

Sri Lanka: from debt default to transformative growth

An essay series

Edited by Ganesan Wignaraja and Dirk Willem te Velde

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About this publication

This collection of essays has been written by leading experts from Sri Lanka and across the world specialising in macroeconomic issues in Sri Lanka. It has been edited by Ganeshan Wignaraja and Dirk Willem te Velde.

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Contents

Acknowledgements / i

Tables, figures and boxes / viii

Acronyms / x

Executive summary / xiii

1 Introduction: overview and policy proposals / 1

Part 1: Debt and shocks / 12

2 The evolution of Sri Lanka's sovereign debt crisis: lessons for better borrowing / 13

3 Lessons from bondholder restructurings / 22

4 Debt-for-nature swaps in Sri Lanka / 37

5 Insolvency reforms for growth in Sri Lanka / 45

Part 2: Monetary and fiscal policy / 52

6 Disinflation in an economy in crisis: the case of Sri Lanka / 53

7 Navigating fiscal challenges in Sri Lanka: key issues and policy recommendations / 61

8 A first look at fiscal policies and multiplier effects in Sri Lanka / 70

Part 3: Trade and foreign direct investment / 79

9 Sri Lanka's FTAs and the pathway to RCEP / 80

10 The impact of tariff removal in proposed FTAs for Sri Lanka / 94

11 Trade and FDI facilitation in Sri Lanka / 108

12 Economic diplomacy for transformation in Sri Lanka / 115

Part 4: Key reform priorities and implementation lessons / 127

13 Consolidating IMF-style stabilisation and priorities for growth in Sri Lanka / 128

14 Accountability: the key to sustained and inclusive growth in Sri Lanka / 136

15 An overview of Greece's financial crisis and its implications / 144

Tables, figures and boxes

Tables

- Table 1.1** From indebtedness towards transformative growth: key transitions / 3
- Table 1.2** A typology of public actions to promote economic transformation / 6
- Table 1.3** Policy proposals for transforming's Sri Lanka path from debt to growth / 9
- Table 3.1** Case studies of recent bondholder restructurings / 23
- Table 3.2** Recent debt-for-nature swaps, key indicators / 33
- Table 4.1** Recent debt-for-nature swaps / 38
- Table 9.1** Economies of ASEAN and RCEP, 2022 / 87
- Table 9.2** Sri Lanka's merchandise trade with RCEP countries, 2022 / 88
- Table 10.1** Sri Lanka's import tariffs in the model by FTA partner (%) / 96
- Table 10.2** Tariffs imposed on Sri Lankan exports by FTA partner (%) / 97
- Table 10.3** Impacts on Sri Lanka's trade by broad sectors (%) / 100
- Table 10.4** Impacts on output by sector (%) / 103
- Table 10.5** Impacts on unskilled employment by sector (%) / 104
- Table 11.1** Key trade, investment and facilitation indicators for Sri Lanka and selected Asian countries / 108

Figures

- Figure 2.1** Evolving sovereign debt stock (% of GDP) / 14
- Figure 2.2** Real GDP growth (%) / 14
- Figure 2.3** Net foreign borrowing: all creditors (\$ million) / 16
- Figure 2.4** Public debt interest payments (% of revenue) / 17
- Figure 3.1** Creditor composition of external debt eligible for restructuring (%) / 27
- Figure 3.2** Zambia's bond payments (principle and interest): base and upside scenarios (\$ million) / 32
- Figure 4.1** Belize debt-for-nature swap / 39
- Figure 5.1** Share of NPLs in gross loans (%) / 45
- Figure 6.1** Headline inflation: food and non-food (CCPI, year on year), 2010–2024 (%) / 54
- Figure 6.2** Movements of gross official reserves and exchange rate, 2019–2024 / 56
- Figure 6.3** Central Bank's financing to the government, 2018–2024 (LKR billion) / 57
- Figure 6.4** Movements of policy interest rates and market interest rates, 2019–2024 (%) / 58
- Figure 7.1** Trends in key fiscal indicators, 2009–2028 (% of GDP) / 61

Figure 8.1 Fiscal multiplier scenarios: growth impact of fiscal policy options / 75

Figure 9.1 Sri Lanka's exports as share of GDP, 2000–2022 (%) / 89

Figure 10.1 Sri Lanka goods exports and imports to selected countries / 95

Figure 10.2 Impacts on the volume of merchandise export and imports in the model / 99

Figure 10.3 Impact in terms of change in Sri Lanka's real GDP (%) / 102

Figure 11.1 FDI inflows in Sri Lanka, 1978–2022 (\$ million) / 109

Figure 14.1 GDP per capita in Sri Lanka, 1950–2018 (\$) / 137

Figure 14.2 Kernel density estimates of the log of gross output per acre, by crop / 139

Figure 14.3 Crop productivity (gross value of output/acre in rupees), 2006–2016 / 139

Boxes

Box 3.1 Sequencing of debt negotiations / 25

Box 10.1 Model specification / 98

Acronyms

ADB	Asian Development Bank
APTA	Asia-Pacific Trade Agreement
ASEAN	Association of Southeast Asian Nations
BOG	Bank of Greece
BOI	Board of Investment
CAC	collective action clause
CBSL	Central Bank of Sri Lanka
CCRIF	Caribbean Catastrophe Risk Insurance Facility
CEB	Ceylon Electricity Board
CEPA	Comprehensive Economic Partnership Agreement
CF	Common Framework
CGE	computable general equilibrium
CID	Center for International Development
CoO	Certificate of Origin
CPC	Ceylon Petroleum Corporation
CRDC	climate-resilient debt clause
DFC	U.S. International Development Finance Corporation
DSA	Debt Sustainability Analysis (IMF)
ECA	export credit agency
ECB	European Central Bank
EDB	Export Development Board
EFF	Enhanced Fund Facility (IMF)
EPZ	export processing zone
EU	European Union
FDI	foreign direct investment
FMRA	Fiscal Management (Responsibility) Act
FTA	free trade agreement
GCRG	Global Crisis Response Group

GDP	gross domestic product
GNI	gross national income
GSP	Generalized System on Preferences
GTAP	Global Trade Analysis Project
HIC	high-income country
HIES	Household Income and Expenditure Survey
IADB	Inter-American Development Bank
IMF	International Monetary Fund
IPS	Institute of Policy Studies
IRA	Inland Revenue Act
IT-BPM	information technology-business process management
ITMIS	Integrated Treasury Management Information System
LIC	low-income country
LIA	Lending into Arrears
LIOA	Lending into Official Arrears
LMIC	lower-middle-income country
LTTE	Liberation Tigers of Tamil Eelam
MAC	market access country
MFN	most-favoured nation
MOF	Ministry of Finance, Economic Stabilization and National Policies (Sri Lanka)
MTFF	medium-term fiscal framework
n.e.c.	not elsewhere classified
NPL	non-performing loan
NPP	National People's Power
NPQS	National Plant Quarantine Service
NPV	net present value
NTB	non-tariff barrier
OCC	Official Creditor Committee
OECD	Organisation for Economic Co-operation and Development
PFM	public finance management
PIP	Public Investment Programme

PMD	President's Media Division
PTI	Press Trust of India
PV	present value
RAMIS	Revenue Administration Management Information System
RCEP	Regional Comprehensive Economic Partnership
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asian Free Trade Area
SCDI	state-contingent debt instrument
SCI	Statement of Corporate Intent
SeyCCAT	Seychelles Conservation and Climate Adaptation Trust
SJB	Samaji Jana Balwegaya
SLSI	Sri Lanka Standards Institution
SMEs	small and medium enterprises
SOE	state-owned enterprise
SRR	Statutory Reserve Requirement
TFA	Trade Facilitation Agreement
TNC	The Nature Conservancy
TRAINS	Trade Analysis Information System (UNCTAD)
UK	United Kingdom
UMIC	upper-middle-income country
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
US	United States
VAT	value-added tax
VRI	value recovery instrument
WTO	World Trade Organization

Executive summary

On 12 April 2022, Sri Lanka announced a pre-emptive sovereign default on all its foreign debt of about \$50 billion pending an International Monetary Fund (IMF) programme and a debt restructuring process. The sovereign default precipitated the worst economic crisis in the country's post-independence history. In 2022, Sri Lanka suffered a -7.8% contraction in gross domestic product, end-of-year Consumer Price Index inflation of 54.5%, shortages of essentials (like fuel, food and medicines) and a doubling of poverty (\$3.65 poverty line) to 25% of the population.

The Sri Lankan economy has stabilised faster than expected compared with several other debt-defaulting developing countries and also IMF expectations. However, it is not enough for Sri Lanka to stabilise its economy and return to the same growth path it was on before the crisis. The essays in this book, by leading scholars and experts on the Sri Lankan economy, as well as international experts, offer 27 proposals on how to continue to shift the economic trajectory of Sri Lanka from one of debt distress to one of growth over the next few years:

Build a cross-party consensus on the economic direction of Sri Lanka:

- Develop a vision for economic growth and transformation among political parties, businesses, trade unions and civil society.
- Through consistency of policy and regulation, maintain trade openness and a level playing field for all investors.

- Implement the government's time-bound plan to address rent-seeking and corruption vulnerabilities.

Ensure external and domestic debt sustainability:

- Implement the Public Debt Management Act, to allow a modern debt management office to function.
- Pursue active debt management (that is, shift from a loan-/aid-recipient mindset to one that monitors and takes action to mitigate debt risks).
- Consider use of a sustainable brand to ensure better borrowing and non-debt-creating flows linked to climate action and conservation.
- Revise the draft insolvency bill and build the capacity of practitioners and judges on domestic debt management laws.
- Undertake future foreign borrowing from the cheapest lender, regardless of the state of diplomatic relations with the creditor's country.
- Ensure timely, proactive and transparent engagement with stakeholders to minimise the risk of protracted restructurings

Make the Central Bank's independence work:

- Implement the Central Bank Act and a flexible inflation-targeting regime through the hiring and retention of high-calibre managers and professionals in the Central Bank of Sri Lanka (CBSL).
- Develop CBSL's early warning system with support from the SAARCFINANCE Governors process and the IMF's South Asia Regional Training and Technical Assistance Center.

Support fiscal sustainability:

- Implement the Public Finance Management Act expeditiously to promote fiscal transparency and discipline.
- Re-engineer the national budget process towards revenue-raising and debt sustainability, as well as transparent public monitoring.
- Rigorously apply controls for all infrastructure projects in the Public Investment Programme prepared by the Ministry of Finance.
- Rationalise state-owned enterprises based on a clear policy framework and implement operational and governance reforms for such entities.
- Use economic assessment techniques to guide fiscal spending.

Undertake pragmatic economic transformation:

- Undertake ‘stroke-of-the-pen’ reforms to drastically cut cumbersome regulations related to entry, exit and business operation for foreign and local investors.
- Implement the long-delayed national single window to streamline/speed up trade facilitation and capacity-building for related institutions.
- Consider the sequencing of free trade agreement (FTA) negotiations guided by economic assessments.

- As an early priority of the newly enacted Economic Transformation Act, ensure a properly resourced Office of International Trade to manage FTA negotiations.
- Consult key stakeholders on the implementation of the Economic Transformation Bill to be enacted.
- Undertake regulatory reforms and trade adjustment measures to exploit the opportunities available from bilateral FTAs and eventual membership of the Regional Comprehensive Economic Partnership.
- Create hub embassies in major trading and FTA partners with specialised marketing/commercial staff.
- Improve engagement with the Sri Lankan diaspora community through a variant of the Overseas Citizen of India scheme.

Make growth inclusive:

- Better target cash transfers towards the poorest along with a modest rationing of basic food where necessary.
- Improve food security by liberalising imports of basic food items and ensuring better storage systems in rural areas.
- Repeal the Paddy Lands Act to increase the economic freedom and prosperity of farmers.

1 Introduction: overview and policy proposals

Ganeshan Wignaraja and Dirk Willem te Velde

1.1 Background and motivation

The emergence of a large number of debt-distressed developing economies in the post-COVID world economy has prompted a search in policy and think-tank circles for pathways out of debt distress towards transformative growth while avoiding another default in the near future.

This is an acute issue in Sri Lanka, a middle-income country of 22 million people in South Asia. On 12 April 2022, for the first time in its history, Sri Lanka announced a pre-emptive sovereign default on all its foreign debt of about \$50 billion. This was pending an International Monetary Fund (IMF) programme and a debt restructuring process, after exhausting a search for sources of bilateral financing (Ministry of Finance, 2022). The suspension of payments to private bondholders and bilateral creditors (particularly China, the largest bilateral creditor) was in response to a severe balance of payments crisis, with foreign reserves down to a historic low of a few hours of import cover.

The sovereign default and the lingering fallout from the pandemic precipitated the worst economic crisis in the country's post-independence history (Raiser, 2023; Athukorala, 2024). In 2022, Sri Lanka suffered a -7.8% contraction in gross domestic product (GDP), end-of-year Consumer Price Index inflation of 54.5%, shortages of essentials (like fuel, food and medicines) and a doubling of poverty (\$3.65 poverty line) to 26% of the

population. Not surprisingly in a country with high literacy and strong democratic traditions, the economic crisis morphed into a political crisis. Mass public protests over economic mismanagement triggered the downfall of the powerful government under President Gotabaya Rajapaksa, who had been elected with a two-thirds parliamentary majority (de Silva et al., 2022; Wignaraja, 2024a).

Fast-forwarding 15 months to end-July 2024, under a new government headed by President Ranil Wickremesinghe the economy is showing signs of stabilisation. Inflation has fallen to single digits, foreign reserves are heading towards three months of import cover and there is an absence of waiting lines for essentials, although prices remain elevated. The Sri Lankan economy has stabilised faster than expected compared with several other debt-defaulting developing countries and also IMF expectations.

These improvement in the economy can be traced to a combination of decisive stabilisation measures, the IMF programme and interim Indian aid (Wignaraja, 2024b).

- Domestic stabilisation measures: The Central Bank of Sri Lanka (CBSL) allowed the exchange rate to float; raised policy interest rates significantly to control inflation; and carried out actions to safeguard the stability of the banking system. The government also started negotiations on an IMF bailout; raised taxes; curtailed non-essential recurrent expenditure

and suspended capital expenditure; imposed restrictions on non-essential imports; removed energy subsidies and adopted cost-reflective pricing mechanisms; and initiated a programme to restructure and privatise state-owned enterprises (SOEs).

- IMF programme: On 20 March 2023, the Executive Board of the IMF approved an Enhanced Fund Facility (EFF) of \$3 billion over 48 months for Sri Lanka. The country's 17th IMF programme has brought in the toughest policy conditionalities and austerity measures so far in Sri Lanka. It focuses on revenue-based fiscal consolidation and seeks to significantly raise tax revenue and increase utility prices; control inflation by raising interest rates, eliminating monetary financing and ensuring an independent central 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 through better fiscal transparency and public financial management (IMF, 2023).
- Indian aid: As the negotiations with the IMF were prolonged, Sri Lanka sought bridging finance and aid from India to finance essential imports of food, fuel and medicines. In the first six months of 2022, Indian aid worth \$3.8 billion flowed to Sri Lanka, through credit lines and deferred loans and grants. This meant this was India's largest bilateral aid programme to any country in recent times.

However, the growth side of the story is suboptimal. Available growth forecasts for Sri Lanka in 2024 range from the pessimistic to the optimistic, from 1.9% (ADB, 2024) to 2.2% (World Bank, 2024) to 3.0% (CBSL: Iqbal, 2023). It is encouraging that Sri Lanka's growth could enter positive territory in 2024, after the deep economic

contraction in 2022. But these projections are at best moderate by developing country standards. For instance, the CBSL 3% projection is much less than the Asian Development Bank's projection of average growth of 4.9% for all developing Asian economies in 2024 (ADB, 2024).

Furthermore, the economy remains fragile, clouded by political risks that could derail the EFF and growth beyond 2024: presidential elections have been announced for 21 September 2024, to be followed by parliamentary elections. Worryingly, there seems to be little consensus among political parties on the direction of Sri Lanka's economic policy and the IMF programme. A doubling of income poverty – measured against a poverty line of \$3.65 – to 25% of the population since the sovereign default, as well as apparent dissatisfaction with mainstream political parties, may be boosting support for opposition parties seeking an electoral mandate for renegotiation of the IMF agreement, and even for home-grown policies that emphasise state control of resource allocation and inward orientation (see Uyangoda, 2024).

In addition, there are sovereign debt repayment risks in the medium term. As a significant milestone, on 26 June 2024 Sri Lanka reached a deal with the Official Creditor Committee to restructure the debt owed to its bilateral lenders, including India, and signed a separate agreement with China for debt treatment. Under these deals, totalling about \$10 billion, Sri Lanka has a temporary grace period on debt repayments to bilateral creditors until 2028. Financing from international financial institutions will also be available during this period. At the time of writing, a deal with private bondholders seems likely in the next few weeks, whereby interest payments commence in late 2024 and capital payments from 2028. After 2028, however, the expectation is that Sri Lanka would resume borrowing from capital markets

and generate non-debt-creating foreign exchange (e.g. through tourism, remittances, exports and foreign direct investment (FDI)) to service debt repayments and other development expenditures. If it does not, an 18th IMF programme and more stringent austerity policies await Sri Lanka. This could trigger social unrest.

It is therefore not enough for Sri Lanka to stabilise the economy and return to the same growth path it was on before the crisis. Sri Lanka has stabilised its economy with support from the IMF on several occasions in its history, yet each time growth appears to have been fuelled by fiscal deficits and not export surpluses or transformative

change. There is therefore little doubt that Sri Lanka needs to shift from an economic situation of indebtedness and slow growth to transformative growth in the medium to long term. Transformative growth involves looking at the quality of such growth rather than focusing only on its rapidity.

Table 1.1 presents seven characteristics involved in meeting the challenge of shifting Sri Lanka's growth path from one of indebtedness to one of transformative growth, encompassing important dimensions such as debt, productivity and exports, openness and market orientation, fiscal and monetary policy, and climate change.

Table 1.1 From indebtedness towards transformative growth: key transitions

Indebtedness	Transformative growth
Growing, unstable public debt (to GDP) and debt service	Declining debt-to-GDP ratios
A weakly diversified low productive economy	A transformed, high-productive, export-oriented economy (high-quality manufacturing and services)
A closed, protected economy (tariffs, subsidies)	A more open and liberal economy
Growth driven by fiscal deficits	Growth driven by export surpluses
Monetary policy affected by political interference	An independent Central Bank focused on price stability, avoiding crises and creating jobs
A low tax economy with few fiscal rules	An economy governed by principles on the economic effectiveness of fiscal spending
An unequal, paper economy vulnerable to climate shocks	An inclusive, digital and zero-carbon economy

Source: Authors

The essays in this ODI book, written by leading Sri Lankan and international experts, examine the state of play of the Sri Lankan economy in the present stabilisation phase, explore impediments and challenges to achieving transformative growth and trace policy implications. The essays cover three interrelated topics:

- *Debt and shocks*: This topic covers addressing debt crises and associated shocks immediately, to stabilise the economy.
- *Monetary and fiscal policy*: This topic covers short-term, cyclical macroeconomic policies that help stabilise the economy but also create conditions for growth.

- *Trade and investment policy*: This topic covers enabling and targeted policies that can help transform Sri Lanka's economy and raise productivity and competitiveness.

The essays also cover *prioritisation and implementation issues*.

All essays include clear policy proposals related to moving from debt to transformative growth, How the government of Sri Lanka, development partners, think-tanks and civil society reflect and act on these issues will likely influence the growth trajectory of the Sri Lankan economy over the next few years.

1.2 Findings from the essays

Debt and shocks

Four essays provide policy proposals related to addressing debt crises.

Gregory Smith reviews 15 years of Sri Lanka's borrowing decisions, highlighting key trends, and draws lessons from the period leading up to the default. He explores the link between growth and debt, drawing inferences and comparisons with peer countries. By illustrating the impact of several growth scenarios on debt risks, this essay shows that accelerating growth is fundamental to reducing Sri Lanka's debt burden to sustainable levels over the next five to 10 years. Suggestions on ways Sri Lanka can shift to better borrowing include a modern debt management office, an active debt management strategy and a sustainable brand to attract better borrowing and non-debt-creating flows linked to the climate and conservation.

The essay by Yunnan Chen, Frederique Dahan and Tom Hart analyses lessons for Sri Lanka from

private sector debt restructuring experiences. Sri Lanka is restructuring \$13 billion in US dollar bonds, about 16% of its 2023 GDP, following its 2022 default. Drawing from recent experiences of emerging market restructurings over the past decade, this essay synthesises nine cases of bondholder restructuring from a wide range of developing countries, drawing lessons on the speed and scale of restructuring. It evaluates the utility and limitations of legal instruments like collective action clauses and state-contingent debt instruments in facilitating successful restructuring, emphasising long-term debt sustainability and climate resilience. The policy lessons include the need for proactive and transparent engagement with stakeholders to minimise the risk of protracted restructurings.

Michael Iverson, in his essay, argues that, as Sri Lanka faces an increasing debt burden and pressing environmental commitments, debt-for-nature swaps present the possibility of addressing the opportunity costs of debt repayments and mobilising finance for essential investments in climate change adaptation and mitigation. This will require coordination and a prioritisation of climate goals over debt relief.

Much discussion in Sri Lanka is around external debt but there are also important issues around domestic (private) debt. Murtaza Jafferjee and Ashanthi Abayasekara argue that insolvency – that is, the inability of a business to settle debts owed to creditors – is a critical issue in Sri Lanka, but that the country is struggling with an insolvency system that is in desperate need of an overhaul. This is being exacerbated by an increasing rate of non-performing loans that is burdening the Sri Lankan economy. Revisions need to be made to the draft insolvency bill and the capacity of practitioners and judges needs

to be built. Carrying out these reforms will lead to a climate that is conducive to entrepreneurship and increased investment.

Monetary and fiscal policy

Monetary and fiscal policy has helped Sri Lanka stabilise its economy, yet policy proposals in three essays suggest these policies can be improved to enable a move towards transformative growth in the future.

P. Nandalal Weerasinghe, Chandranath Amarasekera and Sujeetha Jegajeevan note that Sri Lanka recorded its highest-ever levels of inflation during the 2022 economic crisis. These were the result of fuel supply shortages, heavy exchange rate depreciation leading to rising import prices and monetary financing of expanding fiscal deficits, among others. However, the country was able to rapidly reduce inflation to single-digit levels within 10 months of the peak through active monetary policy, including CBSL significantly tightening monetary policy, almost doubling the policy rate at once. This essay summarises Sri Lanka's recent experience of high inflation, the high costs to the economy and the role of monetary policy. It also underlines the importance of Central Bank independence and the cessation of monetary financing of fiscal deficits for successful inflation management, which is a prerequisite for sustained high growth.

Roshan Perera points out that Sri Lanka has faced an unsustainable fiscal deficit as a result of low tax revenue and inefficient expenditure management, which are symptomatic of lacklustre macroeconomic management historically and more recently. Key vulnerabilities include weak tax collection, poor fiscal management and inefficient SOEs. Policy recommendations focus on enhancing tax revenue, strengthening

public finance management and carrying out comprehensive SOE reform. Doing this, and attaining fiscal sustainability, will require strong political will, technical capabilities and cooperation among all stakeholders.

In their essay, Derrick Abudu, Hazel Granger, Sherillyn Raga, Dirk Willem te Velde and Ganeshan Wignaraja take a first look at the role of fiscal spending policies and their growth impact – known as ‘fiscal multiplier’ effects. International experience of high-performing countries suggests that the type of fiscal spending matters for growth. The authors use simple modelling techniques and multiplier analysis to argue that it matters markedly for growth in Sri Lanka whether increases or contractions of fiscal spending occur in consumption or investment. There should be more and better-informed debates on types of fiscal spending and policy choices. Policy-makers in Sri Lanka should consider maximising the growth effects of fiscal spending based on analysis of fiscal multipliers and on other techniques for the economic assessment of fiscal spending.

Trade and investment policy

Trade and investment represent a crucial factor in economic transformation (McMillan et al., 2017). Four essays discuss a number of trade and investment policies, which, together with policies on education, skills, innovation and learning, finance, infrastructure and other issues, can support economic transformation in Sri Lanka.

ODI analysis on policies for economic transformation over the past decade suggests overall business climate reform and macroeconomic policies (such as those normally included in IMF programmes) alone are not enough: additional, targeted, support is critical (see McMillan et al., 2017; Ripley and te Velde,

2020). General investment climate reforms are not always working or are not sufficient, and need

to be complemented by targeted interventions. These include the interventions in the right-hand column in Table 1.2.

Table 1.2 A typology of public actions to promote economic transformation

	General enabling interventions	Targeted interventions
Public actions to support structural change	• Investment climate reforms • Financial sector development • Strengthening state–business relations	• Export push policies • Exchange rate protection • Selective industrial policies • Spatial industrial policies • National development banks
Public actions to support within-sector productivity growth and sector transformation	• Building fundamentals • Investments in basic production knowledge • Managerial good practices as public goods • Agricultural innovations • Promoting competition	• Management training • Attracting FDI • Export diversification • Developing global value chains • Increasing agricultural productivity

Source: McMillan et al. (2017)

This set of essays addresses some of these transformation policies (on trade and investment).

For example, Sirimal Abeyratne examines Sri Lanka’s free trade agreement (FTA) landscape in 2024 and the economic rationale behind its request to join the Regional Comprehensive Economic Partnership (RCEP) involving 15 Asia-Pacific economies. The benefits and challenges of Sri Lanka’s bilateral FTAs and of RCEP membership are carefully explored. The benefits include market access for goods and services exports, increased FDI, entry into global value chains and geopolitical engagement. Challenges faced include the need to undertake unilateral reforms to gain from FTAs and RCEP, anti-FTA protectionist lobbies, risks of losing sectors and firms, and the long timeline for RCEP membership. Suggestions include

implementing domestic reforms and a trade adjustment package for losing sectors.

An essay by Max Mendez-Parra, Yohannes Ayele and Ganeshan Wignaraja attempts to fill an important gap in the literature on economic policy in Sri Lanka by undertaking the first computable general equilibrium (CGE) model-based analysis of Sri Lanka’s post-2023 thrust towards FTAs with multiple Asian countries, including India, China, Indonesia and Malaysia and through RCEP. The modelling assesses the impact of full tariff liberalisation by all parties on the goods sectors of Sri Lanka. The findings suggest that preferential liberalisation using Sri Lanka’s Asian FTAs offers an opportunity for national economic and efficiency gains – but the adjustment and distributional aspects must be addressed. Policy implications include the need to consider the sequencing of FTA negotiations, guided by more comprehensive

CGE analysis and other economic assessments; capacity-building for trade negotiations; and a trade adjustment package for losing sectors and workers.

M. Ganeshamoorthy argues that Sri Lanka's performance on trade and FDI is poor relative to comparable regional peers. Cumbersome, lengthy and costly administrative and bureaucratic red tape in addition to high and variable import tariffs have contributed to this weak performance. Governance reforms could improve the efficiency of institutions and reduce incentives for rent-seeking behaviour. Key recommendations for improvements focus on streamlining export and investment processes through capacity-building, administrative reforms and the centralisation of trade and FDI processes through digitalisation.

The essay by Ravinatha Ariyasinha argues that Sri Lanka has a long history of engagement in economic relations and diplomacy but with mixed results in terms of higher trade and FDI flows. Factors within and outside policy control explain this situation. The current debt and economic crisis provides an impetus for increased effort by national agencies and the Ministry of Foreign Affairs to boost trade, investment and tourism. Several proposals are posited to make this happen, including improving inter-agency coordination, creating overseas hub missions with specialised staff, increasing engagement with diaspora communities, providing a consistent domestic policy and regulatory framework and ensuring a level playing field for all foreign investors.

Prioritisation and implementation issues

Beyond proposing a range of policies that are crucial in triggering transformative change and dealing with crises, it is also important to consider how these policies are prioritised

and implemented. Lessons from economic transformation experiences (McMillan et al., 2017) suggest it is important to see this as a national building project, one that ensures a set of institutions that can override sectoral interests, embedded within but autonomous from the private sector, with good state–business relations that are based on principles of accountability and trust and with a culture of experimentation.

Indrajit Coomaraswamy and Ganeshan Wignaraja provide a practical framework for the prioritisation and implementation of such policies. They argue that Sri Lanka has made a remarkable turnaround since the dark economic days of default in 2022. But the country's economy remains fragile amid political uncertainty. The period ahead requires continued commitment by Sri Lanka to the IMF programme. This needs to be complemented by a laser-like focus on structural reforms to construct an outward-looking competitive economy that drives sustained growth and poverty reduction. Five sets of proposals to achieve these goals are provided, under the headings of consensus on the economic direction; making Central Bank independence work; supporting fiscal sustainability; providing for pragmatic economic transformation; and making growth inclusive. If Sri Lanka sticks to this course of action, there is every chance the country will move from debt distress to sustained economic development.

In his essay, Shanta Devarajan argues that Sri Lanka's policy agenda and the sources of Sri Lanka's collapse have a common root: a lack of government accountability. International experiences as well as those in Sri Lanka (such as the economic reforms of 1977, which increased accountability to world markets) show that inclusive growth takes place when the people hold the government accountable – when citizens,

especially poor citizens, demand quality services from service providers and pro-poor policies from politicians. It is also more likely when entrepreneurs face competitive prices rather than politically motivated taxes and subsidies. Proposals include repealing the Paddy Lands Act and allowing farmers to grow their desired crop mix, reducing welfare-distorting energy subsidies, improving the targeting of cash transfers to the poor and undertaking future foreign borrowing based on purely economic considerations such as borrowing from the cheapest lender.

Other countries can provide insights into how to move from indebtedness to growth. Greece is a case in point. Phyllis Papadavid argues there are lessons for Sri Lanka from Greece's economy, which has recently shown resurgent growth following its deep and multi-year crisis of 2009–2018. External financial support, and Greece's unprecedented fiscal adjustment, has been essential in reversing its recession. There is now thought to have been an initial overemphasis on fiscal consolidation and an initial underemphasis on growth-enhancing reforms. Rebalancing to tradeable, export-oriented sectors augurs well. Further diversification of the economy towards a digital, knowledge-based and export-led growth model will be key for resilience to future shocks. Greece's wide-ranging structural reform agenda – which has boosted inward investment and trade – is indicative of potential policy interventions for Sri Lanka.

1.3 Conclusion and policy implications

International experience suggests that debt crisis-hit developing countries like Sri Lanka can recover by mustering the political will to implement the right kinds of economic policies. As Sri Lanka's economy is stabilising now after the worst crisis in its history, now is the time to shape the speed and type of recovery it puts in place. Sri Lanka has stabilised its economy before but has not then been able to set off on a sufficiently transformative path. Things could be different this time. Sri Lanka is coming out of the crisis and the worst is over; there is now time to spend political capital implementing some of the country's recently passed acts to put in place a good framework to enable Sri Lanka's growth to be transformative.

The essays in this book offer a rich array of proposals on ways to continue to shift the economic trajectory of Sri Lanka from one of debt distress to one of growth over the next few years. These proposals are intended to offer food for thought rather than a definitive and comprehensive policy agenda. The proposals are shown in Table 1.3 under several headings: (1) build a cross-party consensus on the economic direction of Sri Lanka, (2) ensure external and domestic debt sustainability, (3) make CBSL's independence work, (4) support fiscal sustainability, (5) undertake pragmatic economic transformation and (6) make growth inclusive.

Table 1.3 Policy proposals for transforming's Sri Lanka path from debt to growth

Issue	Proposals
Build a cross-party consensus on the economic direction of Sri Lanka	1. Develop a vision for economic growth and transformation among political parties, businesses, trade unions and civil society 2. Through consistency of policy and regulation, maintain trade openness and a level playing field for all investors 3. Implement the government's time-bound plan to address rent-seeking and corruption vulnerabilities
Ensure external and domestic debt sustainability	4. Implement the Public Debt Management Act, to allow a modern debt management office to function 5. Pursue active debt management (that is, shift from a loan-/aid-recipient mindset to one that monitors and takes action to mitigate debt risks) 6. Consider use of a sustainable brand to ensure better borrowing and non-debt-creating flows linked to climate action and conservation 7. Revise the draft insolvency bill and build the capacity of practitioners and judges on domestic debt management laws 8. Undertake future foreign borrowing from the cheapest lender, regardless of the state of diplomatic relations with the creditor's country 9. Ensure timely, proactive and transparent engagement with stakeholders to minimise the risk of protracted restructurings
Make the Central Bank's independence work	10. Implement the Central Bank Act and a flexible inflation-targeting regime through the hiring and retention of high-calibre managers and professionals in CBSL 11. Develop CBSL's early warning system with support from the SAARCFINANCE Governors process and the IMF's South Asia Regional Training and Technical Assistance Center
Support fiscal sustainability	12. Implement the Public Finance Management Act expeditiously to promote fiscal transparency and discipline 13. Re-engineer the national budget process towards revenue-raising and debt sustainability, as well as transparent public monitoring 14. Rigorously apply controls for all infrastructure projects in the Public Investment Programme prepared by the Ministry of Finance 15. Rationalise SOEs based on a clear policy framework and implement operational and governance reforms for such entities 16. Use economic assessment techniques to guide fiscal spending

Issue	Proposals
Undertake pragmatic economic transformation	17. Undertake ‘stroke-of-the-pen’ reforms to drastically cut cumbersome regulations related to entry, exit and business operation for foreign and local investors 18. Implement the long-delayed national single window to streamline/speed up trade facilitation and capacity-building for related institutions 19. Consider the sequencing of FTA negotiations guided by economic assessments 20. As an early priority of newly enacted Economic Transformation Act, ensure a properly resourced Office of International Trade to manage FTA negotiations 21. Consult key stakeholders on the implementation of the Economic Transformation Bill to be enacted 22. Undertake regulatory reforms and trade adjustment measures to exploit the opportunities available from bilateral FTAs and eventual membership of the Regional Comprehensive Economic Partnership 23. Create hub embassies in major trading and FTA partners with specialised marketing/commercial staff 24. Improve engagement with the Sri Lankan diaspora community through a variant of the Overseas Citizen of India scheme
Make growth inclusive	25. Better target cash transfers towards the poorest along with a modest rationing of basic food where necessary 26. Improve food security by liberalising imports of basic food items and ensuring better storage systems in rural areas 27. Repeal the Paddy Lands Act to increase the economic freedom and prosperity of farmers

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Part 1: Debt and shocks



2 The evolution of Sri Lanka's sovereign debt crisis: lessons for better borrowing

Gregory Smith

Summary

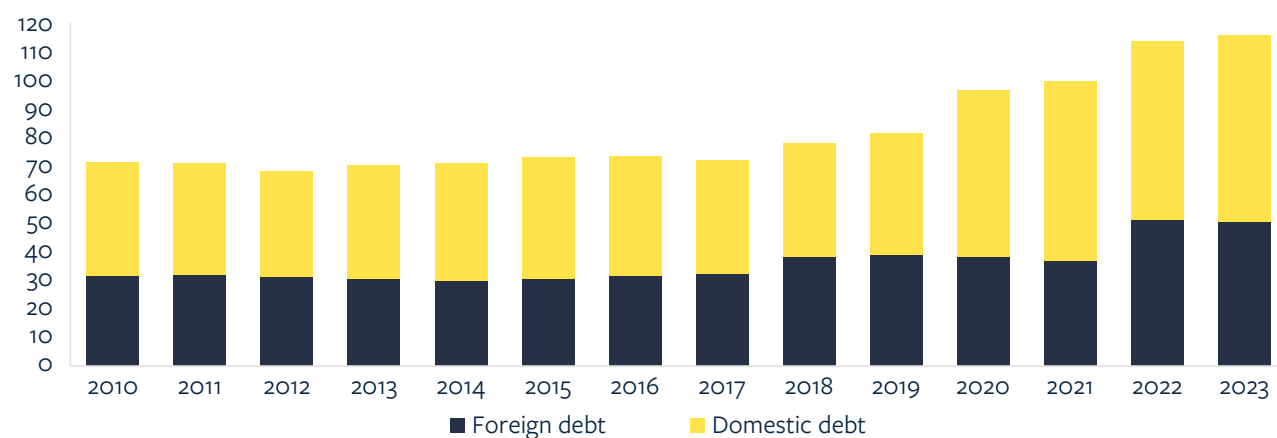
In May 2022, Sri Lanka defaulted, having announced the previous month that it would no longer service its debt in full. A restructuring of both foreign and domestic public debt followed between 2022 and 2024. The debt and economic crisis that forced this default led the country into a deep recession, whose social, political and humanitarian impacts caused Sri Lankan people huge pain. The crisis was characterised by nationwide power cuts, long queues for fuel, shortages of essential goods and popular protest movements that led to the political leadership fleeing overseas. During the crisis, the World Bank reported that the share of people living below the (\$3.65 per day) poverty level had nearly doubled from the pre-pandemic level, to 25%.

The sustainability of Sri Lanka's debt is closely linked to its path of economic growth and stability. This essay identifies the factors that caused this

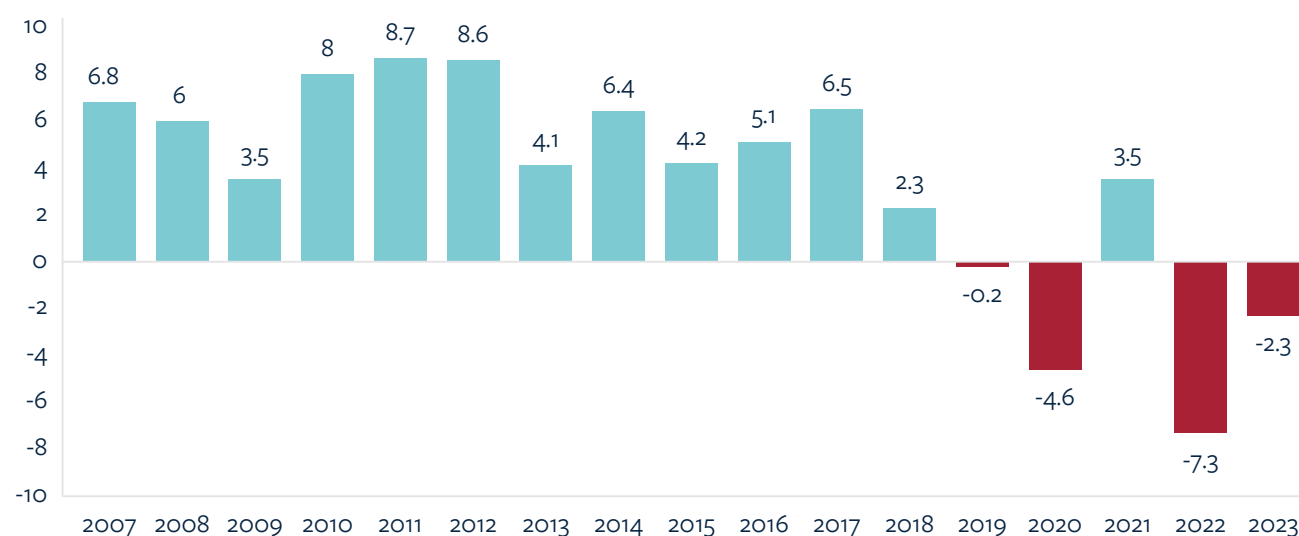
debt distress, a task that requires reflection on 15 years of borrowing decisions that saw the scale and composition of public debt evolve significantly. Lessons are drawn from the debt build-up and crisis to inform better borrowing in Sri Lanka and elsewhere.

2.1 Drivers of increasing debt risks

The default followed a 15-year period in which the country's sovereign debt changed radically in terms of its risks and composition. Over this period, the economy experienced a passage of real gross domestic product (GDP) growth averaging 6.2% between 2007 and 2017. This growth spurt occurred with moderate levels of public spending (averaging 18.2% of GDP over the period, while South Asian peers spent 26% of GDP on average). An end to the conflict and some reform helped bolster this growth but on close inspection it appears that it was debt-fuelled, making it hard to replicate at higher levels of indebtedness.

Figure 2.1 Evolving sovereign debt stock (% of GDP)

Source: World Bank

Figure 2.2 Real GDP growth (%)

Source: World Bank

The public debt stock remained remarkably stable between 2009 and 2017 when measured in proportion to GDP, with borrowing on both fronts, foreign and domestic, keeping pace with the economic expansion. However, the changing nature of the stock meant that debt risks grew over this period, leaving the economy vulnerable in the event of a shock.

Nine drivers of the debt risks are observed:

- 1. Less concessional financing:** Sri Lanka received a steady but small stream of positive net financing in the early 2000s, a period characterised by concessional terms from official sector lenders. By 2014, as the country rose to middle-income status, Sri Lanka's net concessional lending had dried

up. Lending opportunities were increasing rapidly in scale but on harder terms. That said, Sri Lanka re-accessed concessional loans from the World Bank and the Asian Development Bank, having ‘reverse graduated’ during the crisis.

2. Refusal of debt relief: The country stands out from other developing countries for its decision in the early 2000s to decline debt relief from the Heavily Indebted Poor Countries Initiative. This was in part because Sri Lanka was concerned about a blemish on its debt repayment record as it pursued access to international markets.

3. Access to international capital markets: The country dipped its toe in capital markets with the issuance of a \$50 million floating note in 1997 and by issuing several syndicated loans between 2000 and 2005 (Siriwardena, 2011). In 2005, Fitch Ratings assigned Sri Lanka (long-term foreign and local currency ratings) of BB minus, while S&P rated Sri Lanka B plus. These initial ratings were followed by issuance of a debut international sovereign bond (henceforth Eurobond) in 2007, the point when Sri Lanka’s market access reached scale. Sri Lanka went on to tap the market with vigour. Between 2007 and 2019, the government issued 19 Eurobonds at an average tenor of 7.6 years and with a 6.47% average coupon. The cost of borrowing ranged from 5.125% on a five-year issued in 2019 to 8.25% on one issued in 2007. Total Eurobond issuance over this period was \$17.7 billion, of which only \$5.2 billion was repaid prior to the default, leaving Eurobonds making up 38% of the 2022 external public debt stack. Both push and pull factors permitted this scale of commercial borrowing. Sri Lanka’s post-conflict economy was growing well, while low global interest rates had increased investors’ risk tolerance (Haque et al., 2017).

