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Sovereign Default and Economic Crisis in Sri Lanka: Causes and Policy Lessons

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NUS National University of Singapore

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Executive Summary

Following an acute balance of payments crisis, Sri Lanka opted to default on its foreign debt in April 2022. This triggered the worst economic crisis in over 70 years of post-independence Sri Lankan history in a once enviable basic needs success case. Understanding what happened in Sri Lanka could help prevent or lessen the impact of future economic crises in South Asia and the rest of the developing world.

This South Asia Scan examines Sri Lanka's sovereign debt default and economic crisis as a cautionary tale for the other developing countries in South Asia and beyond. It maps the effects of the crisis, discusses underlying causes and draws key policy lessons.

The findings reveal that the default led to a severe economic contraction, rising inflation and a significant rise in poverty. Mass public protests led to the resignation of a powerful government led by President Gotabaya Rajapaksa.

Although external economic shocks and a Chinese debt trap did play their part, the evidence suggests that the main cause of the crisis was economic mismanagement through multiple policy missteps and inward-looking, home-grown economic remedies.

The findings also highlight the remarkable stabilisation of the Sri Lankan economy in early 2024. This can be traced to the decisive policies by the new government under President Ranil Wickremesinghe, supported by a delayed International Monetary Fund (IMF) bailout and interim emergency Indian aid. However, political uncertainties lie ahead with presidential elections scheduled in late 2024 and parliamentary elections in 2025.

Policy lessons for other debt distressed developing countries include the benefits of early recourse to IMF financing, the insufficiency of foreign currency swaps and loans for external debt management, the need to strengthen safety nets at the onset of a crisis, having a strong independent central bank and effective crisis management capabilities.

Introduction

Sri Lanka, a tear-drop shaped small island economy in South Asia, is under the international spotlight for its economic woes and hardships felt by its 22 million people. Following a severe balance of payment crisis in early, 2022 Sri Lanka chose to default on its foreign debt pending an IMF agreement.[1] The sovereign default triggered a crippling economic contraction and rising income poverty[2] in a once enviable low-income country which met basic human needs as early as the late 1970s. Not surprisingly in a country with high literacy and strong democratic traditions, it also led to a political crisis with mass public protests triggering the resignation of the powerful government led by the Rajapaksa brothers, Gotabaya (who was the president) and his brother, Mahinda (who was the prime minister). A seasoned opposition politician, Wickremesinghe, was sworn in as president in late July 2022 to steer Sri Lanka out of the crisis.

Sri Lanka's economic crisis is even more unusual in the regional context because it is occurring when South Asian countries like India and Bangladesh are growing rapidly and not in recession and certainly not depression. However, Sri Lanka is not alone in this predicament and alarm bells on debt distress levels are ringing across the region. Pakistan is facing an increasingly difficult political crisis and economic uncertainties after elections in February 2024 did not produce a clear winner.[3] Foreign reserves fell to their lowest level; foreign debt is unsustainable and Pakistan is at serious risk of a sovereign debt default. Political chaos (including the jailing of former prime minister, Imran Khan) is also threatening to cloud an IMF bailout of US$3 billion (S$4 billion) which could be important to restoring Pakistan's economic stability.

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1 Ministry of Finance, "Interim policy regarding servicing of Sri Lanka's public debt", Colombo: Ministry of Finance, Sri Lanka, 2022, https://www.treasury.gov.lk/api/file/54a19fda-b219-4dd4-91a7-b3e74b9cd683.

2 M. Raiser "Sri Lanka's crisis offers an opportunity to reset its development model", *World Bank Blogs End of Poverty in South Asia*, 27 February 2023, https://blogs.worldbank.org/endpovertyinsouthasia/sri-lankascrisis-offers-opportunity-reset-its-development-model.

3 M. Kugelman, "Pakistan's worst-case scenario bodes ill for 2024", *East Asia Forum*, 7 February 2024, https://eastasiaforum.org/2024/02/07/pakistans-worst-case-scenario-year-bodes-ill-for-2024/.

Moreover, the Maldives has been experiencing growing foreign debt distress challenges, and there have been recent calls for policy adjustment from the IMF.[4] The election of President Mohamed Muizzu in September 2023 has led to a new government seeking elevated relations with China believing that this will bring development opportunities for the Maldives. Inevitably perhaps in the current highly charged geopolitical times, relations with India have deteriorated and the Maldives is facing a boycott from one of its biggest sources of tourism income – Indian tourists – which has affected its macroeconomic fundamentals. Compared to Pakistan and the Maldives, Nepal seems at low risk of external debt distress, but its debt levels could increase in the medium term linked to fiscal and current account deficits.

There are several reasons why Sri Lanka's sovereign debt default could interest scholars, observers and policymakers from diverse fields, including economics, international relations, defence studies and politics.

First, Southeast Asia has been exploring bilateral economic opportunities with Sri Lanka despite the disruptions of the COVID-19 pandemic. The ending of Sri Lanka's 30-year civil conflict in 2009 led to Singapore seeking improved economic ties with Sri Lanka. Underlining high-level political interest, trade ministers from the two countries signed the Sri Lanka-Singapore Free Trade Agreement (SLSFTA) in Colombo on 23 January 2018 following discussions between Singapore's Prime Minister Lee Hsien Loong and Sri Lankan President Maithripala Sirisena.[5] The SLSFTA underlines Singapore's serious search for trade and investment partners beyond East Asia and its recognition of a strategically located Sri Lanka as a trading hub in the rapidly growing Indian Ocean, close to the main East-West shipping lane. This was Sri Lanka's first free trade agreement (FTA) since 2005 and one of the most comprehensive among its handful at the time.[6] On 3 February 2024, a Sri Lanka-Thailand FTA was signed

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4 C. P. Chandrasekhar and J. Ghosh, "Maldives: debt and dependence", *Business Line*, 19 February 2024.

5 This was Prime Minister Lee Hsien Loong's first official visit to Sri Lanka which took place from 22 to 24 January 2018. See https://www.pmo.gov.sg/Newsroom/official-visit-pm-lee-hsien-loong-democraticsocialist-republic-sri-lanka-22-24-january.

6 It covers goods, services, investments, trade facilitation, intellectual property rights and government procurement. See G. Wignaraja, "Using RCEP as a Stepping Stone to East Asia: Case Studies of Sri Lanka and India", in Weerakoon, D. and Jayasuriya, S. (eds.) *Managing Domestic and International Challenges and Opportunities in Post-Conflict Development: Lessons from Sri Lanka, Singapore*, (Singapore: Springer, 2019).

in the presence of Thailand Prime Minister Srettha Thavisin and Wickremesinghe.

Second, the management of Sri Lanka's economic crisis is being closely watched as it has become the first sovereign debt defaulter in Asia in the 21st century. This means that Sri Lanka has regressed into the ranks of other sovereign debt defaults in the developing world since the COVID-19 pandemic such as Ghana and Zambia. To glean applicable policy lessons, other debt distressed developing countries are scrutinising the causes of Sri Lanka's default and its efforts at economic stabilisation. Various explanations are attributed to Sri Lanka's crisis without sufficient analysis, including the severe COVID-19 economic shock, a Chinese debt trap and disastrous economic mismanagement by the Rajapaksa government.

Third, according to the Sri Lanka constitution, presidential elections are due to be held in late 2024, followed by parliamentary elections in 2025. A heated political debate is currently taking place among the presidential candidates on how Sri Lanka could be in sovereign debt default despite occupying a strategic location and blessed with an ample natural endowment of agricultural land, tourism assets and high human development indicators.

Diverse visions also exist on how Sri Lanka can pull itself out of the economic crisis and a common minimum agenda is yet to be forged.[7] At the time of writing, the main declared presidential candidates include the incumbent president, Wickremesinghe, representing the United National Party (UNP); Leader of the Opposition, Sajith Premadasa, representing the Samagi Jana Balawegaya (SJB) and a member of parliament from Colombo District Anura; and Kumara Dissanayake, representing the National People's Power (NPP) and the Janatha Vimukthi Peramuna. The first two offer similar market-oriented agendas to tackle Sri Lanka's economic crisis while the third proposes a more state-centred inward-oriented socialist agenda.

[7] N. Devotta, "Electoral uncertainty casts a shadow over Sri Lanka's progress", *East Asia Forum*, 25 January 2024, https://eastasiaforum.org/2024/01/25/electoral-uncertainty-casts-a-shadow-over-sri-lankasprogress/.

