Reforming Macroeconomic Policies for Stability and Growth

Sri Lanka's Road to Economic Recovery

Sirimevan Colombage

Sri Lanka Innovators' Forum
Monograph – 2024

GAMANI COREA FOUNDATION

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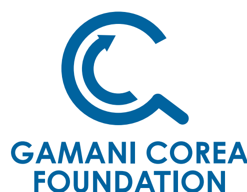

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The Gamani Corea Foundation

The Gamani Corea Foundation (GCF) was established by the late Deshamanya Dr. Gamani Corea on February 10, 2000. In keeping with his passion for global development, the vision of the GCF is to promote equitable and inclusive economic development through policy-oriented research. Its mission is to contribute to the socioeconomic development of Sri Lanka and other low-income and middle-income countries through informed, independent, and high-quality research.

The GCF is an autonomous non-profit institution that aims to promote development-oriented economic research, while being open to research from allied social sciences with a multi-disciplinary perspective. Perceiving research as a catalyst for prudent policymaking for economic development, the GCF introduced its first competitive research grant scheme in April 2024 to support economic and multi-disciplinary research. The initial round of research awards mainly focuses on economic policy issues in the context of the socio-economic challenges facing Sri Lanka.

In tribute to Dr. Corea's mother, Freda Corea, the GCF set up the competitive Freda Corea Awards (FCA) scheme in 2023. The scheme rewards women from low-income categories who have been empowered through their own initiatives and creativity and succeeded in uplifting the living conditions of their families.

The GCF launched the Sri Lanka Innovators' Forum (SLIF) in February 2023 with a view to objectively analyzing the socioeconomic challenges facing Sri Lanka and providing evidence-based policy recommendations to overcome the present economic crisis. In response to GCF's request, industry practitioners, officials and academics have contributed 20 issues papers on critical sectors of the economy. Since its launch, the SLIF has conducted a series of roundtable discussions with stakeholders to draw policy recommendations from each of those issues papers. This monograph is the first of the series of issues papers contributed to the SLIF project.

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List of Acronyms

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
APTA	Asia Pacific Trade Agreement
AWCMR	Average Weighted Call Money Rate
BOI	Board of Investment
BOP	Balance of Payments
CBA	Central Bank Act
CBI	Central Bank Independence
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CEB	Ceylon Electricity Board
CESS	Commodity Export Subsidy Scheme
CID	Customs Import Duty
CIT	Corporate Income Tax
CPC	Ceylon Petroleum Corporation
CPI	Corruption Perception Index
DCS	Department of Census and Statistics
DDO	Domestic Debt Optimization
DSA	Debt Sustainability Assessment
ED	Excise Duty
EDB	Ease of Doing Business
EFF	Extended Fund Facility
EP	Export Promotion
EPF	Employees Provident Fund
ETF	Employees Trust Fund
FDI	Foreign Direct Investment
FIT	Flexible Inflation Targeting
FLFC	Foreign Law Foreign Currency
FMRA	Fiscal Management (Responsibility) Act
GB	Governing Board
GCF	Gamani Corea Foundation
GDCF	Gross Domestic Capital Formation
GDP	Gross Domestic Product
GFN	Gross Financing Needs

GoSL	Government of Sri Lanka
GSTP	Global System of Trade Preferences
ICOR	Incremental Capital Output Ratio
IFIs	International Financial Institutions
IMF	International Monetary Fund
IRD	Inland Revenue Department
IS	Import Substitution
ISBs	International Sovereign Bonds
ISFTA	Indo-Sri Lanka Free Trade Agreement
IT	Information Technology
LKR	Sri Lanka Rupee
LLC	Local Law Currency
LLFC	Local Law Foreign Currency
M2	Broad Money Supply
MB	Monetary Base
MLA	Monetary Law Act
MMT	Modern Monetary Theory
MOF	Ministry of Finance
MPB	Monetary Policy Board
NCG	Net Credit to Government
NDA	Net Domestic Assets
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Assets
NPD	National Planning Department
OMO	Open Market Operations
PAL	Ports and Airports Development Levy
PBC	Political Budget Cycle
PFM	Public Financial Management
PIP	Public Investment Programme
PIT	Personal Income Tax
PSFTA	Pakistan-Sri Lanka Free Trade Agreement
QRs	Quantitative Restrictions
R&D	Research and Development
RDA	Road Development Authority
REER	Real Effective Exchange Rate
SAFTA	South Asia Free Trade Agreement

SCL	Special Commodity Levy
SDFR	Standard Deposit Facility Rate
SLFR	Standard Lending Facility Rate
SLIF	Sri Lanka Innovators' Forum
SLTFTA	Sri Lanka-Thailand Free Trade Agreement
SOEs	State-owned Enterprises
SRR	Statutory Reserve Ratio
SSCL	Social Security Contribution Levy
SSLFTA	Singapore-Sri Lanka Free Trade Agreement
STI	Science, Technology, and Innovation
TIN	Taxpayer Identification Number
USD	United States Dollar
VAT	Value Added Tax
VECM	Vector Error Correction Model
Y-o-Y	Year-on-Year

Foreword

In the 76 years since Independence, Sri Lanka has regressed from being second in Asia only to Japan on many socio-economic indicators, to losing ground to several East and Southeast Asian countries. The primary cause of this regression has been almost continuous macroeconomic stress, caused by unsustainable budget deficits. This macroeconomic stress has led Sri Lanka to seek crisis relief from the IMF 17 times. The inability to effectively address the repeating cycles of unsustainable fiscal performance can be attributed to a political landscape that fostered a toxic combination of populist policies and an entrenched entitlement culture.

The negative impact of unsustainable fiscal policies in terms of high inflation and balance of payments pressure was amplified by fiscal dominance in monetary policy through two channels: deficit financing and financial suppression to keep interest rates artificially low. In addition, the value of the Sri Lanka Rupee was propped up repeatedly through the depletion of external reserves. The upshot was that Sri Lanka became a twin deficit country with unsustainable budgetary and current account deficits.

Professor Sirimevan Colombage draws on the knowledge and experience gained during a stellar career as a Senior Central Banker and an academic of high repute to analyze with great expertise the complex interlinked causal relationships that have led to the repeated cycles of macroeconomic stress. He also goes on to elaborate on the clear frameworks for macroeconomic policymaking that would enable Sri Lanka to move out of the negative cycles of the past and lay the foundation for macroeconomic stability which is a prerequisite for sustained growth and development.

This monograph by one of the foremost macroeconomists in the country should be read by anybody with an interest in understanding the root causes of the present pluri-crises and exploring the way forward to fostering sound macroeconomic fundamentals. Policymakers and students of economics will find this publication particularly edifying.

Dr. Indrajit Coomaraswamy

Preface

This publication is based on a policy issues paper contributed to the Sri Lanka Innovators' Forum (SLIF), an initiative of the Gamani Corea Foundation (GCF). The original version of the paper was presented at a roundtable discussion held in March 2023. It has been substantially revised since then for this publication incorporating the current economic trends and policy reforms. In keeping with the scope of the SLIF, this study is intended to diagnose the macroeconomic policy failures that led to Sri Lanka's present economic crisis and to underscore the macroeconomic policy strategies that are required to ensure stability and growth for economic recovery.

The economic problems and policy challenges diagnosed in this monograph are more or less similar to those presented in my professorial address, titled 'Sri Lanka's Export-led Growth after 25 Years of Trade Liberalization', delivered at the Open University of Sri Lanka in 2003. However, the economic problems facing the country today are much more severe than ever before reflecting the failure of successive governments to adopt the imperative policy reforms to arrest the downturn of the economy. The country has encountered a multifaceted economic crisis since 2022 with negative GDP growth, unsustainable twin deficits in fiscal operations and balance of payments, monetary expansion, inflationary pressure, foreign reserve depletion, and external debt default.

The policy reforms adopted in Sri Lanka throughout the post-liberalization period since late 1977 have moved in a stop-go fashion switching between the market economy and command economy approaches, on the one hand, and the inward-looking and outward-looking approaches, on the other. In recent decades, the countries that enjoy a free-market environment accompanied by outward-looking policy strategies have emerged as the fastest-growing economies in the world, particularly in Asia. In the absence of such policy strategies, Sri Lanka has missed the opportunity to forge ahead with export-led growth although the economy was liberalized far ahead of other South Asian nations. The weak governance, institutional failures, and widespread corruption exacerbated the economic setback.

In order to overcome the economic crisis, the Government undertook a comprehensive economic recovery programme in 2023 with the support of the Extended Fund Facility (EFF) programme of the IMF. A greater political commitment is needed for the successful implementation of these ongoing economic reforms irrespective of the contrasting ideologies of the different political parties aiming to gain power. Against the backdrop of the current economic crisis, Sri Lanka cannot afford another stop-go cycle of reforms that experiment with alternative policy strategies in the years ahead.

I wish to express my gratitude to the Chairman, Dr. Lloyd Fernando, and the Board of Directors of the Gamani Corea Foundation for extending their fullest cooperation to make this publication a reality. My sincere thanks go to Felicia Adhihetty, Managing Director of B-connected Pvt. Ltd. and her team for the high-quality layout design and printing of the book. I am most grateful to Niranjali Jeyashanker for painfully carrying out the seemingly endless task of editing the book in several rounds, on my second and further thoughts.

I sincerely hope that this monograph will be of use to policymakers, researchers, academics, and the public.

Prof. Sirimevan Colombage
September 5, 2024

Executive Summary

Sri Lanka has encountered an unprecedented economic crisis since 2022 with multiple setbacks in the economy, including unsustainable fiscal and balance of payments deficits, external debt default, foreign exchange shortages, inflationary pressures, and negative GDP growth. The crisis was the culmination of the imprudent macroeconomic policies adopted over the decades. A series of ill-conceived policy decisions taken during 2019-2022 triggered the enduring macroeconomic imbalances, causing a severe economic catastrophe.

Over the decades, Sri Lanka's fiscal and monetary policies were mostly procyclical, and thus, they tended to aggravate the economic fluctuations rather than mitigate them. In effect, the current economic crisis is indicative of poor governance and policy failures, mainly in the fiscal and monetary sectors. Concurrently, inconsistent foreign trade and investment policies aggravated the imbalances on the external front.

In order to overcome the economic crisis, the Government entered into a four-year Extended Fund Facility (EFF) arrangement with the International Monetary Fund (IMF) in March 2023. The successful implementation of the policy package is quite a challenging task, given the grave and complicated nature of the economic crisis and the political uncertainties associated with the upcoming elections to be held in 2024. Previously, Sri Lanka had sought IMF assistance 16 times since 1965 but failed to make the necessary policy adjustments to ensure economic stability and growth due to the lack of political commitment. Consequently, the economic reforms of the past were pursued in a stop-go fashion. In the backdrop of the current economic crisis, however, the ongoing policy reforms are more important than at any other time in the country's history and, therefore, a far greater political commitment that sets aside divergent party politics is essential. The country cannot afford another stop-go cycle of economic reforms and experiment with alternative policy approaches in the years ahead.

Sri Lanka adopted far-reaching structural reforms accompanied by liberalization of foreign trade and investment in anticipation of promoting export-led growth as far back as 1977, ahead of all other South Asian nations. The reforms initially helped the country to overcome the economic setback that had prevailed in the pre-liberalization period, reflecting increased Foreign Direct Investment (FDI) inflows, and high export and GDP growth. However, the economic recovery was short-lived mainly due to policy failures.

By and large, the fiscal, monetary, and foreign trade and investment policies implemented by successive governments during the post-liberalization period have been based on politically-motivated discretionary decisions rather than on rule-based decisions driven by sound economic principles. Such policies, characterized by the phenomenon of the Political

Budget Cycle (PBC), led to severe macroeconomic imbalances predominated by the twin deficits – fiscal and balance of payments deficits. The prolonged macroeconomic instability discouraged FDI and suppressed export-led growth. Policy imperfections dampened the business environment and depressed private sector activities. The institutional weaknesses and corrupt practices aggravated the economic setback.

Persistent budget deficits are a major source of economic instability in Sri Lanka. These imbalances have not only exerted ripple effects on the money supply, inflation, the balance of payments, and debt burden but also caused "financial repression" that led to preempt private sector resources, retarding economic growth. The politically-motivated fiscal policies adopted over the decades are a classic example of the PBC. Government expenditure outpaced the revenue, resulting in a widening fiscal deficit that reached unsustainable levels by 2020. The total tax revenue to GDP ratio has declined over the years, indicating that tax mobilization did not keep pace with economic growth. Fiscal discipline has continuously deteriorated as successive governments never attempted to abide by the fiscal rules stipulated in the Fiscal Management (Responsibility) Act (FMRA) of 2003[1] .

In contrast to some of the neighbouring countries in the region that have reaped the benefits of trade liberalization through prudent policies, the weak macroeconomic fundamentals and inconsistent foreign trade and investment policies that prevailed during the post-liberalization period in Sri Lanka have had negative effects on FDI, hampering export-led growth. Moreover, the inward-looking policies have led to the creation of a complex tariff and para-tariff structure coupled with Quantitative Restrictions (QRs) on imports. In addition, the less-flexible exchange rate regime created anti-export bias, further inhibiting export growth. Such policies caused a substantial decline in the country's trade openness, resulting in Sri Lanka having one of the most restrictive and complicated trade regimes in the world.

The economic crisis facing Sri Lanka today is the culmination of such long-standing imprudent economic policies and structural weaknesses in the economy. A series of ill-conceived fiscal, monetary, and foreign trade policy measures implemented since 2019 triggered macroeconomic imbalances and plunged the country into a deep economic crisis in 2022.

In a historic ruling delivered in November 2023, the Supreme Court decreed that the ex-President, two former Finance Ministers, along with several senior officials, including two former Governors of the Central Bank of Sri Lanka (CBSL), the former Secretary to the President, the former Secretary to the Ministry of Finance, and several members of the

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1 Fiscal Management (Responsibility) Act No. 3 of 2003.

Monetary Board of the CBSL, bear responsibility for mismanaging the economy during the period 2019-2022, leading to the severe economic crisis.

The tax cuts implemented in late 2019 caused a significant increase in the fiscal deficit. Direct lending by the CBSL to the Government for monetary financing of the fiscal deficit restricted monetary policy space and caused an acceleration of the money supply. Referring to an unfounded notion called the 'Modern Monetary Theory' (MMT), the CBSL authorities justified monetary finance by arguing that a sovereign government is free to meet its fiscal deficit by printing money in place of taxation and that it would have no impact on inflation. While continuing monetary financing, the CBSL's attempt to artificially fix both the interest rates and the exchange rate at unrealistic levels resulted in an outflow of foreign reserves, as proved in the 'policy trilemma' or 'impossible trinity' theorem.

During the period 2019–2022, the CBSL authorities repeatedly refused to seek assistance from the IMF to rectify the macroeconomic fundamentals, reiterating that the economy could be recovered through 'home-grown' solutions such as monetary financing, import and foreign exchange controls, and fixed interest and exchange rates.

The crisis intensified with the mounting external debt service payments that clustered during the period 2019–2022, leading Sri Lanka to become a foreign debt default country in April 2022. As debt sustainability weakened over the years, the global credit rating agencies downgraded Sri Lanka's sovereign debt ratings on several occasions, further inhibiting access to international financial markets[2]. This resulted in a rapid depletion of foreign reserves. The foreign exchange crisis caused severe shortages of essential goods, including fuel, medicine, cooking gas, and intermediate goods, causing immense hardship for the people. The crisis sparked massive public protests across the country in 2022, with demands for a 'system change' to overcome the country's dire economic mismanagement and widespread corruption. The civic unrest ultimately prompted changes in the topmost positions of the Government.

The IMF-EFF arrangement launched in 2023 lays the foundation for the recovery process, creating sufficient breathing space to implement vital structural adjustments needed to tackle the problems of the twin deficits, debt restructuring, and growth slowdown. The recovery package envisages the restoration of macroeconomic stability and debt sustainability while safeguarding financial stability, reducing corruption vulnerabilities, and unlocking the country's growth potential. Revenue-based fiscal consolidation, aimed at reversing the

2 Global credit rating agencies are an integral part of modern capital markets. Their assessments of sovereign and corporate entities have been increasingly used as benchmarks by regulators and investors. The three main credit ratings are Standard and Poor's (S&P), Moody's Investor Services (MIS), and Fitch Ratings (Fitch). All these agencies have downgraded Sri Lanka's sovereign ratings from time to time in the recent past.

downward trend in tax mobilization, is a major component of the policy reforms. The success of the reforms largely depends on the Government's ability to ensure fiscal discipline.

The Central Bank Act (CBA) of 2023 was enacted to enhance Central Bank Independence (CBI). Under this Act, two boards have been set up to separate monetary policy operations from administrative activities of the CBSL: (a) Governing Board (GB) is charged with the responsibility of overseeing the administration and management of the affairs of the CBSL and the determination of its general policy, other than monetary policy, and (b) Monetary Policy Board (MPB) is charged with the formulation of the monetary policy of the CBSL and the implementation of a flexible exchange rate regime in line with the Flexible Inflation Targeting (FIT) framework to achieve and maintain domestic price stability.

While the crucial economic reforms are in place under the IMF-EFF programme, it needs to be emphasized here that several deficiencies in the current policy package should be addressed in order to successfully achieve the envisaged economic recovery, as summarized in the macroeconomic policy-gap matrix (Table 1).

Table 1: Macroeconomic Policy-Gap Matrix

Area of Concern	Policy Issues	Actions Taken	Outstanding Gaps	Proposed Policy Actions	Respon-sible Agency
Fiscal Policy	Political dominance over fiscal policy	Fiscal reforms under the IMF-EFF agreement	PBC-styled populist budgetary measures continuing with upcoming elections in 2024	Formulate fiscal policy in conformity with a robust macroeconomic framework	GoSL MOF
	Fiscal indiscipline	FMRA (2003) stipulates rules for fiscal deficit, public debt, and Treasury guarantees	FMRA was amended several times and the rules were neglected	Comply with the original FMRA rules	GoSL MOF
	Low tax revenue	Tax reforms under the IMF-EFF arrangement	Revenue targets too optimistic	Ensure realistic revenue targets	MOF IRD & BOI
			Tax hikes detrimental to economic recovery	Reconsider tax burden on the critical sectors	
			Delays in enforcing new tax measures	Enforce tax laws promptly	
			Regressive taxation	Raise direct tax mobilization	
			Indefinite tax incentives offered by BOI	Introduce time-bound tax incentives	
			Ineffectiveness of tax amnesties	Reexamine current tax amnesties	
	High expenditure		Less emphasis on current expenditure cuts	Prune unproductive current expenditure	MOF
		New social welfare scheme "Aswesuma"	"Aswesuma" improperly targeted	Streamline the "Aswesuma" programme	MOF
			Absence of an exit clause	Introduce a graduating procedure	
		Divestiture of eight SOEs	Slow process due to the economic setback and public protests	Expedite divestiture	MOF
	Monetary financing of fiscal deficit	CBA prohibits CBSL's NCG	Commercial banks' NCG increasing	Reduce dependence on expansionary bank financing	MOF

Table: 1: Macroeconomic Policy-Gap Matrix (continued)

	Unviable foreign debt-funded projects		Lack of evaluation of foreign project loans	Comply with standard project loan evaluation criteria	MOF CBSL
	Governance and corruption vulnerabilities	Governance Diagnostic Assessment by IMF	Governance weaknesses and corruption vulnerabilities prevail	Address institutional weaknesses, and enforce ant-corruption laws	GoSL .
Monetary Policy	Political influence on the CBSL	CBA 2023 provides CBI	Members of the GB and the MPB are appointed by the President on the recommendation of the Minister of Finance	Amend CBA to depoliticize the appointments and introduce merit-based appointments	GoSL .
			Monetary policy autonomy is not explicit in CBA	Amend CBA to include monetary policy autonomy	
	Fiscal dominance over monetary policy	FIT monetary policy	FIT monetary policy is ineffective without fiscal discipline	Enforce fiscal discipline	MOF, CBSL
	Administratively controlled interest and exchange rates	Flexible interest and exchange rate policy under EFF	The exchange rate and interest rates do not respond to market forces	Allow market-determined exchange and interest rates	CBSL
	Open Market Operations (OMO)	-	OMO inactive	Activate OMO	CBSL
Foreign Trade and Investment	Inconsistent foreign trade policy measures	-	Foreign trade policy inconsistencies remain	Adopt a legally-bound national trade policy	GoSL
	Anti-export bias	-	Protective tariff structure	Adopt an open trade tariff policy	GoSL
			Overvalued exchange rate unfavourable to export growth	Allow market-determined exchange rates	CBSL
Policy Coordination	Resource imbalances	-	Pressures on fiscal sector, BOP & debt	Adopt a macro-economic policy coordination mechanism	GoSL MOF CBSL

Source: Originally compiled by the author

Although the fiscal policy reforms undertaken to date are noteworthy, it is doubtful whether such reforms are sufficient to deal with the country's longstanding problem of fiscal imbalance, which is the root cause of economic instability. There is a tendency for governments to manipulate fiscal policy to influence voter perception before elections, as elaborated in the PBC. In Sri Lanka, such practices have led to the expansion of the fiscal deficit over the decades, and despite the ongoing reforms, politically motivated budgetary measures seem to be continuing with the upcoming elections to be held in 2024. It is crucial to deviate from this practice and to formulate fiscal policy in conformity with a robust macroeconomic framework. In this regard, there is an urgent need to reactivate the FMRA, which was relaxed on several occasions in the past for political reasons. In terms of the FMRA, the targets of fiscal deficit, public debt, and Treasury-guaranteed debt should be strictly enforced to improve fiscal discipline. The tax revenue forecasts for 2024 seem too optimistic considering the low GDP growth. It may also be noted that certain steep tax hikes imposed since 2023 are detrimental to economic recovery. The enforcement of certain new tax laws has been delayed due to administrative problems and public agitation. Action needs to be taken to ease the indirect tax burden on poor households. There is also a need to evaluate the effectiveness of tax amnesty measures. The fiscal consolidation is largely confined to revenue-based measures, and there are hardly any expenditure adjustment policy strategies. The household-level social security programmes need to be restructured based on a strict scrutiny process along with a time-bound graduation mechanism to rationalize social welfare expenditure. The divestiture of underperforming State-Owned Enterprises (SOEs) is crucial for reducing the fiscal burden. Speedy action must also be taken to eliminate corruption practices, as envisaged in the reform package.