4. Bigger bilateral borrowing: Net financing from large Chinese official lenders increased from \$100 million (annual average) between 2005 and 2009 to \$732 million (annual average) between 2010 and 2014, and then moderated. Most loans were for infrastructure projects, including a \$113 million revolving restaurant in a tower shaped like a lotus flower. By 2022, Chinese official creditors (here including the government, China Exim Bank and China Development Bank) were owed 19% of the total public foreign debt stock (MOF and CBSL, 2023). China’s lending to Sri Lanka became globally infamous in 2017 when Sri Lanka handed over Hambantota Port on a 99-year lease. For a balanced insight into China’s lending to Sri Lanka, see Moramudali and Panduwawala (2022). Meanwhile, India’s net lending to Sri Lanka increased to a lesser extent between 2011 and 2015 only to then moderate, before massive crisis support was provided in 2022. The only other large bilateral creditor was Japan, whose net lending remained smaller and steadier over this period.

5. Not enough foreign exchange earnings: Workers’ remittances did well (averaging 7% of GDP from 2009 to 2023) but exports lagged (averaging 14% GDP) and foreign direct investment (FDI) was absent (net flows averaged -0.1% of GDP). With the large net inflows of external borrowing, a stronger currency persisted longer than it would have otherwise, making a growing import bill appear more affordable. When the currency eventually adjusted, as it did in 2018 and to a much larger extent in 2022, the debt ratios jumped. A bias against exports and competitiveness in the growth model was a big issue. Crucially, there was an insufficient link between increasing foreign borrowing and efforts to generate additional foreign exchange to service it.

6. A lack of revenue: The Achilles heel of Sri Lanka’s debt sustainability was an increasing debt interest burden while government revenue

fell as a percent of GDP. Debt interest payments in proportion to government revenue grew from 31% in 2007 to 40% in 2017 and reached 80% in 2023. The main issue was that government revenue collection fell from 14% of GDP in 2007 to 11.7% in 2017, and crashed down to 8.8% in 2020, where it largely remained through the crisis. Despite decent economic growth, as Sri Lanka borrowed more, it was less able to service it.

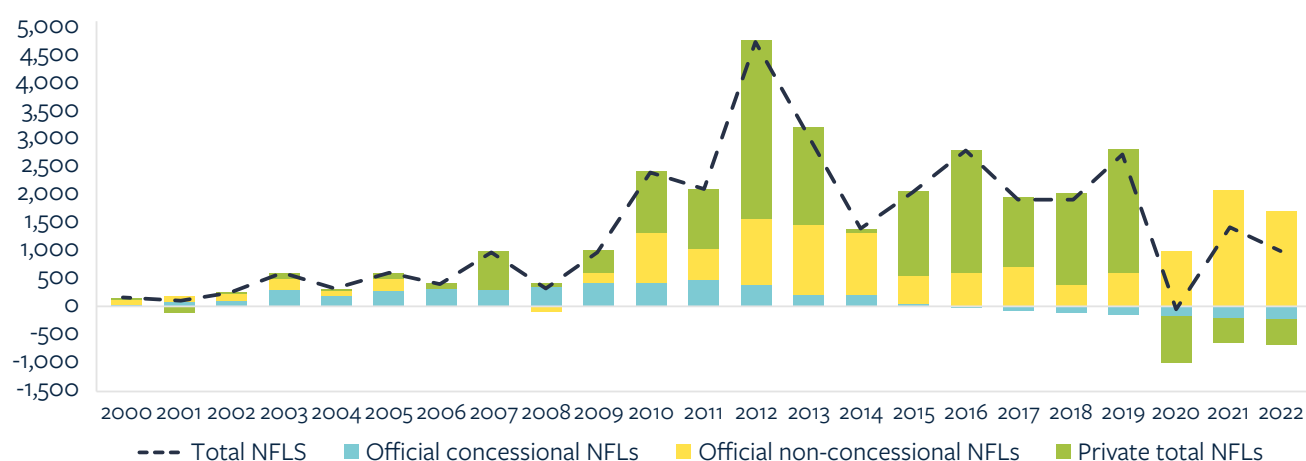
7. Aiming at the wrong debt target: Conversations about the amount of debt Sri Lanka could carry were overly focused on the total and external debt-to-GDP ratios. Further, debt limits or ceilings ended up as de facto targets. From 2009 to 2017, public debt-to-GDP hung around 70% (the International Monetary Fund – IMF – rule of thumb public debt limit for emerging market countries), with the domestic portion at around 40% and the external at 30%. This left the country with a debt position that was deemed sustainable – but only in the absence of global or domestic shocks. In the presence of shocks, the vulnerabilities became clear. The room for error was much lower than the focus on debt-to-GDP targets had suggested. Had, for example, foreign debt-to-exports or debt service-to-revenue ratios been the focus, then debt risks might have been better understood.

8. Passive ‘wait and see’ debt management:

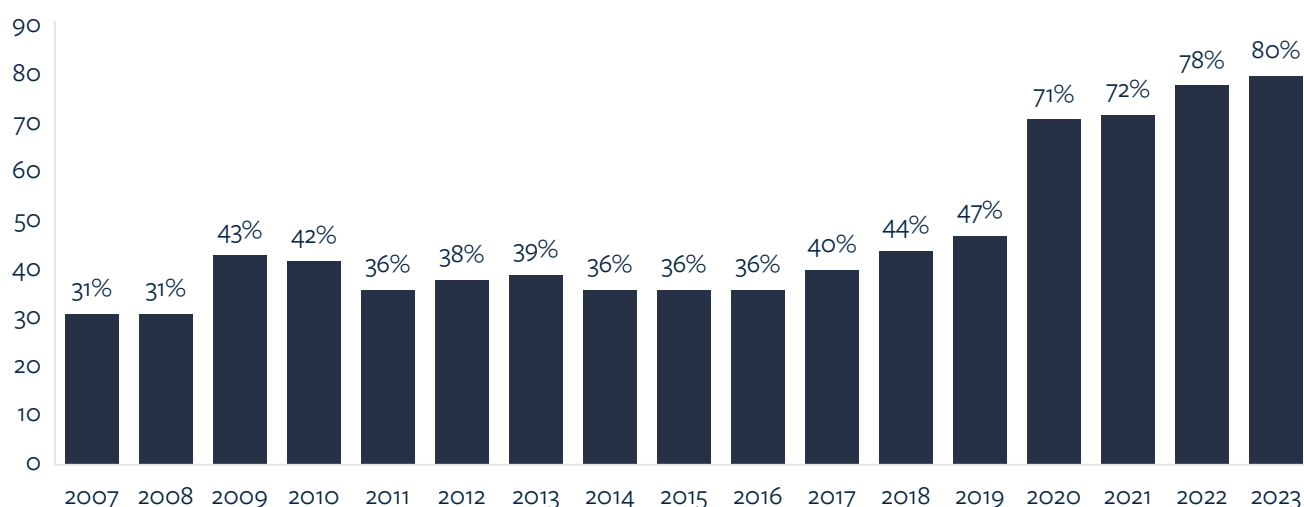
Many other frontier market countries were active in their debt management, reducing maturities ahead of time or issuing bonds that matured in steps rather than as a bullet payment (Smith, 2021). Sri Lanka sat back and waited for its bullet payment bonds to mature, assuming the market would always be there. This strategy was fine in good markets but became a big issue when markets shut. Issuing many Eurobonds was easy but paying them back after their typically 10-year tenor was not. While the seeds of the 2022 default were sown by massive net foreign borrowing back in 2012, there was time after that to actively reduce repayment risks.

9. Partial reform: Despite countless reams of strategy, years of reform efforts and 16 IMF programmes prior to the 2022 edition, implementation of reform lagged. Weak revenue collection and insufficient foreign exchange inflows were symptomatic of this. Gaps also emerged in the government’s balance sheet away from its centre. Several of the larger utilities, the state airline and the state oil company took on foreign borrowing while resisting reform.

Figure 2.3 Net foreign borrowing: all creditors (\$ million)



Source: World Bank

Figure 2.4 Public debt interest payments (% of revenue)

Source: World Bank

2.2 The collapse into debt crisis

A political crisis in 2018, followed by the Easter bombings in 2019, slowed the economy down. Government revenue plummeted as tax cuts were used to win political support for the coming elections. Large borrowing took place, with the government tapping the Eurobond market for \$4.4 billion in 14 weeks in 2019. The debt-to-GDP ratio rocketed from its plateau of around 70% (2010–2017) to 116% in 2022, before moderating to 110% of GDP once the exchange rate had settled from its overshoot.

Sri Lanka stood out from peers as it failed to secure the emergency financing or any debt suspension in 2020 or 2021 that other countries received during the pandemic. Net lending, having averaged \$2.5 billion annually over the five previous years, went to zero in 2020. Absent foreign borrowing, the government switched to more aggressive domestic borrowing to meet an increasing mismatch between its revenue and spending

needs. Treasury bill issuance increased by 85% in 2020 compared with 2019, while Treasury bond issuance increased by 24%.

The Eurobond market had shut. It was closed for all frontier markets for most of 2020 but, when it opened for others, Sri Lanka remained locked out. Yields on Sri Lankan Eurobonds remained elevated. For example, those due in 2027 never returned to single digits after COVID-19 hit in March 2020. The market assumed an additional risk premium was required, considering the increasing debt risk. Credit rating agencies reflected a similar concern. Moody's rated Sri Lanka Caa1 in September 2020, Fitch downgraded to CCC in November 2020 and S&P went to CCC+ in December 2020. While the market was already pricing Sri Lanka outside the market at this point, the credit agencies' view cemented the stress.

Some reprieve was felt in 2021 when net foreign lending flows bounced back to \$1.5 billion, driven by support from official and commercial

lenders. A \$550 million financing facility from China Development Bank contributed to its shift to becoming an emergency lender; Bangladesh extended \$200 million of swap lines. But the fiscal and debt position had become untenable, and Sri Lanka could not secure new IMF or multilateral support at scale.

Debt was clearly unsustainable but, despite the massive pressure, the government remained current on its debt servicing in 2021. It remained adamant that it could pull through. As foreign exchange reserves depleted, including via protection of the exchange rate and the servicing of debt, ideas on how to resolve the problem became ever more creative. Import bans were not enough to see trade liabilities mount and swap lines exhausted. With large external debt maturities looming in 2022, most expected the government to cease its debt service, but, even in November 2021, the ‘We will pay’ mantra continued. The president briefed the media the day after the 2022 budget reading that ‘Sri Lanka has never defaulted in its history and that record will be maintained.’ He added, ‘we want to reduce borrowings. I guarantee that the \$1.54 billion up to July 2022 will be repaid’ (Jayasinghe, 2021). This prioritisation of debt repayment over the pain already being felt by the Sri Lankan population led to protests.

Some breathing space came via an extension of swap lines by the Reserve Bank of India in January 2022 (worth \$400 million). This helped buy crucial imports, as standard trade facilities were exhausted, but it was not enough. On 12 April 2022, the government announced it would ‘suspend normal debt servicing of affected debts’ pending a restructuring consistent with an IMF-financed programme (MOF, 2022). Up to the default, Sri Lanka had a good, but not perfect, debt record. In only two years did the country have a total debt

in default of over \$1 billion (2017 and 2020) and in only nine years was it over \$300 million, going back to 1960 – up to and including the \$30 billion in default in 2022 (Beers et al., 2023).

2.3 The debt restructuring

Progress with the restructuring began with staff agreement of the IMF programme in September 2022, followed by six months of collating financial assurances (that included debt reduction intentions by most creditors). IMF Board approval in February 2023 enabled publication of the IMF’s Debt Sustainability Analysis (DSA). As the IMF is umpire on recent sovereign restructuring, this DSA set the magnitude of the haircuts needed to achieve a suitable debt reduction (Smith, 2022).

The IMF applied its market access DSA, which is focused on financing needs and overall public debt-to-GDP ratios as targets, the goal being to provide breathing space and support to Sri Lanka in regaining market access. These types of debt analysis are harsh, and often more of an art than a science, and tend to be only as good as the forward-looking forecasts. This mid-crisis DSA was particularly challenging, given the extent of the uncertainty about where the economy, the exchange rate and other macro variables were headed.

The government spelled out its intent in the IMF programme document by stating its commitment to reducing ‘the ratio of public debt to GDP to below 95 percent by 2032,’ ‘annual gross financing needs below 13 percent of GDP, on average, in 2027-32’ and ‘the central government’s annual debt service in foreign currency below 4.5 percent of GDP in every year in 2027-32’ (IMF, 2023). These IMF-approved commitments were consistent with the DSA and set the ambition of the debt restructuring. However, there were concerns at

the time that a debt stock of over 90% of GDP might be insufficient. The World Bank warned that a prolonged or insufficiently deep external debt restructuring was among the key risks to the recovery and growth (World Bank, 2023).

Multilateral debt was outside the restructuring perimeter, as were the emergency swap lines. Bilateral loan restructuring was negotiated with an Official Creditor Committee formed in 2022 by 17 countries and co-chaired by India, Japan and France (as chair of the Paris Club). Chinese creditors negotiated independently, while Eurobond bondholders formed committees. The government also decided to restructure some of its domestic debt via what was labelled ‘domestic debt optimisation.’

2.4 What’s next?

Absent a large debt reduction, countries in debt distress have reduced their debt burden in several ways, including by running repeat primary surpluses, through financial repression and via economic growth. The only one of these without limit is the last one. Any resort to financial repression must be balanced with the need to have a healthy financial sector to underpin growth and job creation. And running repeat primary surpluses in a low-spend economy will prove politically challenging beyond a few years, especially if the primary surplus target is set too high, as it will drag on economic recovery and growth.

This leaves economic growth as a necessity not only for prosperity in Sri Lanka but also to further reduce the debt burden. So much so that, without sufficient growth, the need for another debt restructuring becomes an increasingly likely scenario in the years to come. There is little choice but to try and enact the reforms that return growth to an annual average of 4%, 5% or 6%. This

will take much more than simply avoiding policy blunders. It will require ‘passenger’ growth as Sri Lanka hangs to the coattails of regional giants’ robust growth. It will also entail long-awaited structural reforms that permit some ‘creative growth,’ so that Sri Lankan firms can compete with entrepreneurs and firms by more actively tapping into global supply chains.

Alongside growth-enhancing reforms, there are several technical steps Sri Lanka can take towards better borrowing. These include (i) implementation of debt legislation that requires and allows a modern debt management office to function; (ii) pursuing active debt management (that is, shifting from a loan- or aid-recipient mindset to one that monitors and takes action to mitigate debt risks); and (iii) considering how a sustainable brand can be utilised to attract better borrowing and non-debt-creating flows linked to the climate and conservation.

2.5 Wider lessons from the debt build-up and crisis

Several global lessons can be drawn from Sri Lanka’s experience on debt management.

Lesson 1: Assess debt risks well. While debt is building up and deemed sustainable on some metrics, a good debt management office should be searching for potential risks more widely. Forecasts should be stress-tested to see what may happen in the event of economic bad luck or bad policy. Analysis pointing to the risks can inform politicians and debt-making decisions.

Lesson 2: Don’t over-borrow on commercial terms and be active not passive. Frontier market economies should assume that markets may close during crises or interest rate hiking cycles. Spikes in refinancing should be tackled in advance; even

when market are awash with lending ability, a frontier market needs to be cautious and to think about how this money will be refinanced or paid back, even if markets don't care at that point.

Lesson 3: Ensure fit-for-purpose modern debt management. Skill up the debt management office to be able to conduct core modern functions. Structures designed for signing concessional loans are not sufficient to deal with many different creditor types or sustained market access.

Lesson 4: When debt is clearly unsustainable, don't drag it out until reserves are depleted.

Delays in throwing in the towel tend to cost millions of dollars, deepen the eventual crisis and further increase people's misery.

Lesson 5: Don't suffer a multiyear debt restructuring to obtain only a mild debt reduction. If investments are to be put off and efforts focused on complex restructuring, then it makes sense to push for a sufficient debt restructuring that will clearly avoid default in the coming years. Markets will forget a past, even deep, restructuring if the debt then appears sustainable.

Lesson 6: Check you have the right type of growth. To be able to service an increasing amount of foreign debt, the economy needs not only headline GDP growth but also sufficient growth in foreign exchange earnings to cover the increasing outflows. A sustained decline in revenue in proportion to GDP should also be seen as a debt red flag.

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3 Lessons from bondholder restructurings¹

Yunnan Chen, Frederique Dahan and Tom Hart

Summary

Sri Lanka is restructuring \$13 billion in US dollar bonds, about 16% of its 2023 gross domestic product (GDP), following its 2022 default. Drawing from the recent experiences of emerging market restructurings over the last decade, this essay synthesizes across nine cases of bondholder restructurings, drawing lessons on the speed and scale of restructuring. It evaluates the utility and limitations of legal instruments like collective action clauses (CACs) and state-contingent debt instruments (SCDI) in facilitating successful restructuring, emphasizing long-term debt sustainability and climate resilience. We conclude with three policy lessons for Sri Lanka and other sovereigns facing similar challenges.

3.1 Introduction

Following its default in 2022, Sri Lanka is negotiating debt restructuring deals with its external creditors. The largest component of this comprises \$13 billion of US dollar bonds, equivalent to around 16% of 2023 GDP.² What can Sri Lanka learn from the recent experience of other emerging market economies that have restructured external bonds?

We focus particularly on eight bondholder restructurings that have taken place over the past decade, plus Greece's 2012 bond restructuring, the largest in history. These cases are summarised in Table 3.1.

¹ This essay draws from the ODI paper by Tom Hart, Yunnan Chen and Frederique Dahan, 'Negotiating with private bondholders: Insights from country case studies'. For a fuller account of findings, please refer to the full report or authors.

² Apart from these bonds, Sri Lanka's external debt includes a further \$11 billion of debt to official bilateral creditors and \$3 billion to commercial creditors (almost all of which is to China Development Bank). A further \$12 billion of debt to multilateral creditors (e.g. the International Monetary Fund (IMF), the World Bank and the Asian Development Bank) is not restructured as these creditors benefit from so-called 'preferred creditor treatment'.

23 Sri Lanka: from debt default to transformative growth

Table 3.1 Case studies of recent bondholder restructurings

Restructuring process					Debt composition		Debt reductions			
Country	Income classification	Start date ¹	Default date ¹	End (exchange) date ¹	Duration (in years)	External debt/GDP (%)	Bondholder/external debt (%)	NPV haircut (%) ²	Market haircut (%) ²	Debt treated (\$ billion)
Greece	HIC	Jul-11		Mar-12	0.7	192	n/a	64.6	76.9	261.4
Barbados	HIC	Jun-18	Jun-18	Dec-19	1.5	34	22	24.3	26.5	0.8
Ecuador	UMIC	Mar-20		Aug-20	0.4	59.4	40	42.4	40.8	17.4
Argentina	UMIC	Dec-19	May-20	Sep-20	0.8	56.9	49	36.2	51.6	65.5
Suriname	UMIC	Jun-20	Apr-21	Nov-23	3.3	164	28			0.7
Belize	UMIC	Nov-16		Mar-17	0.3	68	46	19.7	29.9	0.5
Zambia	LMIC	May-20	Nov-20	Jun-24	4.1	67.1	19			3.3
Ghana	LMIC		Dec-22	Jun-24 ⁴	1.5	46	45			13
Mozambique	LIC	Oct-16	Jan-17	Sep-19	2.9	84.2	7	11	6.3	0.7

Source: Authors' compilation from Cruces and Trebesch (2013) 2014 updated dataset; Asonuma and Trebesch (2016) 2020 updated dataset; and IMF (2020). Debt composition data from IMF Country Reports and Debt Sustainability Analyses. Bondholder to debt ratio for Greece not available.

Notes:

1. Start and end of restructurings correspond to either the announcement or default, and completion of exchange, respectively. They do not necessarily correspond to the start of talks with private sector creditors. Source is IMF (2020) for 2014–2020 restructurings and Asonuma and Trebesch (2016) for 2005–2013.
2. PV (net present value) haircut is 1 - (PV of new bonds/PV of old bonds) and market haircut is 1 - (PV of new bonds/face value of old bonds). Source is IMF (2020) for 2014–2020 restructurings and Cruces and Trebesch (2013) for 2005–13.
3. Participation rate is CACs of bonds were triggered.
4. Exchange date for Ghana is date of agreement in principle with bondholders as bond exchange not completed at the time of publication.
5. Since the exit yield for Ghana is still unavailable at time of writing, we base NPV calculations on market reports (Amobila, 2024).

Although an informal process for debt restructuring has emerged over several decades (see Box 3.1), these experiences teach us that there are no simple blueprints for how best to conduct debt restructuring with bondholders, and approaches inevitably vary case by case.

To understand what processes can increase the likelihood of a swift resolution of negotiations, and ensure a sustainable balance of debt reduction for long-term growth prospects, we first look at the speed and scale of restructurings, and the factors associated with this. We then examine the instruments that have been used to facilitate restructurings, including CACs and SCDI. Given the rising costs of climate change and the links between climate investment needs and fiscal capacity for external debt repayment, we look at how actions to increase climate resilience can be integrated into the restructuring process.

We conclude with three lessons:

- 1. Timely, proactive and transparent engagement with creditors and stakeholders is crucial** to minimise the risk of protracted restructurings, and sequencing negotiations when there is a complex creditor mix. While not bulletproof, CACs are effective tools in streamlining negotiations.
- 2. Careful design of debt restructuring terms is needed to maximise debt relief.** Considered use of state-contingent tools should provide liquidity relief to the sovereign if economic conditions worsen, as well as gains to creditors if economic conditions improve.
- 3. Ensure future economic recovery and debt sustainability is climate-resilient.** Explore innovations such as climate-resilient debt clauses (CRDCs) and debt-for-conservation swaps in future debt issuances, once immediate debt restructuring is resolved.

Box 3.1 Sequencing of debt negotiations

While debt restructuring negotiations and outcomes are not standardised and vary significantly on a case-by-case basis, an informal process for restructuring debt has developed, with the following steps:

- 1. Request to International Monetary Fund (IMF):** Country requests an emergency loan from the IMF.
- 2. IMF Debt Sustainability Analysis:** If the IMF finds that debt is unsustainable, it can lend to a country only if it has credible assurances from bilateral official creditors that they will undertake a restructuring to restore debt sustainability (so-called ‘financing assurances’) and if a credible restructuring process with private creditors is underway.³ The DSA (whose methodology varies depending on whether the country is a low-income country (LIC) or a market access country (MAC)) also sets the available financing envelope for debt service payments, so setting the amount of debt relief that a country must obtain from its creditors.
- 3. Paris Club and official sector creditors:** This group historically consisted of Paris Club donors and official financing agencies (such as export credit agencies). The prominence and scale of new official creditors from China, which is not a Paris Club member, have complicated proceedings. Within the G20 Common Framework (CF), official creditors including China have been represented under a single Official Creditor Committee (OCC). For non-CF countries, there will be more than one group of official creditors to deal with. Paris Club debt relief is conditional on ‘comparable treatment’ of private creditors and other official creditors.
- 4. Private sector creditors:** During the 1980s debt crisis, this consisted of commercial banks; it is now increasingly made up of private sector bondholders. In recent restructurings, sequencing has tended to proceed first with bondholders and then with commercial lenders, including Chinese state-guaranteed commercial lending and non-Eximbank loans.

This informal regime is widely perceived to be struggling to deal with a sovereign debt landscape made up of a greater diversity of creditors, most notably non-Paris Club official lenders, as well as domestic and international private creditors. This is leading to many suggestions for reforms to the Common Framework process, including clarifying timelines, suspending debt service during negotiations, creating clarity on the parameters for comparability of treatment between official and private creditors, expanding eligibility to all middle-income countries (Georgieva and Pazarbasioglu, 2021), and moving to simultaneous, rather than sequential, information-sharing and negotiations with official and private creditors (Hagan, 2023).

Source: Based on Buchheit et al. (2018) and Corsetti et al. (2023, pp. 106–107)

3 The IMF Lending into Arrears (LIA) and Lending into Official Arrears (LIOA) policy allows it to lend to countries unable to meet debt repayment obligations to private creditors and official creditors, respectively, conditional on receiving financing assurances, and the borrowing country making ‘good faith’ efforts to reach a restructuring agreement with creditors and to restore debt sustainability (see IMF, 2022). Recent (2024) reforms to the LIOA policy, widely viewed as a means to break issues of deadlock with Chinese creditors, mean that the Fund will be able to lend to countries where no debt agreement or financial assurances with bilateral creditors has been reached, as long as ‘additional safeguards’ have been provided (see Jones, 2024).

3.2 Debt restructuring outcomes: speed and scale of debt relief

Two key parameters in assessing debt restructuring are the speed of restructuring and the scale of debt relief obtained. A debt restructuring process that is slow, or that does not resolve an unsustainable level of debt, can depress growth, as Latin America experienced in its ‘lost decade’ of the 1980s. However, there may be a trade-off between the two, with bondholders able to agree more rapidly to a shallower restructuring, and external and structural factors can influence both of these outcomes. However, in ensuring speedy, smooth restructurings, governments have considerable agency in their strategic approach, and in the legal instruments they can deploy.

Speed

In recent decades, most sovereign restructurings have been relatively fast, with an average duration of one year between either default, or initiation of a pre-emptive restructuring, and completion of the restructuring. The use of minimum participation thresholds and legal tools such as exit consents⁴ and CACs (see below) has successfully ensured high creditor participation and reduced holdouts.⁵ Early, proactive and transparent actions by governments tend to pay off, with pre-emptive exchanges (before a default has occurred) being completed significantly faster than post-default exchanges. Between 1978

and 2010, the average duration of pre-emptive debt restructuring was one year, whereas post-default restructuring was five years (Asonuma and Trebesch, 2016). These ‘hard’ defaults tend to reflect breakdowns in relations and an adoption of a more ‘coercive’ stance by sovereigns, often leading to more confrontational protracted negotiations (Ferry, 2023a).

However, there are also cases that have taken significantly longer. Litigation from holdout creditors, as well as confrontational stances between government and creditors, prolonged Argentina’s 2005 restructuring for over three years (with legal disputes concluded only 15 years after the initial default, in 2016). More recently, the complex creditor composition and a larger number of fragmented creditors also influenced the prolonged restructurings in Suriname and Zambia, which both took over three years (see Table 3.1).⁶ Across our cases, a greater plurality and diversity of creditor types tends to correlate with more protracted negotiations, particularly when both Paris Club and non-Paris Club creditors are involved (Figure 3.1). The challenge of creditor coordination and integrating newer, non-Paris Club, creditors into multilateral arrangements, as in the case of Zambia’s restructuring under the CF, also entailed extremely protracted negotiations around creditor comparability of treatment.⁷ In the case of Ghana, another CF country, these issues were less salient. Ghana chose to focus first

4 Minimum participation thresholds are a condition in debt restructuring that requires a certain level of creditor participation for restructuring to proceed. Exit consents are formal agreements that allow a majority of creditors to change the non-financial terms of the loan, overriding minority holdouts and motivating them to accept a restructuring offer.

5 See Bi et al. (2016). However, the authors note that, in cases where exit consents are used to extract too high a haircut, small creditors have a strong incentive to coordinate and holdout.

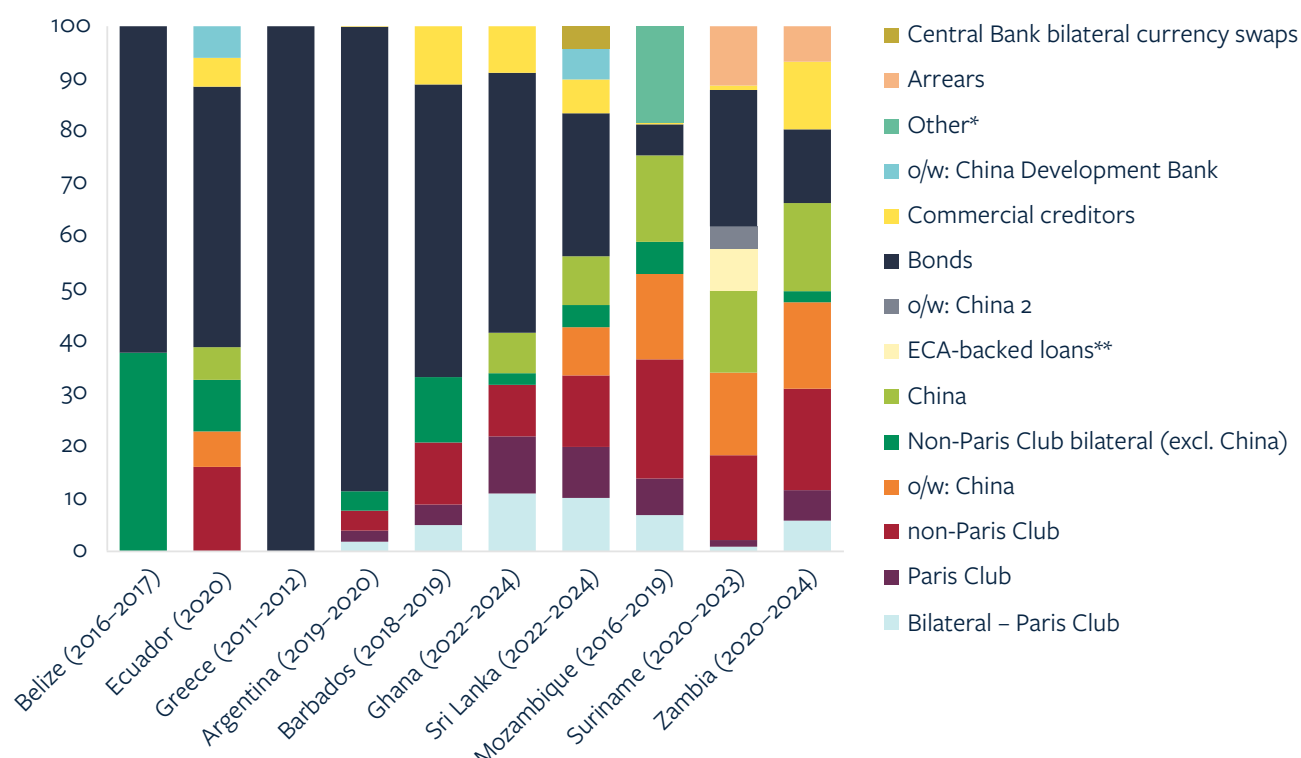
6 Zambia’s restructuring was agreed in principle in March 2024 but was not complete at the time of writing in May 2024.

7 Notably, the official creditors rejected a deal from bondholders in late 2023 over comparability of treatment concerns. Official creditors then accepted a revised agreement with bondholders, which offered slightly more debt relief, in March 2024.

on its domestic bond restructuring, while in its external restructuring non-Paris Club creditors were a smaller part of the creditor composition,

mitigating against some of the inter-creditor equity issues that had bogged down Zambia.

Figure 3.1 Creditor composition of external debt eligible for restructuring (%)



Source: Authors' compilation, based on IMF Country Reports and Debt Sustainability Analyses, Zettelmeyer et al. (2013), Bi et al. (2016) and Asonuma et al. (2018)

Notes:

Countries are ranked by duration of restructuring, shortest to longest. Debt to multilaterals is excluded.

* Mozambique's other private debt included \$2.8 billion in debt to its Liquefied Natural Gas Project partner ENG.

** Export credit agency (ECA)-backed loans in Suriname involve commercial lending guaranteed by official export credits and are classified under Paris Club as official sector lending, alongside bilateral loans. However, this norm has not applied to Zambia's ECA-covered loans from non-Paris Club lenders.

Meanwhile, Greece (2012), Belize (2016/17), Argentina (2020) and Ecuador (2020), where creditor diversity was lower and dominated by bondholders, managed to complete their restructurings in under a year. The use of CACs, and particularly of enhanced 'two-limb' CACs, contributed to the relative speed of Argentina

and Ecuador's 2020 restructurings. However, alongside legal instruments, transparency and proactive engagement by the government with the IMF and international creditors in the case of Ecuador was critical to a smooth and non-confrontational restructuring process. With non-Paris Club creditors,

Ecuador also leveraged high-level political meetings and sequenced them separately from other negotiations, two years following its bondholder restructuring.

Scale

Private bondholder restructurings from 2005 to 2020 averaged a 34% haircut in net present value (NPV) terms, with significant variation between Mozambique in 2019 with an 11% haircut, Ecuador in 2020 with 42% and Greece in 2012 with a massive 65%.

Factors influencing higher haircuts include pre-default external debt surges, being a low-income borrower, being a first-time bond issuance, having a prolonged debt crisis and severe post-default economic contractions (Graf von Luckner et al., 2023). Post-default restructurings are associated with deeper haircuts than are pre-emptive restructurings (48% vs 18%) (Asonuma and Trebesch, 2016), in part because a public declaration of default is a costly signal of a lower willingness to pay owing to domestic constraints (Ferry, 2023b).

In our cases, the largest haircuts, of above 35%, are associated with an external debt surge in the five years before default or start of restructuring, with external debt as a proportion of gross national income (GNI) (or debt to GDP for Greece) doubling on average in the five years before the crisis (from a 64% increase in Suriname to a 195% increase in Mozambique).⁸ In addition to experiencing a debt surge, Zambia is a lower-middle-income country and a first time

Eurobond issuer. Argentina, Ecuador, Greece and Suriname all suffered deep economic crises going into their default or restructuring, with GDP shrinking by an average of 14%. In Argentina, Ecuador and Suriname, this was related to the COVID-19 pandemic, and in Greece to the Eurozone financial crisis.

The international regime, or norms around debt restructuring, has also evolved: haircuts on private lending were higher in the 1990–2000s than in the 1970–1980s, as Brady deals and bond restructuring replaced the loan maturity extensions typical to the 1980s (Cruces and Trebesch, 2013). Newer bilateral creditors tend to prefer debt reprofiling (rescheduling and maturity extensions) over outright haircuts.⁹ In contrast, the Paris Club has progressively softened its terms, especially for International Development Association-eligible countries. As a result, official creditors received on average higher haircuts than did private creditors from 1978 to 2015, despite official debt typically being considered senior (Schlegl et al., 2019).

3.3 Debt restructuring instruments: legal tools and tactics

A key concern for governments in debt restructuring is that some bondholders will refuse to participate, and will hold out for full payment of their bond, perhaps even seeking to enforce this by means of litigation in the jurisdiction under which the bonds were issued (typically New York or England). Governments

8 Data are for external debt stocks (% of GNI) from the World Bank International Debt Statistics except for Barbados and Greece, which are high-income countries for which the World Bank does not collect this data. For these countries, general government gross debt as a percentage of GDP from the IMF's World Economic Outlook database is used instead.

9 For Chinese creditors, banks face institutional constraints against providing debt relief, and generally prefer to provide NPV-neutral debt treatment. See, for example, Rudyak and Chen (2021).

can use different ‘sticks’ and ‘carrots’ to compel or incentivise bondholder participation in restructuring arrangements.

Recent restructurings illustrate the utility of CACs as a ‘stick’ to gain full or near-full participation of creditors. These clauses provide a menu of different voting structures that allow a vote by a qualified majority of creditors to bind all creditors to a restructuring deal, thus preventing holdout creditors.

State-contingent debt instruments (SCDIs), and particularly value recovery instruments (VRIs), have been deployed as ‘carrots’ in cases such as Argentina (2005), Greece (2012), as well as in recent Common Framework cases of Ghana (2024) and Zambia (2024) to incentivise and reward creditor participation. However, the difficulties of pricing these instruments and their asymmetric impacts mean they may present little net benefit for sovereigns in the longer term, and should be carefully considered and designed.

Collective action clauses

Series-by-series CACs have been part of English law bonds since the 19th century, and of New York law since the early 2000s. These clauses, which generally require a 75% bondholder vote to enforce restructuring terms on all holders of a single bond series, aim to prevent minority holdouts from blocking restructuring efforts. Since 2015, CACs have been employed in all major restructurings except for in Mozambique (2016) and Mongolia (2017), where bonds did not contain these clauses. Successful cases include Belize (2016) and Barbados (2018), which achieved full bondholder participation.

However, series-by-series CACs still have limitations, as seen in Greece’s restructuring, when holdout creditors blocked restructuring in about half of Greece’s foreign law bond series, leaving €6.4 billion in non-restructured bonds. In contrast, for its domestic law bonds, Greece ‘retrofitted’ an aggregated CAC that allows for a single vote with a two-thirds threshold across all outstanding bonds, and that was crucial to its success in managing a speedy domestic bond restructuring with full participation.

Since 2014, ‘enhanced’ aggregated CACs that allow a single vote across the stock of bonds (as used by Greece) have become the standard under both New York and English law, after endorsement by the IMF, the US Treasury and the International Capital Markets Association. These enhanced clauses offer various voting methods: a single series vote with a 75% threshold, a ‘two-limb’ vote with a 50% threshold per series and 66 % in aggregate or a ‘single-limb’ aggregate vote with a 75% threshold (IMF, 2020).

These aggregated CACs were first utilised in Argentina and Ecuador’s 2020 restructurings. Unlike in Greece’s 2012 domestic law restructuring, both countries used the ‘two-limb’ voting procedure, rather than a single aggregated vote. This is because use of the aggregated vote requires a ‘uniformly applicable’ offer to all bondholders, and both Argentina and Ecuador decided that slightly different terms needed to be offered to holders of very short-term debt. The results were that Ecuador secured over 98% consent, leading to 100% participation after the use of CACs. Argentina obtained over 93% consent and a 99% participation rate. Two bond series with only single-series (rather than enhanced) CACs failed to meet the voting

threshold (IMF, 2020). Both restructurings introduced new legal strategies¹⁰ that proved controversial; ultimately, the countries and their bondholders negotiated safeguards on their use.¹¹

Ultimately, CACs are not bulletproof but they remain an effective ‘stick’. As Greece’s experience shows, series-by-series CACs remain vulnerable to holdout creditors but enhanced CACs have proved essential for fairly rapid restructurings with private sector bondholders, and remain important instruments in minimising the proportion of holdout creditors.

State-contingent debt instruments

The evolution of the creditor landscape in recent decades has shifted how bond investors respond to default, opting to work through sovereign defaults rather than selling bonds at distressed values. This has brought SCDIs, particularly VRIs, to the forefront in facilitating and incentivising quicker debt workouts. VRIs, a subset of SCDIs, reward creditors during favourable economic periods (so-called ‘upside’ periods) with better payouts triggered by factors like higher GDP growth or commodity prices. In theory, they serve as incentives for creditors to agree to restructuring proposals and discourage holdouts; in practice, they have become a means for bondholders to compensate themselves for the cost of haircuts.

Notable uses of VRIs include Argentina in 2005, Greece in 2012 and Ukraine in 2015; all employed GDP-linked securities. Suriname’s 2023 exchange featured an oil-linked VRI to compensate bondholders. Zambia’s 2024 agreement in principle

includes an ‘upside case’ with higher interest rates and shorter maturities if exports and tax revenues exceed IMF projections. By linking payout to variables such as GDP or commodity prices that influence a sovereign’s debt service capacity, SCDIs can theoretically reduce conflicts over current valuations and potentially benefit sovereigns, allowing lower payouts during ‘bad’ times and higher payouts in ‘good’ times.

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Notable uses of VRIs include Argentina in 2005, Greece in 2012 and Ukraine in 2015; all employed GDP-linked securities. Suriname’s 2023 exchange featured an oil-linked VRI to compensate bondholders. Zambia’s 2024 agreement in principle includes an ‘upside case’ with higher interest rates and shorter maturities if exports and tax revenues exceed IMF projections. By linking payout to variables such as GDP or commodity prices that influence a sovereign’s debt service capacity, SCDIs can theoretically reduce conflicts over current

10 Redesignation, changing the voting pool of bonds after votes have been cast and the so-called Pac-Man strategy of offering successive restructurings, offering slightly better terms each time, to gradually include holdouts.

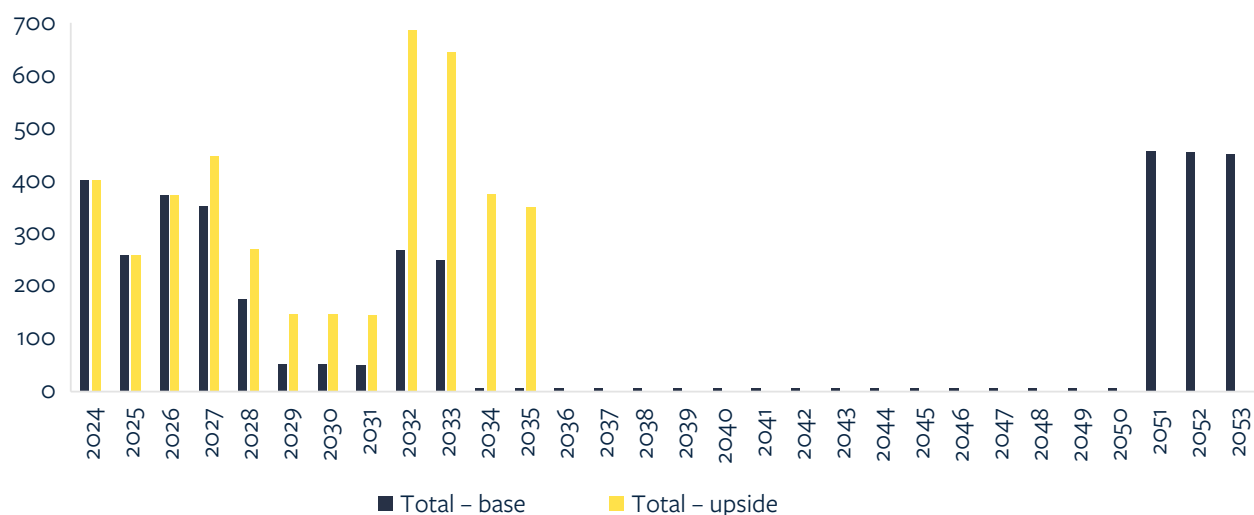
11 See IMF (2020) for a summary; for discussions, see Clark and Lyratzakis (2021) and de la Cruz and Lagos (2021).

valuations and potentially benefit sovereigns, allowing lower payouts during ‘bad’ times and higher payouts in ‘good’ times.

