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Economic Crisis in Sri Lanka: The way-in and the way-out

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Economic Crisis in Sri Lanka: The way-in and the way-out

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Abstract

This paper is aimed at an investigation into the sources of current economic crisis in Sri Lanka and to outline a policy approach to the way forward. The crisis has built up slowly from the country's anti-export bias growing over the past 20 years. Its last episode ended with the collapse was triggered by a series of external shocks and domestic policy issues during 2020-2021. Sri Lanka presents a classic example of a "twin-deficit" economy with growing policy bias against exports along with an unsustainable economic growth from the debt-financed non-tradable sector. In the absence of a sustainable growth momentum from the tradable sector, there was growing foreign exchange imbalances even though foreign exchange was needed for financing the country's growing imports and maturing foreign debt. The paper concludes that Sri Lanka has a policy need not only to recover from the crisis but also to ensure an export-led progressive growth path beyond the crisis.

Keywords: *Economic crisis, Foreign exchange crisis, Debt crisis, Sri Lanka*

1. Introduction

Economic crises build up slowly, but the collapse is instant. This has been the experience of Sri Lanka as well as elsewhere; the country was caught up in its unprecedented economic crisis in 2022 and with its spiral effects, it is getting deeper. The crisis manifested through the domestic supply shortages in essential commodities, utilities and services such as fuel, gas, electricity, food, medicines, and other necessities. The rate of inflation, which was within the Central Bank's inflation target band of 4 – 6 percent, gradually and steadily increased since late 2021, reporting the highest rate of inflation in Asia since early 2022. While people's real incomes have fallen sharply against skyrocketing prices, the economy had already lost production and aggregate demand since the second quarter of 2020 due to the economic impact of the global health crisis – the COVID-19 pandemic. Although the COVID-19 pandemic was abated by the early 2022, the shortages of inputs including fuel, gas, and electricity did not permit the country's economic recovery.

The crisis-impact on the country's poverty and people's livelihood appears to be significant, although it is too early to provide nation-wide information. According to the estimates of the United Nations Office for the Coordination of Humanitarian Affairs (OCHA), out of the 22 million total population "around 5.7 million women, men, girls and boys are now in urgent need of humanitarian assistance" (UN, 2022). In addition, as the report, which is based on surveys revealed, up to 70 percent of households had to reduce food consumption, by skipping meals and reducing quality and quantity, while food prices in Sri Lanka have reportedly increased by 73 percent in the last two years. The delays in the recovery of the country from its economic crisis naturally leads to multiple crises in the areas of political, social and humanitarian domains. With the loss of the bargaining power, the country is also seen as becoming a victim of geopolitical power struggles.

It is a big question as to why a country as such, which had admirable economic and welfare standards even at the time of its political independence from Britain in 1948, has now fallen into a tragic economic crisis and has been reduced to a 'hand-to-mouth' status (of existence). Once it could also boast of its leading role played in the region by being the first country in South Asia to adopt trade policy reforms and offering itself as the most liberal economic regime in the region. For the same reason, Sri Lanka was once seen as performing to be one of the Newly Industrializing Countries (NICs) of the second generation, following the footsteps of its first generation that comprised Singapore, South Korea, Taiwan and Hong Kong. The end of the separatist war in 2009, if it was at all responsible for the dismal economic performance at the time (Abeyratne & Rodrigo, 2006; Athukorala & Jayasuriya, 1994), was a turning point for the Sri Lankan economy which would have gained its momentum to prosper within a peaceful political environment. However, the economic journey after 2009 was clearly marked by the building up of the crisis.

The purpose of this paper is to investigate the sources of the crisis and outline the policy recommendations required for the country's recovery plan. The paper concludes that Sri Lanka's

foreign exchange problem is in the heart of the current economic crisis. An investigation into the sources of the crisis is necessary in order to address the problem at its source. While there are diverse popular explanations underlying the causes of the crisis, the importance of the foreign exchange problem seems to have been diluted among them, if not completely ignored. For the same reasoning, the recovery path that has been under discussion, seems to have little focus on the foreign exchange problem.

The paper is organized as follows: Section 2 presents an analysis of Sri Lanka's policy bias against export growth, in spite of its initial move towards an 'export-oriented' economy. In the midst of a growing 'anti-export bias', Sri Lanka's increasing reliance on short-term capital flows is discussed in Section 3. Accordingly, Sri Lanka missed the opportunity to grow on par with many other Asian countries, which made up the 'Asian Century' as explained in Section 4. While Section 5 outlines the 'disabling' environment for FDI promotion which is an integral component of export growth, Section 6 converges the end of the journey with the economic crisis, led by a series of triggering factors. Finally, Section 7 presents the concluding remarks with policy implications directing the country towards its way out of the crisis.

2. Anti-Export Bias

The twin deficit hypothesis is an interesting macroeconomic relationship that has been studied extensively from both theoretical and empirical perspectives in the subject areas of macroeconomics, international economic and development economics. The hypothesis shows that there is a strong link between a country's budget deficit and its trade deficit. In other words, there is a causal relationship between a country's internal finance (government budget) and external finance (balance of payments). Although studies have derived mixed conclusions owing to the selection of methodology, specification of data and, the hypothesized causal relationships, the prevalence of a twin deficit problem is undisputable.