Political influence on monetary policy operations is expected to be eliminated with greater independence granted to the CBSL under the CBA. However, several shortcomings in the CBA tend to weaken the independence of the CBSL. The Governor, six members of the Governing Board (GB), and two experts of the Monetary Policy Board (MPB) are appointed by the President on the recommendation of the Minister of Finance with the concurrence of the Constitutional Council. Such provision is likely to pave the way for the appointment of persons who are unduly loyal to the Minister and thereby influence administrative and monetary policy operations of the CBSL at the whims and fancies of the political authority. The situation could become even worse when the President himself holds the position of the Minister of Finance, as at present, thereby acquiring enormous power by a single individual to arbitrarily choose appointees to the two boards. Hence, instead of such political appointments, there should be a rigorous screening process for appointing members to the two boards on a merit basis, thereby minimizing political interference.

Although monetary policy operations were to be separated from the administrative activities of the CBSL by setting up the two boards, such a separation does not seem to exist, as all members of the GB are members of the MPB with the Governor of the CBSL holding the position of the Chairman of both boards. Another shortcoming of the CBA is that it does not explicitly specify the monetary policy autonomy of the CBSL.

The introduction of a FIT-monetary policy framework is a major component of the CBA. It is expected that the FIT framework would enable the CBSL to conduct monetary policy effectively, countering the inflationary pressures emanating from fiscal dominance. However, it should be noted that the FIT is a necessary but not a sufficient condition to achieve price stability, as the fiscal imbalance could still create expansionary effects through increased government borrowings from commercial banks. Hence, the FIT will not be successful without enforcing the stringent fiscal rules for which unwavering political commitment is imperative. Optimal fiscal-monetary policy mix is essential for achieving price stability, as envisaged in the FIT framework.

Another caveat, the only condition stipulated in the CBA, is the requirement that the MPB presents a report to Parliament in the event of failing to achieve the inflation target, with an explanation of the reasons for such deviations. No further actions apart from this condition are stipulated in the Act. It needs to be noted here that no significant improvement in monetary policy operations is evident following the adoption of the CBA. Although the Act prohibits the CBSL from monetary financing of the fiscal deficit, commercial bank lending to the Government has risen, causing expansionary effects on the money supply. The CBSL has not used Open Market Operations (OMO) to mop up the excess liquidity caused by such expansionary fiscal operations. The interest rates and the exchange rate seem to be less flexible, reflecting the undue interventions by the CBSL.

Trade openness and FDI inflows have proved to be the major driving forces behind the success stories of fast-growing economies in the Asian region and the rest of the world. By contrast, the inconsistent trade policies adopted in Sri Lanka throughout the post-liberalization period, switching between Export Promotion (EP) and Import Substitution (IS) regimes, retarded export growth and plunged the country into a deep balance of payments and foreign debt crisis. Sri Lanka has one of the most protective and complex import regimes in the world and as a result, the country's trade openness has declined drastically over the decades. The distorted investment incentive structure and the overvalued exchange rate created an anti-export bias that favoured non-tradables. Sri Lanka has not been an attractive destination for FDIs due to several detrimental factors, including weak macroeconomic fundamentals, poor business environment, corruption, labour indiscipline and political instability.

Foreign trade and investment policies need to be integrated with the overall macroeconomic framework to promote export-led growth. The trade facilitation and regulatory environment have to be improved with a robust trade policy enabling trade openness. Trade agreements, which are often hailed as a means to stimulate trade openness and export-led growth, can become convoluted and challenging to navigate when the country lacks the right economic fundamentals.

The coordination of public investment is required to prevent fiscal and balance of payments pressures emanating from public investment projects carried out by different ministries. Such a system prevailed under the purview of the National Planning Department (NPD) in the 1980s and it helped ensure the overall resource balancing of the economy. Eventually, the system disappeared during the subsequent decades, causing disarrays in macroeconomic resource balancing. It is essential to reestablish such a mechanism for integrating sectoral capital projects into an overall public investment programme in order to prevent macroeconomic imbalances.

1. Introduction

Sound fiscal and monetary policies are essential for sustaining a country's macroeconomic stability, the cornerstone of long-term economic growth. While the government directly influences the economy through fiscal policy by changing taxation, expenditure, and borrowings, the main responsibility of a country's central bank is to ensure price stability by managing the overall liquidity of the economy through policy interest rates, open market operation, and bank reserve requirements. Central banks are also responsible for maintaining a market-determined flexible exchange rate regime to ensure export competitiveness, supplementing foreign trade and investment policies.

Prudent fiscal and monetary policies help achieve low inflation, external balance, and debt sustainability, creating a conducive environment for private saving and investment and thus, facilitating economic growth. For this purpose, fiscal policies need to be counter-cyclical by raising government expenditure and curtailing taxes during a recession and vice-versa. The central bank, on the other hand, has the responsibility to adopt counter-cyclical monetary policy geared towards achieving price stability. In this regard, insulating the central bank from political interference, which is referred to as CBI, is crucial since such interference could undermine the central bank's main goal of price stability, posing risks to economic stability and growth.

The neglect of counter-cyclicality objectives in framing both fiscal and monetary policies over the decades, exacerbated by several imprudent policy decisions taken in 2019-2022, paved the way for the current economic crisis. Fiscal policy decisions were mostly based on political considerations rather than on the grounds of sound economic fundamentals, as theorized in the PBC. Such policies caused a severe deterioration in the fiscal situation, resulting in debt unsustainability. Giving way to fiscal dominance, the CBSL willingly accommodated fiscal shortfalls by directly lending to the Government, thereby fueling monetary expansion and inflation. By and large, macroeconomic management was based on discretionary decisions rather than on rules. As a result, both fiscal and monetary policies became pro-cyclical, aggravating economic fluctuations instead of being counter-cyclical to mitigate the fluctuations. In effect, Sri Lanka's current economic crisis is indicative of poor governance and institutional failures in the arenas of fiscal and monetary policies.

The adoption of such imprudent macroeconomic policies led to economic instability, negative GDP growth, and debt unsustainability. In April 2022, the Government announced its inability to service foreign debt, and accordingly, Sri Lanka became the first country in the Asia-Pacific region to default on foreign debt in this century. Fiscal and balance of payments deficits have been at the forefront of the multiple economic imbalances faced by

the country in recent times. In 2022, the depleted foreign exchange reserves caused severe shortages in food, medicine, fuel, and other essentials throughout the country. During this time, shipments carrying diesel, petrol, and LP gas remained anchored off the port, awaiting settlement of payment.

Although the outbreak of the COVID-19 pandemic had adverse effects on the economy, the present economic crisis is largely an outcome of a series of ill-conceived economic decisions adopted by the Government since the latter part of 2019. In particular, politically-motivated tax cuts implemented in the aftermath of the presidential election in November 2019 had devastating effects on the country's macroeconomic instability. They led to a substantial revenue loss and a consequential rise in the budget deficit. The Government has been increasingly dependent on borrowings from the CBSL and commercial banks to finance its growing fiscal deficit. In the meantime, the CBSL adopted obsolete monetary policy measures, including fixed ceilings on the exchange rate and interest rates on bank deposits. Such direct policy measures resulted in an overvalued exchange rate and rapid depletion of foreign reserves to minimum levels. This was a classic case of the phenomenon known as the "impossible trinity" or "policy trilemma", which postulates that a country's central bank cannot fix both the exchange rate and interest rates at the same time without losing its foreign reserves.

In keeping with the scope of the GCF-SLIF project, the objective of this study is to diagnose the causes of the macroeconomic policy failures that paved the way to Sri Lanka's current economic crisis and identify the policy strategies that are required for economic recovery. The analysis draws the attention of policymakers to the need for adopting prudent fiscal, monetary, and foreign trade and investment policies and integrating them into a coherent macroeconomic framework to ensure economic stability and growth.

This monograph is organized as follows: Section 2 reviews the macroeconomic policy issues, focusing on the economic crisis. Section 3 presents an analysis of the economic instability stemming from the twin deficits. Section 4 analyzes the causes of the country's growth setback. Section 5 focuses on the fiscal policy. Section 6 presents an analysis of the monetary policy. Section 7 evaluates the foreign trade and investment policies. Section 8 stresses the need to adopt an integrated approach towards macroeconomic policies. Section 9 reviews the progress of the ongoing macroeconomic policy reforms including debt restructuring. The concluding remarks are presented in Section 10.

2. Macroeconomic Policy Issues

The adoption of a cohesive macroeconomic strategy to overcome the economic crisis is the most formidable policy challenge currently faced by the policymakers. In the latter part of 2022, the Government began negotiations with the IMF to adopt an economic recovery programme and accordingly, the policy reforms are currently in progress.

2.1 Economic Crisis

Following the imprudent economic policies adopted during the period 2019–2022, Sri Lanka fell into a deep economic crisis. The problems associated with the crisis are threefold, namely; (a) economic instability, (b) growth setback, and (c) debt unsustainability. Amidst upcoming elections, political uncertainties, and social unrest, the Government is confronted with the daunting task of implementing the recovery programme in order to overcome the economic catastrophe.

The current economic crisis is the culmination of internal and external macroeconomic imbalances experienced over the decades. Internally, the persistent fiscal deficits have had adverse consequences on price stability, debt management, and export competitiveness. Externally, the widening balance of payments deficits caused a continuous depletion of foreign reserves and accumulation of foreign debt to unsustainable levels. These two deficits are closely interrelated, and therefore, they are known as the 'twin deficits'. Reflecting the adverse effects of the twin deficits, national savings, and domestic investment demonstrated a long-term downward trend, constraining economic growth. These imbalances aggravated following the irresponsible policy decisions adopted since 2019[3].

In a historic ruling delivered in November 2023, the Supreme Court declared that the ex-President and two former Finance Ministers, along with several senior officials, had violated public trust and breached Article 12 (1) of the Constitution in their administration of the economy, leading to the economic crisis in the country[4].

The overall budget deficit to GDP ratio remained above 10 percent during 2020-2022 (Table 2.1). The Government's excessive borrowings from the banking sector, particularly from

3 The present author pointed out the pitfalls of such imprudent policies in a series of newspaper articles listed at the end of this monograph

4 The Supreme Court decreed that ex-President Gotabaya Rajapaksa, former Finance Ministers Mahinda Rajapaksa and Basil Rajapaksa, and several officials bear responsibility for Sri Lanka's severe economic crisis, whereby they violated the fundamental rights of the people by mismanaging the economy between 2019 and 2022. The apex court found that 13 respondents, including former CBSL Governors Ajit Nivard Cabraal and Prof. W. D. Lakshman, former Secretary to the President Dr. P. B. Jayasundara, former Secretary to the Ministry of Finance S. R. Attygalle, and several members of the Monetary Board of the CBSL had violated public trust and breached Article 12 (1) of the Constitution in their administration of the economy, leading to the economic crisis in the country.

the CBSL, caused a rapid increase in the money supply, fueling inflationary pressures. Measured in terms of the Colombo Consumer Price Index (CCPI), inflation rose to 57.2 percent in December 2022 on Year-on-Year (Y-o-Y) basis. The rise in the cost of living adversely affected the livelihood of the poor segments of the society whose income has declined in recent years due to the growth slowdown. Since then, inflationary pressures have eased and the Y-o-Y inflation rate declined to 4.0 percent in December 2023 and to 0.9 percent in May 2024.

Table 2.1: Macroeconomic Performance

Indicator	2019	2020	2021	2022	2023
Real Sector					
Real GDP Growth, %	-0.2	-4.6	4.2	-7.3	-2.3
GDP at Current Market Price, Rs. mn.	15,911	15,646	17,612	24,054	27,630
Per Capita GDP, USD	4,082	3,851	3,999	3,464	3,830
External Sector					
Trade Balance, % of GDP	-9.0	-7.1	-9.2	-6.7	-5.8
Current Account Balance, % of GDP	-2.1	-1.4	-3.7	-1.9	1.8
Overall Balance, USD mn.	377	-2,328	-3,967	-2,806	2,826
Gross Official Reserves, USD mn.	7,642	5,664	3,139	1,898	4,392
Fiscal Sector					
Current Account Balance, % of GDP	-3.4	-7.5	-7.3	-6.4	-6.0
Primary Balance, % of GDP	-3.4	-4.4	-5.7	-3.7	0.6
Overall Fiscal Balance, % of GDP	-9.0	-10.7	-11.7	-10.2	-8.3
Central Government Debt, % of GDP	81.9	96.5	100.1	114.2	103.9
Monetary Sector and Inflation					
Broad Money Supply (M2b) Growth, %	7.0	23.4	13.2	15.4	7.3
Private Sector Credit Growth, %	4.2	6.5	13.1	6.2	-0.6
CCPI Inflation (Y-o-Y) %	4.8	4.2	12.1	57.2	4.0

Source: CBSL, 2024

The balance of payments faced severe stress by 2022 due to the outflow of foreign reserves, limited access to foreign borrowings, and a decline in worker remittances. Heavy debt repayments clustered from 2019 onwards further worsened the balance of payments situation, and in April 2022, Sri Lanka became a debt-default country for the first time in its post-independence history.

Given the deteriorating balance of payments situation and the debt unsustainability, the international credit rating agencies downgraded Sri Lanka's sovereign credit ratings on several occasions. Both the Government and the CBSL rejected the downgradings outright,

asserting that Sri Lanka could stand on its own by adopting so-called "home-grown" policies. However, the authorities did not explicitly announce such policies and merely took steps to correct the imbalances by adopting several ad hoc administrative measures such as interest rate ceilings, exchange rate fixing, export conversion rules, restrictions on non-essential imports, and increased dependence on domestic borrowings. These measures were detrimental to both export competitiveness and economic growth.

The authorities continued to refrain from seeking the assistance of the IMF until the latter part of 2022. Given the stringent conditionalities attached to the IMF facilities, the Government preferred to resort to commercial loans raised from bi-lateral lenders and global capital markets. The failure to adhere to any structural adjustments to achieve macroeconomic stability, particularly for ensuring fiscal discipline aimed at reducing the budget deficit, led to a rapid accumulation of the debt stock.

GDP growth declined to -7.3 percent in 2022, largely reflecting the combined effects of the economic disruptions caused by frequent power cuts and shortage of imported intermediary and investment goods due to the foreign exchange crisis. The economy contracted by 2.3 percent in 2023. Economic activities were also adversely affected by the COVID-19 pandemic. However, it needs to be noted here that GDP growth was on a downward trajectory even before the current economic crisis and the pandemic. The average growth rate was only 3.7 percent per annum during the pre-pandemic period of 2015–2019. The long-term growth setback reflects that Sri Lanka is caught up in the "middle-income trap". Apart from the macroeconomic imbalances discussed above, the supply-side bottlenecks also inhibit growth potential. In particular, the country failed to graduate from "factor-driven" growth to "technology and innovation-driven" growth. This was an outcome of the failure of successive governments to advance Science, Technology, and Innovation (STI) through progressive economic policy agendas.

The total external debt rose to as much as 60 percent of GDP by the end of 2021. The gross official reserves fell from USD 7.6 billion in 2019 to USD 1.9 billion in 2022. The deteriorating balance of payments situation exerted severe pressure on the exchange rate, resulting in the rupee depreciating by around 200 percent against the USD between 2020 and 2022.

2.2 Economic Recovery Programme

In September 2022, the Government and the IMF reached a staff-level agreement to support the economic recovery policies with a USD 2.9 billion EFF arrangement over a period of 48 months. This arrangement was approved by the IMF in March 2023 (IMF, 2023a). The objectives of this new Fund-supported programme are to restore macroeconomic stability and

debt sustainability while safeguarding financial stability, protecting the vulnerable, stepping up structural reforms to address corruption vulnerabilities, and unlocking Sri Lanka's growth potential. Debt relief from Sri Lanka's creditors and additional financing from multilateral partners will be required to help ensure debt sustainability and closing of financing gaps. According to the Fund, financing assurances from Sri Lanka's official creditors for restoring debt sustainability and making a good faith effort to reach a collaborative agreement with private creditors are crucial before the IMF can provide financial support to Sri Lanka.

In line with the EFF arrangement, the Government has embarked on a policy reform process to correct the country's macroeconomic misalignments. Revenue-based fiscal consolidation is a major component of the reform package. As regards monetary management, the CBA approved by Parliament in 2023 is expected to provide greater autonomy to the CBSL, facilitating an inflation-targeting monetary policy framework. The Government has also initiated the restructuring of foreign and local debt. The domestic debt restructuring labeled as Domestic Debt Optimization (DDO) covers only the government securities held by the CBSL and superannuation funds, excluding commercial banks and individuals. The maturity period of the securities will be extended under the DDO and there are no "haircuts". The foreign debt rescheduling is currently in progress.

2.3 Macroeconomic Outlook and Risks

The EFF-supported adjustment programme envisages a gradual recovery of the economy depending on the successful implementation of reforms, and sovereign debt restructuring that meets the debt sustainability targets (Table 2.2). The real GDP is projected to grow marginally by 1.5 percent in 2024 and by around 3.0 percent from 2026 onwards. It indicates the country's inability to reach a higher growth trajectory due to the balance of payments constraints and structural bottlenecks, including technology and innovation backwardness. Inflation is projected to decelerate mainly on account of the favourable effects of the inflation-targeting monetary policy, discontinuation of monetary financing, and fiscal consolidation.

Table 2.2: Macroeconomic Projections (Restructuring Scenario)

Variable	2024	2025	2026	2027	2028
Real Sector					
Real GDP Growth (% change)	1.5	2.6	3.0	3.1	3.1
Inflation (Y-o-Y % change)	6.7	5.6	5.2	5.1	5.0
Government Finance					
Revenue and Grants (% of GDP)	13.3	14.9	15.0	15.1	15.3
Expenditure (% of GDP)	19.7	19.9	19.9	19.6	19.4
Budget Deficit (% of GDP)	-6.4	-5.0	-4.8	-4.5	-4.2
Public Debt (% of GDP)	108.5	107.8	106.8	104.4	101.3
Money and Credit					
Broad Money Supply (% change)	11.2	7.3	8.4	8.3	8.3
Credit to Public Sector (% change)	-0.8	-4.7	-4.2	-3.6	-2.4
External sector (USD Mn.)					
Current Account Balance (% of GDP)	-1.4	-1.4	-1.4	-1.3	-1.3
Total Foreign Debt (% of GDP)	76.7	78.0	78.6	79.6	77.6

Source: IMF, 2023a

The budget deficit to GDP ratio is projected to decline to 6.4 percent in 2024 and to 4.1 percent in 2028, with the anticipated increase in the revenue to around 15 percent of GDP in the medium-term. Bank credit to the public sector is expected to decline in the medium-term due to fiscal consolidation, the prohibition of CBSL credit to the Government, and the restructuring of SOEs. The current account deficit of the balance of payments is projected to remain around 1.4 percent of GDP until 2026. The total foreign debt to GDP ratio will continue to remain high, over 75 percent of GDP in the medium term.

There are several downside risks in implementing the policy package, given Sri Lanka's poor track record of economic management stemming from PBC-styled fiscal policies. The success of the recovery package depends largely on the Government's commitment to implement the policy reforms, leaving aside the political motives. Dilution of such commitment, however, is already evident in the Budget 2024, which offered popular handouts like salary and pension hikes to public servants, increased social welfare benefits, and decentralized budget allocations to members of Parliament. Capital expenditure has been allocated in the Budget during these difficult times for several large-scale infrastructure projects, including an airport, without following the standard project evaluation procedures. As regards the revenue-based fiscal consolidation, the deadline given for opening the Taxpayer Identification Number (TIN) has been postponed indefinitely.

Further risks are likely to arise from factors such as social unrest, political instability, corruption, weak governance, and difficulties in absorbing policy shocks. The upcoming elections in 2024 are likely to further disrupt the ongoing reforms. The probability of such risks is high, considering Sri Lanka's poor track record in implementing previous reforms initiated under 16 adjustment programmes with the IMF since 1965.

3. Macroeconomic Instability

As mentioned earlier, Sri Lanka is facing severe macroeconomic imbalances stemming from unprecedented deficits in the government budget and the balance of payments. These twin deficits are the major causes of the current economic crisis.

3.1 Twin Deficits

The continuous budget deficits and the current account deficits of the balance of payments are prominent features of the macroeconomic instability in Sri Lanka. The budget deficit has negative effects on the balance of payments, as explained in the twin deficit hypothesis. According to the Mundell-Fleming model (Mundell, 1963; Fleming, 1962), a budget deficit causes interest rates to rise, which in turn leads to exchange rate appreciation. These result in an increase in imports and a decline in exports, causing a deterioration of the balance of payments.

