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# The Sovereign Debt Crisis in Sri Lanka: Anatomy and Policy Options

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# The Sovereign Debt Crisis in Sri Lanka: Anatomy and Policy Options*

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**Abstract**

During the COVID-19 pandemic, there has been a dramatic increase in national debt levels across the world, with reported cases of downgrading sovereign debt ratings and difficulty of fulfilling debt obligations ('debt distress') heavily concentrated in low and middle-income countries. In this context, the unfolding sovereign debt crisis in Sri Lanka has attracted worldwide attention as the canary in the coalmine for what could become a global 'development' crisis. This paper examines the Sri Lankan crisis encompassing both the sources of vulnerability to the COVD-19 shock, and stabilization and structural adjustment reforms after the debt default, with emphasis on the systemic 'solvency' challenge of dealing with the massive debt overhang evolved over the previous two decades. The prime focus of the Extended Fund Facility Arrangement (EFFA) that Sri Lanka signed with the IMF in March 2023 is on economic stabilization through fiscal consolidation. This paper makes a strong case for combining economic stabilization with coherent structural adjustment policies to redress the long-standing anti-tradable bias in the incentive structure that underpinned vulnerability of the economy to external shocks.

**Key words**: Sri Lanka, sovereign debt crisis, IMF, Extended Fund Facility (EFF), debt restricting

**JEL Codes**: F33, F35, O11, O53

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# The Sovereign Debt Crisis in Sri Lanka: Anatomy and Policy Options

## 1. Introduction

The COVID-19 pandemic has brought into forefront the subject of sovereign debt management in the international development policy debate. While the pandemic has resulted in dramatic increase in national debt levels across the entire world, the reported cases of downgrading sovereign debt ratings and 'debt distress'— difficulty of fulfilling debt obligations—are heavily concentrated in low and middle-income countries (Kose et al. 2022, Rogoff 2022). Managing unsustainable sovereign debt to restore access to capital markets is a vital policy priority for sustained and equitable economic recovery from the COVID-19 shock in these countries.

The purpose of this paper is to contribute to the pandemic-propelled literature on sovereign debt crisis by undertaking an in-depth study of the experience of Sri Lanka, the second country to default on sovereign debt after Zambia in the COVID-19 era. Sri Lanka entered the pandemic with a huge debt overhang built up over the previous two decades. Some significant policy initiatives of a new government that came into power in November 2019, which were inconsistent with the needed reform priorities of a country with an elevated level of public debt, added to the 'debt distress'. The debt distress worsened when the government pursued a 'muddling through' approach that was not congruent with the immediate impact of the pandemic on the balance of payments. When the government eventually went to the IMF in April 2022 after defaulting on foreign debt, the crisis-propelled socio-political instability had further complicated the process of debt restructuring and negotiating a stabilization and structural adjustment program. The unfolding crisis in Sri Lanka has attracted international attention a 'warning sign' for policy strains faced by 'countries with high debt levels and limited policy space' (Georgieva 2022) and an illustrative case of how 'postponing a reckoning through various piecemeal measures will ... make matters worse in the end' (Krueger 2022). Given that China is Sri Lanka's largest bilateral creditor nation, the ongoing process of debit restricting is Sri Lanka and China's refusal to participate on equal terms with the Western creditors has become a test case for the global financial architecture in an age of superpower rivalry (*The Economist* 2023).

The rest of the paper is structured in four sections. Section 2 examines the origins of the debt overhang and the mounting debt service burden that made the economy vulnerable to the ongoing crisis. Section 3 discusses the onset of the debt crisis, and the initial 'muddling through' policy response that ended up with declared default on foreign debt. Section 4 discusses the ongoing policy reforms under the Extended Fund Facility Arrangement (EFFA) signed with the IMF. Section 5 undertakes a speculative analysis of the policy challenge of moving from stabilization to growth in the post-default economy against the backdrop of experiences of sovereign debt default episodes in other countries. Conclusions and policy inferences close the paper.

## 2. Debt-driven growth and vulnerability to the COVID-19 shock

Why Sri Lanka succumbed to a sovereign debt crisis with the stigma of becoming the only country in Asia to officially default on foreign sovereign debt over the past five decades? Why the road to recovery has become long and hazardous? The previous diagnoses have emphasized two major policy missteps of the government immediately before and after the COVID-19 shock[1] and the government's failure to take timely action with the help of the IMF (Basu 2022, Krueger 2022 and Devarajan and Kharas 2022). In this section, I argue that a fuller diagnosis of Sri Lanka's vulnerability to the COVD-19 shock and the subsequent deepening of the crisis require a systematic analysis of the policy regime shift and performance of the Sri Lankan economy during the decade after ending of the civil war in May 2009. Systematic diagnosing the causes is essential for determining what type of policy response is necessary for the economy to come out of the crisis and sets on a sustainable growth trajectory beyond the crisis. My analysis draws on two papers published in this journal on policy and performance of the Sri Lankan economy (Athukorala and Jayasuriya 2016, Athukorala 2022).

### 2.1 Policy context

The three-decade secessionist war between Liberation Tigers of Tamil Eelam (LTTE) against the security forces of the government of Sri Lanka ended in May 2009. Massive

[1] A massive tax cut in 2019 and an abrupt ban on fertilizer and pesticide imports in 2021 (to be discussed later)

infrastructure development became the key priority under the governments development strategy following the country returned to a state of normalcy after the war. Of course, a large-scale reconstruction effort with substantial public sector involvement was clearly needed after a quarter century of destruction, neglect, and decay of essential infrastructure. However, the program of public investment was not geared to island-wide infrastructure rehabilitation. Many government infrastructure projects, such as a modern port, an airport a modern cricket ground and other facilities are located in the Southern regions of Sri Lanka—the heartland of the electoral support base of the president Mahinda Rajapaksa.

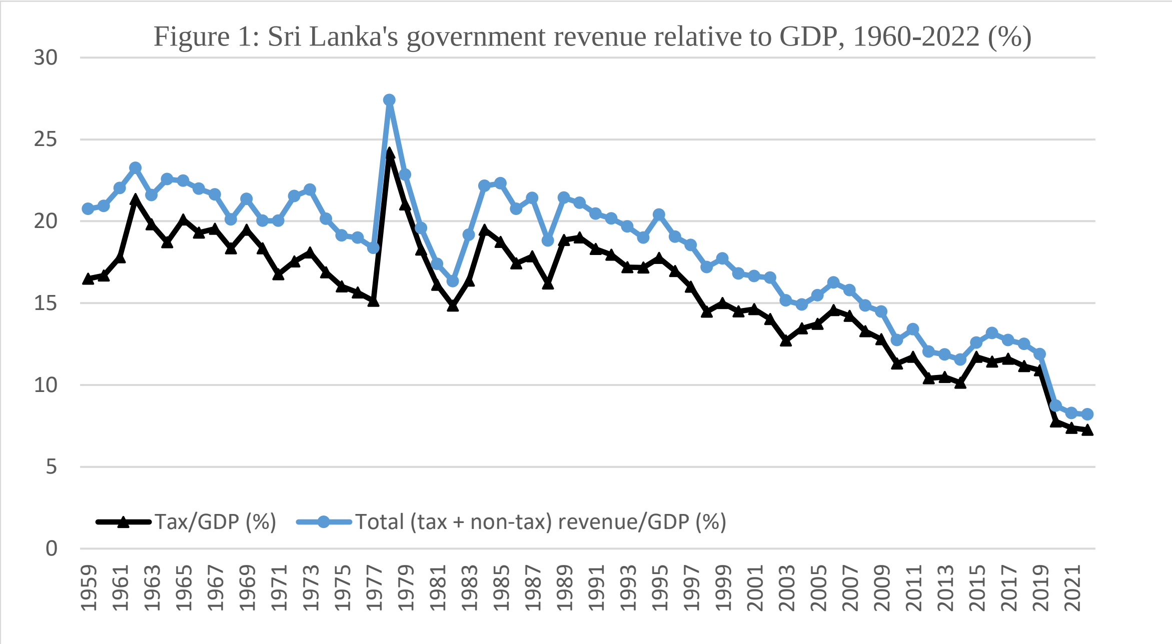
The emphasis on infrastructure development received added impetus from China's geopolitical ascendency marked by its signature 'Belt and Road' initiative (Drehar and Fuchs 2022). Initially, the large investment projects were funded with loans from the China Export and Import Bank and the China Development Bank (CDC). The subsequent expansion of the investment program involved borrowing from other Chinese sources and issuing sovereign Euro bonds and dollar-denominated national development bonds. The foreign-funded projects pulled in substantial domestic resources for counterpart funding and contributed to the fiscal deficits, financed from domestic bank borrowing and mostly from borrowing from the central bank, or pure money printing.[2]

The massive public investment program was implemented in the context of a newfound nationalist-populist policy trust that emphasized the role of the state in 'guiding the markets' with a view to redressing perceived untoward effects of economic globalization (Government of Sri Lanka 2010). The trade regime was the first victim of this policy reversal. Import substitution in both manufacturing and agriculture was put back on the policy agenda. New export taxes were introduced on tea and rubber exported in raw and semi-processed form to promote further domestic processing of these products. There were many case-by-case adjustments of duties for manufacturing imports, which directly competed with domestic production, resulting in higher levels and inter-industry variations in the effective rates of protection.

