Guest Speech delivered by Mr. K. M. Mahinda Siriwardana, Secretary to the Treasury, and Ministry of Finance, Economic Stabilisation and National Policies on "*Emerging Economic Landscape Relevant to Sri Lanka*" at the National Defence College, Sri Lanka, on 07th June 2024

1. Background

There are important links between national security, defence, and the economy. A stable and prosperous economy is a necessity for sovereignty and peace. Where there is persistent economic instability, there is room for increased internal and external threats to a country's national security and sovereignty. In fact, the "*national security is a precondition for economic and social development as much as economic and social development is a precondition for national security*"[1]. At the same time, in today's context, the "*economic security has become an increasingly vital aspect of national security, and these two dimensions are inherently interconnected. Where there is no economic security in a country, its national security is definitely threatened. Therefore, it is imperative to take proactive measures to ensure economic security, thereby strengthening the overall national security*"[2]. Hence, it is important to understand the relationship between the national security and the economic and social development when we are moving forward in a country like Sri Lanka which faced its deepest, most complex and unprecedented crisis in its post-independence history two years ago.

When we are talking about the *Emerging Economic Landscape Relevant to Sri Lanka,* which is the topic of my speech today, we should not forget the causes for the crisis that the country faced two years ago. In fact, there have been various causes attributed to the crisis. The long-standing structural weaknesses in the Sri Lankan economy which have been neglected for many decades given the pain associated with remedying these issues are among the key causes for the crisis. These weaknesses include fiscal sector imbalances, inadequate external policy buffers, financial and monetary sector vulnerabilities, deficiencies in governance, corruption vulnerabilities and shortcomings in the legal and institutional framework in the country. In addition, the external shocks faced by the country, including the Easter Sunday attack, the COVID-19 pandemic, the Russia-Ukraine conflict, coupled with significant domestic policy errors, exposed these macroeconomic vulnerabilities and triggered the prevailing economic crisis. The significant policy errors was something that we all should pay special attention in moving forward as any attempt

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[1] Wolfgang-Peter Zingel, *National Security and Economic Development: Securing Development – Developing Security*, Bundesministerium für Landesverteidigung
https://www.bmlv.gv.at/pdf_pool/publikationen/eco_impacts_02_national_security_zingel.pdf

[2] Kalpani Gunathilaka Danangalage, *Exploring the link: Economic Insecurity as a growing threat to National Security*, Institute of National Security Studies, 12th December 2023, https://www.inss.lk/index.php?id=568

to make similar mistakes going forward will be highly costly. At the same time, the situation in Sri Lanka by early April 2022 was something that we all should never forget. The severe shortage of essential items, country-wide demonstrations, and sudden relinquishing of office by senior economic managers, created a serious lacuna in the economic management process, putting the country and its people in serious danger, culminating in a change in the administration. These provide critical lessons on the importance of responsible economic management in a country.

Today, Sri Lanka is gradually emerging from the economic crisis. As economic stability is being restored, it is essential that the past mistakes are not repeated and the stability is converted into inclusive and sustainable economic growth, such that the prosperity and well-being of all Sri Lankans is enhanced.

That said, it is equally important to be mindful of the fact that Sri Lanka's economic stabilisation is still at a very early and delicate stage. Often when countries go into sovereign default, particularly during the Latin American crises in the 1980s, the economic literature refers to a "*lost decade*[3]". Thus far, whilst Sri Lanka has experienced stabilisation within 2 years of the announcement of the debt standstill, experiences of other countries provide ample evidence of the necessity for continued reform and discipline in economic management in order to avoid a repeat of the crisis.

2. Economic Stabilisation Measures

Economic stabilisation has not been achieved without cost. There were several decisive macroeconomic policy measures that were implemented in a coordinated manner that enabled stabilisation. Many of these policy measures imposed further adjustment costs on the country's population who were already under significant stress due to the aftermath of the COVID-19 pandemic and other economic shocks. However, there were no options at the time other than the measures that were implemented.

Tax revenues had to increase since Sri Lanka was running a budget deficit as a percentage of GDP in double digits. Failure to do so would require further monetary financing from the Central Bank which could have led to hyper-inflation. With inflation running up to 70%, it was necessary for the Central Bank to increase its policy interest rates in order to curb inflation. It was impossible for the Ceylon Electricity Board and Ceylon Petroleum Corporation to purchase fuel whilst running large losses and debt, and as a result, cost-reflective energy pricing was essential.