Understanding what happened in Sri Lanka could help prevent or lessen the impact of future economic crises in South Asia and the rest of the developing world. Although there is a wide spectrum of views at discussion forums and in commentaries and reports by international organisations on the Sri Lankan crisis, a comprehensive evidence-based economic analysis seems to be lacking.

This Scan describes Sri Lanka's sovereign debt default and economic crisis to cover events leading to the default and the immediate post-default period (April 2022 to end-February 2024). It attempts to understand the challenging task of an evidence-based economic analysis of an ongoing crisis period to study the causes and economic interventions to draw policy lessons. The Scan discusses Sri Lanka's living standard achievements and charts the macroeconomic effects of the crisis. It also assesses the causes of the crisis like the Chinese debt trap and economic mismanagement. At the same time, it examines three cures – the Wickremesinghe government's stabilisation policies, an IMF bailout and Indian aid. It then examines the economic effects of these cures and the outlook. Finally, it provides policy lessons from Sri Lanka's debt crisis.

A Crippling Economic Crisis and Development Reversal

Development Promise

Sri Lanka has often been considered a good development bet in Asia at key inflection points in its history, including at independence from over a century of British rule in 1948, at the switch from import substitution to outward-looking trade strategies in 1977 and at the end of a costly 30-year civil conflict between the Sri Lankan government and the Liberation Tigers of Tamil Eelam insurgent group in 2009.

Influential economists, including Nobel Laureate in Economics, Amartya Sen, viewed Sri Lanka as a basic needs success story in the 1960s and 1970s for its high social welfare expenditure (including free health, free education and subsidised food) despite being a poor country.[8] A re-interpretation of Sri Lanka's growth and equity experience by World Bank economists, S. Bhalla and P. Glewwe (1986), nicely summarised the prevailing orthodoxy of the time as follows:

> "Among developing countries, Sri Lanka is frequently cited as a country which has successfully implemented the direct approach to raising economic welfare while still maintaining a respectable rate of economic growth. In recent years, it has been argued that the large social expenditures of the Sri Lankan government are the chief cause of its high standard of living as indicated by the long-life expectancy, low infant mortality, and high level of literacy of the country's population."[9]

To illustrate Sri Lanka's impressive achievements in living standards, Table 1 reproduces data on the key social indicators for Sri Lanka from Bhalla and Glewwe (1986) between 1948 and 1982 updated to 2021

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[8] A. K. Sen, "Sri Lanka's Achievements: How and When" in P. Bardhan and T. N. Srinivasan (eds.) *Rural Poverty in South Asia*. (Delhi: Oxford University Press, 1988).

[9] S. Bhalla and P. Glewwe, "Growth and Equity in Developing Countries: A Reinterpretation of the Sri Lankan Experience", *World Bank Economic Review*, 1:1,1986, pp. 35-63.

using the World Bank's open data. The data shows two important facts about the initial conditions for economic development in Sri Lanka: it had relatively high living standards at independence and in the 1960s and these continued to improve over time through high welfare expenditure. Thus, Sri Lanka's already high life expectancy at independence increased from 50 years to 63.5 years between 1948 and 1965; its infant mortality rates fell from 92 deaths per thousand to 53 deaths per thousand; and its adult literacy rates rose from 58 per cent to 71.6 per cent. Sri Lanka's living standard achievements at independence and in the 1960s were similar to the averages for the East Asian countries in the early 1960s. Sri Lanka's living standards have continued to improve over time linked to high levels of welfare expenditure. By 2021, Sri Lanka's life expectancy increased to 76 years, infant mortality fell to six deaths per thousand and adult literacy rose to 92 per cent.

Table 1: Living Standards in Sri Lanka, 1948-2021

Year	Life Expectancy (Years)	Infant Mortality (Per thousand)	Adult Literacy (% of people aged 15 and above)
1948	50	92	58
1965	63.5	53	71.6
1982	69	32	86.5
2021	76	6	92

Source: S. Bhalla and P. Glewwe, "Growth and Equity in Developing Countries: A Reinterpretation of the Sri Lankan Experience", World Bank Economic Review, 1:1,1986, pp. 35-63; World Bank Open Data, https://data.worldbank.org.

The problem lay with the growth side of Sri Lanka's development equation. Notable living standards were admirable but growth remained low.[10] Real gross domestic product (GDP) grew at an annual average of 3.8 per cent during 1951-1977 with higher growth occurring during periods of partial economic liberalisation. During a period of significant inward-orientation and state intervention in the economy, growth decelerated to 2.9 per cent per year during

[10] S. Ahmed and P. Ranjan, "Promoting growth in Sri Lanka", Washington DC: *World Bank Policy Research Working Paper* 1478, 1995

1971-1977. Punctuated by the first Organization of the Petroleum Exporting Countries oil price shock in 1973, the global economic environment also deteriorated during this period causing balance of payments pressures for Sri Lanka. By 1977, Sri Lanka was considered "a low investment, low growth and high unemployment economy".[11] With Sri Lanka's undertaking trade and exchange rate reforms in 1977 to increase export-oriented foreign investment, the focus of public policy somewhat shifted from welfare to promoting economic growth as an indirect engine for poverty reduction. While the partial opening up of the economy did enable manufactured export expansion, this was concentrated in ready-made garments based on cheap wages and under-utilised multi-fibre agreement export quotas.[12] Little appetite thereafter for deep second-generation reforms meant that little export diversification beyond garments occurred and growth moderated. From the mid-1980s to the next three decades or so, Sri Lanka became embroiled in a bloody and costly domestic civil conflict which stunted growth and basic needs.

The civil conflict finally ended in 2009, offering the opportunity for a renewal of economic development. Writing as recently as 2016 following a visit to Sri Lanka, Nobel Laureate in Economics, Joseph Stiglitz, spoke about Sri Lanka's potential rebirth after the civil conflict:

> "Sri Lanka, beautiful and ideally located in the Indian Ocean, is in a position to become an economic hub for the entire region – a financial center and a safe haven for investment in a geopolitically turbulent part of the world. But this won't happen by relying excessively on markets or underinvesting in public goods. Fortunately, with peace and the emergence of representative political institutions, Sri Lanka today has a better opportunity than ever to make the right choices."[13]

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[11] N. Weerasinghe, "Sri Lanka's macro-financing developments: issues and challenges in structural transformation and lessons from China's experience", UNCTAD/BRI Project/RP13, Geneva: United Nations Conference on Trade and Development, June 2021, p.7.

[12] G. Wignaraja, *Trade Liberalization in Sri Lanka: Exports, Technology and Industrial Policy,* (Basingstoke: Macmillan Press, 1998).

[13] J. E. Stiglitz, "Sri Lanka's Rebirth", *Project Syndicate*, 25 January 2016.

Such optimism reflected the country's many favourable initial conditions for post-conflict economic development. These include a strategic geographical location close to the dynamic Indian economy, an export-oriented economy with tea and garments, functioning institutions inherited from British rule (including a parliamentary democracy, a strong judiciary and a competent civil service), high living standards and ample tourism assets (for example, abundant sunshine, pristine beaches and ancient heritage sites).

Default and Development Reversal

Fast forward to 2022; however, optimism about Sri Lanka's development promise did not materialised. Instead, a tragic story of debt distress and development reversal unfolded. A worrying pattern of growing indebtedness and falling foreign reserves is chronicled in Table 2. Between 2017 and 2022, gross public debt ballooned from 82.7 per cent to 128.1 per cent of GDP, fuelled mainly by a build-up of the United States (US) dollar-denominated external debt from 57.7 per cent to 78 per cent of GDP. Traditional 'rules of thumb' recommended by the IMF to guide reserve adequacy suggests that countries should hold reserves covering the equivalent of three months' worth of imports. Sri Lanka's foreign reserves, which were above IMF's rules of thumb at 4.6 months of imports in 2017, dropped to one month of imports in 2021 and 0.2 months of imports in 2022 as payments in US dollars outpaced inflows.