Twin deficit hypothesis

As derived from the twin deficit hypothesis, at the outset, it is apt to outline the following two growth scenarios which may be strongly observable in some of the developing countries in the world:

- *Growth through trade expansion*: In some countries, increased export growth has become the main growth driver so that their growth was sustainable and that it has led to a sound budgetary position as well as a better trade performance. This has been the story of successful export-oriented economies in East Asia and South East Asia from the beginning and, now in some of the South Asian countries like India and Bangladesh. As a result, their economic growth is strongly associated with export expansion, leading to a self-accelerating growth momentum.
- *Growth through fiscal expansion*: In some countries, increased government spending has become an important growth driver making their growth unsustainable, while resulting in

the so-called 'twin deficit' – budget deficit and trade deficit. Growth is unsustainable because it repeatedly requires increased government spending largely through credit financing on the one hand and, it increasingly tends to be biased towards 'non-tradable' sector expansion on the other hand. The need for increased government spending generates budget deficit, while the increase bias towards the non-tradable sector leads to trade deficit.

Undoubtedly, Sri Lanka has been a country entangled in the second growth scenario. While the country has suffered from "policy bias against exports" over a long period of time in its liberalized trade regime (Abeyratne, 1993), its increase in favour of non-tradable sector growth has been outstanding in the recent past, particularly since the turn of the century.

Dismal export performance

Compared to many of its Asian neighbouring countries, including those of which the economic status was much lower, Sri Lanka presents a rather wretched status of export growth. The country's total merchandise exports amounted to US$5 billion in 2000 and increased to only US$10 billion by 2020. Bangladesh, which had just US$6 billion increased to US$34 billion. Cambodia and Myanmar, which had just US$1 and US$2 billion worth exports in 2000 respectively, appear to have increased their exports to US$18 and US$17 billion by 2020. Vietnam, which had levels of exports similar to Sri Lanka amounting to US$5 billion 25 years ago, improved tremendously reaching US$283 billion by 2020.

Table 1: Merchandise exports expansion in 25 years (US$ bn)

Country	1995	2000	2010	2020
Bangladesh	4	6	19	34
Cambodia	1	1	5	18
India	31	42	226	276
South Korea	125	172	466	512
Malaysia	74	98	199	234
Myanmar	1	2	9	17
Singapore	118	138	352	363
Sri Lanka	4	5	9	10
Thailand	56	69	193	232
Vietnam	5	14	72	283

Source: World Bank, World Development Indicators

As a percentage of GDP, Sri Lanka's exports have declined from around 33 percent in 2000 to 15 percent by 2010 and, continued to remain below 15 percent throughout the subsequent period. Exports of goods and services have recorded a decline from 39 percent of GDP in 2000 to below 20 percent in 2010. Largely owing to the rapid increase in tourist arrivals and tourist earnings after the end of the separatist war in 2009, there has been a slight upward trend in exports of goods and services reaching over 23 percent of GDP in 2019; given the global health crisis led by the COVID-19 pandemic, it has dropped sharply thereafter.

These indicators clearly show that Sri Lanka is far from being a distinguished export performer in Asia, in spite of its ability to boast about being one of the first few countries in the region to undertake export-oriented trade policy reforms some 40 years ago. An investigation into the issue reveals a couple of important historical facts with a distinction that can be made between the pre-2005 policy regime and the post-2005 policy regime.