[3] Lee Buchheit and Mitu Gulati, *Oxford Review of Economic Policy*, Volume 39, Issue 2, Summer 2023, Pages 360–366.

Therefore, whilst the remedial measures were painful, it is also important to consider the counter-factual. What would have been the outcome if the remedial measures were not implemented? We have seen how inflation in countries like Argentina (289% in April 2024[4]) has ravaged economies, particularly the poor and vulnerable sections of society that do not have the assets to hedge against inflation. In Sri Lanka's case as well, there is a lot of discussion about income tax rates being high, but we often forget that in 2022 inflation wiped out 70% of the value of people's rupee denominated wealth. For many decades, Sri Lanka has neglected its tax base and instead relied on borrowings to bridge the resultant high budget deficits. When deficits are financed directly by the Central Bank, it results in inflation, which rose to unprecedented levels during the crisis. Therefore, if the macroeconomic reforms were not implemented since mid-2022, Sri Lanka could have easily gone down the path of Argentina, or Lebanon, or Zimbabwe.

To share another example, when VAT was introduced for items such as petrol and diesel in January 2024, the public consensus was that it would lead to cascading higher price levels in the economy. The reality is that through improving the VAT base by removing the vast majority of VAT exemptions, the fiscal deficit is further narrowed. This helps overall macroeconomic demand management, including reducing the current account of the balance of payments. This in turn allows the currency to appreciate, which in fact helps prices to reduce. Lower budget deficits allow interest rates to decline, helping reduce finance costs in the economy. On aggregate, these macroeconomic impacts allow price levels in the economy to decline. This was confirmed by the data, in December 2023; prior to the VAT reforms the Colombo Consumer Price Index was 195.1, whereas by May 2024, it had in fact declined to 194.1.

The control of inflation, currency depreciation, fiscal deficits, interest rates, and current account deficits have all been major aspects of the stabilisation of the economy. During this period, a primary budget deficit of 5.7% of GDP in 2021 was converted into a primary budget surplus of 0.6% of GDP in 2023. Inflation reduced from 70% in September 2022 to 0.9% in May 2024. Interest rates (Treasury bill yields) reduced from around 30% to single digits at present. In 2023, Sri Lanka achieved a current account surplus in the balance of payments for the first time since 1977. These have been made possible by the coordinated fiscal and monetary policy reforms implemented over the last 2 years. A failure to bring these key economic factors under control would have led to a continuing vicious cycle of adverse economic and social outcomes, which in turn would undermine both internal and external security considerations. Therefore, the hard won gains made through

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[4] *"Inflation in the 12 months through April landed at 289.4%…."*: Reuters. https://www.reuters.com/world/americas/argentina-inflation-nears-300-climb-prices-slows-bit-2024-05-14/

macroeconomic reforms must be protected in order to ensure continued economic and social stability.

Whilst revenue enhancement has been the primary means of improving fiscal balances, the government has also introduced a number of measures to manage expenditure. In addition to strict circulars on recurrent spending controls, stringent prioritization of capital expenditure, and introduction of zero based budgeting principles, the government is also carefully reviewing sector-wise spending. One such exercise is the National Security 2030 framework.

In the 2022 Interim Budget Speech, it was proposed to review the defense strategy called the "National Security 2030" framework, which aims to be lean, technologically advanced, and capable of addressing a wide array of threats. This strategy includes several core objectives, with one of the key goals being the reduction of the active military size to a more sustainable and efficient level while maintaining operational readiness and capability. Right-sizing the defence sector is part of a broader strategy to streamline and optimize the country's defense expenditures while ensuring national security. The budget emphasizes the need to adapt the defense sector to current economic realities and future challenges, aiming to balance fiscal responsibility with effective defense capabilities. The introduction of this initiative marks a significant shift in how the government plans to manage its defense resources, focusing on efficiency and strategic allocation of funds. The specifics of the right-sizing initiative include reducing excess personnel, modernizing equipment, and reallocating resources to more critical areas of defense and security.

3. State Enterprises Reform

Reforms to State Owned Enterprises (SOEs) are also a long neglected area that have seen significant public debate recently. State Owned Enterprises (SOEs) have a substantial impact on the economy, particularly in terms of fiscal implications. The 52 major SOEs made a collective loss of Rs. 775 billion in 2022. Accumulated losses over the years have led to large fiscal costs and resulted in deterioration of the balance sheets of state banks as SOE losses have often been funded by the state banks. These risks have long exposed the Sri Lankan economy to financial vulnerabilities that threatened the country as a whole.