On 12 April 2022, Sri Lanka's Finance Minister, Ali Sabry, and the Central Bank Governor, Nandalal Weerasinghe, jointly announced a pre-emptive negotiated default[14] on external public debt of US$51 billion (S$69 billion) when faced with an acute balance of payments crisis and historically low foreign reserves of about US$20 million (S$27 million). This meant that the country gave notice to its international bond holders and bilateral creditors that foreign debt payments were suspended pending an IMF bailout and a debt restructuring programme. The move was also asking creditors to come to the table to negotiate on debt restructuring. In technical

[14] Ministry of Finance, "Interim policy regarding servicing of Sri Lanka's public debt", Colombo: Ministry of Finance, Sri Lanka, 2022.

terms, Sri Lanka defaulted on 18 May 2022 after missed interest payments on two sovereign bonds worth US$78 million (S$105 million).

Table 2: Sri Lanka – Key Macroeconomic Indicators

	2017	2018	2019	2020	2021	2022	2023*
Public Finances (% of GDP)							
Revenue and grants	13.7	13.5	11.9	8.8	8.3	8.3	10.2
Expenditures	19.2	18.8	19.5	21.0	20.0	18.5	19.0
Primary balance	0	0.6	-1.9	-5.9	-5.7	-3.7	-0.7
Central government balance	-5.5	-5.3	-7.5	-12.2	-11.7	-10.2	-8.8
Gross public debt	82.7	91.0	89.0	105.1	114.9	125.8	114.1
Balance of Payments							
Exports (in US$ millions)	11360	11890	11940	10048	12499	13106	12365
Imports (in US$ millions)	20980	22233	-19937	-16055	-20638	-18291	-17887
Current account balance (in US$ millions)	-1742	-2799	-1844	-1187	-3285	-744	1232
Current account balance (% of GDP)	-2.6	-3.2	-2.1	-1.4	-3.7	-1.0	1.5
Balance of Payments							
In US$ millions	7959	6919	7642	5664	1565	462	2371

*Note: *estimate*
Source: IMF, Sri Lanka: First Review Under the Extended Arrangement Under the Extended Fund Facility, IMF Country Report No. 23/408, Washington DC: International Monetary Fund.

The sovereign debt default triggered the worst economic crisis in Sri Lanka since independence, culminating in an unholy combination of stagflation, significant currency depreciation, an acute dollar shortage, economic uncertainty and rising poverty. Major foreign exchange earning sectors like garments and tea exports, inbound tourism and worker remittances were significantly down. As Figure 1 shows, reflecting contractions across the major sectors, the Sri Lankan economy shrank by -7.8 per cent in 2022 which is far worse than the COVID-19 contraction of -3.6 per cent in 2020. The 2022 contraction ended a tentative post-COVID-19 recovery of 3.7 per cent in 2021 which was trending towards annual average growth of 3.7 per cent in 2015-2019. Average yearly inflation (as measured by the Colombo Consumer Price Index) also spiralled to an estimated 46.4 per cent in 2022 linked to rising global food and fuel prices, and it created shortages and food insecurity for the population compared with six per cent in 2021 and an annual average of five per cent in 2017-2020.[15]

Figure 1: Sri Lanka – GDP Growth, 2022 (Annual and Quarter % Change)

Source: Central Bank of Sri Lanka and IMF

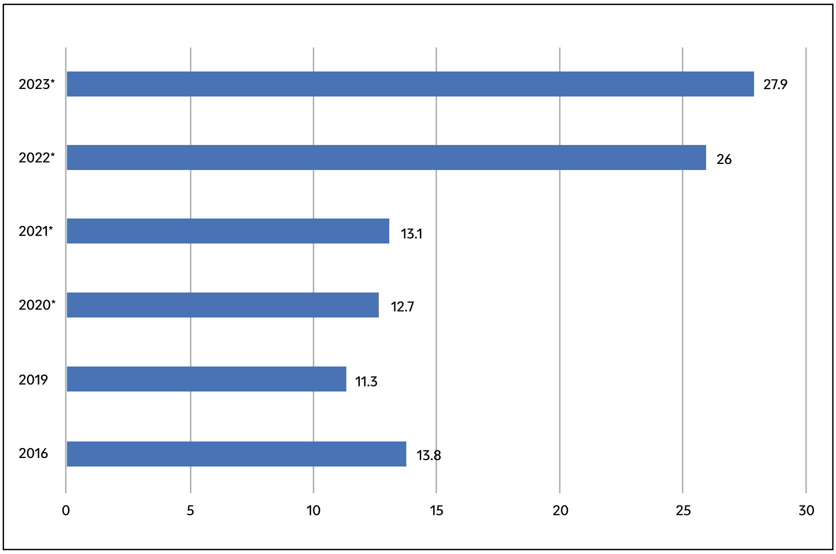
The social impact of the crisis has been terrible. Per capita GDP (current US dollar) fell to US$3,293 (S$4,442) in 2022, compared with US$4,401 (S$5,936) in 2017 underpinned by an economic hit of the crisis and an ageing population.[16] As businesses went under and laid off workers, more people became the 'new poor', reversing previous gains in poverty reduction in Sri Lanka. Figure 2, showing actual

[15] Central Bank of Sri Lanka, Annual Report 2022, Colombo: Central Bank of Sri Lanka, 2023.

[16] Statista, "Sri Lanka: Gross domestic product (GDP) per capita in current prices from 1982 to 2022 (in US dollars)", https://www.statista.com/statistics/728513/gross-domestic-product-gdp-per-capita-in-sri-lanka/.

poverty data and micro-simulations by the World Bank, suggested that the US$3.65 (S$4.92) poverty rate doubled from 13.1 per cent to 25.6 per cent between 2021 and 2022, reversing a decline in poverty between 2016 and 2019. Many poor families are surviving on one meal a day and malnutrition among children is on the rise. Not surprisingly, these conditions have encouraged a brain drain with professionals and skilled workers scrambling to depart an ailing economy to exploit new economic opportunities globally.

Figure 2: Sri Lanka US$3.65 PPP Poverty Rate, 2016-2022



Source: World Bank (2023)

The economic crisis prompted the largest mass island-wide protests in the country's history. Social discontent about economic mismanagement, corruption and a rising cost of living sparked a political crisis. A high-profile casualty was the collapse of the powerful government of Gotabaya (president) and Mahinda (prime minister), whose Sri Lanka Podujana Peramuna (SLPP) party and its allies had a two-thirds parliamentary majority. Mahinda resigned in May 2022 while Gotabaya resigned in mid-July 2022 after fleeing Sri Lanka. This appeared to mark a fall from grace for a family dynasty that dominated Sri Lanka's politics for the past two decades. The unlikely winner, Wickremesinghe, became president through an election by the parliament on 20 July 2022 and can serve the rest of Gotabaya's term until November 2024.[17] This is an extraordinary political comeback as Wickremesinghe has only one national list seat in parliament. Perhaps most members of parliament in Sri Lanka's parliament thought that he had the political and administrative experience as a former six time-prime minister to restore economic stability.

[17] Article 40 of the Constitution of Sri Lanka states that "Any person so succeeding to the office of President shall hold office only for the unexpired period of the term of office of the President vacating office." Parliament Secretariat, The Constitution of the Democratic Socialist Republic of Sri Lanka, (Amended up to 31 October 2022), revised edition 2023, Colombo: Parliament Secretariat Sri Lanka, Printed by the Government Printer, 2023.

Causes of the Economic Crisis

Several internal and external reasons can be offered for Sri Lanka's economic crisis: 1) persistent twin deficits; 2) economic mismanagement by family-dominated governance; 3) a Chinese debt trap; and 4) external economic shocks.

First, Sri Lanka has been referred to as a *classic twin deficit economy*, running both a fiscal deficit and a current account deficit for decades, which indicates major economic imbalances.[18] Sri Lanka's twin deficit problem reflects the populist spending policies of successive governments with scant attention to generating tax revenue; high defence expenditure and indirect costs of a prolonged civil conflict; a limited industrial base which encourages import dependence; and an electorate with a high preference for social welfare services (for example, free health and education). Persistent large twin deficits have caused high indebtedness due to borrowing internally from local capital markets and externally by issuing international sovereign bonds; hence, imposing a burden on future generations.

