ColomboArts
Journal of Social Sciences and Humanities
Volume 6 | Issue I 2021
ISSN 2536-894X

Sri Lankan Economy: A Tale of Misidentification of Priorities, COVID-19 Shock, and Recovery

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Recommended Citation
Vidanagama, S. (2021). Sri Lankan Economy: A Tale of Misidentification of Priorities, COVID-19 Shock, and Recovery. *ColomboArts Journal of Social Sciences and Humanities, 6*(I). 1-26.
Available at: https://colomboarts.cmb.ac.lk/?p=556

Sri Lankan Economy: A Tale of Misidentification of Priorities, COVID-19 Shock, and Recovery

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Abstract

With the onset of the pandemic, certain areas of the economy had to be closed down. The immediate reaction of many analysts was to place the blame of the resultant slowdown of economic activities on the pandemic. However, a close examination of the Sri Lankan economy over the past decades shows that the economy was in no place to face an exogenous shock such as a pandemic. Thereby, such a slowdown was inevitable. However, the pandemic only aggravated the problems caused by three longstanding gaps in the economy. These gaps were mainly caused by poor growth performance and misidentifications of priorities by policy makers since independence in 1948. Considering the seriousness of the pandemic, the immediate way-out strategy in the short and medium term appears to be implementing measures to achieve the long-term growth that the country anticipated before the pandemic destabilized the economy. Once that is achieved, long term policies could be put in place to reach the status of a 'developed country'.

Keywords: COVID-19 shock, Sri Lankan economy, missed opportunities, GDP growth, Sri Lanka

Introduction

The COVID -19 pandemic, which was spreading across the globe arrived in Sri Lanka, in early 2020, slowing down economic activities which was already had only a growth rate of 2.3 % in 2019 to a negative figure of 3.6 % in 2020 (CBSL, 2020). The pandemic continues to further deteriorate macro-economic fundamentals this year as well. However, it must be emphasized that, the slowdown of the economy was not entirely the result of the pandemic. The slowdown of the economic growth rate began much earlier. In fact, the country witnessed a slow economic growth a few years after its independence in 1948 (Corea, 1950; Das Gupta,1955; Kelegama, 1957) and it continued with some intermittent exceptions resulting from several endogenous as well as exogenous factors. Whilst there were frequent downturns, the current phase began since 2013, after a few years of extraordinary high economic performance, first during the period of 2005 -2008 and next during the period of 2010- 2012, deviating from the average growth rate of about 4.5 – 5.0 percent seen during the period of post-independence in Sri Lanka. The first period witnessed a growth rate of 6.8 percent while the second period saw an extraordinary growth rate of 8.5 percent followed by a drop to 3.4 percent in 2013. The six years that followed (up to 2019) recorded only an average growth of 4.0, which significantly reduced in 2019 to 2.3 percent before becoming a negative figure in 2020, suggesting that the growth was on the decline even without the pandemic. Therefore, the pandemic only aggravated the situation, and is not entirely responsible for all the economic ills of the country.

In reality, the country has faced some infrequent good times, but often has had bad times during the seven decades after independence. This was partly due to the nature of the economy we inherited from the colonial rulers and mostly due to the weak economic management that led to 'missed opportunities' after the independence (Snodgrass, 1966). It has to be emphasized that problems of the external balance which emerged during the first decade after independence continuously affected the economy, except during a couple of years, and that it worsened in later years, which forced the authorities to curtail the import expenditure in order to save foreign reserves. The shortage of reserves compelled authorities to look for alternative measures to pay off the foreign debt accumulated over the years.

In the current phase, the government's decision not to negotiate and accept assistance from the IMF has created a serious problem of paying the foreign debt amounting to $19 billion during the next few years with depleted foreign reserves, which could, at the end of 2020, cover the import costs for only 3 more months. The sources of earning foreign exchange have dried up forcing the country to obtain funds from other avenues at market rates of interest. On the internal front, both agriculture and industry have shown signs of slowing down and the services, the dominating sector of the economy, is severely affected due to the closure of some areas affecting production, distribution, trade, and self-employment activities.

The objective of this paper on the one hand is to examine whether the pandemic occurred at a time when the economy was in a sound position or if the economy was unstable with main economic variables displaying weak characteristics, because the state of the economy when the pandemic occurred matters in appraising its effect on the economy. The examination of the macro- economic performance in recent years clearly indicates that the economic growth of the country has been lower than a long-term growth path amounting to less than 4% per annum from 2013 onwards. The past global experience shows that how an economy reacts to and is affected by an exogenous disturbance is determined by the status of the economy at the time of its occurrence. For instance, a country with sound economic fundamentals such as a high growth, less indebtedness and a sound external position with a stable exchange rate would be more resilient to an external shock, than a country that has weak economic fundamentals. Thus, we must firstly examine if there were growing fundamental problems in the Sri Lankan economy, even before the onset of the COVID-19 pandemic, which should have been identified and resolved by different regimes that were in power over the past seven decades. We should examine whether these problems were not identified on time for treatment or whether they were not identified at all, which could have led to misidentification of priorities (Snodgrass, 1966, 1998). On the other hand, we should examine if the pandemic worsened the state of the economy by forcing the country to a lockdown.

In attempting to answer these questions we need to be conscious of the nature and the status of the economy, not only at the point of the exogenous shock, but also over a much longer time. In this context, more attention must be paid to the modern period, i.e., after the economic liberalization of 1978. However, we need to understand the major strengths and weaknesses of the economic fundamentals at the time the independent economic policies commenced, because the original status of the economy had a substantial influence on its later stages. That would give an idea of the strengths and weaknesses of the economy at the time of the exogenous shock, i.e., the pandemic.