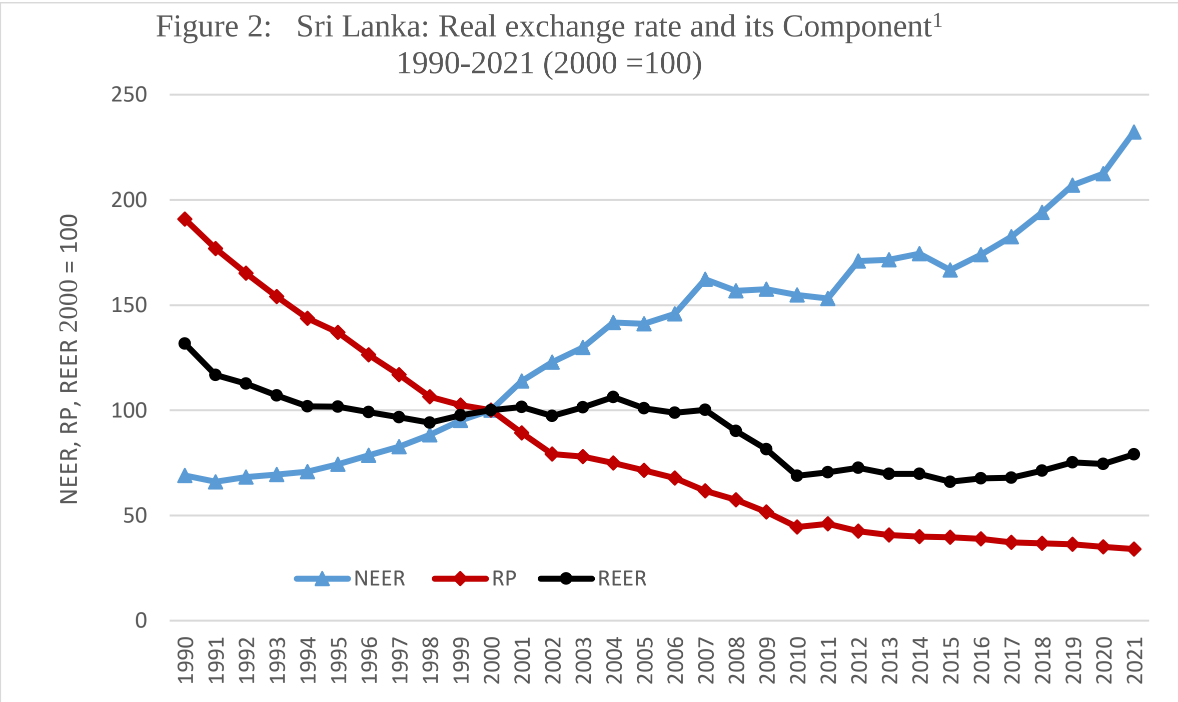
[2] Of course, the possibility of accessing external concessional funding (grants and soft loans) had dried out after the country attained low-middle income status in 2007. In any case, the white-elephant projects that figured prominently in the public investment drive would not have had any appeal to the donor nations.

The foreign investment approval procedure became interventionist and opaque. The Central Bank commitment to maintain the ‘dollar value of the rupee by resisting any pressure for nominal depreciation.  The foreign investment approval procedures also became more interventionist and opaque following the promulgation of the Strategic Development Projects Act in 2008, empowering the minister in charge of the Board of Investment (BOI) to grant exemptions from all taxes for a period of up to 25 years to “strategic development projects.” A Revival of Underperforming Enterprises and Underutilized Assets Act was passed in November  2011, empowering the government to acquire and manage 37 “underperforming” or “underutilized” private enterprises. A number of new state-owned enterprises were set up, including a second national airline with a name adapted from the president’s first name (Mihin Air).

On the macroeconomic front, there emerged a fundamental contradiction between exchange rate policy, and fiscal and monetary policies. The ballooning of government expenditure occurred against the backdrops of a long-standing failure of successive governments to restructure the revenue base and to improve the efficacy of the tax administration (Moore 2017). Tax revenue as a percentage of GDP had declined from over 20% in the 1960s to less than 14% by the 2000s (Figure 1). Therefore, the government had to increasingly resort to money printing.  In a context where fiscal and monetary policy excesses continued to fuel domestic inflation, the Central Bank maintained a stable nominal exchange rate of the rupee vis-`a-vis the U.S. dollar. The persistent stability of the nominal exchange rate, coupled with higher domestic inflation compared to that of the trading partner countries, resulted in an appreciation of the real effective exchange rate (REER), eroding the competitiveness of tradable production (export-oriented and import-competing production) in the economy (Figure 1).  The REER appreciated by about 25 percent during 2010–19 compared with the previous decade.




Source: Data compiled from CBSL (various years)




*Note*: 1. Nominal effective exchange rate (NEER) is Sri Lanka's export-weighted nominal exchange rate (measured as rupees per foreign currency unit) with the top six export destination countries (which accounts for over 90% of the country's total exports). Real effective exchange rate (REER) is NEER adjusted for the relative price (RP) measured using the export-weighted producer price indices of the six countries and the domestic price level of Sri Lanka measured by the GDP deflator. An increase (a decrease) in the REER shows an improvement (a deterioration) in international competitiveness.

Source: Data compiled from CBSL (various years) and World Bank, World Development Indicators.

## 2.2 Debt distress

During the five years following ending of the long civil war in May 2009, the Sri Lankan economy grew at an average annual rate of 7.0%, the fasted average growth rate for any sub-period in the country's post-independent history. [3] The growth spurt dissipated in the subsequent years with the completion of the construction projects, but the average annual growth rate during the ten year prior before the COVID-19 shock (4.2%) was higher compare to any other preceding comparable period.

As discussed, massive debt-fuelled infrastructure investment during this period tilted domestic price structure in favour of prices of non-tradable production. Consequently, the growth was characterised by a distinct non-tradable bias, as predicted by the dependent economy model of economic adjustment to an investment boom in a small open economy (Corden 1994). The share of tradable sectors in GDP shrank to less than 20% during 2009-19, compared to over 30% during the preceding decade (Figure 2).[4] The export-GDP ratio, which is relatively more precise, through imperfect, indicator of the relative importance of tradable production in the economy, declined from about 30% in the early 2000s to about 10% by 2019. Non-tradable production accounted for over two-thirds of the total increment in real GDP during this period

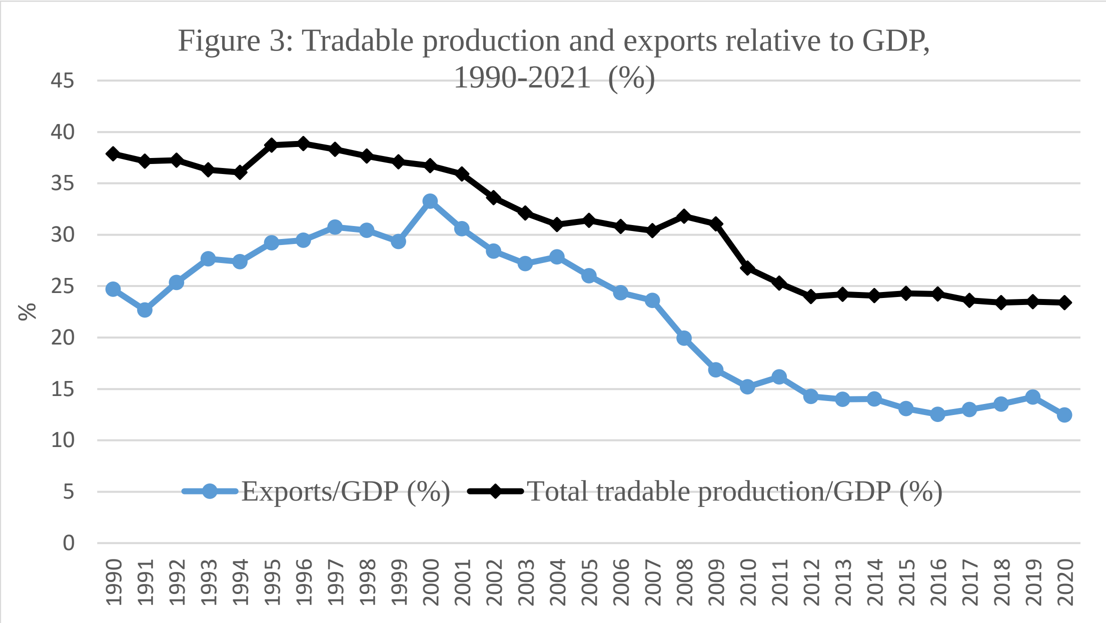
The post-civil war growth spurt was underpinned by a massive build-up of public debt, with external debt accounting more than half of total debt (Figure 4). The end-of-year stock public debt had reached 125% percent of GDP in 2019, up from 78% in 2008. The stock of external debt doubled from about 30% of GDP to 61% between these two years. In calculating the external debt, the Central Bank has valued international sovereign bonds (ISBs), which accounts for over a third of total debt, at market price.[5] When the data are

[3] Data reported in the paper, unless otherwise stated, are from CBSL (various years).