The relationship between the fiscal balance and the external balance can be explained as follows:

The basic macroeconomic identity defines Gross Domestic Product (Y) as the sum of private consumption (C), private investment (I), government expenditure (G), and current account balance of the balance of payments (CA).

$$Y = C + I + G + CA \qquad (1)$$

The current account balance consists of exports minus imports (X – M, which is equivalent to the trade balance), services (S), primary income (PI), and secondary income (SI).

$$CA = (X - M) + S + PI + SI \qquad (2)$$

Private savings (S_p) equal income net of consumption expenditure and taxes (T).

$$S_p = Y - C - T \qquad (3)$$

Government savings (S_g) could be expressed as the difference between tax revenue and government expenditure.

$$S_g = T - G \qquad (4)$$

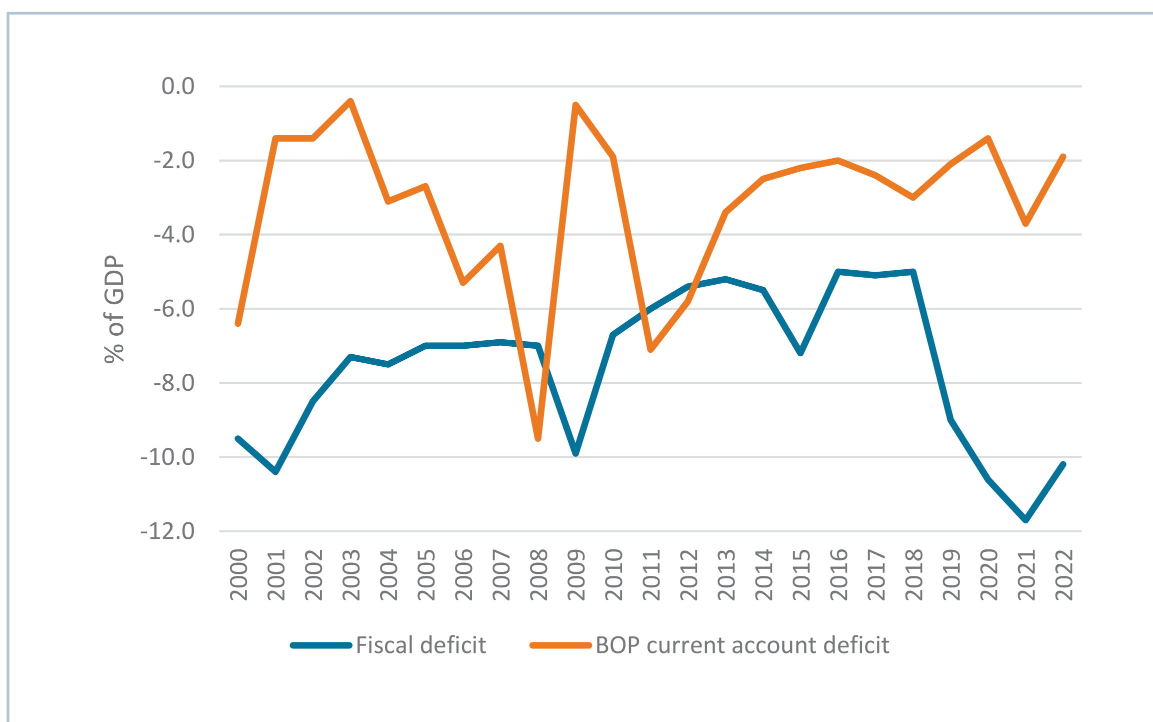
By substituting (1) into (3), the current account balance equals the sum of private and government savings.

$$CA = (S_p - I) + (T - G) \qquad (5)$$

Equation (5) implies that the external current account balance is directly related to the sum of private and government savings. In other words, the current account balance is identical to the difference between domestic savings and investment. It is also clear that the two main sources of savings (i.e., private domestic savings and foreign capital inflows) finance both private investment and the budget deficit. This indicates that the widening budget deficit absorbs a part of private savings and foreign capital instead of diverting them to domestic investment for more productive purposes.

In the case of Sri Lanka, the twin deficits have moved more or less in the same direction over the last two decades (Figure 3.1). The fiscal deficit, which averaged around 7.4 percent of GDP per year during 2000–2015, declined to an average of 5.4 percent of GDP during 2016–2018, reflecting the fiscal consolidation efforts adopted under the previous IMF-EFF agreement (2016–2019). Since then, the fiscal situation worsened with the rise in the budget deficit as a ratio of GDP from 5.0 percent in 2018 to 9.0 percent in 2019, and to 11.7 percent in 2021, followed by 10.2 percent in 2022. The current account deficit of the balance of payments as a ratio of GDP rose from 1.4 percent in 2020 to 3.7 percent in 2021. This was a reversal of the lower current account deficits experienced before 2019, which had reflected the positive effects of the structural reforms implemented under the previous EFF agreement. The current account deficit to GDP ratio declined to 1.9 percent in 2022 and to 1.8 percent in 2023 indicating an improvement in the trade balance due to a significant reduction in imports.

Figure 3.1: Twin Deficits



Source: Compiled by the author using CBSL data

As several empirical studies based on the time series analyses revealed, Sri Lanka's fiscal deficit has a uni-directional causal effect on the balance of payments. Based on a Vector Error Correction Model (VECM), Colombage (2015) found a significant uni-directional causality running from the fiscal deficit to the current account deficit. Similar uni-directional causality was also found in the studies of Saleh, Mehendhiran, and Agalewatte (2005), Chowdhury and Saleh (2007), Premaratne, Ravinthirakumaran, and Kesavarajah (2011), Perera and Liyanage (2012), and Weerakoon, Kumar, and Dime (2019). These studies emphasize the importance of reducing the fiscal deficit to ease the balance of payments pressures.

3.2 Fiscal Crisis

The ill-advised policy decisions taken after 2019 aggravated the fiscal imbalance that had persisted for several decades. The fiscal deficit increased from Rs. 1,439 billion in 2019 to Rs. 1,668 billion in 2020 and to Rs. 2,058 billion in 2021 (Table 3.1). This can be primarily attributed to the decline in tax revenue by 30 percent, from Rs. 1,735 billion in 2019 to Rs. 1,217 billion in 2020, caused by the arbitrary tax cuts. Against such revenue downfall, the sharp increase in the total expenditure from Rs. 3,041 billion in 2020 to Rs. 3,522 billion in 2021 and to Rs. 4,473 billion in 2022 exerted enormous pressure on the fiscal situation. The fiscal deficit rose to a peak level of Rs. 2,460 billion (10.2 percent of GDP) in 2022.

Table 3.1: Key Fiscal Indicators **Rs. billion**

Item	2019	2020	2021	2022	2023
1. Total Revenue and Grants	**1,899**	**1,373**	**1,464**	**2,013**	**3,074**
1.1 Total Revenue	1,891	1,368	1,457	1,979	3,049
Tax Revenue	1,735	1,217	1,298	1,751	2,721
Non-tax Revenue	156	151	159	228	328
1.2 Grants	8	5	7	33	26
2. Expenditure and Net Lending	**3,338**	**3,041**	**3,522**	**4,473**	**5,357**
2.1 Recurrent	2,425	2,548	2,748	3,520	4,700
2.2 Capital and Net Lending	913	493	774	953	657
3. Current Account Balance	**-534**	**-1,180**	**-1,290**	**-1,540**	**-1,651**
4. Primary Balance	**-538**	**-687**	**-1,010**	**-895**	**173**
5. Overall Fiscal Balance	**-1,439**	**-1,668**	**-2,058**	**-2,460**	**-2,282**
6. Financing of Fiscal Deficit	**1,439**	**1,668**	**2,058**	**2,460**	**2,282**
6.1 Foreign Financing (Net)	543	-83	-14	425	495
6.2 Domestic Financing (Net)	896	1,751	2,072	2,035	1,788

Source: CBSL, 2024

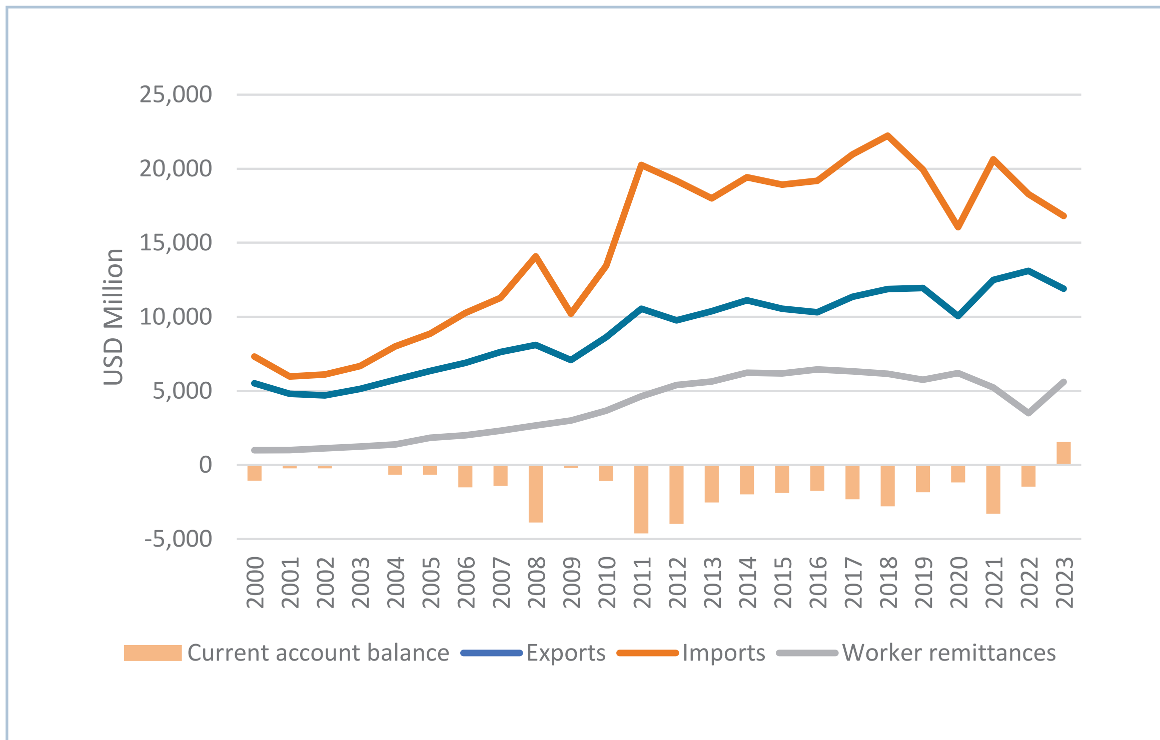
The financing of the wide fiscal deficit became extremely difficult since access to foreign capital markets was constrained by the country's weakening debt sustainability. Consequently, the entire fiscal deficit was financed through domestic borrowings mainly from the CBSL and commercial banks in 2020 and 2021. Such borrowings caused a significant monetary expansion, fueling inflation, exchange rate overvaluation, balance of payments deterioration, and debt unsustainability.

In 2023, the fiscal situation improved slightly, reflecting a marginal decline in the fiscal deficit to Rs. 2,282 billion from Rs. 2,460 billion in 2022. This was mainly due to a 55 percent increase in the tax revenue in 2023 as a result of the tax reforms. Nevertheless, the exorbitant increase in the recurrent expenditure by 34 percent from Rs. 3,520 billion in 2022 to Rs. 4,700 billion in 2023 still poses severe risks to fiscal sustainability.

3.3 Balance of Payments Crisis

The balance of payments has been under stress over the decades due to the widening trade deficit, which was partly siphoned-off by worker remittances (Figure 3.2). The external sector underwent a severe setback in 2021 with a more than two-fold increase in the current account deficit to USD 3,284 million from USD 1,187 million in 2020 (Table 3.2). This was partly caused by a significant increase in imports that led to a rise in the trade deficit from USD 6,008 million in 2020 to USD 8,139 million in 2021. In addition. there was a considerable diversion of inward remittances through informal channels such as Hawala and Undiyal, largely due to the overvalued official exchange rate. Consequently, official remittances declined from USD 6,207 million in 2020 to USD 5,228 million in 2021 and to USD 3,496 million in 2022. The depreciation of the rupee since then caused a rise in the remittances to USD 5,619 million in 2023.

Figure 3.2: Balance of Payments Trends



Source: CBSL, 2024

Table 3.2: Balance of Payments **USD million**

Item	2019	2020	2021	2022	2023
Current Account Balance	-1,843	-1,187	-3,284	-1,448	1,559
Trade Balance	-7,997	-6,008	-8,139	-5,185	-4,900
Exports	11,940	10,047	12,499	13,106	11,911
Imports	19,937	16,055	20,637	18,291	16,811
Services & Primary Income (net)	388	-1,386	-373	240	841
Transfers (net)	5,766	6,207	5,228	3,496	5,619
Capital Account (net)	23	28	25	19	63
Financial Account	-2,460	-394	-4,211	-1,569	1,304
Long-term Capital (net)	-375	-533	-1,281	819	1,194
Direct Investment	-666	-420	-575	-869	-678
Other Private	203	56	167	9	27
Government	89	-169	-873	1,679	1,845
Short-term (net)	-2,085	138	-2,930	-2,388	109
Overall Balance	377	-2,328	-3,967	-2,806	2,826

Source: CBSL, 2024

The overall balance of the balance of payments, which reflects the change in net international reserves, was in deficit during the period 2020-2022. As a result, gross official reserves continued to decline from USD 7,642 million (6.3 months of imports) in 2019 to USD 1,898 million (3.9 months of imports) in 2022 (Table 3.3). The external sector was severely strained due to the critically low level of gross official reserves coupled with acute liquidity shortage in the domestic foreign exchange market and the lack of access to foreign financing sources. As a result, the rupee depreciated by 81 percent against the USD in 2022, on Y-o-Y basis.

Table 3.3: Foreign Reserves and Exchange Rate Movements

Item	2019	2020	2021	2022	2023
Gross Official Reserves (USD million)	7,642	5,664	3,139	1,898	4,392
Toral Foreign Assets					
Amount (USD million)	10,402	8,521	6,122	5,874	9,373
Months of Imports	6.3	6.4	3.6	3.9	6.7
Exchange Rate (LKR /USD)					
Year-end	181.63	186.41	200.43	363.11	323.92
Annual Average	178.78	185.52	198.88	324.55	327.53

Source: CBSL, 2024

In 2023, the balance of payments situation somewhat eased, reflecting a surplus in the current account backed by a decline in imports and an increase in inward remittances. This, together with the non-servicing of foreign debt helped generate a surplus in the overall balance, causing a rise in international reserves. The CBSL built up gross official reserves to the tune of USD 4,392 million by the end of 2023 by directly absorbing foreign exchange from the domestic foreign exchange market. In spite of such improvements, the underlying pressure on the balance of payments continues to remain, as evident from the significant decline in exports and FDI in 2023, which are to be the key drivers of export-led growth. Hence, the rise in the international reserve stock against the backdrop of the foreign debt default is no ground for complacency.

3.4 Debt Unsustainability

The Government had to resort to various financing sources to bridge the budget deficit. Until Sri Lanka was elevated to lower-middle-income status in 1997, it had been possible to obtain foreign borrowings at concessional rates. Since then, the country has had to rely heavily on commercial borrowings from global capital markets and non-traditional bilateral lenders. Such borrowings increased substantially after the cessation of the war in 2009 in order to fund large-scale infrastructure projects, including highways, an airport, and a

port. The standard project evaluation methods for determining the necessity, effectiveness, efficiency, impact, and sustainability were not complied with when launching such debt-funded projects, making debt-service capacity extremely vulnerable. Thus, changes in the sources of deficit financing over the last two and a half decades resulted in a sharp increase in non-concessional foreign debt, causing severe debt unsustainability.

The Government raised foreign market borrowings through 10-year International Sovereign Bonds (ISBs), short-term investment in Treasury Bills and Bonds, and syndicated loans. Sri Lanka had the benefit of attracting such foreign loans following the financial crisis of 2008, as global capital markets were flooded with excess liquidity until around 2018, and foreign investors were eager to lend to emerging economies at attractive interest rates. As such borrowings began to mature in 2019, Sri Lanka's external debt repayments rose to USD 4-6 billion per year, bringing about severe debt unsustainability that ultimately led to the foreign debt default in 2022.

Continuous government borrowings have resulted in an unprecedented increase in the public debt stock in recent years, causing interest payments to rise by 84 percent from Rs. 852 billion in 2018 to Rs. 1,565 billion in 2022. During this period, the total amount of interest payments was higher than the total government revenue, reflecting the severity of the debt-service burden. The primary balance was in deficit, implying that the total government revenue was insufficient even to finance the expenditure items, other than interest payments[5]. This indicates that borrowings were necessary not only to meet interest payments but also to finance a part of non-interest expenditure. Achieving a primary surplus is considered critically important for countries such as Sri Lanka with a large outstanding public debt relative to GDP. This is why the generation of a primary surplus of 2.3 percent of GDP in 2025 is earmarked in the IMF-EFF arrangement. In 2023, the primary balance showed a marginal surplus of 0.6 percent of GDP due to the suspension of foreign debt servicing.

The Government's total outstanding debt stood at 100.1 percent of GDP at the end of 2021 (Table 3.4 and Figure 3.3). The ratio increases further to 108 percent of GDP when government-guaranteed loans are included. The outstanding foreign debt currently exceeds 60 percent of GDP. Of the total amount of government debt, domestic and foreign debt accounted for 63 percent and 37 percent, respectively. The annual debt service payments accounted for 163 percent of government revenue in 2021, reflecting the gravity of the debt burden. The ratio of interest payments as a ratio of tax revenue, which could be considered a more appropriate indicator of the debt burden, rose from 44 percent in 2017 to 81 percent in 2021.

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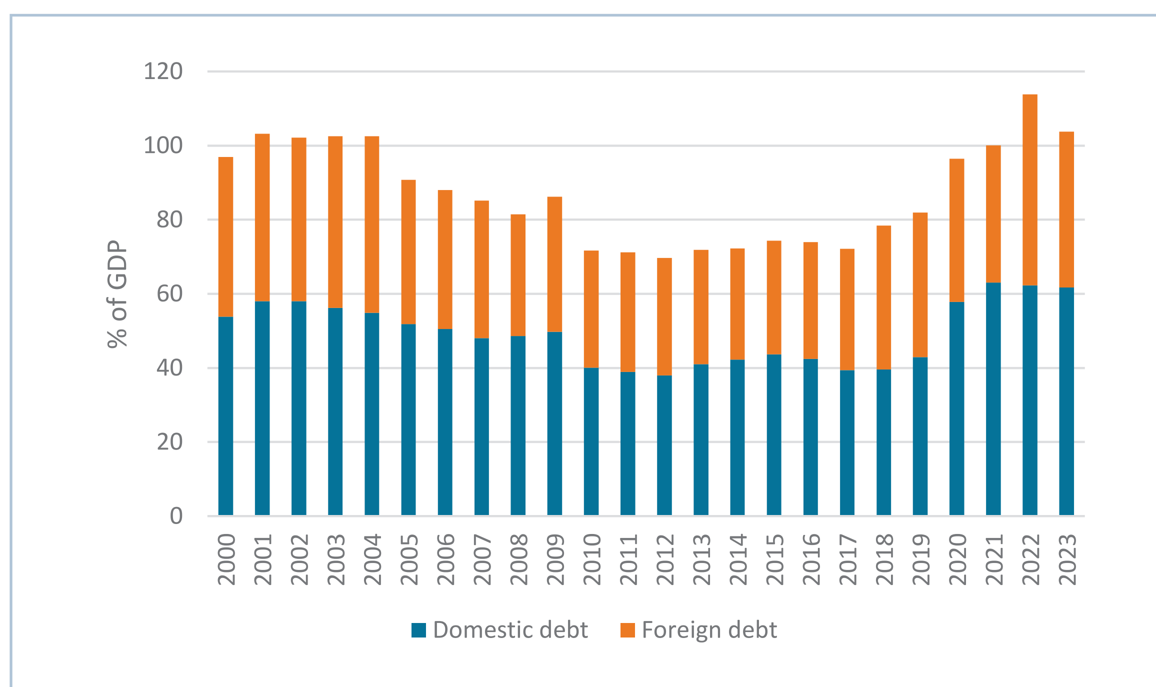
5 The primary balance is the difference between government revenue and its non-interest expenditure.

Table 3.4: Outstanding Government Debt (End of Period) **Rs. billion**

Item	2019	2020	2021	2022	2023
1.Domestic Debt	**6,830**	**9,065**	**11,097**	**15,034**	**17,052**
Treasury Bills	874	1,621	2,271	4,114	4,017
Treasury Bonds	4,606	5,713	6,966	8,709	12,002
Rupee Loans	24	24	24	24	-
Other	1,326	1,707	1,836	2,187	1,032
2.Foreign Debt	**6,201**	**6,052**	**6,517**	**12,458**	**11,644**
3.Total	**13,032**	**15,117**	**17,614**	**27,492**	**28,696**
4.Total (% of GDP)	**81.9**	**96.6**	**100.1**	**114.2**	**103.9**
Domestic (% of GDP))	42.9	57.9	63.0	62.5	61.7
Foreign (% of GDP)	39.0	38.7	37.0	51.8	42.1

Source: CBSL, 2024

Figure 3.3: Government Debt



Source: CBSL, 2024

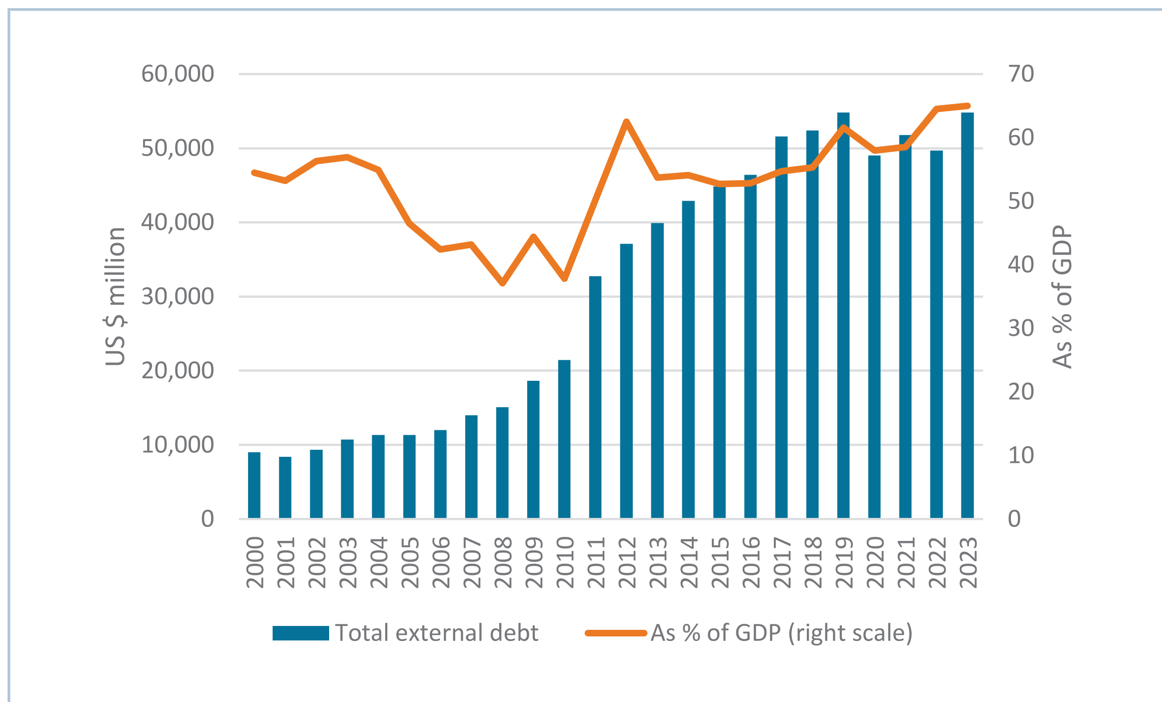
The external debt consists of foreign loans taken by the Government, CBSL, other financial institutions, and other sectors (Table 3.5). The outstanding external debt remained high, around USD 60 billion, accounting for around 60 percent of GDP in recent years (Figure 3.4).