This is a descriptive analysis, performed based on data published over the years and the literature on the behavior of the economy over a period of seven decades. The first part presents the background information and statistics related to the first period considered relevant for this study, which is the period up to 1978, also described as the first missed opportunity. Thereafter, a brief analysis is carried out on what we consider to be the period of the second missed opportunity; the liberalized period from 1978 onwards. The main analysis focuses on the period after 2000, during which the current vulnerabilities in the economy heightened, worsening the three gaps in the economy, and making it almost impossible to manage an exogenous shock such as a pandemic.

Contextual setting: The first missed opportunity

At the time of independence in 1948, Sri Lanka (Ceylon) was considered a “developed” third world country, in comparison to many other countries in the Asian region. As Table 1 shows, even by the mid-50s, it was only second to Malaysia (which included Singapore as a part of the country). The country had an annual growth rate of 6.0 percent, ample foreign reserves for almost 10 months of imports, and a small population of approximately 7 million. With the growth of the export income due to the Korean boom and the tea boom in the early 50s, there arose a good opportunity to lay the foundation for economic growth. But the first Sri Lankan administration’s preoccupation with two main policies, i.e. (a) developing domestic agriculture and (b) the provision of welfare measures covering the entire population, prevented the country from pursuing those opportunities (Hicks, 1959; Kaldor, 1958, 1959; Robinson, 1959). Furthermore, the recommendations made by the first World Bank mission in 1952 (WB, 1953) did not support changing the status quo to diversify the economy through measures like industrialization, making it the first missed opportunity of Sri Lanka (Snodgrass, 1966). In addition, the ‘misidentification of priorities’ by the regime proved to be very costly and, in some ways, supported the opinion expressed by the British colonial government at one point during the struggle for independence, which was that Ceylon and its people were ‘not ready yet’ to have self-governance, to manage economic affairs successfully and to enjoy democracy. It was proven to be true in no uncertain terms, through actions taken during the State Council era which entailed the decision to extend the welfare culture introduced during the colonial time (mainly to help

Indian estate workers), as well as policies that were heavily consumer oriented. A few years later, the country experienced an economic downturn, with a slow growth rate of 0.7% by 1956. This trend continued for the next few years and the country suffered from a weak external financial position with dwindling reserves.

Table 1 shows how, in the mid-fifties, only two countries (Malaysia which included Singapore and Hong Kong) were ahead of Sri Lanka with higher per capita incomes in the Asian region (Bhagwati, 1966). But South Korea that had a per capita income of $80 in the mid-50s became equal to Sri Lanka by 1960 and surpassed Sri Lanka, with a rapid growth rate, to have five times the Sri Lankan per capita GDP by 1980. Many other countries surpassed Sri Lanka, except the South Asian countries. By 2019, as the Republic of Maldives went ahead on GDP per capita terms, Sri Lanka had the lowest per capita income among the Southeast Asian countries.

Table 1: Comparative position of SL among selected Asian countries in selected years (per capita income in US dollars)

Country	Mid 50s	1960	1980	1995	2010	2019
India	72	68	207	349	1203	2090
Pakistan	56	76	259	467	867	1286
Indonesia	84	91	472	1025	3264	4135
Thailand	100	95	716	2870	5361	7807
Sri Lanka	122	152	255	714	2744	3826
S. Korea	80	152	1528	10144	26761	31486
Malaysia	298	280	1715	4244	12120	11414
Hong Kong	292	310	4015	23172	38781	48713
Singapore	(in Malaysia)	428	4592	27898	58247	65233

Sources: Mid 50s from Bhagwati. J. (1966). *Economics of developing countries*
Others: World Bank, World development reports, various years

Since then, the economy failed to recover and for almost 75 years, it has deteriorated with a few isolated years of success. This decline was influenced by both exogenous and endogenous factors, which could have been managed if proper leadership was given (Wriggins, 1960). Sri Lanka was envied by leaders such as Lee Quan Yu, the former Prime Minister of Singapore, who in the 60s envisioned to make his country like Ceylon.

But unfortunately, it was not to be, as Singapore, and many other countries surpassed Ceylon. Many economic, social, and political factors can be identified as reasons for this situation. In this article, we focus on one of them, which is misidentification of priorities.

R.C.O Mathews, a distinguished British economist and a [1]Professor of Political Economy at Oxford and Cambridge universities, analyzing the status of the troubled British economy in the 1970s stated; “if the policy maker identifies issues facing the country wrongly and implements completely wrong measures, only the God can help that country” (Mathews, 1975). The extent to which this statement can be applied in the case of Sri Lanka needs to be investigated in detail.

The second missed opportunity

After a dismal performance of slow progress, failing to achieve major internal economic targets as well as long standing balance of payment difficulties, Sri Lanka went into a complete Completely closed economy model for almost seven years. Additionally, new policies of the United Front that came into power did not revitalize the economy and seven years passed without any significant change in the economic fortunes of the country.

Another good opportunity to change the economic fortunes of the country dawned in 1977 (Indraratna, 2016) with the commencement of the economic liberalization programme that was gaining popularity worldwide, with the initiation of the ‘new monetarist counter revolution’ by the proponents of the monetarist school. The world was getting weary of the Keynesian economic policy prescriptions, that successfully operated for almost a quarter of a century after the Second World War. Turning towards new economic policies propagated by Milton Freidman and his followers, international institutions such as the IMF and the World Bank recommended these new policies to developing countries such as Sri Lanka. The newly elected government of the UNP decided to go along with the IMF policies, liberalizing the economy by removing all the restrictions that were in operation until then.[2] On the international front, the government, while completely liberalizing the current account transactions, decided to do away with the dual exchange rate system (FEEC System) that existed since 1967 and have a unified rate together with a devaluation of the currency from

[1] Mathews expressed these views in 1975 when the OPEC price hike of oil precipitated a crisis in the British economy that was already showing signs many ills, including slow growth, high inflation and unemployment after a quarter century of good performance under the Keynesian policy prescriptions

[2] Sri Lanka, together with Chile and Turkey are considered the first developing countries to embark on structural adjustment policies advocated by the WB-IMF group under the monetarist policies which dominated the West by then.