Despite theoretical advantages, SCDIs face practical challenges, including low liquidity, exclusion from key bond indices and trade at steep discounts in secondary markets. In Argentina, the GDP-linked warrant was detachable from the bond and separately traded, nullifying its purpose of rewarding original bondholders. These instruments also attract a high and persistent risk premium that is procyclical, and often higher than traditional bonds (Igan et al., 2021). While often attributed to novelty, this appears to be a permanent feature, owing to ‘distorted probabilities’ by which lenders price ambiguity and potential ‘downside’ scenarios, leading to systematic under-pricing (Roldán and Roch, 2021).

As such, SCDIs result in poor value for issuers in terms of debt relief, and it has proven difficult to structure them in a way that achieves their theoretical benefits of matching debt service

levels to the state of the economy without them becoming extremely complex. Ideally, SCDIs should be symmetric, offering better terms and liquidity relief during downturns. However, there is a trade-off, as added complexity reduces their market attractiveness and exacerbates market under-pricing, reducing their appeal as a ‘carrot’. Consequently, restructurings have favoured simpler, ‘upside-only,’ instruments, which can impose significant long-term costs for short-term performance gains. Argentina’s higher-than-expected growth from 2005 to 2011 entailed additional payments costing the country almost \$10 billion (Guzman, 2016). Upside-only GDP-linked and macro-linked instruments in Ukraine and Zambia also pose longer-term repayment burdens that are permanently higher even if economic conditions worsen, potentially pushing countries back into crisis. Zambia’s one-time trigger SCDI pushes its bond coupon from 0.5% to 7.5%, based on economic data over 2026–2028, entailing significantly higher repayments until 2035, even if economic conditions subsequently worsen, with the risk of pushing it back into debt distress.

Figure 3.2 Zambia's bond payments (principle and interest): base and upside scenarios (\$ million)

Source: Authors' calculation based on Government of Zambia (2024)

In contrast, Ghana's government pushed backed against bondholder proposals for a macro-linked bond opting and instead offered bondholders a choice of two restructured bonds, one with a face value haircut and a coupon of 5%, and a 'par' bond that does not have a face value haircut but that has a low coupon of 1.5% and a longer maturity, of 2037.

SCDIs need careful design to be beneficial in restructurings. This includes creating symmetric payouts that adjust for both good and bad times and standardising terms to improve liquidity (Cohen et al., 2020; Heller and Virketis, 2022). Official promotion and endorsement of standardised term sheets, drawing from the experiences of CACs and CRDCs, will be needed (Cohen et al., 2020). Financial sector representation and inclusion will also be crucial for market clarity around their inclusion in standard bond indices, and in credit default swap contracts (Heller and Virketis, 2022).

3.4 Aligning debt with climate goals: building long-term resilience

Debt relief and climate change are increasingly intertwined. Onerous external debt repayment limits a country's fiscal capacity to invest in climate mitigation and adaptation. Meanwhile, worsening climate risks and natural disasters can severely affect these countries' future debt service capabilities and creditworthiness. The push to adapt DSAs to better account for these fiscal costs of climate-related expenditures, and to integrate climate objectives into new innovative debt instruments like sustainability-linked bonds (SLBs), reflects broader recognition of the need to ensure debt sustainability is also resilient to future climate risks (Bolton et al., 2022).

While issued separately to SCDIs, climate-shock buffers in the form of CRDCs are becoming widely adopted by official lenders, including the UK, the Inter-American Development Bank (IADB) and the

World Bank. CRDCs can suspend debt repayment in the event of hurricanes or natural disasters, and thus provide liquidity relief in ‘downside’ events; however, their coverage remains limited to climate-related shocks. Barbados used another example of this in the form of parametric insurance from Munich RE and the Caribbean Catastrophe Risk Insurance Facility (CCRIF) to manage natural disaster risks as part of its debt restructuring, allowing for capitalisation of interest and deferral of scheduled amortisation over two years following a natural disaster. As of July 2024, the first CRDC, in Grenada’s 2030 bonds, may be activated for the first time, which would allow it to defer both principal and interest payments. The trigger is tied to payouts from the CCRIF, which, in the wake of damage from Hurricane Beryl in July 2024, has made its largest payout, of \$44 million, in 2024 (CCRIF, 2024).

Debt-for-nature swaps are another instrument that has been employed in several recent restructurings with private creditors, as part of a multilateral arrangement. Debt-for-nature swaps have been

attractive as dual-purpose instruments, to reduce debt service and redirect fiscal resources to climate and conservation needs by using the reduced interest savings from bond buybacks to finance concrete conservation projects.

Barbados, Belize and Ecuador utilised ‘blue’ bond issuances linked to marine conservation as part of debt-for-nature swap transactions (see Table 3.2). Ecuador’s 2023 debt swap reduced debt service by \$1.1 billion, generating \$450 million for conservation activities. Belize’s debt swap of its single ‘superbond’ significantly reduced its debt service (around 9% of GDP). A more recent debt swap in Gabon provided minimal relief in debt service costs but allowed for maturity extension that extended maturities, and crowded in other capital (Albinet et al., 2024). While they are not a panacea for debt distress, and should not be used as an instrument for debt relief, they can serve a purpose during periods of liquidity stress (in the case of Belize and Ecuador) and in supporting refinancing needs (Barbados and Gabon) (ibid.).

Table 3.2 Recent debt-for-nature swaps, key indicators

	Blue loan (\$ million)	Debt retired (\$ million)	Immediate debt reduction		Average repurchase price (cents per \$1)	Funds for marine conservation (\$ million)
			(\$ million)	(% of GDP)		
Barbados	146	150	4	0.1	96.2	50.178
Belize	364	580	216	8.7	55.0	450
Ecuador	656	1,628	972	0.8	41.0	

Source: IMF (2023)

As a second-best instrument, debt-for-nature swaps serve better as a pre-emptive measure than as a comprehensive solution to debt restructuring and default. Their impact for debt relief is generally modest relative to

the sizeable material and transaction costs involved via third-party fees for risk insurance (such as for the U.S. International Development Finance Corporation (DFC)), as well as costs in establishing conservation project structures.

Their use also does not avoid default: Belize and Ecuador's bond buybacks were still classed as 'distressed exchanges' by Moody's, due to their significant discounts (Nestmann, 2023).

While the case for debt swaps is narrow, they may be part of a menu of tools for long-term growth and conservation goals. Using them as 'fair-weather' instruments prior to default or following a successful restructuring can be a political signal of commitment to sustainable development, reduce the likelihood of further debt restructuring and ensure earmarked fiscal resources for climate investment over debt service.

3.5 Lessons

1. Timely, proactive and transparent engagement with stakeholders is crucial to minimise the risk of protracted restructurings. A cooperative and transparent stance, along with early engagement with creditor groups, can build goodwill, demonstrate good faith and be more likely to lead to a smoother and faster restructuring process. While larger haircuts may be possible through a post-default restructuring or a more confrontational stance, which may be necessary to restore debt sustainability, this is also likely to entail a more protracted restructuring process, with the prospect of higher future borrowing costs (Marchesi, 2015). Adapting different strategies with different
- creditors could avoid inter-creditor conflicts over comparability of treatment.
2. Design of debt restructuring should take care to maximise debt relief for the size of haircut possible, frontloading fiscal adjustment following a restructuring and ensuring that the repayment profile of restructured bonds matches future revenue streams, avoiding sharp increases in payments. While VRIs and SCDIs have a strong theoretical case, experience has not supported their utility as a debt relief instrument. Use and design of SCDIs should be carefully considered through market and sovereign consultations, to ensure they also provide liquidity relief if economic conditions worsen.
3. Future economic recovery and debt sustainability must also be climate-resilient, and debt relief should consider use of insurance or CRDC instruments to reduce the vulnerability of future debt repayment to the risk of external shocks. Debt-for-climate and debt-for-nature swaps can be a second-best tool, to help improve debt sustainability and redirect fiscal resources to long-term conservation investment need, only once the immediate crisis is resolved. Exploring options with third-party actors such as The Nature Conservancy (TNC) or bilateral creditors should begin with outlining the conservation rationale and investment structure, and focus on designing concrete conservation projects that can be supported in future under these structures.

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4 Debt-for-nature swaps in Sri Lanka

Michael Iveson

Summary

As Sri Lanka faces an increasing debt burden and pressing environmental commitments, debt-for-nature swaps present the possibility of addressing the opportunity costs of debt repayments and mobilising finance for essential investments in climate change adaptation and mitigation. However, this will require coordination and a prioritisation of climate goals over debt relief.

4.1 Introduction to debt-for-nature swaps

As developing countries face mounting debt pressures that impose fiscal constraints on climate change mitigation and adaptation strategies, policy-makers require innovative solutions that can facilitate essential investments to fulfil climate change commitments and pursue sustainable economic growth. Debt obligations in developing countries have enormous opportunity costs, and it is estimated that 3.3 billion people are living in countries that currently spend more on interest payments than they do on education and health care (GCRG, 2023). In fact, developing countries face net capital outflows to developed countries, composed significantly of debt service repayments flowing in the opposite direction to aid, grants and investment (Hickel et al., 2021). Given the growing pressures of the climate crisis, these opportunity costs

also extend to developing countries foregoing climate change mitigation and adaptation efforts to service their ballooning debt burdens. Therefore, developing countries must explore ways to tackle the opportunity costs of debt and repurpose unproductive debt obligations towards more economically and environmentally beneficial projects.

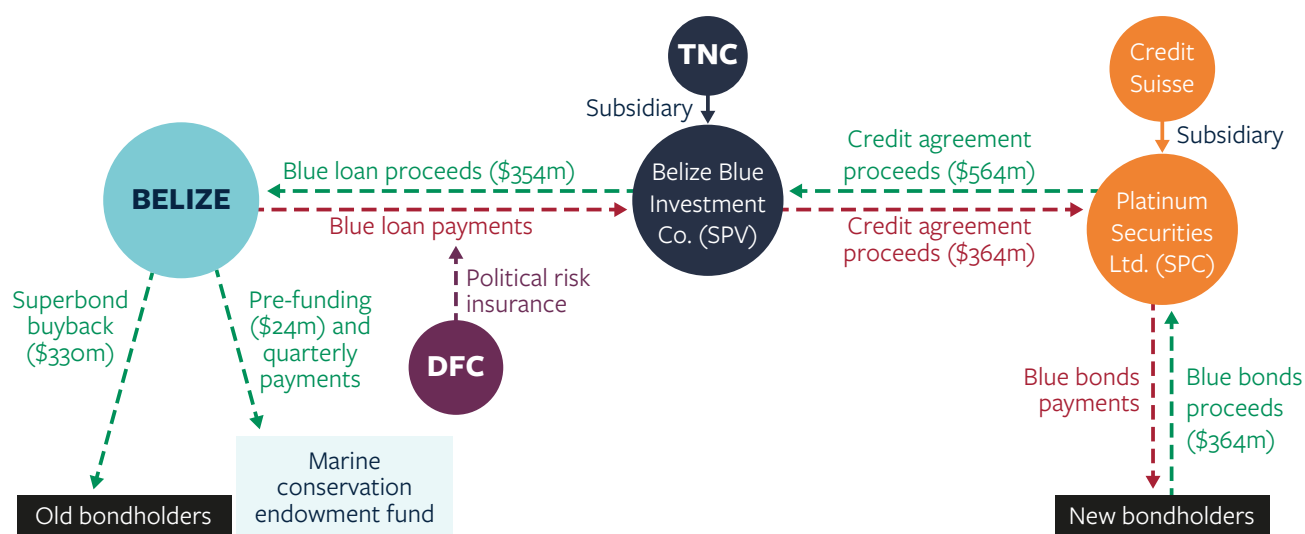
Debt-for-nature swaps have emerged as a potential instrument for developing countries to mobilise additional finance for climate change investments. They enable heavily indebted countries to restructure their external debt onto more favourable terms in exchange for environmental commitments. These are voluntary mechanisms that involve creditors cancelling or reducing some of their unsustainable debt obligations and instead reallocating the finance towards conservation projects. Debt-for-nature swaps were introduced in the 1980s in Latin America but remained relatively niche as large-scale unconditional debt relief initiatives and more traditional debt restructurings became more and more frequent. However, given the scale of the current global debt crisis and the urgent need for environmental action, these instruments have re-emerged as a potential solution to addressing these growing challenges simultaneously. Table 4.1 summarises the most recent debt-for-nature swap deals and their impact on debt-to-gross domestic product (GDP) ratios in the respective countries.

Table 4.1 Recent debt-for-nature swaps

Country	Year	Debt relief	Finance for conservation	Conservation commitments	Support
Seychelles	2018	\$21.6m	\$15m	Marine protected area increased to 30% of its exclusive economic zone and develop marine spatial plan	\$5m guarantee from World Bank; \$5m concessional loan from Global Environment Facility
Belize	2021	\$553.0m repurchased at \$364.0m (55% of original value)	\$180m	Marine protected areas increased from 16% to 30% of oceans by 2026 \$4m per year on marine conservation until 2041	Credit enhancement by U.S. International Development Finance Corporation (DFC)
Ecuador	2023	\$1.6bn repurchased at \$656m (40% of original value)	\$450m	Marine conservation and sustainable activities in over 198,000 marine km ² (\$12m per year)	\$85m guarantee from Inter-American Development Bank; \$656m in political risk insurance from DFC
Gabon	2023	\$500m	\$163m	30% of its ocean protected through targeted marine conservation (\$5m per year)	DFC provided \$500m in political risk insurance

Source: Commonwealth Secretariat (2020); Owen (2022); GGGI (2023); U.S. Embassy in Gabon (2023)

The debt-for-nature swap in Belize demonstrates how these mechanisms can be scaled up to mobilise finance for large conservation projects. In 2021, Belize faced a rising debt-to-GDP ratio of 125% and severe risk of default on its sovereign debt. By employing a tripartite debt-for-nature swap, Belize mobilised approximately \$180 million to fund ocean conservation projects and protect the Belize Barrier Reef System (Owen, 2022). Figure 4.1 presents a visualisation of the Belize debt-for-nature swap.

Figure 4.1 Belize debt-for-nature swap

Source: Grund and Fontana-Raina (2024)

A tripartite debt-for-nature swap involves a third party that lends money to the debt-distressed government to repurchase its sovereign debt and restructures the debt on more generous terms in exchange for environmental action. In the case of the Belize debt-for-nature swap, The Nature Conservancy (TNC), a US non-governmental organisation, provided the funding and coordinated the obligations of the agreement. Belize committed to spending an additional \$4 million per year on marine conservation until 2041 and to double its marine-protected area from 16% to 30% of oceans by 2026. The deal was also enhanced by political risk insurance from DFC, which allowed Belize to raise funding through highly rated blue bonds at below-market rates (TNC, 2022).

TNC was also involved in the recent debt-for-nature swap in Ecuador, which is the highest-value agreement to date. Ecuador repurchased \$1.6 billion of its national debt at a discounted rate of \$0.40 on the dollar, which reduced its total

debt by an estimated \$1.1 billion. Credit Suisse issued a \$656 million loan through a blue bond branded the ‘Galapagos Bond,’ which requires that a sizeable portion of the debt relief be invested in ocean conservation projects in the Galapagos Marine Reserve. The agreement was also supported by political risk insurance, this time through a guarantee issued by the Inter-American Development Bank, which supports institutional strengthening policies for environmental and public debt management in developing countries.

Recent debt-for-nature swaps demonstrate that there are incentives for creditors, debtors and international organisations to engage in large-scale agreements to mobilise finance for climate-resilient investments. The remainder of this paper examines the potential of debt-for-nature swaps in Sri Lanka and how these instruments could be employed to facilitate investments in climate change mitigation and adaptation while also reducing the debt burden.

4.2 Swapping debt for nature in Sri Lanka

For Sri Lanka to develop a successful policy framework for a debt-for-nature swap, it is vital to underline the unique components of previous agreements and apply them to the Sri Lankan case study. The first, and arguably most striking, difference between Belize, Ecuador and Sri Lanka is that Sri Lanka defaulted on its external sovereign debt whereas Belize and Ecuador faced debt distress. This is an important difference as Belize and Ecuador were able to employ debt-for-nature swaps to support debt sustainability efforts whereas Sri Lanka has begun to restructure its debt through a more traditional approach.

Introducing climate conditionalities or leveraging a debt-for-nature swap as part of traditional debt-restructuring negotiations may complicate the processes and delay debt sustainability. Therefore, to increase the likelihood of a successful debt-for-nature swap, policy-makers should wait until ongoing debt restructuring processes are complete to avoid increasing the burden of debt-restructuring negotiations. However, it is also essential to acknowledge that, while the Belize debt-for-nature swap reduced its sovereign debt by an estimated \$200 million over the lifetime of the agreement (from 101% to 80% of GDP), Belize's external debt was still assessed as unsustainable, and the deal did not immediately stabilise the public debt situation. Rather, the agreement complemented ongoing fiscal consolidation efforts.

A deal of a similar magnitude in Sri Lanka would reduce Sri Lanka's external debt stock by only approximately 1% of GDP (World Bank, 2024). Therefore, it is unwise to prioritise the negotiation of a debt-for-nature swap purely on the grounds of debt relief or achieving debt

sustainability. Instead, it is more useful to assess the effectiveness of employing a debt-for-nature swap to address the opportunity costs of Sri Lanka's external debt obligations and create fiscal space to maintain climate investments in sectors with a high economic, social and environmental multiplier effect.

An examination of the Belize and Ecuador agreements shows that the respective countries had unique environmental landscapes that could be leveraged against their debt repayments. Belize, for example, had in 2011 developed a Sustainable Tourism Master Plan to utilise its natural comparative advantage in ecotourism, adventure and marine tourism (Chow, 2019). This plan sought to exploit Belize's natural resources, rich biodiversity and geographical advantages to attract greater tourist numbers while maintaining its natural assets. Therefore, Belize was able to leverage the increasing tourism demand and established plans for the sector to reassure creditors that revenues would be sufficient to meet repayments. This income stream, backed by the credit guarantee, made Belize's debt-for-nature swap an attractive prospect on both financial and environmental grounds.

Ecuador was also able to facilitate a debt-for-nature swap by leveraging its iconic environmental assets – namely, the Galapagos Islands. Globally recognised as a unique archipelago rich in biodiversity and marine life – and as a hub for conservation research – the Galapagos Islands were an attractive prospect for marine conservation projects funded through a debt-for-nature swap, and the broader economic, social and environmental benefits of such an agreement were easily measurable.

For a successful debt-for-nature swap in Sri Lanka, it is vital that policy-makers identify

environmental investments that are both financially and environmentally feasible. If the government were to implement environmental projects that are undeliverable, this would lead to a loss in credibility both financially and politically. For Sri Lanka to develop a credible debt-for-nature swap agreement, the government must leverage its existing climate targets that it may risk falling short on as a result of fiscal constraints. Much like in Belize and Ecuador, where plans and commitments were already underway, Sri Lanka must demonstrate the high opportunity costs of its debt repayments and the challenges it faces in meeting its environmental commitments under the current debt schedule. By leveraging already-established climate targets, the government can provide a stronger case for finance and streamline negotiations. However, given its sovereign default and low credit rating, Sri Lanka would still also require a credit guarantee or other forms of risk insurance to reassure creditors that the deal would be sustainable.

Sri Lanka has already made strong environmental commitments through its Nationally Determined Contributions and the Climate Prosperity Plan but the targets remain ambitious under current fiscal constraints. Sri Lanka's commitment to renewable energy development is one example of a sector where a debt-for-nature swap could be productive. The Sri Lankan government has committed to generating 70% of domestic electricity from renewable sources by 2030, with a goal of achieving carbon neutrality by 2050 (Ministry of Environment, 2021). Sri Lanka's energy sector – in which electricity generation accounts for only 13% of total energy demand – has placed significant pressure on the economy as a whole in recent years. Sri Lanka's dependence on imported fossil fuels created a large trade imbalance whereby, in 2022, monthly fuel imports cost up to \$600 million, equivalent to roughly 1% of GDP (Jayasinghe, 2022). This

manifested as vulnerabilities in Sri Lanka's domestic energy sector, where price shocks to global commodity markets, such as the Russian invasion of Ukraine, dictated the prices at which Sri Lanka imported fuel. As prices soared, foreign exchange reserves were depleted to maintain domestic energy demand. Eventually, this contributed significantly to Sri Lanka's default on its external debt in April 2022.

By investing in domestic energy capacity, Sri Lanka not only reduces its reliance on foreign exchange-denominated fossil fuel imports but also ensures affordable, domestically generated electricity with broader economic, political and security benefits. Sri Lanka has significant wind and solar energy; solar capacity is planned to be increased up to 4.7 MW by the end of 2030, and installed wind capacity to up to 1.7 GW at the same time (Ceylon Electricity Board, 2023). Furthermore, it is estimated that Sri Lanka has 56 GW of potential offshore wind capacity, though the complexity and costs of such investments mean longer-term timelines would be required (World Bank Group, 2023). There have also been indications from both Sri Lankan and Indian government officials that electricity sector integration is a priority by 2030. This would enable Sri Lanka to export excess renewable energy generation to southern India and massively increase the potential market size of consumers and thus the return on investment.

The multifaceted economic benefits of renewable energy investments in Sri Lanka create strong incentives for domestic policy-makers to consider a debt-for-nature swap in this sector, while guaranteed revenue from the sale of electricity provides some assurance to creditors regarding debt sustainability. One challenge that would have to be overcome, however, is that much of Sri Lanka's external debt is denominated in US dollars, whereas electricity revenues would be generated in

Sri Lankan rupees. This mismatch would continue to place significant pressure on Sri Lanka's foreign exchange generation and potentially maintain an unsustainable debt environment. Requiring repayments in US dollars fails to holistically address the debt challenges facing developing countries and sustains debt distress and economic pressures (Herscowitz, 2023).

As Sri Lanka continues to allocate an increasing share of its national budget to interest payments on external debts, the possibility of financing necessary investments is very low. The renewable energy sector embodies these challenges; long-term economic, social and environmental prospects hindered by short-term debt obligations. Debt-for-nature swaps could provide a key to responding to such challenges by overcoming the opportunity costs of debt and unlocking finance for projects and investments that can contribute significantly to Sri Lanka's sustainable economic development.

4.3 How to make it happen?

Debt swaps are a practical and attainable solution in the long run but debt sustainability and the ongoing debt-restructuring processes must be prioritised. As established in this essay, developing countries have completed the most effective debt-for-nature swaps under debt distress, rather than in default, so Sri Lanka must achieve stability and complete its ongoing obligations before complicating the process with additional agreements.

Sri Lanka must also overcome significant bureaucratic hurdles to make a debt-for-nature swap feasible. Given that a debt-for-nature swap would require collaboration from the Ministries of Environment, Finance and Foreign Affairs and the Central Bank at a minimum, there must be

coordination across government that promotes accountability and delegates responsibilities. This could involve the establishment of a special-purpose vehicle, much like that of the Seychelles Conservation and Climate Adaptation Trust (SeyCCAT) in Seychelles, which strategises investments in marine conservation using the revenues generated from sustainable finance. This will be a crucial component to ensure that an agreement is negotiated with the consultation of key stakeholders, which will maximise the deliverability and impact of a debt-for-nature swap.

Finally, Sri Lankan policy-makers must prioritise the environmental impacts over the financial impacts. A debt-for-nature swap will not single-handedly improve Sri Lanka's debt sustainability, given the scale of the challenges and financing involved, but it can address some of the opportunity costs of Sri Lanka's debt distress. To frame a debt-for-nature swap as purely debt relief misses the point entirely. It is far more credible for the government to leverage existing climate targets that are at risk of being foregone than to approach creditors with a blank page to secure climate financing. By demonstrating the financial requirements to fulfil climate targets that have repercussions beyond the debt-for-nature swap arrangement, Sri Lanka presents a more attractive option to creditors and investors who may have reservations about the likelihood of repayment and the overall sustainability of such a deal.

A debt-for-nature swap should unlock targeted financing, rather than going 'by any means necessary,' and this involves providing strong assurances to creditors through clearer forecast revenues and wider economic and environmental benefits. This assurance can also be supported by multilateral development banks and bilateral partners who can provide guarantees and insurance for such agreements, which has been

a defining feature of the largest-scale debt-for-nature swaps in recent years. Without the support of the international community and reforms in the financial architecture, a debt-for-nature swap in Sri Lanka will face significant

challenges, given the scale of the debt crisis. However, until additional financing is made available, Sri Lanka's environment – and the climate as a whole – will continue to suffer at the hands of the global debt crisis.

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5 Insolvency reforms for growth in Sri Lanka

Murtaza Jafferjee and Ashanthi Abayasekara

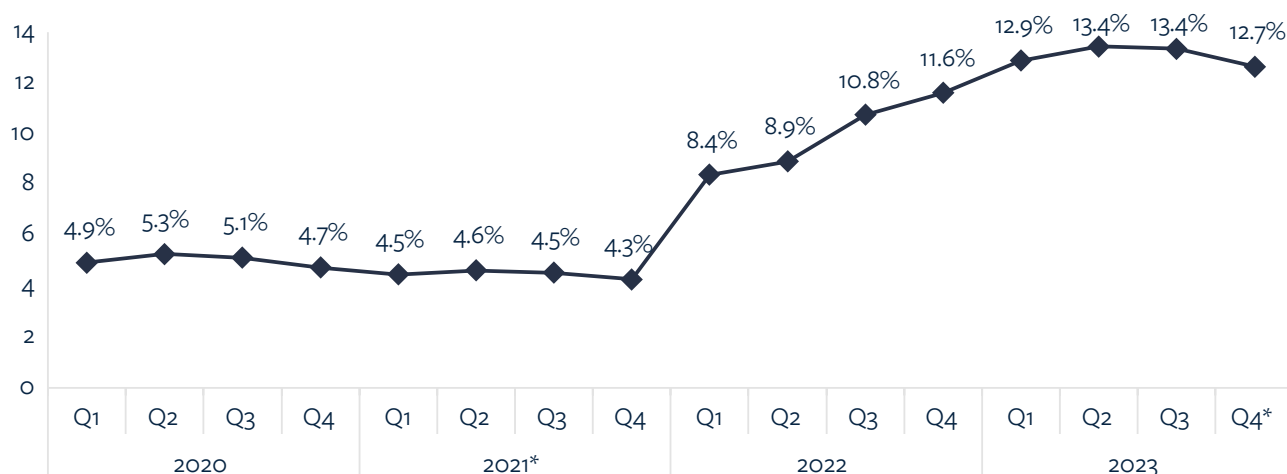
Summary

Sri Lanka is struggling with a weak and outdated insolvency system that is in desperate need of an overhaul. This is exacerbated by the increasing rate of non-performing loans that is burdening the Sri Lankan economy. Revisions need to be made to the insolvency framework, in terms of both new legislation and improvements to the insolvency infrastructure. Carrying out these reforms will lead to a climate that is conducive to entrepreneurship, increased investment and, subsequently, economic growth.

5.1 Introduction

Sri Lanka currently has no structured insolvency regime, which means businesses are stranded in financial turmoil without adequate support. Insolvency – that is, the inability of a business to settle debts owed to creditors – is a critical issue in any economy. Moreover, increasing rates of non-performing loans (NPLs) burden many Sri Lankan banks. This is evidenced by a rise in the NPL rate from 4.3% in Q4 2021 to 12.7% in Q4 2023, underscoring the urgency for reform.¹²

Figure 5.1 Share of NPLs in gross loans (%)



Source: Central Bank of Sri Lanka Financial Soundness Indicators

¹² Central Bank of Sri Lanka Financial Soundness Indicators.

It is imperative to understand that insolvency does not mean the end of a business but rather an opportunity for rehabilitation. Strategies such as debt restructuring, cost reduction and securing additional funding can serve as lifelines for struggling firms, with the result that jobs are preserved and failure rates among small businesses diminish.

Strengthening the insolvency framework holds the benefits of bolstering creditor recovery rates, which reduces the cost of capital. A revamped insolvency regime can also instigate significant behavioural shifts among borrowers and creditors alike. In the case of borrowers, it encourages greater risk-taking, as risks are more equitably shared. It also reduces the possibility of wilful default. For banks, it increases their willingness to lend to a broader range of borrowers and towards more high-risk projects, like those found in fast-growing industries. The financing of these high-risk, fast-growing industries, along with the overall rise in investment, is crucial to the economic development of Sri Lanka.

In an open market system, enterprises inevitably encounter downturns – yet, in the absence of a robust bankruptcy infrastructure, the repercussions can be severe. The essence of a well-organised bankruptcy system lies not only in mitigating the impact of insolvency but also in fostering an environment that is conducive to entrepreneurship and economic activity. In light of these pressing concerns, this essay aims to highlight the critical need to reform Sri Lanka's insolvency laws and infrastructure and endeavours to pave the way for a more resilient and dynamic economic environment.

5.2 Issues and challenges

The underlying issue with Sri Lanka's insolvency regime lies in its inclination towards liquidation over

rehabilitation. When a company is insolvent, an insolvency practitioner is needed to determine how to revive the business and sustain its operations, much like a doctor is needed to diagnose a patient's illness and prescribe a cure. However, resorting to liquidation prematurely is similar to calling in an undertaker without first exhausting all possibilities for recovery. Liquidation should be the last resort, pursued only when all other viable options have been thoroughly explored.

However, the country's outdated legal framework, governed predominantly by the Companies Act No. 7 of 2007 and the Personal Insolvency Ordinance of 1854, lacks the necessary provisions to support rehabilitation. In particular, it neglects the needs of small and medium-sized enterprises. This deficiency is compounded by challenges within the court system. Given all these issues, the urgency of comprehensive reform in Sri Lanka's insolvency regime becomes increasingly evident.

Key components of an ideal insolvency law

An ideal insolvency regime has two overarching objectives. The first of these is to allocate risks among participants of a market economy in a predictable, equitable and transparent manner. The second objective is to maximise value for the benefit of all stakeholders. To achieve these goals, the insolvency framework must encompass a robust insolvency law that defines the rights and responsibilities of participants as well as an institutional framework that implements these provisions (IMF, 1999).

In terms of liquidation procedures, the commencement and the consequences of commencement should be clearly laid out. Both creditors and debtors should be able to commence insolvency proceedings; in the case of creditors, this will typically be upon

the cessation of payments. To incentivise management to commence insolvency procedures in a timely manner, it may be beneficial to impose penalties. Additionally, debtors should be incentivised to pursue rehabilitation early.

Upon commencement, it is vital to establish and protect the estate. Transferring all assets to an independent liquidator as well as enforcing a stay of creditor actions will accomplish this. The stay on creditors' actions should be extended to secured creditors for a specified period, with systems established to protect their interests over the course of this stay on action. Care must be taken to ensure that transactions that took place prior to the commencement of insolvency proceedings do not unduly benefit certain creditors at the expense of others. For this reason, liquidators must be empowered to void certain transactions involving insiders, such as transfers carried out with false intent.

With regard to the treatment of contracts, liquidators should have the authority to terminate or continue unperformed contracts, depending on whether or not these contracts allow for the maximisation of recovery value. Asset liquidation must be timely and efficient, and creditors must be given prior notice of asset sales. The priority of distribution is another critical aspect. Proceeds from the sale of estate assets should prioritise secured creditors, followed by administrative expenses incurred over the course of the insolvency proceedings. Ultimately, once the proceedings have concluded, debtors should be discharged of their debts and offered the chance of a fresh start, provided that they have not engaged in fraudulent actions during liquidation.

Rehabilitation procedures can be instigated by either a debtor or a creditor and do not require a cessation of payments by the debtor. Similar to liquidations, rehabilitation procedures should include a stay on creditor actions. The debtor should be allowed to remain in control of the enterprise under the supervision of an independent administrator, as, without this provision, there is no incentive for the debtor to opt for rehabilitation. Time limits need to be imposed on rehabilitation proceedings.

As with liquidation, transactions carried out prior to commencing rehabilitation must be scrutinised for evidence of deceit, and fraudulent transactions need to be rendered void. Administrators also need to be empowered to continue or terminate contracts in the event that doing so will improve the success of rehabilitation. The insolvency law should also include provisions to enable conversion from rehabilitation to liquidation proceedings in the event that rehabilitation is deemed to have very little chance of success, or the process exceeds a specified time period.

Rehabilitation plans can be prepared by either the debtor, the administrator or the creditor as a means to encourage the use of rehabilitation procedures, with the law placing minimal restrictions on the content of these plans. Care must be taken to ensure that the interests of those creditors who disapprove of the plan are safeguarded to ensure they receive as much through rehabilitation as they would through liquidation. The law should also provide a mechanism whereby administrators can secure additional finance for the business, which is often crucial to a successful rehabilitation. These post-petition creditors should receive administrative priority to encourage them to provide funding to the distressed entity.

Institutions and participants play pivotal roles in insolvency proceedings. Creditors should have avenues for active involvement, potentially through the formation of a creditors' committee. Liquidators and administrators must possess adequate legal and commercial expertise, with transparent appointment and remuneration processes. The law should provide clear guidance on the role of the courts. Specialised bankruptcy courts will potentially enhance efficiency. Cross-border insolvency issues add another layer of complexity. Measures to facilitate recognition of foreign proceedings and global cooperation, such as the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency, are essential for ensuring seamless resolution across jurisdictions (IMF, 1999).

Existing situation in the Sri Lankan insolvency regime

Antiquated and insufficient laws

As mentioned earlier in this essay, Sri Lanka's current insolvency legislation consists of the Companies Act of 2007 and the Personal Insolvency Ordinance of 1854. While these laws contain some of the criteria of a robust insolvency law as detailed in the previous section, they fall short of ideal law for several reasons.

The **Companies Act of 2007** contains most of the provisions needed for liquidation proceedings, such as on commencement of liquidation, protections of the estate and avoidance of certain transactions carried out prior to commencing liquidation procedures. It also has provisions for the treatment of contracts and priority of distribution. With regard to rehabilitation, the law touches on the commencement of rehabilitation, its content

and approval of the plan. The law also clearly outlines the responsibilities of all institutions and participants involved in the insolvency proceedings as well as detailing their means of appointment and dismissal.

However, the law does not have provisions for the discharge of debtors post-liquidation. It is also very limited in its approach to rehabilitation, omitting many necessary clauses covering areas such as treatment of pre-commencement transactions and other contracts, transition from rehabilitation to liquidation and obtaining post-commencement financing. The law also does not acknowledge cross-border insolvency issues.

The **Personal Insolvency Ordinance of 1854** pertains to the insolvency of individuals and, as such, is limited in its scope. Additionally, this piece of legislation is quite archaic in its approach towards insolvency. It does contain quite a few of the provisions for liquidation, such as protection of the estate, avoidance of certain pre-commencement transactions, priority of distribution and discharge of the debtor post-liquidation. It also lays out the responsibilities of the debtor, creditors and liquidators as well as the courts. It does not, however, contain any reference to rehabilitation.

A large number of laws were passed in 1990 with the aim of accelerating debt recovery. Among them is the **Recovery of Loans by Banks (Special Provisions) Act No. 04 of 1990**. Under this, in the event that a borrower has defaulted on a loan, a bank is entitled to pass a Board Resolution in authorising the sale by public auction of any property that has been mortgaged to the bank as security for that loan so that the unpaid portion of the loan and any interest due can be recovered (Rathnapala, 2015).

This process is referred to as **Parate Execution**. The right of Parate Execution was earlier limited to state-owned or -sponsored financial institutions but, with the imposition of this particular piece of legislation, this right was extended to licensed commercial banks (Gamarachchi, 2008). A 2011 amendment to the Act states that Parate Execution cannot be carried out for loans that are less than the sum of 5 million rupees at the time of default, not including interest.

Limited capacity of the courts

The delays in the Sri Lankan court system not only destroy value for all stakeholders but also erode trust in the insolvency process. Additionally, delays in executing the liquidation process arise owing to limited capacity as a result of a shortage of qualified judicial officers in commercial courts. Judges often lack the necessary commercial expertise to adjudicate insolvency issues accurately, further exacerbating stakeholders' concerns.

5.3 Key policy proposals

Recommendations pertaining to the law

The new insolvency bill, the Rescue, Rehabilitation and Insolvency Act No. [X] of 202[X], while a welcome move by the Law Commission, faces several shortcomings. First, there is a lack of clearly defined trigger events for admission into personal insolvency, administration and liquidation, which could ideally be set as a threshold default amount. The absence of creditor segregation along the lines of creditor type or class in the draft law poses challenges with regard to forming a creditors' committee and managing claims. Furthermore, there is uncertainty

regarding the role and responsibility of creditors during administration and liquidation; these require precise definition. Tighter definitions are required for protected property that is not subjected to insolvency proceedings.

Additionally, there is ambiguity regarding the appointment of administrators and liquidators. Clear guidelines for this are necessary and, in the case of joint administrators, roles and responsibilities need to be clearly defined. The draft law also lacks clear process timelines, which hampers efficiency and asset preservation. Establishing definitive timelines for each stage of the process would aid in value maximisation.

Lastly, a streamlined mechanism for concluding the process and prioritising claim treatment is essential to provide clarity and efficiency. Addressing these issues would enhance the effectiveness of insolvency, administration and liquidation procedures.

Recommendations pertaining to implementation and enforcement

When it comes to implementation of the law, care must be taken to minimise process risk, especially as it pertains to consistency in the judgements passed down through the courts. Given the issues with the Sri Lankan judicial system, where possible it may be best to place responsibility regarding judgements in the hands of administrators who are incentivised to be consistent and reach resolutions quickly. It would also be beneficial to develop a cohort of insolvency practitioners who are competent and ethical. Judges and judicial officers need to be well trained in dealing with the complexities surrounding insolvency.

Challenges in carrying out these reforms

The new insolvency bill, currently being drafted, is a step in the right direction. However, it is far from an ideal insolvency law, and significant revisions are needed. In addition to adopting a new insolvency law, improvements need to be made to the insolvency infrastructure, in terms of improving

the court system and developing a cohort of qualified and experienced insolvency practitioners. While revising and enacting the new law may be relatively straightforward, effectively enforcing it is likely to prove difficult unless these insolvency infrastructure developments are carried out. Given the nature of the issues in the Sri Lankan legal system, it is unlikely that this will be resolved in the near future.

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Part 2: Monetary and fiscal policy



6 Disinflating an economy in crisis: the case of Sri Lanka

P. Nandalal Weerasinghe, Chandranath Amarasekara and Sujeetha Jegajeevan

Summary

Sri Lanka recorded its highest levels of inflation in 2022. However, the country was also able to rapidly reduce inflation to single-digit levels within 10 months of the peak. This essay summarises this experience and highlights the importance of Central Bank independence for successful inflation management, which is a prerequisite for sustained high growth of a country.

6.1 Introduction

Sri Lanka's economic crisis in 2022, including the lead-up and its causes and consequences, is well documented. Similar to other nations that launched multipronged policy stimuli in the wake of the COVID-19 pandemic, Sri Lanka eased monetary policy significantly from early 2020, among several fiscal measures. While there was some tightening from August 2021, monetary policy remained broadly accommodative until April 2022. The exchange rate was maintained around Rs 200 per US dollar from late April 2021 until early March 2022, despite the continued decline in official international reserves. Continuation of debt servicing under trying conditions without corresponding foreign

exchange inflows to the government, along with the need to finance essential imports, resulted in useable international reserves declining to near-zero levels by early April 2022. The drying-up of foreign financing to the government also prompted an unprecedented increase in Central Bank lending to the government.

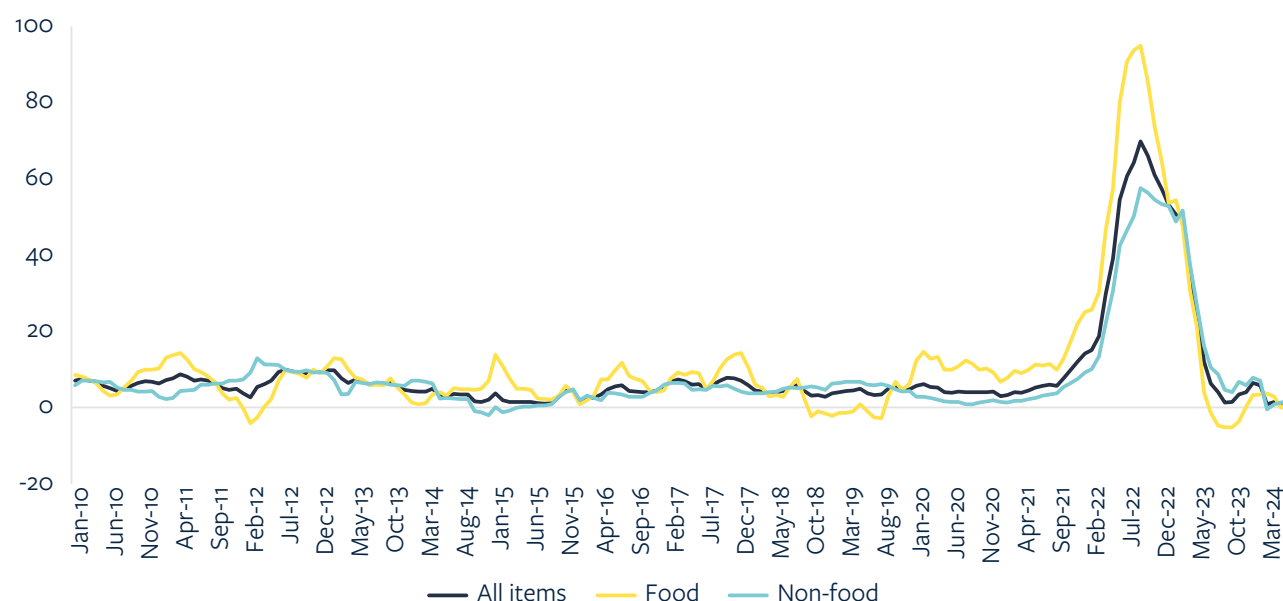
Meanwhile, shortages of essentials and upward revisions to administratively determined prices, together with adverse speculation, destabilised inflation expectations. Inflation moved to double digits from December 2021, breaking the 12-year streak of single digit inflation. When allowed to float freely in March 2022, the exchange rate showed a sharp adjustment. This, along with adjustments to domestic petroleum and electricity prices and continued shortages of food and non-food items, escalated inflation further.