Table 3.5: Outstanding External Debt, End of Period **USD million**

Item	2019	2020	2021	2022	2023
1. General Government	34,249	28,187	27,556	27,518	33,117
Short-term	119	4	1	31	210
Long-term	34,130	28,183	27,555	27,488	32,907
Debt securities	14,513	7,613	6,265	3,926	6,918
(of which) International Sovereign Bonds	14,102	7,555	6,233	3,866	6,794
Loans	19,617	20,570	21,289	23,562	25,988
2. CBSL	2,318	2,690	4,892	6,391	6,081
3. Other Financial Institutions	6,997	6,657	7,146	5,370	4,933
4. Other Sectors	6,469	6,517	6,847	4,443	4,542
5. Gross External Debt	54,811	49,041	51,775	49,667	54,832

Source: CBSL, 2024

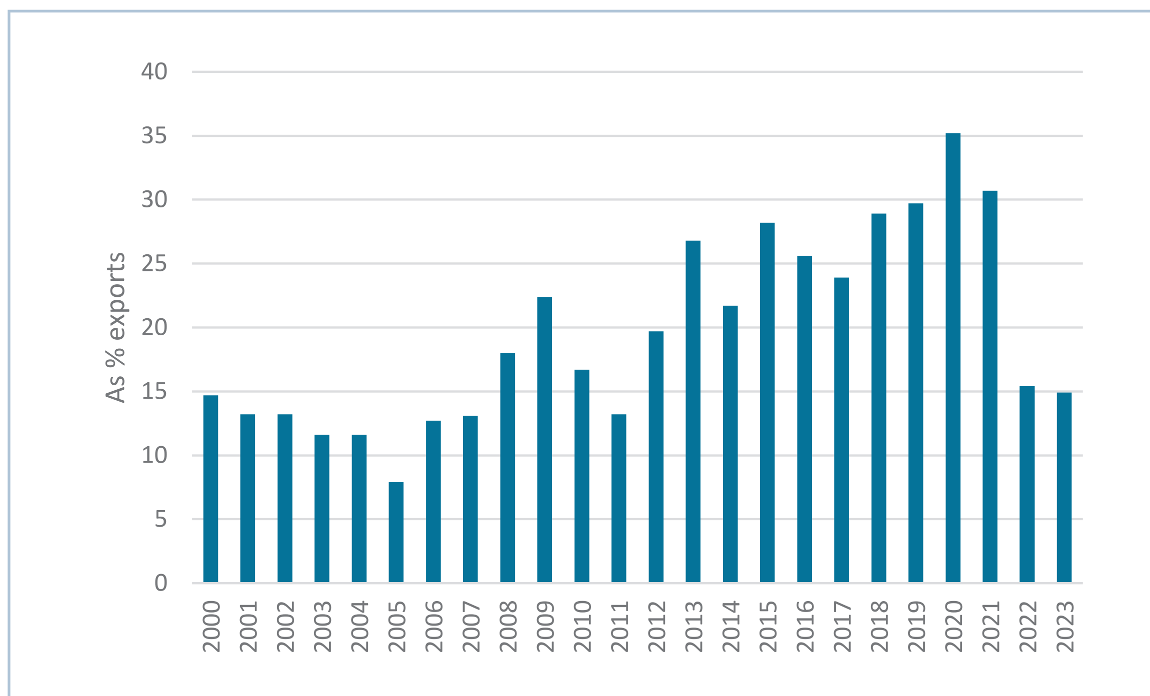
Figure 3.4: Outstanding External Debt



Source: CBSL, 2024

Following the rapid rise in external debt, the country's external debt service commitments rose to a peak level of 35 percent of total export earnings in 2020 (Figure 3.5). It ultimately resulted in the foreign debt default in 2022.

Figure 3.5: Debt Service Ratio



Source: CBSL, 2024

Access to foreign capital markets was severely restricted when global credit rating agencies downgraded Sri Lanka's sovereign debt ratings on several occasions. Therefore, in the recent past, the Government turned to bilateral swap agreements to overcome the immediate balance of payments difficulties. Foreign borrowings were raised mainly in the form of commercial loans from capital markets, particularly from China, without adequate attention being paid to the rate of return on investment or debt servicing capacity, unlike in the case of loans taken from multilateral agencies such as the World Bank and the Asian Development Bank, which are usually subject to strict scrutiny. As a result, many debt-funded projects have failed to generate sufficient economic growth or foreign exchange earnings, making debt service payments extremely difficult, since the bulk of such loans have matured during the last couple of years. The rupee depreciation and the upward movements of interest rates aggravated the country's debt service burden. Proper debt evaluation needs to be introduced for future borrowings to avoid such debt sustainability crises.

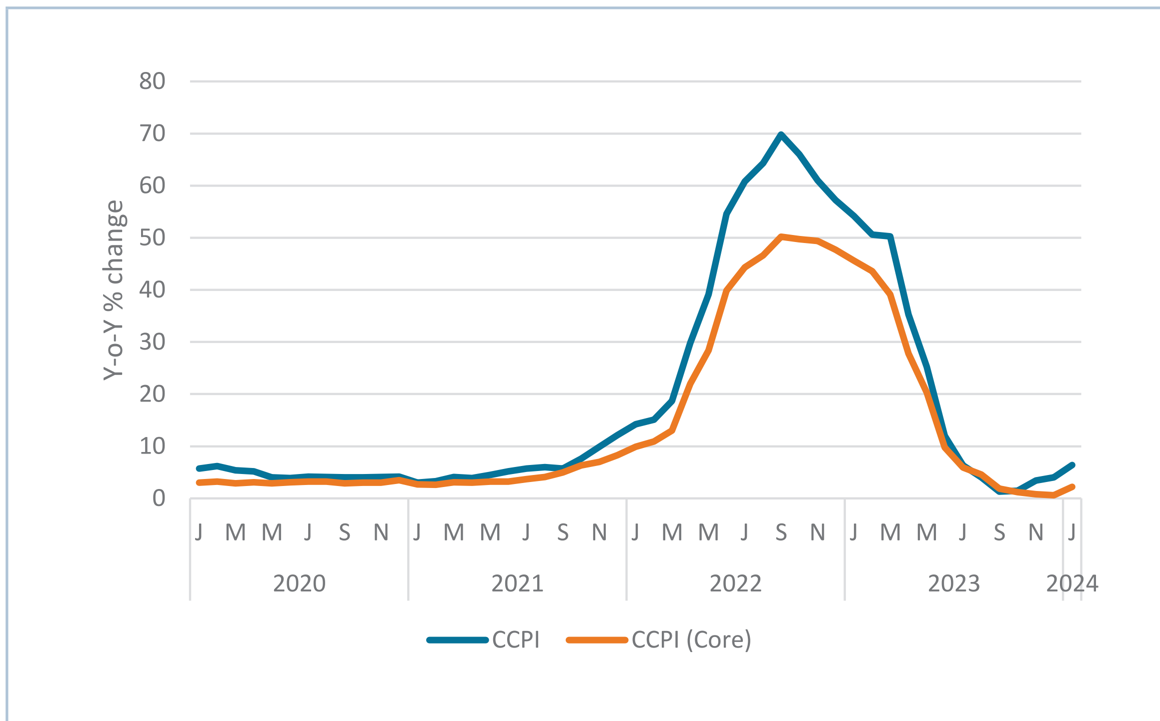
In terms of the benchmarks of the Debt Sustainability Assessments (DSAs) of the World Bank and the IMF, Sri Lanka's debt unsustainability was evident by 2021. The country's debt solvency ratio at 108 percent of GDP (gross public debt to GDP ratio) was much higher than the threshold of 55 percent of GDP. Its liquidity ratio of 64 percent (debt service payments on long-term public and publicly guaranteed debt as a ratio of government revenue) was also much higher than the threshold of 23 percent. Accordingly, Sri Lanka was ranked in the "extremely speculative/substantial risk" category, along with seven other countries: Angola,

the Congo, the Congo DRC, Gabon, Lao PDR, Mali, and Mozambique. These countries, including Sri Lanka, were classified as "next in line for the default" and as projected, Sri Lanka became a debt-defaulting country in 2022.

3.5 Inflation Volatility

Since April 2022, the Y-o-Y headline inflation measured in terms of the CCPI, rose to 69.8 percent in September 2022 (Figure 3.6)[6]. In September 2022, food and non-food inflation rates increased to 94.9 percent and 57.6 percent, respectively. The core or underlying inflation, which excludes food and energy price movements, rose to 50.2 percent on Y-o-Y basis in September 2022.

Figure 3.6: Headline and Core Inflation



Source: CBSL, 2024

6 The headline inflation refers to the changes in the prices of all goods and services in the consumer basket. The core inflation excludes food and fuel items from the headline inflation. Core inflation, which reflects the underlying long-term trends of consumer price movements, is widely used for monetary policy purposes.

The monetary expansion caused by CBSL's extensive lending to the Government was a major contributory factor for the exorbitantly high inflation. The sharp depreciation of the rupee since March 2022 was another factor that led to the acceleration of inflation on the cost side. Imports became costlier with the depreciation of the rupee, precipitating a cost escalation in a significant portion of consumer goods.

In the backdrop of supply shortages due to the COVID-19 pandemic and import restrictions, inflationary pressures intensified further. The removal of maximum retail prices of several essential goods including rice, wheat flour, milk powder, and LP gas also had a significant impact on the general price level. In April 2021, the Government's sudden decision to ban chemical fertilizers and other agrochemicals resulted in a decline in agricultural productivity and a surge in food inflation, further aggravating inflationary pressures.

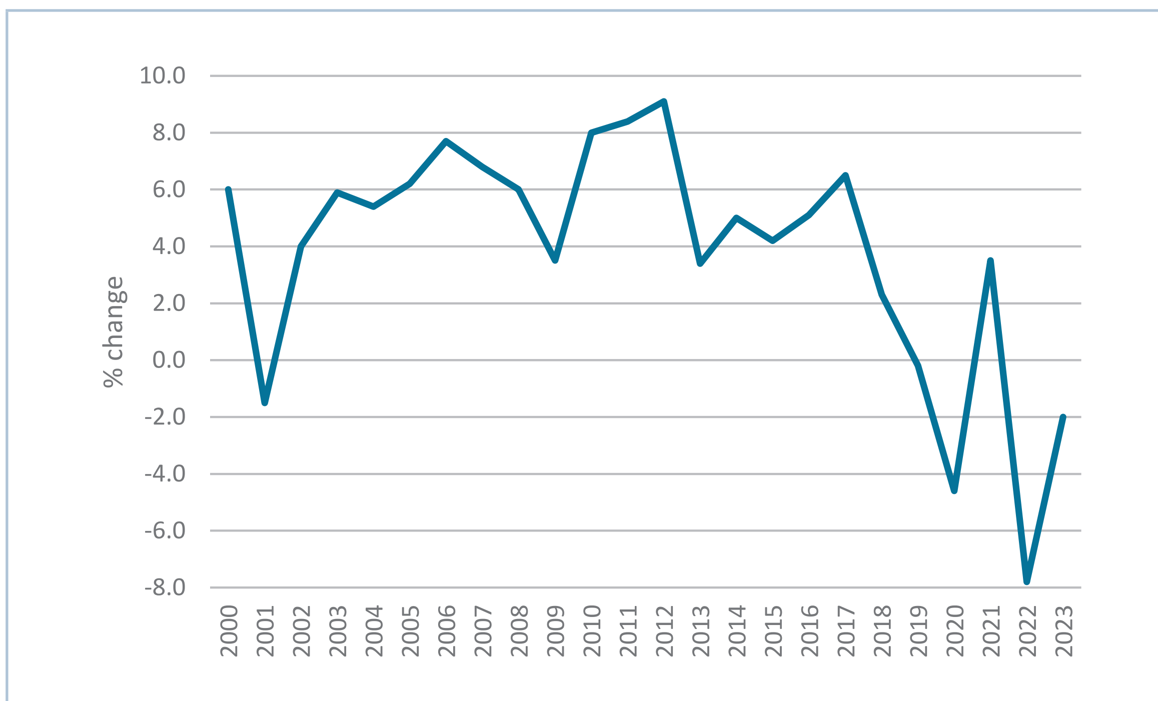
4. Economic Downturn

Reflecting the gravity of the economic crisis, on average, the economy contracted by 2.0 percent per year during 2019-2023. GDP growth continued to remain negative during this period, except in 2022. As a result, Sri Lanka has been downgraded from the upper-middle income category to the lower-middle income category in the World Bank's country classification. The annual GDP growth rate is projected to hover around 3 percent in the medium term. Robust macroeconomic policies coupled with supply-side adjustments are essential for elevating the economy to a higher growth trajectory.

4.1 Growth Setback

There has been a downward trend of GDP growth, particularly during the last decade (Figure 4.1). Although there was an economic recovery in the years following the negative growth experienced in 2001, the economy contracted at the height of the North-East conflict during the period 2007–2009. Thereafter, the country enjoyed an economic boom propelled by post-conflict reconstruction activities and mega infrastructure projects funded by foreign commercial loans, mainly from China. This lasted only for about two years, after which GDP growth continued to decline.

Figure 4.1: GDP Growth



Source: CBSL, 2024

GDP growth declined to -4.6 percent in 2020 mainly due to the economic disruptions caused by the COVID-19 pandemic, which included lockdowns, curfews, and travel bans (Table 4.1). The growth capacity, inhibited by the effects of COVID-19 since 2020, was further constrained by frequent power cuts, and the shortage of investment and intermediary goods stemming from the balance of payments crisis. Thus, the balance of payments difficulties are a severe constraint for economic growth in Sri Lanka, as stipulated in 'Thirlwall's Law' (Thirlwall, 1979)[7].

Table 4.1: Gross Domestic Product

Item	2019	2020	2021	2022	2023
GDP at Current Market Prices (Rs. bn.)	15,911	15,646	17,612	24,064	27,630
GDP at Current Market Prices (USD n.)	88,989	84,420	88,611	76,845	84,403
Per Capita GDP at Current Market Prices (Rs.)	729,761	713,822	794,926	1,084,882	1,253,785
Per capita GDP at Current Market Prices (USD)	4,082	3,851	3,999	3,464	3,830
GDP Growth Rate (%)	-0.2	-4.6	4.2	-7.3	-2.3
Share of GDP					
Agriculture (%)	7.3	8.3	8.8	8.5	8.3
Industry (%)	29.2	28.2	30.0	29.8	25.6
Services (%)	55.7	57.8	55.9	57.0	59.9
Share of GDP					
Consumption (%)	71.7	73.3	70.7	75.0	76.2
Investment (%)	34.1	32.9	36.7	28.6	25.3
National Savings (%)	32.0	31.3	33.0	27.2	27.2

Source: CBSL, 2024

The low-growth trajectory in the past also demonstrates the failure to put in place the necessary pre-conditions to boost GDP growth, in line with the evolving growth paradigms in modern economies. In contrast to 'technology and innovation-driven' growth experienced by fast-growing economies, Sri Lanka still depends on outmoded 'factor-driven' growth process, which demands larger amounts of capital and labour inputs.

4.2 Inadequate Capital Formation

While national savings continued to remain below domestic investment, both variables have declined relative to GDP since 2018 (Figure 4.2). The downward trend of savings and investment has had negative implications for GDP growth.

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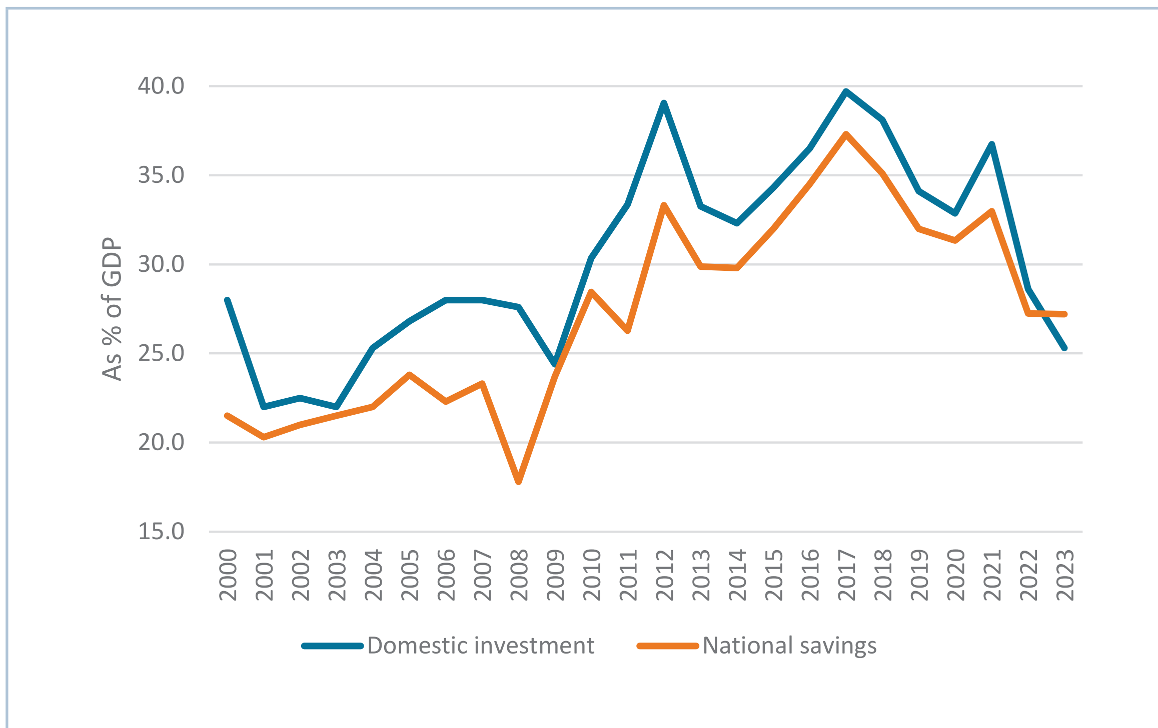
7 According to Thirlwall, a country's GDP growth rate can be approximated by the ratio of growth of exports to the income elasticity of demand.

Figure 4.2: Savings and Investment



Source: Compiled by the author using CBSL data

The gap between savings and investment could be explained in terms of the twin deficits hypothesis, discussed earlier. During the last two decades, the widening fiscal and current account deficits had detrimental effects on both national savings and domestic investment. Domestic investment should rise to at least 35 percent of GDP to sustain an annual GDP growth rate of around 7 percent. Had there been such high domestic investment, the savings-investment gap would have risen to more than 15 percent of GDP, instead of the present level of around 4 percent of GDP.

The setback in domestic investment is partly due to Sri Lanka's inability to attract FDI. The annual FDI inflows amounted to only around USD 500 million during 2019–2021. In making their investment decisions, foreign investors give high priority to factors such as political stability, social cohesion, sound macroeconomic fundamentals, labour discipline, law and order, ease of doing business, and a corruption-free administration. Sri Lanka has had poor global rankings in most of these attributes. The macroeconomic policy inconsistencies are a major impediment to attracting foreign investment to this country. Frequent trade union strikes and public protests are also contributing factors in discouraging foreign investment.

4.3 Low Investment Efficiency

Investment efficiency is another major factor that determines a country's GDP growth. An economy's investment efficiency or rate of return on capital can be measured by using a

metric called the Incremental Capital-Output Ratio (ICOR)[8]. In the case of Sri Lanka, the ICOR rose continuously from 2.99 in 2011 to 5.57 in 2019. This indicates that Rs. 2.99 worth of investment was needed to generate Rs. 1.00 of additional production in 2011, while Rs. 5.57 investment was needed for the same amount of additional production in 2019, demonstrating that the Sri Lankan economy is less efficient in using capital.

Low investment efficiency is an outcome of several factors. One of the main reasons is that the rate of return on some of the major infrastructure projects, such as highways, is not immediately transmitted to production increases. In this regard, the large amounts of debt-funded public infrastructure projects in the post-conflict period since 2009, adversely affected the country's debt sustainability as they did not generate sufficient returns to service the debt, as mentioned earlier.

Prior project evaluation procedures would have prevented such inefficient investment. Cost escalation due to administrative irregularities compounded by ubiquitous corruption in the public sector had negative impacts on investment efficiency. The bulk of the Gross Domestic Capital Formation (GDCF) was not allocated to export-oriented production but to non-tradable activities such as construction and transport equipment. Investment in the construction sector accounted for 43 percent and transport equipment for 14 percent of GDCF in 2020. A similar pattern could be seen concerning the FDI inflows of the enterprises under the Board of Investment (BOI), which was set up to promote export-oriented industries. Housing, property development, shops, offices, hotels, and restaurants accounted for nearly 50 percent of FDI inflows in 2020, indicating a heavy concentration of investment in non-tradables.

4.4 Middle-Income Trap

Sri Lanka graduated from low-income country status to lower-middle-income country status in 1997, as per the World Bank classification of countries. The country was elevated to upper-middle-income country status, according to the classification published in 2019. However, the World Bank downgraded Sri Lanka to the lower-middle-income category in its classification for 2020-2021.

The country has been caught up in the "middle-income trap" for more than two decades, failing to leap into the high-income category. Apart from macroeconomic instability and structural bottlenecks, a major cause of the growth setback has been the continuous reliance on low-value-added and low-tech industries. The initial wave of economic growth ran out

8 ICOR is the ratio of investment to GDP growth. It is equivalent to the reciprocal of the Marginal Product of Capital (MPC). The higher the ICOR the lower the investment efficiency.

of steam, as a result. Heavy concentration of investment in low-knowledge-intensive sectors such as construction and real estate development has restricted the country's growth potential.

The old-style manufacturing ventures dependent on cheap labour and backward technology are not sufficient to accelerate GDP growth in the modern world. If labour and capital are to be used more productively, creativity and innovation should become critically important. The production process would require an entirely new modus operandi. The ratio of government expenditure on R&D to GDP is only 0.12 percent in Sri Lanka, compared with 0.65 percent in India, 0.95 percent in Malaysia, 1.21 percent in Thailand, 2.16 percent in Singapore, and 2.43 percent in China. Private sector investment in R&D is also considerably low in Sri Lanka.