Rs. 8.83 a US Dollar to Rs. 15. 56 a Dollar (CBSL, 1977). However, with the concurrence of the IMF, some capital account transactions remained under control as it was before 1977.

The economic growth rate which was lingering under 5% throughout the 60s and the 70s, except during a very few isolated years reacted to the new economic policy and registered a growth rate of 8.2% in 1978. This was mainly due to the measures undertaken to liberalize the economic activities in the domestic front and the external front (and the sudden increase in demand after a seven-year closure). However, it didn’t last long as it dropped to 6.3% in the following year itself and settled down at the normal trend rate of around 5%, with the exception of the 87-89 period during which the rate went down to an average of 2.5% due to the communal riots in 1983 and the internal strife caused by the JVP insurrection.

Full benefits of the liberalization policy could not be reaped, firstly, due to the way it was implemented. The country, after being subjected to restrictive economic policies for a substantial period of time since the early 60s until 1977 (with a partial opening between 65 -70) and having an inward looking closed economic setup with severe restrictions for seven years since 1970, was opened overnight giving full freedom in the domestic as well as external fronts, spurting economic activity. But it could not be sustained due to macroeconomic imbalances and structural rigidities. Had the government learnt a lesson from its neighbor, India and taken steps to make a gradual transformation, it wouldn’t have faced the difficulties that it encountered in the years that followed. For instance, the government’s policy of allowing consumer expenditure to increase amid liberalization, relative to savings in the economy, led to the continued gap between savings and investment. The associated resource gap was filled by borrowing which created continuing budget deficits, in turn keeping the aggregate demand at a high level relative to the aggregate supply in the economy which resulted in a heavy public debt. This, in turn, created inflationary pressure reaching an average of 16.0% from 1978-82, reaching a very high rate of 26.1% in 1980, and continuing to be over 10% until 1993 (CBSL, 1994). On the other hand, the desire to end a long-standing shortage of investment and intermediate goods and the imported consumer goods kept the total demand for foreign goods high, compared to the relatively stagnant export income, creating balance of payments problems. Furthermore, the government’s expectation of the private sector taking the leading role was not realized as the traditional thinking on the ‘engine of growth’ happened to be less effective and the role of the public sector continued to grow.

Lifting restrictions on capital transactions to integrate the domestic capital market with the world, allowing certain transactions such as the repatriation of profits arising from sales of shares and the repatriation of foreign investors' capital brought in some flexibility. Many other foreign exchange transactions were also allowed under the new policy package, but the currency was not made fully convertible. The financial repression (Mckinon, 1973, Shaw 1973)[3] was somewhat eased by permitting interest rates to be determined at market rates while foreign banks were allowed to re-establish in the country. Many other far-reaching policies such as new strategies and institutions were promoted for export expansion. Liberalization was supplemented by massive investment projects of the public sector like the Mahaweli Development Programme and many large-scale housing programmes.

But everything was not favourable as the country's export prices fell and it had to face the second oil shock causing the terms of trade to become unfavourable, which in turn adversely affected the current account, forcing the government to obtain commercial credit as official assistance and creating enormous adjustment problems. With problems in the domestic and external economy, the country's economic growth fell to a very low level but partially recovered in 1990 reaching 6.2% only in 1992. However, "economic growth [slowed down], exports stagnated, unemployment increased to around 15% and there [was] continuing pressure on the balance of payments and a major crisis was averted only because of [the] substantial assistance [received] from Japan and Western donors and Sri Lanka became a simmering volcano of political, social, and ethnic conflicts" (Athukorale & Jayasuriya, 1994).

Although there was a change in the government in 1994, economic problems continued both in the internal as well as external fronts, a situation described in the literature under the 'three gap model'. In addition to the two well-known gaps in the economy, there appeared to be a third gap known as the fiscal gap in developing countries (Bacha, 1990; Taylor, 1994). Thus, policy makers and economists must be very concerned about the three gaps in the economy: savings-investment, foreign trade, and the fiscal balance. The Sri Lankan

[3] Robert McKinon and Edward Shaw (1973) presented the idea that administrative credit controls lead to financial repression in developing countries which makes the financial system inefficient and suggested that it is required to effect financial deepening by allowing market forces to operate. This is known in the literature as the McKinon- Shaw hypothesis.

economy has been subjected to all three of them over the years. Notwithstanding the somewhat better growth performance during the 90s and in the first decade of the 21st century, the overall economic growth registered at 5.2% for the period 1994 -2012, reinforced by few years of high growth of over 8% (2010-12). This is an extraordinary performance amid some bad years such as 2001 where the growth was -1.5%. Frail macroeconomic fundamentals were displayed in the form of the three gaps mentioned above. Then onwards, the economic growth slowed down reaching 2.3% in 2013 and remained low at an average of 4.0% for the next couple of years.

The savings gap which portrayed the difference between the national savings ratio and investments in the country remained high from the very beginning due to the 'living beyond syndrome' (Indrartna, 2016) with a consumption level of over 85% of the GDP, which remained at the said level right throughout the post-independence period. Despite the rising per capita GDP from about Rs. 600 to approximately Rs.700,000 P.A (US$ 122 in 1952 to 3800 in 2019), in seven decades, there was no substantial increase in the savings ratio, and as a result, the country had to fill the gap by borrowing. This led to the current indebtedness. On the other hand, the deficit financing policy that was practiced throughout worsened the country's fiscal deficit and aggravated the debt problem. The third gap, the external balance was the worst, mainly due to the export-import economy the country inherited from the colonial rulers. The first five years after independence showed a healthy external balance of US $36.5 million mainly due to the boom of rubber exports during the Korean War and the subsequent tea boom in 1954 leading to an increase of export prices for a short period. While the deficit in the trading account began to increase over time the current account also went into deficit as adequate receipts were not flowing in as services and transfers, except during a few years. Although a substantial income was received in the later years as migrant remittances and income from tourism, it was hardly sufficient to offset the ever-multiplying trade deficit. Subsequently, for the first time in history, the import expenditure became almost twice as much as the export income putting a heavy burden on the external balance. On the other hand, the country failed in the export diversification drive, except in the export of apparels which, however, had low value addition. Hence, the export of plantation crops remained high.