The past decade saw a familiar boom-and-bust economic cycle, leading to a balance of payment crisis and a recourse to an IMF programme. In June 2016, a previous coalition government sought a US$1.5 billion (S$2 billion) IMF programme subject to conditionality that it would implement stabilisation measures, including streamlining the tax system and reducing a large fiscal deficit. However, the IMF programme prematurely ended in November 2019 with the election of a government led by the Rajapaksa brothers on an economic populist platform known as the 'Vistas of Prosperity and Splendour'.[19] A signature policy was significant tax cuts which were not only unwanted by businesses but also led to Sri Lanka losing

[18] Simply put, the fiscal deficit means government expenditure exceeds tax revenue while a current account deficit means the economy is building up liabilities to the rest of the world that are financed by flows in the financial account. External creditors need to be paid back over time. D. Weerakoon, U. Kumar and R. Dime, "Sri Lanka's macroeconomic challenges: a tale of two deficits", *ADB South Asia Working Papers No. 63*, March 2019: Manila: Asian Development Bank.

[19] Ministry of Finance, National Policy Framework: Vistas of Prosperity and Splendour (2020-2025), Colombo, Ministry of Finance Sri Lanka, 2020 https://www.treasury.gov.lk/web/economic-phases/section/national%20policy%20framework%20vistas%20of%20prosperity%20and%20splendour%202025.

access to international capital markets due to a rating downgrade.[20] This move and other missteps contributed to large and growing fiscal and current account deficits which led to unsustainable debt levels in the Sri Lankan economy since 2017, but particularly in 2020-2021 (see Table 2).[21] Thus, in 2021, months before defaulting, Sri Lanka had a central government deficit of about -12 per cent of GDP, a current account deficit of -4 per cent of GDP and external debt of 64.4 per cent of GDP.

Second, the literature makes growing reference to *economic mismanagement by family dominated governance* in Sri Lanka.[22] The hallmark of the Gotabaya and Mahinda governments was a concentration of power in the family (a third brother was Minister of Finance while a fourth was Minister of Agriculture), which was supported by some trusted senior officials. Family dominated government, a two-third parliamentary majority, an economic populist ideology and distrust of independent economic advice[23] inevitably led to multiple policy missteps between 2019 and mid-2022. Economic mismanagement pushed the fragile economy off precipice into an economic crisis.

[20] IMF (2022), p. 1 details these tax cuts, "For 2020, it raised the tax-free allowance for the PIT from 500,000 LKR to 3,000,000 LKR and cut the top marginal tax rate from 24 to 18 per cent, substantially reducing the effective tax rate at all income levels. The government also cut the standard Corporate Income Tax (CIT) rate from 28 to 24 per cent and raised exemptions for many sectors. In particular, the agriculture and information technology sectors are now fully CIT exempt. In addition, the government cut the standard value added tax rate from 15 to 8 per cent and introduced additional exemptions. Furthermore, it simplified the tax system by eliminating the Nation Building Tax, the Economic Service Charge and the Debt Repayment Levy", IMF, "Sri Lanka: Selected Issues", *IMF Staff Country Reports* Volume 2022: Issue 341.

[21] P. Athukorala and S. Wagle, "The Sovereign Debt Crisis in Sri Lanka: Causes, Policy Responses and Prospects", *UNDP RBAP Policy Paper*, UNDP Regional Bureau for Asia and the Pacific, August 2022.

[22] See K. Basu, "Why Sri Lanka imploded", *Project Syndicate* 20 July 2022; B. Klem and D. Samararatne, "Sri Lanka in 2021: Vistas on the Brink", *Asian Survey*, 62:1, 2022, pp. 201-210; T. De Silva, S. Commander and S. Estrin, "What lies behind Sri Lanka's collapse", *LSE Business Review*, 19 July 2022; and N. Wickramasinghe, "Mahinda Rajapaksa: from populism to authoritarianism", in A. Dieckhoff, C. Jaffrelot and E. Massicard, (eds.) *Contemporary Populists in Power, The Sciences Po Series in International Relations and Political Economy*, (Palgrave Macmillan, Cham, 2022).

[23] Economic assessments of the IMF and the multilateral development banks were dismissed while studies requested by the government from local think tanks such as the Pathfinder Foundation on policies to tackle the economic fallout from COVID-19 were given a hearing but not acted upon. See Pathfinder Foundation, *A New Economic Vision for a Post-COVID-19 Sri Lanka*, Recommendations Submitted to H.E President Gotabaya Rajapaksa by the Pathfinder Foundation Study Group Chaired by Dr. Indrajit Coomaraswamy, Colombo: Pathfinder Foundation, April 2020, https://pathfinderfoundation.org/images/publications/outcome_documents/2020/Pathfinder%20Beyond%20The%20Box%20A%20New%20Economic%20Vision%20for%20Post%20Covid-19%20Sri%20Lanka.pdf.

The key missteps included the tax cuts in 2020 mentioned earlier, wasting scarce foreign reserves to defend a fixed exchange rate policy, fostering an already bloated public sector by hiring an additional 100,000 young people and promoting about 14,000 military officers to the next rank every independence day, an overnight ban on chemical fertilisers in favour of organic fertilisers without preparing the farmers or ensuring sufficient supplies, increasing regulatory red tape facing businesses and promoting endemic cronyism in business. Such haphazard interventions were later justified as inward-looking so-called 'home-grown' economic remedies to the economic crisis (see page 35).

The third is an influential claim first coined by Brama Chellaney and popularised by a *New York Times* article that Sri Lanka fell into a Chinese debt trap due to uneconomic commercial infrastructure loans and became vulnerable to China's influence.[24] An extension of this argument suggests that rising commercial debt to China, coupled with domestic rent-seeking activities, ultimately led to Sri Lanka's sovereign debt default.[25] However, others argue that the debt trap narrative on Sri Lanka maybe overstated.[26]

It is worth considering the evidence. Sri Lanka did borrow heavily from China. Sri Lanka borrowed at least US$13.2 billion (S$17.8 billion) worth of commercial loans from China for infrastructure projects between 2006 and mid-2022 after graduating from concessionary financing through the multilateral development banks (MDBs) in the 2000s.[27] Although China is Sri Lanka's largest bilateral creditor, the debt trap is not exclusively Chinese and linked to private

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24 B. Chellaney, "China's Debt Trap Diplomacy", Project Syndicate, 27 January 2017. https://www.project-syndicate.org/commentary/china-one-belt-one-road-loans-debt-by-brahma-chellaney-2017-01. N. Abi-Habib, "How China Got Sri Lanka to Cough Up a Port', *New York Times*, 25 June 2018, https://www.nytimes.com/2018/06/25/world/asia/china-sri-lanka-port.html.

25 See T. De Silva, S. Commander and S. Estrin, "What lies behind Sri Lanka's collapse", *LSE Business Review*, 19 July 2022.

26 Brautigam argues that critical narratives about the China debt trap in Angola, Djibouti, Sri Lanka and Venezuela are driven more by geopolitical anxiety about China's remarkable rise than facts about Chinese projects. See Brautigam "A Critical Look at Chinese Debt Trap Diplomacy: The Rise of a Meme", Area Development and Policy, 5:1, 2020, pp. 1-14.

27 Estimate based on the value of individual Chinese loans and projects in Sri Lanka. See G. Wignaraja, D. Panditaratne, P. Kannangara and D. Hundlani, "Chinese Investment and BRI in Sri Lanka", *Chatham House Research Paper*, March, Chatham House: London, 2020. https://www.chathamhouse.org/sites/default/files/CHHJ8010-Sri-Lanka-RP-WEB-200324.pdf.

creditors too. As Table 3 shows, Sri Lanka's external public debt to China (government, EXIM Bank China and China Development Bank) nearly tripled from US$2.7 billion (S$3.6 billion) to US$7.6 billion (S$10.3 billion) between 2013 and 2021 (from 3.6 per cent to nine per cent of GDP). Sri Lanka borrowed more heavily from by issuing international sovereign bonds to private creditors (17.4 per cent of GDP in 2021). Multilateral creditors (11.1 per cent of GDP in 2021) are notable but the terms of multilateral loans are less onerous than Chinese loans.