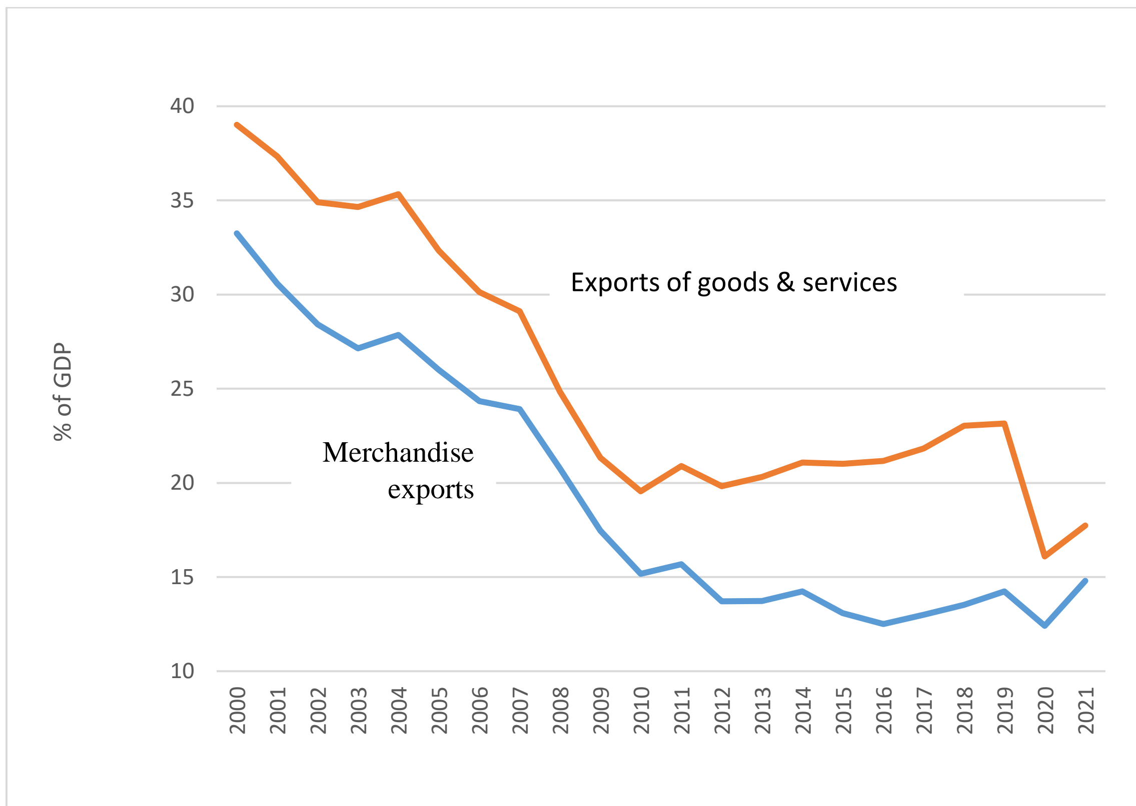

Figure 1: Exports of Sri Lanka, as a % of GDP
Source: World Bank, World Development Indicators

Sri Lanka's export-oriented policy reform process has been marked by two major reform initiatives. The first is the initial trade liberalization that was implemented in 1977. This entails a dramatic shift in its trade-orientation from one of the import-substitution regimes to an export-oriented regime with the adoption of tariff reforms, removal of non-tariff barriers, relaxation of foreign exchange payments, liberalization of the market mechanism and the establishment of a flexible and unified exchange rate system. However, Sri Lanka did not undertake public sector reforms and public enterprise reforms but opened the floodgates for large-scale corruption and the deterioration of the rule of law. Thus, some of the fundamental pillars of an 'open economy' were not established in order to strengthen the newly-established export-oriented trade regime.

The second wave of trade policy reforms came into effect in 1989 where the policy reforms were aimed at stabilizing the economy with fiscal and monetary prudence, reducing pressure on the balance of payments, deregulating the market mechanism and enhancing export promotion. As a result of these reforms, the tariff schedule was simplified and rationalized further, and the Sri Lankan rupee was fully convertible on current account transactions. The government intervened in the country's export promotion drive, while the government initiated the delayed privatization programme as well.

Sri Lanka's export expansion and the structural changes in the country's traditional export mix were the results of these two-tier policy reforms. Even after 40 years, whatever the positive achievements that Sri Lanka achieved and maintained in terms of its export expansion are a result of these two-tier policy reforms. An interesting observation is that the export-oriented policy reform process of Sri Lanka has come to a standstill over the past 25 years. Under the new government that came to power through the Presidential and the Parliamentary elections, Sri Lanka's export expansion started recording a dismal performance in spite of the favourable global market conditions. It was also the decade that many of the late-comers to trade liberalization policy reforms, including the South Asian countries, reported achieving better export performance.

3. Short-Term and Volatile Capital Flows

Under the post-2005 policy regime established by the new government that came into power in 2005, there was a virtual termination of the export-oriented policy drive. Instead, the government re-directed the country's development strategy emphasizing on the government's extensive role in the economy and on the importance of domestic economic activities and rural agriculture, undermining the export drive. In the context of a re-defined macroeconomic policy framework, the government was assigned to play a more intensive role in the economy than before. This resulted in an expansion of the size of the government and increased public spending. This was also the time when externally, the international economy was moving into the global financial crisis in 2008-2009, while internally the country was experiencing the final stage of the war. Therefore, whatever the medium-term economic outcome may be, the re-directed development strategy and the re-defined macroeconomic policy framework received popular political mandate.

Even though Sri Lanka was able to maintain its moderate rate of growth, the balance of payments and the government finance came under severe strain worsening the country's fundamental macroeconomic problems. The worsened macroeconomic problems were also aggravated internally by the increased military expenditure and, externally by the global energy and food crises. The internal economic and political developments in Sri Lanka as such show that the country felt the impact of the global financial crisis in 2008-2009 in the midst of its home-grown macroeconomic crisis. The economy appeared to have been hit by a 'twin crisis' – one being the global crisis and the other, the internal crisis.

The country's official foreign exchange reserves declined sharply in the attempt to defend the weakening exchange rate by the Central Bank. The monetary authorities were left with two short-

term options to face the emerging foreign exchange crisis. The first was to let the exchange rate depreciate and the second was to use the official foreign exchange reserves; they chose the latter. The outcome was the sharp decline in official foreign exchange reserves from US$ 3.5 billion to US$ 1.2 billion just within 12 months ending in March 2009. Thereafter, there were no other options left in order to rescue the country from falling into a foreign exchange crisis. However, the IMF finally approved its much-awaited financial assistance with a reform programme in July 2009 – the Stand-By Arrangement with US$ 2.6 billion which would be disbursed in eight tranches within 20 months. The country narrowly escaped from the crisis which was averted with the increase in short-term capital inflows followed by the Stand-By Arrangement with the IMF.

