Driving Policy Action in Sri Lanka from Economic Crisis to Recovery

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The Institute of Policy Studies of Sri Lanka (IPS) held a seminar on 25 October 2022 to coincide with the release of the Institute's annual flagship report, *Sri Lanka: State of the Economy 2022*, on the theme ***Driving Policy Action from Crisis to Recovery***. IPS researchers Chathurrdhika Yogarajah and Kimuthu Kiringoda captured the highlights of the discussion.

Session I: Economic Crises and Policy Adjustments for Stabilisation

Presenter:

Dr Dushni Weerakoon, Executive Director, IPS

Keynote Speakers:

Dr Nandalal Weerasinghe, Governor, Central Bank of Sri Lanka

K M Mahinda Siriwardana, Secretary to the Treasury/Ministry of Finance, Economic Stabilisation and National Policies

In her presentation, Dr Dushni Weerakoon drew attention to the need to minimise output losses in the short term amidst the ongoing economic challenges. Towards this end, (1) debt restructuring negotiations must be concluded as swiftly as possible and (2) credibility established by stabilising macroeconomic fundamentals. In the medium term, Sri Lanka will require more macroeconomic flexibility without throwing standardisation efforts into reverse, along with a gradual shift to an emphasis on growth aligned with an appropriate long-term policy framework.

Dr Weerakoon further noted that Sri Lanka's inflation trajectory over the last few months had been driven primarily by high food inflation and increased transport costs. However, there has been a moderation in food price inflation in recent months. With Sri Lanka's current elevated inflation levels, there is no scope for trade-offs. Anchoring inflation expectations is essential to help contain inflation at a lower economic cost. Equally, it is necessary to watch for wage catch-up in the context of the erosion of real wages, tax-related income cuts, and higher labour mobility.

Dr Weerakoon stressed the need to bring inflation under control to stabilise the exchange rate. Persistent high inflation leads to immediate or anticipated currency depreciation, as experienced during the last 12 months. The exchange rate has stabilised to some extent. Still, in recent months, because of the appreciation of the US dollar, exchange rates are coming under pressure again, and the Sri Lankan currency is no exception. Managing the exchange rate will continue to be one of the biggest macro policy challenges for Sri Lanka in the coming months.

“Building up reserves for more than three months of import cover will be a slow process. On average, regaining access to capital markets will take at least two years from a successful restructuring. Bridging financing on budgetary support will materialise only on an agreement between the government and creditors on debt restructuring, while bilateral lending is more or less exhausted and China is most likely to scale back lending globally,” she stated. Dr Weerakoon cautioned that costs could encourage the government and creditors to engage in shallow restructuring, leading to repeat serial defaults and restructuring.

Commenting on the International Monetary Fund (IMF) programme, she noted that IMF programmes have positive catalytic effects on private lenders, but risks of sovereign defaults increase in the long run. “If countries do run into trouble, IMF conditionalities often tend to delay governments from availing themselves of bailouts,” she said, emphasising that for countries in default, IMF programmes are found to reduce the likelihood of subsequent sovereign defaults significantly due to debt risk analyses and stringent conditions.

Dr Nandalal Weerasinghe expressed optimism that Sri Lanka will recover from the economic crisis but pointed out that the process depends on how successfully the authorities can implement economic reforms and the extent of public support. Responding criticisms of the proposed IMF bailout, he said, “The ongoing economic stabilisation effort is a painful one, but whether there is an alternative to it is the question. It is up to those criticising the State’s decision to go to the IMF to develop a viable alternative programme, which is not easy to formulate. Conspiracy theories are also being aired in some quarters to the effect that the state announced a debt default prematurely to bring the country under IMF control. There is no truth in this allegation. The recovery process will be difficult for the country in the future, but there are currently some improvements in the local economy.”

K M Mahinda Siriwardana flagged the importance of ‘political will’ to take necessary but unpopular decisions for economic recovery. “The crisis has shown us the importance of evidence-based policymaking underpinned by sound analysis, accurate data and objective judgment. Policy advice must be informed by appropriate risk assessments considering prospective developments and global factors, and more importantly, such advice should not be counted by ideological considerations,” he stated.

Siriwardana explained that in the short term, fiscal, monetary and structural reforms have to be implemented to put the economy on the correct path and regain access to global capital markets as early as possible. In the medium term, tourism inflows, remittances, and asset divestments will be critical. In the long term, consistently implementing appropriate fiscal and monetary policies that result in a stable current account balance and project macro stability to attract sustainable long-term capital inflows will be vital. The first step in achieving these objectives was to establish an IMF programme, without which it is impossible to obtain budgetary financing from multilateral and bilateral partners, he said.