The countries that have reached 'knowledge economy' status have had a rapid acceleration in GDP growth, as evident from the success stories of East Asian countries. A knowledge economy is one that creates, disseminates, and uses knowledge to enhance its growth and development. Such an economy is characterized by high-value-added products containing advanced knowledge inputs. Sri Lanka has a long way to go before achieving knowledge economy status. Hence, her growth potential will continue to remain low in the years to come unless high priority is given to Science, Technology, and Innovation (STI), enabling the graduation to a 'technology and innovation-driven' growth process, instead of the present outmoded 'factor-driven' growth path.

5. Fiscal Policy

Persistent budget deficits are a major source of economic instability in Sri Lanka, as mentioned earlier. The fiscal imbalances have not only exerted ripple effects on the money supply, inflation, balance of payments, and debt burden but also preempted private sector resources, restraining economic growth. The economic policies of successive governments were primarily aimed at winning the electorate by offering various handouts to voters rather than implementing far-reaching economic policies that create a conducive business environment where the private sector could promote export-led growth. Sri Lanka's experience in the conduct of fiscal policy reveals that short-term political gains only serve to bring about adverse consequences for economic stability and growth in the long run.

5.1 Political Budget Cycle

The politically motivated fiscal policies adopted in Sri Lanka over the decades are a classic example of the phenomenon referred to as the PBC, theorized by Nordhaus (1975). The theory of PBC suggests that in modern democracies, the incumbent governments act opportunistically before elections to improve the chance of re-election. They attempt to stimulate the economy before elections by increasing expenditure to reduce unemployment and offer various welfare benefits. Governments usually prefer low unemployment to price stability, taking advantage of the short-run Phillips curve, which depicts an inverse relationship between unemployment and inflation [9]. Such populist policy measures result in an acceleration of the money supply, fueling inflation.

The PBC model assumes that voters have adaptive expectations, i.e., they base their voting decision largely on the most recent performance of the government. In this way, a government can use expansionary fiscal policies to attract votes before elections by rewarding the voters with new jobs. Nordhaus argues,

> "Voters cannot conceive a simple economic average of the socioeconomic variables in the last election period, perhaps of a decaying memory. Yet, on election day, recent history events are probably much more powerfully rooted in their memory than an old suffering".

The existing literature on the PBC offers both theoretical frameworks and empirical evidence proving that economic performance determines the re-election of the incumbent government. There is a usual tendency to increase public expenditure heavily before elections for infrastructure projects such as rural roads and bridges (Rogoff, 1990; Veiga and Veiga,

9 The Phillips curve, named after A. W. Phillips, illustrates that there is an inverse relationship between unemployment and inflation in the short run but not in the long run.

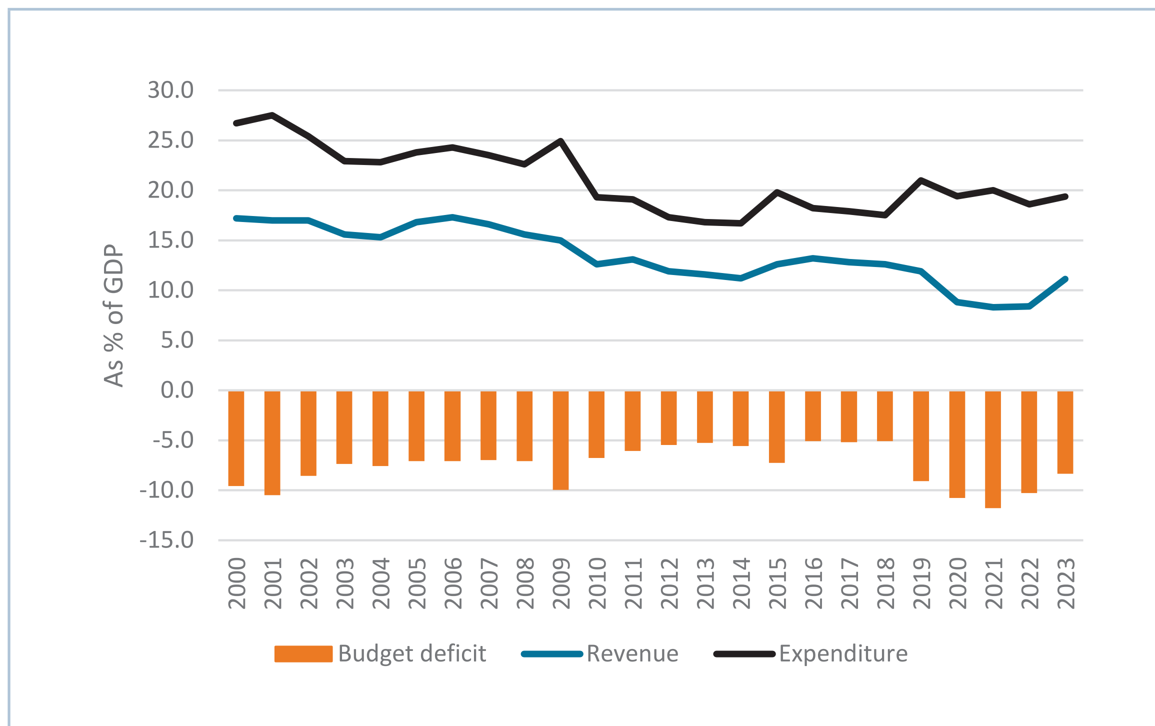
2007). Short-term opportunistic policies can also be observed in the social sector, where governments offer various social benefits to low-income earners to capture votes (Schneider, 2010). The empirical evidence suggests that the opportunistic behaviour of governments driven by political aspirations causes adverse consequences for economic growth and stability in emerging and developing countries.

Given the politically motivated expenditure decisions, as expounded in the PBC model, the fiscal policies adopted in Sri Lanka by successive governments over the decades are discretionary, lacking a rule-based system. Most of the annual budget proposals presented in the past had the underlying objective of satisfying the voter-base to secure election victory rather than introducing policy measures within a coherent macroeconomic framework, ensuring sustained stability and growth.

5.2 Expenditure Overruns

The government expenditure outpaced revenue over the last two decades, resulting in a widening fiscal deficit that reached unsustainable levels by 2020 (Figure 5.1). The budget deficit rose more than threefold from Rs. 761 billion in 2018 to Rs. 2,460 billion in 2022. This was due to the continuous increase in expenditure and the downfall of revenue.

Figure 5.1: Fiscal Trends



Source: CBSL, 2024

In 2022, the current expenditure accounted for 79 percent of the total expenditure. The major current expenditure items were interest payments (44 percent), salaries and pensions (36

percent), and transfers and subsidies (14 percent). As successive governments increased public sector employment over the years for political gain, the expenditure on salaries and pensions has become a major burden on the budget. In 2022, the total public sector employment stood at 1.4 million, accounting for nearly one-fifth of the country's total employment. It includes employees in ministries, departments, district secretariats, divisional secretariats, provincial councils, and SOEs. Current expenditure on transfers and subsidies includes Samurdhi benefits granted to households as well as other subsidies.

There was no significant increase in capital expenditure in recent years, apart from higher lending to SOEs. Lending was provided to meet the accumulated losses of large SOEs, particularly the Ceylon Petroleum Corporation (CPC), the Ceylon Electricity Board (CEB), and Sri Lankan Airlines. Such capital and current transfers to these SOEs have a considerable bearing on the fiscal sector.

5.3 Revenue Shortfalls

The total tax revenue to GDP ratio has declined over the years, indicating that tax collection did not keep pace with economic expansion. It also reflects the inefficiency of the tax system due to multiple factors, including tax evasion, tax exemptions, tax holidays, corruption, and administrative constraints. The efficiency of a tax system could be gauged by the measure of 'tax buoyancy' [10]. According to our estimates, the coefficient of tax buoyancy for Sri Lanka is -0.05 for the period 2015–2021, indicating that tax revenue is less responsive to GDP growth. The coefficient is as low as -148.3 for 2020 due to the negative effects of the tax cuts implemented in 2019.

As the tax system is less buoyant, the Government does not have a sustained fiscal resource base to finance its outlays. This compels fiscal authorities to frequently make discretionary changes in both the tax base and tax rates to meet rising public expenditure. Such frequent adjustments create uncertainties and distortions in the market, exerting adverse consequences on private investment. The discretionary changes have inevitably led to an increase in the share of indirect taxes in the revenue structure over the years. The recent tax reforms have helped raise the share of direct taxes. The share of direct tax revenue to indirect tax revenue rose from 22:78 in 2020 to 34:66 in 2023.

Against the backdrop of the substantial revenue loss due to haphazard tax cuts, the Government gazetted the Tax Amnesty Bill in July 2021 to provide relief to tax defaulters who were prepared to voluntarily divulge previously undisclosed taxable income or assets. The bill also offered assurance of liability from investigation, prosecution, and penalties under

10 Tax buoyancy is an indicator to measure the efficiency and responsiveness of revenue mobilization in relation to GDP growth. If the tax buoyancy is greater than 1, it indicates a more than proportionate response of tax revenue to GDP growth and demonstrates the built-in efficiency of the tax system, and vice versa.

specified laws. However, the low tax compliance could be better addressed by introducing far-reaching reforms in tax administration rather than accommodating corrupt tax defaulters with tax amnesties. It is widely recognized that tax amnesties induce corruption and money laundering. Tax reforms that go beyond tax amnesties, therefore, are essential for overcoming the structural weaknesses of Sri Lanka's tax policy and administration.

5.4 Non-compliance with Fiscal Rules

The FMRA (2003) was enacted to improve fiscal discipline through the imposition of strict fiscal rules. It sought to reduce the fiscal deficit to 5 percent of GDP by 2006 and beyond. It also aimed to reduce the gross government debt to GDP ratio to 85 percent by 2006 and to 60 percent by 2013. The Treasury-guaranteed debt was to be reduced to 4.5 percent of GDP.

While the original fiscal target remained unchanged, the other two targets were relaxed several times (Table 5.1). The most recent amendment to the FMRA was approved by Parliament in 2021. Accordingly, the public debt target of 60 percent of GDP was extended to 2030, and the Treasury-guaranteed debt was raised from 10 percent to 15 percent of GDP.

Table 5.1: Amendments to FMRA

Fiscal Rule	FMRA (2003)	Amendment in 2013	Amendment in 2016	Amendment in 2021
Fiscal deficit (% of GDP)	Less than 5% by 2006 and beyond	Unchanged	Unchanged	Unchanged
Public debt (% of GDP)	Less than 85% by 2006 and less than 60% by end-2013	Less than 80% by end-2013 and less than 60% by 2020	Unchanged	The target of 60% extended to 2030
Treasury guarantees (% of GDP based on 3-year moving average GDP)	Less than 4.5%	Less than 7.5%	Less than 10%	Less than 15%

Source: Ministry of Finance

Since the enactment of the FMRA, the fiscal authorities have failed to comply with the stipulated rules on budget deficit and public debt. The given fiscal targets could not be achieved mainly due to the increases in expenditure for infrastructure development, social welfare, salaries, debt repayments, interest payments, and transfers to loss-making state enterprises. The revenue shortfalls that arose from the arbitrary tax cuts led to the failure to reach the legalized fiscal targets. Thus, legal (de jure) fiscal targets enforced by the Act have little meaning in actual practice (de facto). Taking into account the severe imbalances in the government's budgetary operations at present, it is essential to reactivate the FMRA with original fiscal targets to restore fiscal discipline.

6. Monetary Policy

The prime responsibility of a country's central bank is to insulate monetary management from the pressures of PBC-styled fiscal policies and to conduct monetary policy to achieve its main goal of price stability. This section will analyze how far the CBSL has been able to conduct monetary policy withstanding the fiscal pressures and the prospects for independent central banking in the context of the current reforms.

6.1 Political Economy of Central Banking

Despite the mandate given to central banks to conduct monetary policy independent of politics, they are usually subject to political influence. Political authorities are generally inclined to incur high government expenditure for populist welfare measures, offering various subsidies and income transfers to households, and creating jobs in the public sector, to retain their electoral vote base, as explained in the PBC. These policies lead to large budget deficits, which are then financed through borrowings from domestic and foreign sources. The political influence on monetary policy is evident in Sri Lanka, as the CBSL has had to accommodate the fiscal shortfalls throughout the decades (Colombage, 2017).

The unfinanced portion of the fiscal deficit is usually accommodated by a country's central bank, which can use its monopoly power to create 'fiat money' to lend to the government[11]. Revenue generation by the government through such money creation, known as 'seigniorage', results in an increase in the central bank's monetary base, bringing about a multiple expansion of the aggregate money supply, and causing high inflation. Monetary expansion resulting from budget deficits has been a perennial problem in Sri Lanka (Colombage, 1993).

In order to insulate monetary management from such inflation-biased political pressures, CBI becomes crucial. It is broadly recognized that central banks with more independence perform better in achieving their main objective, price stability. The most prominent argument put forward in favour of the CBI is the time inconsistency problem (Kydland and Prescott, 1977)[12]. The problem arises when policymakers prefer a certain policy to be implemented in a future period, but it is no longer desirable when that period comes. As a result, policymakers are compelled to continuously revise the pre-announced policy decisions. As regards monetary policy, the time inconsistency problem arises when governments attempt to manipulate the trade-off between unemployment vis-à-vis inflation, as explained earlier. In order to retain popularity ahead of an election, the government may be tempted to reduce interest rates to

11 Fiat money, or paper money, is not backed by any commodity, such as gold. Fiat money became popular after the collapse of the Bretton Woods system in 1971, when the U.S. government ceased the conversion of the dollar into gold.

12 Further contributions were made in Barro and Gordon (1983) and Rogoff (1985).

induce employment. This type of PBC-related policy helps boost employment and incomes in the short run, delivering the anticipated gains to politicians but causing inflation in the long run. The necessity to maintain CBI implies, in a way, that political authorities are not trustworthy. Empirically, it is found that countries with independent central banks experience lower inflation as compared with countries with government-controlled central banks.

6.2 Catastrophic Home-grown Monetary Policy

The adverse impact of government intervention on monetary policy is amply evident in Sri Lanka. Deviating from the well-established mainstream macroeconomic principles to satisfy the political authorities, the monetary policy stance adopted by the CBSL from November 2019 to around April 2022 was based on so-called home-grown solutions. The CBSL authorities claimed that the country's economic problems could be resolved by using home-grown policies without resorting to IMF assistance. Apart from the ad hoc policy measures which had no logical macroeconomic framework, the CBSL never specified what these home-grown solutions were. Administratively fixed exchange and interest rates were part and parcel of such solutions. In addition, several other direct measures, such as credit allocation controls, export proceeds conversion regulations, favourable exchange rates for migrant remittances, and credit margins on imports, were used to deal with the economic problems. These types of policy measures were in vogue in the heyday of IS regimes prevalent in many developing countries, including Sri Lanka, several decades ago.

The home-grown policies were largely based on an unfounded phenomenon known as the Modern Monetary Theory (MMT), which states that money printing should be used to meet government expenditure in place of taxation[13]. The proponents of MMT argue that a government can never run out of cash, as it can repay its debts without any limit by getting the central bank to print new money instead of resorting to taxation for revenue mobilization. This idea was developed by a few academics who broke away from mainstream economics. It became popular when some U.S. politicians endorsed it, reinforcing their accommodative monetary policy viewpoints. MMT gained the attention of policymakers in several developing countries, as money printing was found to be a convenient way to finance budget deficits in the context of expenditure overruns and revenue shortfalls amid the COVID-19 pandemic.

The CBSL authorities embraced the MMT to finance the fiscal needs that escalated due to the tax cuts in 2019. Amidst bulging debt service commitments, the Government had to rely heavily on the domestic market to finance the fiscal deficit, as foreign borrowings became almost prohibitive with the drastic dip in Sri Lanka's global credit ratings. Given the limitations of domestic money and capital markets, the CBSL had to bear the brunt of the

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13 Based on MMT, the notion that a sovereign government can print any amount of money to repay its debt without any financial limit has gained popularity particularly in the U.S. in recent times.

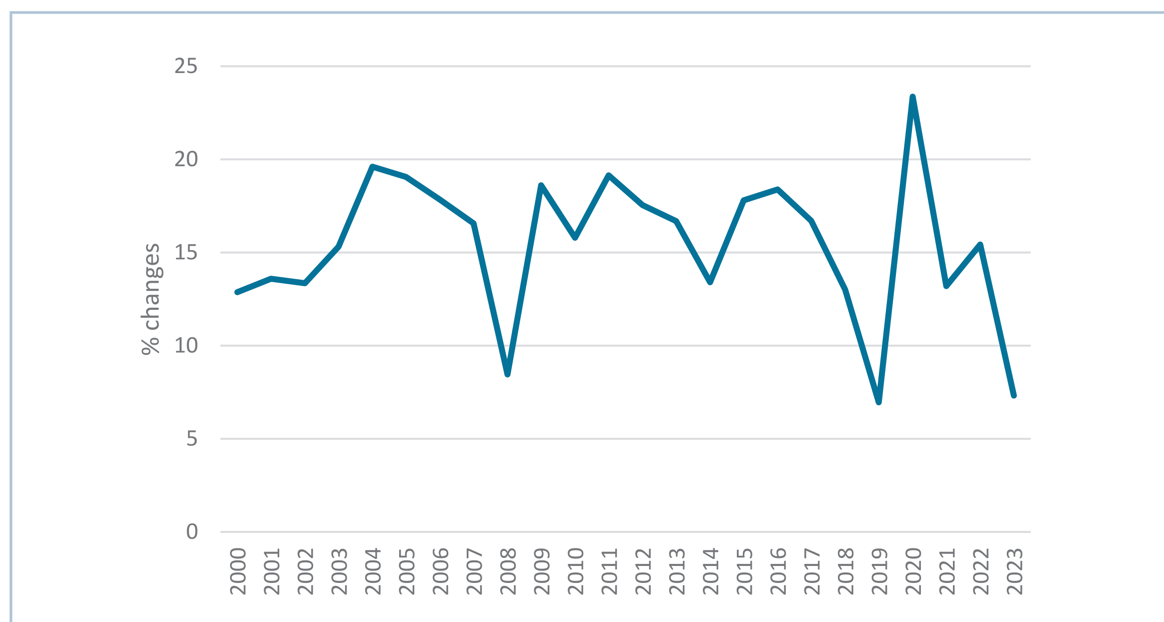
fiscal burden by directly lending to the Government, causing a rapid increase in the money supply by 23.3 percent in 2020 (Table 6.1 and Figure 6.1).

Table 6.1: Monetary Aggregates **Rs. billion.**

Item	End 2019	End 2020	End 2021	End 2022	End 2023
1. Reserve Money	933	964	1,306	1,349	1,329
Net Foreign Assets of the CBSL	896	527	-387	-1,614	-837
Net Domestic Assets of the CBSL	37	438	1,693	2,963	2,166
2. Narrow Money Supply	865	1,177	1,460	1,454	1,658
3. Broad Money Supply	7,624	9,406	10,647	12,290	13,189
3.1 Net Foreign Assets	101	-209	-982	-1,767	-456
CBSL	896	527	-387	-1,614	-837
Licensed Commercial Banks	-795	-736	-595	-153	381
3.2 Net Domestic Assets	7,523	9,615	11,629	14,056	13,645
Domestic credit	9,411	11,721	14,002	16,632	16,421
Net Credit to the Government	2,796	4,548	5,832	7,471	8,285
CBSL	363	869	2,094	3,432	2,376
Licensed Commercial Banks	2,433	3,679	3,738	4,039	5,909
Credit to Public Corporations/SOEs	818	1,002	1,188	1,750	770
Credit to Private Sector	5,797	6,171	6,981	7,411	7,366
Other Items (net)	-1,887	-2,106	-2,373	-2,576	-2,776

Source: CBSL, 2024

Figure 6.1: Changes in Money Supply



Source: CBSL, 2024

A major shortcoming of the home-grown policies was that they focused on individual segments of the economy instead of taking into account the overall economic interactions. Such policies based on direct monetary and exchange controls led to a deviation from the market-based monetary policy instruments that were introduced by the CBSL in the 1980s and 1990s.

6.3 Fiscal Dominance over Monetary Policy

As the CBSL continued to lend to the General Treasury to finance its cash shortfalls, the monetary policy was severely constrained by the fiscal accomodation, reflecting fiscal dominance over monetary policy[14]. Fiscal dominance exists when monetary policy is subject to the constraint of providing sufficient seigniorage to the government to ensure fiscal solvency. Under this coordination scheme, the central bank faces the constraint imposed by the demand for government securities, as the central bank is compelled to finance with seigniorage the part of the budget deficit not financed by other sources.

By contrast, monetary dominance prevails when a central bank focuses entirely on controlling inflation, and the fiscal authorities adjust budgetary operations to remain solvent subject to the exogeneous flow of seigniorage. Accordingly, the central bank independently sets monetary policy, and thus, it determines the amount of revenue that it will supply to the fiscal authority through seigniorage. Monetary dominance can be considered as a situation where monetary policy is 'active' and fiscal policy is 'passive'.