Table 2: Foreign Direct Investment (FDI) and International Sovereign Bonds (ISB) (US$ mn)

Year	FDI inflows	ISB issuance*
2007	603	500
2008	752	-
2009	404	500
2010	478	1,000
2011	956	1,000
2012	941	1,000
2013	933	-
2014	894	1,500
2015	680	2,150
2016	897	1,500
2017	1,373	1,500
2018	1,614	2,500
2019	743	4,400
2020	434	-
2021	598	-
Total	12,300	17,550

* ISB does not include US$-denominated Sri Lanka Development Bonds (SLDB) and the foreign borrowings of the State-Owned Enterprises (SOEs).
Source: FDI inflows from UNCTAD database and, ISB data from CBSL

With the approval of the IMF programme and the successful conclusion of the separatist war, the year 2009 was marked with an unprecedented opportunity to embark upon its much-delayed policy reform programme to focus on trade performance. However, what is interesting to note is that instead of strengthening the foreign exchange earning capacity through exports and FDI inflows, the country entered to a real "gala time" supported by the increased short-term capital flows (Abeyratne, 2009). In the midst of global economic recessions, there were increased FDI outflows from advanced countries such as the USA, the EU and Japan mainly to developing countries in Asia, but these FDI flows seem to have avoided Sri Lanka which failed to present itself as an attractive investment destination. Instead, Sri Lanka increasingly resorted to short-term capital

inflows through the Stock Exchange and Government Securities and commercial borrowing through the issuance of International Sovereign Bonds (ISBs). In the absence of export growth and FDI inflows, portfolio capital inflows to the stock market and the government security market made the foreign exchange transactions more volatile and the BOP problem more vulnerable to external shocks.

In 2007, while the government security market was opened for foreign investment, Sri Lanka also commenced its foreign commercial borrowings by issuing ISBs. During the 12-year period from 2007-2019, the Sri Lankan government has borrowed US$ 17.55 billion in total by issuing ISBs, while the period of the last five years from 2015-2019 was marked by over 68 percent of foreign borrowings from ISBs. The ISBs had the maturity periods of 5 and 10 years and offered at 6 – 8 percent interest rates with one of the highest premium offerings in the world; compared to that, during the same period, Sri Lanka has received FDI inflows amounting to US$ 12.5 billion only. In addition, the government also borrowed by issuing the US$-denominated Sri Lanka Development Bonds (SLDB) while providing bank guarantees for some of the State-Owned Enterprises (SOEs) to borrow in foreign currency.

4. The Asian Growth Trajectory and Sri Lanka

Global FDI outflows over the past few decades exhibited two-fold distinctive features as exponential growth and increased diversion towards developing Asia. But the irony is that Sri Lanka, firstly due to the internal conflict and secondly due to the unfavourable policy and regulatory framework, was unable to benefit from it. The global FDI outflows, according to UNCTAD data, which amounted to US$ 200 – 300 billion in the first half of the 1990s, continued to report over US$ one trillion after 2006; they remained at an annual average around US$ 1.5 trillion during the past 15 years although there were intermittent falls in some of the troubled years. Until the 1990s, global FDI flows, which emanated from the world's advanced countries – mainly the US, the EU and Japan – flowed largely into the same advanced countries, while the developing countries were receiving only 20 – 25 percent of the global FDI flows. The period after 2010 was marked by increased global FDI flows to developing countries as high as 50 percent of the global total, while in 2014 it reached 60 percent.

As part of the global economic dynamics, there has been a global shift in production from the Western advanced countries towards Asian developing countries over the past few decades. Global capital begins to flow out during economic recessions, a process which makes the recessions faster. As the advanced countries were speeding up their economic recession leading to 2009 global economic crisis, the Asian developing countries were opening their economies to welcome global capital flows from the advanced countries. Thus, slowing down of the engine of growth in the West and the rising of many Asian economies at the same time were two sides of the same coin.

The countries that were the largest beneficiaries of the changing FDI dynamics in the world were in Asia. The top-three FDI recipient countries in Asia were China, Singapore and India during

2011-2020; on annual average basis, China has secured US$ 133 billion, Singapore almost US$ 70 billion and India US$ 41 billion.

Table 3: FDI Inflows to Selected Asian Countries (US$ bn)

	2011-2020 Annual average	2021
Bangladesh	2.1	2.9
Cambodia	2.5	3.5
China	133.2	181.0
India	40.8	44.7
Malaysia	9.4	11.6
Myanmar	2.1	2.1
Singapore	69.5	99.1
Sri Lanka	0.9	0.6
Thailand	7.0	11.4
Vietnam	12.0	15.7