Session II: Policy Action for Shared Sustainable Growth: A National Policy Framework

Chair/Moderator:

R H W A Kumarasiri, Director-General, Department of National Planning

E A Rathnaseela, Additional Director-General, Department of National Planning

Presenters:

Dr Nisha Arunatilake, Director of Research, IPS

Dr Ganga Tilakaratna, Research Fellow, IPS

Dr Manoj Thibbotuwawa, Research Fellow, IPS

The second session focused on the prospects for a National Policy Framework (NPF) to drive policy action for economic recovery. The proposed framework would focus on macro-stability, social inclusion, improved governance, and environmental sustainability for shared sustainable growth.

Dr Nisha Arunatilake recalled that in 2015, the World Bank predicted that the perceived post-war economic growth in Sri Lanka would not be sustained, as it was driven mainly by public debt and growth in the non-tradable sector. As expected, this was the case, and the country could not withstand the massive economic shock of the COVID-19 pandemic. Dr Arunatilake highlighted that the proposed NPF should envision systematic changes to the structure of the economy and the institutions to move Sri Lanka towards an inclusive growth path. Further, growth should be sustainable without compromising natural resources, foster innovation, and create a more open market economy.

Dr Ganga Tilakaratna observed that high politicisation and constant changes to ministries by combining non-aligned subjects impede good governance, hamper the efficiency of institutions and impede policy formulation, and implementation. She stressed that transparent appointment mechanisms and streamlining ministries are essential for reducing inefficiencies and improving the performance of the public sector.

Focusing on education, Dr Tilakaratna noted that the poor are left out under the current education system, as they leave education earlier. This is partly due to the low relevance of education, and the increasing out-of-pocket expenses relating to education despite free education. She also observed that public investment in education has been relatively low, and to achieve the envisioned development of the education sector, mechanisms will need to be put in place to mobilise non-public funds to bridge the financing gaps.

Dr Tilakaratna stressed the need for better social protection (SP) schemes with rising levels of poverty and inequality. Dr Tilakaratna pointed out that the vulnerable are not adequately covered under the current social protection schemes and even those who are covered are not adequately covered. Further, she noted that there is little coordination between SP programmes. In moving forward, she proposed that the SP system be integrated through a social registry, benefits improved, and coverage broadened so that no one is left behind.

Dr Manoj Thibbotuwawa identified several reasons for the growing food insecurity in Sri Lanka: low factor productivity primarily due to inefficient use of resources and poor investments on R&D and technology, lack of diversification towards nutrition-rich food crops, food losses, lack of value addition, and increasing cost of production due to poor technologies and fertiliser and fuel price hikes. He explained that these issues need immediate attention and suggested promoting the adaptation of cost-effective production systems, precision farming including site-specific applications and Integrated Plant Nutrient Management (IPNM) for maximum productivity and farm incomes. he further highlighted the importance of promoting methods to reduce post-harvest losses.

Dr Thibbotuwawa pointed out that climate change is a cross-cutting aspect critical to the above debate. Rising temperatures, changes in rainfall patterns, extreme climatic events and sea level rising broadly impact agricultural yield. He noted that information, technological, policy and governance, institutional and coordination and resource mobilisation gaps hinder action against climate-induced effects. Mainstreaming adaptation mechanisms, capacity building of the vulnerable, surveillance and monitoring and innovative risk management instruments were recommended.

Dr Thibbotuwawa also highlighted that growing land scarcity, poorly functioning land markets, land fragmentation, encroachments and deforestation and degradation of lands are among the major policy challenges faced by land resources in Sri Lanka at present. He stressed that land policies and regulations should be shaped to cater to economic efficiency, inclusivity and environmental sustainability of the country. He further highlighted the importance of adopting modern land management practices such as land banks and reviewing the institutional and legal framework for removing barriers to such initiatives.

In exploring the trade sector, Dr Thibbotuwawa explained that Sri Lanka's backward and forward linkages to global value chains were relatively weak and declining compared to the countries like India, Bangladesh, Vietnam and Singapore. The post-COVID-19 import controls, lack of diverse exports and the imposition of tariffs further reduced the competitiveness of the trade sector. He flagged that a lack of quality assurance and certification infrastructure impeded trade sector growth and recommended shifting to high-value exports, removing tariffs, and revisiting trade agreements.

H W Kumarasiri stated that public involvement and support are essential to ensure that policy documents are translated into action. There have been many wrong turns in the past that led to the crisis. However, a concerted policy framework and a sound action plan will be able to pull the country back on track.

E A Rathnaseela observed that the proposed Policy Framework should not be another 'shelved document' but must be coupled with a time-bound action plan to ensure its implementation. All Sri Lankan citizens should share the burden of pushing the project through to realise its full potential.

The IPS' annual flagship report, *Sri Lanka: State of the Economy 2022* is available for sale at IPS, No. 100/20, Independence Avenue, Colombo 07, and at leading bookshops island-wide. For more details, contact Amesh Thennakoon, Mob: +9477 373 7717; Dir: +94-11-214 3107; Gen: +94-11-2143 100