論説

The Origins of Sri Lanka's Crisis and Way Forward: Political Economy Perspectives

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1. Introduction

In the past, Sri Lanka has been recognized as a developing country with an outstanding record of achievements in physical quality of life (Osmani 1994). It was hailed as a model for emerging market economies based on its impressive economic growth performance, with an average growth rate of 6.2% during 2010-2016, following a prolonged internal military conflict that ended in 2009. In 2019, the World Bank classified it as an upper-middle-income country. Still, it was later downgraded as a lower-middle income country in 2020, before the onset of the current economic crisis. By early 2022, it spiralled into an economic crisis of historical proportions that was unprecedented in its economic history since independence. In a very short time span, the crisis has generated far reaching consequences beyond the economic sphere into the political and social spheres.

The Sri Lankan crisis has attracted increased international attention since the country was forced to suspend the repayment of its foreign debt in April 2022. The stock of foreign debt amounted to 51 billion US dollars. The debt comprised bilateral loans from several countries such as China, India and Japan, multilateral loans from international institutions such as the International Monetary Fund (IMF) and World Bank, and borrowings from lenders in the international financial markets (for details, see the figure below on Sri Lanka's foreign's debt).

The current economic crisis is predominantly a foreign exchange crisis that manifests in various forms such as the shortage of foreign exchange, unsustainability of public debt, acute shortages of essential goods and services such as food, medicine, energy and gasoline, and spiralling inflation. In the political sphere, the crisis has led to instability in governance and pressure for broader and deeper political reforms. In the social sphere, the situation has led to problems with basic needs, a sharp deterioration of the quality of life, increased poverty and civil unrest. The experts in various fields and several political parties and their leaders in and out of the parliament and civil society representatives have made recommendations for a solution. So far, none of them has been entirely accepted by the country's political authority.

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The main purpose of this paper is to present an analysis of the current crisis in Sri Lanka, focusing broadly on its causes and possible solutions. An account of the long term and short term causes of the crisis is provided in Section two. It will be followed by a brief political economy analysis of the crisis in Section three and a presentation of some solutions to it, emphasizing the institutions' significance in Section four. Concluding remarks are presented in Section five.

2. Origins of the Crisis

The current Sri Lankan crisis has deep roots and effects spread not only over the economic sphere but also in the political and social spheres. The widespread economic mismanagement by the governing authorities that adopted imprudent economic policies and funded uneconomic projects such as ports, airports and landmarks through excessive borrowing and reckless spending over a long period, during the last two decades or so in particular, has played a decisive role in paving the way for the present crisis. It is widely believed that a host of political factors, such as corrupt politicians and political regimes, dynastic politics, violations of the rule of law and human rights, lack of transparency and accountability, and bad governance, have been behind the widespread economic mismanagement. Prolonged over several decades, the economic mismanagement generated favourable conditions for the present crisis that appeared in various forms of macroeconomic imbalances and vulnerabilities. Among these imbalances and vulnerabilities are the extensive trade and current account deficits in the balance of payment (known as external sector deficit), large budget deficits and savings-investment gaps (known as domestic deficits), overvalued currency, and unsustainable levels of external and domestic debt[2]. Several of these macroeconomic imbalances and vulnerabilities were already at critical levels at the onset of the COVID-19 pandemic, under which the poor performance in foreign exchange earnings resulted in a severe shortage of foreign exchange that made it challenging to meet the international debt obligations and pay for imports. Consequently, in early 2022, the country found itself in the current crisis. Table 1 below provides some data representing the macroeconomic imbalances developed over time.

[2] Wijewardane, W. A. (27 June 2022) Child's guide to debt restructuring: Not a cakewalk but a task entailing hard work.

https://www.ft.lk/columns/Child-s-guide-to-debt-restructuring-Not-a-cakewalk-but-a-task-entailing-hard-work/4-736706. Accessed date 29 July 2022.