Table 3: Sri Lanka's External Public Debt by Holder

	2013		2019		2020		2021	
	US$ Bn	% of GDP	US$ Bn	% of GDP	US$ Bn	% of GDP	US$ Bn	% of GDP
China (Govt, EXIM, CDB)	2.7	3.6	4.4	5.3	5.0	6.2	7.6	9.0
Bilateral creditors (excl China)*	5.8	7.8	5.5	6.6	5.6	6.9	5.0	5.9
Multilateral creditors	7.0	9.4	8.1	9.8	8.8	11.0	9.3	11.1
Private creditors	9.6	12.9	16.2	19.6	13.3	16.5	14.7	17.4

**Includes Japan, India, Korea, Germany, France, the United States, Canada and others*
Source: Author's own calculations based on data in IMF, 2021 Article IV Consultation – Press Release; Staff Report Table 1, p. 51, Wignaraja et. al (2020) and http://bizenglish.adaderana.lk/sri-lanka-should-have-gone-to-imf-sooner-says-central-bank-governor/.

That said, there appear to be quality problems with the Chinese funded infrastructure portfolio in Sri Lanka. A mixed bag of 'good' and 'white elephant' projects could be associated less than optimal economic development in Sri Lanka and growing external debt to China.[28] Some projects like the modern Colombo International Container Terminal at Colombo Port have supported transhipment trade with India. However, Hambantota Port, Mattala Airport and the Lotus Tower are examples of low economic rate of return projects with high-cost over-runs and long implementation delays

[28] For an economic analysis of benefits and costs of BRI projects in Sri Lanka based on painstaking site visits and interviews, see G. Wignaraja, D. Panditaratne, P. Kannangara and D. Hundlani, "Chinese Investment and BRI in Sri Lanka", *Chatham House Research Paper*, March, Chatham House: London, 2020. https://www.chathamhouse.org/sites/default/files/CHHJ8010-Sri-Lanka-RP-WEB-200324.pdf.

but on commercial terms. Guided by borrower-friendly and profit maximisation principles, China's policy banks were perhaps too lenient on financing Sri Lanka's requests under governments led by the Rajapaksa brothers. Local political motives (for example, attempting to accelerate economic development of a backward rural region, Hambantota District) trumped decision-making in such projects at the expense of rigorous project evaluation and environmental impact assessments undertaken in projects financed by the MDBs.

Fourth, *external economic shocks* increased the vulnerability of an already weak Sri Lankan economy weighed down by twin deficits, infrastructure debt and mismanagement.[29] These shocks beyond policy control include 1) droughts which severely affected domestic agricultural production; 2) the COVID-19 pandemic and lockdown down style curfews which contracted the economy in 2020; 3) the continuing economic fallout from the Russia-Ukraine conflict disrupting global supply chains, fuelling food and fuel inflation, slowing international trade and driving down incomes; and 4) slowing global growth amid rising geopolitical tensions resulting in reduced demand for Sri Lanka's foreign exchange earners – exports, inbound tourism and worker remittances.

Both internal and external reasons have played a part in Sri Lanka's economic crisis. On balance, however, the evidence suggests that internal reasons like the persistent twin deficits and economic mismanagement by family dominated governance are more important in explaining Sri Lanka's economic crisis while external reasons like the Chinese debt trap and external shocks are supplementary.

[29] World Bank, "Sri Lanka Development Update: Protecting the Poor and Vulnerable in a Time of Crisis", Washington DC, World Bank, 2022.

Cures for the Crisis

Stabilisation Policies

Wickremesinghe's government, formed with the support of members of the SLPP, assumed office on 22 July 2022 and pledged to build a stronger economy capable of settling Sri Lanka debts and recovering from the economic crisis. From mid-2022 onwards, the government proceeded to implement a range of orthodox macroeconomic stabilisation policies in cooperation with the IMF and the MDBs.

Two key measures included:[30]

1. A significant tightening of monetary policy to control inflation, thereby attempting to mitigate the risk of hyperinflation and prolonged economic contraction. The central bank's two main policy interest rates to influence commercial bank interest rates – the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) – were increased by 10 percentage points between 2021 and 2022. Thus, the SDFR increased from five per cent to 14.5 per cent between 2021 and 2022 and the SLFR from six per cent to 15.5 per cent over the same period.

2. Removing fuel price subsidies. A pricing formula fuel was introduced to allow international fuel price fluctuations to determine domestic fuel prices. Previously, the state-owned Ceylon Petroleum Corporation had fixed fuel prices below international market prices. The gap between international and domestic fuel prices was paid for by the government as a debt to the Ceylon Petroleum Corporation.

Other measures included stabilising the exchange rate through market guidance from the central bank, improved foreign exchange management, continuous financial sector oversight, passing a law to improve the independence of the central bank, increasing taxes and initiating a privatisation programme for state-owned enterprises.

[30] Central Bank of Sri Lanka, *Annual Report 2022*, Colombo, Central Bank of Sri Lanka, 2023.

In parallel, the government also engaged in a flurry of economic diplomacy involving intensive negotiations with the IMF on an Enhanced Fund Facility (EFF), foreign debt restructuring talks with bilateral creditors and private bondholders and seeking Indian aid.

The IMF Bailout

The IMF bailout concluded 11 months after Sri Lanka's default in April 2022 which underlined the crucial interim role played by India in supporting Sri Lanka. It took six months to reach an IMF staff-level agreement under the EFF on 1 September 2022 worth US$2.9 billion (S$3.9 billion) over 48 months. However, the actual disbursement of IMF finance was delayed until the IMF Board approval on 20 March 2023 – some 11 months after Sri Lanka's default. The delay was due to the need to seek adequate assurances from Sri Lanka's creditors that debt sustainability would be restored. China appeared reluctant to commit to debt restructuring on high interest infrastructure loans to Sri Lanka as it would have to offer the same terms to other countries[31] but finally gave the requisite assurances in March 2023, paving the way for IMF Board approval.

Since its first IMF programme in 1965, Sri Lanka has been in 16 programmes, which means that for most of its post-independence history, the country has needed to secure IMF funding in return for various forms of policy conditionality. In this vein, Sri Lanka differs significantly from India which has not returned since its historic IMF programme in 1991, illustrating a strong bipartisan consensus principle of ensuring the macroeconomic stability of successive Indian governments in the 1990s and 2000s.

Nonetheless, coming in the wake of sovereign debt default, Sri Lanka's 17th IMF programme is widely regarded as bringing with it the toughest policy conditionality so far. It focuses on revenue-based fiscal consolidation and seeks to raise tax revenue and increase utility prices; control inflation by raising interest rates, eliminating monetary financing and pass a law to create an independent central

[31] G. Wignaraja "China's Dilemmas in Bailing Out Debt-Ridden Sri Lanka", *Asia-Pacific Economic Bulletin*, Honolulu, East West Center, 20 January 2022.

bank; rebuild foreign exchange reserves through a flexible exchange rate and other measures; safeguard financial stability by ensuring adequately capitalised banks and a new banking act; and reduce corruption risks by better fiscal transparency and public financial management.[32]

The first review by the IMF Board on 12 December 2023 rated "Sri Lanka's performance as satisfactory",[33] meaning that total IMF disbursement was US$670 million (S$903 million) [22 per cent in 2023]. The EFF unlocked additional funding from the World Bank and the Asian Development Bank for budget support, social protection, financial sector development and infrastructure development. A second review by the IMF Board on Sri Lanka's performance which could trigger a third disbursement under the EFF is likely in mid-2024. However, several risks exist which could lead to only partial implementation of the EEF over the next few years. These include the following:

1. Can revenue collection be improved to meet strict IMF revenue targets?

2. Can an independent central bank resist political pressures for monetary financing of the government's deficit in an election year?

3. Can a domestic banking crisis be avoided if a haircut is imposed on domestic rupee-denominated debt?

Indian Aid and Trade

Sri Lanka-India relations have witnessed ups and downs since the 1980s due to legacy issues such as the intervention of Indian

32 IMF, "Sri Lanka: First Review Under the Extended Arrangement Under the Extended Fund Facility, Requests for a Waiver of Nonobservance of Performance Criterion, Modification of Performance Criteria, Rephasing of Access, and Financing Assurances Review-Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka", *IMF Country Report* No. 23/408, Washington: International Monetary Fund, December 2023. https://www.imf.org/en/Publications/CR/Issues/2023/12/12/Sri-Lanka-First-Review-Under-the-Extended-Arrangement-Under-the-Extended-Fund-Facility-542441.