Source: UNCTAD database

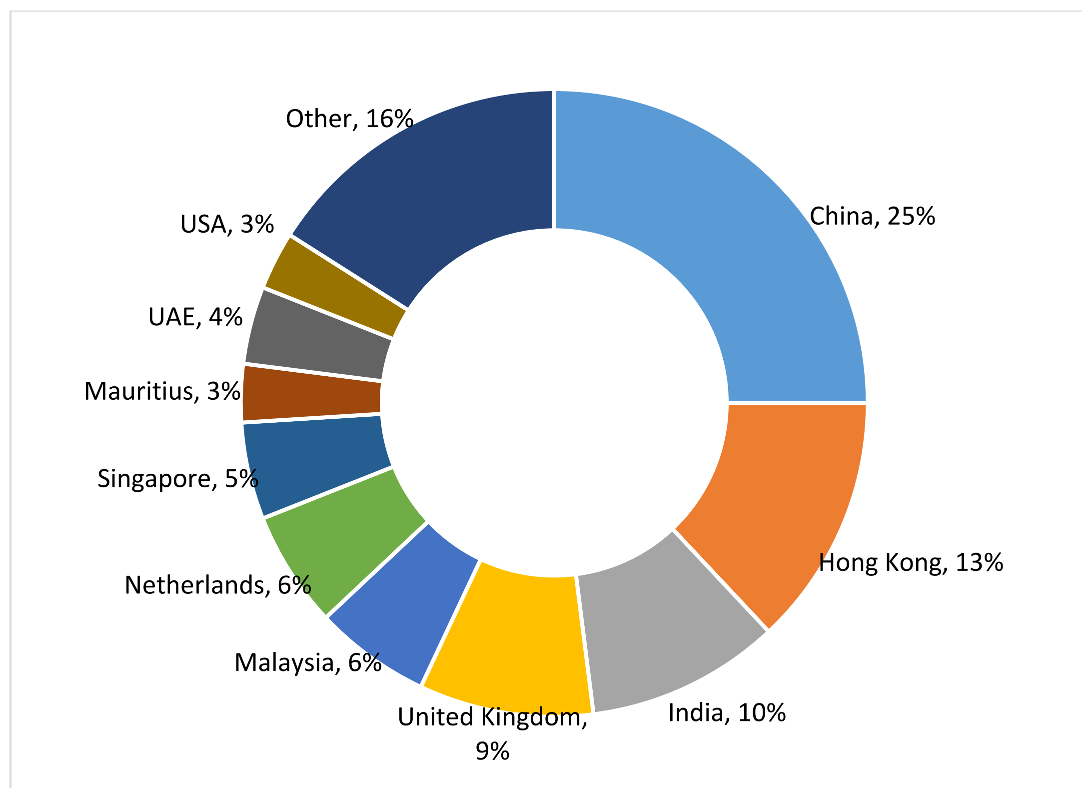

Figure 2: Cumulative FDI inflows to Sri Lanka by source countries (2012-2021) as a % of total FDI flows

Although Sri Lanka had already restored its peaceful political environment during this time, its performance in terms FDI inflows was even lower than Bangladesh, Cambodia, and Myanmar. In fact, Sri Lanka reported to be one of the lowest FDI recipient countries in Asia with less than US$ one billion a year on average during the same period of 10 years.

Source: Board of Investment, Sri Lanka

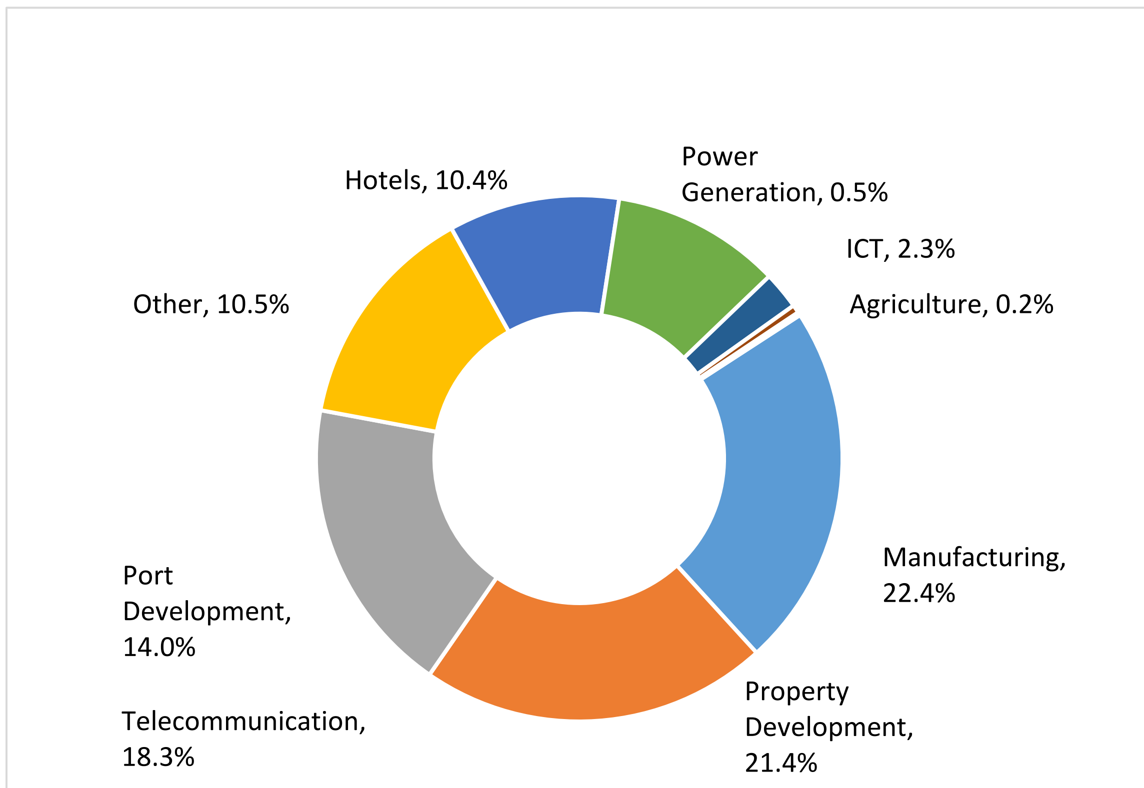

Figure 3: Cumulative FDI inflows to Sri Lanka by Sector (2012-2021) as a % of total FDI Flows

Source: Board of Investment, Sri Lanka

Interestingly, it is not only that Sri Lanka had a poor record of FDI flows, but they were also confined to a few source countries indicating that Sri Lanka was not generally considered to be an attractive investment destination in Asia. A quarter of FDI flows have emanated from China, followed by Hong Kong, India, UK and Malaysia. Chinese investment also had a bigger share of Sri Lanka's foreign investment due to the 99-year lease of the Hambantota Port for US$ 1.12 billion in 2017 and the construction of the Colombo Port City on a reclaimed piece of land at the cost of US$ 1.4 billion during 2016-2020; this is a considerable share of the total foreign investment of US$ 13 billion during 2012-2021.