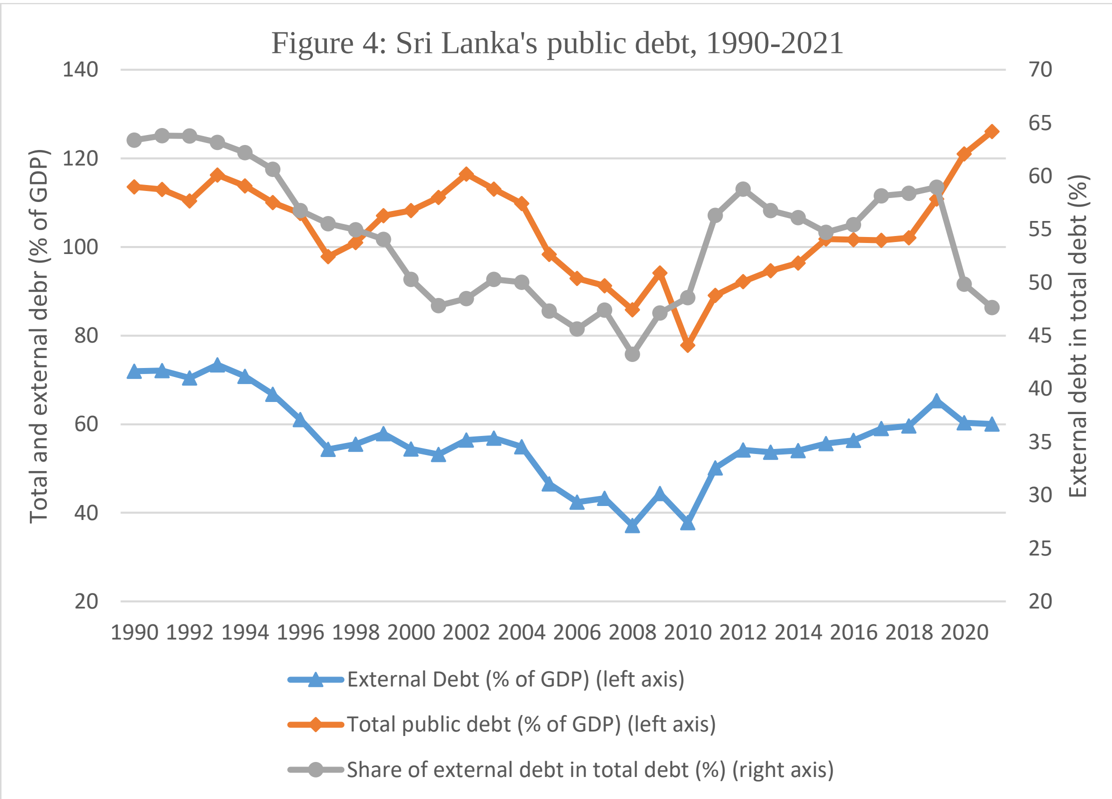
[4] Disaggregation of GDP into tradables and nontradables is based on the methodology of Goldstein and Officer (1979). The available two-digit level GDP data do not permit precise disaggregation. Some quasi-tradeable agricultural products are treated as tradables, whereas international tourism related services are scattered across a number of services categories and hence treated as nontradables. The available GDP data also do not permit separating international competitive domestic products (which are genuine substitutes for imports) and internationally non-competitive products nurtured by trade protection and government subsidies.

[5]See Chapter 5, Table 5.12 in the CBSL 2020 *Annual Report*. At the time market price was only about 40% of the coupon value (face value) of ISBs, actual debt obligation of the country.

adjusted to include ISBs at face value, the external debt to GDP ratio in 2019 increases to about 66%.




Source: Data compiled from CBSL (various years)

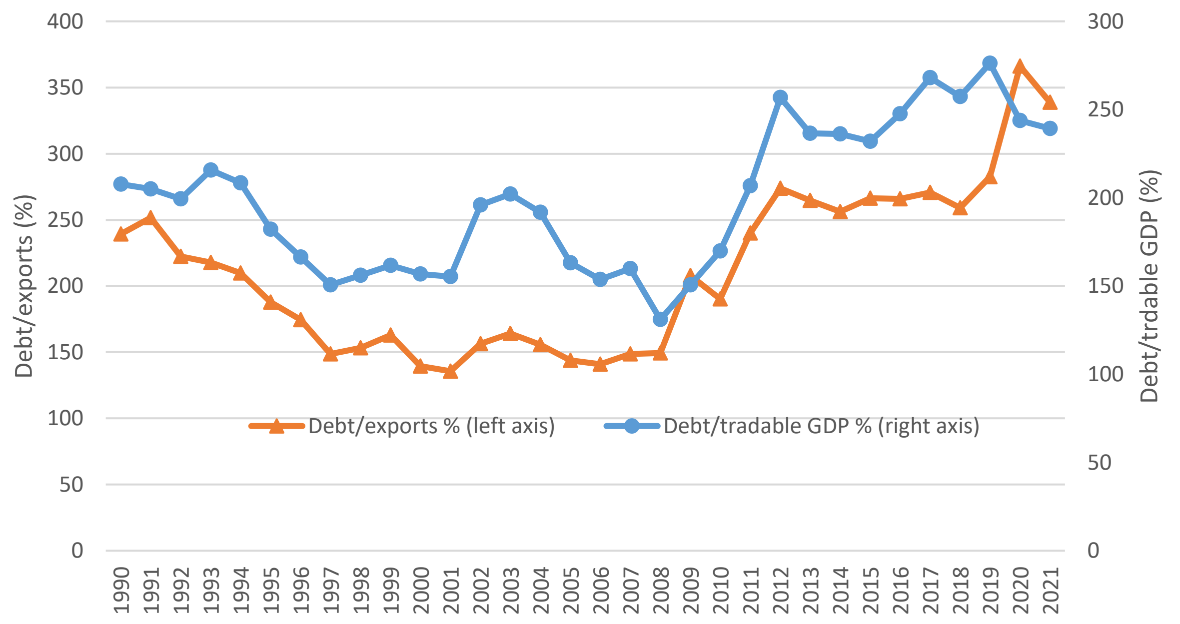



Source: Data compiled from CBSL (various issues).

Even after making this adjustment, the external debt-to-GDP ratio understates the external debt burden because, as noted, the composition of the denominator of this indicator (GDP) has dramatically changed in favour of non-tradable production. Non-tradable production does not directly contribute to debt repayment capability of a country. Of course, increase in domestic production, regardless of the tradable-nontradable composition, enhances the domestic tax base and thus helps reduce debt dependence of the government, depending on the efficacy of tax administration. However, in a country where external debts are denominated in foreign currency (mostly in the US$), expansion in nontradable production financed by external debt raises questions about the country's capacity to transform tax revenue into dollars for debt servicing.

Figure 5 depicts two alternative indicators of the external debt burden after allowing for the non-tradable bias. The first is the debt to export ratio. It is an indicator of whether debt accumulation has been consistent with the growth of export earnings from both merchandise and services exports (Dornbusch 1983, Dias-Alejandra 1984, Tanzi 1987). The other indicator is the debt to tradable GDP ratio that measures (albeit, imprecisely (see note Note 5)) a country's debt servicing capability rooted in both import substitution and export production capabilities. Interestingly, both indicators clearly show a dramatic increase in debt accumulation in the one-and-a-half decades prior to the COVID-19 pandemic.