The overall position of growth, exports imports, trade balance and current account balance over the entire period is given in Table 2. The average growth has been less than 5%

throughout with only two periods showing a higher number and the import expenditure had been rising more rapidly than the export income. As a result, the trade deficit has grown at an alarming rate reaching almost twice the export income in later years. While the export income grew by a little over 4 times during 1977-2020, the expenditure on imports has grown more than 6 times showing the enormity of the problem. In addition, the ever-depreciating exchange rate since 1978, (from Rs.15.50 to the dollar in 1978 to Rs. 200 by 2020) has extensively contributed to widen the gap between the export income and import expenditure. Additionally, the current account deficit has risen over the years showing the failure of other avenues of receipts to bring some balance to the external front, although tourism and migrant remittances have reduced the trade gap to some extent.

Table 2: Growth rate, exports, imports. Trade balance and current ac. balance under different political regimes

Period	GDP growth %	Exports $ Million	Imports $ Million	Trade Balance $ Million	Current Balance $ Million
1950 - 56	3.7	357.9	-310.8	47.1	36,0
1957 - 65	3.4	365. 3	-387.8	-22.5	-32.5
1966 –70	5.2	357.7	-413. 0	-55.3	-74.6
1971 -77	2.8	487.1	-569. 6	-82. 5	-15.4
1978 - 93	4.9	1429.1	-2119.4	-690.3	-448.3
1994 – 04	4.4	4601.3	-5931.8	-1330.8	-488.8
2005 - 14	6.4	8965. 3	-13993.5	-5028.2	-2185.1
2015 -19	3.9	11301.6	-20337.4	-9035. 8	-2286.9
2020	-3. 6	10074.4	16055.4	5981.0	-1280.8

Source: Central Bank Reports (Various Issues)

Arrival of the COVID-19 pandemic

The exploration of the state of the economy and the macroeconomic environment of over seven decades clearly indicate the vulnerabilities faced by the economy of Sri Lanka at the onset of the pandemic. The immediate past shows that some of these problems were worsening since 2013 notwithstanding the growth rate figures shown through the official statistics of the Central Bank (CBSL, 2020). Whilst the first deviation from the trend, as seen in Table 2, for the period from 2005 to 2008 showed an average growth rate of more than 6% per annum, the second, in the period of 2010 -12 showed over 8% of growth enabling the increase of the GDP per capita income from US $1063 to 3609, while pushing the country towards the higher middle-income level. However, vulnerability to an external shock remained the same since independence, especially in the later years as there was a worsening savings investment gap resulting in a heavy public debt. There were other isolated occurrences of growth surges like 6.2% in 1951, 6.7% in 1960, 6.4% in 1964, 8.2% in 1968 and 78, 6.2% in 1990, 6.9% in 1993 and 6.0% in 2000. But the long-term trend in the growth rate has been less than 5% for the entire post-independence period with two exceptionally low growth years: 1956 and 2001, with the first having a 0.7% and the second with a negative growth of -1.5%. It is fair to conclude that the growth performance had not been promising, throughout the past 7 decades, although the country was called a 'rich developing country' at the time of independence. Apart from the savings – the investment gap and two other gaps (the external gap and the budgetary gap) were becoming critical and the external debt was increasing dramatically over the period. Furthermore, the declining foreign exchange reserves in the country had made the repayment of foreign debt a major challenge as sources of earning have dried up in the recent past.

The unexpected onset of the pandemic had immediate adverse effects on various quarters of the economy and the society, mainly due to the lockdown policy adopted to avoid the spread of the COVID-19 virus. This slowed down Sri Lanka's growth prospects. Adverse effects were visible due to three causes: the lockdown strategy, breakdown of international economic links, and the emerging global economic recession (Abeyratna & Saheed, 2020). The lockdown had adverse effects on all three sectors of the economy; agriculture, industry, and services. Many industries and related activities came to a standstill affecting exports which was intensified by international lockdowns. The domestic agricultural production was severely affected due to the breakdown of supply chains, but somewhat recovered as supply chains reorganized themselves through online delivery systems and other indigenous techniques. However, the service sector, including self-employment involving many economic activities lost the drive to exist resulting in loss of incomes, jobs, and livelihoods of thousands which increased the poverty in low-income households. Amid all these, the government finance and the external finance faced great disruption with appeals for assistance by the public. The government was compelled to pay a disaster allowance of Rs. 5000 per family to a substantial proportion of the population which led to the expansion of money supply.

It should be kept in mind that economic growth is an essential requirement to achieve several major economic goals such as the increase in per capita income, reduction of poverty, creation of employment, achieving price stability, consolidation of fiscal balance and determining internal balance objectives. On the external front, it is an important element influencing the balance of payments position of the country, the external reserve position, stability of the exchange rate and the external debt position. In other words, it is a vital variable influencing the macroeconomic stability of a country. Sri Lanka, however, has been experiencing a steady slowdown in its growth rate, after having two extraordinary but short periods of high growth during the periods 2005-2008 and 2010-2012. However, it went down to 2.3% in 2019, the lowest in 18 years. Resultantly, by international categorization, Sri Lanka was downgraded from the “upper-middle income” category to the “lower-middle income” category.