Since May 2022, the government introduced cost reflective pricing in the retail fuel sector. Similarly, cost-reflective tariffs was introduced for the CEB since August 2022. With the appropriate pricing structure in place, both CPC and CEB reversed their loss making positions and returned to profit in 2023. This also eliminated the requirement of the state banks to fund these losses, and allowed the additional liquidity to help reduce market interest rates and free up funds to be channeled to more productive investments to support the economic recovery. Cost-reflective energy pricing also helped appropriately balance supply and demand for Sri Lanka's largest import which is fuel. This has contributed to stabilizing the balance of payments and the appreciation of the currency.

In addition to the implementation of cost reflective pricing, the government restructured the balance sheets of key SOEs and has introduced a number of governance related reforms in state enterprises. Collectively, these reforms have helped turn around the financial performance of SOEs, with the 52 largest SOEs turning the Rs. 775 billion loss in 2022 into a profit of Rs. 456 billion in 2023.

The government is also in the process of divesting a number of non-strategic SOEs. This process has been subject to substantial public debate, particularly with regard to profit making sectors and sectors with perceived national security concerns. In sectors such as telecommunications, insurance, and private healthcare, the government's role is in regulation and oversight. Security related interest in sectors such as telecommunications can be effectively managed through the licensing and regulatory provisions under which all operators must function. In sectors such as telecommunications and healthcare, there is a constant need for re-investment of funds due to the capital intensive nature of these industries. Given the government's fiscal constraints, there is limited scope for the government as a shareholder to contribute to such capital outlay, without which the business will not remain competitive. A stringent, transparent process of RFPs and selection is ongoing with regard to the process of divestment, supported by globally renowned transaction advisors. Proceeds from such divestments can be used to settle long-standing debt, thereby reducing recurrent interest costs (which amounted to around 80% of government revenue in 2023) and freeing up tax payer funds for spending on priority public services, such as healthcare and education.

4. Addressing Welfare Concerns

Whilst these reforms have enabled Sri Lanka's economy to stabilize and resulted in a significant improvement in macroeconomic indicators, lives and livelihoods on the ground have by no means returned to a state of normalcy comparable to pre-crisis levels. This is to be expected given the magnitude of the economic crisis faced by Sri Lanka. The government has made every effort to ensure that the poor and vulnerable are shielded from the impacts of the crisis and the challenges arising out of the remedial measures due to higher taxes, higher costs of utilities and so on.

Social protection reform became one of the priority reform agendas of the government as it attempted to address the crisis. The Samurdhi framework was overhauled with new selection criteria being implemented. The new criteria under the new Aswesuma programme were based on objective, verifiable factors which minimized room for subjective decisions or politicization. A clear framework for application, verification, and transparent selection was implemented. Another key mechanism was the grievance handling process and allowing for appeals and review. Naturally, like with any other major reform after 3 decades, there have been teething issues and public resistance. However, with the grievance handling mechanism falling into place, these issues have eased.

The cash transfers now take place direct to the beneficiaries' bank accounts, and the improved selection mechanism has enabled a larger allocation of funds to each vulnerable household. The total cash transfers to vulnerable households have increased by over three-fold compared to pre-crisis levels in 2019. A graduation mechanism is also being put in place, whereby those who are no longer eligible for cash transfers will still receive other non-cash benefits such as livelihood support, concessionary financing, among others.

With this major social protection reform now in place, it has enabled the government to pursue critical reforms in the tax structure, utility pricing and SOE reforms, knowing that poor and vulnerable households will be protected through direct cash transfers. The macroeconomic impacts of these reforms in terms of controlling inflation and reducing interest rates, has important positive impacts on the poor.

Whilst the Aswesuma programme provides the cash-based support to help poor and vulnerable households mitigate the impacts of the economic crisis, the government has a broader strategy to empower the poor to emerge from poverty and deprivation. Government programmes such as "Urumaya" are designed to endow low income households with real assets that can empower them economically. The government envisages economic recovery and growth to be more inclusive than the past. This is why growth measures are supported by programmes to boost the SME sector through measures to enhance financial inclusion (measures including the SME financing programme and National Credit Guarantee Institution) and capacity enhancement of the SME sector. The government's fiscal policy reforms are intended to boost domestic revenue mobilization which will enable the government to allocate sufficient resources to improve public healthcare, education, child nutrition, and other key public services. The holistic impact of these collective measures is expected to enable a material reduction in multi-dimensional poverty in the country.

