

Interviews with Dr Muttukrishna Sarvananthan on Sri Lanka's economic crisis

1. What are the major reasons for the current economic crisis in Sri Lanka? How did they contribute to the crisis?

In a nutshell, a welfare state built on borrowed money rather than on earned money, fiscal profligacy, populist rather than prudent economic policy milieu, patronage/cum greed-based governance system rather than meritocracy cum need-based governance system, and siphoning-off public resources with impunity (corruption) are the most important causes of sovereign bankruptcy of Sri Lanka as detailed below. ALL successive governments since independence are responsible for this human-made economic homicide.

The economy of Sri Lanka between independence and becoming a republic

Sri Lanka became independent on February 04, 1948 (nearly 75 years ago) but became a republic only on May 22, 1972 (years ago). Sri Lankan economy has been relief-cum-welfare-oriented ever since the Malaria epidemic of 1934-35 ushering in universal free healthcare to the entire population (non-means tested) and universal free education (from Grade 1 to university undergraduate level) since 1946 during limited self-rule (under the [Donoughmore Constitution](#)) between 1931 and 1947. The positive aspect of this relief-cum-welfare orientation of the Sri Lanka economy has been that it was a poster country for newly emerging decolonial countries in the third world in the 1950s and 1960s because of its high life expectancy at birth, high literacy rate, and other positive human development indicators amidst low per capita income. The flip side of this relief-cum-welfare-oriented economic model was that it was devoid of strategies to boost economic growth in order to maintain and sustain the universal relief-cum-welfare oriented economic model for an ever-rising population. The annual economic growth in Sri Lanka between 1948 and 1977 was less than 5% (barring just 4 years; i.e. 1960, 1964, 1967, and 1968) ([see Table 2 here](#))

From the time of independence until 1977, most successive governments have been on a concerted course of nationalisation of the banking and financial sector (since the mid-1950s) and attempts to nationalise the plantation sector (tea, rubber & coconut - the highest foreign exchange earner until the 1980s); the latter was realised only in early-1970s. Although the nationalisation of the plantations took place only in the early 1970s, due to the threat of nationalisation lingering ever since independence, the predominantly British/Scottish plantation estate owners had begun to move out of Sri Lanka to elsewhere in the Commonwealth, especially to Kenya in East Africa, since the late-1950s.

Sri Lanka was one of the major exporting countries of tea and natural rubber from the 19th Century until around 1975. During those days (1948-1977) there was anti-private sector and anti-export bias (as reflected in the export tax/cess on primary export

commodities such as tea and rubber and fixed exchange rate regimes thereby over-valuing the domestic currency) coupled with strong import substitution policies ([Donald R. Snodgrass, Sri Lanka's Economic Development during twenty-five years of Independence](#)). Price controls on essential food and medicine were the norm until 1977 (to a very limited extent even to date).

It needs to be noted that the foreign exchange earnings of primary commodities, such as tea and rubber, and the export tax revenue derived therefrom is what primarily sustained the welfare state after independence at least until 1977 ([ibid](#)). Particularly, the vast irrigation systems-centred population settlements (aka colonisation schemes) (hugely subsidised by the state) in the dry zones of the country were financed by the blood and sweat of the indentured labour brought from the southern part of the Tamil Nadu state in India (especially from Tiruchirappalli (aka Trichy) and the surrounding districts) since the late 19th century to work in the plantation estates who to date (for over 150 years) live in abject poverty, squalor, and misery.

Because of the effective price controls and tight monetary policy (e.g. very high-interest rates), Sri Lanka had low inflation rates until 1977. The flip-side of the low inflation regime was low economic growth (less than 5% average annual growth rate between 1948-1977) and low per capita income coupled with double-digit unemployment rates ([see Table 1 here](#)). This very high unemployment (especially among the youths) is what led to the first youth-led armed insurgency in 1971.

Post-1977 economic development

The new government that came to power in 1977 attempted to unshackle the inward-looking dirigisme economic model of the 1970s and integrate the economy of Sri Lanka with the rest of the world (ala newly industrialised countries in East and South-East Asia). Sri Lanka was the very first country in South Asia to liberalise its economy in 1977. Export and import controls/restrictions and foreign exchange controls were removed and the private sector was christened as the "engine of growth".