Table 03: Domestic savings/ investment and resource gap as a % of the GDP

Year	Domestic Savings	Domestic Investment	Resource Gap
2000	17.4	28.0	-10.6
2001	15.8	22.0	-6.2
2002	14.4	21.2	-6.8
2003	15.9	22.1	-6.2
2004	15.9	25.0	-9.1
2005	17.9	26.8	-8.9
2006	17.0	28.0	-11.0
2007	17.6	28.0	-10.4
2008	13.9	27.6	-13.7
2009	17.9	24.4	-6.5
2010	19.3	27.6	-8.3
2011	15.4	29.9	-14.5
2012	16.9	30.6	-13.7
2013	20.0	29.5	-9.5
2014	21.1	29.7	-8.6
2015	20.2	26 4	-6.2
2016	19. 6	26.8	-7.2
2017	18.9	28 7	-9.2
2018	19.6	29.9-	-10.3
2019	17.3	25.6	-8.3

Source: Central Bank of Sri Lanka, various years

In view of the three gaps constraining the capacity to change and further intensified by poor economic growth, the onset of the pandemic hit the economy catastrophically. Whilst the economy had less capability to cope with the issue, the social and economic impact of the resulting fallout seems unresolvable at least in the short run. Furthermore, for the second time in history, the growth rate has hit a negative figure of -3.6% in 2020 due to pandemic related disturbances. Negative effects could be seen in all areas including investment, fiscal sustainability, and external sector performance. The lockdown severely affected the overall production capacity in the agricultural and industrial sectors including medium and micro enterprises and construction. While the tourism sector got severely disrupted, self-employment activities were reduced to a minimum and migration for employment was also at a standstill to some extent due to travel restrictions.

Challenges

Fiscal imbalance

Although not considered essential when Keynesian policies were dominant in the 50s and 60s, the need for fiscal strengthening has been in existence from the very beginning, which turned out to be a major constraint in macroeconomic management. The fiscal policies affect the overall economic performance of the country through national savings and investment, economic growth and development, level of unemployment, poverty and welfare, prices and wages, private sector operations, external sector performance, and income distribution (Rajapatirana, 2020). Nonetheless, the government had high expenditure throughout, causing a resource gap which was filled by increased borrowing. Table 3 provides the information on domestic savings, investment, and the associated resource gap from 2000 to 2019 which is a clear indication that the savings failed to cope with the investment requirement. The years the country had the highest growth rates, i.e., 2011 -12, has the highest resource gap and when economic activity slowed down, the gap appears to have narrowed down.

On the other hand, the government revenue has reached a low level of 11. 4 percent of the GDP in 2020 which is lower than the revenue in 1950 soon after independence. Since 1950, the government revenue began increasing reaching the highest level of 28.9% of the GDP in 1977, which started dropping thereafter to less than 15% after 2000 and reached the lowest level by 2020. The low government revenue with increased government expenditure led to an intensified fiscal gap which required filling by domestic borrowing through monetary expansion. One would have expected the tax revenue to increase with the increase in the per capita income in the country and economic growth performance over the years, but it failed to materialize even though the country reached the higher middle-income level from 2002 onwards with a per capita income of $4000.

The government expenses are rising at present with new commitments created by the impact of COVID-19 and the government revenue is declining due to a standstill economy and recent tax reforms. The accumulated debt burden diverts scarce resources from pressing obligations to forgone expenses. The depreciation of the Sri Lankan rupee is adding pressure on government coffers as external debt servicing is becoming more expensive. There is a possibility for a recessionary-inflation situation to occur in the economy if the government turns to the Central Bank for excess printing of money to bridge the growing gap between its revenue and expenses (Wimalaratna, 2020).

In the current uncertain environment, there is some hope for Sri Lanka. The economy has successfully absorbed several external and internal challenges at a cost since independence, such as two insurrections, thirty years of civil war, the tsunami disaster, oil shocks, the US financial crisis, impacts of extreme weather conditions and the 2019 Easter Sunday bombings. The country and its people have experience to cope with severe economic situations. On the international front, Sri Lanka is receiving bilateral and multilateral grants and assistance to provide necessary concessions to its people.

External imbalance

The widening external gap has emerged as a major outcome of the already weak foreign receipts and persistent payment difficulties of the pandemic affected economy. On the other hand, the external balance in Sri Lanka has been unfavorable for many years since the 1960s with the import expenditure outstripping the export income and weak accommodating flows in the current account, except during a few isolated years. The trade deficit began worsening dramatically with the expenditure on imports becoming twice as much as the export revenue in 2011 for the first time and continuing to be so during the following years. The pressure on the balance of payments became acute over time, external reserves deteriorated, and the rupee steadily depreciated making debt repayments more expensive. The country was at such a juncture when the present crisis emerged putting further pressure on the external sector of the economy.

At the onset of the pandemic, the export earnings declined and expenditure on imports increased. The country is facing an inadequacy of foreign reserves and the position is likely to worsen with the global economic slowdown. Other avenues for balancing the current deficit, such as income from tourism and worker remittances remain flat and are expected to deteriorate further. Foreign direct investment in Sri Lanka, compared to other Asian countries, remained at a measly figure of less than $1 billion. Meanwhile, foreign investment in the government securities had been weak and the stock market was flat with net outflow.

The value of the currency that depreciated throughout remained broadly stable in January 2020 but depreciated sharply in March/April to over Rs.200 a dollar. The exchange rate has become somewhat stable recently, perhaps in response to the import restrictions imposed by the government. However, measures taken to arrest the crisis appear to be controversial since it can lead to an anti-export bias in the future (Ganeshmoorthy & Vidanagama, 2020).

Effects on agriculture

The agricultural sector of the country comprising domestic agriculture (rice, other field crops, fruits, and vegetable), the plantation sector (tea, rubber, coconut, oil palm, and sugar cane), livestock and poultry, fisheries, and forestry are responsible for employing approximately one third of the population even though their contribution to the GDP has reduced in the recent years. The sector is still important as a key food supplier, a major source of livelihood to rural and estate communities, a raw material supplier to the industrial sector and a foreign exchange earner of high value-added exports.