Chinese investment is distinctively different from the world's general investment patterns due to the expected rate of return on investment over a considerably longer period of time. Usually, return to investment is expected through 10 – 20 years, but Chinese investment does not hesitate to offer

a period much longer than that, perhaps, even more than "double" of that. By implication this means that, generally, FDI is sensitive to the current policy and political environment of the host country—the Chinese investment appears to have looked at the current circumstances and decided on available investment opportunities favourably.

Furthermore, most of the FDI that flowed into Sri Lanka was not in the tradable sector, contributing to the country's export growth. While FDI in manufacturing sector was only 22.4 percent of the total during 2012-2021, large FDI projects were in the areas of property development, telecommunications, port development, and hotels. By implication, FDI flows to Sri Lanka appears to have made little contribution to the country's tradable production and to generate export growth.

5. Disabled Environment for FDI

The question of why Sri Lanka failed to attract FDI into tradable production needs to be answered. It is the inability of the country to present itself as a conducive environment for investment and business promotion. Sri Lanka's regulatory framework governing trade, investment and business directly or indirectly consists of 67 Parliamentary Acts and Ordinances, resulting in a complex and lengthy bureaucratic procedure with a lack of clarity and consistency. According to the determinants for the ease of doing business as computed by the World Bank Group (2020), out of the 10 most important areas of doing business, Sri Lanka scored well over 80 only in one area – starting a business. In the areas of construction permits, getting electricity, protecting minority investors and, trading across borders, Sri Lanka's score was behind 50 countries in the world; in all other areas of business operations, namely registering property, paying taxes, getting credit, enforcing contracts and resolving insolvency, Sri Lanka scored poorly. The main issue is not the fact that Sri Lanka has been poorly positioned among other Asian countries, but its continuous stagnation in that position without progress. Sri Lanka has never addressed over the past 40 years the need for reforms in the areas of the rule of law, corruption, judiciary and police, resulting in a deterioration of the country's law and order and an escalation in political interference undermining the democratic institutions.

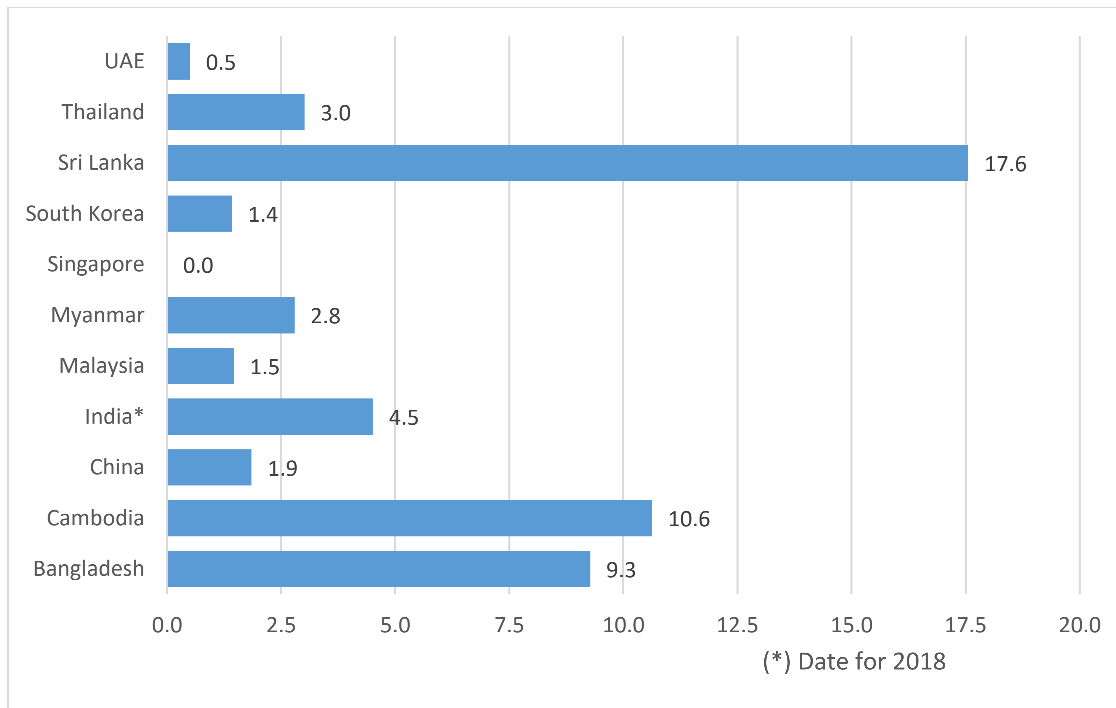

Figure 4: Taxes on international trade 2019 in selected countries as a % of government revenue
Source: World Bank, World Development Indicators