Wijewardane, W. A. (11 April 2022) Welcome Nandalal & Mahinda: But You Both Have Herculean Tasks Ahead

https://www.colombotelegraph.com/index.php/welcome-nandalal-mahinda-but-you-both-have-herculean-tasks-ahead/?fbclid=IwAR0rgiTnjWygY-kU6eilPIq1YC_rHReKeD3lF1P1AkMEypVoKg5InnItVhM

Accessed on 29 July 2022.

Table 1: Selected macroeconomic variables of the Sri Lankan Economy

	1995	2000	2005	2010	2015	2020	2021
Overall fiscal Balance (as a % of GDP)	-8.7	-9.5	-7.0	-7.0	-7.6	-11.1	-12.2
Current Account Balance (as a % of GDP)	-6.0	-6.4	-2.7	-1.9	-2.3	-1.5	-4.0
External Debt (as a % of GDP)	66.7	54.5	46.5	37.8	55.7	60.5	60.0
Total Government Debt (as a % of GDP)	95.2	96.9	90.8	71.6	78.5	100.6	104.6
Government Domestic Debt (as a % of GDP)	43.3	63.8	51.8	40.1	46.2	60.3	66.0
Government Foreign Debt (as a % of GDP)	51.9	43.1	39.0	31.6	32.4	40.3	38.6
Inflation (GDP Deflator 1996=100)	8.4	6.7	10.4	7.3	0.6	4.0	7.9
GDP Growth	5.5	6.0	6.2	8.0	5.0	-3.6	3.7

Source: Central Bank of Sri Lanka, Various Issues of Annual Reports

The researchers who analysed the causes of the current crisis have identified several practices and policy decisions made by the monetary and fiscal authorities since 2019 and their consequences as the factors that triggered and accelerated the current situation after 2019. Among them are the following.

Untimely tax revisions in 2019: In 2019, the government revised several tax rates by reducing the value-added tax rate from 15 to 8% and altogether abolishing several other taxes that benefitted the high-income earning income taxpayers and value-added tax payers. Consequently, the annual government revenue fell by about 600 billion rupees, which amounts to 4% of GDP[3]. Thus, the tax cuts significantly affected the government revenues in the ensuing period, limiting the capacity of the government to service its debt, which negatively affected the government's credit ratings and the investors' confidence[4].

Arbitrary adopting a fixed exchange rate system: The Central Bank of Sri Lanka's attempt to maintain the exchange rate at about Rs 200 per dollar in the face of the inevitable depreciation of the Sri Lankan rupee under the unfolding crisis led to an overvalued domestic currency and the drastic erosion of official foreign exchange reserves. It is estimated that the official foreign exchange reserves have decreased by about 5 billion dollars due to this policy. This led to an increase in the black-market activity in foreign exchange that deprived the banking system of substantial foreign currency inflows through legitimate channels.

The ban on the use and importation of agrochemicals in April 2021: In an attempt to become the first country in the world to ultimately adopt fully organic farming, the Sri Lankan government imposed a

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[3] Dr. Wijeyadasa Rajapakshe (2022) on Economic crisis and possible way out
https://island.lk/economic-crisis-and-possible-way-out/
Accessed on 29 July 2022.

[4] Ratnayake Ravi, (22 April 2022), Partners in economic crimes against the nation
https://www.ft.lk/columns/Partners-in-economic-crimes-against-the-nation/4-733736?fbclid=IwAR3YFsQPjxJxOyoqonmJc2rSm6WEPK_PBHhuh29zvVzTdwHMo1SZPkatzJk#.YmLKWgVvX_k.facebook
Accessed on 29 July 2022.

complete ban on the use and importation of agrochemicals (chemical fertilizers, pesticides and weedicides) that had severe implications for both the total agricultural output and the productivity. According to some estimates, the ban has resulted in about a 50% decline in agricultural production, aggravating the problems of food shortages and overall inflation in general and food inflation in particular.