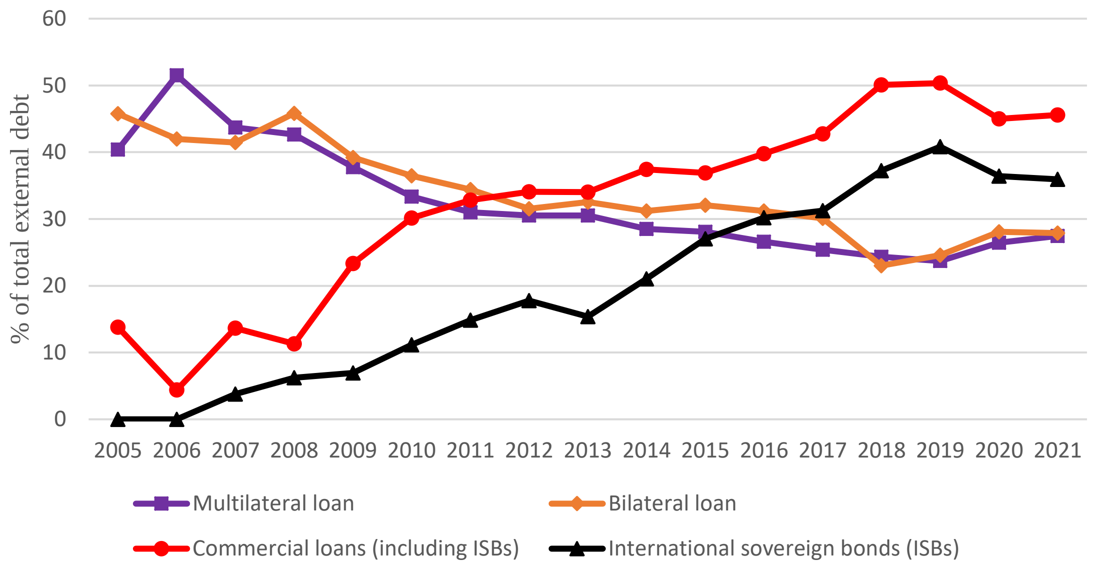
Figure 5: External debt relative to tradable GDP and export earnings, 1985-2021 (%)




Source: Data compiled from CBSL (various issues).

This increase in the stock of external debt was underpinned by a palpable shift in the composition of debt from concessional loans from bilateral donors and international developmental agencies, to borrowings on commercial terms (Figure 6). In particular, starting with the debut international sovereign bond (ISB) issue of US$500 million in 2007, the share of ISBs in total external debt increased nine-fold from under 4% in 2007-2009 to about 36% in 2020-2021. The share of multilateral and bilateral loans, which are generally at much lower interest rates, declined from 43.2% and 42.8% of total government external debt during 2005-09 to 26.5% and 28.1% in 2019, respectively. Table 1 provides a further disaggregation of the stock of external debt by creditor nations and institutions.

Figure 6: Sri Lanka: Composition of external government debt (%)




Source: Data compiled from CBSL (various issues).

The debt service burden (amortization of debt and interest payment) remained modest until the early 2000s (Figure 7). Reflecting the cumulative effect of debt accumulation and the significant compositional shift in favour of private market borrowing, the debt service burden of the country increased continuously since. The annual debt service ratio (amortization of debt and interest payment as a percentage of total export earnings), which remained at an average level of about 12% during 2000-08, increased to 35% in 2020. A tentative estimate based on the maturity structure of accumulated debt suggests that, if it were not for the debt moratorium declared in March 2022, this figure could have surpassed 40% by 2022. Interest payments on (external and domestic debt) accounted for over 70% of total government revenue in 2020, up from an average of about 30% during 2000-08. According to the data reported in the World Bank, World Development Indicators Database, Sri Lanka topped the world in terms of both these indicators during the entire decade preceding the CONVID-19 shock!

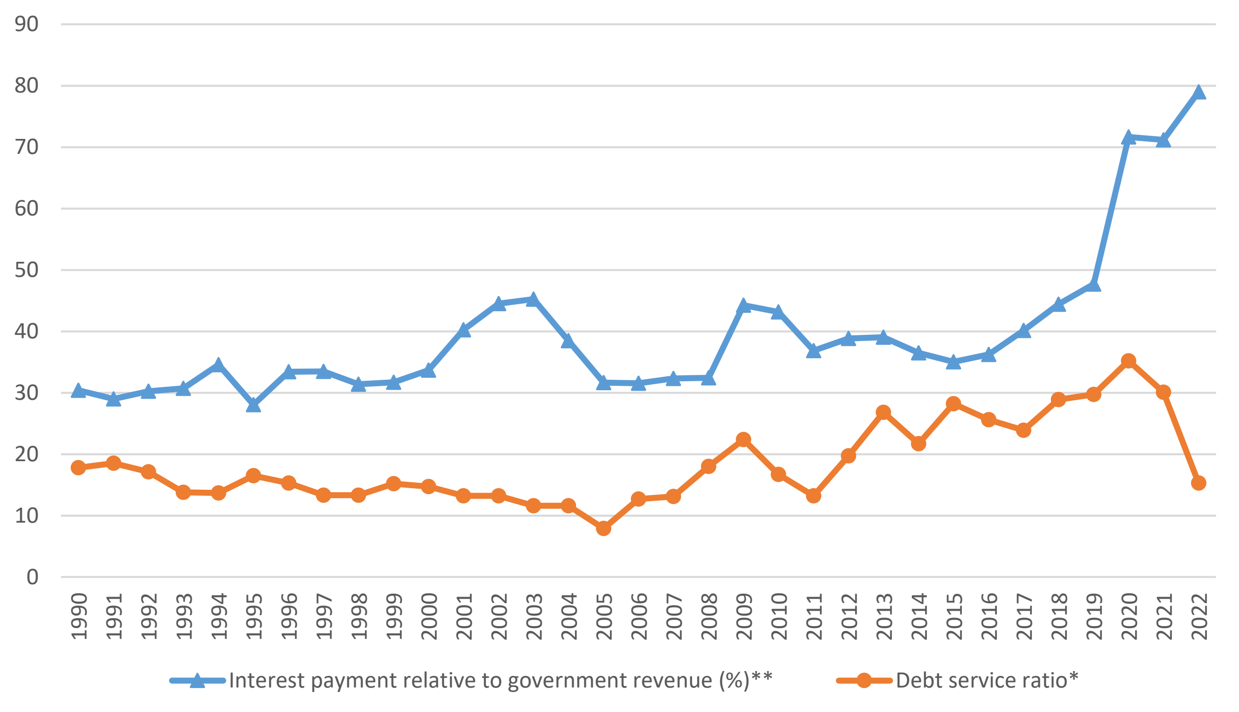
Table 1: Sri Lanka: Composition of public external debit (including arrears), US$ million

| | 2021 | 2023 |
|---|---:|---:|
| **Multilateral (IMF, World Bank and Asian Development Bank)** | **11,196** | **11,495** |
| **Official (bilateral)** | **11,219** | **11,419** |
| Paris club creditors | 5.458 | 4,784 |
| Japan | 3,236 | 2,828 |
| France | 410 | 418 |
| Korea | 332 | 317 |
| Other | 1,481 | 1,221 |
| Non-Paris Club creditors | 5,761 | 6,635 |
| China[1] | 4,572 | 4,483 |
| India | 864 | 1,833 |
| Saudi Arabia | 130 | 139 |
| Other | 195 | 180 |
| **Private** | **16,367** | **16,524** |
| International sovereign bonds (ISBs)[2] | 13,225 | 13,364 |
| China development Bank[3] | 2,883 | 2,901 |
| Riggs National Bank | 8 | 8 |
| SOE trade payables (non-guaranteed) | 251 | 251 |
| **Central Bank swap lines** | **1,774** | **2,036** |
| **Total** | **40,556** | **41,474** |

Notes: (1) includes all loans from China Export-Import Bank, and loans from private lenders (including China Development Bank) backed by China Export & Credit Insurance Corporation (Sinosure); (2) ISBs held by domestic investors are classified under domestic debt; (2) Excludes Sinosure-backed loans.

Source: IMF (2023a), Table 5 (executive summary)

Figure 7: Sri Lanka: Debt serviceing, 1990-2022 (%)




Note: *External debt amortisation and interest payment as a percentage of exports of goods and services.
Source: Data compiled from CBSL (various years)

By the time of the political regime shift in early 2015, the dark clouds of the impending economic storm were already gathering on the horizon. In 2016, the new government entered into a four-year Extended Fund Facility (EFF) program with the IMF. The program specifically focussed on fiscal consolidation and a wide range of structural adjustment reforms to restore international competitiveness of the economy (Coomaraswamy 2017). The revenue-enhancing fiscal consolidation program of the reform package managed to reverse the dwindling tax-revenue to GDP ratio in the economy and achieve a modest surplus during 2018-19 in the primary balance of the budget after several decades. However, the government, a coalition of disparate groups with divergent ideologies, did not have a steady hand on the policy leavers to successfully implement the proposed structural adjustment reforms. The implementation of the EFF program abruptly terminated with the regime change in November 2019, and the policy pendulum begun to shift in favour of 'guiding the markets' by the state' (CBSL 2020).