Although the domestic production was not seriously disrupted, the food and industry supply value chains had to face an unprecedented shock due to the sudden onslaught of the pandemic and authorities had to take immediate corrective measures to resurrect the value chains. The effect of the break down in the link between the participants of the food supply chain, i.e., the producers and consumers, was felt as there was no alternative mechanism to reestablish this link effectively. However, urgent corrective measures were taken by state agencies with the assistance of stakeholders to identify the difficulties and to minimize the potential disruption.

Industry

The industry sector satisfying the needs of consumers and producers with a vast array of products is also responsible for a large share of foreign exchange earnings through merchandised exports (79%) and contributes 24.6% to the GDP while employing 27.6% of the population. The pandemic has caused large scale and micro level shocks in the industry, thereby weakening its production.

According to the World Bank estimates, the Sri Lankan economy is expected to contract further in 2021, in addition to a growth of -3.6% in 2020, as the outbreak dampens export earnings, private consumption, and investment. The ADB predicts a -1.68 and -2.55 percent impact on the GDP and -1.23 and -2.55 percent impact on employment under smaller demand shocks and larger demand shocks respectively. At the sectoral level, the predicted negative impact on the value-added industry sector is -0.75 and -1.63 percent and the impact on employment is -0.79 and -1.74 percent under smaller and larger demand shocks (Chandrarsiri, 2020).

Medium and small industry

The economic stoppage and its outcomes due to the pandemic are largely felt by the informal, home-based, self-employed, and micro, small and medium enterprises (MSME) sectors. These impacts are likely to continue for quite some time all over the world and sequential effects of the economic damage will increase if timely corrective policies are not implemented. Policymakers must devise suitable plans to address the medium-term and long-term effects on all these sectors.

MSMEs represent more than 95% of the enterprises in Sri Lanka. Many studies have shown that over 60% of micro and small businesses have shut down during the lockdown while predicting that more than 90% will be shut down if this situation continues. Some businesses are working but not at its full capacity using strategies such as working from home, using online platforms to keep in touch with regular customers and developing their websites. Most of the MSMEs in the country face cash shortages making it hard to sustain their businesses. The challenge started in 2018 after the Ester Bombings, and the situation worsened in 2020 with the COVID-19 lockdown. MSMEs face severe challenges from aspects of demand and supply. Supply chains have almost died out and firms suffer from a lack of raw materials. Firms engaged in exports face difficulties due to constrains in demand and supply. Labour retention has emerged as a challenge since there was no cash inflow or income to make payments of wages, utility bills, loans, and rentals. While many firms reduced their labour force and will cut down training budgets and salaries (by reducing allowances and overtime payments), they will also revisit their investment decisions and portfolios. A major decline has occurred in sectors of tourism, travel, hospitality, entertainment, foreign employment and garment, as well as in the financial industry including the microfinance sector. The damage is somewhat reduced due to the availability of online facilities and ICT facilities, home-based work, and self-employment. However, the micro and small businesses are badly affected since they are not exposed to the government information system. In the midst of all these challenges, MSMEs in many countries have been playing a commendable role to fight pandemic (Premaratna, 2020).

Services

Sri Lanka's economy became dominated by the services sector, starting from about 37% of the GDP in 1950, reaching over 50 % in the mid-60s and increased further to 57% of the GDP by 2019. The services sector which accounts for 46% of employment in the economy, was exposed to a great risk in mid-March 2020 with the onset of the pandemic. The role of this sector is likely to further increase in the future as an overwhelming majority of the young generation is eager to work in the services, with a preference for self-employment over agriculture or industry. A carefully designed service sector will generate sustainable sources of income, employment, revenues for the government as well as external income to the country. In the 21st century, world economies have recognized knowledge as the main economic drive with a focus on services coupled with intellectual aptitude. The COVID-19 is an eye-opener to develop world class services in Sri Lanka (Dayaratna, 2020).

Tourism

Tourism has developed to be a multidimensional, interconnected, and vibrant sector in the economy, becoming the third highest foreign exchange earner, contributing more than $5 billion to support the balance of payments of the country, next to exports and migrant income. Tourism related secondary activities in the services sector are so vast that they have developed into one of the areas which carries the highest forward and backward linkages in Sri Lanka. The 'Lonely Planet' travel magazine recognized Sri Lanka as the top best destination country in the world for travel in 2019. The tourism sector, which was heading to be a major foreign exchange earner, was able to recover from the devastating effects of the Easter Sunday attack in April, 2019. However, the total tourist arrivals in 2019 was 1.9 million compared to 2.3 million in 2018. Even though the income generated by tourism did not completely regain the status that was before 2019, it earned nearly US $3.6 billion in 2019 and it was the 3rd highest foreign exchange earner in Sri Lanka that year. Direct and indirect tourism related employment was more than 440,000 in 2019 and accounted for 5% of the total employment in the country.

Covid 19 had a disastrous impact on the tourism industry in Sri Lanka. It is estimated that the total unemployment level in the tourism industry will stand between 350,000 - 450,000 because of the pandemic. Sri Lanka is likely to fail in its attempt at increasing foreign exchange earnings from the industry due to the ongoing crisis affecting travel worldwide. The predictions are that world tourism will not recover in the near future. Furthermore, the contraction of tourism would have critical implications on the domestic market as it would reduce the demand for local products as well as the government revenue to some extent.

Construction

The construction industry, one of the areas that was hit hard by the calamity, comprises many products and services connecting the economic activities of the country, namely; residential, commercial, and industrial erections, education and health infrastructure, dams, bridges, roads, highways, harbors, and airports. This sub-sector in Sri Lanka has been very active in recent years and has contributed 7% to the GDP in 2019 where the annual growth rate was 4%. However, the growth of the industry slowed down after 2015. Its contribution would have been much higher had its potential was fully utilized.