Excessive printing of money and monetization of the debt: In the interest of putting downward pressure on market rates of government securities, the government relied heavily on printing money and monetizing the debt. For example, in just five months, from February to June of 2020, the central bank injected 459 billion rupees into the banking system (Economynext, 2020). This policy reliance led to lower interest rates, higher inflation rates, downward pressure on the value of the rupee, and a decrease in foreign exchange reserves under the fixed exchange rate policy. At the same time, it increased the banking system's vulnerability to a banking crisis in the event of increased default risk on government debt.

Ignoring the credible warnings of a possible debt crisis: As early as 2020, the International Monetary Fund (IMF) has warned Sri Lanka that the country has reached an unsustainable level of debt[5]. This warning was ignored by the fiscal and monetary authorities, who refused to seek timely support from multilateral financial institutions like the IMF, World Bank and Asain Development Bank (ADB)[6]. It is necessary to analyze the composition of the debt if one wants to comprehend the current debt crisis's nature. As of 2021, the total debt is Rs. 17,589.4 billion (104.6% of GDP), of which domestic and foreign debt constitute 66% and 38.6% of GDP, respectively (see table 1). The Figure below reveals the detailed composition of the foreign debt. Most borrowed debt, particularly international sovereign bonds, has been borrowed with high commercial interest rates and invested in the non-tradable or low returns sectors. Therefore, the amortization of capital and interest has become a severe issue for the country.

As indicated above, by the time of the eruption of the present economic crisis, the several macroeconomic imbalances and vulnerabilities that represent long term causes of the crisis had already heightened the potential for a severe economic crisis. In that context, the practices and decisions described above worked as the triggers and accelerators of the present crisis that aggravates both in depth and breadth. Those triggers and accelerators were direct outcomes of imprudent exchange rate and monetary policy manipulations and a politically-driven fiscal policy that was fundamentally inconsistent with the much-needed budgetary

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[5] Gunatilleke, Nimal (2022) The Sri Lankan debt crisis: A layman's review.

https://island.lk/the-sri-lankan-debt-crisis-a-laymans-review/.