Immediately after coming into power, the new president implemented an unprecedented tax cut. The tax cut, introduced in preparation for the upcoming parliamentary election, wiped out almost a third of government revenue in 2020 compared to the previous year. Tax revenue relative to GDP plummeted from 11.6% in 2019 to 8.1 in 2020 and the share of total government interest payments in total government revenue jumped from 46% to over 70% between 2019 and 2020 (Figures 1 and 7).

The resultant historically high budget deficit was financed by printing money. In response to this unprecedented fiscal misstep, which jeopardized the ongoing fiscal consolidation program under the EFF, the three leading international sovereign credit rating agencies immediately revised downward Sri Lanka's outlook, virtually cutting off the country from global capital markets. Since then, Sri Lanka's ISBs have been trading at just 40% of face value. Short-term investors shunned the country in spite of the subsequent significant relaxation of restrictions on such investment by the government.

## 3. The COVID-19 shock and debt crisis

The onset of the pandemic in March 2020 compounded debt distress evolved over the preceding decade. The biggest blow to the balance of payments was the collapse of tourism inflows: total estimated earnings dwindled from about US$4 billion in 2019 to US$606 million in 2020 and US$500 million in 2021. Merchandise exports declined by about 20% in 2020 from the previous year (from US$12 billion to US$10 billion). Formal (officially recorded) inward remittances by Sri Lankan workers significantly increased in 2020, reflecting intensified family support money transferred during the height of the pandemic. However, these inflows tended to decline subsequently reflecting diversion to informal channels because of foreign exchange restrictions and fixing of the exchange rate at an overvalued level for several months.

In March 2020, the government approached the IMF for financial assistance under the rapid financial instrument (RFI) facility. The request was unsuccessful because the massive tax cut was not consistent with the IMF's assessment of Sri Lanka's external debt sustainability.[6] At the same time, the IMF terminated the 2016 EFF program before disbursing the final instalment of SDR 118.5 million (about US$155 million).

[6] According to it Charter, the IMF lends to a member country only if the country's external debt position is sustainable, that is, it has the capability to meet the existing debt servicing commitments.

The negative response of the IMF was a strong signal for the government to enter into a stabilization program to achieve debt sustainability and to become eligible for IMF balance of payments support. However, the government decided to manage the crisis on its own. The government seemed to have viewed the crisis as a temporary liquidity shock resulting from the COVID-19 pandemic while ignoring the systemic 'solvency' challenge—the arduous task of dealing with the debt overhang. Consequently, the government's crisis response turned out to be tinkering with symptoms, rather than addressing the root cause, hoping that the economy would be able to pull itself out of difficulty and regain access to global financial markets when the COVID-19 shock dissipated.

Sri Lanka has been a 'repetitive' client of the IMF, with 16 IMF-supported stabilisation programs under governments of both political camps (Athukorala 2021). Its clean record in dealing with the IMF, and, in particular, the fact that it had never defaulted debt before, could have helped Sri Lanka in speedy negotiation of a stabilisation program with the IMF (Asonuma and Trebesch 2016). The resistance of the government this time to follow the well-traversed path was presumably the concern that IMF conditionality could close loopholes in fiscal operation that had become the prime source of political patronage. The populist concern propagated by the government at the time was that an IMF program could involve sacrificing equity and fairness in development policy. This was, however, not consistent with the IMF's emphasis in recent decades on a more inclusive ('pro poor') approach to stabilization and structural adjustment reforms (Boughton 2009).

The so-called 'home grown' response to the crisis was an *ad hoc* mixture of import restrictions, artificial fixing of the exchange rate and subsequent floating, and restrictions on foreign exchange transactions on both current account and capital account transactions. The direct interventions were supplemented with swap agreements with the central banks of India (US$800 million), Bangladesh (US$200 million) and China (US$1.5 billion), and financing facilities from the governments of India (US$ 1.5billion) and China ( US$ 1.3 billion) to meet debt service commitments and finance necessary imports. [7]

[7] In addition, South Korea signed a framework agreement with Sri Lanka in May 2021 for a concessional loan of US$500 million, with a repayment period of 40 years, to finance mutually agreed projects.

Import controls comprised of quantitative restrictions (QRs) rather than increase in tariffs. Over 80% of items at the 6-digit level of the Harmonised System (HS) were subject to QRs by the end of 2022 (Wijesinghe et al 2023). A rather incongruous element of import controls was a complete ban imposed on imports of two critical categories of agricultural inputs, synthetic fertilizers and pesticides. The stated objective of this ban imposed on 27 April 2021 was to convert Sri Lanka into the world's first country with pure organic ('green') agricultural produce to mitigate adverse health implications of excessive use of inorganic fertilizer in domestic agriculture. The government finally revoked the ban on 30 November 2021 in response to farmers' protests. However, it resulted in massive harvest failure of crops in 2021compared to the previous year. The need to import essential food items to fill domestic supply shortfall added further pressure on the balance of payments. During 2021-22, the country had to fill over 50% of the domestic rice requirement alone from imports at an estimated cost of over US$150 million (Marambe 2022).

Following the precipitous depreciation of the exchange rate of the rupee triggered by the balance of payments shock, in September 2020 the Central Bank fixed the exchange rate at Sri Lankan rupee (LKR) 200 per dollar. This attempt, which was officially justified by the need to avert inflationary pressure of a free fall of the official exchange rate, set the stage for the emergence of a thriving black (curb) market for foreign exchange. By late 2020, the US dollar was exchanged in Colombo at a 25% to 30% premium over the official exchange rate. There was also anecdotal evidence of vibrant free market abroad involving the diaspora/migrant workers, where buying/selling deals occur with the corresponding rupee transactions effected in Sri Lanka without any cross border financial transfer.

The Central Bank abandoned the non-credible peg of LKR 200/US$ and allowed exchange rate to float on 7 March 2022, with the expectation of the exchange rate settling around LKR 230/US$. However, because of the failure to sequence exchange rate adjustment as part of a comprehensive macroeconomic package (including relaxing of imports and foreign exchange restrictions), official exchange rate of the rupee fell to LKR360/US$ by the April 2022. The floating of the official exchange rate failed to avert diversion of foreign exchange into the curb market, binding import and foreign exchange restrictions, shattering business confidence, and aggravating political instability. Black-market rates moved in tandem with the official rate at a premium of over 10%.

On May 13, 2022, the Central Bank introduced a variant of the ‘target zone (band)’ system of exchange rate determination with a view to limiting overshooting and excessive volatility (CBSL 2022). Under the new system, the Central Bank announced to the licensed commercial banks a ‘middle’ rate based on the rates determined in the interbank market on the preceding day advising the banks to maintain the buying and selling rates within a narrow two side band. Following this, the exchange rate moved in the narrow range of LKR/US$ 360 to 365. The curb market exchange rate premium considerable narrowed, to about 10 by the early 2023.

The COVID-19 shock and the uncertainty created by the ‘muddling-through’ response begun to stifle the economy. In 2020, the economy contracted by -3.6%. The level of GDP recovered to the pre-crisis level in 2021, but contract by 8.2% 2022. In July 2020, the World Bank downgraded Sri Lanka from upper-middle to lower-middle income status. According to World Bank estimates, people living below the US$ 3.20/day poverty line had increased by about half a million in 2021 compared to January 2020 (World Bank 2022). A tentative estimate made by the Department of Census and Statics (CDS) based on the Household Income and Expenditure Survey suggested about 60% of total household in the country were below the poverty line (CDS 2022). By July 2022, the headline year on year inflation had reached 66.7%, with food, which accounts for 44 percent of the NCPI basket, recording a rate of 82.5%.[8]

The IMF Article IV consultation report, published on 26 March 2022 (IMF 2022), concluded that Sri Lanka’s public debt was unsustainable. The report stressed the urgency of implementing a credible and coherent strategy to restore macroeconomic stability and debt sustainability, while protecting vulnerable groups and reducing poverty through strengthened, well-targeted social safety nets. The authorities argued (in their response published as part of the IMF report) that the country’s debt was sustainable and there was no need for rescheduling.