33 IMF, "IMF Executive Board Completes the First Review Under the Extended Fund Facility Arrangement with Sri Lanka", Press Release No. 23/439, https://www.imf.org/en/News/Articles/2023/12/12/pr23439-sri-lanka-imf-executive-board-completes-first-review-under-eff-arrangement.

peacekeeping forces in Sri Lanka in 1987, fishing disputes and opposition from domestic-oriented business to trade with India.[34] Sri Lanka's crisis has altered bilateral relations. As the negotiations with the IMF were prolonged, Sri Lanka desperately appealed for bridging finance and foreign aid to finance essential imports of food, fuel and medicines after its sovereign debt default. India was the first responder to Sri Lanka's appeal for assistance. The decision to support Sri Lanka was taken at the highest level. Indian Prime Minister Narendra Modi himself approved the assistance while Finance Minister Nirmala Sitharaman, Reserve Bank of India Governor Shaktikanta Das and Foreign Secretary Vinay Kwatra were personally involved in facilitating Indian aid for Sri Lanka.[35]

With India becoming one of the world's fastest growing major economies, it has gradually shifted from aid recipient to aid donor in the 21st century. Concessional lines of credit (that is, concessional loans or guarantees) have formed the bulk of Indian aid while grant aid is relatively small. In the first six months of 2022, Indian aid worth US$3.8 billion (S$5.1 billion) flowed to Sri Lanka through credit lines, deferred loans and grants, making it India's largest bilateral aid programme to any country in recent times. This figure is equivalent to as much as 10.3 per cent of India's aid at that time.[36] Indian aid has been greatly appreciated by the Sri Lankan people as it brought timely relief during the economic crisis. It has also confirmed India's elite status as a proven emergency regional donor among emerging donors.

The key question asked is why Indian taxpayers should provide financial bailout to Sri Lanka, when there is a perception that the country's sovereign debt default is largely of its own making, the result of largely of economic mismanagement and corruption.

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[34] R. Gamage, "Sri Lanka-India relations in 2024", *ISAS Brief 1006*, 1 March 2024, https://www.isas.nus.edu.sg/papers/sri-lanka-india-relations-in-2024/.

[35] N. Sathiya Moorthy, "Sri Lanka: is a new India-centric aid group more viable than others?", New Delhi: Observer Research Foundation Expert Speak (Raisina Debates), 2 July 2022.

[36] The denominator (US$32.9 billion [S$44.4 billion]) in this estimate is from available official data (1) suggesting that India's concessional lines of credit presently amounts to US$30.5 billion (S$41.1 billion), with just over half of it going to poor Asian countries; and (2) the allocation in 2021-2022 Indian Budget, grants US$2.4 billion (S$3.2 billion). See https://www.mea.gov.in/Lines-of-Credit-for-Development-Projects.htm#:~:text=Development%20assistance%20in%20the%20form,been%20extended%20to%20 64%20countries.

Indeed, the discussion in Chapter 3 (see page 20) suggests that Sri Lanka's crisis is largely due to persistent twin deficits and economic mismanagement by family dominated governance. A more detailed answer is needed to respond to Indian aid skepticism. A mix of humanitarian, geopolitical and political motives probably underpin India's assistance to Sri Lanka. First, there was a moral responsibility to respond to the dire humanitarian crisis affecting the Sri Lankan people after the sovereign debt default. Second, this move constitutes a major win for Modi's cherished 'Neighbourhood First' policy and enabled India to steal a march over China's commercial loans through the Belt and Road Initiative. Third, it was a reaction to significant political pressure from South Indian states (particularly Tamil Nādu) for India to assist Sri Lanka.

Continuing to support Sri Lanka's towards economic recovery remains in a globally rising India's own self-interest. It would confer prestige on India as a regional economic powerhouse and support India's long held ambition of securing a seat on the United Nations Security Council. Furthermore, an unstable Sri Lankan economy in prolonged crisis may lead to a flood of refugees across the Palk Strait and could pose negative externalities to India such as overwhelming the welfare system in South India and creating domestic security risks. With Indian emergency aid helping to stabilise the Sri Lankan economy in 2024, India should evaluate two steps for medium to long-term economic engagement with Sri Lanka.

First, India could go big on aid to Sri Lanka.[37] Back of the envelope calculations suggest that Sri Lanka would require foreign financing of between US$20 million (S$27 million) and US$25 billion (S$34 billion) over the next three years for essential imports and investment in recovery. Although this sum is only a fraction of India's foreign exchange reserves,[38] domestic political constraints may restrict increasing Indian aid in the short-term. Nonetheless, India has a unique opportunity to cement its aid reputation by co-leading an

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[37] The author is grateful to Dr Rathin Roy, a Visiting Senior Fellow at ODI (formerly the Overseas Development Institute) and a former Managing Director of ODI, for this insight.

[38] The US$20 million (S$27 million) to US$25 billion (S$34 billion) is about three per cent to four per cent of India's foreign exchange reserves of US$619 billion (S$835 billion) on 1 March 2024. The reserves data is from the Reserve Bank of India and available at https://www.rbi.org.in/scripts/WSSView.aspx?Id=26719.

aid consortium for Sri Lanka, working closely with other friendly countries (for example, Japan, the US and the European Union) and the IMF and the World Bank.

To counter criticisms, three principles could guide the effectiveness of Indian and other aids to Sri Lanka. One is to use the modality of public private sector partnerships with built-in performance incentives or guarantees for private sector projects rather than traditional public sector aid projects. This modality seems useful for high quality projects in the digital infrastructure and energy sectors for which India is internationally reputed. In addition, some aid should be allocated for income generating poverty reduction activities like enhancing small holder agriculture for food security throughout Sri Lanka, not just to relatively prosperous Colombo and the Gampaha District. Finally, it would be prudent to strengthen controls and implement stronger competitive procurement procedures to minimise and ensure aid leakages and dead weight losses to acceptable levels.

Second, India-Sri Lanka economic relations should shift from a humanitarian aid relationship to trade and investment. India's Adani Group joint venture investment in Sri Lanka's port sector in 2024 is a promising start (see page 31). Concluding the ongoing negotiations for the Economic and Technology Cooperation Agreement (ECTA) – an India-Sri Lanka FTA involving goods, services and investment – can support rules-based bilateral trade. Simulations of FTAs using a computable general equilibrium (CGE) model suggest 1) larger export gains for Sri Lanka from a deep ECTA than a goods only FTA with China; and 2) Sri Lanka's export gains increase further from a regional FTA involving India and other members of the Bay of Bengal Multi-Sectoral Technical Cooperation (BIMSTEC) FTA. Thus, FTAs can offer a pathway to reduce bilateral trade barriers and can spur wider regional economic integration.

Appendix 1 discusses the details of the model and the results.

Economic Progress in 2024

The economic progress became visible after 18 months of the stabilisation policies. Consumer price index inflation fell significantly to four per cent in December 2023 but rose to 5.9 per cent in February 2024 with an increase in the value added tax from 15 per cent to 18 per cent in January 2024. The Sri Lankan rupee appreciated by 12.1 per cent against the US dollar in 2023. Foreign exchange liquidity pressures eased, with usable foreign reserves up to US$2.8 billion (S$3.8 billion) [about two months of imports] in January 2024. More import capacity means shortages of essentials and waiting lines have disappeared. The IMF projects a return to growth of 1.8 per cent in 2024 and three per cent in 2025 compared with -3.6 per cent in 2023.

Furthermore, foreign direct investment (FDI) in infrastructure – attracted by Sri Lanka's strategic location – may seem to be picking up, thereby increasing non-debt creating foreign exchange. A joint venture project between India's Adani Group and Sri Lanka's John Keels Holdings seeks to develop the US$700 million (S$944 million) West Container Terminal at Colombo Port. Signalling American interest, the US Development Finance Corporation has committed US$553 million (S$746 million). This will expand Colombo Port's capacity and transshipment trade with a rapidly growing Indian economy.

In a geopolitical twist, China's Sinopec Group, which will also manage 200 fuel filling stations in Sri Lanka, has committed US$4.5 billion (S$6.1 billion) to an oil refinery in the controversial, low-profit Hambantota Port. Foreign exchange constraints and an inefficient state-owned Ceylon Petroleum Corporation led to fuel shortages and hardships for Sri Lankans during the crisis. FDI by China's Sinopec in petroleum refining and distribution may help to improve Sri Lanka's energy security provided the energy market is open to all investors and a strong competition policy is adopted. If not, Sri Lanka could be vulnerable to problems of a private monopoly under Sinopec with higher fuel prices and variable fuel supply.