Giving way to fiscal dominance, the CBSL accommodated budgetary requirements by directly lending to the Government [15]. Such direct lending to the government, known as monetary financing, has an expansionary effect on the Monetary Base (MB), causing a multiplier effect on the money supply (Figure 6.2)[16]. CBSL's Net Credit to the Government (NCG) rose to a peak level in 2021 due to the accommodation of fiscal shortfalls by purchasing Treasury Bills and Bonds and the provision of temporary advances to the Government. It resulted in a rapid increase in the money supply. Reflecting the expansionary impact of monetary financing, the broad money supply (M2) rose by 23.4 percent in 2020 and by 13.2 percent in

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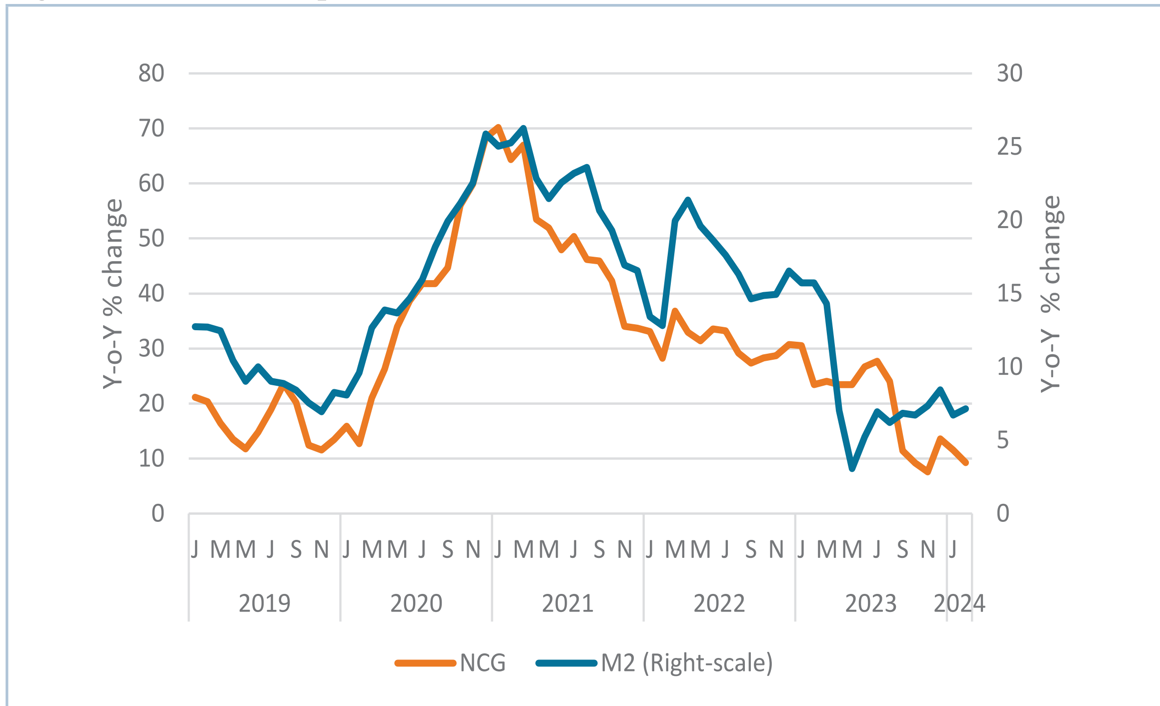
14 Friedman asserted (1968) that, in the long run, a central bank can influence inflation but not output or employment. Contradicting this view in their "unpleasant monetarist arithmetic" doctrine, Sargent and Wallace (1981) argued that a central bank's ability to control inflation depends on the way in which fiscal and monetary policy are coordinated between the two polars of fiscal and monetary dominance.

15 CBSL's lending to the Government included credit against collateral from government securities and 6-month provisional advances.

16 MB is also known as high-powered money or reserve money. On the assets side of the CBSL's balance sheet, MB consists of currency (notes and coins) in circulation, commercial bank deposits, and deposits of government agencies with the CBSL. On the liabilities side, MB includes CBSL's Net Foreign Assets (NFA) and Net Domestic Assets (NDA). NDA consists of Net Credit to the Government (NCG), claims on commercial banks, and other items.

2021[17]. The impact of monetary financing on the money supply would have been far more severe, if not for the decline in Net Foreign Assets (NFA) due to the foreign exchange crisis during this period.

Figure 6.2: Relationship between M2 and NCG

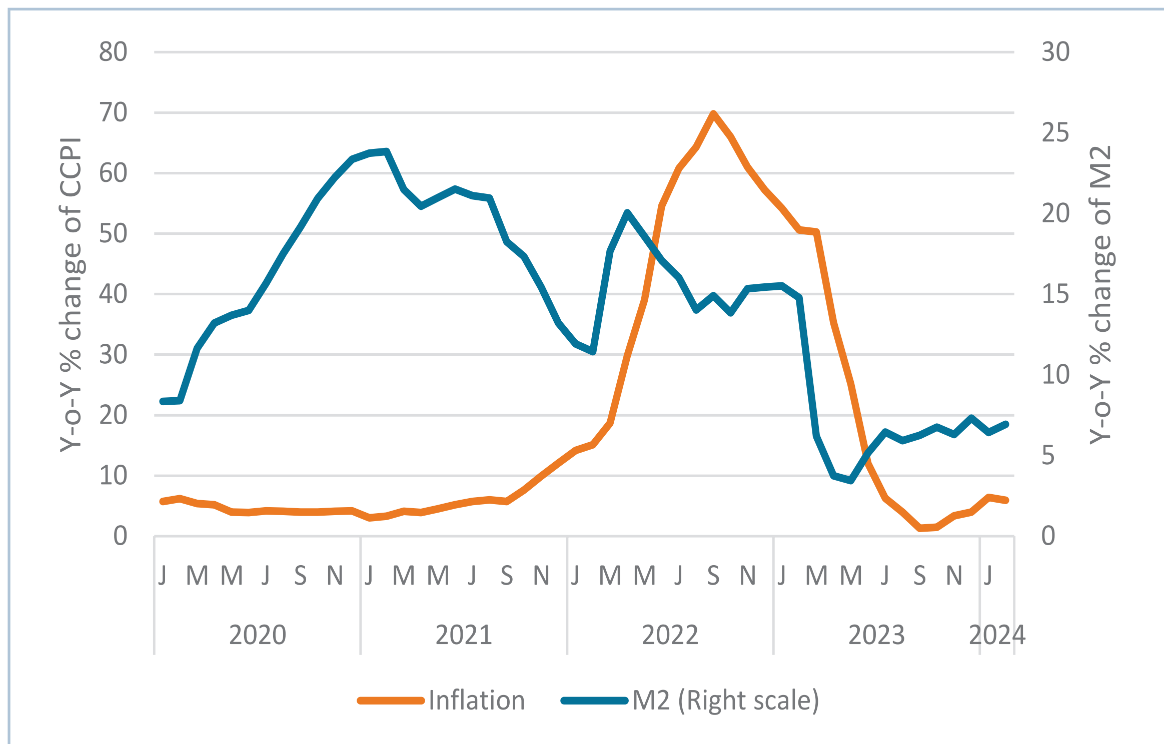


Source: Compiled by the author using CBSL data

The inflationary effects of monetary expansion were evident with a time lag of around 12 months (Figure 6.3). Inflation began to accelerate in early 2022 and Y-o-Y inflation reached a peak level of 70 percent in September 2022. Embracing the MMT, the CBSL authorities denied the well-established relationship between the money supply and inflation and allowed monetary expansion by accommodating fiscal imbalances.

17 The broad money supply (M_{2b}) consists of narrow money supply (currency and demand deposits) and time and savings deposits (quasi money).

Figure 6.3: Relationship between M2 and Inflation



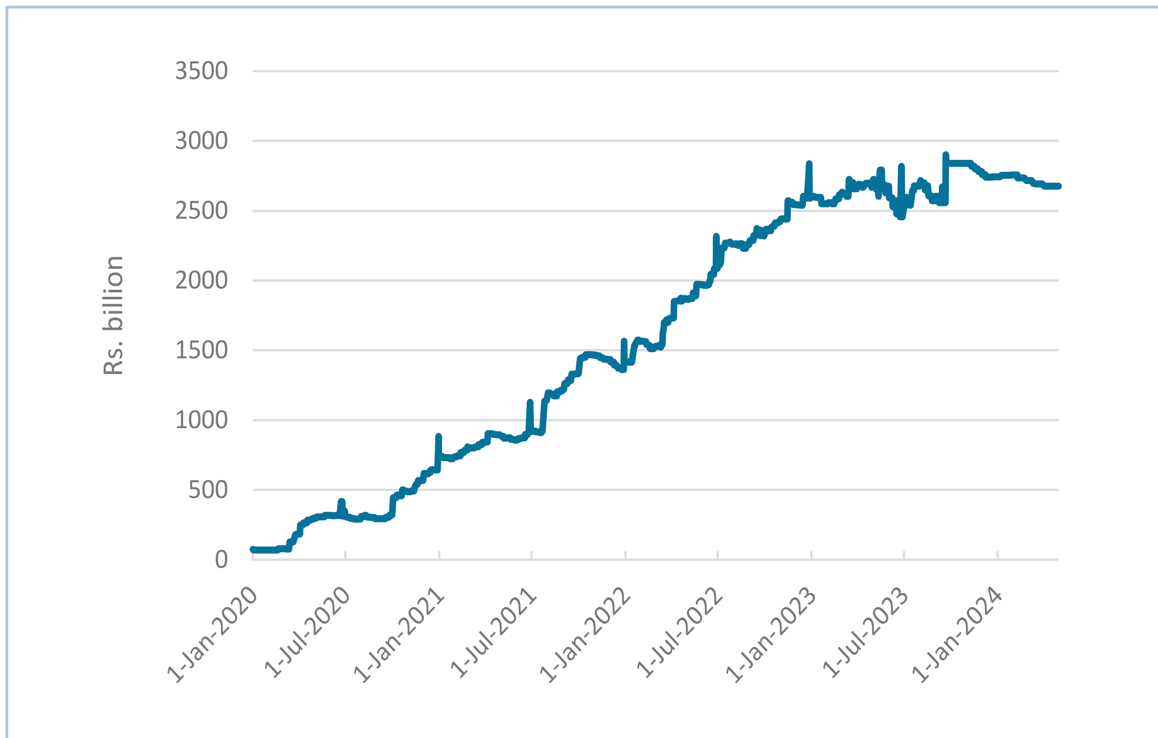
Source: Compiled by the author using CBSL data

6.4 Inactivity of Monetary Policy

The CBSL's increased lending to the Government during the period 2020-2022 created surplus market liquidity, exerting inflationary pressures. The outstanding amount of CBSL's holdings of government securities rapidly increased from Rs. 70 billion in early January 2020 to a peak level of nearly Rs. 3,000 billion in September 2023 (Figure 6.4). As the CBSL continued to purchase Treasury Bills from the market for fiscal accommodation, it failed to use the Open Market Operations (OMO), which is one of its main policy instruments, to mop up excess market liquidity by selling government securities[18]. Since the CBSL is prohibited from lending to the Government under the CBA, the security stock marginally declined to Rs. 2,675 billion in April 2024.

18 OMOs are used to absorb excess liquidity by selling government securities to the market or to inject liquidity by purchasing government securities from the market..

Figure 6.4: CBSL's Holdings of Government Securities



Source: CBSL, (https://www.cbsl.gov.lk/)

The CBSL was also not in a position to use its other main policy instrument, the policy rates, to mop up excess liquidity[19]. While engaging in monetary financing, the CBSL adopted an easy monetary policy with historically low levels of interest rates, reducing its policy rates in January 2020 (Figure 6.5). The Standing Deposit Facility Rate (SDFR) was reduced from 7.00 percent to 6.50 percent and the Standing Lending Facility Rate (SLFR) from 8.00 percent to 7.50 percent. The Statutory Reserve Ratio (SRR) was reduced to 4.00 percent in March 2020 and gradually brought down to 2.00 percent by June 2020. In addition to this, the CBSL imposed upper limits for deposit rates offered by commercial banks and other financial institutions. These measures led to a substantial decline in the market interest rate structure, causing "financial repression", which occurs when governments borrow from the rest of the economy at extremely low interest rates to fund public expenditure[20].

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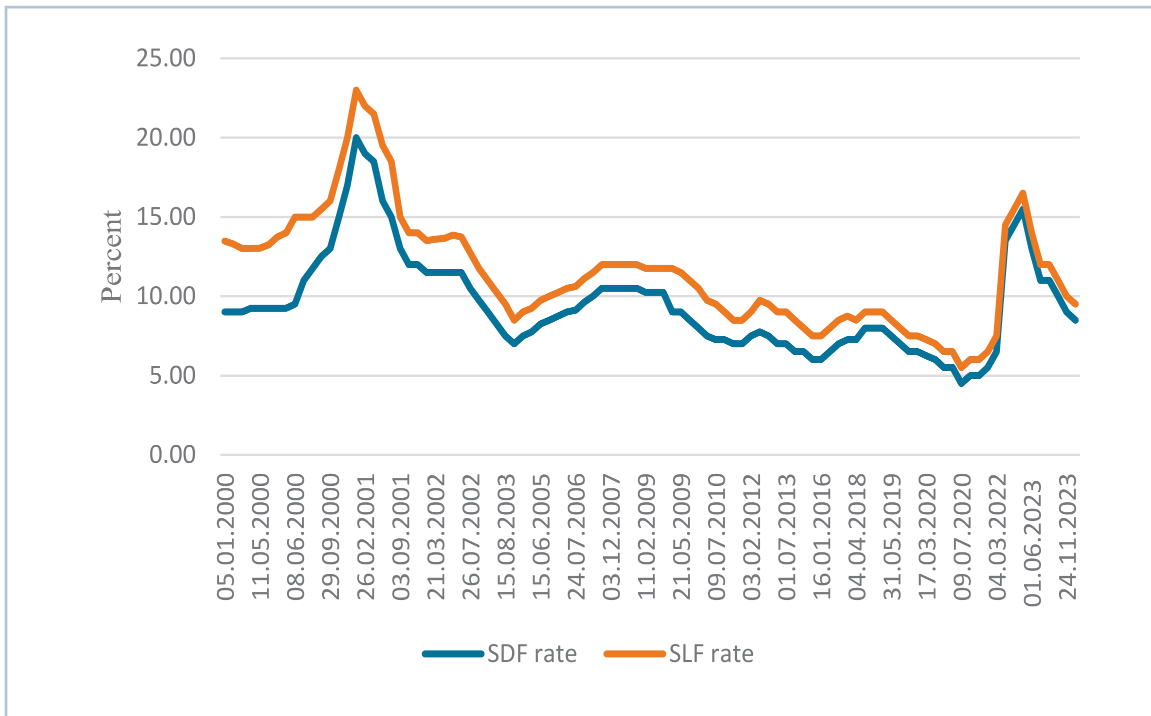
19 The CBSL's two policy (interest) rates, SDFR and SLFR, form the lower and upper bounds for overnight interest rates in the money market. SDFR is the floor rate (minimum rate) paid by CBSL for absorption of overnight excess liquidity from the banking system. SLFR is the ceiling rate (maximum rate) charged by CBSL for injection of overnight liquidity to the banking system.

20 The concept of financial repression was first introduced by McKinnon (1973) and Shaw (1973) to disparage government policies, mainly interest rate ceilings and administratively-directed investment programmes, that suppressed economic growth in developing countries.

Figure 6.5: Changes in Policy Rates



Source: CBSL, (https://www.cbsl.gov.lk/)

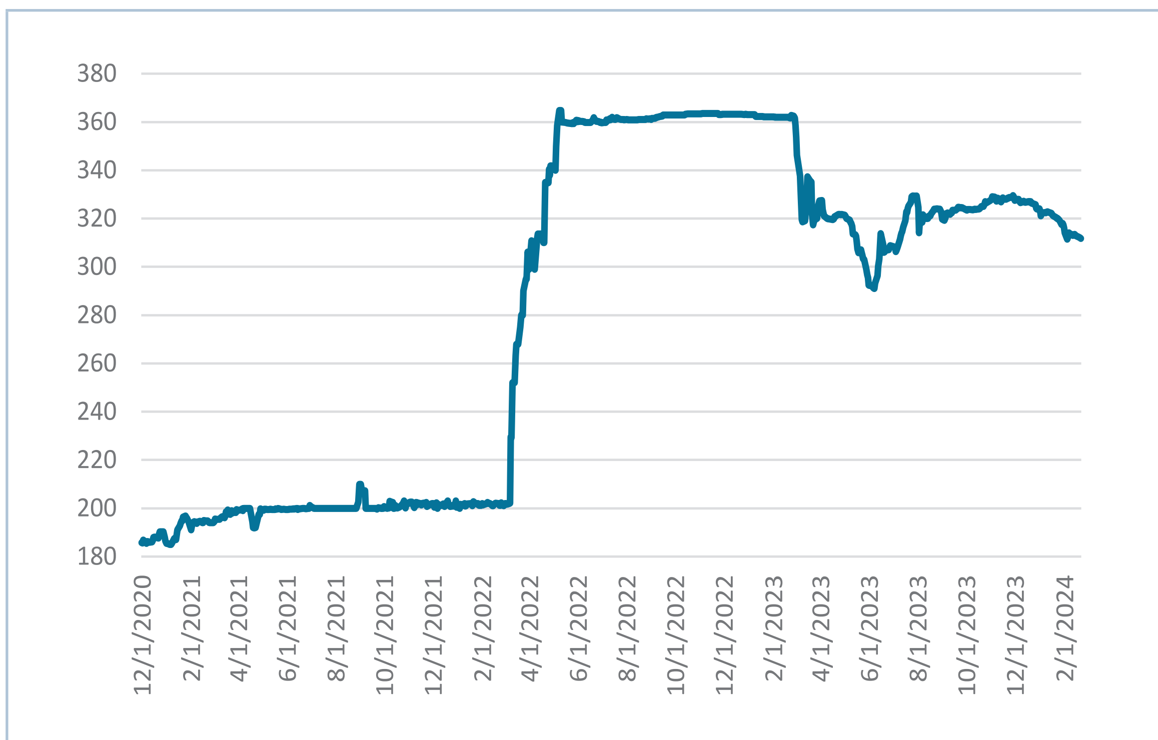
In line with the reduction in policy rates, the average yield rate for 91-day Treasury Bills declined from 7.51 percent in 2019 to 4.69 percent in 2020. As the cut-off yields determined by the CBSL were much below the asking rates of market players, there were heavy undersubscriptions in consecutive Treasury Bill auctions. Since the CBSL purchased the unsold Treasury Bills, its outstanding NCG continued to rise.

The CBSL authorities claimed that the major objective of the low-interest rate policy was to induce bank credit to the private sector in order to help mitigate the adverse effects of the COVID-19 pandemic on individuals and businesses. However, such private credit disbursements did not materialize as anticipated due to the economy's prolonged structural weaknesses combined with the pandemic-led disruptions, including frequent lockdowns, transport difficulties, and social distancing. The economic recovery became more challenging as a result of the macroeconomic constraints faced by the country even before the pandemic, including the growth slowdown, high fiscal deficit, debt burden, and balance of payments difficulties. Eventually, the low-interest rate policy only served to ease the Government's debt service burden, causing financial repression.

As a result of fiscal dominance over monetary policy, the CBSL lost its grip on both policy instruments – policy rates and OMO. Concurrently, the CBSL applied a rigid exchange rate policy stance to prevent the depreciation of the rupee during the period from 2021 to early 2022 (Figure 6.6). The limited foreign currency supply in the domestic foreign exchange

market during the first four months of 2021 had considerable pressure on the depreciation of the rupee. This was an outcome of the depletion of debt and non-debt foreign exchange inflows as against heavy outflows to meet import bills and the Government's debt service payments. Instead of permitting the rupee to depreciate in such circumstances, the CBSL attempted to fix the exchange rate artificially by adopting administrative measures such as the pre-announced exchange rate bands, mandatory export proceeds conversion rules, foreign exchange controls, and forward market restrictions. They were a part of the CBSL's so-called home-grown solutions that were used to maintain an overvalued exchange rate at around LKR 200–203 per USD during the latter part of 2021.

Figure 6.6: Exchange Rate Movements, LKR per USD



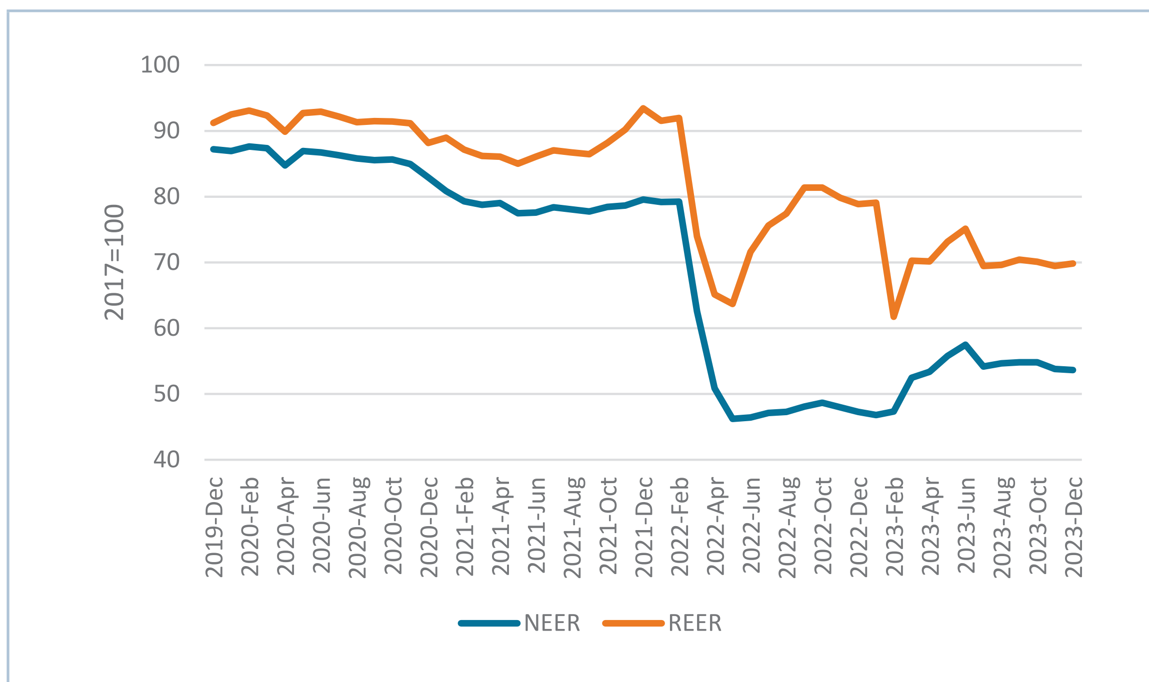
Source: CBSL, (https://www.cbsl.gov.lk/)

The severe shortage of liquidity in the domestic foreign exchange market and the widening spread between the official exchange rate and the 'grey market exchange rates' resulted in a depreciation of the LKR against the USD by 51 percent in March 2022. The exchange rate continued to depreciate, reaching the mark of LKR 365 per USD in May 2022 as against LKR 201 per USD in February 2022. Since then, it has been stabilized around the guidance-band introduced by the CBSL in May 2022. The easing of foreign exchange market pressures has caused an appreciation of the rupee since March 2023.