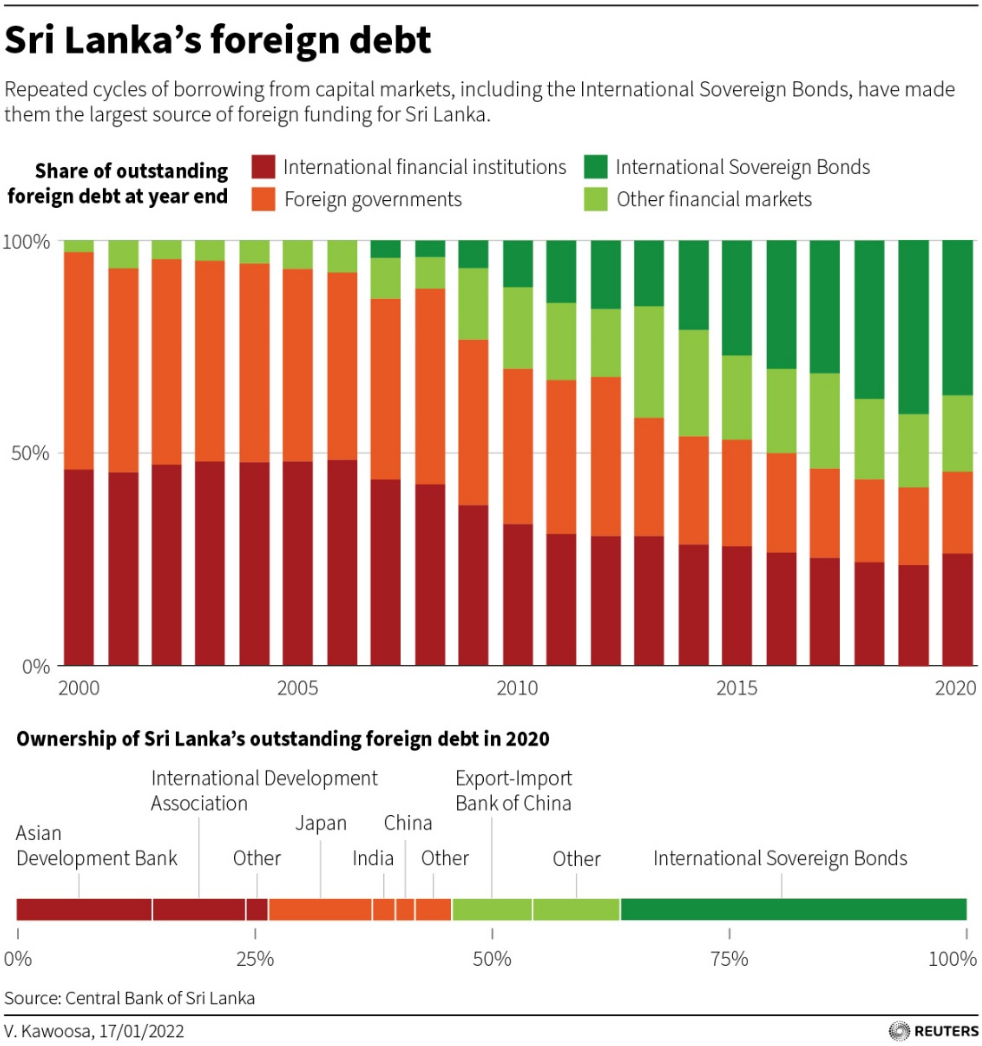
Accessed on 29 July 2022

[6] Prema-chandra Athukorala: Economist Sri Lanka produced for the world

https://www.ft.lk/columns/Prema-chandra-Athukorala-Economist-Sri-Lanka-produced-for-the-world/4-724172.

Accessed on 29 July 2022.

consolidation. For example, the outcome of the politically driven fiscal operations is reflected in the total government expenditure that was 2.2 and 2.4 times higher than the government revenue in 2020 and 2021, respectively. The government's overall budget deficit as a percentage of GDP was -11.1 and -12.2 for 2020 and 2021, respectively (see Table 1).



The above figure is taken from https://www.reuters.com/markets/rates-bonds/sri-lanka-edge-debt-burden-mounts-2022-01-17/

3. The political economy of the crisis

The current Sri Lankan crisis is unprecedented in that the economic crisis has become a significant political and social crisis, with island-wide protests going on continuously from 9th April 2022. These protests are called "Aragalaya" in Sinhala. The citizens have lost trust in the government and political institutions and the protestors continue to demand that the President, Prime Minister and Rajapaksa family members resign immediately from their political positions. As a result, the fragility of the government has increased. Loewe and Zintl (2021) argue that state fragility and social contracts are two sides of the same coin. The former idea emphasizes that for governments to be accepted by societies, they must provide the three "Ps" of protection, provision, and political participation. In contrast, the latter view contends that nations might fail due to a lack of legitimacy, authority, or capability. Popular discontent is frequently caused by broken social contracts (Loewe and Zintl, 2021).

Governments have only ever existed and sustained in history with at least some level of social acceptance. A social contract outlining the rights and obligations of the state and various socioeconomic groups towards one another must exist and be upheld for states to have a basic level of legitimacy. According to social contract theory, a government is legitimate in the eyes of society if it meets the expectations of its citizens in terms of protecting both individual and collective security, provision of economic and social services, and permitting some degree of participation in political decision-making (Loewe and Zintl 2021). The phrase "social contract" has a long and rich intellectual history and positive connotation. Hugo Grotius (2012), Thomas Hobbes (2017), John Locke (2009), and Jean-Jacques Rousseau (1762) all used it to contrast the "natural condition of anarchy" with a state-controlled atmosphere containing property rights, security, and perhaps distributive justice.

The allocation of resources (inputs and outputs) and political power depends on the structure of a country's political institutions. The design of rules and principles of political institutions within which they operate depends on many factors. The type of political system, whether democratic or non-democratic, also affects the structure and outcome of those institutions. By democratising, elites transfer political power to citizens, enhancing social stability (Acemoglu and Robinson 2013, 2019).