Using reserves to repay debt and to defend the pegged exchange rate (during September 2021-March 2022) caused gross foreign exchange reserves to deplete from US$7.6 billion at

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[8] The NCPI presumably understates the degree of inflation because of the substantial presence of items subject to price control in the commodity basket.

the end of 2019 to about US$50 million (equivalent to less than one-month of import requirement of the country) in early April. The foreign exchange situation was even more alarming in terms of the Central Bank's net reserve position. For the first time in post-independence era the net reserve position of the Central Bank turned out to be negative (-US$ 4.1 billion) in April 2021. Given the Central Bank's subsequent recourse to swap arrangements with other central banks and reliance on credit facility from the Asian Currency Union, the net reserve position could have worsened during the ensuing months. Much anticipated further balance of payments support from China was not forthcoming. Coupon payments on ISBs amounting to US$125 million was due in the coming month.

On 12 April 2022, the government unilaterally suspended repayment of all external debts (except those to the 'senior' creditors[9] and swap loans from Central Banks), for the first time since independence. On 16 April, the government started discussions with the IMF.

The forces unleashed by rampant scarcity and price increases of food, fertilizer, gas and fuel, and frequent power cuts, begun to threaten the constitutional order in the country. Protest rallies across the country saw record crowds, of all social classes. Thousands camped at the entrance to the Presidential Secretariat demanding the government to resign. Similar protests have started across all major cities. In response, the Prime Minister and the entire cabinet resigned and a new cabinet was formed with some multiparty representation. On 9 July 2022, the protesters stormed the official president's residence. The president fled the country and tendered his resignation from Singapore on 14 July. On 20 July, the parliament appointed a new president for the remainder of the presidential term that ends in 2024. However, the political stability needed to make progress on an agreement with the IMF remain elusive. The new president is a veteran politician, a three-time prime minister, but he has to work hand in gloves with the former president's party that dominate the parliament (Wickramasinghe 2023)

[9] The World Bank, the IMF and the Asian Development Bank

## 4. Stabilization and structural adjustment

In late May 2022, the Sri Lankan government appointed financial and legal consultants for debt structuring and commenced consultation with the IMF.[10] On July 31, 2022 the IMF and the Sri Lankan authorities reached a staff-level agreement for economic adjustment and reform policies with a 48-month Extended Fund Facility Arrangement (EFFA), with an access of SDR 2.286bn (equivalent to US$2.9 billion) over a period of four years. The IMF Director Board approved the EFFA program on 21 March 2023. The approval was based on an assurance from the official (bilateral) creditors (Paris Club creditors, India, Hungary and the Export-Import Bank of China) [11] to bring debt to a sustainable level, and expression of readiness to negotiate debt relief by a group that held Sri Lankan ISBs (holding about half of the outstanding Sri Lankan ISBs) (IMF 2023a). The IMF issued the first instalment of the EFF loan (US$330mn) immediately after IMF directors approved the program. The rest of the loan are to be distributed uniformly in four instalments over the period (2023-27) subject to assessment of the progress, before each disbursement, of meeting the performance criteria of the EFFA.

The main reason for the delay in the approval of the staff-level agreement was the refusal of China to agree with the Western donors represented by the Paris Club members[12] on the terms of debt restructuring. China initially offered to extend the period of repayment of debt rather than re-profiling debt with a haircut (lighter repayment terms). The Paris Club members were reluctant to restructure debt before the Sri Lankan government comes to a negotiated settlement with China because of the concern that any prior concessions granted to Sri Lankan would unjustly benefit China. In early March 2023, the Exim Bank of China, which held about US$ 4.1billion of Sri Lanka's bilateral (official) debt to China (US$4.6 billion) (Table 1), came up with an assurance to 'provided debt relief that is compatible with the parameters of the Fund-supported program' (IMF 2023a, 28 ). In addition, the Exim Bank offered a moratorium on debt service payments of Sri Lanka due through 2023 and to financing Sri Lanka notwithstanding arrears to the Chinese government and the China Exports and Credit Insurance

[10] The French firm, Lazard Asset Management, and the British firm, Clifford Chance, respectively.
[11] Iran, Kuwait, Pakistan, and Saudi Asabi, which together accounted for about 7% of Sri Lanka's bilateral debt, wanted more time to decide.

[12] The Paris Club is a group Western donor countries formed in 1950 to find coordinated solution to developing countries' debt problems.

Corporation. Even though it was not a ’hard’ commitment, the IMF considered the China offer acceptable at that stage, pending further assessment, under performance revives of the program, of the progress on debt restructuring to restore debt sustainability within a reasonable time frame. However, the IMF emphasised that ‘risk to the program implementation are exceptionally high, given the complex restructuring process’ (IMF 2023a, 2).

The key focus of the EFF program is on near-term policy measures to restore macroeconomic stability and debt sustainability while mitigating the impact of the crisis on the poor and vulnerable (IMF 2023a). Structural reforms [for long-term growth] are to be ‘sequenced appropriately throughout the programme period, considering the authorities’ capacity constraints’ (IMF 2023a: 26). The reform program has been structured under five key policy goals: fiscal consolidation accompanied by strong social safety net; public debt restoring to ensure stable functioning of fiscal operations; restoring price stability and rebuilding foreign exchange reserve buffers under flexible exchange rate; ensuring financial sector stability by addressing banking sector vulnerabilities; and reforms to address corruption vulnerabilities.

The estimated external resource gap during the programme period is $25.2 billion. The IMF loan ($3bn) amounts to 12% of the gap and budget support from the World Bank and the Asian Development Bank (US$ 3.8bn) is projected to fill 15%. Restructuring of debts to bilateral creditors and private creditors (dominated by ISB holders) is expected to contribute US$14.1 billion (56.0%).[13] During the final year of the program (2027) is expected to regains access to global credit markets and raise the balance US$1.5bn (6%) by issuing sovereign bond. Total external debt subject to restructuring is about US$27.9 billion (Table 1).

The EFFA predicts the total stock of public debt as percentage of GDP to decline from 128.1% in 2022 to 104.4% in 2027. The comparable figures for foreign debit (both public and private) in the two years are 78.0% (US$59 billion) and 79.6% (US$67.7 billion), respectively (IMF 2023, Table 1). These figures taken together imply that the EFFA is built on the implicit logic that through the proposed debt structuring process and the EFFA reforms Sri Lanka would achieve debt sustainability to tap foreign private credit markets (in particular the Euro bond market) by the end of the program period.

[13] Debt to multilateral creditors (IMF, World Bank, ADB) and swap loans from Central Banks are not subject to restructuring.

As noted, when Sri Lanka started negotiating the EFF with the IMF, domestic and foreign debt accounted for approximately equal shares of the total government debt stock. The government's annual interest payments on total debt was about 74%, with domestic debt accounting for over two thirds of interest payments. These numbers, coupled with the previous global experience of debt restricting in other debt-distressed countries (Das et al 2012, Grigorian 2023) seems to makes a strong case for 'twin restructuring' of external and domestic debt as part of the EFF programme. However, the EFF initially focussed solely on foreign debt, presumably because of the concern that domestic debt restructuring would risk unravelling macroeconomic stability.

It was only after the implementation of the EFFA had commenced that restructuring of domestic debt began. The IMF emphasised satisfactory progress in restructuring foreign debt as a key milestone for releasing the second tranche of the EFFA loan in September or October 2023. At the same time, the holders of international sovereign bonds reiterated equal treatment of foreign creditors and domestic creditors of dollar-denominated debt as a prerequisite for their participation in debt restructuring. Consequently, the government came with a domestic debt-restricting plan (evasively labelled 'domestic debt optimization (DDO)' plan) on 29 June 2023 as an appendage to the original EFFA.

A unique feature of the DDO compared to domestic debt restructuring programs in most other countries is its partial coverage (Das et al 2012). It covers only public debts of three broad categories: Domestically issued dollar denominated bonds (named Sri Lanka Development Bonds, SLDB) worth US$1.4 billion, treasury bills held by the Central Bank worth US$7.1 billion and treasury bonds held by the Employee Provident Fund (EPF) (managed by the monetary board of the Central Bank) worth US$8.8 billion. Together these debts account for about 40% of total domestic debt. Domestic debt in the form of treasury bills and treasury bonds held by domestic commercial banks that account for the balance are excluded the DDO from coverage.