The industry was already adversely affected due to problems such as the low quality of raw materials, short supply of skilled labor, delays in the settlements, non-transparency in the public sector, and the high cost of credit facilities. Further, the industry lost many experienced professionals during the civil war. It is in this context that the COVID-19 affected the industry resulting in a complete standstill and denying employment for the work force which led to loss of livelihoods. The enterprises in the sector face difficulties in honouring their contractual agreements and debts. The importers and sellers also face growing indebtedness due to accumulated inventories. Immediate action is required to salvage the industry from further destabilization (Gunaratna & Jayathilaka, 2020).

Migrant income

Migration for employment became one of the main means of earning foreign exchange in the country while reducing unemployment since the liberalization of the economy in the 70s. It began with unemployed females getting employment in the oil-rich Middle Eastern countries and later expanded to include semi-skilled workers who received employment in several other countries. These two categories of workers are currently estimated to consist around 25% of the total number of foreign employees. However, the employment of males increased with time, bringing the ratio of male to female employees to 2:3, with a decline in the number of females employed as domestic workers in recent years. The remittances of the migrant worker population had been the highest in the transfer category with regards to the balance of payments of the current account for some time in the past and became the second most important foreign exchange earner to the country next to its export income. Sri Lanka received workers' remittances of more than $6 billion per year for the for the period of 2014 to 2020, rising from about $1 billion from 2000. Many countries in the world have imposed various restrictions with the onset of COVID-19 such as travel restrictions, closedown of ports and airports, and lockdowns which adversely affected migrant workers. However, the emerging evidence does not show a substantial adverse effect on transfers. According to the Central Bank Report, it was only marginal with earnings recovering up to $6206.8 billion in 2020 compared to $5766. 0 in 2019. But it did not reach the level of 2017 and 2018.

The pandemic resulted in adverse effects such as the disruption of banking activities and the inadequate use of electronic banking facilities. Some of the export-oriented large companies had to be shut down in foreign countries forcing the work force to return to Sri Lanka which created many hardships to the workers such as travelling difficulties, getting stranded and so on. Some of the employers found it difficult to reopen business under the current health guidelines. Resultantly, the businesses remained closed compelling owners to remove workers which led to mass unemployment. Additionally, when the workers wanted to return to the home country, they faced travel restrictions. Furthermore, because of low crude oil prices, the demand for housemaids, unskilled workers, and skilled workers has declined in the Middle Eastern countries.

Poverty

The present crisis is likely to have short and long-term economic and social impacts at a global level and Sri Lanka would not be spared. As a middle-income country, Sri Lanka faces poverty and inequality within the country at a tragic level. Already, a substantial percentage of the population has fallen below the poverty level. Therefore, sustainable strategies are essential to combat poverty. It is vital that these strategies are implemented by the government in collaboration with development partners, the private sector as well as the community to identify problems and workable solutions.

An individual or a family is supposed to be poor if resources fall short of the poverty threshold. The poverty literature identifies several types of poverty such as situational, generational, absolute, relative, urban, and rural. Poverty in Sri Lanka is primarily a ‘rural’ phenomenon as over 80% of poor people live in rural areas. COVID-19 has reshaped the picture of poverty to a ‘situational’ level by pushing more people into poverty. The payment of Rs.5000 made on a selective basis on two occasions as relief to those who were believed to be badly affected is hardly sufficient to compensate for the shock created by the pandemic. Therefore, carefully designed, effective policies are needed to pull the affected people out of poverty while reviving the locked-down economy. Sustainable policy strategies will ensure a long-term, self-reliant environment for the poor in place of short-term welfare support.

Way out and recovery

When the strategies to recover from the current situation are considered, the most important course of action appears to be the reversal of the current calamitous economic situation to achieve some amount of macro-economic balance, attaining the status that existed at the onset of the pandemic, without expecting miraculous results as suggested by some analysts. The country is facing a grave situation as global growth prospects are not favorable to such a ‘take off’. Many of our important trading partners, such as the European Union, USA, and Britain who are the main export destinations are still struggling to restore their economies. It is unlikely that the virus could be eradicated in the near future, despite vaccination operations.

How then could Sri Lanka address the problems associated with the three gaps which had intensified over the years that are also the root causes of all the other problems described above? The issue of the external gap was addressed with the temporary measure of imposing import restrictions on luxury goods and non-essential imports which helped to reduce the trade gap from a massive US $9 billion in 2019 to $5.9 billion in 2020. However, the other two income sources in the external front, tourism and migrant income remains low. On the other hand, it has been proven throughout history that trade restrictions are not the solution to minimize the external gap. Inventive and sweeping export promotion and diversification is the answer. Therefore, the solution to the increasing trade gap, depreciation of the currency and shortage of foreign reserves should be found elsewhere, not through exchange restrictions. A country that has been living beyond its means for a very long time, with rising external debt, would take some time to address the ‘leisure class syndrome’ and adjust to the reality.

Two problems mentioned earlier, the fiscal gap and the savings gap, created over a long period of time, cannot be solved easily. There seems to be no solution to the fiscal gap unless the government revenue sources are restructured to increase revenue by increasing the tax revenue which has been neglected due to non-economic considerations over a long period of time, reducing the total receipts to 9.2% of the GDP in 2020. It was the lowest figure in history, despite the growth of the per capita income in the recent year, as the expenditure increased to 20.3%. There is room to increase the tax net as the per capita income rose to US $4000 recently, making Sri Lanka a higher middle-income country. On the other hand, reduction of government expenditure appears to be impossible in the present context. In the first place, the government needs funds to sustain the economy, to pay the 1.4 million public sector employees, to provide health and education services, and to sustain social protection measures. Welfare measures such as the Samurdhi payments have to be paid to nearly 47% of the households and payments related to farmers' pension insurance, senior citizens' allowance, disability allowance, and chronic disease allowance (kidney disease) have to be paid to over 3 million recipients (Rajapatirana, 2020). In addition, it is also necessary to continue the public investment programme, an important push factor in the economy. The SOEs which produce losses will aggravate the need for public funds.