This pivot to a free-market economy in 1977, transformed the Sri Lankan economy from a primary commodity (tea, rubber, and coconut) exporting economy to manufacturing (led by ready-made garments) cum services (labour exports to the Middle East and tourism) exporting economy. Hence, foreign remittances from Sri Lankan workers in the Middle East, Cyprus, Korea, Japan, Singapore/Malaysia became the single largest source of foreign currency earnings to the country (in recent years, 6-8 billion US dollars annually), followed by ready-made garments export earnings (in recent years, 3-5 billion US dollars annually), tourism earnings (since 2010, 2-4 billion US dollars annually), and export earnings of tea (1-2 billion US dollars annually, in recent years). The foregoing 4 foreign currency earning sectors of the economy contributed roughly about 20% of the GDP in the post-civil war period (2010-2021).

Yet, the new Constitution of 1978 with its Executive Presidency and the change of electoral system to proportional representation (as opposed to the first-past-the-post Westminster model) eroded deliberative and representative democratic accountability by the Executive President and the Parliament to the people. The proportional representative electoral system bloated the significance of minor political parties in Sri Lanka thereby undermining political stability and promoting a massive rise in political and financial corruption. The proportional representative electoral system increased political patronage/matronage and financial corruption due to district-level political campaigns as opposed to constituency-/electorate-based political campaigns, and minor political parties becoming queen-/king-makers in forming different governments thereby spurring wasteful and unsustainable public expenditures.

The civil war that commenced in earnest in 1983 also derailed the process of economic liberalisation and restructuring.

Economic liberalisation should have been accompanied by institutional cum economic reforms/restructuring and fiscal consolidation/prudence both of which were lacking ([see Chapters 1, 2, and the last chapter](#)). For example, although the then government professed that the private sector is the so-called engine of growth, the public sector personnel doubled between 1980 and 2000 from more than 600,000 in 1980 to 1.2 million in 2000 ([ibid, Chapter 2](#)), 1.4 million in 2016 (government and semi-government employees accounting for 1.1 million plus 0.3 million armed forces personnel) ([see page 6 here](#)), which stands at 1.5 million in 2022. While the population of Sri Lanka has increased by only 47% between 1981 (15 million) and 2022 (22 million) the public sector personnel has increased by 150% during the same period (600,000 in 1980 to 1,500,000 in 2022). The public sector includes general public administration, education, health, and semi-government institutions such as the state-owned enterprises such as the Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), National Water Supply & Drainage Board (NWSDB), Air Lanka/Sri Lankan Airlines, Ceylon/Shell/Litro Gas, state-owned commercial/specialised banks such as the Bank of Ceylon (BoC), People's Bank, National Savings Bank (NSB), and the police and armed forces personnel. Sri Lanka's public sector employee per citizen is one of the highest in the Asia-Pacific region.

Until 1987, the current account balance in the government budget has been positive barring just a few years ([see Table 6 - 1968, 1971, 1972, & 1982](#)). That means the total government revenue (tax + non-tax revenue) has been sufficient, at least, to cover the annual recurrent expenditures of the government. Ever since 1988 to date (2022), the total government revenue has been insufficient to meet even the annual recurrent expenditures of the government budget. Therefore, part of the annual recurrent expenditures of the government as well as the entire annual capital expenditures of the government budget plus the annual public debt repayments (both capital and interests) had to be financed through domestic and external borrowings ([see, ibid, Table 6](#)). THIS PROBABLY IS THE GENESIS OF THE CURRENT SOVEREIGN BANKRUPTCY IN SRI LANKA.

Due to an acute balance-of-payments crisis around 1990, caused by the second youth armed insurrection during 1987-1989 (which was in addition to the separatist armed conflict in the northern and eastern parts of the country since 1983), throughout the 1990s a second wave (some may call it 3rd wave) of economic liberalisation, and indeed a few institutional/structural reforms were undertaken by successive governments under President Premadasa and President Chandrika Bandaranaike Kumaratunga. For example, a Voluntary Retirement Scheme (VRS) was introduced in 1990 for public sector employees to prematurely retire, and the perennially loss-making Sri Lanka Transport Board (SLTB) was partially privatised during President Premadasa's tenure. Subsequently, President Kumaratunga continued with the institutional/structural reforms by partially privatising the then state-owned Department of Telecommunications to Sri Lanka Telecom (SLT) (selling off 48% of the share), divesting the management of the perennially loss-making state-owned national carrier, then Air Lanka, to the Emirates Airlines under the name of Sri Lankan Airlines, and divestiture of the Ceylon Gas to a multinational company, namely Shell Gas Lanka Ltd.

In 2001, Sri Lanka recorded negative economic growth (-1.5) for the first time in its history due to the intensification of the civil war between April 2000 and July 2001. The new government under Prime Minister Ranil Wickremasinghe passed the Fiscal (Management) Responsibility Act in 2003 committing the government to maintain the annual budget deficit to less than 5% of the GDP. However, this mandatory commitment was breached during most of the years since then to date (for e.g., in 2021 the annual budget deficit was nearly 12% of the GDP).