As the economic crisis continued to escalate, the government sought the assistance of the International Monetary Fund (IMF) in March 2022. Discussions with the IMF towards securing an adjustment programme commenced in April 2022, while the process of public debt restructuring was initiated. To contain demand-driven inflationary pressures, re-anchor inflation expectations and

also stem the sharp depreciation of the rupee, the Central Bank tightened monetary policy significantly, almost doubling policy rates at once. Meanwhile, the government also commenced adopting corrective fiscal and quasi-fiscal measures to address the severe imbalances that prevailed, thereby working with the Central Bank to stabilise the economy. Inflation peaked at 69.8% (Colombo Consumer Price Index (CCPI)-based, year on year) in September 2022, while

food inflation shot up to a staggering 94.9% in the same month. In response to decisive measures adopted mainly by the Central Bank and also by the government, the country experienced rapid disinflation, which brought inflation back below 5% by August 2023. Figure 6.1 illustrates these movements, together with the historical evolution of inflation. This appears to be the sharpest disinflation observed in a country coming out of a crisis of a similar magnitude.

Figure 6.1 Headline inflation: food and non-food (CCPI, year on year), 2010–2024 (%)



Source: Department of Census and Statistics

6.2 Causes of high inflation

Continued high fiscal deficits amid dwindling revenues and the absence of foreign financing, along with continued debt servicing, resulted in the government relying increasingly on the Central Bank for rupee liquidity as well as foreign exchange liquidity. This resulted in an unprecedented escalation of Central Bank credit to the government, and an exhaustion of

usable reserves. Severe mispricing of domestic petroleum products and electricity as well as the non-market clearing exchange rate masked the build-up of underlying aggregate demand pressures in the economy. Abrupt policy decisions, such as the reduction of direct and indirect taxes and the ban on chemical fertiliser, taken without proper analysis, added significant pressures to the domestic economy. While these developments de-anchored inflation expectations and resulted

in inflation moving to double digits by end 2021, corrective measures inevitably caused further upward pressures on prices, thereby accelerating inflation further, before aggregate demand contracted. This section summarises these causal factors of high inflation.

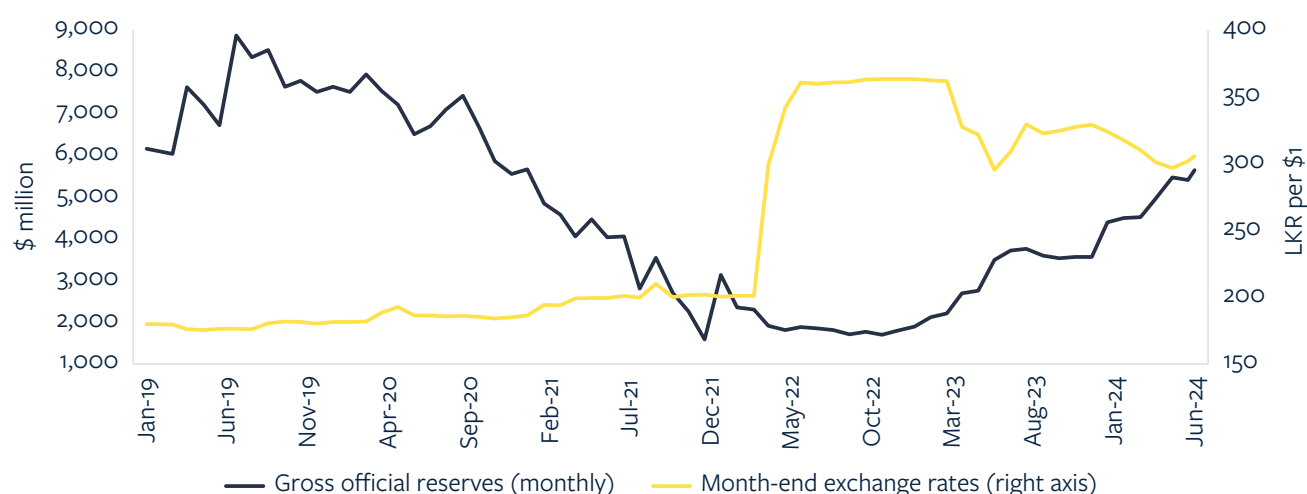
Mispricing of domestic petroleum and electricity supplies and resultant shortages

A key factor that destabilised inflation and inflation expectations was the shortages of fuel supplies. In late 2019, the government abandoned the formula-based pricing of domestic petroleum products introduced under the previous IMF programme. Domestic petroleum prices were adjusted only twice during the period between September 2019 and December 2021 in spite of notable fluctuations in global petroleum prices. Amid accumulating losses to the Ceylon Petroleum Corporation, the shortage of foreign exchange and the drying-up of foreign credit lines resulted in an escalation of the effective cost of petroleum imports, at the same time as impacts on availability. Coal and cooking gas imports faced similar challenges. Meanwhile, dry weather conditions in early 2022 and limited supplies of petroleum also affected electricity generation. By then, the Central Bank had commenced providing foreign exchange to finance essential imports, including fuel and medicines. However, the sharp decline in reserves amid continued financing of essential imports and debt servicing meant that depreciation and domestic price adjustments were inevitable. Inadequate adjustments in prices and inability to import adequate supplies caused shortages of petroleum and cooking gas, as well as power cuts, by early 2022. The combination of these factors prompted a sharp acceleration of

inflation, while fuel rationing and scheduled power cuts had to be continued for a prolonged period of time.

Depletion of international reserves and exchange rate depreciation

The onset of the pandemic had severe impacts on Sri Lanka's foreign exchange inflows, particularly in terms of tourism earnings, while concerns on fiscal sustainability following the tax cuts in late 2019 had restricted the country's access to international capital markets. From early 2020, some restrictions were introduced on imports and selected capital outflows to dampen the imbalances in the external sector. Although the exchange rate was allowed to adjust with limited foreign intervention by the Central Bank early on, adverse speculation was building up, with official international reserves continuing to deplete. Attempts to maintain the exchange rate within a very narrow margin also led to the emergence of an active parallel market for foreign exchange, which attracted remittance inflows and financed outflows circumventing the restrictions. Global developments, particularly rising oil and other commodity prices, resulted in a continued deterioration of the external sector conditions, and the liquidity crunch in the domestic foreign exchange market worsened. Usable reserves were fully exhausted by March 2022 owing to continued provision of foreign exchange for essential imports and debt servicing of the government by the Central Bank amid sovereign rating downgrades affecting credit lines to the government and the financial sector. Figure 6.2 shows the continuous depletion of official reserves since the onset of the pandemic and the sharp movements in the exchange rate since early 2022.

Figure 6.2 Movements of gross official reserves and exchange rate, 2019–2024

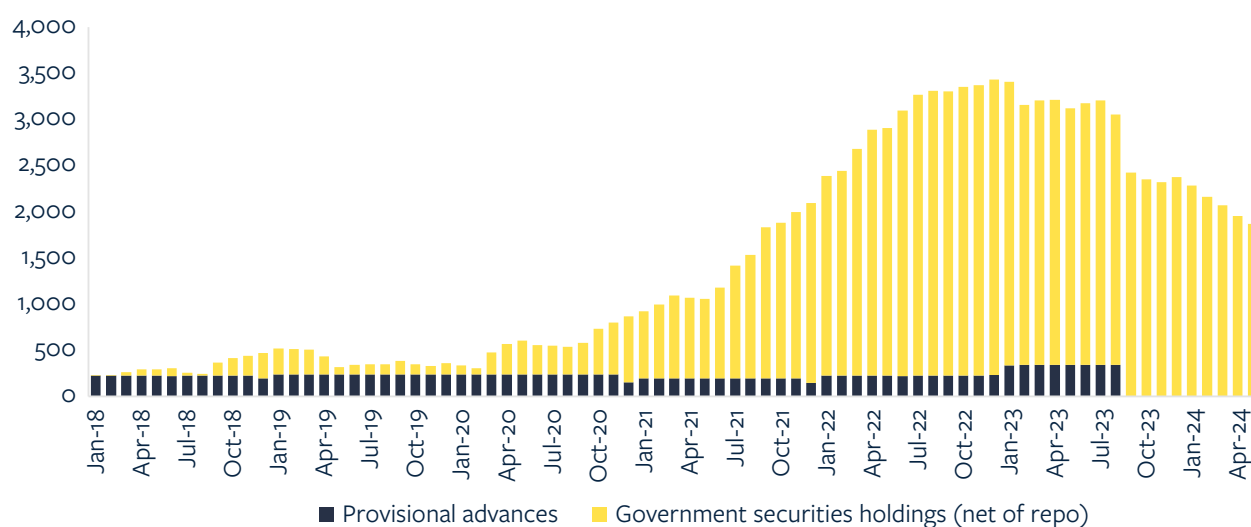
Source: Central Bank of Sri Lanka

A gradual adjustment to the exchange rate was no longer a feasible policy option by then, and the exchange rate was allowed to float by early March 2022, without a policy anchor to dampen any overshooting. As a result, the exchange rate experienced an unprecedented depreciation pressure until mid-May, and the rupee (commercial bank selling rate) depreciated against the US dollar by 46.2% between end February 2022 and 12 May 2022. Heavy depreciation in the official market and financing of imports through the parallel market at an even higher exchange rate led to a sharp rise in the prices of imported items. Moreover, second-round impacts of these increases in the prices of imported goods were also notable. The combined impact of these two effects of depreciation explains a greater share of the acceleration in inflation during mid-2022.

Fiscal deficits and monetary financing of such deficits

Prolonged and substantial monetary support provided by the Central Bank to the economy,

including the government and the private sector, during the pandemic emerged as a source of demand-driven pressure on inflation from late 2021, although it helped enable a faster revival of the economy from the pandemic impact. As a combined effect of the series of sovereign rating downgrades and adverse global financial conditions, the government's access to financing was largely limited to domestic sources from 2020. In spite of limited access to foreign financing, fiscal deficits grew, as a result of the government's decisions to reduce taxes from end-2019 and increased expenditure owing to the pandemic. The overall fiscal deficit increased from 9.0% of gross domestic product (GDP) in 2019 to 10.7% in 2020 and 11.7% in 2021. The primary balance worsened from a surplus of 0.6% of GDP in 2018 to a deficit of 5.7% by 2021. In these circumstances, the Central Bank was compelled to finance the government to smooth fiscal operations, though the implications of a large increase in monetary financing were communicated by the Central Bank to the government in line with the provisions of the Monetary Law Act. Figure 6.3 illustrates the acceleration of financing of fiscal deficits by the Central Bank during 2021–2022.

Figure 6.3 Central Bank's financing to the government, 2018–2024 (LKR billion)

Source: Central Bank of Sri Lanka

6.3 Remedial measures and corrective actions

Monetary policy measures

The Central Bank commenced tightening monetary policy in August 2021 by increasing policy interest rates by 50 basis points (bps) along with a doubling of the Statutory Reserve Requirement (SRR) to 4.0%. This was followed by two more policy rate increases in January and March 2022, by a total of 150 bps. Nevertheless, the extent and the frequency of multiple risks emanating from supply shortages, exchange rate fluctuations and global commodity price dynamics rendered monetary tightening effected during August 2021 to March 2022 inadequate. Meanwhile, with the exhaustion of usable reserves, the exchange rate was allowed to adjust in March 2022. The floating of the exchange rate and resultant spike in imported inflation warranted further tightening of monetary policy, which was carried out in April 2022. An unparalleled monetary policy tightening was conducted in April 2022, with the historically highest overnight increase in policy interest rates, by 700 bps, aimed at decisively taming inflation and adverse inflation

expectations while also seeking to address external stability concerns. Monetary policy communication emerged as an important policy tool in managing expectation towards the disinflation process during the unpopular policy drive. Policy tightening continued until March 2023 with a further increase in policy rates by 200 bps.

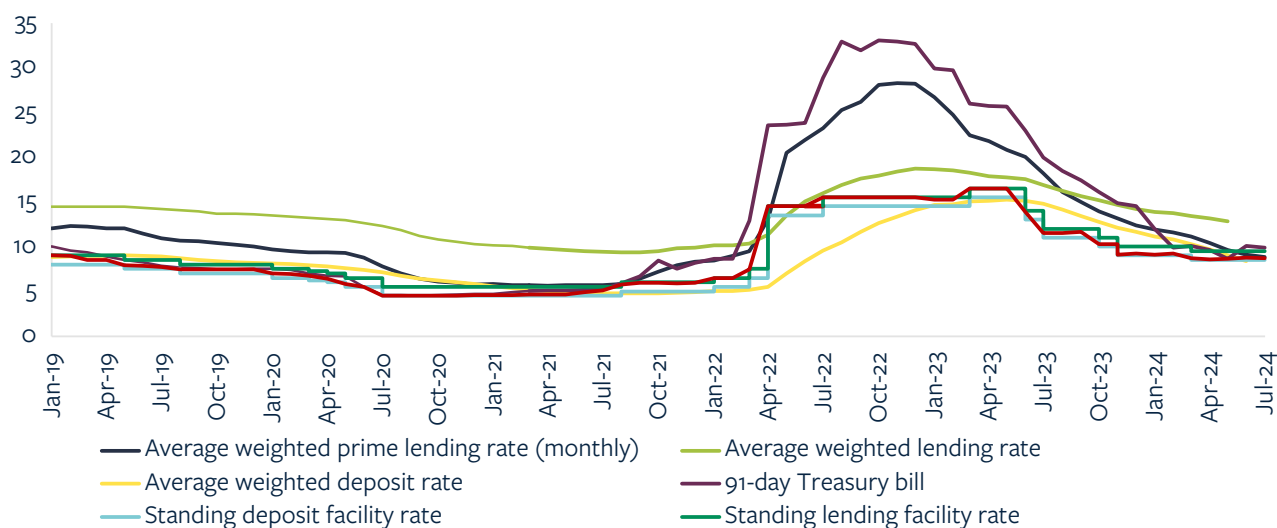
Monetary policy measures were complemented by several other targeted administrative measures and restrictions to restore price and external sector stability. Introduction of market guidance of the daily exchange rate by the Central Bank with a band in May 2022 and the continuation of the same until early March 2023 helped avoid a further escalation of price pressures through exchange rate depreciation. Other administrative measures that were already in place to limit forex outflows from the country, such as a restriction on non-essential imports, several exchange controls and capital flow measures and a surrender requirement for export proceeds, were also instrumental in stabilising the external sector and thereby the price pressures. Foreign exchange leakages through parallel market activities were also tackled through targeted measures, such as prohibiting open account imports of non-essential items. Tight monetary

policy along with tightened rupee liquidity conditions, as well as high-risk premia attached to government securities, resulted in a sharp increase in market interest rates, thereby accelerating the disinflation process.

These coordinated policy efforts from the Central Bank, along with tight fiscal policy, helped in containing aggregate demand and managing adverse inflation expectations. These demand measures, with the support of easing supply conditions, helped achieve an impressive path of disinflation within a record time period and sustain inflation at low levels thereafter. Allowing the exchange rate to be determined mainly by market forces, with the Central Bank intervention being limited to building up international reserves and dampening excessive volatility in the exchange rate, brought back

confidence to the foreign exchange market and resulted in an appreciation of the rupee. This contributed favourably to muted inflation from late 2023, although some imported prices continue to exhibit downward stickiness. With inflation declining faster than expected by many, the Central Bank was also able to normalise monetary policy within a short period of time, which would help with the revival of the economy in the period ahead. Figure 6.4 illustrates the increase in market interest rates, reflecting aggressive monetary policy tightening and risk premia associated with debt restructuring-related uncertainties. The figure also depicts the normalisation of market interest rates since 2023 supported by monetary policy easing following the successful disinflation.

Figure 6.4 Movements of policy interest rates and market interest rates, 2019–2024 (%)



Source: Central Bank of Sri Lanka

Fiscal measures

Notable policy adjustments in the fiscal sector that have already been introduced and are in the pipeline are expected to arrest excessive aggregate demand pressures in the economy. With the ongoing revenue-based fiscal consolidation process, government revenue has already increased from its lowest levels of between 8.2% and 8.7% of GDP observed in 2020–2022 to 11.0% by 2023. A primary surplus of 0.6% of GDP was recorded in 2023 while the overall deficit was contained at 8.3%. Under the IMF programme, the government is expected to continue to generate primary surpluses in the period ahead, thereby reducing the country's debt burden over time. Reduced financing requirements of the government and state-owned enterprises will enhance the availability of financial resources to the private sector, enabling an expansion of production capacity and efficiency of resource use, assisting in a sustainable lowering of inflation in the medium term. Meanwhile, as the impact of past high inflation on the general price level has lingered, strengthened social safety nets to improve living conditions as well as adequate adjustments to real wages of the public sector workforce will be required, along with measures to improve efficiency and productivity of the public sector.

Pricing policies

Under the IMF stabilisation package, monthly cost-reflective domestic petroleum price adjustments were reintroduced in March 2022; electricity prices were also adjusted from August 2022, initially on a six-monthly basis, followed by quarterly adjustments. The government also introduced regular cost-reflective price adjustments for cooking gas

as well as water supply. Demand adjusted in response to cost-reflective prices. Although frequent revisions to domestic energy prices initially induced a more than complete passthrough to prices of related goods and services, the magnitude of direct and second-round effects of these adjustments on inflation has largely reduced since late 2023.

Central Bank independence

At the height of the socioeconomic crisis, the government recognised the need to allow the Central Bank to carry out monetary policy independently. This was reflected in the 700 percentage-point upward adjustment in the policy interest rate in April 2022. To stabilise the economy, the Central Bank maintained its close coordination with the government, as monetary policy alone, in terms of interest rate and exchange rate management, would have taken a longer time, with sharper adjustments, to lift the economy out of the crisis. This coordination required the continuation of monetary financing for a further period until fiscal policy measures generated adequate revenues.

The long-felt need for Central Bank independence, along with enhanced transparency and accountability, was answered by the introduction of the Central Bank Act in September 2023, replacing the Monetary Law Act of 1949. The new Act established achieving and maintaining domestic price stability as the prime objective of the Central Bank; introduced flexible inflation targeting as the monetary policy framework, along with a flexible exchange rate policy; removed government representation on Central Bank boards while establishing channels for coordination between the Central Bank and the government; streamlined the appointment processes of the governor and the members of

the Central Bank boards; specified provisions for transparency and accountability to the Parliament and the general public; and, most importantly, prohibited monetary financing of fiscal deficits.

Since then, as envisaged in the Central Bank Act, the Central Bank and the government have entered into a monetary policy framework agreement that specifies 5% as the inflation target to be maintained by the Central Bank over the medium term, with a margin of $\pm 2\%$. Half-yearly Monetary Policy Reports are published explaining inflation developments and outlook, with awareness programmes carried out at the time of their publication. Press releases are issued after each bi-monthly monetary policy review, followed by a well-attended press conference chaired by the governor of the Central Bank. The Central Bank also makes efforts to regularly update the Parliament through its Standing Committees on various issues, and has continued to improve its transparency in terms of data and information releases and other modes of communication. While the Central Bank has been able to contribute to the government's domestic

debt optimisation exercise by restructuring its accumulated lending to the government, a strategy is in place to gradually reduce this stock of restructured bonds until its full exhaustion.

6.3 The way forward

The ability of the Central Bank to disinflate the economy from historic highs to low single digits in less than one year, among other achievements of stabilising the exchange rate, building up official international reserves and maintaining financial system stability, reflects the benefits to the economy of empowering the Central Bank and allowing it to operate independently. This, however, by no means represents a declaration that the difficulties facing the general public or the challenges facing the country amid its deep-rooted economic crisis are over. But the counterfactual of Central Bank inaction or delayed action could have dragged the country deeper into a crisis of unthinkable proportions. While economic conditions have stabilised, thereby providing some footing for the economy to achieve its potential, it will be essential to sustain the hard-earned gains in terms of stability in the equally challenging period that lies ahead.

7 Navigating fiscal challenges in Sri Lanka: key issues and policy recommendations

Roshan Perera

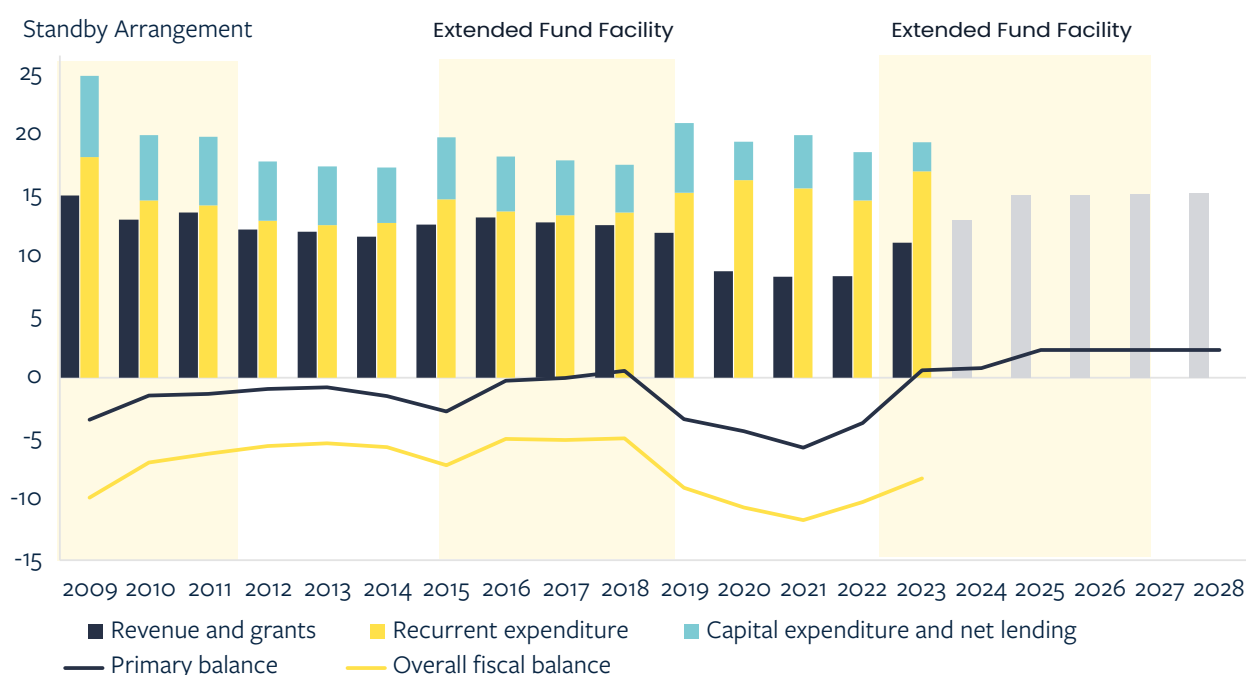
Summary

Sri Lanka faces unsustainable fiscal deficits as a result of low tax revenue and inefficient expenditure management. Key vulnerabilities include weak tax collection, poor fiscal management and inefficient state-owned enterprises (SOEs). Policy recommendations focus on enhancing tax revenue, strengthening public finance management (PFM) and comprehensive SOE reform. Achieving fiscal sustainability requires strong political will, technical capabilities and cooperation among all stakeholders.

7.1 Introduction

High and unsustainable fiscal deficits characterise Sri Lanka's fiscal landscape. Low tax collection without any meaningful rationalisation of expenditure has led to widening fiscal deficits and high and unsustainable debt levels. Extremely low tax revenue accelerated the debt default and the subsequent economic crisis. Attempts to rationalise government expenditure mainly affected capital expenditure: recurrent expenditure related to contractual obligations, such as interest payments, and salaries and pensions of the public sector, has remained largely untouched.

Figure 7.1 Trends in key fiscal indicators, 2009–2028 (% of GDP)



Source: IMF Country Reports for Sri Lanka (various)

Fiscal indiscipline is the root cause of macroeconomic imbalance in Sri Lanka. Unsurprisingly, periods of high fiscal deficit have coincided with Sri Lanka seeking assistance from the International Monetary Fund (IMF) (see Figure 7.1). Since 2009, Sri Lanka has entered three stabilisation programmes with the IMF, with the most recent being the Extended Fund Facility in March 2023. Key programme objectives have been to address the unsustainable fiscal deficit through revenue mobilisation and expenditure management, with debt sustainability a core objective in the most recent IMF programme (see Appendix 1). However, lack of commitment to fiscal reforms has led to cycles of macroeconomic instability. Identifying and addressing the key vulnerabilities in the fiscal sector are critical to long-term macroeconomic stability. Fiscal policy support is also key to structural transformation of the economy and accelerated economic growth.

This essay addresses the role of the fiscal sector in generating cycles of macroeconomic imbalance, examines issues and challenges in tax revenue collection and expenditure management and provides some policy recommendations.

7.2 Vulnerabilities in the fiscal sector

Low revenue collection

A study by the IMF finds the distribution of tax revenue in low-income developing countries averages around 10% of gross domestic product (GDP); in emerging markets and advanced economies it is around 20% and 30%, respectively (Benitez et al., 2020).¹³ Sri Lanka's tax-to-GDP ratio declined to 7.3% in 2022, indicating huge untapped potential. The major contributors to declining tax revenue were ad hoc policy changes

and weak tax administration. Frequent changes to tax rates and thresholds, along with numerous tax exemptions, further narrowed the tax base. This was compounded by a plethora of tax incentives granted under various tax regimes. A large informal economy further complicates tax collection in Sri Lanka.¹⁴

Inefficiencies and corruption in tax administration also weaken tax collection. Limited resources in tax collection departments remain a major obstacle to efficient tax administration. Additionally, complex tax laws and ad hoc changes to tax policy create challenges for tax administration and reduce compliance. The IMF Governance Diagnostic Assessment Report on Sri Lanka identifies complexity in tax systems as leading to rent-seeking and abuse of power (IMF, 2023). The existing institutional structure, with multiple revenue agencies overlooking tax administration and collection, also contributes to a lack of accountability.

Weak fiscal management

Multiple laws govern public finance in Sri Lanka. Section 148 of the Constitution gives Parliament full control over public finance. However, a powerful executive tends to control the legislature, weakening its control over public finances. The Fiscal Management (Responsibility) Act (FMRA) No. 03 of 2003 was intended to strengthen accountability and transparency by setting specific targets for key fiscal indicators and establishing regular reporting on fiscal performance. However, targets were never complied with, and limits were revised multiple times to prevent a breach, reducing credibility and ownership for fiscal targets. The absence of a mechanism to enforce

¹³ Tax to GDP includes social security contributions.

¹⁴ In Sri Lanka, the contribution of informal sector employment to total employment is over 60%.

targets and hold governments accountable highlights the weak institutional structures in PFM. The recently gazetted PFM Bill is expected to address the shortcomings in the FMRA but mere enactment of legislation does not guarantee compliance.

Negative spillover from SOEs

Operations of SOEs have implications for macroeconomic stability as well as economy-wide productivity. The output of some key SOEs (Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), etc.) are major inputs into other sectors of the economy. Hence, inefficiencies in these industries act as a drag on the productivity of businesses and the overall economy. Losses generated, financed mainly through borrowings from state banks, have adverse impacts on the financial sector and financial stability. Since these loans are backed by treasury guarantees, they also raises the contingent liability of the government, worsening debt sustainability. Furthermore, Sri Lanka requires large investments to bridge its infrastructure gap. However, the weak financial position of key SOEs hinders this much-needed investment.

7.3 Key policy proposals

Enhancing tax revenue

The lack of fiscal space constrains the government's ability to provide support in the face of economic shocks. To build fiscal buffers, the government needs to raise revenue to a more sustainable level. A higher tax-to-GDP ratio supports more government spending and stronger institutions. According to Gaspar et al. (2016), once the tax-to-GDP level of the country reaches a level of around 13%, GDP begins to accelerate, and this is sustained over several years.

A recent study by the Asian Development Bank (ADB) indicates that positive impacts depend on other macroeconomic factors such as low inflation and flexible exchange rates, as well as structural factors such as quality of governance and the financial sector (de Padua et al., 2024). A simulation exercise for Sri Lanka (IMF, 2024) on the impact of improved tax collection efficiency finds that, by raising the government's ability to spend on public capital and social transfers, private investment and consumption can be stimulated and the debt-to-GDP ratio reduced.

This underscores the IMF programme's target to raise the tax-to-GDP ratio of 14% by 2026. Reforming the tax system to raise and sustain revenue collection requires building technical capacity and strengthening the institutional framework.

1. Create a national tax commission

comprising tax practitioners, business leaders and academics to guide tax policy reform. The role of this would be to provide independent analysis of proposed tax policy changes, ensuring tax policy aligns with the broader economic and social objectives of the country and is not based on short-term revenue-raising considerations. The commission would evaluate the impact of tax changes on economic growth, labour markets and investment; undertake tax expenditure analysis to ensure tax incentives granted are based on proper identification of costs and benefits; and evaluate revenue forecasts to ensure they are realistic.

2. Establish one revenue-collecting agency

responsible for implementing tax policy. Currently, multiple agencies are responsible for tax collection, leading to a lack of ownership and accountability. Bringing

all taxes under one revenue agency would strengthen coordination and cooperation; prevent duplication of functions; and enable better sharing of information and systems that are essential for an effective tax system.

3. Rationalise tax incentives. Clear objectives and proper criteria for granting incentives should be established, and the tax authority should be held accountable for monitoring the progress of investments to ensure the objectives are fulfilled. Failure to meet the stated objectives should lead to an immediate cancellation of the incentives granted. For transparency, all incentives should require Cabinet and parliamentary approval, and information on incentives granted should be made publicly available through gazette notices. An annual tax expenditure analysis evaluating potential revenue loss and the expected economic benefits of tax incentives should be provided with the budget.

4. Accelerate digitalisation and data analytics to improve the efficiency and effectiveness of tax administration. Using unique digital identification (Digital ID) to connect tax accounts with third-party data from employers, financial institutions, land and motor vehicle registries, and other relevant sources makes it harder to evade taxes. Creating a data warehouse by linking multiple databases could facilitate risk-based tax audits using data analytics, further strengthening compliance.

5. Address capacity constraints. Modernising and improving the efficiency and effectiveness of the tax authorities means the employment of skilled professionals, including chartered accountants, lawyers and IT experts. Attracting skilled professionals will require market-based remuneration packages. The use of data analytics will require new skills sets in revenue agencies and greater interagency coordination.

Strengthening public financial management

Fiscal rules are an important means of fiscal discipline. The recent enactment of a new Central Bank Law seeks to address the longstanding issue of fiscal dominance in monetary policy-making by preventing the Central Bank from monetising the fiscal deficit. The PFM Bill is expected to further strengthen the rules-based framework, with the proposed legislation setting targets on the primary balance and primary expenditure under a medium-term fiscal framework (MTFF). This bill, if passed, will repeal the FMRA. However, mere enactment of legislation will not ensure compliance, as experience with the FMRA shows. Strengthening institutions responsible for fiscal management as well improving technical capabilities within fiscal agencies is a prerequisite for improved fiscal governance.

1. Set up a committee with representatives from the public and private sectors as well as civil society to monitor adherence to fiscal targets. The success of this framework depends on the overall acceptance of fiscal targets by all stakeholders and strict monitoring to ensure targets are met. The committee should have legislative authority and a mandate to independently assess the government's fiscal policies against overall macroeconomic objectives and the long-term sustainability of public finances. The committee's assessment should be made publicly available.

2. Reengineer the budgeting process. Currently, the budget cycle begins with spending agencies (ministries, departments, etc.) submitting their recurrent and capital expenditure estimates, which

are incorporated (after review) into the Appropriation Bill (the first reading of the budget). The Appropriation Bill also includes the borrowing limit of the government. While theoretically this process is guided by an MTFF, practically it is unclear how the parameters in the MTFF are incorporated into the expenditure estimates. It is in the Budget Speech (the second reading) that the government presents its revenue-raising proposals. Reversing this process by first estimating the resources available to the government (potential revenue and maximum borrowing based on a debt sustainability analysis) and then identifying the expenditure priorities would be more likely to ensure fiscal targets are met.

3. Improve credibility of forecasts.

Fiscal estimates in Sri Lanka have been consistently overly optimistic. Credibility could be strengthened by using estimates from independent agencies such as the Parliamentary Budget Office. However, resourcing these agencies with required skills and expertise will be a serious challenge in operationalising this medium-term framework.

4. Enhance transparency in public

procurement. The IMF's Governance Diagnostic Report highlights issues in public sector procurement, including political patronage, conflict of interest and lack of transparency. Recommendations include enacting a procurement law (government has committed to this in the Memorandum of Economic and Financial Policies) with the IMF and publishing all public procurement contracts above Rs 1 billion, along with comprehensive information on contract award winners, on a designated website. Ensuring compliance requires effective enforcement and

empowering agencies responsible to investigate and prosecute violations.

Comprehensive SOE reform

Addressing issues in SOEs is vital to long-term fiscal sustainability as well as improving the productivity and efficiency of the overall economy. Some reforms, such as cost-reflective pricing and the restructuring and divestiture of non-strategic enterprises, have begun. The government has committed to a comprehensive SOE reform policy, including the enactment of an SOE law under which a holding company will be established to set governance and performance metrics for SOEs. However, reducing the government's footprint in economic activity and creating a level playing field will be critical to increase private sector participation in the economy.

1. Rationalise SOEs based on a clear policy framework to identify which sectors require government ownership of SOEs. The rationale for the government's involvement in economic activity should be clear and, where SOEs operate, the right incentives should be in place to ensure they make a positive economic and social contribution.
2. Implement market reforms to ensure a level playing field between SOEs and private firms. SOEs often enjoy preferential status as a result of their size in the economy or exemptions from regulatory requirements. Competitive neutrality needs to be established where public and private enterprises face the same set of rules.
3. Align SOE governance with internationally accepted best practices and corporate sector standards. Board appointments should be based on clearly defined criteria and directors should pass a minimum fit and proper test.

4. Ensure greater transparency and accountability of SOEs through operational reforms. SOEs should follow the same reporting standards as other corporate entities. Managers in SOEs should be given the right incentives to maximise value to the major stakeholders.

7.4 Conclusion

Sri Lanka's fiscal position hangs in the balance. Long-term fiscal sustainability depends on the success of fiscal reforms. Achieving these requires not only the efforts of fiscal agencies but also strong political will, as well as sound technical capabilities. Cooperation between policy-makers, public officials, the private sector and civil society is essential to implement the ambitious fiscal reforms necessary for fiscal sustainability.

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Appendix 1 IMF programmes and fiscal targets/reforms

IMF programme	Standby Assistance programme	Extended Fund Facility	Extended Fund Facility
Amount	\$2.6 billion	\$1.5 billion	\$3 billion
Approved on	24 July 2009	03 June 2016	20 March 2023
Time period	2009–2012	2016–2019	2023–2027
Key fiscal targets	Reduce fiscal deficit to 5% of GDP by 2011.	Reduce fiscal deficit to 3.5% of GDP by 2020 (eq. to primary surplus of 1% of GDP).	• Tax to GDP up to 14% by 2026. • Primary balance of 2.3% from 2025 onwards.
Taxation	• Raise tax revenue by 2% of GDP by 2011 by broadening tax base, reducing exemptions and improving tax enforcement. • Inland Revenue Act (IRA) was amended in 2008 to limit new tax holidays to a maximum of three years, and to notify that those already granted under the IRA or the Board of Investment (BOI) Law would not be extended beyond their current period of expiration. • Submit Tax Commission report by October 2009 and proposals to broaden tax base in Budget 2010.	• Submit new IRA simplifying and broad-basing income tax. • Suspend BOI capacity to grant tax exemptions, holidays and special rates. • Publish a tax expenditure statement. • Time-bound strategy to reduce or eliminate tax expenditures. • VAT reform, including rationalising VAT exemptions.	• Introduce changes to the personal and corporate income taxes and VAT to revise rates and thresholds, and remove exemptions. • Increase excises on alcohol and tobacco products and automatic indexation of excises to inflation. • Introduce a fuel tax. • Revamp the property tax system. • Introduce a wealth transfer tax and a gift and inheritance tax. • Strengthen VAT compliance by e-filing and the fully implemented Revenue Administration Management Information System (RAMIS). • Strengthen the capacity of the Large Taxpayer Unit.

IMF programme	Standby Assistance programme	Extended Fund Facility	Extended Fund Facility
PFM	Reduce spending by 0.5% of GDP relative to the 2008 budget outturn, while maintaining the level of capital spending and preserving expenditure allocations to protect the most vulnerable groups in society.	• PFM reform (Integrated Treasury Management Information System (ITMIS), fiscal risk and reporting). • Revise expenditure ceilings for government ministries and departments in line with the overall budget deficit target.	• Submit to Parliament the new PFM Bill (with new fiscal rules). • Complete rollout of ITMIS, a fully fledged IT-based PFM platform. • Strengthen macro-fiscal analytical, forecasting and reporting capacity. • Progress on developing MTFF. • Maintain social safety net spending at 0.6–0.7% of GDP.
SOEs	• CEB and CPC to break even by 2011 through lower-cost electricity generation and full pass-through of international prices, respectively. • Any subsidies will be targeted to vulnerable groups and transparently reflected in the government budget.	• A resolution strategy for Sri Lankan Airlines will be done by September 2016. • Six major SOEs will establish a Statement of Corporate Intent (SCI). • Introduce formula-based automatic pricing mechanism for petroleum products. • The Public Utilities Commission will be granted authority to set electricity and water tariffs in a cost-reflective manner. • The fiscal cost of non-commercial obligations for SOEs will be included in central government budget	• Retail fuel prices set to cost-recovery levels with monthly formula-based adjustments. • End-user electricity tariff schedule set to cost-recovery level with semi-annual. • Formula-based adjustments. • Comprehensive strategy to restructure the balance sheets of the CPC, CEB, the Road Development Authority and Sri Lankan Airlines. • Clarifying the mandates of key SOEs through SCIs and by reviewing the framework for selecting SOE board members.

Source: IMF Country Reports for Sri Lanka (various)

8 A first look at fiscal policies and multiplier effects in Sri Lanka

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Summary

International experience of high-performing countries suggests that the type of fiscal spending matters for growth. We use simple modelling techniques and multiplier analysis to argue that it matters markedly for growth in Sri Lanka whether an increase or a contraction in fiscal spending occurs in consumption or investment. There should be more and better-informed debates on types of fiscal spending and policy choices. Policy-makers in Sri Lanka should consider maximising the growth effects of fiscal spending based on an analysis of fiscal multipliers and other fiscal spending economic assessment techniques. More detailed background information on the techniques used in this essay and the results generated is available from the authors.

8.1 Introduction

One of the main causes of Sri Lanka's recent economic and debt crisis was several years of external and fiscal imbalances, reflected in high fiscal deficits, tight fiscal space and a high debt burden. When triggered by the impacts of the joint shocks of the COVID-19 pandemic and the war in Ukraine, these vulnerabilities led to a period of instability and policy changes that ultimately caused a rapid contraction in gross domestic product (GDP), by 7.8%, in 2022, an increase in the debt-to-GDP ratio to 125.7% from 89% in 2019 and a rise in inflation to 45% (ADB, 2024).

However, as a result of policy reforms implemented under the auspices of the International Monetary Fund (IMF) Extended Fund Facility (EFF) programme, Sri Lanka is beginning to see some return to macroeconomic stability – notably, a slowing of GDP contraction to -3.6% and a reduction in inflation to 17.9% in 2023 (IMF, 2023b). Growth is expected to be above 2% in 2024.

Sri Lanka has embarked on an ambitious programme of fiscal consolidation to improve debt sustainability and address fiscal imbalances. Typically, consolidation involves some combination of cutting spending or spending rationalisation, debt restructuring and domestic revenue mobilisation. However, each of these scenarios comes with a cost to the economy, as a result of their contractionary effects on aggregate demand (via a 'multiplier effect') and, if unsuccessful, can lead to a protracted low-growth and high-debt burden path (Stiglitz, 2016).

As the fiscal instability in Sri Lanka demands immediate action, the choice of consolidation measures and how they affect growth will be critical to achieving a speedier return to growth. Thus, ascertaining the potential fiscal multiplier – that is, the amount of additional output that can be realised from additional spending – that fiscal policy measures can generate will be crucial to inform policy decisions in this context.

This essay explores the role of fiscal spending policies and their growth impact – known as ‘fiscal multiplier’ effects. It first presents an analysis of relevant fiscal multiplier estimates in the literature in low- and middle-income country contexts and existing studies on the Sri Lanka/South Asia context. These are then applied to Sri Lanka in an exercise on growth scenarios based on fiscal multiplier effects driven by aggregate fiscal policy and disaggregated fiscal policy. The essay concludes with policy implications and suggestions for further analysis.

8.2 Issues and challenges

Fiscal challenges

Fiscal challenges have been a significant constraint to Sri Lanka’s economic development. Tax revenues have been around 10–12% GDP since the early 2000s and below average compared with other lower-middle-income countries. Just before the debt crisis, the ratio dropped significantly. The impacts of shocks, including the 2017 drought, the 2018 political crisis and the terrorist attacks in 2019, have likely contributed to low revenue performance but from 2020 revenue performance took a clear downward turn, to around 7.5% of GDP, reflecting poor policy choices as well as the economic effects of COVID-19. A reduction in income and value-added taxes in 2019 contributed to estimated tax revenue losses exceeding 2% of GDP (IMF, 2023a). Public spending has remained higher than tax revenues, contributing to persistent fiscal deficits, averaging 6% in 2016–2019 (Beyer and Milivojevic, 2021).

These persistent deficits have culminated in low fiscal space, high debt burdens and low reserves, constraining productive public investment and hampering the country’s ability to respond to shocks. Because of these fundamental

vulnerabilities, the economic ravages induced by the COVID-19 pandemic and the Russia–Ukraine war led to an economic crisis.