In line with the depreciation of the Nominal Effective Exchange Rate (NEER), the Real Effective Exchange Rate (REER) depreciated by 20 percent in March 2022, indicating an

improvement in the country's external competitiveness (Figure 6.7)[21]. This trend, however, reversed in the latter part of 2022 due to an appreciation of the nominal exchange rate against high inflation.

Figure 6.7: Nominal and Real Effective Exchange Rates



Source: CBSL, (https://www.cbsl.gov.lk/)

The overvalued rupee created an anti-export bias, as it favoured non-tradables vis-a-vis tradables [22]. This resulted in a setback in the export sector and a diversion of inward foreign remittances to informal channels. Such trends led to a further deterioration in the balance of payments.

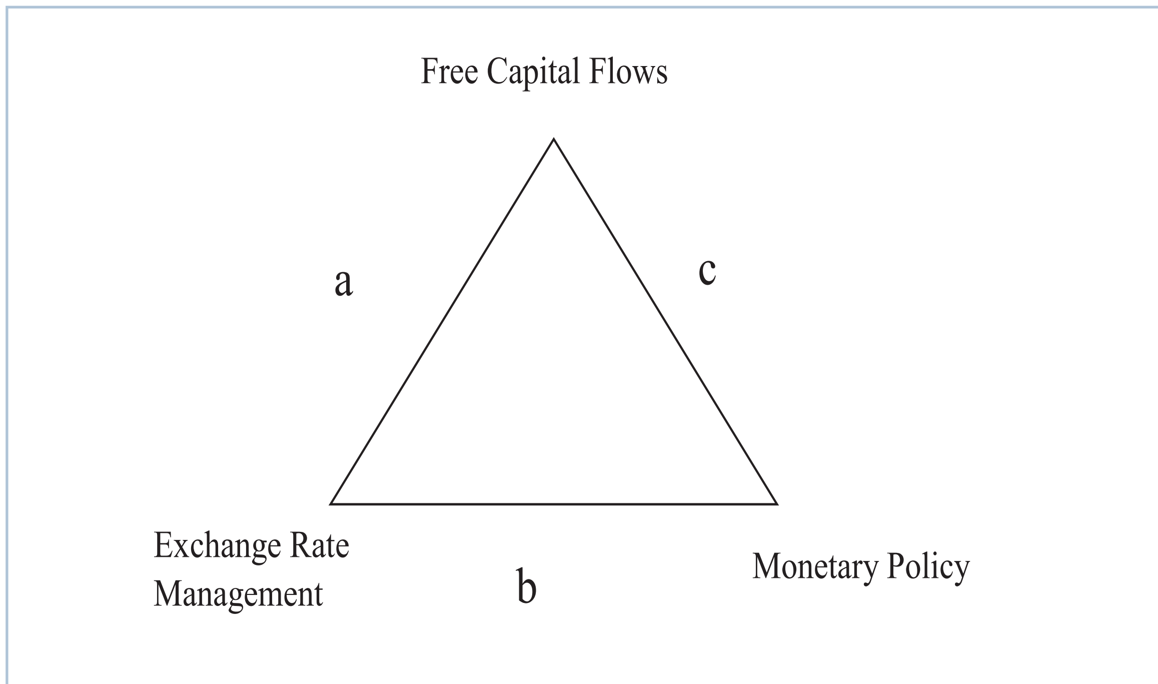
6.5 Impossible Trinity

The fixed interest rate and exchange rate policy stance adopted by the CBSL until around April 2022 laid the ideal foundation for the economic crisis. This can be elucidated in terms of the theorem 'Impossible Trinity' or 'Policy Trilemma', which was introduced independently by Mundell (1963) and Fleming (1962). It refers to the phenomenon that a country's central bank cannot simultaneously achieve the three-policy options of (a) independent monetary policy, (b) fixed exchange rate, and (c) free flow of capital across its borders. A central bank can choose only two out of the three options (Figure 6.8).

21 NEER is the weighted average of a country's currency valued against a basket of currencies of its major trading partners. REER is derived by adjusting the NEER for inflation differentials of major trading partners vis-à-vis the home country.

22 Tradable goods and services can be sold and consumed outside the country where they are produced. In contrast, non-tradables can be sold and consumed only within the country where they are produced.

Figure 6.8: Impossible Trinity



Sources: Fleming, 1962; Mundell, 1963

For example, if a central bank chooses option 'a' in the triangle, then it could maintain a fixed exchange rate and allow free capital flows, foregoing monetary sovereignty. When option 'b' is chosen to fix the exchange rate and interest rates simultaneously by using monetary autonomy, there will be capital outflows. This option cannot be sustained in the long run because increased domestic demand stemming from easy monetary policy will inevitably force a depreciation in the country's currency. Reflecting the reality of the policy trilemma, the CBSL's attempt to fix both the exchange rate and interest rates at the same time (option 'b') resulted in capital outflows that led to diminish foreign reserves to low levels by 2022. Under option 'c', monetary policy autonomy and free capital flows call for exchange rate flexibility.

6.6 Rules vs. Discretion

The superiority of rules vis-à-vis discretion has been a central theme of monetary policy literature in the last three decades. The most common measurement that has been used to evaluate monetary policy is the rule developed by Taylor (1993), which prescribes the systematic adjustment of policy interest rates in response to changes in inflation and macroeconomic activity.

The Taylor rule can be expressed as follows:

$$i_t = \pi^* + \bar{r} + \delta_1 (\pi_t - \pi^*) + \delta_2 (y_t - y^*) \qquad (1)$$

where i_t is the nominal policy interest rate, $\bar{r}$ is the long-term equilibrium real interest rate, π_t is the inflation rate, π^* is the targeted inflation rate, y_t is the actual output and y^* is the potential output.

The coefficients δ_1 and δ_2 measure the sensitivity of the interest rate to variations in the inflation and output gap, respectively. According to the Taylor rule, the coefficients δ_1 and δ_2 should be positive. Taylor proposed values of $\delta_1 = 1.5$ and $\delta_2 = 0.5$.

Using the following monetary policy reaction function, we tested the Taylor rule for Sri Lanka for the period 1978-2016 (Colombage, 2017):

$$i_t = \delta_0 + \delta_1 (\pi_t - \pi^*) + \delta_2 (y_t - y^*) + \delta_3 i_{t-1} + \epsilon_t \qquad (2)$$

The lagged interest rate is introduced in equation (2) to capture inertia in monetary policy. It implies that central banks facing higher-than-expected inflation should raise the nominal interest rate by more than the increase in expected inflation to ensure price stability.

According to our estimates of the Taylor rule, the short-run coefficient on the inflation gap is 0.22 and the long-run coefficient on the inflation gap is 0.61. These coefficients, which are less than 1, indicate poor reaction of the monetary authorities concerning inflation expectations in certain periods. Thus, it can be concluded that the CBSL did not adopt a rule-based policy strategy during the period under investigation, and therefore, the accommodative monetary policy was mostly discretionary.

6.7 Central Bank Independence

It is widely recognized that a sufficiently high level of CBI is desirable for achieving price stability, which is the sole objective of modern central banks. In the literature, the term 'autonomy' is used interchangeably with the term 'independence'. Autonomy implies operational freedom, while 'independence' entails the lack of institutional constraints.

The literature identifies different types of CBI, such as goal independence and instrument independence. The broadest concept is goal independence, which authorizes the central bank to decide on its primary objective. It is generally accepted that monetary policy goals should be decided by the government, as the elected political authorities are accountable to the electorate (Mishkin, 2011).

Various indices have been used in the literature to measure the relationship between CBI and inflation. Most empirical studies on the central bank's autonomy are based on legal or de jure independence. However, it should be emphasized here that legal provisions are necessary for autonomy, but not sufficient. The reason is that CBI in actual practice or de facto may be quite different from what is laid down in the law.

The most widely used CBI index is the one developed by Cukierman (1992) and Cukierman et al. (1992). This index is based on four characteristics of the central bank's charter. They are (a) terms and conditions on appointment and dismissal of the governor; (b) the government's involvement in policy decisions of the central bank; (c) the importance given to the price stability objective in the charter; and (d) limits on government borrowings from the central bank.

It is empirically proved that inflation-targeting monetary policy provides greater independence to a central bank, shielding it from political pressures. It is a monetary policy strategy under which a country's central bank aims to maintain a pre-announced inflation rate over a specific time frame. Transparency and accountability are the two essential components of inflation targeting. Transparency implies that the central bank should disseminate the inflation target with justification via public announcements, ensuring that the central bank does not miss the set target.

In 2017, the CBSL declared its intention to move to a Flexible Inflation Targeting (FIT) monetary framework in the conduct of monetary policy. This was a part of the conditionality attached to the EFF arrangement (2016-2019) with the IMF. The CBSL planned to conduct monetary policy in line with the FIT framework, aiming to stabilize inflation at single-digit levels over the medium term, while supporting economic growth to reach its potential. In terms of the operational aspects of this framework, the CBSL could use its policy instruments to guide short-term interest rates, particularly the Average Weighted Call Money Rate (AWCMR), which is its operating target. Following the change of government in 2019, however, the CBSL had to abandon the FIT framework to accommodate the increasing fiscal demands.

6.8 Central Bank Act

Following the IMF-EFF arrangement of 2023, the Central Bank Act (CBA) was enacted in 2023 [23]. It replaced the Monetary Law Act (MLA) that had been in force since the inception of the CBSL in 1949[24]. In terms of the CBA, the CBSL has two main boards in operation, i.e. the GB and the MPB. The GB is charged with the responsibility of overseeing the administration and management of the affairs of the CBSL and the determination of its general policy, other than monetary policy. The GB consists of the CBSL's Governor as the Chairperson and six members who possess expertise in Economics, Banking, Finance, Accounting and Auditing, Law, or Risk Management.

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23 Central Bank of Sri Lanka Act No. 16 of 2023 was gazetted on 15th September 2023.

24 The CBSL (then Central Bank of Ceylon) was established under the Monetary Law Act No. 58 of 1949. Prior to the establishment of the CBSL, the Currency Board System set up under the Paper Currency Ordinance No. 32 of 1884 functioned as the country's monetary authority. A full exposition of this system is given in the seminal work of Prof. H. A. de S. Gunasekera (1962).

The MPB is charged with the formulation of the monetary policy of the CBSL and the implementation of a flexible exchange rate regime in line with the FIT framework to achieve and maintain domestic price stability. The MPB has the responsibility to regulate the supply, availability, and cost of money, taking into account the macroeconomic and financial conditions of Sri Lanka. The MPB consists of the CBSL Governor as the Chairperson, members of the GB, two experts in Economics or Finance, the Deputy Governor in charge of price stability, and the Deputy Governor in charge of financial system stability.

As per CBA, price stability is to be the primary objective of the CBSL, ensuring a FIT monetary policy framework along with a flexible exchange rate regime. Financial stability is a secondary objective of the CBSL. The MLA, however, had no such hierarchy of objectives. The CBSL's autonomy is strengthened under the CBA by removing government representation from both the GB and the MPB. Under the MLA, the Secretary to the Treasury was a member of the Monetary Board of the CBSL.

The CBA prevents monetary financing of the fiscal deficit in order to eliminate fiscal dominance over monetary policy and to restore price stability. Accordingly, the CBSL is prohibited from (a) purchasing securities issued by the government or any other public entity in the primary market, and (b) directly or indirectly offering credit to the government or any public entities. In contrast, under the MLA, the CBSL was allowed to provide advances and guarantees to the government and participate in primary Treasury Bill auctions. There was extensive monetary financing through primary Treasury Bill auctions when the government faced budgetary shortfalls during 2020-2022, as discussed earlier.

It is significant to note that the prohibition of monetary financing by the CBSL under CBA resulted in a decline in its net credit to the Government by 30.8 percent in December 2023, on Y-o-Y basis. Thus, greater independence given to the CBSL under the CBA helps insulate the monetary authority from political pressures and eliminates fiscal dominance over monetary policy.

The transparency and accountability of the CBSL are enhanced under the CBA. In addition to the annual report and financial statements that are currently published, the CBA mandates the CBSL to communicate Monetary Policy Board decisions. It also requires the CBSL to submit reports to the Minister of Finance in the event of economic disturbances threatening price stability. The CBA provides a legal underpinning for the establishment of an Audit Committee, consisting of non-executive board members, to assist the GB in its oversight of the CBSL.

While the CBA is intended to provide greater independence to CBSL, it has certain weaknesses that tend to countervail CBI. In particular, no objective criterion is laid down for appointing

members to the GB and the MPB. The Governor, six members of the GB, and two experts of the MPB are appointed by the President on the recommendation of the Minister of Finance with the concurrence of the Constitutional Council. Such provision is likely to pave the way for the appointment of persons who are unduly loyal to the Minister and thereby influence administrative and monetary policy operations of the CBSL at the whims and fancies of the political authority. The situation could become even worse when the President himself holds the portfolio of the Minister of Finance, as at present, thereby acquiring enormous power by a single individual to arbitrarily choose appointees to the two boards. Hence, instead of such political appointments, there should be a rigorous screening process for appointing members to the two boards on a merit basis, thereby minimizing political interference.

The lack of mutual exclusivity of the two boards is another weakness of the CBA. It was intended to separate monetary policy formulation overseen by the MPB from the general administration of CBSL, which is entrusted to the GB. However, this objective is self-defeated, as all members of the GB are members of the MPB with the Governor as the Chairman of both boards.

The CBA, which was expected to ensure the independence of the CBSL, does not explicitly specify its autonomy as regards monetary policy. Section 5.1 of the CBA merely stipulates, "The Central Bank shall have administrative and financial autonomy". This refers only to routine activities and budgetary operations of the CBSL. The exclusion of monetary policy autonomy in this clause is a serious defect of the CBA.

The provision of CBI under the CBA is a necessary but not a sufficient condition, as fiscal authorities can undermine the CBSL's autonomy by accommodating fiscal shortfalls through commercial bank borrowings, causing expansionary effects on the money supply. This has been evident since the enactment of the CBA. Commercial banks' NCG rose by 41.8 percent in March 2024 on Y-o-Y basis resulting in an increase in the money supply by 8.4 percent. Thus, the CBI becomes meaningless without ensuring fiscal discipline by strictly imposing the fiscal rules stipulated in the FMRA.

As regards accountability, if the CBSL fails to meet the inflation target as set out in the agreement with the Minister, the MPB is merely required to submit a report to Parliament giving reasons for the deviations along with proposed remedial actions with a timeline for achieving the target. This seems inadequate, as the CBA does not stipulate what legal action will be taken against the MPB, which is accountable for the failure to achieve the specified inflation target.

7. Foreign Trade and Investment Policies

In order to promote export-led growth, Sri Lanka launched a liberalized foreign trade and investment regime more than four and a half decades ago, ahead of all other South Asian nations. However, the inconsistent foreign trade and investment policies adopted by successive governments since then have resulted in a loss of the growth momentum achieved in the immediate aftermath of trade liberalization (Colombage, 2003).

7.1 Trade Liberalization

Open trade has been increasingly recognized worldwide as the key driver of economic growth enabling employment creation, poverty reduction, and economic prosperity. Exports are critically important for small developing countries like Sri Lanka, where the domestic market is limited. Exports allow domestic producers to access international markets and benefit from the economies of scale. Countries with faster export growth are those that enjoy high GDP growth and extensive poverty reduction.

In the pre-liberalization period before 1977, Sri Lanka had adopted restrictive foreign trade policies, including import and exchange controls, prohibitive tariffs, non-tariff barriers, and a fixed exchange rate system. Such policies created an anti-export bias, causing severe balance of payments difficulties in the mid-1970s.

The government elected to power in 1977 took immediate steps to embark on an export-led growth path, removing the array of foreign trade and investment controls to shift the economy from an inward-looking IS regime to an outward-looking EP regime. It was anticipated that such a policy shift would create a market-friendly economic environment conducive to private sector-led export growth. The broad policy package, supported by the stand-by and EFF arrangements of the IMF, included the removal of QRs on imports, tariff reduction, adoption of a flexible exchange rate system, incentives to foreign investors, removal of price controls, and financial sector liberalization.

7.2 Inconsistent Trade Policies

Following the adoption of the trade reforms in 1977, successive governments switched trade policies between the EP and IS regimes from time to time (Colombage, 2003). Such inconsistent foreign trade policies created market distortions, disrupting foreign investment inflows and export growth. The widening twin deficits in fiscal operations and balance of payments in the early 1980s became a major obstacle to the initial trade reforms. In addition, the escalation of the North-East ethnic conflict and the youth unrest in the South had adverse implications for the reform process in the second half of the 1980s. After a

considerable time-lag, the second wave of reforms was implemented in 1989 with the help of the structural adjustment facilities of the IMF. The export sector responded well to these reforms in the early 1990s. However, export growth was disrupted by the ad hoc trade policy measures adopted since the mid-1990s without any consistent trade policy agenda. Import controls and high tariffs and para-tariffs were frequently used to protect domestic production activities, mainly the food crop sector.

In 2017, the government unveiled a new trade policy to improve competitiveness through domestic policy reforms, market access and trade facilitation, macroeconomic policy adjustments, and supportive measures for export-oriented industries. However, the Government elected in 2019 abandoned the new trade policy and shifted its policies to create a protective trade regime. The foreign exchange crisis that emerged thereafter prompted the Government to adopt the so-called home-grown solutions, which included QRs on imports, exchange rate fixing, export proceeds conversion, import credit ceilings, and forward market restrictions, as discussed earlier. Such measures resulted in an anti-export bias and aggravated the balance of payments crisis.

Deviating from its open trade policy, Sri Lanka now has one of the most protective and complex import trade regimes in the world, with more than 7,000 narrow tariff lines and various types of para-tariffs. In addition to Customs Import Duty (CID), imports are subject to several para-tariffs, including Excise Duty (ED), Commodity Export Subsidy Scheme (CESS), Value Added Tax (VAT), Social Security Contribution Levy (SSCL), Ports and Airports Development Levy (PAL), Special Commodity Levy (SCL), and import surcharges.

7.3 Foreign Direct Investment

Trade opening and FDI inflows have proved to be the major driving forces behind the success stories of East Asian economies, as well as those of India, China, Vietnam, and Bangladesh. Outward-oriented economic strategies adopted in these countries, much later than Sri Lanka, enabled them to foster export-led growth and reduce poverty. FDI has played a major role in these countries, promoting export growth through foreign capital inflows, technology infusion, and foreign market access.

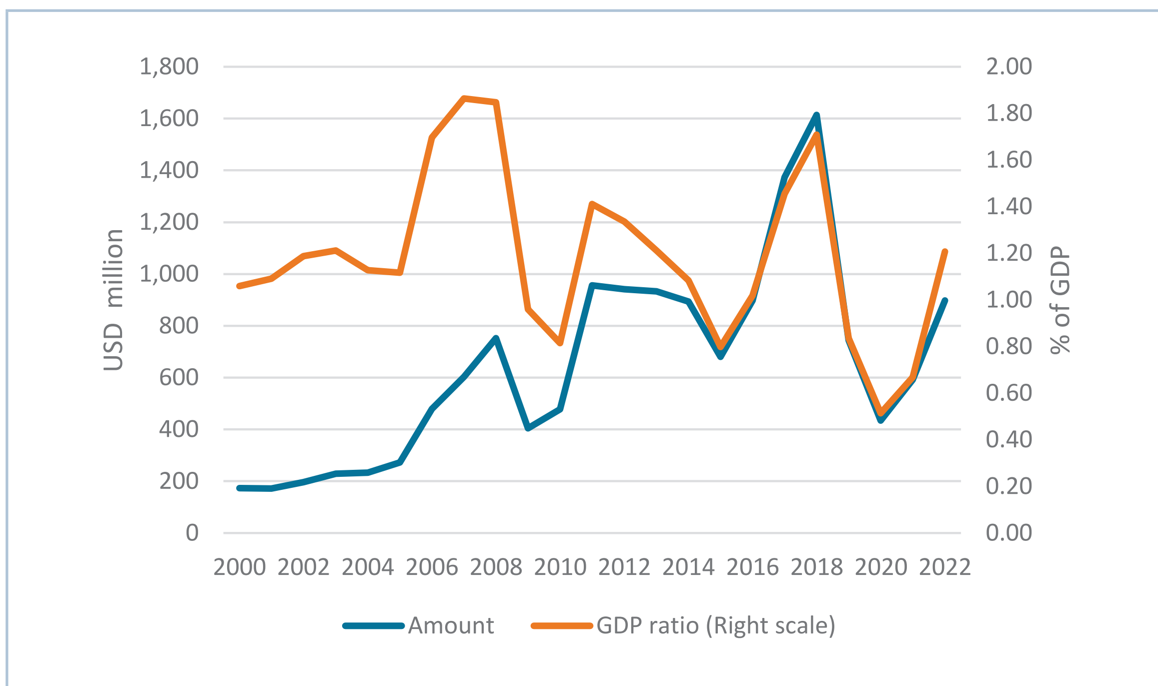
Bangladesh is a good example to illustrate how prudent economic policies can turn a poor country, once branded a "basket case," into the fastest-growing economy in the Asia-Pacific region[25]. It has become the new economic leader in South Asia with an annual GDP growth rate of over 6 percent in recent years, driven mainly by export growth. The key factor that fosters export-led growth in Bangladesh has been the liberal foreign investment regime

25 Bangladesh was famously written off as a "basket case" in 1971 by Henry Kissinger, U.S. President Richard Nixon's national security adviser.

that is ensured through legal protection for foreign investment, generous fiscal incentives, concessions on machinery imports, unrestricted exit policy, and full repatriation of dividends. Prudent fiscal management also helped Bangladesh to maintain low inflation, exchange rate stability, and export competitiveness.

In Sri Lanka, there was an increasing trend in FDI inflows immediately after the cessation of the war in 2009 (Figure 7.1). However, the inflows remained stagnant until 2017, when the investment climate improved due to the policy adjustments supported by the IMF-EFF programme (2016–2019). FDI rose to a peak level of USD 1.6 billion in 2018 and declined thereafter due to the reversal of policy adjustments in subsequent years, as discussed earlier.