Parochial but populist political dynasty takes reign

The new President that came to power in November 2005 reversed most of the partial divestiture of state-owned enterprises such as Sri Lankan Airlines, Shell Gas Lanka, etc, barring just the partial divestiture of Sri Lanka Telecom in 1997. Additionally, a state-owned budget international airline in the name of Mihin Air was established without any proper study of the demand for such a venture (which is defunct since 2017) costing over a billion dollars. Further, [several mega prestige projects](#) in the Hambantota district were started between 2006 and 2014 such as the Hambantota International Harbour, Mattala International Airport, a mega international cricket stadium, a mega international conventional centre, and a state-of-the-art public hospital. All the foregoing projects have become white elephants and a severe drain on the public finances of Sri Lanka. The tallest telecommunication tower in South Asia, namely, Lotus Tower, was built in Colombo city but is still not operational. All of the foregoing mega prestige projects were Chinese state-funded amounting to nearly 4 billion US dollars ([equivalent to about 10% of the total outstanding foreign debt of the Government of Sri Lanka as of April 2021](#)).

The regime that came to power in November 2005 took corruption to an unprecedented level. Most of the stolen money by politicians of all political parties (governing as well as the opposition) is stashed away in Dubai and Singapore.

Since graduating into a lower middle-income country in the early 2000s, successive Sri Lankan governments have been increasingly borrowing from [private international capital markets](#) through the issuance of sovereign bonds ([accounting for 47% of the total foreign debt stock of the Government of Sri Lanka as of April 2021](#)) seriously contributing to the precarity of the balance-of-payments of the country. These capital-market borrowings are unconditional with relatively higher interest rates, and with a much shorter duration for repayments. Ironically, and in hindsight foolishly, the Central Bank Governor between 2006 and 2014 even borrowed from private international capital markets to repay and/or retire the then-existing domestic public debt of Sri Lanka which were at double-digit interest rates. The nominal positive balance-of-payments was maintained with borrowed external finances and NOT with earned external finances.

China and India (2 new emerging bilateral donors since 2005) have also recklessly lent to successive governments in Sri Lanka without necessary checks and balances (undertaken by western bilateral donors as well as international financial institutions such as the ADB and the World Bank). However, Chinese lending account for only about 10% of the total outstanding external debt of the Government of Sri Lanka, and the borrowings from India account for just 2% ([see here](#)). For example, the then Sri Lankan government first requested India to finance the Hambantota International Harbour project. Only after India rejected the request, did Sri Lanka make the request to China which obliged readily probably for geopolitical reasons. The successive Sri Lankan governments have been alternatively using China and India for their lavish populist public spending and, of course, for rent seeking as well.

The total outstanding external public debt stock of the Sri Lankan government was 36 billion US dollars as of April 2021 ([see here](#)). Additionally, another at least 15 billion US dollars of external debt is owed by state-owned enterprises such as the Ceylon Petroleum Corporation, Sri Lankan Airlines, and the state-owned banks such as the People's Bank, National Savings Bank, and Bank of Ceylon (which have borrowed overseas on the behest of the successive governments since 2007). The borrowings by state-owned enterprises are called "contingent liabilities" of the government, which were borrowed under the guarantee of the Government of Sri Lanka. As such, the Government of Sri Lanka is ultimately the custodian of those semi-government foreign currency liabilities as well. The aforementioned data pertains up to the end of April 2021, which has risen further to date.

Of course, the COVID-19 and the ongoing Russia-Ukraine war have also contributed to the plight of the Sri Lankan economy due to rising global commodity prices (fuel, wheat, etc). However, primarily, the economic crisis is home-made and long-running and therefore Sri Lanka should own it instead of passing the buck.

The enigma of twin deficits

Sri Lanka has been undergoing twin deficits (that is, concurrent annual government budget deficit (the difference between annual government income and annual government expenditure) as well as annual current account deficit [the difference between annual exports of goods and services and annual imports of goods and services plus net income (e.g. interest and dividends) and transfers (e.g. remittances, aid, etc.) from abroad] ever since independence in 1948, more so since the liberalization of the economy in 1977. It is very common for developing countries to have twin deficits concurrently for a prolonged period/s of time because of lower national savings (both public and private) vis-à-vis higher investment requirements to foster economic growth.