Ongoing policy reforms under the IMF EFF seek to alleviate these macro-fiscal challenges to support economic recovery via an ambitious fiscal consolidation to restore fiscal and debt sustainability – specifically, maintaining spending at current (or slightly elevated) levels in real terms and expanding the domestic revenue-to-GDP ratio, bringing the fiscal deficit down and the primary balance into surplus.

Crucially, the emphasis on domestic revenue mobilisation is underpinned by unprecedented revenue targets – an increase in the tax-to-GDP ratio from 7.3% in 2022 to 14% in 2025 (IMF, 2023b). Part of this expansion is to be achieved by restoring earlier tax cuts of 2019 to their original rates, but then to generate an additional 2–3 percentage points of GDP within two years, including by raising rates of VAT, personal and corporate income tax; reducing the VAT registration threshold; removing VAT exemptions; and introducing a Social Security Contribution Levy. Revenue reforms introduced in 2022 and 2023 are yielding positive outcomes, with tax as a percentage of GDP rising from 7.3% in 2022 to an estimated 9.2% in 2023 (IMF, 2023b).

Despite the success in increasing tax revenue, there are already indications that the pace and scale of economic recovery have been affected. Industry contracted 9.2% in 2023 on the back of contractions in manufacturing (3.2%) and construction (20.8%). Additionally, weak domestic demand as a result of higher prices and tight fiscal space has contributed to contractions in private consumption (1.6%) and government consumption (5.4%), as well as gross capital formation (7.9%) (ADB, 2024).

This is likely to add to pressures against further revenue expansion, and fiscal consolidation challenges overall. Revenue collections from the first quarter of 2024, following a further increase in the VAT rate to 18% and other measures (effective January 2024), indicate that tax revenues are currently on track to reach the projected target of 12.1% (Government of Sri Lanka, 2024). Nonetheless, historically, revenues in Sri Lanka have underperformed against targets. It is also likely that, after the low-hanging fruit in terms of revenue measures has been delivered, it will be increasingly difficult to achieve the further 2 pp expansion in tax revenue needed to reach the 2025 target. Historically, such rates of expansion are unprecedented in low- and middle- income countries; even annual targets of 0.5 pp are highly ambitious, and potentially counterproductive to the tax administration (Gallien et al., 2024).

In the case that revenue targets are not met, and with limited borrowing options, the fiscal consolidation would need to come from expenditure cuts. This poses additional challenges for growth, in that, typically, in the face of spending squeezes, capital expenditure cuts are prioritised over recurrent spending (e.g. on wages). Without sustained, robust economic growth, the pace and scale of the recovery could be slow or not realised at all, potentially worsening the fiscal challenges. Hence, there is a need for a better understanding of alternative policy combinations that can hasten the pace and scale of economic recovery. We explore these options using empirical evidence on fiscal multipliers in South Asia, complemented with an analysis of historical revenue data for Sri Lanka, to create scenarios reflecting the potential impact of alternative policy combinations on growth.

Fiscal policies multipliers in the context of South Asia

Fiscal multipliers typically refer to the quantifiable effect on economic output (GDP) of a unit of a specified fiscal policy (usually the value of total public spending, or by type of spend) over a given time period (see Batini et al., 2014; Raga, 2022). The fiscal multiplier will be equal to 1 if an additional unit of spending has no reduction or additional effect on other components than GDP. A multiplier of greater than 1 implies that \$1 of additional public spending leads to a more than \$1 boost to national income. Multipliers can also be negative, or lie between 0 and 1. Alternatively, fiscal multipliers can be measured against the effect of a policy on other economic variables, such as trade and employment. Estimates can also vary according to whether the multiplier is applied during fiscal expansions or fiscal consolidation.

Fiscal multipliers are likely to be highly context-specific, since they are affected by the size of the state and the level of income or development (most notably, the consequent efficiency and effectiveness of public spending). Ideally, then, fiscal multipliers should be estimated for Sri Lanka. In the absence of detailed analysis, at this stage we consider the best fit for Sri Lanka.

Specific estimates of fiscal multipliers for Sri Lanka in the literature are few. Instead, most estimates are from studies that include Sri Lanka in a sample of developing or emerging economies or the South Asian region. In this context, fiscal multipliers for the South Asian region have been estimated to range from around 0.2 to 0.4 in the short run and 0.3 to 0.6 in the long run (Hayat and Qadeer, 2016; Beyer and Milivojevic, 2021). These estimates have significant implications. They suggest that, on average, an additional \$1 of government spending can lead to an immediate

increase in GDP of \$0.20 to 0.40. Furthermore, this effect can persist in the long run, with an increase in GDP ranging from \$0.30 to \$0.60 for every additional \$1 of government spending.

The findings of these studies accord with the fiscal multiplier of 0.3 (see (IMF, 2016) estimated for emerging markets. This is the multiplier used in the recent IMF macroeconomic projections for Sri Lanka (IMF, 2023b). Fiscal multipliers computed for a sample of countries, even if Sri Lanka is included, find average estimates, and are unlikely to account for heterogeneity across countries. Such heterogeneity can influence the output implications of fiscal policies.

One empirical study of Sri Lanka-specific fiscal multipliers (Gaiha et al., 2009) estimated the output per capita response to changes in public expenditure (rather than the more traditional aggregate GDP response). The authors found a positive but insignificant elasticity of per capita income growth to total public expenditure (0.02 to 0.11) for Sri Lanka. In their findings, non-infrastructure public spending has negative impacts on per capita growth (-0.12 to -0.14). This study does not use recent data, which implies it does not reflect recent economic trends in Sri Lanka. Additionally, the study does not cover in depth the distinction between capital expenditure (including non-infrastructure forms of capital) and current spending, and does not include taxes in the estimates of fiscal multipliers, which can be policy-relevant.

The composition of the fiscal package influences the efficacy of the fiscal multiplier. Productive investment spending can have enormous long-term effects on output, while the impact of consumption spending can be, at best, short-lived. Similarly, tax measures that increase income and corporate taxes can be detrimental to growth,

unlike less distortive measures like taxes on immovable capital. Against this background, the output-enhancing effect of fiscal policies in South Asian countries comes entirely from productive capital spending instead of recurrent spending and tax increases (Beyer and Milivojevic, 2021).

For our analysis of scenarios on the growth implications of combinations of fiscal measures for Sri Lanka (presented below), we therefore draw on estimates of fiscal multipliers from a study that accounts for fiscal policies that distinguish between public investment and consumption, implemented amid fiscal consolidation (Cavallo et al., 2022). We rely on fiscal multipliers estimated for a sample of 44 developing countries. The study's findings show that fiscal consolidation leads to a reduction in real GDP of 0.4%, but safeguarding public investment during consolidation, vis-à-vis public consumption, can neutralise the contractionary effect and even spur growth. This is the first indication that the type of fiscal spending matters for growth.

Growth scenarios

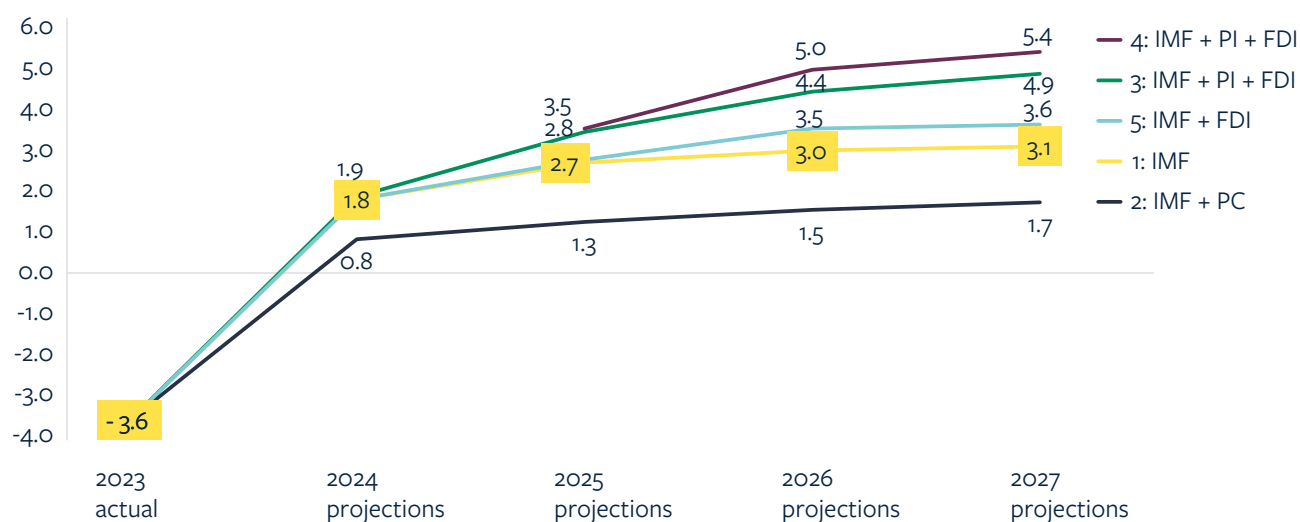
In this essay, we explore a growth scenario exercise projecting the growth impact of fiscal policy options by using existing fiscal multiplier estimates from the literature that are closely related to Sri Lanka's context, particularly Hayat and Qadeer (2016) and Cavallo et al. (2022). We present the following scenarios:

1. Scenario 1 (based on the IMF's restricting programme): The scenario exercise begins by using the latest macroeconomic projections under a debt structuring scenario for Sri Lanka in IMF (2023b). This will be referred to as the baseline scenario.
2. Scenario 2 (revenue shortfall, cutting public investment and protecting consumption,

- PC) assumes that Sri Lanka will not meet its revenue targets, with an annual revenue shortfall of 2% of GDP from the baseline scenario between 2024 and 2027. The shortfall is based on Sri Lanka's historical performance, where actual revenue performance fell short by 2% of GDP from budget speech targets between 2015 and 2023. It is assumed that Sri Lanka may be unable to access international capital markets and may opt not to borrow domestically to protect debt sustainability. In this context, the revenue shortfall is assumed to translate to lower public investment expenditures, while public consumption is protected. This is close to Sri Lanka's historical performance, where public consumption is always higher than budget targets; inversely, public investment is always lower than budget targets. In effect, this scenario assesses the multiplier of fiscal consolidation by protecting consumption while penalising public investment.
3. Scenario 3 (revenue shortfall but protecting public investment, PI) assumes that Sri Lanka will not meet its revenue targets (as in Scenario 2). While this translates to lower public expenditure, the expenditure cut will come mainly from lower public consumption, and public investment will be protected. Public investment is assumed to be protected when the ratio of public investment to total public spending increases during the fiscal consolidation period, following the approach of Cavallo et al. (2022). We utilise the fiscal multiplier size estimates of Cavallo et al. (2022) and lower the effect by 20% in recognition of absorptive capacity/institutional inefficiency for public investment as cited in Asea (2016). In this, this scenario assesses the multiplier effects of fiscal consolidation while protecting public investment.
 4. Scenario 4 (revenue shortfall but protecting investment, PI, + foreign direct investment, FDI) assumes that Sri Lanka will still have revenue shortfalls but will protect public investment (i.e., Scenario 3) but in addition will attract FDI worth 0.2%, 1.6% and 1.4% of GDP in 2025, 2026 and 2027, respectively. These amounts are based on recently approved projects – in particular, the secured \$533 million in US funding for the Adani project and the \$4.5 billion (Chinese) Sinopec refinery investment. The financing for the Adani project is assumed to be spread over 2025 and 2026; the Sinopec refinery investment is assumed to be spread over 2026–2028.
 5. Scenario 5 (IMF + FDI) assumes that Sri Lanka follows the IMF programme but also includes the FDI effects from Scenario 4.
- Meta-analysis by Bruno et al. (2018) suggest a positive correlation between FDI and growth, although Bénétrix et al. (2023) suggest that this relationship is less stable than initially thought (e.g. because of other mediating factors such as absorptive capacities, as well as bargaining power of multinational corporations). Evidence is even more scarce of estimates of FDI multiplier effects on growth. Baiashvili and Gattini (2020) estimate that a 1 pp increase in the FDI-to-GDP ratio leads to a 0.2 pp increase in GDP growth per capita. In China's context, it is estimated that a 1 pp increase in FDI contributes 0.4 pp of growth on impact (Tseng and Zebregs, 2002). These estimates are somewhat close to the fiscal multiplier effect of public investment. In this regard, this scenario utilises the public investment (fiscal stimulus) multiplier estimates in the South Asia context of Hayat and Qadeer (2016).

Figure 8.1 presents the growth impact projections generated by the fiscal multiplier assumptions based on the above scenarios. These illustrate how, even with a revenue shortfall, the choice of associated spending cut could be crucial to the growth impact over the medium term.

Figure 8.1 Fiscal multiplier scenarios: growth impact of fiscal policy options



Source: Authors

Results and policy implications

Under the baseline scenario, annual year-on-year growth is expected to reach 3.1% over the medium term, based on a fiscal consolidation underpinned by revenue mobilisation and debt restructuring. Given that multiple revenue measures have already been introduced and, historically, revenue targets have most often not been met, Scenario 2 considers the implications of a revenue shortfall, in which spending cuts are made to maintain the fiscal balance and debt targets but while protecting recurrent spending or consumption, PC (and therefore cutting public investment). This scenario has a lower-growth outcome, reaching only 1.7% over the medium term, reflecting the weaker multiplier effect of public consumption on growth compared with public investment.

By contrast, under the same revenue shortfall situation, Scenario 3, which assumes that the spending cut comes instead from public consumption and protects public investment (PI), has a higher growth outcome even than the baseline, with the revenue target being met. Under this scenario, annual growth reaches 4.9% by 2027. Scenario 4 builds on this and illustrates how growth may be expanded further to 5.4% under the same circumstances and policy choices but also by attracting FDI through the choice of public investment projects most likely to stimulate investment. Scenario 5 then assumes no spending cuts but simply adds attracting FDI to the IMF programme; this leads to 3.6% rather than 3.1% growth in 2027.

While these scenarios are illustrative only, given that fiscal multipliers are likely to be

highly context-specific and we do not have detailed estimates for Sri Lanka, the modelling demonstrates how fiscal policy choices matter during a debt restructuring and fiscal consolidation process. In practice and historically for Sri Lanka, this has led to the cutting of capital projects in favour of the more politically sensitive public consumption spending (mostly on wages and on goods and services). We can see that the type of spending can lead to a difference between an estimated 1.7% GDP growth (when public consumption is protected) to an estimated 4.9% GDP growth (when public investment is protected).

Cavallo et al. (2022) argue that such results are consistent with existing explanations in the literature. For example, protecting public investment during crises creates incentives for expanding private investment. Public investment directly improves the productive capacity of the economy by increasing the marginal product of private capital and labour, generating a crowding-in on private investment. Further, by cutting politically sensitive consumption spending (e.g. public wages) rather than productive investment, governments can signal a credible commitment to long-term growth trajectories.

Further work to understand the specific fiscal multipliers for Sri Lanka is needed – in particular on how the impact on growth varies by type of fiscal policy under fiscal consolidation, including revenue versus spending, and by type of spending (wages, goods and services, capital projects) as well as FDI. The multipliers assumed in this exercise rely on the assumption that capital projects are well designed and executed. Yet, in lower-capacity environments like Sri Lanka, the efficiency and effectiveness of public investment management is compromised,

as is the quality of the pipeline of capital projects. Further assessment of the quality and efficiency of public investment is needed to make it possible to assess the relative scale of fiscal multipliers between public investment and consumption, to enable a fuller understanding of the most cost-effective fiscal policy choices under these circumstances.

Further and important refinement can come from exploring the effects of investing in different sectors. There could be more emphasis on stimulating specific types of sectors or projects depending on the following types of analysis (McMillan et al., 2017):

- cost-benefit analysis
- input-output and multiplier analysis
- Revealed Comparative Advantage analysis
- Hausman product space
- and others.

8.3 Conclusions

While further research is needed to determine the specific fiscal multipliers for Sri Lanka, the modelling in this essay illustrates the importance of considering multiplier effects of different categories of fiscal spending. Where resources are limited, understanding how to make the greatest positive impact on economic growth from the options available across public consumption and investment is crucial. There should be more awareness of the growth effects of different public spending categories. Efforts to ensure this should include capacity-building on economic assessment techniques such as cost-benefit analysis, input-output and multiplier analysis, Revealed Comparative Advantage analysis, Hausman product space and others.

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Part 3: Trade and foreign direct investment



9 Sri Lanka's FTAs and the pathway to RCEP

Sirimal Abeyratne

Summary

This essay looks at Sri Lanka's pathway to join the Regional Comprehensive Economic Partnership (RCEP) and explores its opportunities and challenges. Sri Lanka has a long history of being a contracting party to multilateral and regional trading arrangements, including repeated attempts to join the Association of Southeast Asian Nations (ASEAN) since its inception. However, the country has not experienced a steady and consistent journey towards global integration through policy reforms and trading arrangements. The proposed accession to RCEP is expected to open unprecedented opportunities to benefit from integration with the world's largest free trade area (FTA) – ASEAN+1FTA. Nevertheless, Sri Lanka, having not undergone a steady unilateral policy reform process in the recent past, and having also recently faced economic crisis, will have to overcome the painful adjustment costs of integration with countries that have already adopted reforms.

9.1 Introduction

RCEP, which became effective on 1 January 2022, opened the room for new members to enter from 1 July 2023. Sri Lanka then became the first country to submit a Letter of Intent to the ASEAN Secretariat to join, on 28 June 2023. In the recent past, Sri Lanka has exhibited a renewed enthusiasm to enter FTAs; during the period 2005–2022 it had adopted a lukewarm approach to doing so.

Given the unprecedented economic crisis in the country from 2022, there is an urgent need for Sri Lanka to unlock its export-oriented growth potential; this has been clearly revealed by the country's own experience (Abeyratne, 2023; Wignaraja, 2024). In this respect, trade and investment opportunities resulting from joining RCEP – the world's largest free trade area – are expected to be unparalleled. There are, however, also challenges, arising mostly as a result of the country's slow pace of reform, particularly during the second half of its liberalisation period.

This essay explores Sri Lanka's FTAs and the pathway to RCEP, looking at both the opportunities and the challenges. It proposes that, in order to reap the benefits of joining RCEP, Sri Lanka needs to establish an enabling business environment by accelerating the country's unilateral reform process so it can unlock export-oriented growth potential and minimise painful adjustment costs.

9.2 Trade agreements: Sri Lanka's twists and turns

Since its independence in 1948, Sri Lanka has supported global free and fair trade. In the same year, it became a member of the General Agreement on Tariffs and Trade and was a founding member of the World Trade Organization (WTO) in 1995. Nevertheless, during 1956–1977, economic policy-making in Sri

Lanka was caught up in the contemporary global whirlpool, which pushed it into being an import-substituting regulated economy.

It was in this context that Sri Lanka became a founding member of the Bangkok Agreement in 1975, later renamed the Asia-Pacific Trade Agreement (APTA). This is one of the oldest regional preferential trading arrangements in the world, coming into being at a time when there were only nine such trade agreements in force, as per the WTO database. APTA was founded by five nations – Bangladesh, India, Laos, South Korea and Sri Lanka; China and Mongolia later became members.

Integration within South Asia

Sri Lanka's integration with its South Asian neighbours commenced in 1985 with the establishment of the South Asian Association for Regional Cooperation (SAARC) by the seven nations in South Asia: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Initially, all the SAARC member states except Sri Lanka remained 'closed economies,' so SAARC focused not on trade relations but rather on technical cooperation and socioeconomic issues in the region. As globalisation swept across South Asia, with policy reforms towards trade liberalisation taking place from the early 1990s, SAARC countries began focusing on economic cooperation and trade among themselves. The first regional initiative was the SAARC Preferential Trading Arrangement in 1995. The primary objective of this was to promote and sustain mutual trade and economic cooperation among the member states through preferential arrangements related to tariffs, para-tariffs, non-tariff measures and direct trade measures.

Ten years later, in 2005, the South Asian Free Trade Area (SAFTA) was established, with an objective to promote and enhance mutual trade and economic cooperation among the SAARC member states. SAFTA focused on eliminating trade barriers, promoting fair competition, creating an implementation mechanism for this Agreement and establishing a framework for further cooperation and integration within the SAARC region.

Sri Lanka had already advanced along its unilateral trade liberalisation agenda ahead of other South Asian countries, mainly through two stages of policy reforms, first in 1977 and second in 1989. As a result, Sri Lanka was able to complete the liberalisation of its current account transactions in 1993 and was eligible to meet the Article VIII obligations of the International Monetary Fund (IMF). Accordingly, as the first country in South Asia to adopt an open economy model, and with the most open economy in the region at the time, it was not a difficult task for Sri Lanka to adjust to the regional and bilateral efforts needed for integration in South Asia.

Interestingly, SAARC made little progress beyond SAFTA, which was a regional FTA limited to trade in goods. The Report of the SAARC Group of Eminent Persons, established by the Ninth SAARC Summit in 1997, on the SAARC Vision beyond the Year 2000, had proposed a 20-year timeline (2000–2020) to achieve higher levels of South Asian integration in stages. Within this, it was envisaged, after establishment of SAFTA in 2005, to form a South Asian Customs Union by 2015 and a South Asian Economic Union by 2020. A customs union is a free trade area among member countries with common tariffs plus non-tariff barriers against their trade with non-member countries, whereas an economic union allows free movement of capital and labour and requires

harmonisation of macroeconomic policies. But little progress was made by SAARC member states towards regional integration beyond SAFTA. It is thus not surprising that South Asia remains one of the least-integrated regions in the world, with countries working more with western advanced countries than with their neighbours.

Integration through bilateral agreements

Against the slow pace of regional integration under SAARC, Sri Lanka moved fast by signing two bilateral FTAs, one with India in 2000 and the other with Pakistan in 2005. While these two FTAs are still the only effective bilateral FTAs within South Asia, they are also limited to merchandise trade, with restrictions through rules of origin and lists of sensitive imports between the member countries. The two agreements left SAFTA redundant with respect to Sri Lanka's trade with India and Pakistan while keeping it effective for bilateral trade with other South Asian countries.

Sri Lanka's trade with its South Asian neighbours is overwhelmingly dominated by the country's bilateral trade with India. About 29% of Sri Lanka's total imports originate from the South Asian region, with India alone the source market for about 25%. In fact, India was Sri Lanka's largest single source market for imports for a long time, although in some years in the recent past it was overtaken by China. Exports from Sri Lanka to the South Asian region remain at under 10% of its total exports; exports to India account for more than half of this.

However, it would be incorrect to conclude that Sri Lanka's strong trade relations with India are an outcome only of the country's bilateral FTA with India. Indeed, bilateral trade under the Sri Lanka–Pakistan FTA did not result in any significant trade creation between the two countries (Abeyratne,

2012). The evidence suggests that the presence of natural trade flows, enhanced by liberalisation policy reforms in both India and Sri Lanka, was an important factor in bilateral trade expansion before and after entering the FTA.

Subsequently, there were several attempts to extend Sri Lanka's two bilateral FTAs in the region to cover services trade, through the respective Comprehensive Economic Partnership Agreements (CEPAs). The India–Sri Lanka CEPA was proposed in 2003; this failed to come to the signing stage. Another, named the Economic and Technical Cooperation Agreement, was proposed in 2015 but is still under negotiation. The Pakistan–Sri Lanka CEPA was proposed in 2008. This attempt was not successful, mainly because of public protests in both countries and Sri Lanka's policy reversals deviating from trade liberalisation, particularly during the period 2005–2015. At the same time, Sri Lanka expressed its willingness to sign an FTA with China but the preparation process for this came to a standstill after several rounds of negotiations, commencing in 2014. Although there have been discussions about commencing new FTAs with some of the Southeast Asian countries, these have not reached signing stage. An FTA with Singapore was signed in 2018, although implementation remained suspended until 2023.

Crisis-led new FTAs

Sri Lanka's economic crisis in 2022 had a significant impact on the country's policy perspectives and political attitudes towards trade agreements. The collapse of the economy was triggered by a series of external shocks and domestic policy issues, although the crisis had built up slowly as a result of the country's anti-export bias over the past 20 years. As a result, it became clear that Sri Lanka needed to strengthen

its export-oriented growth momentum if it was to strengthen its economic stability, debt sustainability and economic progress beyond recovery. It was in this context that a new chapter on Sri Lanka's FTAs opened; apparently, the crisis has created this opportunity.

The suspended Singapore–Sri Lanka FTA was brought back into implementation in July 2023 and a new FTA, with Thailand, was signed in February 2024. These two bilateral FTAs are significantly different from Sri Lanka's former bilateral FTAs with India and Pakistan, given their wider coverage and deeper integration, beyond the premises of merchandise trade. Both new FTAs cover trade in goods, trade in services, investment, and economic and technical cooperation; the FTA with Singapore incorporates government procurement as well. With respect to trade in goods, under both FTAs, immediate elimination of tariffs is applied on half of tariff lines, while tariff phasing-out periods have been scheduled for the rest of the tariff lines at 12 years under the FTA with Singapore and 15 years under the FTA with Thailand. Tariff elimination and phasing-out schedules have little bearing on Singapore, which has only four tariff lines subject to border tariffs. With regard to restrictions stipulated, the FTA with Singapore includes a list of sensitive imports on 20% of tariff lines and rules of origin with 30% domestic value addition. Similarly, the FTA with Thailand includes a sensitive list on 15% of tariff lines and rules of origin with 40% of qualifying value content.

In terms of services trade, both FTAs allow all four modes of trade in services – namely, cross-border supply, consumption abroad, commercial presence and presence of natural persons linked with investment projects. The provisions in both FTAs allow trade in services free of regulatory

barriers in most non-sensitive areas, such as business services (including professional services, computer services, research and development, and rental and leasing), telecoms, construction, distribution, education, environment, tourism and transport. Inward and outward foreign direct investment, including joint ventures, is permitted through the FTAs in any areas other than agriculture, fisheries, forestry, mining and quarrying, real estate, arms and explosives, and traditional handicrafts. A wide range of areas are open for economic and technical cooperation. These include, but are not limited to, construction, customs, energy, environment, finance, intellectual property rights, trade and investment, manufacturing, science and technology, small and medium enterprises (SMEs), transport and infrastructure, tourism and urban solutions.

At present, both Singapore and Thailand do not appear to be significant destination markets for Sri Lanka's exports, although Singapore is important as one of Sri Lanka's source markets for imports. Sri Lanka has a bilateral trade deficit with both countries, which may not turn to a trade surplus as a result of the respective FTAs. More importantly, what is expected from an FTA is the promotion of trade and investment, rather than its balancing bilaterally. It is in this respect that, for the first time, the broader coverage and deeper integration through the two FTAs are important for Sri Lanka. Moreover, for the third time, the government is now in the process of preparing proposals for extending its FTA with India to also cover trade in services and investment. The government has also resumed its work on the proposed FTA with China. In addition, preparations are underway for several new bilateral FTAs with Southeast Asian countries, including Indonesia, Malaysia and Vietnam.

9.3 The road to the Regional Comprehensive Economic Partnership

Interestingly, Sri Lanka's interest in joining ASEAN dates back to the time of its establishment in 1967. It was announced at the inaugural meeting of ASEAN in Bangkok on 8 August 1967, as per details reported by Singapore's sixth president, S.R. Nathan, in his memoirs in 2011. Malaysian Prime Minister Tunku Abdul Rahman had promised then-Prime Minister of Ceylon (Sri Lanka) Dudley Senanayake that Sri Lanka's could be admitted to ASEAN. Given the foreign policy interests of Sri Lanka at the time, which aligned well with ASEAN's anti-Communist and pro-western stance, the founding member states of ASEAN were as ready to welcome Sri Lanka too as a founding member, despite it falling outside the geographical boundary of Southeast Asia. The foreign ministers of the founding five nations – Indonesia, Malaysia, the Philippines, Singapore and Thailand – awaited Sri Lanka's response – but it was Sri Lanka itself that then kept silent.

Later, it was reported that Sri Lanka's desire to join ASEAN had come under pressure, internally from the leftist parties in the country and externally from China, India and the Soviet Union. Some non-aligned nations also felt that Sri Lanka, which was an active founding member of the Non-Aligned Movement founded in 1961, would be giving up its non-aligned status in joining ASEAN. On 8 August 2023, President Ranil Wickremesinghe, at the 56th ASEAN Day at the Embassy of Indonesia in Colombo, said that 'turning down the opportunity to join ASEAN led to a period of socialist economic policies and limited capital formations, hindering the country's growth potential' (Presidential Secretariat, 2023).

The objectives of ASEAN were to accelerate economic growth through trade and investment, social progress and cultural development in the spirit of equality and partnership in order to strengthen the foundation for a prosperous and peaceful community of Southeast Asian nations. Subsequently, ASEAN expanded its membership to 10 countries by admitting five more Southeast Asian nations: Brunei Darussalam (1984), Vietnam (1995), Laos (1997), Myanmar (1997) and Cambodia (1999). Accordingly, ASEAN is a regional association of diverse nations that are coordinating and collaborating for a common set of objectives. It consists of countries with different sized populations and economies at different stages of development. The member states range from high-income countries such as Brunei, Malaysia and Singapore to low-income countries such as Cambodia, Laos and Myanmar; the other four states are middle-income countries. As a whole, ASEAN with over 679 people, accounts for 8.5% of the world population, 3.6% of global gross domestic product (GDP) and 7.8% of exports.

Given the large size of the market and its remarkably high export orientation and trade openness, ASEAN offers a potentially lucrative market for trade and investment opportunities for emerging market economies in the region. Sri Lanka embarked on its own trade liberation after 1977, in a programme led by President J.R. Jayewardene, who admired ASEAN and had close relations with Singapore and some other Southeast Asian nations. In 1981, Prime Minister R. Premadasa went on an official ASEAN tour in Indonesia, Malaysia, the Philippines and Thailand, expressing in Manila Sri Lanka's willingness to be a member of ASEAN (de Silva, 1981). His tour and statement appeared to be the result of discussions at home, particularly with his superior, President Jayewardene, who was keen on regional integration. There were, however, obstacles to

Sri Lanka's move. In the early 1980s, geopolitics in the Indian Ocean were still dominated by pro-Communist and anti-western ideology that was aligned with the Soviet Union, with Sri Lanka trying to go against these currents. Almost at the same time, in response to the proposal of Bangladesh for a regional association in South Asia, Sri Lanka hosted the South Asia Forum, which ran a series of meetings to form SAARC in 1985.

The major obstacle to Sri Lanka's potential membership of ASEAN again related to its geographical location: Sri Lanka was not a Southeast Asian country. This did not appear to be a binding constraint at the beginning. Singapore's Deputy Prime Minister S. Rajaratnam was reported to have said that 'Sri Lanka cannot be a full member of ASEAN on account of its location in South Asia' but suggested it could become an 'Observer' or 'Dialogue Partner' (de Silva, 1981). However, the ASEAN Charter, as adopted at the 13th ASEAN Summit in 2007, included a clause restricting membership to countries located geographically in Southeast Asia, removing any hope of Sri Lanka joining in the future.

Sri Lanka did not give up on its 40 years of effort, however, joining the ASEAN Regional Forum and ASEAN's Treaty of Amity and Cooperation in 2007. In order to widen and deepen relations with external parties, ASEAN introduced different categories of formal status to such parties, including Dialogue Partner, Sectoral Dialogue Partner and Development Partner. The nations playing an influential role in Indian Ocean geopolitics, such as China, India and Russia, as well as the US, have already become ASEAN Dialogue Partners. In a renewed attempt to strengthen economic integration and cooperation with ASEAN, Sri Lanka applied for Sectoral Dialogue Partnership in 2019.

Renewed opportunity with RCEP

After eight years of preparation, RCEP was signed on 15 November 2020 at the virtual ASEAN Summit hosted by Vietnam in the midst of the global COVID-19 pandemic. It became effective on 1 January 2022. This is an FTA among the 10 ASEAN member countries and five ASEAN-FTA partner countries – namely, Australia, China, Japan, New Zealand and South Korea. From 1 July 2023, other countries in the Asia-Pacific region could accede to RCEP – an opportunity that Sri Lanka grasped quickly, sending a Letter of Intent to the RCEP Secretariat to be the first country to do so.

RCEP with the 15 nations is intended to move forward a step, allowing for further integration above and beyond individual FTAs with ASEAN, known as ASEAN+1FTA. It has been formulated with a broader and deeper coverage of trade and investment and their complementary areas among member states, with provisions for flexibility to customise negotiations as per the needs of individual countries. As stated in the Agreement, it is expected to broaden and deepen economic integration, strengthen economic growth and equitable economic development and advance economic cooperation, to create employment opportunities, raise living standards and improve the general welfare of the peoples in member states. It seeks to establish clear and mutually advantageous rules to facilitate trade and investment, including participation in regional and global supply chains, by building on respective rights and obligations as per WTO norms and existing ASEAN FTAs.

The RCEP Agreement takes into account the need to maintain appropriate flexibility and provide special and differential treatment, considering

the different levels of development among the different contracting parties and affirming the right of each party to regulate in pursuit of its own public welfare objectives. It also recognises the importance of good governance and a predictable, transparent and consistent business environment leading to the improvement of economic efficiency and the development of trade and investment. Further, it emphasises sustainable development, acknowledging the important role of economic partnership in this, as well as the need for agreements and arrangements to accelerate trade and investment liberalisation and their role in strengthening the open, free and rule-based multilateral trading system.

The objectives in the RCEP Agreement are to establish an economic partnership framework, to progressively liberalise trade in goods and services and to create a liberal, facilitative and competitive investment environment in the region. Negotiations under RCEP cover trade in goods, trade in services, investment, economic and technical cooperation, intellectual property, competition, dispute settlement, e-commerce, SMEs, government procurement and other related areas. Accordingly, it presents a comprehensive framework of liberalisation in the areas of trade in goods and services, and investment flows covering their liberalisation, promotion, facilitation and protection. Further, it covers related laws and regulatory mechanisms addressing even the most up-to-date areas of emerging issues, such as intellectual property and e-commerce. The level of integration and liberalisation envisaged through RCEP therefore goes well beyond typical trade agreements confined merely to trade and investment. The comprehensive and progressive nature of the RCEP agenda is important for the smooth advancement of integration and liberalisation, to ensure mutual benefits for the contracting

parties, maximise the scope to reinforce the positive outcomes and minimise the scope for increased adjustment costs.

Sri Lanka's potential through RCEP

From the Sri Lankan point of view, an FTA with RCEP is likely to be stronger and more comprehensive than any other FTA that the country has so far signed. It would be wider and deeper in terms of the scope of coverage beyond trade and investment, extending into laws and regulations affecting business, economic and technical cooperation, intellectual property rights, e-commerce, SMEs and government procurement. Sri Lanka's most recent bilateral FTAs, with Singapore and Thailand, have incorporated some of the above areas, but an FTA with RCEP would be expected to extend beyond this. However, RCEP, being a multilateral arrangement with different agreements, maintains flexibility and allows for customised negotiations between potential candidates such as Sri Lanka and the individual RCEP member states.

What is more important for Sri Lanka is the potential benefits of an untapped large market. This is the world's largest 'free trade area,' accounting for about 30% of the world's population, 30% of ITS GDP and 30% of its exports (Table 9.1). As the fastest-growing region in the world economy, RCEP also comprises a rapidly expanding middle-income population segment. It would potentially constitute the basis for unprecedented demand for both consumption and business for a newcomer like Sri Lanka. RCEP covers the richest countries in the Asia-Pacific region – Australia, New Zealand, Japan, Singapore and South Korea – and high-performing emerging markets – China, Indonesia, Malaysia, Thailand and Vietnam. Accordingly, it provides an unprecedented opportunity for

market access that permits trade expansion, potentially providing benefits from economies of scale. For an individual country like Sri Lanka, it is important to enter a multilateral FTA with free access to such a massive market because the possibilities for trade creation are often

greater than those for trade diversion; the former is an advantage of an FTA and the latter a disadvantage. In this respect, a multilateral FTA with a large market is expected to bring more benefits to contracting partners than will their bilateral FTAs.

Table 9.1 Economies of ASEAN and RCEP, 2022

	Population (million)	GDP (\$ billion)	GDP per capita (\$)	Exports (\$ billion)
Brunei Darussalam	0.4	16.7	37,152	14.2
Cambodia	16.8	29.5	1,760	22.5
Indonesia	275.5	1,319.1	4,788	292.0
Laos	7.5	15.5	2,054	8.2
Malaysia	33.9	407.0	11,993	352.5
Myanmar	54.2	62.3	1,149	17.1
Philippines	115.6	404.3	3,499	78.9
Singapore	5.6	466.8	82,808	515.8
Thailand	71.7	495.4	6,910	287.1
Vietnam	98.2	408.8	4,164	371.3
ASEAN	679.4	3,625.3	-	1,959.5
Australia	26.0	1,693.0	65,100	412.6
China	1412.2	17,963.2	12,720	3,593.5
Japan	125.1	4,256.4	34,017	746.9
New Zealand	5.1	248.1	48,419	45.1
South Korea	51.6	1,673.9	32,423	683.6
RCEP	2,299.5	29,459.9	-	7,441.2

Source: World Development Indicators

Interestingly, Sri Lanka's traditional exports markets in the west – the EU, the UK and the US – remained the same even after trade liberalisation. A primary goods-exporting country, from colonial times Sri Lanka specialised in supplying western markets with its traditional export crops – tea, rubber and coconuts. The importance of these in the export mix declined

after liberalisation owing to the expansion of apparel products, rubber products and some other manufactures, destined for the same western markets. These markets today account for over half of Sri Lanka's exports; apparel and rubber products also now account for over half of total exports. Free trade with RCEP is expected to provide an opportunity for a breakthrough

in the country's traditional export patterns in expanding and diversifying Sri Lanka's export mix and destination markets.

RCEP devotes special attention to trade expansion among its member states by strengthening global and regional supply chains that promote 'network trade' in the region. Accordingly, RCEP is expected to open up opportunities for Sri Lanka to enter this network trade by connecting to emerging global supply chains. While network trade has been the fastest-growing trade pattern in the East and Southeast Asian region in the past few decades, South Asia has poorly performed in accommodating global value chains in trade expansion (Athukorala, 2011). Sri Lanka's connectivity to these chains remains rather limited, with the supply of parts and components accounting for less than 10% of exports as well as imports. Nor has the India-Sri Lanka FTA created significant opportunities for Sri Lanka to expand its connectivity to Indian supply chains. India's trade expansion has so far been more in line with traditional trade patterns than with network trade, unlike the role played by China in East and

Southeast Asia. RCEP may have the ability to alter Sri Lanka's conventional trade pattern, which is dominated by supplying more finished products to its traditional Western markets.

As of now, however, Sri Lanka's exports to the RCEP region are at less than 10% of its total exports (Table 9.2). Sri Lanka does export to all RCEP countries other than Laos; the more important countries, taking up more than 1% of Sri Lanka's total exports, are Australia, China, Japan and Singapore. Nevertheless, most RCEP countries are important source markets for Sri Lanka's imports, producing about 40% of the country's total imports. Accordingly, Sri Lanka has a strong trade deficit with RCEP as a region as well as with its individual countries other than Australia. What is more important is to anticipate overall trade expansion as the outcome of joining RCEP rather than attempting to derive a trade surplus from RCEP. More realistically, this trade expansion will ensure economic growth, income generation, job creation and poverty reduction whether or not it leads to a trade surplus.

Table 9.2 Sri Lanka's merchandise trade with RCEP countries, 2022

	Exports		Imports	
	\$ million	% share	\$ million	% share
Brunei Darussalam	0.1	0.0	2.4	0.0
Cambodia	3.5	0.0	2.7	0.0
Indonesia	48.9	0.4	334.7	1.9
Laos	0.0	0.0	0.5	0.0
Malaysia	65.9	0.5	868.1	5.0
Myanmar	3.0	0.0	7.2	0.0
Philippines	10.6	0.1	30.5	0.2
Singapore	138.6	1.1	727.4	4.2

	Exports		Imports	
	\$ million	% share	\$ million	% share
Thailand	57.8	0.5	302.6	1.7
Vietnam	45.7	0.4	255.2	1.5
ASEAN	374.2	2.9	2,531.3	14.6
Australia	254.4	2.0	181.8	1.1
China	253.1	2.0	3,523.0	20.4
Japan	226.3	1.8	266.7	1.5
New Zealand	28.9	0.2	176.8	1.0
South Korea	83.3	0.7	237.9	1.4
RCEP	1,220.1	9.6	6,917.5	40.0
World Total	12,770.0	100.0	17,300.4	100.0

Source: Export Development Board

It is a quite peculiar trade outcome that Sri Lanka has never been able to generate an export revenue beyond \$13 billion during its liberalised trade regime of over four decades. Particularly since the turn of the century, the country's anti-export bias appears to have intensified, with an overwhelming policy focus on the domestic market and the non-

tradable sectors. As a result, the export share of GDP has continued to decline, going from around 33% of GDP in 2000 to 15% by 2010 and to 12% by 2020 (Figure 9.1). Sri Lanka needs to reverse its unsustainable non-tradable sector-biased economic growth towards tradable sector-based growth with an emphasis on trade expansion.

Figure 9.1 Sri Lanka's exports as share of GDP, 2000–2022 (%)



Source: World Development Indicators

RCEP, not a panacea

RCEP is expected to lead to an unprecedented opportunity for trade expansion and investment promotion in Sri Lanka but this will involve overcoming certain challenges. The biggest challenge that Sri Lanka has to face is its lack of reforms. This will make it difficult for Sri Lanka to connect through an FTA with a group of countries that have been pursuing reforms. There will also be a high adjustment cost, which may be politically sensitive.

The lack of reforms can be analysed from different perspectives. The first relates to the incompleteness of the reform process, with certain issues overlooked from the beginning. Although trade liberalisation has been pursued since 1977, some key areas complementary to liberalisation have not been brought onto the reform agenda. These areas include the public sector, regulatory mechanisms, state-owned enterprises, the judiciary, law and order, governance and factor markets, including labour and land laws. These have continued to function in their old fashion, creating inefficiencies with regard to economic progress and hindering potential growth.

The second perspective relates to interrupted continuity in the reform process, which came to a standstill in the mid-1990s. While Sri Lanka has carried out trade liberalisation reforms twice, in 1977 and 1989, this has been interrupted and reversed intermittently as a result of ad hoc and piecemeal policy changes.

