lent large amounts of money. Japan and other creditors will also be unwilling to accept a haircut, if China does not. Even getting emergency funding from the IMF will require complicated negotiations domestically, as the IMF is keen to see unity with the opposition parties on the reform agenda. In multiple instances in the past, Sri Lanka has agreed and then reneged on its promises to reform the economy.

Then, there's the issue of timing. Negotiating with debtors and the IMF is not a quick affair. It may take 6 months in the best case scenario or a couple of years if things prove to be complicated. In

Since China's role in Sri Lanka's indebtedness is quite prominent, the IMF can insist, like it did with Pakistan, that the bailout money cannot be used to repay China.

either case, there will be hardship for ordinary Sri Lankans. The Central Bank will have to raise interest rates and keep it there for a while to tame inflation, which is expected to touch 70% soon. The increased rates will further dampen the economy.

Balancing the budget will be difficult, as expenditure cuts during a disastrous time will be politically costly. Raising tax rates will then become inevitable. Corporation tax may rise back to 30%, indirect taxes to 12%, and income tax rates, at least at the top end, will increase.

There may be some scope to pursue serious disinvestment of large public sector enterprises. Wickremesinghe's administration can look at India's experience in selling Air India and carry out a similar plan to sell Sri Lankan airlines (The Economist 2022).

The Wikremesinghe government must focus on setting up institutional mechanisms to control corruption and mismanagement in the economy, which will act as a strong signal to both the IMF and other creditors. Sri Lanka will have to stabilise itself politically for two major reasons. Political stability is extremely important to control

protests given the public is fed-up with the political class as a whole (Camp 2022). The new government will have a herculean task to restore faith in Sri Lankan democracy and governance. Also, political stability will lead to an increase in tourism. Given the loosening of travel restrictions around the world, Sri Lankan tourism can create an immediate source of foreign currency for the country. Sri Lanka can use this crisis to transform the working of its bureaucracy and advocate for transparency; the country needs to deploy its base of well-educated individuals in daily governance. The near-future for Sri Lanka looks horrendous but maintaining trust and assurance that good days will soon follow can take the country through this period of crisis.

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