Figure 7.1: FDI Inflows



Source: World Bank, World Development Indicators

The country's incentive structure has created an anti-export bias over the years, favouring non-tradables such as construction, domestic trade, finance, real estate business, and speculative deals. Even the BOI, which was set up to promote export-oriented industries, has been granting generous incentive packages to the non-tradable sector, particularly in activities relating to housing, property development, shops and offices, medical care, and power generation.

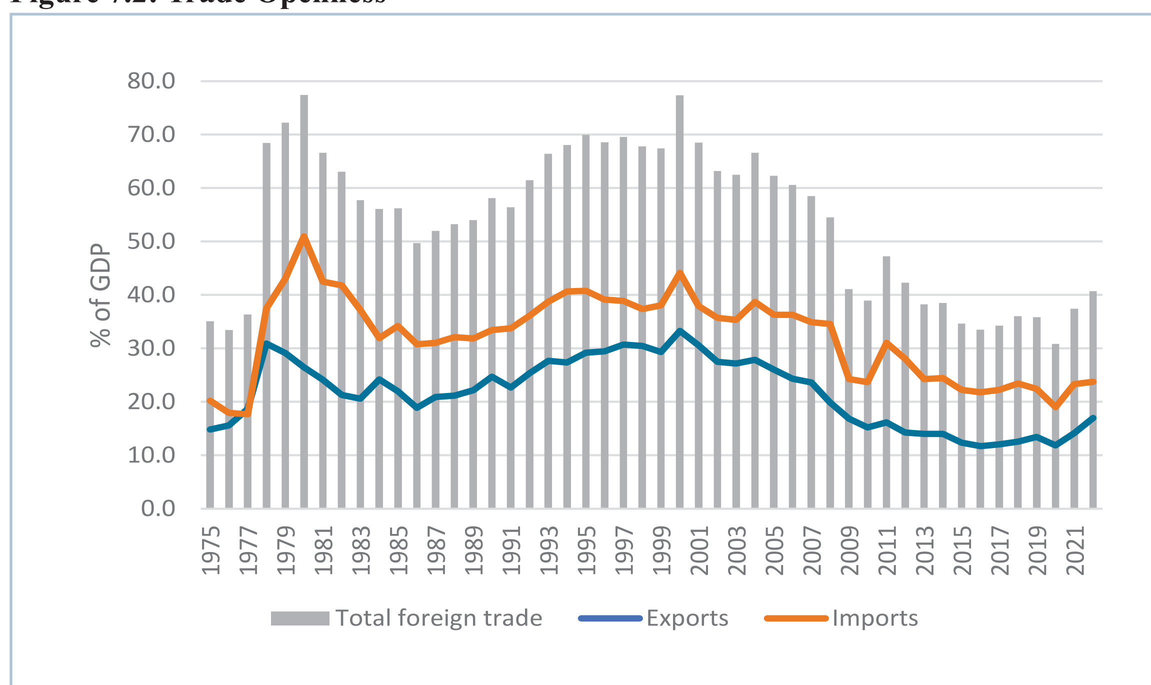
Sri Lanka's FDI inflow has been considerably low in comparison to its regional peers. The country's poor business environment, widespread corruption, and weak macroeconomic fundamentals have been the major deterrents to attracting FDI. Sri Lanka was ranked 99th out of 190 countries in the Ease of Doing Business Index (EDBI) of the World Bank for

2020 [26]. The EDBI for Sri Lanka indicates low scores on regulation for starting a business, dealing with construction permits, obtaining electricity, registering property, obtaining credit, protecting minority investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency. According to the Corruption Perception Index (CPI)[27] for 2023 released by Transparency International, Sri Lanka has a low score of 34 out of 100 (very clean). Sri Lanka has been ranked 115th alongside Ecuador, Indonesia, Malawi, the Philippines, and Turkey.

7.4 Reversal of Trade Openness

Sri Lanka's trade openness, defined as exports plus imports as a ratio of GDP, has shown a declining trend since 2001 (Figure 7.2). Trade liberalization resulted in a rise in the total amount of foreign trade transactions as a ratio of GDP from 36.4 percent in 1977 to 68.4 percent in 1978, and reached a peak level of 77.4 percent in 1980. That momentum did not prevail for long due to weak macroeconomic fundamentals and inconsistent trade and investment policies.

Figure 7.2: Trade Openness



Source: Compiled by the author using CBSL data

The second wave of reforms implemented in the late 1980s helped to boost the economy, and trade openness to GDP ratio rose to 70.0 percent in 1995 and to 77.4 percent in 2000.

26 The *Doing Business* project, launched by the World Bank in 2002, provides objective measures of business regulations and their enforcement across 190 economies and selected cities at the subnational and regional level.

27 The CPI ranks 180 countries and territories around the globe by their perceived levels of public sector corruption, scoring on a scale of 0 (highly corrupt) to 100 (very clean).

Since then, trade openness has declined continuously, and in 2020 it was only 30.9 percent of GDP, the lowest during the post-liberalization period. Ironically, it was lower than the average trade openness ratio of 35.0 percent of GDP that had prevailed during 1975–1977, the immediately preceding years of the trade liberalization.

7.5 Free Trade Agreements

In keeping with the global trend, Sri Lanka has several multilateral and bilateral free trade agreements. These include the South Asia Free Trade Agreement (SAFTA), Agreement of Global System of Trade Preferences (GSTP), Asia Pacific Trade Agreement (APTA), Indo-Sri Lanka Free Trade Agreement (ISFTA), Pakistan-Sri Lanka Free Trade Agreement (PSFTA), Singapore-Sri Lanka Free Trade Agreement (SSLFTA), and the Sri Lanka-Thailand Free Trade Agreement (SLTFTA).

While trade agreements are expected to provide opportunities for partnering with other countries to access foreign markets and improve export competitiveness, domestic economic fundamentals are crucial for harnessing the benefits of trade cooperation. The country's political and economic stability are prerequisites for the fruitful implementation of trade agreements. Multiple trade agreements lead to a complex interweaving between agreements akin to the entangled strands of a "bowl of spaghetti," as coined by Bhagwati (1995). Trade agreements, which are often hailed as mechanisms to stimulate trade openness and export-led growth, can become convoluted and challenging to navigate when the country lacks the right economic fundamentals.

7.6 Adopting a National Trade Policy

Currently, the Government is in the process of formulating a comprehensive trade policy that aligns with the country's evolving economic needs and the changing global trade landscape. Considering the adverse effects of inconsistent trade policies, it is essential to formulate a coherent trade policy that is legally binding to avoid discretionary policy changes under political influence. The national trade policies of some countries, including India, the U.S., and Australia, have such legal basis. There is also a need to improve the existing trade facilitation and regulatory environment with a clear vision, enabling trade openness. The national trade policy needs to be integrated with macroeconomic policy strategies to promote export-led growth.

8. Gaps in Macroeconomic Policy Coordination

It is critically important to focus on the interactions between the real, fiscal, monetary, and external sectors in managing macroeconomic policies. The current economic crisis can be largely attributed to the lack of such policy coordination. For instance, since 2009, several mega-infrastructure projects were carried out without considering their economic viability or implications for the rest of the economy. Such imprudent development activities exerted enormous pressures on fiscal operations, balance of payments, and debt sustainability causing an unprecedented economic crisis. Hence, the coordination weaknesses in decision-making need to be addressed by introducing an integrative policy framework in the form of indicative planning to speed up the economic recovery process and prevent resource imbalances in the future.

8.1 Indicative Planning

While the role of national planning in developing countries diminished with the advent of economic liberalization that began in the 1970s, the usefulness of planning re-emerged in the confines of public sector investment in infrastructure projects (Balassa, 1990). The main objective of indicative planning is to provide medium-term macroeconomic projections with public investment allocations and sectoral targets to guide the private sector without imposing any mandatory requirements.

Such a paradigm shift occurred in Sri Lanka following the liberalization of the economy in 1977. The policy strategy shifted from a centrally-controlled regime adopted by the previous administration to a market-oriented mechanism. A committee of development secretaries, representing the ministries in charge of development, together with a committee of cabinet ministers, became the apex body that guided the development process and approved development programmes. The National Planning Departmen (NPD) of the Ministry of Planning and Employment was reclassified as a 'Department', and brought under the purview of the Ministry of Finance to ensure consistent development planning that aligned with available resources. The NPD consisted of a Macroeconomic Planning Division and several sectoral divisions that dealt with the line ministries.

The indicative planning system was based on a five-year Public Investment Programme (PIP) embedded in a macroeconomic framework with sectoral targets. The development project proposals submitted by the line ministries were subject to rigorous project evaluation and approval processes. In designing the macroeconomic framework, much attention was given to ensuring that the public investment component was fully consistent with the overall

capital budget put together by the Treasury, which was based on line-ministry submissions (Codippily, 2014).

Thus, indicative planning ensured resource balancing in the economy to prevent undue pressure on the government budget or the balance of payments. Such coordination helped minimize the widening of the twin deficits to unsustainable levels. There was also the possibility of reducing the savings-investment gap under that system.

8.2 Integration of Sectoral Investment

Although indicative planning had certain operational limitations in guiding the free-market economy, it continued to function well in Sri Lanka until around the mid-1990s, effectively mitigating macroeconomic imbalances. Since then, the authorities began implementing development projects with less emphasis on indicative planning, disregarding project evaluation procedures and macroeconomic implications.

The neglect of indicative planning became noticeable after the elections in 2005, when the newly-elected government introduced ill-conceived annual plans that deviated from the professional standards of the previous PIPs. The first such document was presented as a 10-year development framework for 2006–2016. While the document contained a loosely-described macroeconomic framework in its last chapter, it lacked the rigour of PIPs in integrating public investment into the macroeconomic framework.

Following the return to peace and normalcy after the cessation of the war in 2009, the Government started launching mega-infrastructure projects by raising commercial loans overseas through ISBs and bilateral loans. They included major highways, ports, airport, road improvements, and recreation parks. The bulk of the projects were carried out by China with loans raised from the EXIM Bank. Given the top priority attached to such projects, the standard project evaluation techniques and tender procedures were not followed at the approval and operational stages. The macroeconomic implications of the projects were disregarded, causing severe imbalances in the government budget and the balance of payments in subsequent years.

The present economic crisis is largely an outcome of the ignorance of the interactions between the real, fiscal, monetary, and external sectors for decision-making. Hence, an integral indicative planning mechanism is needed in project formulation at the ministerial level to prevent such macroeconomic imbalances.

9. Ongoing Policy Reforms

The policy reforms undertaken by the Government under the IMF-EFF arrangement of 2023 include (i) revenue-based fiscal consolidation, accompanied by stronger social safety nets, fiscal institutional reforms, and cost-recovery-based energy pricing; (ii) restoration of public debt sustainability, supported by debt restructuring; (iii) restoration of price stability and rebuilding of foreign reserves under greater exchange rate flexibility; (iv) safeguarding financial sector stability; and (v) structural reforms to address corruption vulnerabilities and enhance growth. It is expected that the reforms of revenue measures and CBI will be implemented upfront during the initial stabilization phase to tackle the root cause of the crisis and build confidence. Reforms aimed at institutional building are to be implemented to ensure macroeconomic stability and debt sustainability.

9.1 Fiscal Policy

In May 2022, the Government implemented a progressive tax reform package. It includes (i) raising the Personal Income Tax (PIT) rate schedule, reducing the PIT tax-free allowance, and introducing mandatory withholding taxes from January 2023; (ii) raising the statutory Corporate Income Tax (CIT) rate from 24 to 30 percent and removing almost all sector-specific CIT exemptions from October 2022; (iii) raising the Value-Added Tax (VAT) rate from 8 percent to 12 percent in May 2022 and to 15 percent in September 2022, and reducing the VAT registration threshold from September 2022; and (iv) raising the fuel excises to yield 0.3 percent of GDP in January 2023. It is also expected that the product-specific VAT exemptions will be removed by 2024 and a property tax, and gift and inheritance taxes will be introduced before 2025.

Several revenue administration reforms are also in progress to improve tax collection efficiency. These reforms include (a) capacity building; (b) strengthening IT-based tax administration; and (c) changes in tax collection methods. On the expenditure rationalization front, action will be taken to limit the growth of the public sector wage bill and pensions. Measures will also be taken to improve public investment efficiency and strengthen processes for prioritizing capital projects. Public Financial Management (PFM) functions will be strengthened by enacting a new PFM law and developing a medium-term fiscal framework[28].

The reform package envisages strengthening the SOEs by (a) restructuring the balance sheets of CPC, CEB, the Road Development Authority (RDA), and Sri Lankan Airlines; (b) the prompt publication of audited financial statements of major SOEs; and (c) the prohibition of foreign exchange borrowings by non-financial SOEs with limited foreign exchange earnings.

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28 The Public Financial Management Bill was gazetted on May 14, 2024 to repeal the FMRA of 2003 with a view to improving fiscal policy for better macroeconomic management.

9.2 Monetary Policy

The CBA, which replaced the longstanding MLA, is expected to provide greater independence to the CBSL to conduct FIT-based monetary policy and exchange rate flexibility without political influence. The CBA envisages (i) the strengthening of the CBSL's mandate by establishing price stability as its primary objective of monetary policy and financial stability as its secondary objective; (ii) buttressing its operational autonomy by preventing any form of government representation or participation on the GB or MPB; and (iii) prohibiting the CBSL from providing monetary financing and primary market purchases of Treasury Bills.

The CBSL's monetary policy decision-making will be facilitated by macro-forecasting models to be used in the newly introduced Monetary Policy Report. Exchange rate flexibility is expected to be supported by developing the foreign exchange market and managing exchange rate risks.

9.3 Restoring Public Debt Sustainability

The reform package includes specific public debt sustainability measures, in addition to fiscal adjustments. The objectives of the measures are to (i) reduce the level of public debt below 95 percent of GDP by 2032; (ii) reduce average central government Gross Financing Needs (GFNs) to less than 13 percent of GDP in the period 2027–32; (iii) keep foreign exchange debt service of the central government below 4.5 percent of GDP in any year during the period 2027–2032; and (iv) ensure that the fiscal and external financing gaps are closed.

The debt restructuring process covers (a) Foreign Law Foreign Currency (FLFC) debt owed to bilateral and commercial creditors, excluding the debt owed to International Financial Institutions (IFIs), CBSL currency swaps, emergency credit lines, and new disbursements; (b) Local Law Foreign Currency (LLFC) debt in the form of Sri Lanka Development Bonds; and (c) Local Law Currency (LLC) debt, including Treasury Bills and Bonds. A debt optimization strategy has been adopted for the LLC.

The CBSL has adopted the Domestic Debt Optimization (DDO) to ensure debt sustainability while maintaining liquidity relief and preserving financial stability. Following this, only those Treasury Bills held by the CBSL are to be restructured, while a voluntary domestic DDO operation is to be conducted for Treasury Bonds. It is also expected that superannuation funds such as the Employees Provident Fund (EPF) and Employees Trust Fund (ETF) will voluntarily opt to restructure their Treasury Bond stock to meet the debt sustainability benchmarks.

9.4 Governance and Anti-corruption

Given the governance weaknesses and widespread corruption, a reform agenda is in place to combat corruption, improve SOE governance, and leverage e-government platforms. It envisages (a) revenue collection and expenditure management; (b) ensuring public sector transparency; and (c) strengthening the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework.

The IMF's governance diagnostic mission has assessed Sri Lanka's governance and anti-corruption status (IMF, 2023b). Based on the assessment, the Government is expected to (a) enact anti-corruption legislation; (b) improve fiscal transparency; and (c) strengthen the AML/CFT regime.

9.5 Raising Potential Growth

Even before the COVID-19 pandemic and the economic crisis, Sri Lanka's growth potential was limited due to drawbacks in the areas of macroeconomic fundamentals, STI, trade protection, anti-export bias, corruption, and poor governance. Export-led growth did not materialize due to the preceding factors, and Sri Lanka has gradually become a closed economy over the years with setbacks in exports and unsustainable trade deficit. Coherent reforms are needed to eliminate anti-export bias and to reduce government involvement in economic activities in order to pave the way for a vibrant private sector. In this regard, policy measures such as exchange rate flexibility and the removal of para-tariffs are crucial. Government expenditure on R&D, which is only 0.12 percent of GDP at present, needs to be raised to emulate the success of fast-growing East Asian countries.

10. Conclusion

Currently, Sri Lanka is undergoing a severe economic crisis characterized by multiple setbacks, including negative GDP growth, high fiscal and balance of payments deficits, shortages in foreign exchange, external debt default, inflation volatility, exchange rate and interest rate misalignments, excessive money supply growth, and low savings and investment. Given its unsustainable debt burden, Sri Lanka has become a debt-default country for the first time in its history.

The current economic crisis is the culmination of imprudent economic policies adopted by successive governments over decades, nullifying the opportunities that could have been gained from trade liberalization. Sri Lanka, once recognized as a model developing economy with impressive social indicators, mainly in terms of health and education, has been overtaken by many other poorer countries in the region. The country's economic compulsions have been undermined by the political motives of successive governments.

Rule-based macroeconomic policy decisions are recognized worldwide as a precondition for orderly economic management. In Sri Lanka, however, macroeconomic policy decisions have been mostly taken at the discretion of political authorities, and as a result, those policies have been pro-cyclical rather than counter-cyclical, which have led to an aggravation of economic fluctuations.

In line with the PBC, annual budget speeches were filled with populist policy measures, including handouts to households, consumer subsidies, and job creation. Such expenditure outlays, coupled with arbitrary public investment projects, have resulted in burdensome deficits in fiscal operations and the balance of payments. The standard project evaluation methodologies were completely ignored when launching foreign debt-funded mega-infrastructure projects. In the absence of a resource balancing mechanism based on an indicative national planning framework, there was no concern about the macroeconomic implications of investment decisions taken by individual ministries at their own will. Alleged corruption activities also compounded project costs. The severe fiscal imbalances that resulted compelled the Government to borrow excessively from the CBSL, causing excessive market liquidity.

Thus, persistent fiscal dominance severely restrained the independent conduct of monetary policy, reflecting the profound influence of the political economy on central banking. Given inadequate revenue and other means to meet its fast-growing expenditure, the Government resorted to seigniorage thereby monetizing its debt. The ensuing increase in the monetary base caused multiplier effects on the aggregate money supply and inflation.

At present, the Government has embarked on an economic recovery process by adopting the policy reform package envisaged in the IMF-EFF programme. This arrangement is expected to support the recovery process by restoring macroeconomic stability and debt sustainability while safeguarding financial stability, reducing corruption vulnerabilities, and unlocking Sri Lanka's growth potential.

While this package is expected to play a pivotal role in overcoming the economic crisis by reversing past policy imperfections, the successful implementation of the package is quite a challenging task, considering the gravity and complications of the problems at hand and the country's poor track record in implementing the 16 adjustment programmes with the IMF in the past.

A core component of the reform package is the reduction of the fiscal deficit, which is the root cause of the economic crisis. As mentioned earlier, fiscal consolidation is largely confined to revenue-enhancing measures, which include raising the tax base and rates and improving the efficiency of revenue collection. As outlined in the IMF-EFF programme, government revenue was projected to rise from 8.5 percent of GDP in 2022 to 11.0 percent of GDP in 2023 and to 14.9 percent of GDP in 2025. Revenue enhancement of such magnitude might not be feasible, given the extremely low GDP growth rates projected for the medium term. The enhancement of tax measures is likely to further depress the growth prospects. If revenue mobilization does not materialize adequately, the anticipated reduction of the fiscal deficit to GDP ratio from 10.4 percent in 2022 to 5.0 percent in 2025 would be rather difficult. Such fiscal constraints will have acute ramifications for the achievement of other policy objectives of the reform package, including CBI, restoration of price stability, financial system stability, and debt sustainability.

In terms of the CBA, the CBSL is prohibited from engaging in monetary financing by way of lending to the government and participating in primary auctions of Treasury Bills and Bonds. In the absence of CBSL lending and foreign loans, the Government has increasingly resorted to domestic bank borrowings to finance fiscal deficits since 2023 causing monetary expansion. Commercial banks are heavily exposed to government securities and continuous fiscal accommodation through commercial bank borrowings will further intensify the exposure.

The success of the planned debt restructuring will heavily rely on the materialization of fiscal targets envisaged for the medium term. Any deviation from such targets would disturb the projected debt sustainability. According to the DDO plan announced by the Government and the CBSL, the treatment will be confined to the CBSL's Treasury Bill holdings and provisional advances to the Government, and the Treasury Bonds held by superannuation funds. This

seems to be a violation of a fundamental principle of debt rescheduling programmes, which stipulates that all creditors should be treated equally.

The conversion of the CBSL's holdings of Treasury Bills into longer-term Treasury Bonds will be reflected in its balance sheet as depleted and negative capital. Recapitalization would be required to mitigate the adverse impact of such negative capital equity on the CBSL's credibility and independence. Recapitalization of state-owned banks will also have to be provided from the government budget, causing an expansion of the fiscal deficit and borrowings, thus negating the very purpose of the DDO.

In common with the typical IMF-supported programmes, Sri Lanka's current EFF intends to restore economic stability mainly through demand management rather than explicitly addressing the supply-side constraints that retard long term GDP growth. Hence, the ongoing policy adjustments under the EFF need to be supplemented with policy reforms primarily aimed at reorienting the production system.

In addition to reducing the fiscal deficit, a key goal of the reform package is to lower the current account deficit of the balance of payments to prevent the danger of further expanding the financing gap. Export-led growth is crucial for overcoming the balance of payments crisis. Sri Lanka's growth performance has not been satisfactory in recent decades, mainly due to drawbacks in production efficiency. The country has failed to graduate from the 'factor-driven growth process' to an 'efficiency and technology-driven growth process'. In contrast, several countries in the East Asian region have been able to accelerate their GDP growth rates by adopting innovation and technology-based production modes. Therefore, high priority needs to be given to STI in the development policy agenda, enabling Sri Lanka to evolve as a knowledge-based economy and accelerate GDP growth. Supply-side policies that complement fiscal and monetary policies are essential to address the deep-rooted structural weaknesses in the economy.

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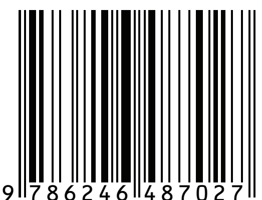

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