The DDO offers three options to the SLDB holders: two options to exchange holdings for new US$-instruments ('US$ options') and a third exchanging holdings for new local currency instruments ('LKR option') (Weerasinghe 2023). The first US$ option is a nominal haircut of 30%, with repayment in six years starting in 2024 at 4.0% interest rate coupled with settlement of past due interest and interest accrued up to the settlement date in LKR. The second US$ option involves maturity extension to 15 years at a 1.5% fixed interest rate, with a 9-year grace period and no haircut. The two ‘US$ options’ are specifically designed to meet the ‘equal treatment’ demand of ISB holders and therefore they are equally applicable to them and SLDB holders. The first of the two US$ options is obviously the most attractive to ISB holders; the second option looks like ‘window dressing’ meant merely to give the impression of another option. The 30% haircut and interest rate adjustment offered to the international bond holders would amounts to about 35% debt relief on the outstanding ISBs, compared to the originally expected rate of debt relief of 50%. The revised figures of the debt stock after the introduction of the DDO are not yet available in the public domain. However, this significant difference between originally posed and the new rates of debt reliefs implies that the level (and the share in total debt) of the stock foreign debt in the EFFA is going to be significantly higher than originally predicted.

The EFFA predicts the Sri Lankan economy to contract by 3% in 2023 and 1.5% in 2024, and gradually converge to an average annual rate of 3% by the end of the programme period in 2027. According to these projections, real GDP in 2027 would be about 15% lower compared to the pre-crisis (2019) level. This raises doubt about whether the country would regain the lost upper-middle income states by the end of the EFFA.

Following the first performance review under the EFFA (conducted during 14-17 September, 2023), the IMF reached a staff level agreement with the Sri Lankan authorities on 20 October for releasing the second tranche (US$ 333million) of the EFFA loan. The approval of the agreement by the IMF Executive Board is required for releasing the second tranche of the EFFA loan (US$333 million). The approval is conditional on prior action by the authorities for meeting an estimated 15% shortfall in government revenues from the EFFA target and confirming that sovereign debt is being reconstructed in a timely manner in line with the programed debt targets.

China’s refusal to work with the Paris Club members remains the main, if not the only, hurdle to speedy restructuring of bilateral (official) debt. There is anecdotal evidence that China’s position has become even harder following the India’s decision to co-chair with Japan the Sri Lanka debt restricting committee (*The Economist* 2023). In early October 2023, China Exim Bank (the Chinese official lender) came up with a proposal for restructure US$4.2 billion owed by Sri Lanka. The proposal is currently under consideration by the IMF (IMF 2023b). Even if the Exim Bank offer meets the IMF requirements, still Sri Lanka has to deal with the remainder of China debt of about US$ 3billion to the China Development Bank (CDB) (treated as private commercial debt) and other Chinese private lenders backed by China Export & Credit Insurance Corpora (treated as Chinese bilateral (official loans) (Table 1). Negotiation of these multiple loans bound to be complicated because the lack of uniformity in terms.

Restructuring debt to private creditors, in particular sovereign bondholders, is normally a long-drawn and costly process. The experiences of other countries with debt restructuring suggest that the process of negotiating with ISB holders take between six months to over two years, with the time involved in post-default debt restructuring episodes clustering at the upper end (Ams et al 2020, Asonuma and Trebesch 2016). A major issue relating to restructuring debt to private creditors is its implications for subsequent market access. The issue is particularly relevant for Sri Lanka because the EFFA has been designed on the assumption that Sri Lanka would be able to access private capital market by the final year (2027) of the program. The available evidence suggests that debt restructuring does not negate the opportunities; but higher haircuts are associated with significantly higher subsequent bond yield spread and longer periods of capital market exclusion (Cruces and Trebesch 2013, Meyer et al 2019).

## 5. Policy challenge of moving from stabilization to growth

A systematic assessment of the EFFA against its quantitative performance criteria needs a separate paper. However, a curtsy glace would raise a number of concerns that worth further scrutiny.

First, fiscal adjustment, the core of the proposed stabilisation strategy, places excessive emphasis on the revenue side of fiscal operation under label 'revenue based stabilisation'. There is surprisingly less emphasis on expenditure reduction/rationalisation, in spite of widespread concerns in policy circles and ample evidence on fiscal profligacy and corruption, including massive burden on the budget from supporting loss-making public enterprises.[14] The dramatic persistent decline in the revenue-GDP ratio has historical roots dating back to the trade liberalisation reforms in the late 1980 since when the successive governments failed to overhaul the tax system to redress the country's historical reliance on trade taxes to finance

[14] The central government budget deficit in 2022 was 10.4 of GDP. A tentative estimate of the 'consolidated budget deficit' (that is the deficit including losses of public enterprises) was about 14% of GDP

the budget (Figure 1). It is not naturally administratively easy or politically palatable to redress this government failure as part of a 4-years crisis management package. Moreover, widespread public dissatisfaction with reforms, in particular protests against tax reforms, is partly rooted in the government's failure to combine revenue-based fiscal adjustment with systematic reforms on the expenditure side.

Second, the EFFA projects Sri Lanka to archive debit sustainability with massive stock of debt amounts to 104% of GDP by the end of the program period. Whether the projected budgetary position would enable the country to manage this massive debt stock, is highly questionable. The the widely accepted rule-of-thumb 'safety' figure of national debt is 60% of GDP (Reinhart and Rogoff, 2009).

As noted, at the time of the COVID-19 shock, Sri Lanka's interest payments on public debt absorbed over 70% of total government revenue. The projected increase in government revenue (an increase in revenue from 8.5% to 15% of GDP), even if fully materialised, is unlikely to substantially reduce the interest payment burden of the projected debt burden. A tentative estimate by Maret and Setser (2023) suggests that with a debt stock of 100% of GDP and assuming an annual fixed interest rate of 8%, Sri Lanka would have to spend more than half of total government revenue on interest payments alone. With a large debt stock, and heavy interest payment burden on the budget, it is unlikely that the government would be able to access global capital markets at reasonable interest rates to manage public debt. As discussed, access to the Euro bond market also depend on the timing and conditions of ISB restructuring.

Third, EFFA seems to have glossed over the balance of payments dimension of external debt sustainability. The program expect the government to commence tapping private capital markets (issuing ISBs) in 2027. By this time, the stock of external debt is projected to have reached US$67.7 billion (80% of GDP), up from US$59 billion (78% of GDP) in 2022. This projected external debt dependence would expose Sri Lanka to a dual challenge of raising sufficient fiscal revenues to service debt and converting these surpluses into foreign exchange. In other words, budgetary reforms alone would not guarantee external debt sustainability, without concurrent improvement in the balance of payments to strengthen the foreign exchange reserve position of the country. This requires, as discussed below, combining stabilization reforms with a coherent structural adjustment reforms to redress the anti-tradable bias in the economy.

Forth, the DDO program, which was subsequently added as an appendage to the original EFFA, runs counter to the so-called ‘forth pillar’ of the EFF programme: ‘policies to safeguard financial sector stability’ (IMF 2023a, p. 2). As the Central Bank Governor has himself pointed out, the conversion of holding of treasury bills into treasury bonds at lower interest rates under the DDO would significantly erode the capital buffers of the Central Bank (Weerasinghe 2023). Therefore, as the Governor has warned, unless recapitalised, the Central Bank would not have capacity, credibility and independence to rescue the deposit-taking banks in the event of a deposit run. This is an important concern because the country entered the crisis a banking sector with weak balance sheets of the banks as reflected in non-performing loan ratio of 13% and a sizeable share of impaired loans in their balance sheets. The DDO has left out the banks from the proposed domestic debt restricting mainly because of the banks’ fragile balance sheet position. However, this ‘ring fencing’ of the banking system within the debt-restructuring programme is a mere palliative for the deep-tooted balance-sheet fragility of the banking system, which calls for comprehensive banking sector reforms as an integral part of the stabilisation reform. There is convincing evidence from debt crisis research that a banking crisis could magnify the lost output of a debt default, or could even derail the reform process (Sturzenegger and Zettelmeyer 2007).

Based on these and related concerns, some observers have questioned whether Sri Lanka would be able to come out of the crisis with the EFFA program or, put bluntly, whether the country would require a ‘second IMF program’. Even if we eschew pessimism and expect the EFFA to reach its targets, an important issue is whether economic stabilisation alone would enable the economy to achieve self-sustained growth.

As noted, stabilizing the economy and achieving debt sustainability through fiscal and monetary policy reforms is the prime focus of the standard IMF-supported stabilisation reform packages. Given that the fiscal operation is the key determinant of domestic excess demand, the IMF approach assumes a tight link between the budget deficit and the balance of payments deficit operating through domestic money that drives inflation. However, since an anti-tradable bias evolved over nearly two decades has underpinned vulnerability of the economy to the crisis by building up a massive debt overhang, economic stabilisation alone is unlikely to set the economy on a sustainable growth path beyond the crisis. It is necessary to combine stabilisation policies with structural adjustment reforms to redress the anti-tradable bias in the economy (Dornbush 1990, Tanzi 1987). Reorientation of the economy from nontradable production to export expansion and efficient import substitution production requires a comprehensive and well-coordinated reform package encompass exchange rate adjustment, trade reforms and unshackling the economy from direct government interventions, and proposing foreign direct investment.