5. A Qualitative Improvement in Economic Growth

In the post-war decade leading up to the crisis, Sri Lanka's economic growth was largely driven by the non-tradable sector with sectors such as construction, finance, wholesale and retail trade, and transport accounting for more than half of the economic value added. Accordingly, Sri Lanka's exports as a percentage of GDP have declined substantially over the last 3 decades. However, at the same time, Sri Lanka's external liabilities were shifting from concessional finance to commercial debt. This resulted in the buildup of a mismatch between the country's foreign exchange inflows and rising external debt service obligations.

Whilst the ongoing debt restructuring will help ease the debt service burden, it is also necessary to build up Sri Lanka's non-debt creating foreign exchange inflows – particularly the exports of goods, exports of services (including tourism), and Foreign Direct Investment. Hence, the government's growth strategy envisages growth being driven by non-debt creating inflows in order to mitigate the risks related to future external debt service. In fact, the Economic Transformation Bill provides the legislative and institutional framework that facilitates this objective.

FDI inflows to the economy have been weak, and therefore, it is necessary to review and revamp the institutional framework that promotes and manages investment into the economy. The new Economic Commission to be established through the Economic Transformation Bill sets the institutional and legislative framework for this. The Office for International Trade which will be established by the Economic Transformation Bill creates the institutional framework to enable Sri Lanka to effectively negotiate complex trade agreements with strategic partners. Trade agreements of this nature are essential for countries like Sri Lanka to effectively participate in global and regional value chains that drive trade in the modern global context. Sri Lanka's isolation from these value chains is a key reason for the lack of growth in the country's trade and exports. In parallel to developing export markets through trade agreements, it is necessary to build domestic competitiveness and productivity to enhance supply capacity and to withstand greater exposure to global competition. The Productivity Commission is established by the Economic Transformation Bill in order to serve this purpose of supporting the productivity and competitiveness of domestic firms as they compete with the rest of the world.

Critiques have said that increased integration with the global economy will hinder Sri Lanka's economic independence, and the country should seek a more inward strategy of self-sufficiency. Indeed, over the last few decades, Sri Lanka has become more inward oriented, with a gradual increase in tariffs and para-tariffs, and the absence of meaningful engagement with international trade agreements. However, the outcome of this has been a gradual decline in exports as a percentage of GDP whilst external debt service costs increased. To illustrate this, in 2005, debt service as a percentage of exports of goods and services was 7.9% whereas by 2021, it had reached 30.7%, reflecting the gravity of the issue. The final outcome of this was the external debt crisis and debt standstill, which was a far worse result in terms of undermining economic independence.

6. Securing Economic Stability and Sustainable Growth

Sri Lanka has had a long history of incomplete economic stabilisation programmes. The country's macroeconomic framework has historically been characterised by persistent budget deficits and deficits in the current account of the balance of payments. This twin deficit leads to frequent balance of payments crises, reserve depletion, and bouts of inflation. As the crisis sets in, Sri Lanka has often sought the support of the International Monetary Fund (IMF), following which macroeconomic stabilisation measures are introduced. However, as soon as a degree of stabilisation sets in, Sri Lanka has a tendency to revert to past habits of fiscal excess, accommodated by monetary policy. Following several such cycles, in the lead up to the economic crisis, Sri Lanka ran out of all of its fiscal and external reserve buffers as debt to GDP ratio increased to around 120% and usable forex reserves declined to near zero levels in 2022.

Sri Lanka has entered programmes with the IMF 16 times in the past. This is because every time a programme ends, the country reverts to bad practices in the absence of an external anchor of discipline. For the ongoing 17th IMF programme to be the last programme, it is necessary for the country to continually behave as if there is such an anchor of discipline. The Economic Transformation Bill is an attempt to create such a legislative anchor. Countries that have successfully emerged from crises are those which have adhered to a broad consensus of basic macroeconomic objectives such as fiscal discipline, monetary prudence, and economic competitiveness. India in post 1991 is a good example of this. Such a framework allows different governments with different political or economic ideology to go about achieving those fundamental objectives in different ways, but the objectives themselves remain a common minimum framework that ensures macroeconomic stability and inclusive, sustainable growth.