Instead of being important pillars of an export-oriented market economy, Sri Lanka continued to perform poorly in the area of legal system and property rights, as well as in policies and regulations affecting international trade, as depicted by the Report on Economic Freedom of the World (Abeyratne, 2021). Even though initial policy reforms were aimed at trade liberalization, the lack of smooth continuity and the ad hoc revisions intermittently have led to significant setbacks in freedom for international trade, which have made Sri Lanka to be one of the "protectionist regimes" among the Asian countries. This is clearly seen through the heavy reliance of government revenue on taxes on international trade. Taxes on international trade refer particularly to those on imports which were subject to a simple three-band tariff schedule plus complicated para-tariffs introduced for revenue purposes. Altogether, Sri Lanka's taxes on international trade made up 17.5 percent of the government revenue, compared with 4.5 percent in India and less than two percent in most of the high-performing Asian economies. This has not only contributed to Sri Lanka's policy bias against exports, but has also made Sri Lanka less attractive to FDI in the areas of tradable production such as manufacturing.

Moreover, FDI flows to the Sri Lankan economy were further discouraged by a series of structural problems which contributed to weaken the country's business environment. Constant and frequent changes – sometimes, overnight changes – in policy measures and regulatory elements implemented in an *ad hoc* and piecemeal manner, made it difficult for foreign investors to

understand the country's legal framework. Sri Lanka's taxes and import duties, customs procedures, rules, foreign exchange regulations and import and export controls are subject to frequent changes within a short time span. Various Acts, including the Foreign Exchange Act, retain a significant number of deviations making the liberalization process a less-meaningful exercise and hindering potential foreign investment. Outdated labour laws, including employment termination procedure, and regulations restricting land acquisition for investment are far from being competitive in the region in attracting FDI.

While there is little opportunity for international arbitration within Sri Lanka, resolving commercial disputes is subject to considerable delays within the Sri Lankan judiciary system. The introduction of arbitration as an alternative dispute mechanism has also failed to provide expeditious dispute resolution mechanisms to investors as it has grown to be very much similar to the normal court proceedings which may take 3 – 4 years or even more to reach a conclusion.

The Sri Lankan Rupee has been subject to constant volatility and long-term depreciation against the US Dollar and other major currencies in the absence of more stable foreign exchange earnings from export growth. Over the past 40 years from 1979-2019, the Rupee exchange rate of the US Dollar has depreciated from LKR 16 to 180, and in the face of the crisis to 360 by the early 2022. Although technically currency depreciation does not affect export-oriented manufacturing, it's both the market instability and *ad hoc* market interventions that cause risks and uncertainty in all types of international business. Thus, exchange rate volatility and depreciation as well as frequent changes in Central Bank's exchange rate policy have had an adverse effect on FDI and portfolio inflows creating foreign exchange risks and uncertainties for foreign investors.

Investors also face higher costs of Political Risk Insurance (PRI) for investments in Sri Lanka, which is an insurance policy for investors against loses due to disruption of business operations by political events as well as by government's actions. While political stability and policy consistency are imperative in attracting FDI, Sri Lanka is regarded as a "high risk" country for doing business due to frequent disruptions to business. The PRI is required by foreign investors for safeguarding their businesses against political risks and uncertainties, it is an expensive cost driver for FDI entering Sri Lanka.

6. End of the Journey and the Fall

By the end of the journey in 2019, it was clearly evident that Sri Lanka cannot repay its "foreign loans" by earning "rupee-incomes" from the non-tradable sector growth. It requires export growth and FDI inflows which were absent in the Sri Lankan prolonged growth trajectory that was pushed through increased government spending. The early post-war high-growth scenario based primarily on construction and reconstruction activities financed largely by government spending had slowed down towards the end of the decade simply because the non-tradable sector could not stand alone in the absence of tradable sector expansion. For instance, in the early years after the war ended, on average the rate of real GDP growth was 8.5 percent during the period of three years from 2010-2012; it gradually declined to 5.0 percent in the middle of the decade and further down to 2.3

percent in 2019. Towards the end, there was a series of attacks too, including the aborted attempt to topple the government by the then President in 2018 and the coordinated Easter Sunday terror attacks in three hotels and three churches in 2019.

Triggering factors

Along with that, the new government that came to power in 2019 committed two more policy blunders. The first is the massive income tax cut in 2019 resulting in a decline in government revenue by one-third, compelling the government to accelerate its borrowings to meet expenditure requirements. The second is the overnight transition to organic agriculture by banning the imports of chemical fertilizer, which resulted in a sharp reduction in agriculture value addition by 2.2 percent in 2020 with a remarkable drop in domestic agricultural output in rice, vegetables and fruits. Although the agriculture sector growth bounced back in the following year 2021, the Central Bank of Sri Lanka noted that "the lack of relevant nutrients and agrochemicals prevented it from reaching its full potential particularly during the second half of the year" (CBSL, 2021, p.59). Additionally, the government increased public sector recruitment – a popular political measure that the Sri Lankan government had increasingly resorted to after 2005, which also aggravated the government's fiscal management responsibility. The government had abandoned its compliance to the fiscal rules introduced by the Fiscal Management (responsibility) Act, No. 3 of 2003. During the 15-year period from 2005-2020, public sector employment has increased in net terms by about 500,000 from one million to 1.5 million, whereas the increase in total labour force was only 350,000.