Today's twin deficits (and the consequent rise in public debt) could be justifiable, if and only if, the anticipated returns from such investments would be able to repay the cumulative public debt (both domestic plus external debt) in the future. However, unfortunately, most of the [mega prestige infrastructure projects](#) undertaken in Sri Lanka between 2007 and 2022 and financed through commercial external borrowings are white elephants. It is not the International Sovereign Bonds (ISBs) per se was the problem, instead financially unviable mega prestige infrastructure projects were the problem (similar to the mega prestige infrastructure projects undertaken during the regime of President Suharto in Indonesia during the 1990s that unravelled during the Asian financial crisis of the late-1990s).

Since transitioning from a low-income country to a lower-middle-income country in 1997, Sri Lanka's access to outright grants as well as concessionary loans from traditional bilateral and multilateral donors has been restricted. However, only since 2007 (when the very first International Sovereign Bond (ISB) to the value of USD 500 million was issued) did Sri Lanka increasingly rely on commercial borrowings from private international capital markets to finance its current account deficit.

One of the advantages of ISB commercial borrowings is that a country need not specify a particular need (e.g. particular investment) and/or a project to borrow. For example, governments could borrow for consumption (ala budgetary support) as well; no questions asked (so much so that, the then Governor of the Central Bank of Sri Lanka boasted that it has borrowed from international capital markets just to payoff/retire higher interest bearing domestic public debt). Secondly, there are no conditions (in terms of economic policy and/or economic and political governance) attached to ISB borrowings. Thirdly, private international capital market lending does not undergo due diligence with regard to the ability of the borrowing country to repay the debt in the stipulated time period, other than the sovereign ratings of the borrowing country by the global rating agencies. Fourthly, for the borrowings through ISBs, countries have to pay only the annual interest rate (not part of the capital/principal as well annually). The entire capital repayment is made at the time of maturity of a particular bond (that is why the duration of ISBs is short-term).

The negative aspects of borrowings through ISBs are that, (i) repayment periods are much shorter (usually within 5 years or the most 10 years), (ii) the interest rates

(between 5 and 10%) are significantly higher than the concessionary loans from traditional donors (from DAC countries) or loans from the new donors or non-DAC countries (such as China and India), and (ii) there is no grace period for interest payment.

In contrast, traditional concessionary bilateral and multilateral borrowings are based on specific investments and/or projects, and therefore undergo rigorous scrutiny as to whether such investment/project is expected to provide adequate returns in terms of economic and/or social benefits to the recipient country. Additionally, traditional concessionary borrowings have a long repayment period (a minimum of 10 years, up to 30 years), bear a grace period for repayment (usually 5 years), and the interest rates are very low (up to just 2%). However, traditional concessionary lending usually bears certain economic policy conditions (especially by western multilateral lending agencies) or conditions based on democratic governance such as human/labour rights (especially by western bilateral donors).

[According to the latest available data](#), out of the total outstanding external government debt (of Sri Lanka) of 36 billion US dollars in April 2021, 47% (or \$16.4 billion) is owed to commercial international private lenders; 13% (or \$4.4 billion) is owed to the Asian Development Bank (ADB), 10% to China (\$3.4 billion), 10% to Japan (\$3.4 billion), 9% (or \$3.2 billion) to the World Bank (IBRD), and 2% (or \$0.9 billion) to India.

In addition to the foregoing external debt of the government, there is at least another 15 billion US dollars in external debt owed by state-owned enterprises such as the Ceylon Petroleum Corporation (CPC), Sri Lankan Airlines (national carrier), and state banks, which are called contingent liabilities of the government because these are lent to the state-owned enterprises on the guarantee of the sovereign/government. This \$15 billion is entirely owed to commercial international private lenders.

So, if we add the outstanding government debt and the contingent liabilities of the government, the total outstanding external public debt of Sri Lanka was at least \$51 billion in April 2021. This total external debt (as of April 2021) was 60% of the GDP in 2021 (US\$ 84.5 billion). Therefore, out of the total outstanding external public debt of Sri Lanka in April 2021, 63.5% (i.e. US\$ 32.4 billion out of US\$ 51 billion) is owed to commercial international private lenders, which is a huge burden on the economy of Sri Lanka.

In the last couple of years (especially since the onset of the pandemic), however, Sri Lanka has been effectively shut out from the commercial international private capital markets because of alarm raised by the international rating agencies questioning the ability of Sri Lanka to repay its external debt. Therefore, Sri Lanka has been mostly relying on currency swaps with China, India, and even Bangladesh, and increased ad-hoc credit lines (mostly in-kind aid of food, medicine, and fuel) from China and India in the past 2 years. In addition, Japan (\$500 million) and the Republic of Korea (\$300 million) have also chipped-in considerable amounts of financial assistance to the ailing economy of Sri Lanka during 2021.