It is also well understood that legislation alone is not sufficient to drive meaningful change. The weak outcomes of the Fiscal Management Responsibility Act of 2003 are a testament to this. Institutions also matter. That is why the government is strengthening institutions such as the Central Bank, establishing new institutions such as the Public Debt

Management Office, and the Parliamentary Budget Office, which can support the implementation of durable economic stabilisation, along with legislation such as the Public Financial Management Bill which helps lock in the fiscal reforms implemented over the last 2 years to improve fiscal prudence and discipline.

It is important to understand that the reforms are essential to overcome the crisis, instil investor confidence as well as to create critical macroeconomic buffers. Hence, in addition to the above reforms, factor market reforms are being pursued to unlock productive capacity of the economy, including labour and land market reforms, along with education and energy sector reforms, agriculture modernization, digitalization and climate related policies, towards a new economic framework that optimizes local capabilities to capitalize on emerging global opportunities. The priority has also given to revive the Micro, Small and Medium Enterprises (MSMEs) sector with appropriate policies.

Institutional and legal reforms constitute an integral part of the ongoing reform efforts. Significant progress has already been made by the government by introducing a number of new laws and making necessary revisions to the existing laws. These legal and institutional reforms will empower key institutions and it is important that the new laws and systems be used effectively by the respective entities to ensure that the country's much needed reform process is strongly supported, their actions are aligned with the government's policies to ensure that the overall development objectives of Sri Lanka are met as envisaged.

Improving governance, addressing corruption vulnerabilities and preserving integrity are paramount in all the endeavours of the government to instil public confidence and improve service delivery. The Anti-Corruption Act No. 9 of 2023 and the strengthened authority of the Commission to Investigate Allegations of Bribery and Corruption (CIABOC) will particularly facilitate the achievement of these objectives.

With these policies and measures, the economy is expected to shift to a more inclusive and sustainable trajectory, where the growth is led by green initiatives, while taking advantage of opportunities associated with climate prosperity. The challenges, such as climate change and population ageing, could act as headwinds to progress along this path. In addition, exogenous factors, such as escalating conflicts and geopolitical tensions that could disrupt supply chains and amplify commodity price volatility, could also disrupt the progress. Hence, efforts are being stepped-up to promote resilience by re-building fiscal and external buffers, enhancing trade and other inflows, cross-border investment, and commodity supply networks.

Some observers have criticised the ongoing reform process saying that Sri Lanka has merely followed an IMF supported reform programme and that has resulted in the abdication of economic sovereignty. I wish to highlight one key fact here; we should clearly understand that it was not the IMF which came to Sri Lanka but it was Sri Lanka's inability to *"put its house in order"* that led the country to ultimately seek the assistance of the IMF for a bailout from the deep crisis. That is why the former President Gotabaya Rajapaksa had to send a letter to the Managing Director of the IMF, making a "*Request for an IMF engagement in Sri Lanka", o*n 18th March 2022 and a subsequent letter dated 07th April 2022, making a "*Request for an Appropriate Fund Supported Programme to Sri Lanka*". In my view, had the country implemented much needed and long delayed reforms in a timely manner, the country could have in a much better position and the need for an IMF bailout programme could have been avoided. For that matter, look at many other countries; they are *"living"* their lives whereas we in Sri Lanka are always in a "*surviving*" mode. We all should ask the question "*why*"? To me, it is because of the short sighted and politically motivated behaviour of some people with ulterior motives. It is abundantly clear that the country has the experience of the alternative home-grown solutions that were mooted prior to the crisis which are being proposed again by various groups in the lead up to elections. However, the reality is that the country was left with no choice but to seek IMF support as mentioned earlier since the previous home-grown policy measures resulted in a serious crisis with the depletion of government revenue, foreign reserves, and all other buffers.

It should be clearly understood that the reforms that are being put in place at present intend to correct the serious mistakes mentioned above that put the entire country of 22 million people in misery, and to restore the resilience of the Sri Lankan economy, enhance its ability to withstand shocks on its own, and protect the entire nation from the severe hardships they went through, particularly the period commencing from mid-2021. I wish to emphasise that the continuity of these reform measures is vital to secure Sri Lanka's economic independence, firmly establish economic stability, and position the country to achieve sustainable, inclusive economic growth that enhances the prosperity and well-being of all Sri Lankans. A stable, prosperous, and equitable economy would also be a necessary condition to secure the country's internal and external security, and sovereignty.

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