The third perspective relates to the deliberate reversal of the reform process towards global integration and export promotion, giving an increased role to the government, which rapidly

expanded and redirected development strategy towards the domestic economy and the non-tradable sector.

Given this policy and regulatory backdrop, it is clear that Sri Lanka needs to embark upon its overdue unilateral reform process in order to accommodate the anticipated FTA with RCEP.

An inevitable result of the lack of reforms over a long period of time is the potentially high adjustment costs of integration and liberalisation through trade agreements. These costs may be even greater with respect to domestic economic activities and the SME sector. The same is true for the low-income countries that have joined RCEP, such as Cambodia, Laos and Myanmar. The RCEP Agreement recognises the problem of adjustment costs in individual countries with respect to their level of development and allows a degree of flexibility that can be maintained by the prospective candidates independently. However, an extensive use of the provisions for flexibility is likely to result in a greater degree of ‘compromises,’ and thus a foregoing of the benefits of an FTA. Moreover, lack of capacity in economic activities in a competitive environment is, perhaps, a result of regulatory barriers, high input costs, sub-standard inputs and technological standards and firms’ internal inefficiencies. It is important to focus on these areas through reforms rather than compensating for their additional costs by maintaining protective markets.

In addition to the structural reforms required to unlock growth potential, current policy responses to the crisis have created new challenges that may have economic and regulatory implications affecting the country’s business environment. As a result of the

economic crisis, Sri Lanka suffered from hyper-inflation and a sharp exchange rate depreciation, with both exerting a cost-push pressure in the economy. The government has also entered an IMF-supported reform programme aimed at restoring macroeconomic stability with debt sustainability. Policies such as tax hikes, cost-reflective energy and utility price increases and other ‘austerity measures’ aimed at fiscal consolidation have an adjustment cost, resulting in an erosion of the country’s cost advantage.

These issues are politically sensitive too, leading to intensified public and trade union protests. In the absence of a broader political consensus over the current policy response to the crisis, there are differences in opinion among different political parties, related more to the power struggle than to resolving the crisis. The economic, political and social unrest has led to increased uncertainties, damaging the stability of the business environment, already underperforming prior to the crisis. Accordingly, it is at this ‘worst time’ that Sri Lanka is choosing to enter an FTA with RCEP, compelling the economy to bear short-term adjustment costs before it can reap any benefits. The prerequisites of an FTA with RCEP are not in order, making it necessary to maintain an uneasy balance between high adjustment costs and the undermining of potential integration through the agreement.

FTAs are, in any case, considered ‘second-best options’ compared with unilateral reforms for trade liberalisation and global integration. In the absence of collective efforts towards unilateral reforms in the world in this WTO era, there is little choice for smaller emerging economies like Sri Lanka but to go for the second-best option. However, unilateral reforms and

second-best options are not alternatives but rather complementary choices – because they can reinforce each other on the one hand and minimise the ‘spaghetti bowl’ effects of FTAs on the other hand. RCEP, despite being the largest free trade area in the world, is also characterised by the biggest spaghetti bowl effects, given the numerous trading arrangements within the region and with external parties.

Sri Lanka must cope with this issue by being a contracting party to RCEP while also understanding that an FTA alone will not result in the outcomes it desires. Although ASEAN was initiated in 1967 by five Southeast Asian nations, growth performance and export expansion among these nations has remained diverse. Singapore has achieved the best performance and the Philippines the worst. The other three countries – Indonesia, Malaysia and Thailand – have shown moderate performance without much consistency over the past 50 years. The most important factor underlying these diverse economic outcomes is the unilateral reform process, within which FTAs can enhance performance.

9.4 Concluding remarks

Accession to RCEP represents the realisation of Sri Lanka’s long desire to integrate with ASEAN, although the former now represents an even wider market than the latter, comprising high-income countries and fast-growing emerging economies as well as low-income countries with greater market potential for growth in the Asia-Pacific region. Accordingly, an FTA with RCEP provides an unparalleled opportunity for Sri Lanka to accelerate its growth performance and export expansion through integrating with the world’s largest free trade area. RCEP, as a wider and deeper regional agreement than any other that Sri

Lanka has signed so far, entails greater capacity for integration, promotion and facilitation of complementary areas beyond typical trade and investment. Given the current economic crisis in Sri Lanka and the importance of the foreign exchange problem as the primary source of the crisis, unlocking the country's export potentials is not a policy option; rather, it is the way out of the crisis and the way forward beyond recovery from the crisis. Nevertheless, Sri Lanka must improve its capacity to exploit the opportunities presented through joining RCEP.

The following represent proposals for capacity improvement:

Policy and regulatory reforms: Accelerate the policy and regulatory reform process, redirecting economic activities to perform in a competitive market. This is, perhaps, the most difficult area for government, given its complexity and scope. However, this is not a choice: unilateral policy reforms are either preconditional or complementary in realising and maximising the benefits of a trade agreement.

Trade adjustment costs: It is more important to address the issue of trade adjustment costs at their source with respect to external barriers and

internal inefficiencies than to make excessive use of the RCEP allowance for flexibility. The reason that domestic industries often fail to perform in a competitive environment is not necessarily that competition is too much.

Cost-push pressure: Policy responses to the economic crisis have resulted in cost-push pressure in the economy undermining the cost advantage of industries. This is a unique issue for Sri Lanka, which has been compelled to choose the 'worst time' to join a trade agreement. The country needs to assess its cost competitiveness for businesses in the region and introduce appropriate adjustments.

Spaghetti bowl effects: Finally, FTAs themselves entail higher administrative and transaction costs arising out of their 'spaghetti bowl' effects; these additional costs need to be managed effectively. In this respect, naturally, RCEP, with diverse economies integrating as individuals with their own independent arrangements, has high additional costs. An important strategy to cope with this issue is to align Sri Lanka's integration with RCEP and its unilateral policy and regulatory reforms, narrowing the gap between the two aspects.

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10 The impact of tariff removal in proposed FTAs for Sri Lanka

Max Mendez-Parra, Yohannes Ayele and Ganeshan Wignaraja

Summary

This essay attempts to fill an important gap in the literature on economic policy in Sri Lanka by undertaking the first computable general equilibrium (CGE) model-based analysis of Sri Lanka's post-2023 thrust towards free trade agreements (FTAs) with multiple Asian countries. The results are useful to assess the impact of the removal of tariffs on those goods sectors. The findings suggest that Sri Lanka's Asian FTAs offer an opportunity for economic and efficiency gains, but the adjustment and distributional aspects need to be addressed. Policy implications include the need for more comprehensive CGE analysis, capacity-building, a trade adjustment package for losing sectors and workers, and consideration to the sequencing of FTA negotiations.

10.1 Background and introduction

After about a five-year hiatus, during 2023 Sri Lanka restarted multiple negotiations on FTAs with selected Asian countries in a bid to gain market access, ensure economic stability and promote growth (PMD, 2024). A notable achievement was the signing of the Sri Lanka–Thailand FTA in February 2024. Talks also restarted with India on a comprehensive Economic and Trade Cooperation Agreement to deepen a limited bilateral FTA, and with China on a new bilateral FTA. Furthermore, in March

2024, Sri Lanka launched talks with Indonesia on a preferential trade agreement, it plans to begin FTA talks with Malaysia and it has expressed interest in joining the Regional Comprehensive Economic Partnership (RCEP) agreement. However, there are hardly any model-based studies on how these proposed FTAs may affect the Sri Lankan economy.¹⁵

This essay simulates the economic effects for Sri Lanka of full tariff removal for both parties in the country's proposed FTAs with China, India, Indonesia, Malaysia, the Association of Southeast Asian Nations (ASEAN) 10-member grouping and the RECP 15-member grouping using a standard CGE model from the Global Trade Analysis Project (GTAP). The GTAP model is a perfectly competitive comparative static CGE model and is designed to evaluate the interregional, economy-wide impact of economic policies such as FTAs (Hertel and Tsigas, 1997). Box 10.1 later provides the model specification.

10.2 Structure of Sri Lanka's trade and tariffs

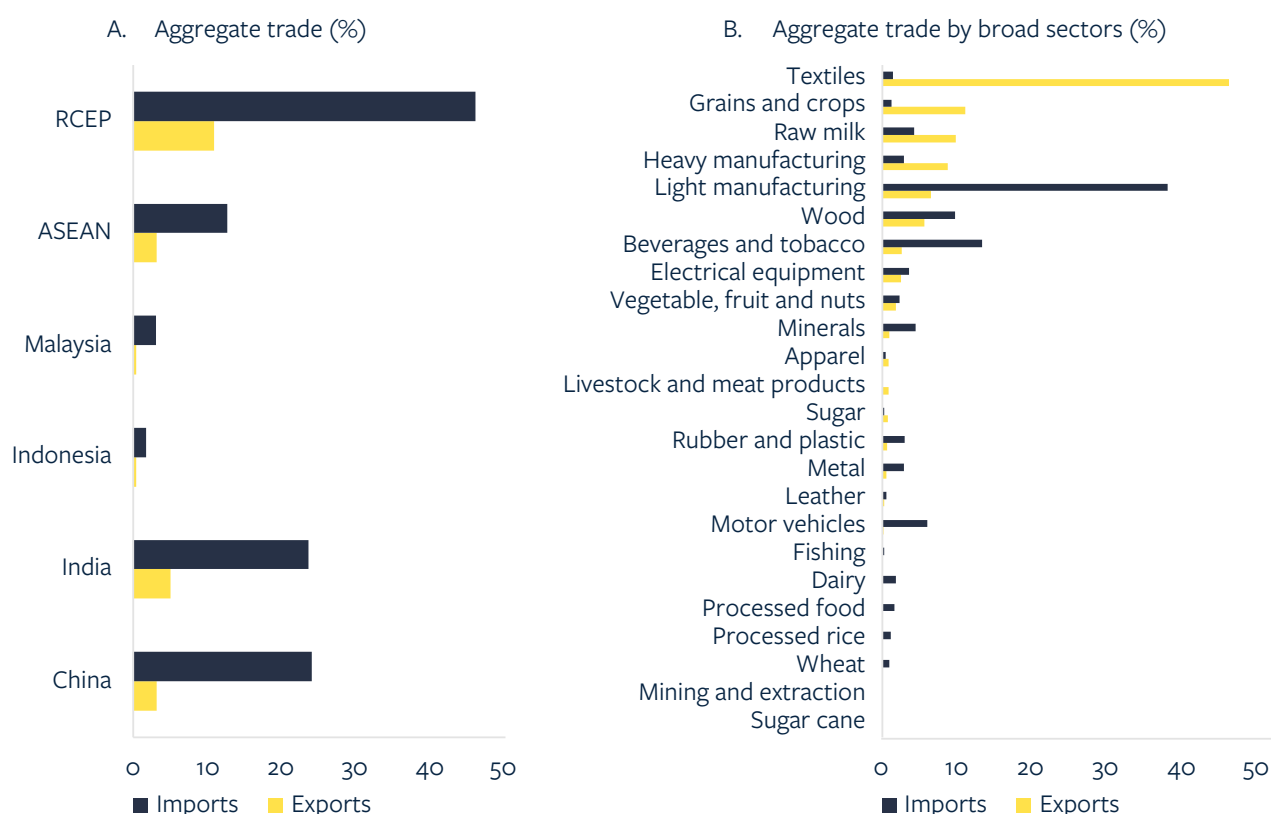
The Asian countries that are relevant for this analysis account for a small fraction of Sri Lanka's exports. Most of Sri Lanka's exports are destined for either the US or Europe, reflecting the composition of the country's export basket (Figure 10.1A). Most exports are concentrated

15 Recent studies include one by the Institute of Policy Studies on the Sri Lanka–Thailand FTA (see Wijesinghe and Rathnayake, 2023) and another by ODI on Sri Lanka's FTAs with India, China and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) (reported in Wignaraja, 2021).

in wearing apparel, grains and crops, processed food, and rubber and plastic (Figure 10.1B). These sectors account for around 75% of total exports. The picture is different in terms of imports.

Together, China and India account for half of all Sri Lanka's imports, with a higher concentration in heavy and light manufacturing, and textiles.

Figure 10.1 Sri Lanka goods exports and imports to selected countries



Source: Own calculation from GTAP Database 2017

Table 10.1 presents Sri Lankan import tariffs applied to each of the FTA partners. In general, agricultural and food products have higher duties than do manufacturing. Interesting for this analysis, duties applied on textiles and

heavy manufacturing tend to be particularly low as Sri Lanka does not have textiles and heavy manufacturing industrial capacity. This anticipates that the impact on the imports on these sectors is expected to be low.

Table 10.1 Sri Lanka's import tariffs in the model by FTA partner (%)

Sector	China	India	ASEAN	RCEP	Indonesia	Malaysia
Grains and crops	9.6	15.3	12.6	11.4	13.0	11.3
Wheat	0.0	11.5	0.0	5.8	0.0	
Vegetables, fruit and nuts	13.5	12.5	14.0	12.2	22.0	11.3
Sugar cane	0.0	0.0	15.0	15.0	0.0	0.0
Livestock and meat products	13.5	5.8	4.5	5.0	0.0	10.6
Raw milk	0.0	0.0	0.0	0.0	0.0	0.0
Mining and extraction	4.3	3.0	2.8	8.5	2.4	0.8
Fishing	15.0	13.3	3.3	6.4	0.0	0.0
Processed food	15.2	14.5	14.7	14.7	15.3	15.2
Dairy	49.5	21.0	24.7	26.2	26.4	23.7
Processed rice	25.0	23.4	15.3	16.5	0.0	0.0
Sugar	17.1	17.3	16.0	17.1	17.1	17.8
Beverages and tobacco	77.1	97.1	125.2	116.4	156.7	17.5
Textiles	1.0	0.9	1.1	1.0	0.9	1.5
Apparel	1.2	1.0	1.2	1.3	1.5	2.1
Leather	4.8	5.7	4.6	4.3	3.9	3.6
Wood	8.6	8.6	7.7	8.5	10.4	7.9
Light manufacturing	6.8	6.8	6.9	7.0	8.4	7.6
Heavy manufacturing	2.4	2.3	2.2	2.3	2.8	3.0
Rubber and plastic	11.8	11.8	11.4	11.5	12.4	12.0
Minerals	10.5	10.4	10.9	10.7	11.7	11.1
Metal	7.2	7.1	10.3	9.1	8.3	7.3
Electrical equipment	5.8	5.8	5.7	5.8	5.8	5.9
Motor vehicles	10.0	10.4	12.1	11.2	13.4	11.8
Average	12.9	12.7	13.4	13.7	13.8	7.9

Source: UNCTAD TRAINS

There is significant heterogeneity in the import tariffs applied by FTA partners to Sri Lanka's exports (see Table 10.2). But it is worth noting that China and India apply relatively high tariffs on critical Sri Lankan exported products such as wearing apparel, rubber and plastics, processed food, and grains and crops.

Table 10.2 Tariffs imposed on Sri Lankan exports by FTA partner (%)

Sector	China	India	ASEAN	RCEP	Indonesia	Malaysia
Grains and crops	10.7	23.8	6.2	13.6	8.0	0.0
Wheat	0.0	0.0	0.0	7.4	3.6	20.0
Vegetables, fruit and nuts	12.0	45.4	14.8	14.7	0.0	0.0
Sugar cane	0.0	0.0	0.0	0.0	0.0	0.0
Livestock and meat products	11.5	33.0	5.6	6.3	5.0	0.0
Raw milk	0.0	0.0	0.0	0.0	0.0	0.0
Mining and extraction	7.1	17.5	1.8	2.1	0.0	0.0
Fishing	9.1	27.5	2.6	4.0	3.8	0.0
Processed food	11.9	36.4	10.1	10.3	9.3	1.9
Dairy	49.5	21.0	24.7	26.2	26.4	23.7
Processed rice	25.0	23.4	15.3	16.5	0.0	0.0
Sugar	17.1	17.3	16.0	17.1	17.1	17.8
Beverages and tobacco	77.1	97.1	125.2	116.4	156.7	17.5
Textiles	1.0	0.9	1.1	1.0	0.9	1.5
Apparel	1.2	1.0	1.2	1.3	1.5	2.1
Leather	4.8	5.7	4.6	4.3	3.9	3.6
Wood	8.6	8.6	7.7	8.5	10.4	7.9
Light manufacturing	6.8	6.8	6.9	7.0	8.4	7.6
Heavy manufacturing	2.4	2.3	2.2	2.3	2.8	3.0
Rubber and plastic	11.8	11.8	11.4	11.5	12.4	12.0
Minerals	10.5	10.4	10.9	10.7	11.7	11.1
Metal	7.2	7.1	10.3	9.1	8.3	7.3
Electrical equipment	5.8	5.8	5.7	5.8	5.8	5.9
Motor vehicles	10.0	10.4	12.1	11.2	13.4	11.8
Average	12.9	12.7	13.4	13.7	13.8	7.9

Source: UNCTAD TRAINS

10.3 Simulation results

Our simulations assume the full removal of all bilateral tariffs between Sri Lanka and each Asian FTA partner. This supposes a significant larger impact as it does not account for the presence of sensitive products in either Sri Lanka or its FTA partners.

Box 10.1 Model specification

Model: We use the standard CGE model from GTAP. This model assumes perfect competition, a static model, no intertemporal choice and international trade in differentiated products. The model is designed to evaluate the interregional, economy-wide impact of economic policies (for more details about the standard GTAP model see Corong et al., 2017).

Database: GTAP Database Version 11. 2017 is the reference year.

Sector aggregation: We aggregated GTAP's 65 sectors to 31 sectors based on sectors relevant to the Sri Lankan economy.

Country grouping: We aggregate GTAP's 141 regions to 11 regions, including China, India, Indonesia, Malaysia, ASEAN, RCEP, rest of Asia, EU, North America, UK and rest of the world.

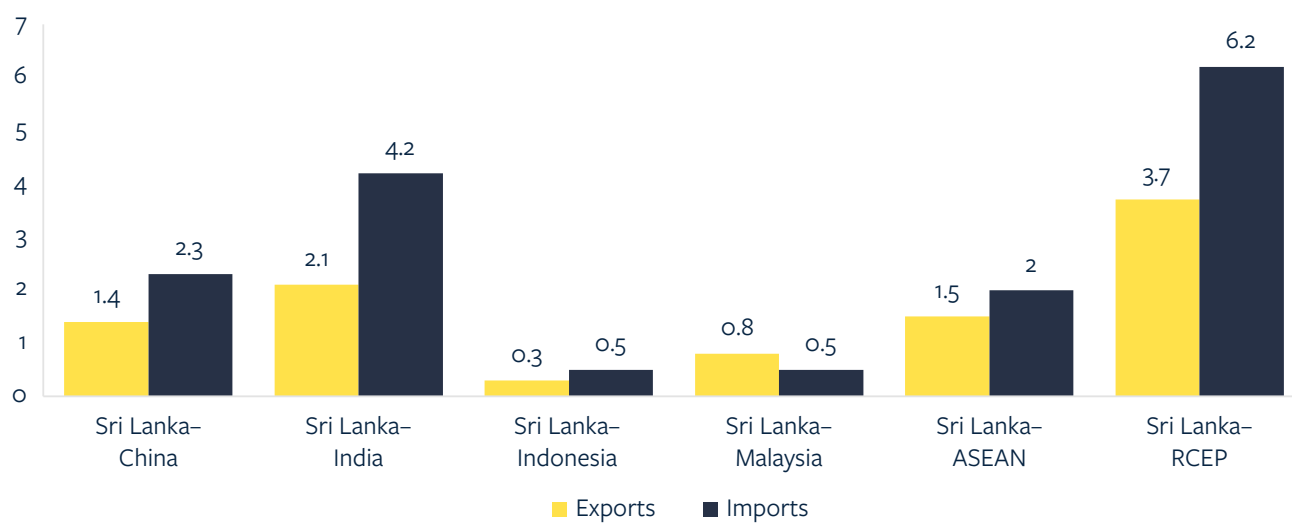
Tariffs: We updated the baseline GTAP 2017 tariffs for Sri Lanka's imports and exports to 2021 using most-favoured nation (MFN) tariffs from the United Nations Conference on Trade and Development (UNCTAD). We use the simple average tariff for aggregated GTAP sectors.

Scenario/policy experiment: The primary policy experiment involves the full liberalisation of trade between Sri Lanka and its trading partners, including China, India, Indonesia, Malaysia and ASEAN countries, implemented in a single step.

Closure: We adopt the standard GTAP closure, except for unemployment. To better reflect Sri Lanka's labour market, the real wage rate is fixed exogenously, and labour supply is endogenised to account for unemployment effects within Sri Lanka.

Figure 10.2 illustrates the effect on Sri Lanka's aggregate exports and imports with each FTA partner. Except in the case of the Sri Lanka–Malaysia FTA, the increase in Sri Lanka's imports is larger than the increase in its exports. Sri Lanka's imports, as expected, grew the most in the FTA with India; this was followed by the FTAs with China, ASEAN and Indonesia. An increase in imports will give business and consumers access to a wide range of competitively priced goods and services. Sri Lanka's exports to China and India also rise but the difference between the FTAs is smaller. This differential effect is notable considering that both partners represent similar shares of imports and exports in the Sri Lanka trade structure. The impact of Sri Lanka's participation in RCEP results in a combination of the individual impacts of the FTA with China and with ASEAN, as well as the addition of other countries.

Figure 10.2 Impacts on the volume of merchandise export and imports in the model



Source: GTAP model estimates

Table 10.3 Impacts on Sri Lanka's trade by broad sectors (%)

Sector	Exports										Imports									
	Sri Lanka-China	Sri Lanka-India	Sri Lanka-Indonesia	Sri Lanka-Malaysia	Sri Lanka-ASEAN	Sri Lanka-RCEP	Sri Lanka-China	Sri Lanka-India	Sri Lanka-Indonesia	Sri Lanka-Malaysia	Sri Lanka-ASEAN	Sri Lanka-RCEP	Sri Lanka-China	Sri Lanka-India	Sri Lanka-Indonesia	Sri Lanka-Malaysia	Sri Lanka-ASEAN	Sri Lanka-RCEP	Sri Lanka-China	Sri Lanka-India
Grains and crops	1.8	8.4	0.7	0.5	1.4	4.3	1.3	21.5	5.7	0.0	7.0	9.5								
Wheat	1.0	-4.5	0.4	327.4	1.4	86.7	-0.8	1.5	-0.2	-0.9	-1.4	-0.8								
Vegetables, fruit and nuts	2.1	33.3	0.0	0.5	0.8	5.5	2.4	9.6	0.1	-0.3	0.3	5.5								
Sugar cane	1.1	15.3	0.3	0.1	17.7	21.2	-0.9	-9.1	-0.3	-0.2	-10.8	-13.1								
Fishing	0.1	-1.4	-0.1	0.5	0.1	-0.6	0.1	2.4	0.1	-0.4	0.3	1.5								
Mining and extraction	15.1	16.9	-0.6	1.6	-1.9	1.7	0.4	1.2	0.0	0.0	0.2	0.7								
Minerals	0.0	23.9	-0.3	2.0	0.8	11.9	10.5	14.0	2.6	0.9	6.4	18.7								
Livestock and meat products	-0.2	47.1	-0.4	1.5	0.0	0.7	1.0	3.1	0.2	-0.6	0.5	12.1								
Raw milk	0.7	-1.8	0.3	1.8	2.4	103.0	-0.4	0.8	-0.2	-0.9	-1.3	-36.5								
Processed food	0.6	11.6	-0.1	1.2	2.9	7.9	7.1	6.0	1.4	9.6	14.8	20.8								
Dairy	-0.7	-5.1	-0.4	1.4	0.0	26.8	0.3	2.8	0.7	-0.2	2.2	57.4								
Processed rice	-1.0	-2.8	-0.1	0.5	-0.6	439.5	1.3	47.7	0.1	-0.3	0.9	3.1								
Sugar	-0.3	1.4	-0.2	0.4	5.2	48.8	0.0	2.6	0.0	-0.1	2.5	2.3								
Beverages and tobacco	-0.4	25.5	1.2	0.4	10.3	5.5	12.6	26.1	0.1	0.4	25.8	48.3								
Textiles	2.6	14.0	2.0	0.8	7.2	11.0	1.2	0.0	0.3	0.3	0.7	3.8								
Apparel	1.6	-2.0	0.3	0.6	0.3	4.9	1.8	3.2	0.3	-0.3	0.9	4.2								
Leather	21.2	-3.5	19.9	1.0	87.0	106.9	10.0	4.7	0.9	-0.2	4.7	16.0								

101 Sri Lanka: from debt default to transformative growth

Sector	Exports								Imports							
	Sri Lanka- China	Sri Lanka- India	Sri Lanka- Indonesia	Sri Lanka- Malaysia	Sri Lanka- ASEAN	Sri Lanka- RCEP	Sri Lanka- China	Sri Lanka- India	Sri Lanka- Indonesia	Sri Lanka- Malaysia	Sri Lanka- ASEAN	Sri Lanka- RCEP	Sri Lanka- China	Sri Lanka- India	Sri Lanka- Indonesia	Sri Lanka- Malaysia
Wood	0.4	4.0	-0.5	1.0	0.6	-4.9	9.6	7.1	0.8	12.2	14.8	25.7				
Light manufacturing*	2.3	22.8	0.6	1.6	9.1	9.8	3.8	7.1	0.7	0.0	2.2	7.4				
Heavy manufacturing**	4.0	6.4	0.0	0.9	1.9	3.9	0.8	1.9	0.1	0.1	0.8	2.2				
Rubber and plastic	2.8	1.5	0.7	1.5	2.0	4.0	10.8	7.3	3.0	0.9	9.7	20.1				
Metal	2.7	7.3	2.0	2.3	6.2	10.3	7.7	5.1	0.3	0.4	2.6	13.3				
Electrical equipment	11.2	11.9	-0.2	1.4	2.4	16.0	4.7	3.9	0.3	0.2	1.4	7.6				
Motor vehicles	1.5	1.4	1.0	3.3	5.7	10.2	2.0	4.2	0.3	0.2	1.5	5.1				
Other services	-0.5	-3.5	-0.3	0.5	-0.8	-2.7	0.3	2.0	0.2	-0.2	0.5	1.7				
Construction	0.4	-2.4	-0.1	0.5	-0.3	-1.0	0.7	2.6	0.2	-0.2	0.8	2.9				
Water transport	0.1	-1.3	-0.1	0.3	-0.2	-0.7	0.0	0.8	0.1	-0.1	0.1	0.6				
Air transport	0.4	-1.4	-0.1	0.4	-0.1	-0.5	-0.1	1.0	0.1	-0.2	0.1	0.6				
Warehousing	-0.2	-2.7	-0.2	0.6	-0.4	-1.6	0.1	0.3	0.0	0.0	0.1	0.3				
Communication	0.7	-1.7	-0.2	0.5	-0.1	-0.1	-0.3	1.1	0.1	-0.2	0.2	0.5				
Financial services	-0.8	-3.9	-0.4	0.4	-1.1	-3.6	0.4	1.6	0.2	-0.1	0.5	1.8				

Source: UNCTAD TRAINS

Notes: Notes:

* Light manufacturing includes paper products and publishing; manufactures n.e.c.; and transport equipment n.e.c.

** Heavy manufacturing includes petroleum and coal products; chemical products; basic pharmaceutical products; ferrous metals and metals n.e.c.

The impact on sectoral imports (Table 10.3) tends to be particularly driven by the height of the tariffs applied by Sri Lanka, which tends to be similar across partners and partly reflects the country's defensive interests. There are expected significant increases in total imports of agricultural products, food (e.g. processed rice) and some manufacturing (e.g. rubber).

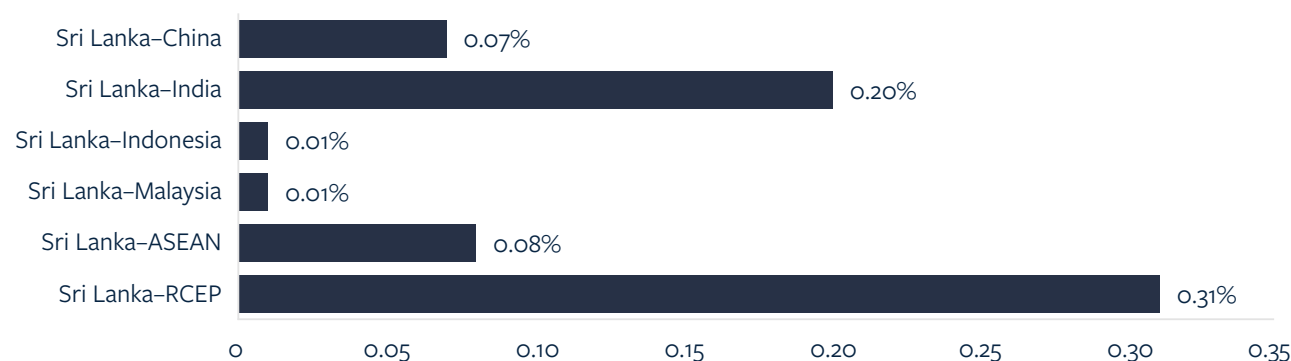
The impact on Sri Lanka's exports depends on the level of the tariffs applied by partners. Following the structure of current trade and the variation in exports, Sri Lanka's FTA with China will have significant impacts on grains and crops, light manufacturing and apparel. Although percentage change variations are small, they are applied on the largest exported products. The impact on exports generated by Sri Lanka's FTA with India will affect the exports of processed food, grains and crops, and light manufacturing. It is also worth noting that exports of other products are likely to increase strongly (vegetables, fruits, nuts; minerals; livestock and meat products), although these are not products currently exported heavily by Sri Lanka.

Impact on gross domestic product, output and the labour market

The real GDP changes illustrated in Figure 10.3 show that the highest impact on Sri Lanka's GDP arises from joining the RCEP, which contributes a 0.31% increase. This is followed by the FTA with India, which contributes a 0.20% increase. These are followed by similar gains from the FTAs with China at 0.07% and ASEAN at 0.08%. The FTAs with Malaysia and Indonesia yield the smallest gains for Sri Lanka's GDP. India and China are the primary import sources for Sri Lanka, in contrast with Malaysia and Indonesia.

The GDP increases, from the demand side, are motivated by increases in investment (albeit applied on low base) and private consumption (a generalised reduction in consumer prices) generated by the reduction on the import tariffs; and by the increase in exports generated by the reduction in duties applied by partners.

Figure 10.3 Impact in terms of change in Sri Lanka's real GDP (%)



Source: GTAP model estimates

Table 10.4 Impacts on output by sector (%)

	Sri Lanka– China	Sri Lanka– India	Sri Lanka– Indonesia	Sri Lanka– Malaysia	Sri Lanka– ASEAN	Sri Lanka– RCEP
Grains and crops	0.3	0.5	-0.1	0.0	-0.2	0.6
Wheat	0.1	-0.4	0.1	4.6	0.0	0.7
Vegetables, fruit and nuts	-0.5	2.1	-0.1	0.0	-0.1	-0.9
Sugar cane	-0.2	-3.7	-0.1	0.1	-3.7	-4.5
Fishing	-0.1	0.0	0.0	-0.1	-0.1	0.0
Mining and extraction	0.6	0.9	-0.1	0.0	-0.2	0.2
Minerals	-1.7	-1.0	-0.5	-0.1	-0.8	-1.4
Livestock and meat products	0.0	0.7	0.0	0.0	0.0	-0.6
Raw milk	-0.1	-0.4	-0.1	0.0	-0.3	-11.9
Processed food	-0.8	1.5	-0.2	-1.0	-1.4	-1.7
Dairy	-0.1	-0.8	-0.2	0.1	-0.4	-23.0
Processed rice	-0.3	-7.9	0.0	0.0	-0.2	0.3
Sugar	-0.2	-3.8	-0.1	0.1	-3.8	-4.6
Beverages and tobacco	-0.3	0.8	0.1	0.0	-0.1	-0.8
Textiles	0.3	1.0	0.4	0.5	1.3	2.3
Apparel	1.1	-1.4	0.2	0.5	0.2	3.4
Leather	4.4	-1.8	6.1	0.4	26.7	31.0
Wood	-1.7	0.2	-0.1	-2.5	-2.2	-4.2
Light manufacturing	-1.0	1.7	-0.2	0.4	1.3	-0.1
Heavy manufacturing	0.0	-0.4	-0.1	0.3	-0.2	-0.9
Rubber and plastic	-1.2	-0.6	-0.3	0.6	-1.1	-2.5
Metal	-5.1	-0.8	0.3	0.1	-0.4	-7.0
Electrical equipment	1.8	4.1	-0.2	0.6	0.7	2.9
Motor vehicles	0.3	-2.7	0.3	1.5	1.8	-4.2
Other services	0.1	0.1	0.0	0.0	0.0	0.2
Construction	1.2	2.0	0.2	0.1	0.9	3.2
Water transport	0.1	-0.8	-0.1	0.2	-0.1	-0.4
Air transport	0.2	0.0	0.0	0.1	0.1	0.2
Warehousing	0.0	-0.5	0.0	0.1	-0.1	-0.2
Communication	0.1	0.1	0.0	0.0	0.1	0.3
Financial services	0.2	0.1	0.0	0.0	0.1	0.5

Source: UNCTAD TRAINS

Finally, Table 10.5 shows the impact on employment among unskilled workers. This tends to follow quite closely the impact on output, explained by the assumption of unemployment in the closure of the model.

Table 10.5 Impacts on unskilled employment by sector (%)

	Sri Lanka– China	Sri Lanka– India	Sri Lanka– Indonesia	Sri Lanka– Malaysia	Sri Lanka– ASEAN	Sri Lanka– RCEP
Grains and crops	0.4	0.7	-0.2	0.1	-0.2	1.0
Wheat	0.1	-0.6	0.1	6.9	0.0	1.0
Vegetables, fruit and nuts	-0.6	3.0	-0.1	0.0	-0.1	-1.2
Sugar cane	-0.2	-5.1	-0.2	0.2	-5.1	-6.1
Fishing	0.0	0.1	0.0	-0.1	-0.1	0.1
Mining and extraction	0.7	1.1	-0.1	0.0	-0.1	0.4
Minerals	-1.3	-0.3	-0.4	0.0	-0.4	-0.2
Livestock and meat products	0.0	1.0	0.0	0.0	0.1	-0.5
Raw milk	-0.1	-0.6	-0.1	0.0	-0.3	-15.5
Processed food	-0.5	2.2	-0.1	-1.0	-1.0	-0.6
Dairy	0.2	-0.1	-0.1	0.2	0.0	-22.2
Processed rice	0.0	-7.2	0.1	0.0	0.2	1.5
Sugar	0.1	-3.2	0.0	0.2	-3.4	-3.5
Beverages and tobacco	0.0	1.5	0.2	0.1	0.3	0.4
Textiles	0.7	1.7	0.5	0.6	1.7	3.5
Apparel	1.4	-0.8	0.3	0.5	0.6	4.6
Leather	4.7	-1.1	6.2	0.5	27.2	32.5
Wood	-1.4	1.0	0.0	-2.4	-1.8	-3.0
Light manufacturing	-0.6	2.5	-0.1	0.5	1.7	1.1
Heavy manufacturing	0.3	0.3	0.0	0.4	0.3	0.4
Rubber and plastic	-0.9	0.1	-0.2	0.7	-0.6	-1.3
Metal	-4.8	-0.1	0.4	0.2	0.1	-5.9
Electrical equipment	2.1	4.9	-0.1	0.7	1.1	4.2
Motor vehicles	0.6	-2.0	0.4	1.5	2.2	-3.1
Other services	0.4	0.9	0.1	0.1	0.5	1.6
Construction	1.6	2.8	0.3	0.2	1.3	4.6
Water transport	0.5	0.2	0.0	0.3	0.5	1.4
Air transport	0.7	1.0	0.1	0.2	0.7	2.0

	Sri Lanka– China	Sri Lanka– India	Sri Lanka– Indonesia	Sri Lanka– Malaysia	Sri Lanka– ASEAN	Sri Lanka– RCEP
Warehousing	0.3	0.0	0.0	0.2	0.2	0.7
Communication	0.3	0.6	0.1	0.1	0.4	1.1
Financial services	0.5	0.9	0.1	0.1	0.5	1.9

Source: UNCTAD TRAINS

10.4 Conclusion

To the best of our knowledge, this is the first CGE analysis to explore the economic effects of Sri Lanka's new FTA drive since 2023 with selected Asian countries. It simulates the demanding scenario of full tariff liberalisation for both parties in Sri Lanka's bilateral FTAs with China, India, Indonesia and Malaysia. It also adds, as a reference, the impact of participation in ASEAN and RCEP. The results are useful to assess the impact on those goods sectors where the impact of the agreement is likely to be associated more with the removal of tariffs.

The simulations suggest three findings:

1. Sri Lanka's FTAs with Asian countries could contribute to greater economic activity, economic efficiency and business/consumer choice in Sri Lanka but the analysis highlighted critical sectoral adjustment and distributional issues.
2. Sri Lanka's FTAs with China and India present, given the magnitude of the partners, the largest overall trade and output impacts bearing in mind trade linkages and tariff structures. Joining RCEP could potentially bring even larger trade and output impacts.
3. There are significant variations in impacts on Sri Lanka across sectors and between agreements, making it difficult to extract general conclusions.

Some qualifications should be noted regarding the CGE analysis. One is that the scenario considers only the effect generated by the reduction of all import tariffs and not the impact generated by other aspects of comprehensive FTAs such as the reduction of non-tariff barriers (NTBs), the removal of services restrictions and the effect that an agreement may have on improving trade facilitation and attracting foreign direct investment (FDI). In this sense, the results also underestimate the beneficial impact that these FTAs may have on Sri Lanka.

Another qualification is that the simulations presented do not consider the possibility of Sri Lanka and its partners introducing sensitive lists and excluding some products from tariff liberalisation. This means that, in terms of tariff liberalisation, the results overstate the actual negative FTA impacts on the goods sectors of Sri Lanka. Accordingly, these results should be viewed as a 'first look' at the impact of these Asian FTAs on Sri Lanka.

Four policy implications can be gleaned from the CGE analysis:

1. A deeper and more comprehensive CGE analysis – including incorporation of the reduction of NTBs and services liberalisation into the model – should be undertaken as a future exercise to inform FTA discussions in Sri Lanka. This is critical, as the effect of the removal of NTBs and trade

facilitation measures could be larger than the tariff liberalisation effects shown here.

2. The effects of these FTAs in attracting FDI into Sri Lanka are hard to measure but they cannot be understated. In fact, the literature (Medvedev, 2006) suggests that the effects are expected to be large and significant.
3. Trade modelling capacity should be built in the Office of International Trade and the Ministry of Finance as a tool to support FTA negotiations
4. Alongside FTA-led liberalisation, a trade adjustment package should be developed to assist losing sectors and retrain workers. This may help harness public support for FTA-led liberalisation and mitigate a backlash.

Finally, the effect of MFN clauses in trade agreements suggests a need to sequence the agreements in such a way that extending preferential treatment to a particular partner will not trigger market access commitments to another. In this sense, given the different sizes and the presence of sensitive products, it is preferable to negotiate and implement first the agreements with Malaysia and Indonesia. This sequencing could be altered if a list of common sensitive goods is used across agreements. This, however, would reduce the possibility of using differential tariff concessions as a bargain chip.

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11 Trade and FDI facilitation in Sri Lanka

M. Ganeshamoorthy

Summary

Sri Lanka's performance on trade and foreign direct investment (FDI) is poor relative to comparable regional peers. Cumbersome, lengthy and costly administrative and bureaucratic procedures in addition to traditional trade barriers have contributed to this situation. Key recommendations for improvements focus on streamlining export and investment processes through capacity-building, administrative reforms and centralisation via digitalisation.

11.1 Introduction

International trade and FDI are two key determinants of economic growth, especially for

small open economies like Sri Lanka. They are inextricably intertwined with government trade and investment policies. Sri Lanka initiated trade and investment policy reforms in 1977 as part of its economic liberalisation. However, it was not able to harness adequate benefits from trade and investment reforms because of bureaucratic and administrative barriers and red tape.

This essay focuses on trade and investment facilitation initiatives that Sri Lanka can employ to eliminate such barriers so as to enhance competition and improve its trade and investment performance. Table 11.1 presents trade and FDI as a share of gross domestic product (GDP) and logistics and ease of doing business index scores for selected Asian countries.

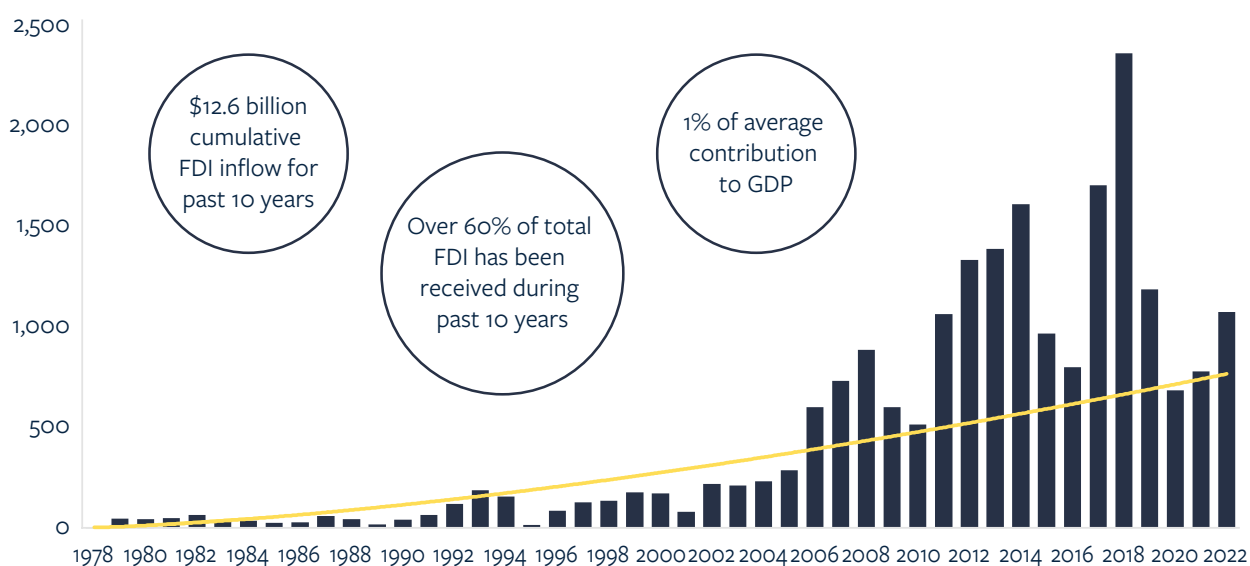
Table 11.1 Key trade, investment and facilitation indicators for Sri Lanka and selected Asian countries

	Trade as % of GDP 2023	FDI as % of GDP 2023	Logistics Performance Index 2023	Ease of Doing Business 2020 (ranking)*
India	46	1.5	3.4	63
Indonesia	45	1.9	3.0	73
Malaysia	132	3.6	3.6	12
Philippines	67	2.3	3.3	95
Singapore	311	29.8	4.3	2
Sri Lanka	42	1.2	2.8	99
Thailand	129	2.3	3.5	21
Vietnam	184	4.4	3.3	70

Source: Board of Investment of Sri Lanka

Figure 11.1 shows the historical trend of net FDI inflows in Sri Lanka. Average FDI inflows in the past decade have remained as low as \$1.29 billion per annum, contributing just 1% to GDP. Continued efforts have been made in this area by different governments since 1978 but it is during the past 10 years that 60% of FDI has been received.