As regards exchange rate policy, it is difficult to ascertain the equilibrium exchange rate through simple 'desk work'. An initial failure to guess that equilibrium rate could necessitate repetitive exchange rate adjustments, resulting in diminished credibility of exchange rate management. The black market rates are an unreliable guide to the equilibrium rate. Black market quotations of course provide a rough guide to the order of magnitude of the degree of overvaluation, but there are wide margins between buying and selling rates that rule out their practical value. The widely recommended and most expedient alternative is to identify the equilibrium level through a transitional phase of floating the exchange rate of the rupee and then stabilizing that rate at the market-determined level though Central Bank intervention in the foreign exchange market to redress erratic deviations of the exchange rate from that level (Corden 2004). It is important to emphasize, that floating the currency under this approach needs to be accompanied by removal of foreign exchanges restrictions on current account transactions, quantitative import restrictions, building adequate reserves to support the currency, and regaining access to capital markets. Once the equilibrium rate is identified through floating, it is necessary for the Central Bank to resume operations in the foreign exchange market to smoothen erratic changes. This is to manage the floating rate to ensure exchange rate behaviour in line with the objective of maintaining a real effective rate consistent with internal and external balance of the economy.

In foreign exchange market operations, the Central Bank should resist 'leaning against the wind', influencing the exchange rate against market forces with a view to taming domestic inflation or to cushion the budget against increase in the rupee value of the cost of debt servicing. Averting the real exchange rate appreciation should be given priority over fiscal stabilization and maintaining inflation targets. Put simply, the exchange rate should continue to function as a shock absorber while maintaining international competitiveness of the economy.

Lifting quantitative import controls (QRs), with the financial support forthcoming from the IMF, should be another key reform priority. At the initial stage of managing the crisis, it would be necessary to retain import duties (tariffs) at reasonably high levels (consistent with bound rates at the WTO) as a 'first aid' measure, for two reasons. All-out import liberalisation (removing both quantitative restrictions and tariffs) could jeopardise the reform process though relentless pressure on the foreign exchange reserve of the country. Second, increased tariff revenue helps hedge against the inevitable pressure of the government budget resulting from exchange rate depreciation. High import tariffs naturally infuse an anti-export bias into the overall incentive structure of the economy. However, this bias can be redress by reforming the existing customs procedures (duty rebate and bonded warehouse facilities) that provide export-oriented firms with duty free access to intermediate inputs.

In Sri Lanka's tariff structure, among all tariff lines (6965, at the 8-digit level of HS) all agricultural tariff lines (1064) (other than whale oil and sperm oil) are bound at 50%; among the non-agricultural tariff lines (5901) only 22.3% are bound at rates between 50% and 75%, except textile which is bound at zero (WTO 2016). There is, therefore, ample room to increase tariffs without violating WTO commitments. Possible violation of WTO tariff commitments relating to luxury goods such as automobiles and liquor can be circumvented by imposing high excise duties alongside the new import tariff structure.

It is important to carefully design the new tariff structure with the aim of gradually moving tariff rates towards a uniform structure in place of the current three-band structure. There is ample evidence that a transparent tariff structure with relatively uniform low *ad valorem* tariffs help increase tariff revenue collection by improving the efficiency of custom administration and eradicating rampant corruption. A tariff structure with a wide array of duties provide incentives to lobby for the reclassification of imports from a high to low duty category, and rampant Customs corruption and delays (Corbo 1997, Edwards 2002).

It is necessary to combine trade reforms with lifting of domestic price controls including government monopoly in certain imports. However, price guidelines could be established for imported inputs given that trading channels are far from competitive. If state trading is required for political/equity reasons, this could be on a competitive basis, private enterprises being allowed to participate side by side.

Maintaining controls over most types of capital account transactions (while lifting restrictions on foreign exchange on current account transactions) is desirable during the reform period. There is evidence from Sri Lanka's own past that in a period of economic recovery short-term capital inflows put unnecessary pressure on macroeconomic management given that the Sri Lankan market for short-term financial assets is shallow.[15]

Stabilization and structural adjacent reforms need to be supplemented with an endeavour, at the highest political level, to promote export-oriented foreign direct investment (FDI). Sri Lanka's own experience under liberalization reforms initiated in the later 1970s, and in particular, the second-wave reforms in the early 1990s, have clearly demonstrated the complementarity of trade and investment liberalization in the process of export-oriented industrialization.

Restoring the Board of Investment (BOI) to its original 'one-stop-shop' status for promoting FDI is vital for linking Sri Lanka's manufacturing industry to the rapidly evolving global production networks. As part of BOI reforms, it is necessary to rationalize, rather than eliminate, the fiscal incentives offered to export-oriented investors. The very objective of giving incentives for promoting FDI is nullified if they are not made strictly time bound and transparent.

In this era of global manufacturing, a product from the beginning to end within national boundaries is ending. As countries are integrating globally and technological advances are creating previously impossible collaborations, rapidly evolving global manufacturing value chain (GMVC) is generating new opportunities for countries to participate in finer international division of labour than ever before. These production processes with cross-border dispersions within vertically integrated global industries, with each country specializing in a particular stage of the production sequence, is becoming an increasingly important structural feature of economic globalization. Urgent action must be taken to integrate Sri Lanka into GMVC that would set the stage for rapid export expansions and creating better employment opportunities (Athukorala 2022).

Notwithstanding the significant liberalisation reforms initiated in 1977, Sri Lanka failed to attract large multinational enterprises to set up production bases in the country because of the country risk during the three decades of civil war. However, a sizeable number (over 30,

[15] I owe this point to Indrajit Coomarasamy, a former governor of the Central Bank of Sri Lanka.

according to Board of Investment records) of fully export-oriented medium scale foreign-invested enterprises (FIEs) (with full or partial foreign ownership) have been successfully operating in electronics, electrical goods, and auto part industries in the country for many years now. Their successful operation points to further opportunities for Sri Lanka in this new form of global engagement in the post-civil war era.

As discussed, the crisis has already had a crushing impact on low-income families in Sri Lanka. A large segment of previously non-poor is now poor. Mass protests that initially spanned the cost-of-living pressure and scarcity of essential consumer items have morphed to threaten the constitutional order in the country. In this context, it is vital to design the stabilization and structural adjustment policy package with a strong emphasis on social protection. A two pronged approach is needed: selective use of public expenditure and taxation to ensure equitably the cost of adjustment (as discussed) and designing safety programs to help households at the bottom of the income scale who would be worse-off owing to direct COVID-19 shock and stabilisation measures, in particular market-based pricing of electricity, gas and oil. Viewed from this perspective, the proposed DDO seems highly inequitable. It passes on most of the burden of adjustment onto salary owners while sparing the banking sector and treating international creditors and individual domestic creditors generously. This is not a recipe for social and political harmony, which is necessary to shape a broader social consensus on reforms.

## 6. Concluding remarks

Contrary to the popular perception that the unprecedented economic crisis in Sri Lanka was caused by a few isolated policy missteps and the COVID pandemic, the crisis was the culmination of debt distress that had been building up for over two decades. In the immediate aftermaths of the COVID-19 shock on the balance of payments, the authorities believed, as they subsequently admitted, they could manage the crisis on their own without entering into a stabilization arrangement with the IMF. Timely action with IMF support could have helped the government to manage the crisis at a lower economic and socio-political cost while avoiding an ugly default. However, it is unthinkable that it would have been possible to reset the economy on a sustainable growth path without fundamental structural reforms to redress the massive anti-tradable bias evolved over the past two decades.

Sri Lanka's policy challenge is to take the unprecedented economic crisis as the spring board for lifting the country to a growth path, into to a dynamic, outward-oriented economy that can deliver sustainable and equitably shared growth. Given the fiscal operation has been the prime source of domestic excess demand, the IMF approach assumes a tight one-to-one link between the budget deficit and the balance of payments deficit, domestic money and credit that drive inflation. Of course, aggregate-demand management is vital for any serious stabilisation plan, in the sense of seeking to eliminate domestic demand pressure on the external balance. However, in the context of an economy where anti-tradable bias has underpinned vulnerability to the crisis, it is necessary to combine stabilisation policies with policies to redress anti-tradable bias in order to set the economy on a 'new beginning' for a long-term self-sustained development path.

It is important to combine these initiatives with a coherent social protection package as an integral part of the reform process to make the reforms 'saleable', politically palatable. 'Effective stabilisation is, above all, not a technical issue but a political issue' (Dornbusch 1983, 229).

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