The savings – investment gap is the most difficult area to handle as the country has been experiencing low savings since independence and failing to achieve a higher rate required for increased investment, which has forced the government to look for funding outside the country. In the first place, the 'living beyond means' syndrome prevalent in the society had a negative impact on national savings. Even though national savings increased over the years to reach an average of around 23% by the 1990s, and further increased to a maximum of 29% by 2012, it remains rather low compared to other countries in the Asian region. It is not likely to increase to a higher level under the current trends in poverty levels as well as the low interest regime introduced in 2020. The only other way to increase investment is through foreign direct investment (FDI) which has not been successful over the years despite efforts to attract FDI.

The projection by The Economist (see Table 4) shows that only China is expected to experience substantial growth in 2021, while Japan, Britain, and Germany are going to have negative growth rates and the USA is expected to have only 0.4% of growth. This indicates that Sri Lanka's major trade partners are expected to stagnate. China is the only country expected to have a healthy growth in 2021 but it is not a major trade partner of SL, as it is responsible for only about 2% of exports. Table 4 gives the expected GDP growth rates of selected countries published in The Economist magazine.

Table 4: Expected growth rates of selected countries

Country	GDP 2021 %
USA	0-4
China	18.3
Japan	-1.6
Britain	-6.1
Germany	-3.1
Singapore	1.3
India	1.6
Pakistan	4.7

Source: The Economist, 2021 March

Sri Lanka's major trade partners are expected to stagnate in the near future which would dampen the efforts to increase exports to these countries.

The current scenario is that around 36% of the population lives on less than LKR 337 (US$ 1.90) and 74% of the people live on less than LKR 613 (US$ 3.40) per day. These statistics indicate that a substantial number of people experience a large negative shock compared to their daily income. These numbers should be much more as a result of the ongoing economic slowdown due to COVID-19. The LKR 5000 paid to give relief to those below the official poverty line (OPL) is inadequate to compensate for the shock. In addition, there are many who do not receive Samurdhi payments even though they are below the OPL. The adverse effects have been intense in terms of household welfare and sources of income have declined substantially, especially among the self-employed. Thus, it is evident that the higher the COVID-19 shock is, the higher would be the uncompensated shock is to the poor.

Furthermore, the earnings in the tourism industry, which was struggling after the 2019 Easter Sunday bombings, have been estimated to have fallen substantially. Some unsuccessful efforts were taken in a haphazard manner to resurrect the industry by welcoming tourists from non-traditional destinations. The industry is expected to be restrained until travel restrictions are cleared. Due to the decline in the demand for workers in the Middle East and in some other countries following the COVID-19 shock, remittances were expected to fall by a third compared to 2019. However, the available statistics show that the migrant income has not been affected drastically. It is most important to emphasize that the government had, to a large extent, contained the spread of the virus and had good results to show until the third wave began. However, steadily progressing vaccination programme is expected to produce positive results.

In the medium and long term, the private sector must be engaged to a large extent to ensure the medium- and long-term growth of the country. The government must take steps to facilitate this by ensuring macroeconomic stability and reforming the incentive environment which was not in effect throughout the last decade.

Conclusion

The impact of COVID-19 has been widespread and alarming, but the Sri Lankan economic crisis cannot be solely attributed to the pandemic. Evidence clearly shows that the country's economy was in decline due to fundamental problems the country had been facing for a long time. The pandemic only aggravated an already weak economy. Three gaps in the economy: savings-investment, revenue and expenditure, and foreign receipts and expenditure, which are largely responsible for many other problems in the country, have been developing since the 1960s. These problems took a disastrous turn before the pandemic which aggravated the hardships of the country.

The problem of living beyond means by the so called 'leisure class' was in existence from the initiation of the independent economic policy, creating an inadequacy in the required level of investment. Additionally, the ambitious welfare programme initiated during the Second World War placed a heavy burden on the government. Of late, provision of welfare has become a political issue rather than a policy matter. In addition, the misidentification of priorities by the politicians due to policy inconsistency has worsened the situation. This included the wrong allocation of resources, extravagance, inability to implement timely policies, corruption, waste, and many other flaws.

There are three crucial strategies which could be adopted to tackle the present crisis. First, it is important to establish and maintain the macroeconomic balance to improve resource allocation. Macroeconomic balance is achieved when the aggregate demand is consistent with the aggregate supply of the economy. Corrective measures such as restructuring foreign debt and enabling the postponement of debt repayments (as decided on at the recent Group of 7 meeting) could help in this context. Implementing a policy framework conducive to attract new investments while maintaining low inflation and a sustainable current account deficit is critical. The second, but equally important policy change is to undertake structural changes such as using price-based polices rather than quantity-based policies and allowing the price system (and not restrictive public policies such as imposing quotas instead of tariffs that encourages rent seeking) to allocate resources better. Finally, Restoring the competitive environment that has been absent in Sri Lanka for a long time by turning a regulatory reform-based system by law is essential. These measures would also help to attract both domestic and foreign private investment (Abeyratna & Saheed, 2020).

At the onset of the pandemic, it seemed that the main contributory factor of the current tragedy was the 'misidentification of priorities' by different regimes that ruled the country since independence. These included, firstly, encouragement given to live beyond means, very ambitious welfare programmes, and foiled development efforts exhausting the country of its resources. They allowed the country the ability to boast of excellent social indicators. Secondly, all regimes prioritized their electoral victory without implementing proper development plans. Thirdly, the policy inconsistency made it impossible to convey to the partners of development, especially the private sector, proper signals for adequate investment. Finally, trade union agitations throughout history, ethnic and religious unrest, radical political struggles, and many other disruptions degraded the country to its present status.

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