Figure 11.1 FDI inflows in Sri Lanka, 1978–2022 (\$ million)



Source: World Bank Open Data

11.2 Hassles posed by inefficient trade/FDI government procedures and red tape

Exporters face delays and red tape in complying with government procedures. It is mandatory for them to register with Sri Lanka's Export Development Board (EDB) and obtain an EDB registration number; they also need to obtain a Taxpayer identification Number and a VAT registration number from the Inland Revenue Department. In addition, they must register with Sri Lanka Customs. The time required to register with these institutions is a few hours to one or two days, according to their respective information desks. In addition to these requirements, exporters need to obtain the following certificates from different agencies:

- **Certificate of origin (CoO):** The Department of Commerce issues CoOs for all Generalised System of Preferences schemes, free trade agreements and preferential trading agreements of which Sri Lanka is a beneficiary or to which it is a party. These are issued within a day. Other exporters must obtain CoOs from the National Chamber of Exporters; for these, exporters must furnish five to seven documents, either online or manually.
- **Quality certificate:** This is issued by Sri Lanka Standards Institution (SLSI); SGS Lanka Ltd issues them privately. It takes between a month and a year to obtain a quality certificate, according to information on the SLSI website.
- **Health certificate or export certificate:** Food exporters must obtain these certificates from the Food Control Administration Unit of the

Ministry of Health to certify that the food is fit for human consumption. This involves a three-step process. It takes between 30 minutes and 5 hours. However, exporters of fish and fish products, fresh vegetables and fruits, and meat and meat products should obtain certification from the Ministry of Fisheries and Aquatic Resources, the Plant Quarantine Unit of the Department of Agriculture and the Department of Animal Production and Health, respectively.

- Phytosanitary certificate: This is issued by the National Plant Quarantine Service (NPQS) of the Department of Agriculture. There are five steps involved. The procedure takes between 40 minutes and 2 hours and 40 minutes. Four laws are applicable in this process.
- Fumigation certificate: This is issued by NPQS and some private sector institutions.

Though these institutions post indicative times needed to complete these processes, actual times can be lengthier in practice, and exporters often have to make several visits. The paperwork involved is long despite the recent introduction of some streamlining.

The Asian Development Bank (ADB) (2019) finds that implementation of trade facilitation is limited in Sri Lanka compared with in Southeast Asian countries such as Indonesia, Malaysia and Singapore. Low levels of trade facilitation with regard to the harmonisation and simplification of trade procedures and documents represent the major obstacle to intraregional trade, according to research by both ADB and the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP).

Moreover, the level of Sri Lanka's implementation of components under the World Trade Organization's (WTO's) Trade Facilitation

Agreement (TFA) stands at 34.9%, for a timeframe of 2017–2030. Reforms have included establishment of the Trade Information Portal, the streamlining of customs process and the revamping of the post-clearance audit system.

11.3 Potential economic benefits from trade and investment facilitation and recent reforms

Trade and investment facilitation initiatives benefit both the business community and the government of Sri Lanka. Businesses benefit by obtaining enhanced competitiveness in both national and international markets. These arise through reductions in delays and costs, achieved through the predictable and efficient movement of goods and services across borders as well as increased net inflows of foreign investment in the country. The government is able to use modern procedures to enhance control to ensure the proper collection of revenue. This also contributes to economic development through increased trade and FDI.

Duval and Utoktham (2014) contend that a 1% reduction in comprehensive trade costs (excluding tariffs) between exporting and importing countries leads to an average of 0.8% in FDI inflows. A recent Asia-Pacific Trade and Investment Country Report reveals that Sri Lanka's trade costs are lowest with the four large developing Asia-Pacific economies of China, India, Indonesia and the Russian Federation (UNESCAP, 2023). In 2020, trade costs with these countries amounted to, on average, 140.8% of the value of goods, as compared with when the countries trade these goods within their borders. Sri Lanka's trade costs were higher with the 'Europe-3' economies (Germany, France and the UK)

and the ‘East Asia-3’ economies (China, Japan and Republic of Korea), at 142.2% and 155%, respectively. As of 2018, Sri Lanka placed in the 45th percentile for logistics performance among countries in the Asia-Pacific region.

According to the Institute of Policy Studies (IPS) (2018), Sri Lanka is ahead of its South Asian neighbours on several logistic performance indicators. For example, on time associated with exporting and importing, it takes 16 days to export from Sri Lanka compared with an average of 33.4 days in South Asia, and 13 days to import compared with 34.4 days. Moreover, the cost to export from Sri Lanka is \$560 per container as against South Asia’s \$1,922.90; the import cost is \$690 compared with \$2,117.80.

Key reforms in trade

Sri Lanka established its National Trade Facilitation Committee in 2014 as required by the TFA. Its aim is to coordinate interagency activities related to implementation of the TFA and other initiatives in Sri Lanka through the participation of all cross-border public and private sector trade stakeholders.

Sri Lanka also launched its national single window in January 2016, as a common platform for border agencies. However, progress on this has stalled as a result of a lack of capacity in relevant agencies related to connection to the single window. The Ministry of Finance, Economic Stabilization and National Policies has taken over the single window initiative from Sri Lanka Customs and is now in the process of recruiting dedicated staff to run the project. The major bottleneck has been lack preparedness and dedication within relevant agencies as a result of poor infrastructure, and limited competence of the workers involved.

Key reforms related to foreign investment

Foreign investors are allowed to purchase up to 100% of equity in Sri Lankan companies in permitted sectors. Investors can open an Inward Investment Account with any commercial bank in the country. As of January 2022, 297 companies representing 20 businesses were listed on the Colombo Stock Exchange (US Department of State, 2023).

To encourage foreign investors, the Board of Investment (BOI) has launched a five-year residence visa programme dedicated to investors, stakeholders and BOI enterprises. This issues long-term visas for investors matching the international benchmarks related to Ease of Doing Business. BOI launched the programme to better facilitate the investor experience in Sri Lanka. BOI is responsible for promoting, approving and assisting with FDI in Sri Lanka.

The following main pieces of legislation and agreements oversee FDI in Sri Lanka:

- BOI Law No. 4 of 1978 (‘BOI Act’)
- Finance Act No. 12 of 2012
- Inland Revenue Act No. 24 of 2017
- Strategic Development Projects Act No. 14 of 2008
- Foreign Exchange Act No. 12 of 2017
- Land (Restriction on Alienation) Act No. 38 of 2014 and its amendments
- Article 157 of the Constitution of Sri Lanka (guaranteeing the safety of investment protection treaties and agents)
- Bilateral investment protection agreements signed with 28 countries
- Bilateral double tax avoidance agreements with 42 countries
- Customs ordinance.

There are no set times needed for incorporating a company, and this process can vary on a case-by-case basis. Usually, the Registrar of Companies takes two weeks to incorporate a company and BOI takes a month to approve this, unless the matter is complex and requires review by other authorities. The Strategic Development Projects review process takes far longer and is dependent on various factors, including project specifics, the ministries involved and the type of exemptions sought. The government proposed having a Cabinet Subcommittee, which will reduce the time taken, so that, within six weeks of Cabinet approval, the project details will be published in the Gazette and within three months of this publication the matter will be presented to Parliament. There are no prescribed fast-track options for any other review process above.

Parties cannot close any financial transaction before the review process is completed and approval is granted. A fine not exceeding LKR 1 million is applicable in the event of non-compliance or breach of the Foreign Exchange Act No. 12 of 2017. In 2022, the Ministry of Technology and Investment Promotion took several measures to streamline the investment application process by eliminating lengthy paperwork. Some 14-page long application forms have been reduced to a single page. BOI recently established an Investment Facilitation Centre to streamline and ease the investment facilitation process.

Expansion of export processing zones

Sri Lanka established its first EPZ in Katunayaka in 1978, its second in Biyagama in 1985 and its third in Koggala in 1991. The network has been expanded to cover different geographical locations, including Kandy, Wathupitiwala, Mirigama,

Malwatta, Seethawaka, Horana, Mawathagama, Polgahawela, Mirijjawila, Bingiriya and Eravur. These provide investors with basic amenities and other support. Around 300 enterprises are operating in EPZs at present. EPZs have had a significant impact on industrial expansion while facilitating external trade.

Tax holidays for investors

Sri Lanka uses tax holidays as a key instrument for attracting foreign investors. Tax holidays up to 5–10 years are granted for BOI projects. In 2022, the Cabinet decided to grant tax holidays of up to 40 years for investment in the Colombo Port City project. However, granting tax holidays leads to loss of tax revenue collection for the government, which is compelled to increase tax revenue to reduce fiscal stress and improve debt sustainability. Therefore, the government's pursuit of trade and investment facilitation may conflict with its fiscal objectives. The government has already cancelled exemptions and tax holidays to local businesses and introduced a capital allowance scheme instead.

11.4 Key policy proposals

Capacity-building on operating the single window

A major obstacle to implementing the single window project in trade and FDI has been poor capacity in the relevant institutions. Lack of physical and human resources at these institutions made the system redundant from its launch. It is therefore imperative to build and improve such capacity. This includes providing both hardware and software as well as other physical resources. Recruitment and proper training of competent staff are equally important.

Establishment of a centralised database

Relevant information needed to enable FDI is scattered across many places. For instance, obtaining land for an FDI project is not easy as there is no centralised system for land acquisition, meaning land details are not readily available to the relevant ministry or BOI. Survey plans for government land are not available, even at land registries. Hence, BOI projects, particularly those located in the peripheries, find it difficult to identify suitable land. Therefore, investments should be made in establishing a centralised system from which all information related to trade and investment can be obtained. Periodic updating of this information should be mandatory.

Centralisation of the trade and investment facilitation process

A centralised dedicated authority to coordinate, implement and oversee overall trade facilitation in the country should be established. At present, different ministries, departments and institutions are involved in the process. There are often conflicts of interest among institutions. Sometimes, ministries compete to obtain funds from the Treasury and show little solidarity with the activities of other ministries.

Administrative reforms

Administrative bottlenecks lead to delays and coordination failures among government agencies. Introducing reforms to administrative procedures could enhance coordination and make service delivery more efficient. The government should thus consider reviewing existing rules and regulations and amending them accordingly to make processes simpler and easier to understand and implement.

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12 Economic diplomacy for transformation in Sri Lanka

Ravinatha Aryasinha

Summary

Sri Lanka has a long history of engagement in economic relations and diplomacy but with mixed results. The current debt and economic crisis provides an impetus for increased effort by national agencies and the Ministry of Foreign Affairs to boost trade, investment and tourism. Five proposals are suggested to make this happen: improve inter-agency coordination; create hub missions with specialised staff; improve engagement with diaspora communities; provide a consistent domestic policy and regulatory framework; and ensure a level playing field for all foreign investors.

12.1 Economic diplomacy: the conceptual basis

Although the term ‘economic diplomacy’ is recent, its practice is longstanding. It involves leveraging diplomatic ties to promote trade, investment and economic development (Hamilton and Langhorne, 1995). It emerged in the latter part of the 20th century in a context of global interdependence, multi-stakeholder networking and evolving roles for non-state actors in the economic and political landscape. Meanwhile, the increasingly intertwined nature of politics and economics has undermined many of the traditional principles governing historic economic relationships. This has meant states have had to develop more defensive strategies to insulate themselves from external economic shocks.

In this context, economic diplomacy involves enabling dispersed actors, in varied terrains, using multiple tools, acting in a coordinated manner, availing of a broad spectrum of diplomatic and communicational tools that might be at the disposal of a state, to move beyond silos and serve the national interest, and at the same time to collaborate more broadly to serve the common good.

Viewing Sri Lanka’s economic transformation efforts since the 2022 economic crisis, and the mass struggle (*aragalaya*) that ensued, through the prism of economic diplomacy, this essay (i) critically appraises efforts towards economic diplomacy in practice – that is, key initiatives, outcomes and explanations; (ii) suggests modalities to overcome the structural difficulties encountered; and (iii) proposes ways to strengthen the pursuit of economic diplomacy both in Sri Lanka and abroad.

12.2 Economic diplomacy in practice in Sri Lanka

Key initiatives

Sri Lanka has practised diplomacy since ancient times, and has been a trade entrepôt hub in the Indian Ocean since precolonial times. Post-independence, from entering into the Rubber-Rice Agreement with China in 1952, to pioneering economic liberalisation in South Asia in 1977 and developing a free trade zone in Katunayake in 1978, economics has been at the forefront of

Sri Lanka's diplomacy. In the early 1980s, with external assistance, Sri Lanka telescoped into 6 years a 30-year project, augmenting the gigantic Mahaweli Hydro power and irrigation scheme; exponentially expanding tourism; and securing foreign employment opportunities, initially in the Middle East but later also in East and Southeast Asia. In the 1990s, efforts focused on developing the apparel industry, which to date remains Sri Lanka's premium manufactured export sector. Throughout, Sri Lanka has shown a panache for 'economic diplomacy.'

To provide structural support in these efforts, in 1978 the Greater Colombo Economic Commission was set up. In 1992, Sri Lanka introduced an innovative adaptation by establishing a Bilateral Cooperation Unit within the foreign ministry itself. This seconded officers from the Department of Commerce, the Board of Investment, the Tea Board, the Tourist Board and the Foreign Employment Bureau, to involve them more integrally in factoring commercial considerations into the day-to-day foreign policy decision-making of the ministry. These years also saw the implementation of many sectorally funded product promotion and familiarisation programmes overseas.

The external economic drive of Sri Lanka was seriously undermined by the 30-year separatist conflict with the Liberation Tigers of Tamil Eelam (LTTE). Sri Lanka experienced tangible setbacks in foreign investment and exports and a drop in tourist arrivals. Its international reputation suffered, with foreign entities dissuaded from trading, investing in and visiting the country. Public diplomacy had to complement economic diplomacy efforts by putting forward a counternarrative on the country, which, notwithstanding considerable adversity, was acting with fortitude and resilience.

After the end of the civil war in May 2009, Sri Lanka faced the challenges of diversifying exports by linking into global value chains, expanding trade in services, attracting foreign direct investment (FDI) and making tourism and foreign employment important growth areas. However, in these years of peace, when one would have expected Sri Lanka to thrive economically and to resuscitate its image, the success of its efforts was hampered. This was because of many unproductive economic projects and the ensuing accumulation of debt (to states, global financial institutions and international sovereign bond-holders), a lack of transparency and allegations of corruption.

In subsequent years, successive governments have undertaken many initiatives to address the difficulties facing the economy. Economic diplomacy has been afforded a prominent place in these. In the immediate post-conflict years, the Mahinda Rajapaksa Administration embarked on rapid infrastructural development, with assistance mainly from China, and redevelopment of the conflict-affected Northern and Eastern Provinces. Following the election of President Maithripala Sirisena and the formation of the National Unity Alliance in 2015 with Prime Minister Ranil Wickremasinghe, a renewed effort was made by the Ministry of Foreign Affairs, in collaboration with the Ministry of Development Strategies and International Trade, to play a more proactive role.

A team from Harvard University's Center for International Development (CID) conducted an analysis of constraints to sustained and inclusive economic growth in Sri Lanka (Hausmann, 2016). This held that, while monetary and exchange rate policy could be used to soften these constraints, solving the underlying problem required structural transformation; it recommended targeting sectors for investment and export

promotion in Sri Lanka (Malalgoda et al., 2018). The initiative adopted a Problem-Driven Iterative Adaptation process, whereby a team of Sri Lankan officials worked with CID facilitators to build capabilities.¹⁶

In collaboration with the private sector, non-governmental bodies and foreign governments, Sri Lanka's Export Development Board unveiled in July 2018 its National Export Strategy 2018–2022, to increase the capacity of the local export sector while also improving trade performance and competitiveness.¹⁷ These measures were aimed at increasing the value of Sri Lanka's exports to \$28 billion by 2025, from approximately \$10 billion at the time. This was supported by the Economic Diplomacy Programme of the Ministry of Foreign Affairs through the operationalisation of a number of pilot projects through its network of missions.

Similarly, conscious of capital flight and of trade shifts occurring out of China and other early high-end investment centres, the government also made efforts to attract investment (Hewage and Weerasekera, 2018). One report noted that, 'there was an expectation that over \$150 billion worth of trade shifts will take place over the next four to five years, and if Sri Lanka could attract just 1% of that investment, it could have a generational impact' (see Abayasingha, 2020).

Outcomes

Despite intentions and efforts over the years, tangible results have fallen well below expectations.

Export earnings, which continue to be the largest source of foreign currency, grew from \$4.5 billion in 2000 to \$8.6 billion in 2010, and to \$11.1 billion in 2014 and \$13.1 billion in 2022 (CBSL, 2024). Exports as a percentage of Sri Lanka's gross domestic product (GDP) moved from 33% in 2000 to 14.6% in 2010, 13.6% in 2014 and 17.6% in 2022 (Ratnayake, 2023). **Foreign employment** was the second largest source of foreign revenue, with workers' remittances bringing in an average of \$1 billion per year between 2014 and 2019, but this fell to nearly \$5.5 billion in 2021 (CBSL, 2024). **Tourism**, the third largest source of foreign currency, saw a rise from \$0.3 billion in 2000 to \$0.6 billion in 2010 and \$4.4 billion in 2018; having dropped to \$0.5 billion in 2021, it rose once to \$2.1 billion in 2023 (ibid.).¹⁸ **Investment**, which since 2000 has been above \$1 billion annually only between 2011 and 2018 and in 2022, reached a high of \$2.1 billion in 2018 (ibid.).

Explanations

Sri Lanka's sluggish economic performance between 1983 and 2009 has largely been attributed to the ongoing separatist struggle and its ramifications. However, post-2009, the expectation that, with the peace dividend, Sri Lanka would take off economically proved problematic. Despite projects such as Colombo Port City and other infrastructural developments with foreign investment, largely unsolicited, very few of these were export-driven and had foreign exchange-generating capacity. Regrettably, in this period, leading Western countries, and also India to some extent, chose not to actively support

16 Officers of the Foreign Service and Commercial Service at senior level were included in this training programme. See <https://growthlab.hks.harvard.edu/podcasts/new-pathways-inclusive-growth-sri-lanka-project-retrospect>

17 The six focus sectors of this were IT-BPM; wellness tourism; boat-building; electrical and electronic components; processed food and beverages; and spices and concentrates. Four targeted activities were undertaken to improve the business environment for all export sectors: logistics; trade information and promotion; national quality and infrastructure; and innovation and entrepreneurship.

18 In 2018, Lonely Planet named Sri Lanka top destination for 2019.

Sri Lanka's quest for economic development, in response to differences related to human rights and for strategic reasons, and also alleged that Sri Lanka had failed to provide a level-playing field for investors. Had a more competitive environment prevailed, Sri Lanka may well have avoided some of the difficulties it faced in subsequent years.

Further, despite the National Unity Alliance's early efforts at reorienting foreign policy and international economic engagement away from China (in response to demands by the US and other Western countries on strategic and human rights concerns), data reveals that, between 2015 and 2019, there was no notable increase in trade, FDI or financial development assistance to Sri Lanka from the US and the West (Wignaraja, 2022).

In the years that followed, Sri Lanka had to endure the ramifications of the Easter Sunday attacks (2019), the effects of the COVID-19 pandemic (2020–2021) and an unprecedented politico-economic crisis (2022) in the midst of a global downturn. However, its performance over the past decade is poor when contrasted with the relative success reaped in the same period by countries that surmounted such challenges – such as India and Bangladesh in South Asia, in addition to others like Vietnam, Malaysia and Thailand, which also operate within critical geopolitical rivalries not dissimilar to those encountered by Sri Lanka.

Quite apart from bringing material losses and emotional strain, the economic crisis of 2022 forced Sri Lanka to arrest the pendulum swings in its foreign policy between the major power centres that had prevailed over the previous decade, arising from these countries and their alliances demanding exclusivity and bringing pressure on Sri Lanka to operate in a seemingly 'zero-sum' environment

(Aryasinha, 2023). The international collaboration that emerged in April 2023 to enable approval of the International Monetary Fund (IMF) Extended Fund Facility (EFF), accommodating the interests of all Sri Lanka's creditors, was proof that, in a crisis, the country continues to command sufficient cooperation from all its international partners, despite the strong bilateral differences that persist among some of them.

On 12 June 2024, the IMF was to disburse the third tranche of \$336 million from its \$2.9 billion bailout package under the EFF arrangement. Following agreement reached on 26 June 2024 with Sri Lanka's official creditors concerning debt restructuring, Sri Lanka will benefit from a grace period until 2028 on its principal loans, amounting to \$5 billion in savings in debt servicing in this period.¹⁹ On 3 June 2024, Sri Lanka had also reached a provisional agreement to restructure \$12.5 billion in sovereign bonds, featuring a 28% cut on face value, an 11% reduction in past interest, interest payments starting in September 2024 and governance-linked bond features (Ahlam, 2024a). While it is expected that these incremental gains will result in an early rating upgrade, State Minister of Finance Shehan Semasinghe has observed that, 'We cannot set a timeline for the rating agencies to update us. What we can do from our end is to create the environment for the rating agencies to look at. So, our responsibility is to create this conducive environment and complete the debt restructuring process in all aspects' (Ahlam, 2024b).

12.3 Modalities that could help overcome structural difficulties

It has been suggested that Sri Lanka has continued to stray from its course not because of a lack of plans or a failure of economic

¹⁹ At present, Sri Lanka's foreign debt totals \$37 billion. This includes \$10.6 billion in bilateral debt, \$11.7 million in multilateral debt, \$14.7 billion in commercial debt and \$12.5 billion in sovereign bonds (PTI, 2024).

diplomacy but more because of a neglect of the economic fundamentals. Hence, in seeking solutions to Sri Lanka's longstanding structural bottlenecks that impede global economic interaction, it is important to correctly assess which issues economic diplomacy efforts can resolve, which solutions it should instead aim to catalyse and which are beyond mere economic diplomacy. This will enable more efficient deployment of the limited financial and human resources Sri Lanka possesses.

Addressing internal/supply-side bottlenecks to enhance exports and investment

Diversification of the export basket

Limited diversification of the export basket, which 'has changed little since the mid-1990s' (Hausmann, 2016: 20), remains at the core of Sri Lanka's woes: 50–60% of exports are apparel and clothing accessories. In contrast, Costa Rica, Thailand, Turkey and Vietnam, which began from an even lower level, rapidly diversified their export baskets.

Introduction and expansion of new products

Even in instances where new product categories have been pursued for export or in the expansion of seafood and wellness products, and in relation to further upgrading of exports such as cinnamon and graphite, besides finding it difficult to increase its value-added component, Sri Lanka has encountered difficulty sustaining supply chains and maintaining quality standards. These are essential for success in the deeply competitive modern marketplace.

Optimisation of trade concessions

Except for apparel products, which do not benefit from the US Generalized System on Preferences (GSP), 44% of Sri Lanka's exports come under free or preferential trading arrangements. Of this, 83% come under GSP schemes (Silva, 2022). Of the trade conducted under GSP arrangements, 71% is with the EU. Despite this, Sri Lanka has shown low capacity in utilising the trade concessions on offer. Under the EU's GSP+, beneficiaries can benefit from complete duty suspensions for products across approximately 66% of all EU tariff lines. Sri Lanka's use level of the GSP+ is only 62%, among the lowest of beneficiary countries (Thavapalakumar, 2021). Additionally, a recent study highlights Sri Lanka's weak positioning in its implementation of trade facilitation measures: the country ranks 104th out of 125 developing and least developed countries over the past six years; it 'has progressed only marginally from a rate of 29% in 2017 to 31.5% in June 2023' (Daily FT, 2023).

Increasing the value-added component in exports

Weak backward linkages and dependence on other countries for raw materials to produce many of Sri Lanka's prime export products, including apparel, remain a bottleneck. Since the country regained GSP+ access in 2017, only 49% of apparel exports have benefited from concessions, as the GSP+ has stringent rules of origin requirements.²⁰ Between January and May 2024, imported inputs used up \$1 million of the apparel trade export income of \$1.9 billion (Bandara, 2024). These weak backward linkages also make Sri Lankan products vulnerable to potential future challenges unleashed as a result of increasing trade wars and geopolitical issues.

20 Duty-free access is only given to apparel manufactured in Sri Lanka from yarn stage. In other words, Sri Lankan exporters who import fabric from outside to make their garments are not permitted to enter the EU market duty-free. Fabrics made in South Asian Association for Regional Cooperation countries and the EU are exempt from this rule (Verité Research, 2022).

External limitations affecting Sri Lanka's exports

Challenge of diversifying markets

As for trade, bilaterally, there has been overdependence on the West as an export market.²¹ A broader base is being sought through the revitalisation and external operationalisation of the Singapore–Sri Lanka Free Trade Agreement (FTA); an FTA signed with Thailand in February 2024; and new FTAs that are under negotiation with Bangladesh and Indonesia. Discussions are also underway on upgrading to an Economic and Technology Cooperation Agreement with India; more effective operationalisation of Trade and Investment Framework Agreements with the US and Australia; and an FTA with China.

Regionally, considering the failure of the South Asian FTA (SAFTA) and trade facilitation measures concerning organisations such as the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation and the Indian Ocean Rim Association, which have provided limited returns, in a bid to increase trade and investment relations with the fast-growing East and Southeast Asian region Sri Lanka has submitted a Letter of Intent to the Secretariat of the Association of Southeast Asian Nations (ASEAN) to join the Regional Comprehensive Economic Partnership (RCEP) (Daily Mirror, 2023). Having come into operation in January 2022, RCEP has now been opened to a membership expansion, although it is yet to determine the mechanism to do so.²²

While potential entry would open up a sizable new market,²³ concern has been expressed as to whether, given Sri Lanka's low current levels of interaction with economies in this region,²⁴ RCEP has the potential to dramatically alter the shortfall in export destinations and investment sourcing.

Sri Lanka's ranking in the OECD Country Risk Classification

As of February 2024, the Organisation for Economic Co-operation and Development (OECD) Country Risk Classification of the Participants to the Arrangement on Officially Supported Export Credits ranked Sri Lanka at 7 – the worst ranking a country can get. This is not something new and connected to the recent economic crisis; the country was at this level even before the end of the conflict in 2009 and it has not changed despite the significant easing of risk factors. Such ratings make obtaining credit for those wishing to do business with Sri Lanka more difficult; friendly countries in the OECD could help Sri Lanka in revising this rating.

Travel advisories

Similarly, out-of-date adverse travel advisories, particularly issued by certain Western countries, which are unduly alarming and continue to caution, for instance, that 'terrorists are likely to try and carry out attacks in Sri Lanka,' have

21 The EU has been Sri Lanka's major export destination, taking 29.8% of its total exports to the world until 2019, of which 8.4% went to the UK.

22 Membership of RCEP comprises 15 countries, including the ASEAN members and its FTA partners – covering 28% of both the world's GDP and global trade.

23 The possible impact that can be expected from RCEP membership, as well as its challenges, is discussed in Perera (2024).

24 Sri Lanka's total exports to the world in 2022 earned \$12.7 billion, of which only \$1.2 billion was from RCEP countries. Exports to ASEAN countries earned \$374 billion. The percentage of inward FDI from RCEP countries to Sri Lanka was 27% of all investment (Pathfinder Foundation, 2024).

resulted in travel insurance risk premiums being placed at a higher level. This has undermined Sri Lanka's tourist promotion efforts.

12.4 Proposals to advance economic diplomacy

Many of the issues flagged under internal/supply-side bottlenecks go beyond economic diplomacy and foreign policy 'fixes' and need considered domestic policy intervention. In relation to those identified under external limitations to exports, economic diplomacy could play a 'catalyst' role to support domestic initiatives and expand state action. If these issues are rectified, economic diplomacy operationalised through the Ministry of Foreign Affairs and its missions abroad would be better positioned to play a more significant role operationally, with the necessary technical support provided by line ministries/agencies in Sri Lanka, working in coordination with it on two fronts.

Improve inter-agency coordination

At present, the economic diplomacy decision-making of Sri Lanka is heavily fragmented – in terms of both institutions and personnel. This results in poor internal coordination and lack of a clear chain of responsibility and accountability. For example, the need to adopt a single window mechanism has been restated repeatedly since 2009, but this has not been operationalised in a meaningful manner.

At the time of writing, the Economic Transformation Bill is before the Parliament of Sri Lanka. This provides for the establishment of an Office for Internal Trade and an Economic Commission of Sri Lanka, to be responsible for trade- and investment-related tasks, respectively, as well as a National Policy on Economic Transformation, a National Productivity

Commission and a Sri Lanka Institute of Economics and International Trade. It also aims to transform Sri Lanka into a highly competitive, export-oriented, digital economy, including through diversification and deep structural changes to the national economy to boost competitiveness; to achieve Net Zero by the year 2050; to increase integration with the global economy; to achieve a stable macroeconomic balance and sustainable debt; to modernise agriculture to boost farmer productivity, farmer incomes and agricultural exports; and to promote inclusive economic growth and social progress.

However, the proposed Bill has been criticised for transferring state powers in the vital area of international trade to a 'non-accountable politically appointed Board of private individuals' (Daily FT, 2024a) and for catering to 'the interests of a few individuals, without consulting experts or investors in the field' (Daily FT, 2024b). The Bill has also been challenged in court: it was announced in Parliament on 2 July 2024 that, 'the Supreme Court has determined that several clauses of the Economic Transformation Bill are inconsistent with the country's Constitution. Consequently, these clauses require a special majority in parliament and, in some cases, approval by a referendum to be passed' (Ada Derana, 2024).

As for the personnel who will staff these newly envisaged structures, it will be crucial that their qualifications and skills match the tasks they are to perform, and that their remuneration is competitive and incentives are commensurate to their performance. Continuity of roles in the areas for which they are likely to receive advanced training must also be ensured; in the past, including in the 2016 Harvard-supported programme, those trained have been moved to other tasks through transfers and promotions, leaving the special

knowledge they gained at considerable cost unutilised or underutilised, and most importantly, the need for consistency compromised.

Create hub missions with specialised staff

Missions abroad also need reforming so they can promote the merits of trading, investing, travelling and drawing on skilled work from or in Sri Lanka. Given limitations regarding both budgets and personnel, there is a clear logic to positioning Sri Lanka's additional resources in the countries where there is significant trade, with which new FTAs are being negotiated and where there has been increased business interest in recent times. These might include the US, the EU, the UK, India, China, Thailand, Singapore and Indonesia. Diplomatic missions/posts here should be seen as 'hub missions,' to focus on economic diplomacy.

Commercial specialist officers are already located in over 24 missions, and foreign employment/welfare specialist officers in over 15 missions. However, given the vulnerability currently faced in traditional export and investment-generating markets, Sri Lanka should also enhance the resources and personnel deployed in the hub missions specified above.

As for personnel, careful consideration must be given to picking those who have the specialised skills required. Experts based in Sri Lanka could act as roving diplomats or carry out short assignments that are event-/issue-related from outside. Irrespective of the choice of modality and the location of operation, it is vital that there be a clear line of command and accountability, both when working overseas and when in Sri Lanka.

There is precedent for having hubs manned by specialised personnel. In 1997, in the face of increasing challenges from the LTTE and its front organisations, and a shortage of media-savvy officers within the foreign ministry ranks, the latter recruited through an open competitive process six mid-career media specialists. These were given contract appointments as 'counsellors (information)' and, following a period of training, were appointed to 10 'regional information nodal centres,'²⁵ along with 4 officers of the Sri Lanka Foreign Service who had received focused exposure/training in public diplomacy. Along with changes made within the then Publicity Division, this made it possible to strengthen institutional structures, including through enhanced technological capabilities to meet the 'internet age' and better coordination and cost-effectiveness.

Engagement with the Sri Lankan diaspora community

Encouraging Sri Lankan diaspora communities, and their business partners, to trade and invest in Sri Lanka is a low-hanging fruit with potentially big returns. In the past, engagement with the diaspora has been scattered, with a multitude of Sri Lankan agencies playing overlapping roles, often at cross-purposes. Since operationalisation of the Office of Overseas Sri Lankan Affairs, located within the Presidential Secretariat, Sri Lanka has been mandated to play a more collaborative role in this regard. The dual citizenship scheme was intended partly to encourage more engagement with diaspora communities but some perceive it to be expensive and cumbersome. A cheaper and more effective alternative might involve a version

25 Bangkok, Bonn, Canberra, London, New Delhi, Ottawa, Paris, Pretoria, Stockholm and Washington, DC (Ministry of Foreign Affairs, 1998).

of India's successful Overseas Citizen of India scheme, to attract young people of Sri Lankan origin to engage in business activities in Sri Lanka.

Policy and regulation consistency

With respect to both trade and FDI, constantly changing government policies and regulations have been a serious impediment, resulting in a lack of predictability over time. Shortcomings in transparency and allegations of corruption have also posed challenges. As well as improvements on commercial ratings, then Sri Lanka needs to considerably increase its ranking on global indices such as those on Ease of Doing Business, Corruption Perceptions and Democracy. Modalities to arrest these trends have already been proposed and feature prominently in recent developments, such as in the IMF's Sri Lanka Governance Diagnostic Assessment of September 2023.

Ensuring a level playing field for all investors

Absence of a level playing field in Sri Lanka has been a constant accusation, ironically by all competing global foreign powers seeking to do business in the country, particularly over the past decade. In this context, Sri Lanka has made efforts to ensure that Colombo International Financial City remains a level playing field that can draw investment from all countries, in spite of it being built by a Chinese company that continues to have a lease on parts of the land.²⁶ However, so far, success in this respect has been limited. Achieving this will be pivotal to Sri Lanka's credibility as an investment destination.

12.5 Conclusion

Beyond the above aspects that impact economic diplomacy – from within Sri Lanka and abroad – one must also expect trade and investment to be fungible and mutually interchangeable, and to sometimes be used as a trade-off with unrelated political, defence and strategic assets and interests, forcing Sri Lanka to have to make difficult choices with consequences. Hence, in the foreseeable future, Sri Lanka's economic prospects will continue to be considerably intertwined with the foreign policy positioning it takes in a deeply polarised strategic environment, where exclusivity is being sought by Sri Lanka's core bilateral partners – India, China and the US – while other important bilateral and multilateral economic partners are also making demands.

Additionally, with a new GSP+ regulation likely to be adopted, Sri Lanka's trade prospects face vulnerability, as experienced previously with the EU on account of human rights concerns. Sri Lanka must additionally guard against disruptions caused by external policy changes directed at it – as retaliation for any resistance to pressures imposed, or if Sri Lanka becomes mere collateral in broader global actions by the major powers. Navigating in an increasingly 'zero-sum' environment, Sri Lanka must scope out options that take these broader considerations into account.

Ironically, notwithstanding the immense difficulties resulting at the public level from the economic crisis of 2022, in retrospect it could be considered to have to some extent allowed Sri Lanka sufficient wriggling space to avoid being

26 Governed by Colombo Port City Economic Commission Act No. 11 of 2021.

compelled to choose between different powers in the conduct of its foreign policy, and to enable it to gravitate to the middle. As a result, despite strong bilateral differences among the major powers, Sri Lanka has successfully navigated a complicated negotiation process with all countries and parties concerned and secured the international collaboration necessary for the release of three tranches of a total of \$2.9 billion under the IMF EFF.

While Sri Lanka's main focus in the immediate term no doubt will be on overcoming the current economic crisis and its multifaceted ramifications, the country must also restore its overall image, in order to regain its lost leverage in the international sphere. It will be important to use the current momentum and solidarity shown by international partners in debt restructuring as a catalyst in evolving a national consensus on a sustainable strategic rebranding and repositioning of Sri Lanka globally.

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Part 4: Key reform priorities and implementation lessons



13 Consolidating IMF-style stabilisation and priorities for growth in Sri Lanka

Indrajit Coomaraswamy and Ganeshan Wignaraja

Summary

Sri Lanka has made a remarkable turnaround since the dark economic days of default in 2022. But its economy remains fragile amid political uncertainty. The period ahead requires continued commitment by Sri Lanka to the International Monetary Fund (IMF) programme. This needs to be complemented by a laser-like focus on structural reforms to construct an outward-looking competitive economy that drives sustained growth and poverty reduction. Five sets of proposals, under the headings of consensus on the economy; making Central Bank independence work; supporting fiscal sustainability; pragmatic economic transformation; and making growth inclusive are provided to achieve these end goals. If Sri Lanka sticks to this course of action, there is every prospect of the country moving from debt distress to sustained economic development.

13.1 Assessing progress in the IMF programme

The outcome of the IMF Board's second review of the \$3 billion IMF Extended Fund Facility (EFF) with Sri Lanka on 12 June 2024 is a positive development. Sri Lanka is reported as overperforming the IMF targets on several key macroeconomic indicators, such as growth, inflation, government revenue and the primary balance, the current account of the balance of payments and external reserves (see IMF, 2024). The review has translated into the country's 17th IMF programme, providing another \$333 million to

help Sri Lanka implement policies to continue to stabilise the crisis-hit economy. Some critics (e.g. Kadirgamar, 2023) argue that the austerity policies may not be worthwhile, given the relatively small value of the IMF EFF in relation to Sri Lanka's import cover and debt service. However, this ignores the fact that successful conclusion of the IMF second review will also unlock direct budgetary support from the Asian Development Bank and the World Bank of at least \$500 million and new money from bilaterals. Furthermore, the IMF's seal of 'good housekeeping' gives confidence to citizens, local businesses, investors, trading partners and creditors that Sri Lanka has been serious about implementing the EFF.

Indeed, Sri Lanka's rapid economic stabilisation in mid-June 2024, compared with the dark economic days of 2022, is remarkable. Days-long fuel queues have disappeared, and there are ample supplies; cost-reflective pricing has been introduced for fuel and electricity; inflation is down to single digits (although the overall price level is elevated); the exchange rate is broadly stable; foreign exchange reserves are up to \$5.5 billion, enabling liberalisation of all import restrictions other than for personal vehicles; remittances have stabilised near pre-pandemic levels; and tourists are flocking to the country. Recent analysis (e.g. Wignaraja, 2024) has attributed the turnaround to a combination of (i) decisive stabilisation policies by the Wickremasinghe administration and the Central Bank of Sri Lanka (CBSL), (ii) implementation of the IMF's EFF, (iii) Indian emergency aid,

(iv) financial and technical support from many development partners and (v) Sri Lanka being a small economy with a favourable geographical location in the Indian Ocean close to high-growth markets as well as institutions and markets that are sensitive to changes in policies.

However, it is very important to remember that Sri Lanka has been here before, in several of the 16 previous IMF programmes during which stabilisation targets were achieved. Two points must be emphasised. First, on previous occasions, the good work on stabilising the economy has been undone by fiscal indiscipline, often supported by loose monetary policy, during elections (Weerasinghe, 2021). Clearly, the same mistakes need to be avoided this time around. Second, previously, there has invariably been a very poor record of implementing the challenging structural reforms required to deliver sustained growth and higher-value employment, primarily through constructing a competitive and outward-looking economy that delivers export transformation.

13.2 The path ahead

It is important to underline that this time around the economic crisis has extracted a terrible human toll. Estimates of post-default poverty vary but the available data indicate a worrying trend despite methodological issues. The standard international income poverty measure for lower-middle-income countries (\$3.65 a day 2017 purchasing power parity) suggests that 25.9% of the Sri Lanka's population lived below the poverty line in 2023, a doubling of poverty since the crisis (World Bank, 2024). However, this is based on micro-simulations by the World Bank of 2019 data from the Department of National Census and Statistics rather than a recent survey. Based on the 2022–2023 National Citizen Survey of 25,000 households, 55.7% of the population in Sri Lanka is

multidimensionally vulnerable (UNDP, 2023). This means that an eye-catching 12.3 million people are deprived on at least three out of the 12 indicators that span the critical dimensions of education, health, disaster and living standards. However, some double-counting may be involved, leading to higher-than-expected deprivation numbers.

Tragically, children have suffered the brunt of the economic crisis. The Ministry of Health (2023) measured the nutritional levels of 1.4 million children aged under five years registered with public health midwives in June 2023. It reported that the percentage of children aged under five who were underweight rose from 15.3% to 17.1% between 2022 and 2023, with Nuwara Eliya recording the highest underweight percentage, at 26.4%. In addition, over 15,000 children aged under five years in Sri Lanka were reportedly suffering from severe acute malnutrition. High child malnutrition levels suggest that families on low fixed incomes were struggling to make ends meet and switching to fewer meals and less nutritious diets during high inflation and job losses.

Issues of the 'new poor' receive attention in the second review of the IMF EEF, which states that 'all quantitative targets for end-December 2023 were met, except the indicative target on social spending.' This seems to reflect a disturbing lack of priority being attached to the urgent and potentially destabilising phenomenon of sharply increased poverty and vulnerability, including less access to health and education and greater vulnerability to natural disasters.