Sri Lanka introduced open economic policies in 1977, the first in South Asia. Since then, the country has performed well compared to the economic situation during the relatively closed economy of the early 1970s. In place of liberal policy regimes, the government which came to power in 2015 implemented a Social Market Economy (SME) (Cooray 2017). Germany introduced the SME in 1961, highlighting the need for the state to ensure that the free market produces outcomes near its potential and that the market is incorporated into legal and political systems. The advocators of SMEs believe it is essential to protect individual freedom and human dignity. The free market, people's participation in society, and a strong state are the three foundational elements of the SME. The "constitutive principles should protect an effective competition-based economic system." The complementing "regulatory principles" were created to enhance the humane aspect of the economic order. The SME, however, continues to serve only as a symbol, as many of these ideas have been absent in Sri Lanka, particularly during the last few years (Cooray 2021). Sri Lanka needs appropriate alternative paradigms or an institutional road map in policy-making process instead of defunct ideological predilection rather than factual analysis (Acemoglu, Johnson, and Robinson 2005; Acemoglu et al. 2019).

Table 2 shows the political economy perspectives of various governments since independence in 1948. In 1977, the United National Party (UNP) government enacted "market-oriented policies" influenced by neo-liberal political theory and the Washington Consensus. However, the centre left administration that took office in 1994 altered some of these neo-liberal policies to "market-oriented policies with a human face."

Similar market-oriented policies were followed by the government that took office in 2005, along with significant government intervention.

The unity government, which came to power in 2015, decided to pursue a social market economy under ideological reconciliation that combined the two main political parties' left- and right-centred ideologies. The unity administration pledged in its electoral manifesto to enhance democracy, bring about social improvement, and achieve high economic growth.
President Gotabaya Rajapaksa took power in late 2019, promising the citizens to bring propriety to the country. Immediately after his arrival family members Mahinda Rajapaksa, Chamal Rajapaksa, Basil Rajapaksa, and Namal Rajapaksa occupied many important ministerial positions. Due to the Rajapaksas' family dominance, they could control the entire country. Moreover, the political institution became more extractive, leading to the deterioration of market forces and the creation of extractive economic institutions. For example, because of the autocratic and military nature of the government, the Central Bank and Ministry of Finance, the two vitally critical economic institutions, could not manage the fiscal and monetary policy of the country properly.

Table 2: Economic Policy Regimes in Sri Lanka

Period	**Policy regime**
1948-1956:	Populism with open and liberal economy
1956-1965:	Populism with controlled economy
1965-1970:	Limited liberalisation
1970-1977:	Resumption of controlled economy
1977-1983:	Liberalisation with relative peace
1983-1994:	Liberalisation with second round of policy reform
1994-2004:	Market oriented policies with human face
2005-2015:	Market oriented policies with more government intervention
2015- to date	Social Market Economy (SME)

Source: (Cooray 2017)

4. An Institutional road map to overcome crises and prosperity

It is imperative that the present crisis is contained as early as possible to avoid the potentially catastrophic outcomes of a prolonged crisis, which may also entail a more severe exchange rate crisis and a balance of payment crisis, a severe banking and domestic financial system crisis, and a long term economic depression. The two major dimensions of the economic crisis are the shortage of foreign exchange and the shortages of essential goods and services for consumption and production in the economy. In the short term, the mitigation (elimination) of both shortages requires the assistance of the international community, mainly in the forms of commodity and financial aid, either as grants or loans. However, in the long run, these shortages can effectively be eliminated only through (a) the expansion of the economy's capacity to generate foreign exchange from various sources such as exports, tourism, remittances, and capital inflows and (b) the promotion of production and income through a comprehensive economic growth and development strategy, and (c) the implementation of sound macroeconomic policies designed appropriately for the structural features and required transform of the national economy and the international context in which the national economy and the policies operate in achieving (a) and (b). In the long run, effective crisis resolution requires successfully removing macroeconomic imbalances and vulnerabilities through a regime of credible and sustainable macroeconomic policies.