Sri Lanka needs sustained economic growth of five to six per cent in the medium term to eventually escape from indebtedness. However, its economic outlook is vulnerable to different external and internal risks. The first is geopolitical competition between the US and China. For instance, an intensified US-China trade war and dampened global growth following a Donald Trump presidential election victory could be devastating for FDI and trade for Sri Lanka. While such high impact events are difficult to predict, Sri Lanka should include such conceivable risks into its foreign and economic policies.

The second is debt restructuring. In November 2023, after year-long talks, Sri Lanka concluded an initial agreement with key bilateral creditors, including India and the Paris Club, to restructure US$5.9 billion (S$8 billion) in external debt. This was important to reduce interest payments and to unlock IMF financing in 2024. This deal follows China's separate debt restructuring agreement with Sri Lanka by September/October 2023. While the details are not public, these agreements are on similar terms, extending deadlines and lowering interest rates. However, perhaps ominously, private bondholders, who held about 40 per cent of external debt (end-2022), have expressed concerns about the extent of discounts applied during the debt restructuring process (that is, a 'haircut') and say little engagement has occurred with them due to the focus on talks with official creditors.

Third, political risks could derail the EFF and growth beyond 2024 – presidential elections are due by September/October 2024 and parliamentary elections in 2025. A doubling of income poverty – measured by a poverty line of US$3.65 (S$4.92) – to 25 per cent of the population since the default and growing dissatisfaction with mainstream political parties (for example, the UNP and the SLPP) appears to be boosting support for the left-wing populist NPP party. The NPP says that it is seeking an electoral mandate for alternative, home-grown policies which emphasise state control of resource allocation in Sri Lanka and that it wants to renegotiate the IMF agreement. However, the NPP is yet to issue an election manifesto detailing its economic policy programme for Sri Lanka and what elements of the IMF programme it wishes to renegotiate.

Lessons from the Economic Crisis

Sri Lanka's experience suggests five policy lessons to mitigate the costs of an economic crisis in debt distressed developing countries.

First, *early IMF financing and advice bring benefits*. To tackle the economic fallout from the COVID-19 pandemic, Gotabaya's government adopted inward-looking 'home-grown' economic remedies (for example, overly loose monetary policy, stringent import controls, bilateral swap arrangements with regional economies and lengthy financial subsidies to affected sectors and firms) with temporary and limited results.[39] The dominant faction of Rajapaksa's government and its key economic advisors were ideologically staunchly anti-IMF equating it with an instrument of western imperialism while others believed that the austerity policies the IMF demands would be politically unpopular (including public expenditure cuts, higher taxes, a floating exchange rate and the removal of fuel subsidies).

However, there was little discussion within Rajapaksa's government on the benefits of securing an IMF programme early such as a low-interest loan to bail out Sri Lanka, the restoration of some investor confidence, the ability to borrow from international capital markets once again and the benefit of IMF economic advice on macroeconomic stabilisation and debt restructuring. It took a worsening economic and political crisis to force the Rajapaksa government to finally go to the IMF in March 2022, some 18 months after the COVID-19 pandemic hit. It is arguable that the worsening economic crisis compounded by the delay in going to the IMF imposed social costs with poverty rising markedly. Furthermore, the government was in a much weaker bargaining position in negotiations with the IMF and, therefore, subject to greater austerity measures than otherwise.

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[39] For a critical economic analysis see G. Wignaraja, "COVID-19 Effects and Home-grown Policy Response in Sri Lanka", *Journal of the Asia Pacific Economy*, 20 February 2024, https://doi.org/10.1080/13547860.2024.2318948.

In an ideal world, a debt distressed country should adopt a robust early warning crisis system and request IMF assistance prior to or at the onset of a balance of payments crisis.

Second, *currency swaps and loans are insufficient for external debt management*. With unfavourable credit ratings inhibiting the issuance of international sovereign bonds, the central bank turned to other options, particularly three bilateral currency swaps with regional countries to obtain foreign currency to boost the country's foreign exchange reserves while making external debt repayments. The existence of a swap can improve market sentiment even if actual utilisation is limited. Market players look favourably at swaps because they signify a source of foreign exchange liquidity and support from a major regional central bank. In July 2020, the Reserve Bank of India extended a currency swap under the South Asian Association for Regional Cooperation framework amounting to US$400 million (S$540 million). In March 2021, a bilateral currency swap was extended by the Peoples Bank of China for CNY10 billion (about US$1.5 billion [S$2 billion]). Sri Lanka also obtained a two-tranche loan from China Development Bank for US$1 billion (S$1.35 billion) in 2020-2021. In a rare stroke of fortune, a third option of a one-off special drawing rights allocation of US$780 million (S$1.1 million) from the IMF – under an initiative to boost reserves of all IMF members and help global recovery – was received in August 2021.

However, these options did little and Sri Lanka's reserves fell from 3.2 months of import cover to one month import cover between 2020 and 2021 (see Table 2). The stark reality is that swaps are only a very short-term measure and have strict conditions attached.[40]

While the swap with the Peoples Bank of China has a three-year validity, it is in Chinese yuan (rather than US dollars) and is only to be used to promote bilateral trade and investment. In theory, it could be used to source essential imports from China such as food and refined petroleum. However, historically, Chinese importers invoice in US

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[40] The conditions attached to a swap agreement are intended to protect both parties from currency fluctuations and the risk that a central bank may be refuse or be unable to honour the conditions of the agreement.

dollars and not in Chinese yuan which means that the swap with the Peoples Bank of China is not usable in practice.

In an ideal world, central banks should resort to bilateral currency swaps and foreign currency loans as a very short-term policy response rather than as a medium-term external debt management solution. Furthermore, the conditions attached to such options should be carefully reviewed and alternatives weighted up.

Third, *it is important to strengthen safety nets to mitigate poverty and political instability*. Sri Lanka's British style welfare system provides free universal healthcare and education through public hospitals, state schools and universities. Sri Lanka also has the *Samurdhi* programme – a large poverty reduction initiative launched in 1995 – covering about 1.8 million beneficiaries. It provides cash transfers and various empowerment programmes (for example, rural infrastructure, livelihood support, housing programmes and microfinance through *Samurdhi* banks). The World Bank provided US$145 million (S$196 million) for emergency cash transfers to about three million poor between May and July 2022.

However, public hospitals faced shortages of medicines hindering outpatient services and postponing surgeries. Critics argue that *Samurdhi* benefits are not well-targeted as the poorest segment was not receiving *Samurdhi* benefits and that the sums offered were small in relation to the poor's food security needs during high food price inflation.[41] Fuel shortages meant long queues for days to obtain fuel in early 2022. Fuel prices eventually increased and the introduction of an innovative fuel QR code weekly fuel rationing system made access simpler and fairer. However, these measures were insufficient to stem growing poverty and social discontent over rising food inflation and shortages of food and fuel.

In an ideal world, donor-funded cash transfers targeted to the poorest should be introduced at the onset of an economic crisis along with a rationing of basic food and fuel.

41 D. Gunawardena and S. Siyambalapitiya, "Targeting assistance: electricity consumption is a superior method", Verite Research, July 2022. https://www.veriteresearch.org/wp-content/uploads/2022/07/VR_EN_BN_Jul2022_Targeting-Assistance-Electricity-Consumption-is-a-Superior-Method.pdf.

Fourth, *a strong macroeconomic regulator is crucial to mitigating the economic costs of a crisis*. This responsibility rests with the central bank. In the 28 or so months before the sovereign debt default, successive political appointees linked to Gotabaya's government headed the central bank. Moreover, the Monetary Board, which manages the central bank, includes the Treasury Secretary. The resulting political capture and lack of operating autonomy meant that the central bank's monetary policy, exchange rate and foreign reserve decisions were heavily influenced by short-term political pressures rather than macroeconomic rationale.[42] Insufficient attention was given to ensuring debt sustainability and early warning about the impending sovereign debt crisis.

The Wickremesinghe administration passed a new Central Bank Act in September 2023 to create an independent central bank with the goal of ensuring macroeconomic and financial stability. The provisions of the new act include 1) a framework for effective implementation of a system of inflation targeting; 2) removal of monetary financing of the government's budget deficit; 3) appointment of the Governor for a fixed term by Sri Lanka's president on the recommendation of a constitutional council; and 4) for the Monetary Board to exclude the Treasury Secretary.