Additionally, growth is expected to be in positive territory after six consecutive quarters of negative growth, with a peak to trough decline of at least 12% between 2022Q1 and 2023Q3. It seems unlikely that gross domestic product (GDP) will recover to its 2022 level till at least 2027. The

IMF's forecast is for tepid growth in Sri Lanka of 2.0% in 2024 and 2.7% in 2025. This is well below the 6.0%+ growth expected in South Asian high performers like India and Bangladesh and what is needed to create jobs and reduce Sri Lanka's high poverty levels. Higher growth also makes it easier to achieve the targets in the IMF's Debt Sustainability Analysis, and sets in motion a positive virtuous cycle of accelerating growth and investment, both public and private.

One of the key areas identified in the IMF second review is the anchoring of Sri Lanka's macroeconomic policies in clear frameworks backed by law. This is a work in progress, with the enactment of the Central Bank Act and the tabling in Parliament of the Public Finance and Public Debt Management Bills. These are the key pillars of the reforms to stabilise the economy and avoid repeated bouts of macroeconomic stress.

Repeated cycles of fiscal forbearance in monetary policy have greatly compounded macroeconomic instability in Sri Lanka (Coomaraswamy et al., 2023). There has been little recognition in political circles that CBSL is not a development bank, and that price stability is its primary responsibility. The past actions of CBSL, which supported fiscal indiscipline through deficit financing on a consistent basis, led to an amplifying of the adverse effects of budgetary imbalances. It has been the practice for CBSL to participate in the primary auctions for Treasury bills, the most egregious form of money-printing. This has resulted in inflation, balance of payments pressure and increased debt. In addition, the yield curve has been suppressed through financial repression. This has also contributed to pressure on prices and the current account as well as unsustainable leveraging for businesses and households.

Within this misaligned framework of macroeconomic policies, there have also been repeated attempts to artificially fix the exchange rate. This inevitably led to the double whammy of a rapid depletion of external reserves and eventually a sharp devaluation.

13.3 The new macroeconomic framework

A positive development is that the Central Bank Act of 2023 is in place, which enables greater central bank independence in implementing a flexible inflation targeting regime. This means that CBSL's primary objective rightly becomes price stability. The Central Bank Act stops money-printing to finance the government's fiscal deficits. However, overall political direction by the sovereign is maintained through the finance minister setting the inflation target in consultation with the CBSL governor – presently 5% plus minus 2%. The Act provides for operational/instrument autonomy for CBSL to formulate policies to meet the inflation target. This is a point that has been misunderstood by some critics (e.g. Nicholas and Nicholas, 2023), who allege that there is no political oversight of CBSL's core objective of price stability.

In addition, concerns have been expressed about the accountability of CBSL for its policy actions. In this regard, it should be noted that the Central Bank Act provides for the CBSL governor to be called before Parliament to explain their course of action at regular intervals. Furthermore, if the inflation target is missed for two consecutive quarters, the CBSL governor is required to send the finance minister a written explanation and set out a path for returning to the target. Accountability to the public is achieved through publication of various CBSL reports and data on the CBSL website.

Nonetheless, there are two issues related to the Central Bank Act that require attention. First, the flexible inflation targeting regime is a highly sophisticated monetary policy framework dependent on CBSL having a high-calibre governor and skilled professional staff. Unfortunately, CBSL's institutional capacity has been diminished by a 'brain drain' of over 100 key staff since the economic crisis, many of them in search of better salaries and prospects elsewhere. Second, while the Central Bank Act makes CBSL the macroprudential authority to monitor systemic risk, its early warning system and tools are at a very early stage of development.

But the recently passed Public Finance Management Act of 2024 and the Debt Management Bill of 2024 need to be implemented. These are crucial to bring discipline and transparency in public finances to avoid repeating macroeconomic crises in Sri Lanka, to address economically irrational foreign borrowing and to help prevent future debt distress. The former strengthens the fiscal rules with a target of 13% of GDP for primary expenditure and a 2% budget reserve. It also has measures to strengthen tax administration, which has been a serious historic problem. This includes targets for the three key revenue agencies (the Inland Revenue, Customs and Excise Departments) and digitalisation through more effective use of the Revenue Administration Management Information System (RAMIS). Moving to a medium-term budgetary framework, more robust expenditure and cash flow management, and digitalising using the Integrated Treasury Management Information System (ITMIS), are positive initiatives in the Bill.

One area of fiscal weakness has involved the lapse of project appraisal and technical selection of infrastructure projects, and its replacement with fast-tracking of unsolicited bids through

Cabinet approval. The politicisation of the selection process has led to a mixed portfolio of infrastructure projects, including some low-return, loss-making infrastructure projects that have been a drain on the budget and contributed to external debt (see Wignaraja et al., 2020).

Meanwhile, the Public Debt Management Act creates a single office for debt management, instead of the current highly fragmented system, involving CBSL, the External Resources Department and the Treasury Operations Department. Removing debt management as an agency function of CBSL removes an important conflict of interest between formulating prudent monetary policy to achieve price stability and raising money at least cost for the government.

Finally, the Economic Transformation Act just passed attempts to embed in law some overdue structural reforms to accelerate growth and enhance structural change. It sets ambitious targets such as achieving 5% annual GDP growth by 2030 and sustaining this thereafter, increasing exports to 40% of GDP by 2030 and achieving net foreign direct investment of at least 5% of GDP by 2030. The Bill proposes a radical approach to attain these targets – namely, the creation of several new agencies, including the Economic Commission (to replace the Board of Investment), Investment Zones SL, the Office for International Trade, the National Productivity Commission and the Sri Lanka Institute of Economics and International Trade.

The government does need to review the effectiveness of the current fragmented structure of trade and investment promotion agencies (e.g. the Board of Investment and the Department of Commerce) and modernise the overall institutional support system to facilitate exports and investment. The Bill rightly highlights this issue

and envisages a radical, big bang agenda. However, it will take some time for the new agencies in the proposed Bill to become fully operational in a context of scarce human, technical and financial resources in Sri Lanka. In the interim, there are concerns that the institutional void could have a negative impact in relation to attracting foreign and local investors and promoting exports. Some also argue that the lack of a comprehensive consultation process with key stakeholders has led to highly uneven participation in the discussions during the development of the Bill (see the review in Gamage, 2024). Furthermore, reform of the plethora of cumbersome and outdated red tape regulations hampering foreign investment and local business start-up and operation is not directly addressed in the Bill.

13.4 Alternative policies and political risks

There are important criticisms of the present macroeconomic framework and the IMF programme. It is noteworthy that even influential international critics (e.g. Guzman et al., 2024) accept the continuing need for Sri Lanka's engagement with the IMF. They also make the case for reviewing some aspects of the IMF programme to change the burden-sharing of the transitional costs of adjustment. However, deviation from the basic structural parameters of the IMF programme is fraught with risk, given that the economy remains very fragile despite signs of stabilisation and green shoots of recovery. In the past, constant policy reversals and mismanagement have been the very causes of economic crises in Sri Lanka. Two episodes of so-called home-grown inward-looking policies have been accompanied by disastrous economic results. One was in 1970–1977, which resulted in very low investment, very low growth and very high unemployment. The other episode was in

late-2019 to mid-2022, which resulted in the worst economic crisis in post-independence history, with a contracting economy and a significant reversal in gains in poverty reduction.

Several elements of the IMF EFF are what Sri Lanka should be doing anyway, such as ensuring an independent central bank, fiscal consolidation and better government. The time is not for experimentation but for consensus and continuity on the broad macroeconomic framework and acceleration of structural reforms. This is a lesson that can be learnt from other countries such as those of East Asia plus India, which have come out successfully from major crises.

Political risks could derail the IMF EFF and recovery beyond 2024 – presidential elections are due in late 2024 and parliamentary elections in 2025. Rising income poverty since the default, the squeezing of the disposable income of the middle class through increased costs and taxes, and anti-incumbency may be increasing support for the left-wing populist National People's Power (NPP) party and the centre-right Samaji Jana Balwegaya (SJB). Although they are short on details, both the NPP and the SJB say they want to renegotiate the IMF agreement, which is causing uncertainty about the post-election direction of Sri Lanka's economic policy if either party does form a government. The economic truth should be told: there is little room to manoeuvre in these challenging circumstances apart from through positive policy proposals such as on trade and investment facilitation.

13.5 Proposals

Various proposals are suggested under five broad headings to lay the platform for sustaining macroeconomic stabilisation and promoting the recovery of growth.

1. Build a cross-party consensus on the economic direction of Sri Lanka. A fragile economy and political uncertainty mean consensus on a 10-year vision for national economic development must be reached among political parties, business organisations, trade unions and civil society (Coomaraswamy and Wignaraja, 2023). Events co-hosted by think-tanks and the media can facilitate candid conversations on the merits of inward-versus outward-looking policies and the IMF programme versus alternatives in an uncertain global economy. Areas of agreement should be codified into a readable national economic development vision document for the next decade outlining the following: economic development achievements and failures; realistic targets for economic development; an outward-oriented, market-friendly policy agenda; and risks to implementation.

2. Make CBSL's independence work. The flexible inflation targeting regime requires CBSL to have high-calibre managers and professionals. Most importantly, the CBSL governor needs to have a thorough understanding of monetary policy tools to steer an economy and be a competent manager to oversee a complex organisation. Ideally, the governor should come from among the deputy-governors of CBSL. In addition, to retain talented CBSL professional staff, performance-related competitive salaries should be benchmarked with a sample of state and private financial institutions. Finally, CBSL's early warning system and data analysis tools need development. The progress already being made by CBSL in establishing an effective early warning system needs to be supported regionally through the SAARCFINANCE Governors process and built up with the IMF's South Asia Regional Training and Technical Assistance Center. This will enable CBSL to implement its new mandate on macroprudential surveillance.

3. Support fiscal sustainability. The important Public Finance Management and Debt Management Acts need to be implemented expeditiously to promote fiscal transparency and discipline. In addition, to reduce wastage and leakages, project controls must be rigorous and effectively applied for all infrastructure projects in the Public Investment Programme (PIP) prepared by the Ministry of Finance. This requires (i) the introduction of a formal process of project appraisal to evaluate value for money in infrastructure projects, rigorous project selection, a strict internal process for on-boarding projects into the PIP and publication of reports; (ii) a strict use of competitive bidding to select contractors and suppliers for projects; and (iii) a powerful parliamentary committee on infrastructure financing, backed by a technical secretariat, to randomly investigate successful infrastructure project bids and appraisal reports.

4. Undertake pragmatic economic transformation. Scarcity of resources and some concerns by opposition political parties suggest that implementation of the Economic Transformation Act may be slow and intermittent even if it is enacted by Parliament. Four suggestions should be considered: (i) 'stroke-of-the-pen' reforms to drastically cut redundant regulations hindering foreign and local investors must be undertaken alongside the creation of new agencies for investment and trade. For instance, the steps and paperwork required to start a business need streamlining and digitisation; (ii) it is important that the government's time-bound plan to address rent-seeking and corruption vulnerabilities be implemented to ensure efficiency and attract badly needed investment (see IMF, 2023); (iii) there is a case for some prioritisation in creating new agencies under the Bill. It is arguable that establishing a properly resourced Office of International Trade should be an early priority

5. as Sri Lanka is currently involved in multiple free trade agreement negotiations with its trading partners (e.g. China, India, Malaysia and Indonesia) but lacks capacity here; (iv) consultation with all key stakeholders when rolling out these long-overdue institutional reforms in the Bill will enhance their efficacy and durability. The roles of existing agencies and experienced staff should be repurposed for effective achievement of key reforms in the Bill.

6. Make growth inclusive. Growth must be made more inclusive to deal with high poverty and political dissatisfaction. This requires better-targeted cash transfers towards the poorest along with a modest rationing of basic food where necessary. Eligibility also should be determined through a unique ID system and the benefits should be transferred directly to bank accounts of beneficiaries (as in the UIDAI (Aadhar) System in India) to eliminate rent-seeking and inefficiencies. The World Bank is currently working with Sri Lanka on a new cash

transfer system (the Aswesuma social welfare benefit programme), introducing a unique digital ID system to better target the poor, reduce leakages and expand bank accounts for the poor. Furthermore, food security should be improved by liberalising imports of basic food items and encouraging private investment in modern temperature- and humidity-controlled storage systems in rural areas to reduce high post-harvest losses in rice, vegetables and fruit.

The above is not intended to be an exhaustive list but rather the core of a common minimum economic agenda for the future. Other important policy priorities include improving agricultural productivity; modernising the education system; reforming the labour market; promoting small business development, especially micro-enterprise start-ups; building firm-level technological capability and the national innovation system; and improving the judicial system.

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14 Accountability: the key to sustained and inclusive growth in Sri Lanka

Shantayanan Devarajan

Summary

As the Sri Lankan economy has stabilised since the economic collapse of 2022, the highest priority now is the resumption of growth. This essay shows that the underlying weaknesses in the economy, and therefore the key to sustained and inclusive growth, have to do with accountability – of entrepreneurs to markets and of governments to citizens. In four areas – agriculture, energy subsidies, targeted cash transfers and macroeconomic policy – policies have made entrepreneurs and citizens accountable to government rather than the other way around. To restore growth, reforms should make producers accountable to world markets and governments accountable to citizens. While these reforms may, as usual, be resisted by governments and some elites, the disastrous effect of unaccountable government in 2022 that led to a citizens' movement that overthrew the president may mean that this time is different.

14.1 Introduction

In 2022, Sri Lanka suffered its worst economic crisis since independence. Two years later, the economy has stabilised: inflation has declined from 70% to about 5%; foreign exchange reserves are exceeding the targets of the International Monetary Fund (IMF)-supported programme; the rupee is appreciating; and, after being negative for two years, economic growth is turning positive.

But the challenge of achieving sustained and inclusive growth is formidable. Many of the structural measures needed for rapid economic growth – in trade policy, state-owned enterprise reform and governance – have yet to be implemented; the tax-to-gross domestic product (GDP) ratio, one of the lowest in the world, has risen by only 2 pp; when concluded, the debt restructuring programme will leave the country with a precarious debt-to-GDP ratio of 95%; and the hardship and suffering of the increased number of poor people continue unabated.

This essay shows that the agenda going forward, as well as the sources of Sri Lanka's collapse, have a common factor: accountability. Global experiences as well as those in Sri Lanka show that inclusive growth takes place when the people hold government accountable – when citizens, especially poor citizens, demand quality services from service providers and pro-poor policies from politicians (World Bank, 2003). It is also more likely when entrepreneurs face competitive prices rather than politically motivated taxes and subsidies.

The economic history of Sri Lanka can be characterised as one in which the government has held the people accountable rather than the other way around. In one case of the government actually ceasing to hold people accountable, the outcome was rapid economic growth and poverty reduction. That was in the late 1970s, when the country decided to remove import barriers. At that time, there was great concern

that import-substituting firms, and therefore the manufacturing sector, would collapse. The small garment sector that catered to the domestic market feared that it would not survive the influx of cheap imports. Instead, when trade was liberalised, the economy boomed. Per capita GDP growth accelerated

(Figure 14.1). The unemployment rate fell to 4%. Rather than collapsing, the garment sector took off, thanks to cheap imported inputs and foreign investment. In per capita terms, Sri Lanka's garment exports to the US far exceeded those of Bangladesh, China and India.

Figure 14.1 GDP per capita in Sri Lanka, 1950–2018 (\$)



Source: www.ourworldindata.org

Note: GDP per capita adjusted for price changes over time (inflation) price differences between countries; measured in international \$ in 2011 prices.

The experience with trade liberalisation shows that Sri Lankan entrepreneurs can compete when they are accountable to world markets rather than to the government. The solution to the current crisis, therefore, is to undertake policies that strengthen people's ability to hold government²⁷

accountable. Here, we apply this principle of accountability in four areas to spur inclusive growth in Sri Lanka.

²⁷ This meant that the government could no longer control industries and curry favour with certain producers. Recent governments have attempted to reverse this situation by introducing para-tariffs and other trade restrictions. Worse, existing reforms have been implemented selectively, leading the IMF in its 2023 Governance Diagnostic Assessment to conclude that 'exposure to corruption in Customs... is substantial' (p. 13). Not surprisingly, Sri Lanka's trade ratio (exports plus imports as a share of GDP) has fallen from 80% to about 40%.

14.2 Agriculture

Sri Lanka's agriculture sector has traditionally been the lowest contributor to overall GDP in the country. As in all countries that transform from a rural economy to an industrial and services-oriented economy, agriculture's share of GDP has been declining steadily. Unlike in other countries, such as those in East Asia that have achieved structural transformation, productivity in Sri Lanka's agriculture sector has not been increasing. Earnings in the sector have rather been low and falling (World Bank, 2021).

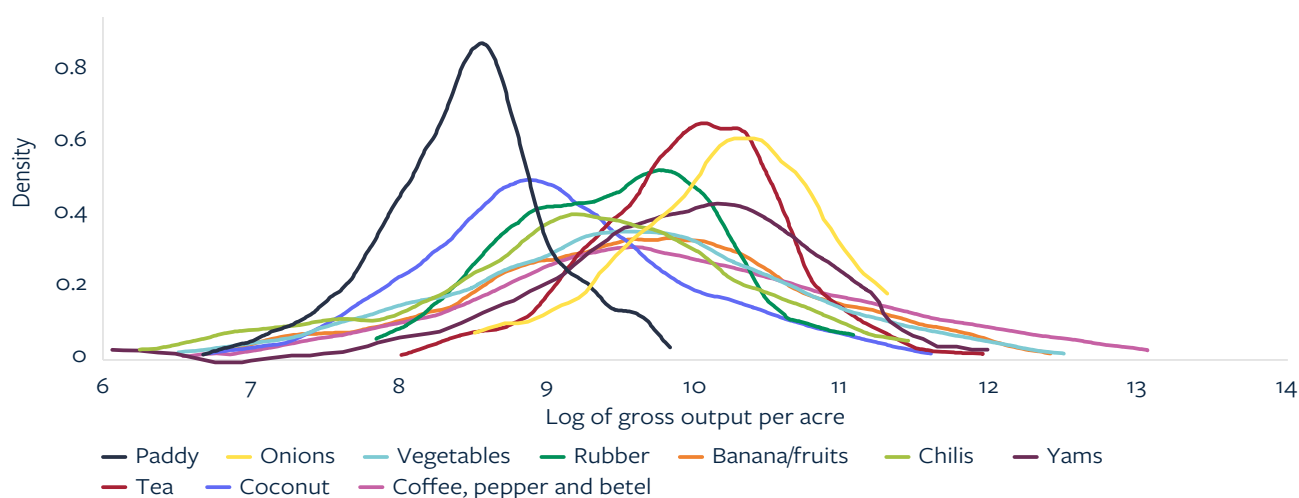
One reason for this is that about 45% of farm households, most of which are among the poorest 20% of the population, are engaged in the cultivation of paddy. Paddy is the least productive crop (Figure 14.2). It is also the least remunerative in terms of value of output per acre (Figure 14.3). Why, then, do they continue to grow paddy when the returns are so low? Because they are required to by law. The Paddy Lands Act of 1958 and its successors oblige farmers who lease land from the state to grow only paddy. The Act was introduced to ensure self-sufficiency in rice, a staple food in Sri Lanka. The government also subsidises various inputs, such as fertiliser, and restricts (cheaper) imports. Yet growing fruits and vegetables could

be much more lucrative for farmers. There is anecdotal evidence of farmers who try to grow fruits and vegetables on their land being fined.

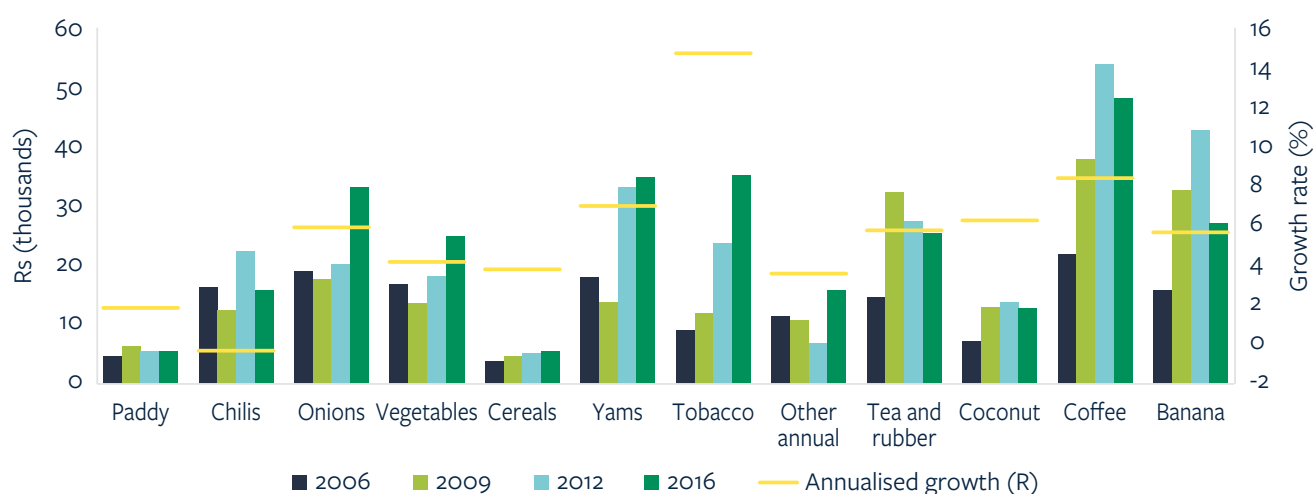
Nevertheless, some find it worthwhile to continue to grow such other crops and pay the fine.

The Paddy Lands Act made the farmer accountable to the government rather than to the market. If the farmer were able to choose which crop to grow, he or she would be accountable to the market, which is how other countries such as China have increased their agricultural productivity and reduced poverty. This is also how Sri Lankan entrepreneurs increased output and profits after trade liberalisation in the 1980s. By forcing farmers to grow only paddy, the government is not only constraining farmers' choice but also keeping poor farmers poor.

The solution in this case is straightforward: repeal the Paddy Lands Act and allow farmers to grow whatever they wish. Unfortunately, this is politically sensitive since it touches on the distribution of land rights. As an intermediary step, Sri Lanka could experiment with allowing farmers in one district to exercise choice. In a year or two, the experiment could be evaluated and, if successful, scaled up.

Figure 14.2 Kernel density estimates of the log of gross output per acre, by crop

Source: World Bank staff calculation using HIES 2016

Figure 14.3 Crop productivity (gross value of output/acre in rupees), 2006–2016

Note: HIES combines tea and rubber as one category for 2006, 2009 and 2012. In 2016, tea and rubber are included as separate categories but are aggregated for this table. Gross value of output is temporarily and spatially adjusting using the Colombo Consumer Price Index. 1% and 99% tails are trimmed.

Source: World Bank staff calculation using HIES 2016

14.3 Energy subsidies

Sri Lanka has been subsidising fuel and electricity, as reflected in the losses of the

Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB), which had grown by the end of 2022 to 3.8% of GDP (IMF, 2023). Ostensibly designed to protect poor

people from rising fuel and electricity prices, these subsidies have the opposite effect. They transfer resources to the rich, who drive cars that consume high levels of petrol and who are able to run air conditioners and washing machines in their homes. About 70% of the fuel subsidies accrue to the richest 30% of the population (World Bank, 2017). This is consistent with the evidence from developing countries in general of about half of fuel subsidies going to the richest 20% of the population (Coady et al., 2015)

Worse, these subsidies lead to inefficiencies in the production and distribution of electricity and fuel. Since consumers are not paying the full cost, the electricity utility has little incentive to provide an efficient service. It neglects maintenance of the electricity grid, leading to power cuts and blackouts. When these blackouts occur near election time, the incumbent government panics and buys high-cost diesel from power stations to supplement the dysfunctional grid. As a result, the overall cost of power is even higher and the subsidy greater. The problem, again, is lack of accountability. When there is a subsidy for electricity, the CEB is not accountable to the consumer but to the government, which pays the subsidy. The outcome is poor service and high fiscal costs.

There is another way in which these subsidies are corrosive. They send a message to the poor that, if they want to receive a benefit from the state, they have to consume fuel. Yet, as we have just seen, it is not poor people who consume a great deal of fuel. Compare the subsidy with a

targeted cash transfer. With the latter, a poor person can decide how to spend the benefit from the state – on children’s education, on investing in a business or on improving the home. In short, energy subsidies take away poor people’s agency.

14.4 Targeted cash transfers

As mentioned above, targeted cash transfers are a powerful alternative to energy subsidies, which are regressive, inefficient and disempowering. Any programme of energy subsidy reform should be accompanied by targeted cash transfers because the poor, even though they consume very little fuel, will still be affected by the removal of subsidies. An increase in cash transfers that enables poor people to afford the higher-priced energy alongside other items would allay the concern (usually expressed by the non-poor) that subsidy reforms ‘will hurt the poor.’ Successful energy subsidy reform programmes in Egypt and Indonesia have done just this.²⁸

Sri Lanka has had a targeted cash transfer program, Samurdhi, since the 1990s. But this reaches only 40% of the poor – at the same time as 16% of the nonpoor (World Bank, 2021). This is not surprising since the criteria for eligibility are based on a complex formula that is prone to manipulation. Furthermore, as in other countries (Diaz-Cayeros et al., 2016), there is evidence that transfers are used for political purposes rather than poverty alleviation. Sharif (2005) found that Samurdhi transfers were concentrated in those districts that voted between 40% and 60% for the incumbent party. As Gunatilaka (1997) observed:

28 In Iran, to make the promise of the accompanying cash transfers credible, the government handed out the transfers in advance of the cuts in subsidies. Individuals could see the money in their bank account but they could not spend it until the subsidies were removed. This shifted public support for subsidy reform and the programme was quickly approved by parliament (Guillaume et al., 2011).

Political affiliation determined the eligibility of some to receive the consumption grant... The niyamakas said that they are under pressure from area politicians and village-level party organizations to give the Samurdhi grant to [incumbent party] families and to deny them to [opposition party] supporters (p. 26).

In sum, while cash transfers are a way of increasing poor people's agency, in Sri Lanka they have been designed with sufficient discretion that politicians can capture them and undermine the public's ability to hold the government accountable for them. The proposed new programme, Aswesuma, although approved by parliament, was met with protests by people who had been taken off the Samurdhi rolls. These people were put back on the rolls pending a review of their cases. This review has yet to be completed.

Reform of the cash transfer programme should include a simplified and transparent eligibility mechanism, such as the proposal to use 60 kwh per month of electricity consumption as the criterion, which will perform better than Samurdhi (Gunawardena and Siyambalapitiya, 2023). Electronic transfers will prevent capture by intermediaries. Finally, data on the incidence of the transfer – the income of the people receiving the cash transfer – should be made public. There is considerable evidence that transparency in the allocation of public expenditures, by empowering poor people with information, can make these transfers more pro-poor (World Bank, 2013).

14.5 Macroeconomic policy

Sri Lanka has been running high fiscal deficits and high inflation for a long time. One reason for this is lack of accountability for the financing of fiscal deficits. All

governments have three choices for financing a given fiscal deficit: they can (i) borrow abroad, which can lead to a debt crisis; (ii) borrow from domestic capital markets, which leads to higher interest rates and some political backlash; or (iii) borrow from the central bank, which may result in inflation a year or two later, at which point you can blame the inflation on world price shocks and supply chain disruptions. Not surprisingly, Sri Lankan policy-makers in 2019–2022 chose the last option – and ended up in the worst economic crisis since independence.

The Central Bank Act of 2023 constrains government's ability to borrow from the central bank and should restrain inflation in future. This is an extreme form of enforcing accountability: tying the central bank's hands so it cannot be pressured to finance the deficit.

There is one more type of accountability that needs to be introduced to avoid future debt crises, and that is in the foreign borrowing strategy. Sri Lanka borrows from governments in the form of loans and from the private sector in the form of sovereign bonds. In some quarters, private borrowing is controversial because it is seen as excessive and as the source of the debt crisis (e.g. Nicholas and Illanperuma, 2023). But private creditors will punish a borrower if they run a reckless fiscal policy, as they did Sri Lanka in 2019. The higher bond yields in response to fiscal deficits act as a device disciplining the government to keep the deficits low. When Indonesia first issued sovereign bonds, a television was installed in the cabinet meeting room so cabinet members could see the impact of their budgetary decisions on the price of Indonesian bonds in real time. By contrast, borrowing from official creditors is often based on geopolitical considerations rather than economic ones. In 2019, the Sri Lankan government turned down a \$500 million grant from the US Millennium Challenge Corporation

and a \$1.5 billion loan at a 0.1% interest rate from Japan and instead took on loans from China at commercial interest rates. The reasons must have been political since there is no economic justification for these choices.

To avoid such mistakes in the future, Sri Lanka's foreign borrowing should be separated from its foreign policy. Foreign borrowing should be based purely on economic considerations, such as borrowing from the cheapest lender, regardless of the state of diplomatic relations with the creditor country. Foreign policy should be based on geopolitical considerations, independent of the borrowing strategy. If this sounds unrealistic, consider the case of China and Taiwan, two countries that do not even recognise each other and, from time to time, threaten each other militarily. Yet China is Taiwan's largest trading partner and investment destination.

14.6 Conclusion

To generate inclusive growth in Sri Lanka, policy-makers and the public should focus on measures that strengthen citizens' ability to hold government accountable. This essay has identified four areas where such measures are sorely needed. If implemented, they are likely to yield results, as Sri Lanka's experience with trade liberalisation in the 1980s, and worldwide experience in several areas, shows. However, such reforms are likely to be resisted. Many governments do not want to be held accountable by their people. But the people of Sri Lanka, especially the poor, have suffered for too long as a result of the capture of public resources by the elite. As one of the posters during the Sri Lankan Aragalaya protests in 2022 said, 'The people should not be afraid of the government; the government should be afraid of the people' (Hettiarachchi, 2022).

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15 An overview of Greece's financial crisis and its implications

Phyllis Papadavid

Summary

Greece's economy has shown resurgent growth since its multi-year crisis of 2009–2018. External financial support and Greece's unprecedented fiscal adjustment were essential in reversing the country's recession. There is now thought to have been an initial overemphasis on fiscal consolidation and an underemphasis on growth-enhancing reforms. However, a rebalancing to the tradable, export-oriented sectors augurs well. Further diversification of the economy towards a digital, knowledge-based and export-led growth model will be key to building resilience to future shocks. The country's wide-ranging structural reform agenda – which has boosted inward investment and trade – holds lessons for potential policy interventions for Sri Lanka.

15.1 Introduction: the implications of Greece's financial crisis

Since its debt crisis, which lasted from 2009 to 2018, Greece has shown significant recovery, and is now thought by some, to represent an economic success story (The Economist, 2023). Greece's inward investment and its trade-to-gross domestic product (GDP) ratio have accelerated significantly, the latter surpassing those of many of its European counterparts. Greece's fiscal consolidation and wide-ranging structural reform agenda – which have boosted

inward investment and trade – hold lessons for potential policy interventions to aid Sri Lanka with its recovery.

Following the 2008 global financial crisis, Greece's long-standing macroeconomic imbalances and institutional shortcomings became evident. Debt-led consumption growth, in both the private and the public sector, was compounded by fiscal mismanagement. The country's underreporting of its fiscal deficit was the trigger for its crisis in 2009. Meanwhile, Europe's lack of a banking union at the time and the ambiguity of the European Central Bank's (ECB's) role as lender of last resort exacerbated the crisis (Wyplosz, 2017).

Greece's crisis experience was unique and unprecedented in that it occurred in the context of its membership of the Economic and Monetary Union of the EU – which both constrained its policy options and enabled its recovery. The lack of an independent exchange rate narrowed policy options but, at the same time, Europe's institutions ultimately facilitated and financed Greece's stabilisation while it embarked on its fiscal and structural adjustment.

Both the magnitude of Greece's fiscal indebtedness, and the 'sudden stop' (see Calvo, 1998) associated with the spike in risk aversion linked to its funding ability, induced the need for a prolonged macroeconomic adjustment (Gourinchas et al.,

2016). EU financial support (totalling approximately €256.6 billion between 2010 and 2018) represented 0.29% of euro area GDP (Council of the EU, 2018). This paper examines the timeline of Greece's multi-year crisis and its interplay of reforms, including fiscal adjustment, competitiveness, debt renegotiation and banking consolidation.

15.2 Greece's financial crisis: issues and challenges

The magnitude of the financial assistance to Greece, in the form of guarantees and three significant bailout packages totalling \$330 billion, owed in part to the systemic nature of the country's crisis. What is more, the International Monetary Fund (IMF) rewrote its rule book (Papaconstantinou, 2016) and altered its lending terms. Greece's government debt overhang remains an ongoing risk to its outlook. It continues to maintain a twin deficit in its current and fiscal accounts.

Greece's bailout packages, in 2010, 2015 and 2017, were necessitated by a number of policy developments, including overly optimistic debt projections by domestic authorities, an initial lack of debt restructuring, the growing difficulty of borrowing in the capital markets and domestic resistance to austerity. Greece's debt position was stabilised while it undertook an unprecedented fiscal adjustment.²⁹

Greece's first IMF–EU bailout package, in 2010, encompassed its first economic adjustment programme, worth €110 billion (\$146 billion), and was predicated on a new blueprint for recovery. Cuts in benefits and wages were expected to boost investment-led growth (IMF,

2010). Greater trade was targeted, though an export-led recovery failed to materialise (see de la Maisonnette, 2016) and economic transformation remains a priority.³⁰

Greece's second bailout package, in 2012, worth €130 billion (\$172 billion), included a significant debt write-down for private bond-holders in exchange for a reduction in the debt-to-GDP ratio from 160% to 120.5% by 2020 – the largest such restructuring in history. This debt restructuring represented over 50% of 2012 GDP (Zettelmeyer et al., 2013).

The third (and final) bailout package, in 2015, of €85 billion (\$95 billion) was a renewed attempt at reform implementation (Schrader et al., 2015), after the Tsipras-led government engaged in brinksmanship with Greece's creditors (Pagoulatos, 2018), defaulted on a €1.5 billion payment to the IMF (IMF, 2015) and imposed emergency capital controls (Papadimas and Georgiopoulos, 2015).

Drivers and catalysts in Greece's crisis

The crisis 'trigger' stemmed from government revelations that the country's fiscal accounts had been misreported (Barber, 2010). This then led to significant upward revisions in Greece's fiscal deficit, a loss of credibility and investor confidence, and difficulty borrowing in global financial markets. This occurred against the backdrop of the 2008 global financial crisis, which also exposed Greece's over-indebtedness.

Once the crisis had commenced, an initial lack of debt restructuring and delays in guaranteeing a backstop exacerbated problematic funding conditions. Fears of contagion into the banking

29 Personal communication with Professor Georgios Papakonstantinou, 22 February 2024.

30 Greece's export share typically exhibited limited value-added potential; this is similar to the export patterns of low-income countries given the focus on raw materials and labour-intensive goods (Schrader et al., 2016).

system then triggered fears of a bank run and wider financial instability, which then resulted in emergency capital controls. Crucially, the lack of upfront debt restructuring meant that the fiscal adjustment had to be larger, which made the economic downturn even more severe (Stournaras, 2019).

The sequencing of reforms was mis-calibrated. Greece's nominal wages declined faster and more strongly than prices, which had catastrophic economic and social consequences for the population and deepened the recession. There was a significant underestimation of the extent to which the economy would contract with the fiscal adjustment that had been undertaken. The unemployment rate for younger females peaked at nearly 65% during the crisis.

Greece's long-standing deficits in both its current and fiscal accounts, made it more vulnerable to external shocks. In this context, there was an overemphasis on fiscal consolidation and an underemphasis on growth-enhancing reforms, resulting in a larger-than-expected growth downturn. Greece's sizeable import share made the country vulnerable to a loss of purchasing power, given its internal devaluation.

Greece's broad policy interventions

Greece's financial crisis resulted in a wide-ranging domestic reform agenda, enacted as a part of the troika's financial assistance.³¹ Between 2010 and 2018, the sequence of institutional reforms, policy interventions

and coordinated measures constituted an unprecedented fiscal and macroeconomic adjustment. During the crisis, the Greek Parliament is estimated to have passed 14 austerity packages.

Fiscal tightening was at the forefront of Greece's reforms. In its first adjustment programme, in 2010, Greece agreed to austerity amounting to €30 billion, including cuts in pension payments, raising the retirement age and stricter penalties for tax evasion. The second bailout extended the debt repayment period, with reduced interest rates, and the third further streamlined and digitalised tax compliance.³²

Competitiveness-inducing measures were introduced. Pension payments were highlighted as a key constraint to Greece's competitiveness and to its long-term economic growth prospects. Greece's pension system was considered to be 'highly fragmented across occupations, types of pensions and benefit rules' (Nikolopoulou, 2022). And its wage structure represented 'a complex collective bargaining system with a generous minimum wage system decoupled from productivity' (ibid.).

Privatisation was scaled up in part through the Hellenic Republic Asset Development Fund, established in 2011, to separate the privatisation process from the Greek state (UNCTAD, 2011). The mechanism was thought by some to lack neutrality, given that the privatisations occurred in the context of the urgency of the bailout

31 The troika – the triumvirate of the European Commission, the ECB and the IMF – was established in 2010 as a decision group for the financial support packages disbursed to Greece and other southern European economies during the European debt crisis (see Dijsselbloem, 2019).

32 Greece's VAT lottery scheme is estimated to have had a significant impact on tax revenue (Nicolaidis, 2023).

agreement (Vlachogiannis, 2019). Greece's privatisation push has coincided with higher levels of inward foreign direct investment (FDI).

The ECB was a key stabilising factor for Greece. It held considerable quantities of Greek public debt (Gerlach, 2010) and its continued debt purchases until end-2024 effectively containing Greece's borrowing costs (Fitch, 2021), thus mitigating the recessionary impact. Any loss of trust, and re-emergent risk premia, would have risked further destabilising the Greek economy (Dimakopoulou et al., 2022).

The Bank of Greece (BOG) was pivotal in stabilising the banking system, particularly in coping with the 49% decline in bank deposits it reported between September 2009 and December 2015. The finance-growth nexus was essential given Greece's predominantly bank-based financing (Migiakis and Louri, 2019). BOG liquidity provision, recapitalisation and restructuring led to renewed trust. Greece's non-performing loans have now declined, owing in large part to state-backed securitisation.³³

Gauging Greece's success in its reform efforts

Greece's economic acceleration, and its re-entry into financial markets following its crisis, is a testament to its unprecedented policy push. The composition of Greece's growth has also become increasingly diversified. Greece's inward investment and its trade-to-GDP ratio have

accelerated. Although there are continued risks, key elements of Greece's economic turnaround are outlined below.

Greece's inward FDI has now surpassed pre-crisis levels, led in part by its push for privatisation and an improved investment ecosystem. Inward FDI has spurred Greece's vibrant start-up ecosystem: 78% of its start-up investments are funded from abroad (Foundation and EIT Digital, 2024). Cisco's investments (Diedrich, 2023) and Microsoft's first Athens data centre in its 'GR for GRowth initiative' (Microsoft, 2020) are emblematic of this.

Greece's tourism inflows have surged – a significant development, given the sector's near-20% share in the economy.³⁴ Construction projects, and property prices, have jumped, driven by surging demand for hotels and Airbnb rentals and by Greece's golden visa programme, which facilitates non-Greeks obtaining a visa with the purchase of Greek real estate. Tourism flows are expected to increase despite new restrictions (Mouzakis, 2024).

Greece's rebalancing, including towards the tradable, export-oriented sectors, has been essential. Sector splits show that value-added has increased in manufacturing compared with agriculture, and economic complexity index readings³⁵ for trade are indicative of broad improvement. However, Greece's comparative ranking has yet to improve significantly compared with those of other European economies.

33 For further details of the Hellenic Asset Protection Scheme, see <https://hfsf.gr/en/banks-asset-quality/>

34 See www.mfa.gr/usa/en/about-greece/tourism/for-sustainable-tourism-industry.html

35 Economic complexity is based on the complexity that emerges between the number of individual activities taking place within an economy. Indices are based on interpreting countries' trade data as a bipartite network in which a country's economic complexity is connected to the products it exports (Hidalgo and Hausmann, 2009).

Successful and effective debt management has been a key marker of Greece's success. Greece now has a robust Public Debt Management Agency in place, which has played an integral part in Greece's sovereign debt upgrades back to investment grade status, thanks to its proactive approach to debt management, including through its swaps programme (Becker, 2018).

15.3 Conclusion: growth interventions for Sri Lanka's growth

Greece's financial crisis, and its experience with an unprecedented fiscal adjustment, underscores the benefits of regional monetary union and the importance of competitiveness and of transparent debt management. Domestically, too, the strengthening of Greece's banking system, supported by the BOG and the ECB, was essential as an anchor for the economy. The BOG has since been pivotal in stabilising Greece's banking system.

Despite delays in debt restructuring and past domestic political resistance to the reform process, Greece has made significant strides in its post-crisis period. Its economic adjustment programme, the rapid elimination of its fiscal

imbalance and the streamlining of its public sector all indicate ongoing resilience. The rebalancing to the tradable, export-oriented sectors also augurs well promoting economic diversification to safeguard against future shocks.

Notwithstanding Greece's significant economic turnaround, significant wage cuts are deemed to have undermined social welfare. This has largely been through the dismantling of collective bargaining, the flexibilisation of working time and the easing of employment protection (Kouzis, 2017; Nikolopoulou, 2022). Greece's real effective exchange rate drop³⁶ was in line with those of other euro area economies, though the recession was at par with the US Great Depression of the 1930s (Thomsen, 2019).

Ultimately, it took three consecutive economic bailout packages, each of a duration of about three years, and an unprecedented fiscal adjustment to restore the Greek economy. Emergency EU and IMF institutional support was also essential and was effectively mobilised to preserve the credibility of the euro area. Greece's fiscal consolidation and its structural reform efforts are ongoing under the Mitsotakis-led government.

36 Calculation based on the World Bank measure of Greece's real effective exchange rate.

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