For the first time since 1990, the [net foreign assets](#) of the Central Bank of Sri Lanka had fallen to a negative level, i.e. (-) 400 million US dollars in August 2021, which continued to rise to (-) 790 million US\$ by the end of September 2021, and (-) 1,200 US\$ by the end of October 2021.

Populist tax cuts amidst a pandemic (this sub-section is copied and pasted from Sarvananthan and Samarakoon, forthcoming)

In preparation for the parliamentary elections due any time after February 2020, the minority government in the parliament in late November 2019 proposed lavish reductions in both consumption (indirect) and income (direct) taxes (with effect from December 01, 2019, and from January 01, 2020, respectively) as well as arbitrary price reductions of several essential consumer goods with immediate effect, in order to woo all segments of the electorate (both rural and urban).

For example, the corporate income tax for the construction sector (one of the highest contributing sub-sectors to the GDP; almost 7% of the GDP in 2019) was halved from 28% to 14%. The threshold for personal income (PAYE) tax payment was raised from LKR 100,000 to LKR 250,000 per month (i.e. only those earnings more than 3 million rupees annually were subjected to personal income tax payment). The Value-Added Tax (VAT) rate was almost halved to 8% from 15% for all goods and services barring financial services. Moreover, the threshold for VAT registration was raised to LKR 300 million per annum (from 100 million per annum previously). The para tariffs (with cascading effects) such as the Nation Building Tax (NBT-2%) and Economic Service Charges (ESC-1.5%) were abolished ([Pricewaterhouse Coopers, 2020: 11](#)).

As a result of the foregoing (direct and indirect) tax reductions, the total government tax revenue as a proportion of the GDP declined to just 8% in 2020 and 7% in 2021 (a record low, as well as for the first time dropped to single-digit level since independence), which was around 12% on average in the previous five-year period (2015-2019). As a corollary, the total government revenue (both tax and non-tax revenue) plus grants as a proportion of the GDP for the first time since independence dropped to single digit level, i.e. to 9.2% in 2020 and 8% in 2021, which was on average 13.5% during the previous five-years; 2015-2019. ([Central Bank of Sri Lanka, 2021: special statistical appendix table 6](#)). It is very important to understand that the drops in government tax revenue, as well as total government revenue plus grants as a proportion of GDP, are not due to economic decline caused by the pandemic, because these are percentages wherein the decline in GDP (by -3.6%) in 2020 has been factored in.

According to [World Bank data](#), government tax revenue as a proportion of GDP for lower-middle-income countries (such as Sri Lanka) on average was around 12.5% during the ten-year period between 2009 and 2018.

In order to fulfil the profligate fiscal measures noted above (and to compensate for the consequent drop in government revenue), the government had to drastically reduce public investments in particular and public expenditures in general during 2020 (and beyond), which is reflected in the negative GDP growth in the 1st quarter of 2020 (-1.8%) despite the fact that the lockdown/curfew was only in place during the last 12 days of the quarter. Under normal circumstances, corporate income tax reduction has the potential to boost private investments and the reduction in VAT rate has the potential to stimulate demand for goods and services, thereby boosting GDP growth, which could have partly offset the reductions in public investments and public expenditures. However, due to the emergence of the coronavirus pandemic, the anticipated surge in private sector investments and demand for goods and services hardly materialised.

For example, the All Share Price Index (ASPI) of the Colombo Stock Exchange dropped by over 20%, between the detection of the first coronavirus case in Sri Lanka on January 28, 2020, (albeit a Chinese national), and March 31, 2020, to lowest in the five-year period between March 31, 2015, and March 31, 2020, ([Pricewaterhouse Coopers, 2020: 5](#)). Moreover, according to the [International Monetary Fund \(IMF\)](#) there was an outflow of portfolio investments (in government securities as well as in private blue-chip companies) from Sri Lanka to the tune of USD 450 million during the 1st quarter of 2020.

In addition to the fiscal profligacy noted above, the new government in early 2020 rejected the USD 500 million outright grant from the Millennium Challenge Corporation (MCC) of the USA on the grounds of the spurious claim of "infringement of sovereignty" (ironically, a similar claim by the critics in the case of the Colombo Port City Economic Commission Act was dismissed by the government). Moreover, the government also pulled out of a memorandum of understanding between the previous government of Sri Lanka and the governments of Japan and India to jointly develop the eastern container terminal of the Colombo harbour thereby depriving the country of valuable foreign direct investment.