When the COVID 19 pandemic hit the economy causing lockdowns and economic losses as a triggering factor of the crisis, the Sri Lankan economy was already at the doorstep of a collapse. In fact, Sri Lanka had already come to such critical points of collapsing several times earlier, but each time it was narrowly averted by some external factors, which was not so this time. The economic contraction in terms of loss of economic growth and trade performance only made the situation worse, setting the parameters to a deeper crisis. Because the country's credit worthiness has been downgraded by the international credit agencies such as the Fitch, Standard & Poor and, Moody's, the government was in a difficult position to borrow internationally.

Table 4: Internal and External Finance, 2018 and 2021

	2018	2021
Internal Finance		LKR bn
Government revenue	1932	1464
Recurrent expenditure	2090	2748
Salaries and wages	626	846
Interest payments	852	1048
Subsidies & pensions	343	596
Total expenditure	2693	3522
Total debt service payment	2089	2376
External finance		US$ bn
Foreign exchange inflows	27.5	20.6
Merchandise exports	11.9	12.5
Services including tourism	8.4	2.5
Remittances and other transfers	7.0	5.5
Other	0.2	0.1
Foreign exchange outflows	36.2	28.2
Merchandise imports	22.2	20.6
Sale of services	4.6	0.9
Other income payments	3.5	2.1
Foreign debt service payment	5.9	4.5

Source: Annual report CBSL, 2019 and 2021

As the tax revenue declined further against the negative economic repercussions of the health crisis, the government resorted to excessive borrowings from the Central Bank, which is widely known as “money printing”. Trade performance and foreign exchange earnings contracted due to the health crisis, while foreign portfolio investments in stock exchange and government securities were withdrawn by the foreign investors. Thus, the exchange rate was under pressure, while the government attempted to deal with the foreign exchange shortage by adopting import controls and foreign exchange restrictions as well as by resorting to a couple currency swaps and credit lines with the neighbouring countries. Policy measures as such were inadequate, and the Central Bank attempted to avert, though temporarily, the pressure on the exchange rate by using the Central Bank’s foreign exchange reserves. However, by the end of 2021, the Central Bank lost its stock of foreign exchange reserves, which was, anyway, no more than US$ eight billion.

Internal and external finance

The current crisis was clearly seen through the internal and external finance situation of the country in 2021, compared with that of 2018 – the year with better performance before the crisis. With respect to internal finance, the government’s revenue was LKR 1,464 billion in 2021 – a decline by LKR 468 billion from 2018. However, government expenditure has increased by LKR 829 billion accounting to more than double the revenue. Salaries and wages, interest payments and, subsidies and pensions alone accounted for LKR 2,490 billion or 170 percent of government

revenue. In addition, debt service payments have also increased far above the government revenue compelling the government to resort to more borrowings to pay off its previous borrowings. However, the main issue in question was that the government which has already lost its "credit worthiness" had limited options to borrow other than getting the Central Bank to "print money" which was done continuously.

With respect to the country's external finance situation, there was a US$ 8.7 billion shortage of foreign exchange receipts in 2018 even after meeting US$ 5.9 billion foreign debt service. In 2021, after adopting import controls and foreign exchange restrictions, utilizing bilateral credit lines and swap arrangements and, exhausting the Central Bank's foreign exchange reserves, there was a US$ 7.6 billion shortage of foreign exchange receipts. The main issue was that there were neither foreign exchange reserves left with the Central Bank nor foreign borrowing options available under the downgraded credit worthiness. Thus, since the early 2022, domestic supply shortages engulfed the remaining economic activities and people's incomes and livelihoods, while the Central Bank declared suspension of the payment of maturing bilateral and private debt on the 12th April 2022.

7. Concluding Remarks

The Sri Lankan experience with its current economic crisis confirms that "crises build up slowly, but the collapse is instant". It was primarily a foreign exchange crisis which was nurtured through increased government spending pushing non-tradable sector expansion in the midst of aggravating policy biases against export growth. As the "twin deficit hypothesis" suggests, the countries which deviate from export growth and prioritize fiscal expansion are likely to end up with an unsustainable growth momentum and a twin deficit – trade deficit and budget deficit. Sri Lanka presents a classic case study of the twin deficit hypothesis. When a series of policy blunders and external shocks knocked the economy in 2019 and 2020, it already prepared itself for the collapse.

Recovery from the crisis is not at all a simple way out because returning to 2019 status of the economy does not ensure long-term growth and stability. It requires a much longer-term path beyond recovery. While export growth and, for that matter FDI promotion, is an essential component of the way out of the crisis, macroeconomic stability with fiscal consolidation and monetary discipline is expected to support the long-term recovery and progress through tradable sector expansion. There is no dispute over the fact that export growth and FDI promotion require far-reaching policy reforms that have been abandoned over the past 25 years. In the meantime, short-term measures including recovery programmes with the IMF and other multilateral donor agencies such as the World Bank and the Asian Development Bank (ADB) are worthwhile to keep the economy floating. However, such multilateral programmes are unlikely to bring about a long-term reform programme for export growth which is primarily the responsibility of Sri Lanka and not of any donor agency.

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