To contain the current crisis and the potential for future crises, any government must understand fully why the country is failing. Acemoglu and Robinson (2013), in their book titled "Why Nations Fail," argued that a nation fails "because it has been ruled by a narrow elite that has organized society for their benefit at the expense of the vast mass of people." Therefore, public policy makers should consider an appropriate institutional mechanism that will serve the wellbeing of the majority of citizens rather than catering to a limited number of elite politicians(Landes 1998; Wilensky 2012; Iversen and Soskice 2020). The institutions are three types-economic, political, and social. According to Acemoglu and Robinson, these economic institutions fall into one of two categories: extractive or inclusive. Inclusive economic institutions promote economic progress and well-being by promoting citizens' involvement in economic activity and preserving liberty and freedom. Additionally, extractive economic institutions restrict economic freedom and independence and take advantage of certain social groups' resources to benefit other groups (Acemoglu and Robinson, 2013).

Political institutions can be inclusive or extractive, just like economic institutions. Democratic pluralism with free media and other individual liberties is the defining feature of inclusive political regimes. This suggests that the values and freedoms of many communities and groups are appropriately represented. Political institutions that lack democratic characteristics are typically classified as extractive political institutions that serve a few political elites at the expense of the majority of society.

The government, the judiciary, the legislature, the executive branch, and other important economic and political institutions are losing public trust. To implement inclusive economic institutions, the nation urgently needs inclusive political institutions. It is essential to create a solution that balances the state, markets, and communities—the three pillars of social existence. Inclusive localism is the best option for aligning those three pillars (Rajan, 2019; Acemoglu and Robinson, 2019).

On July 9, 2022, President Gotabaya Rajapaksa and Prime Minister Ranil Wickremesinghe were compelled to announce their resignations by hundreds of thousands of largely peaceful protesters motivated by the three-month-old protest known as "Aragalaya" in Sinhala. The President's House, the President's Secretariat, and the Prime Minister's Office have all been taken control of by protesters for the first time in Sri Lankan history after they breached a high security zone. At the moment, opposition parliamentarians are busy talking with various political parties representing the current parliament and forming a new government. The speaker has had several meetings with political party leaders and protesters and has announced that Parliament will meet on 15th July to discuss forming a government. Then the election will be held to nominate a possible presidential candidate on 20th July 2022. The citizens are eargerly waiting for a new interim government finding solutions to the immediate problems and to undertake necessary reforms to create inclussive political institution which will lead to inclusive economic institiuion.

5. Conclusion

Sri Lanka's current crisis is primarily a foreign exchange crisis that resulted in problems of external debt repayment, inability to finance necessary imports, dwindled foreign exchange reserve, shortages of essential goods and services in domestic markets, and spiralling inflation, among other things. Its roots and effects are not only economic but also political and social as well. The economic mismanagement through imprudent manipulations of macroeconomic policies, based on a host of political factors such as corrupt political regimes, uninsightful political decisions and bad governance, has been responsible for the economic imbalances and vulnerabilities that increased the potential for a crisis in the long term and also the triggers and accelerators in the short term. There is imminent danger of spiralling into a more catastrophic macroeconomic depression that involves a break down in banking and financial systems and a prolonged recession unless the crisis is contained urgently. A practical solution for the crisis requires the choice of a promising development model and the commitment to and implementation of a credible policy regime to realize the economy's full potential. Given the causes of the present crisis, significant broad economic, political, and institutional reforms will be an internal part of such a solution.

Sri Lanka must overcome the crisis and establish a prosperous and tranquil society where people live without fear of being persecuted or subjected to violence. The weak must be safeguarded, and the opportunities for realizing their full potential in achieving goals must be provided for all citizens. The attention given to public trust is a critical factor in this regard. Those in positions of authority, whether in politics, the executive branch of government, or business, are required to resign or be dismissed if they have violated the public trust. Even during political unrest, the public's rights must be upheld and regulations followed. An independent and accountable bureaucracy must also be selected based on merit, along with a clear separation of the legislative and executive branches of the government.

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