Modern Monetary Theory (MMT)

In macroeconomic theory, usually, the inflation rate and unemployment rate in an economy have an inverse relationship. That is, when inflation rises, unemployment drops, and vice versa; i.e. when inflation drops unemployment rises. Stagflation is defined as a situation wherein a persistently high inflation rate (relatively) coupled with a persistently high unemployment rate (relatively) coexists resulting in prolonged subdued economic growth (if not negative growth).

After the global financial crisis of 2008-2009, all the affected advanced countries resorted to fiscal stimulus policies (by stepping-up government spending) to shore-up consumer/public demand in order to revive the crisis-ridden/recession-hit economies. In contrast, the economic revival measures during the pandemic, both in developed and developing countries, heavily rely on monetary policies to ramp up the supply of goods and services. Monetary policy, during the pandemic, is primarily driven by printing money to

maintain liquidity in the economy, which is a revival of the Modern Monetary Theory (MMT) propagated during the 1980s in the United States, United Kingdom, and many other developed countries. The MMT assumes that governments are sovereign and therefore cannot default on their debt, which justifies printing unlimited money (subject to ceilings in many advanced countries including in the United States). In the post-World War II period, Keynesian fiscal stimulus strategies (demand-pull), Friedman's monetary stimulus strategies (supply-push), or a combination thereof, have alternatively driven the world economies (especially advanced economies) from time to time.

The over-stock of money in the market (as a result of money printing by the central banks worldwide), in the absence of a commensurate rise in production (primarily due to lack of demand), depreciates the domestic currencies resulting in hyper-[inflation](#) (including food inflation). In Sri Lanka, in the 21-month period between January 01, 2020, and September 30, 2021, due to [excessive money printing](#) by the Central Bank, the stock of money rose by 38% (i.e. by LKR 2.9 trillion) whilst the GDP grew only by just 1%. This has caused inflation to rise to over 11%, and food inflation rose to over 18% in November 2021. These have seen steady rise ever since; resulting in the overall inflation reaching 55% in June 2022, and the food inflation was about 80% in June 2022.

In most developing countries as well as in many developed countries there is a severe shortage of consumer goods (including essential commodities) and/or spiralling of cost-of-living. Inflation is at historical highs in many European countries and the USA, and the UK supermarket shelves were reported to be empty in October 2021 (partly due to supply-chain disruptions caused by Brexit and partly due to the economic fallout of the pandemic). The Russian war on Ukraine has fuelled the global inflationary trend due to the huge rise in global prices of fuel, wheat, and many other essential commodities as a result of the severe economic sanctions on Russia and the consequent disruptions to the global commodity supply chains.

Theories of physical sciences are not subject to political or social circumstances, contexts, situations, or territories; that is, the outcomes of physical sciences theories are universal. In contrast, the outcomes of macroeconomic policies/theories vary according to the political and social circumstances, contexts, situations, and territories. Thus, the right macroeconomic policies should be adopted taking into consideration of the individual political and social circumstances, contexts, situations, and territories. Just because advanced industrial countries are printing unlimited money for prolonged periods during the pandemic, any developing country cannot afford to print unlimited money for an indefinite period of time to revive its pandemic-affected economy.

For example, in the post-global financial crisis period (post-2008), Greece, for example, indulged in lavish fiscal stimulus to revive its financial crisis-hit economy, which resulted in amassing huge public debts that made Greece virtually insolvent. The consequent austerity policies in Greece and the dampened economic growth in advanced industrialised countries those helped bailout Greece resulted in the emergence of nationalist and populist political forces in the UK (Brexit), USA (Donald Trump), Hungary, and Poland,

inter alia. The Keynesian macroeconomic theories emerged in the 1930s precisely to counter the nationalist populism of Adolf Hitler (in Germany) and Benito Mussolini (in Italy). In recent times, the experience of Greece reveals that the reverse could also happen; that is, unsustainable public debt could inspire or promote nationalist populism. In South Asia, Sri Lanka appears to be caught in a vicious cycle of the public debt trap as noted above resulting in surging nationalist populism in the past decade and a half, including during the pandemic.

2. **Sri Lanka is in discussions with the IMF to negotiate a bailout plan, and the World Bank has already agreed to provide \$300 million to \$600 million over the course of four months. Nations such as China and India have also agreed to provide support in various ways. In your opinion, do you think these are enough to bring Sri Lanka out of its crisis?**

Absolutely not; the anticipated bailout by the IMF and other commitments by the World Bank, China, and India would not be sufficient to lift Sri Lanka out of its current economic crisis because the causes of the current economic crisis are multiple and very long-running that requires fundamental structural and institutional reforms to the economy of Sri Lanka (primarily macroeconomic restructuring) that are long overdue as elaborated above. However, the anticipated IMF and other assistances are a temporary respite to a bankrupt sovereign economy.