In an ideal world, a central bank should be free from short-term pressures and be sufficiently autonomous to be able to make tough decisions. Central bank independence can bring benefits such as delivering lower inflation than the alternative, contributing to debt sustainability and lowering the risk of crises.

Fifth, *effective crisis management capabilities are a parallel need*. Gotabaya appointed three parallel structures for crisis management which stifled information sharing, sparked infighting and led to poor decision making. One was a large, unmanageable Presidential Task Force to coordinate the COVID-19 response. Another was two overlapping committees – one of key ministers and another of

[42] I. Coomaraswamy and G. Wignaraja, "What can we learn from Sri Lanka's debt default?", *LSE Blog*, 16 October 2023, https://blogs.lse.ac.uk/southasia/2023/10/16/what-can-we-learn-from-sri-lankas-debt-default/.

business leaders – to tackle the debt crisis. Finally, a group of eminent economists with experience of international institutions advised Gotabaya on debt restructuring and the IMF programme. However, it is unclear what influence these parallel bodies had on high-level decision making compared to the president's closest economic advisors.

In an ideal world, a US-style President's Council of Economic Advisors should be mandated with offering objective economic advice to a head of state supported by a national economic monitoring unit within a finance ministry.

Conclusion

This Scan analysed Sri Lanka's sovereign debt default in 2022 and the crippling economic crisis to provide a cautionary tale for others in South Asia and beyond. It mapped the macroeconomic effects of the economic crisis, discussed major causes, explored cures and drew policy lessons.

Three points from the evidence on Sri Lanka's crisis experience are worth highlighting.

First, external shocks (for example, the COVID-19 pandemic and the Russia-Ukraine conflict), and a Chinese debt trap due to uneconomic commercial borrowing did play a part in causing Sri Lanka's crisis. These factors added to the macroeconomic vulnerabilities of a persistent twin deficit economy. However, much of this explanation for the weak economy being pushed off the edge of the economic cliff into default and economic crisis lies with economic mismanagement by family-dominated governance of the Rajapaksa brothers. Multiple policy missteps and inward-looking, home-grown economic remedies were stubbornly pursued as the panacea cure for the crisis. With the benefit of hindsight, the single biggest policy error was the refusal of the Rajapaksa government to seek an IMF bailout to tackle the economic fallout from the COVID-19 pandemic in 2020-2021.

Second, it took Sri Lanka 11 months to conclude an IMF bailout and, in the interim, emergency Indian aid provided a lifeline to the defaulted Sri Lankan economy enabling essential imports for the suffering Sri Lankan people. Signs of economic stabilisation in 2024 suggest that shifting from a Sri Lanka-India aid relationship to one on trade and investment can bring trade gains and be a building block for regional economic integration.

Third, besides going early to the IMF, other indebted countries in South Asia and beyond should heed important policy lessons from Sri Lanka's crisis. These include the insufficiency of currency swaps and foreign loans for external debt management, strengthening safety nets to mitigate poverty and political instability and developing effective crisis management capabilities.

There was some cause to celebrate progress in economic stabilisation on Sri Lanka's 76th Independence Day on 4 February 2024 compared to its 74th Independence Day in 2022 when Sri Lanka was on the brink of foreign debt default. Wickremesinghe deserves credit for pulling Sri Lanka back from the abyss of economic misery. Only time will tell whether he can win the presidential elections in late 2024 in challenging economic times and continue the EFF and reforms to realise his vision of a high growth, prosperous Sri Lanka.

Appendix 1:
Export Effects of Sri Lanka's FTAs

Model-based studies of FTA policy scenarios can help guide policy choices on sequencing of a country's trade deals. The exercise simulating the exports effects for Sri Lanka from various FTAs used a static multi-country, multi-sector CGE model and the GTAP 10 dataset from the Centre for Global Trade Analysis of Purdue University in the US. Table A1 provides the export effects for Sri Lanka from three FTA scenarios in percentage change from the baseline in the overall volume of Sri Lanka's merchandise exports:

Scenario 1: A goods only China-Sri Lanka FTA. This covers the removal of all import tariffs on goods trade between both countries.

Scenario 2: A deep India-Sri Lanka FTA. This covers the removal of all import tariffs between both countries plus elimination of some non-tariff barriers (NTBs) plus an increase of service preferences by 10 per cent.

Scenario 3: A goods only BIMSTEC FTA. A regional FTA covering removal of all import tariffs between the seven BIMSTEC members (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand).

The export effects are 2.34 per cent for the India-Sri Lanka FTA, 2.71 per cent for the BIMSTEC FTA and 1.41 per cent for the China-Sri Lanka FTA. A deeper bilateral FTA with India brings more export gains to Sri Lanka than a narrower FTA with China. Typically, a large regional FTA involving free trade in goods among the BIMSTEC members produces greater export gains for Sri Lanka than a bilateral FTA with China involving free trade in goods or one with India involving free trade in goods and partial services trade.

The effects on Sri Lanka's export sectors vary between FTAs. Strikingly, garment exports see limited gains under the China or India FTAs (about one per cent) and negligible change under the BIMSTEC FTA. Rubber and plastics products and other light manufacturing also achieve modest gains under all three FTAs. Meanwhile, textile exports gain significantly under the BIMSTEC FTA (18.57 per cent) and the India FTA (5.19 per cent) but have limited gains under the China

FTA (2.5 per cent). Likewise, tea, other beverages and other food products gain significantly under the BIMSTEC FTA (27.31 per cent) and the India FTA (12.82 per cent) but negligible change under the China FTA. Machinery, equipment, electronics and metal work see significant gains under the BIMSTEC FTA and some gains under the China and India FTAs. Adding partial services liberalisation to the India FTA yields gains for some services exports particularly transport and logistics (3.08 per cent) as well as information and communications technology/business process management (1.82 per cent).

Table A1: Exports Effects for Sri Lanka from FTA Scenarios (Percentage Change from Baseline)[1]

Export Sector	A goods only China-Sri Lanka FTA	A goods and services India-Sri Lanka FTA	A goods only BIMSTEC FTA
Rice and cereals	0.33	2.10	4.44
Vegetables, fruit and nuts	0.79	1.09	2.53
Crops nec	1.16	10.94	10.82
Coconut products, other forestry and sugar products	3.54	0.11	0.69
Food products nec	0.41	0.70	0.83
Cattle, sheep, goats and other animal products	0.55	0.35	12.76
Fish and seafood	0.09	0.37	0.37
Textiles	2.50	5.19	18.57
Chemical and pharmaceutical products	2.48	2.16	7.71
Garments	0.92	0.86	- 0.18
Tea, other beverages, dairy and other food products	0.10	12.82	27.31
Vegetable oils and fats	0.50	2.21	1.34
Coal	0.13	0.61	27.56
Oil	2.22	4.84	1.34
Gas, gas manufacture and distribution.	3.19	10.38	4.12
Petroleum and coal products	2.80	0.35	37.74
Electricity	2.65	5.60	5.15
Rubber and plastic products	2.35	3.16	3.56

Computer, electronic and optic products	3.55	3.73	7.27
Electrical equipment	7.09	3.48	12.07
Machinery and equipment	6.33	3.34	10.66
Motor vehicles and parts	3.48	2.18	24.61
Boats and misc transport equipment	3.36	3.64	3.31
Leather products; Wood products; Paper products, publishing; Manufactures nec	4.70	2.12	3.65
Minerals and mineral products	0.71	0.61	1.19
Metals and metal working	7.00	4.14	9.27
ICT/BPM services	1.39	1.82	0.72
Financial services and insurance	0.34	0.76	- 0.53
Real estate activities and misc business services	0.05	1.13	- 0.28
Tourism and recreation	0.01	0.92	- 0.10
Water; Construction; Trade; Public Administration and defense; Education; Human health and social work a; Dwellings	0.18	0.71	- 0.25
Transport and logistics	1.27	3.08	2.33
Total exports	1.41	2.34	2.71

Notes:
China-Sri Lanka FTA = removal of all tariffs between both countries.
India-Sri Lanka FTA = removal of all tariffs between both countries plus elimination of some NTBs plus increase of service preferences by 10 per cent.
BIMSTEC FTA = Removal of all tariffs between BIMSTEC members (Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand).
[1] Volume of merchandise exports.
Source: ODI estimates based on a static GCE Model and the GTAP 10 Database.

About the Author

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