In order to overcome the aforesaid enduring economic mismanagement, in addition to IMF bailout and other bilateral and multilateral economic assistance, the following proposals are suggested for serious consideration.

- (i) Prudent fiscal management to keep a positive primary balance in the government budget (primary balance is positive when the annual total government revenue is greater than the annual recurrent and capital expenditures of the government other than the annual public debt repayments (capital plus interests).
- (ii) Greater reliance on direct income taxes as opposed to indirect consumption taxes.
- (iii) Free float of the rupee thereby promoting exports from Sri Lanka.
- (iv) Arresting massive corruption by politicians as well as senior public officials and private crony capitalists.
- (v) The import, refining, and distribution of fuel (petroleum products), which accounts for an average of around 20% of the total import value of Sri Lanka annually, should be divested to an oil-producing country or a multinational

company that does not open letters-of-credit in the banks based/operated in Sri Lanka.

- (vi) Total independence of the Central Bank of Sri Lanka (devoid of political interference).
- (vii) Downsizing/right-sizing the public administration in the country.
- (viii) Downsizing/right-sizing the armed forces in the country after the end of the civil war. Sri Lanka Army today has around 300,000 personnel for a 22 million population, whereas the British army is less than 200,000 in total strength for a population of more than 67 million. Do these figures make sense to Sri Lanka?
- (ix) The government should invest more in public healthcare and public education rather than investing in perennially loss-making state-owned enterprises in fuel/energy, banking & insurance, ports, railways, airlines, etc.

3. What could China and India do to alleviate the suffering of Sri Lankans?

I sincerely believe that Sri Lanka's decade-long honeymoon with the new emerging bilateral donors such as China and India is over for good. China has emerged as the single largest bilateral donor to Sri Lanka in the last decade and a half, replacing Japan which has traditionally been the single largest bilateral donor to Sri Lanka at least since 1977.

In addition to the International Sovereign Bonds (ISBs), illiberal emerging donors such as China and Russia have become a [moral hazard](#) to the people of many developing countries in Africa, Asia, and Latin America, especially to the people of those countries governed by illiberal populist governments such as in Cambodia, Ethiopia, Rwanda, Sri Lanka, Sudan, Venezuela, et al ([Zendejas, Gaillard, and Michalek, 2022](#): part II). This is because aid from China and Russia does not come with conditions/strings attached in terms of economic policies (such as slashing budget deficits and/or prudent public debt management) or political governance (such as maintenance of human rights and labour rights, and/or upholding the rights of ethnic/religious minorities, transparency in public procurement, and arresting corruption) as in the case of aid from DAC (Development Assistance Committee) countries of the OECD.

The unconditional loans from China to Sri Lanka in the past 15 years have resulted in the building of the world's emptiest international airport in Mattala (circa US\$ 250 million), the Hambantota international port (circa US\$ 1.1 billion) (which has been leased to China for 99 years in 2017 as a result of a debt-equity swap), an international cricket stadium in Hambantota where hardly any (domestic or international) match is played, a state-of-the-art international convention centre (US\$ 15 million), Matara-Beliatta railway line (circa US\$ 278 million), 6-8 lane highways in Hambantota and Mullaitivu districts in which

more cattle roam than the vehicles ply because the cattle population in those districts are greater than the human population of the respective districts, and a telecommunications tower in Colombo city (Lotus Tower - circa US\$ 100 million) that is said to be the tallest in South Asia, but it is yet to begin operations; nearly 5 years after its completion. All the foregoing and many more physical and/or economic infrastructure development projects funded by Chinese loans have become national liabilities (as opposed to national assets) ([see here](#)). Moreover, the bulk of the labour for the construction of the above projects was Chinese.

Above all the foregoing, a Foreign Direct Investment (FDI) of US\$ 1.4 billion by the China Harbour Engineering Corporation (CHEC), a state-owned Chinese corporation, has reclaimed land from the sea just off the Colombo city centre, which lay idle for the past 3 years after completion. However, this may not be a liability to Sri Lanka because it is an FDI and not a loan-funded project.

During colonial times, trade followed the flag; that is, colonies in the third world became new markets for manufactured goods (trade) from the colonial powers (flag). In the post-cold war period, trade and labour followed economic aid from the new emerging bilateral donors.

In the traditional development aid model, DAC countries primarily focus on the development or public funding of the social sectors (such as education, health, water & sanitation, and poverty alleviation) in third world countries. Thus, aid for economic infrastructure development was less prioritised. In the development aid model of the new emerging donors, project financing for economic infrastructure development (such as airports, highways, ports, power plants, roads, and telecommunications) is prioritised over development aid for the social sectors.

The people of Sri Lanka in general and the taxpayers, in particular, have contributed counterpart funds to all the foregoing projects with NEGATIVE returns on such investments.

In the foregoing reality and circumstances, Sri Lanka should avoid seeking unconditional easy aid from foreign countries; both traditional and modern. Instead, Sri Lanka should seek trade transactions in Chinese and Indian domestic currencies and/or barter trade for at least the next 5 years, and a moratorium on debt repayments (both capital & interest) for at least 5 years ahead. In fact, the bilateral trade between Sri Lanka and India was undertaken in Indian rupees (INR) until the early-1990s. Since 1991, India requested payment in US dollars.

International relations and foreign policy of countries are governed by *quid pro quo*. Sri Lanka does not have any natural/mineral resources to offer to China (unlike many African countries), except its geopolitical location across the Palk Strait from the southern tip of the Indian subcontinent.

Besides, the Chinese economy is also very much stretched due to the ongoing pandemic as well as the ongoing war on Ukraine. Further, many African, Asian, and Latin American countries indebted to China much more than Sri Lanka (for example, whilst China accounts for 10% of the total external debt of the Government of Sri Lanka, it accounts for 30% of the total external debt of Zambia, and 27% of the total external debt of Pakistan) are also in economic distress due to COVID-19 and the Russia-Ukraine war. In South Asia, Pakistan is the single largest borrower from China, which is also undergoing a severe balance-of-payments crisis. Probably, from a geopolitical point of view, Pakistan is a more important country for China in South Asia than Sri Lanka.

Therefore, in the acute circumstance of several countries indebted to China experiencing economic distress, Sri Lanka does not appear to be a high priority or a favoured country for China to bail out. I presume that China would like to be even-handed in dealing with the requests for financial assistance or debt relief from all its borrowers.

Moreover, a smart country like China would be wary of bailing out a deeply unpopular government such as the one currently in place in Sri Lanka in order to avoid anti-Chinese backlash from the ordinary people of Sri Lanka.

4. What are your concrete suggestions for overcoming the sovereign bankruptcy of Sri Lanka?

Required measures in the immediate-term/short-term (within the next 2 years)

- (i) Sell off Sri Lankan Airlines immediately to an international airline. The average annual loss of Sri Lankan Airlines is about USD 250 million in recent years.
- (ii) Freeze public sector hiring (barring highly technically-skilled personnel as well as professional personnel for education and health sectors), and implement a voluntary retirement scheme (VRS) as was done in 1990-1991 and/or offer a golden handshake for non-executive level public sector employees. Introduce PAYE (Pay As You Earn) tax scheme and contributory pension scheme for public sector personnel.
- (iii) Freeze hiring to the armed forces (barring highly technically-skilled personnel), implement a voluntary retirement scheme (VRS) and/or offer a golden handshake to all levels of armed forces personnel. Introduce PAYE (Pay As You Earn) tax scheme and contributory pension scheme for armed forces personnel.
- (iv) Sell off Litro Gas (cooking gas) to a multinational company that should be barred from opening letters of credit (LC) for imports from the domestic or foreign banks based in Sri Lanka. Litro Gas is a perpetually loss-making state-owned enterprise consuming on average about 300 million dollars for import of cooking gas.

- (v) Sell off Ceylon Petroleum Corporation (CPC) to an oil-producing country or multinational company/ies which should be barred from opening letters of credit (LC) for imports from the domestic or foreign banks based in Sri Lanka. Until the importation of crude oil, refining, and retailing was nationalised and monopolised by the state-owned CPC in the early-1960s, it was done by a multinational company. Petroleum imports consume 3-4 billion dollars annually and account for 20% of the annual total imports of Sri Lanka.

Required measures in the medium-term (between 3-5 years)

- (i) Downsize/right-size the public administrative system (barring public education and public health sectors) through VRS or golden handshake. At least a 40% reduction in the number of public sector personnel is desirable.
- (ii) Downsize/right-size the armed forces through VRS or golden handshake. The total number of armed forces personnel should at least be halved within the next 5 years.
- (iii) Sell-off Sri Lanka Railways and Sri Lanka Transport Board.
- (iv) Sell-off National Water Supply & Drainage Board.
- (v) Sell-off the Ceylon Electricity Board - production, transmission, and distribution of electricity.

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