Summary of the Plenary Speech

Understanding Sri Lanka's Economic Challenges and Solutions

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Sri Lanka faced an unprecedented social, political and economic crisis in 2022. While some stability on these three fronts can be observed at present, normalcy is yet to be restored in full. The crisis was a culmination of the country's long-standing structural vulnerabilities, amplified by external shocks and domestic policy missteps. In summary, these long-standing structural vulnerabilities include unsustainably high fiscal deficits, persistent external trade and current account deficits, and weak institutions. Within this summary view, prominent weaknesses could be observed in relation to low tax revenues, rigid structure of government expenditure, a bloated public sector including a large state-owned enterprise (SOE) sector, unsustainably subsidized universal education and health provision, inefficient social safety nets, unsustainable debt trends, stagnant exports, rising import expenditure, inefficiencies in product and factor markets, and negligible improvements in overall productivity of the economy, especially compared to those of Sri Lanka's historical peers. The crisis in 2022 has deepened the public understanding of these weaknesses and the need to address them decisively to enable future Sri Lankans to enjoy sustained prosperity.

Solutions to the economic crisis comprise near-term stabilization measures as well as longer-term growth supportive reforms. On long-term reforms, although there is broader consensus on required solutions, implementation is frequently postponed and, at times, reversed. Recent debates involving politicians, academics, social activists and policymakers have shown that near-term stabilization measures are perhaps more controversial and unpopular. Therefore, this paper aims to provide a better understanding of three such solutions that policymakers are in the process of implementing to stabilize the economy, amidst severe public criticism. Namely, these measures are a) fuel and electricity price adjustments and reforming SOEs, b) tax hikes aimed at fiscal consolidation, and c) monetary policy tightening through interest rate adjustments. This paper seeks to discuss these measures, the expected outcomes, and the adverse spillover effects of the implementation and non-implementation of these measures.

First, with regard to fuel and electricity price adjustments and reforming SOEs, the government is in the process of implementing cost-reflective price adjustments for petroleum products and electricity, while reviewing the performance of SOEs and taking steps to identify future action on these SOEs. There is resistance for such reforms, and the common arguments include that increasing fuel and electricity prices will increase the cost of living and the cost of production and that national assets must be preserved. Sadly, it is not well understood that Sri Lanka mostly depends on petroleum products to fulfil most of its energy needs. When domestic prices are not allowed to reflect global prices movements, the relevant SOEs accumulate losses, which must be subsidized by the government, and ultimately, the users and non-users alike. Mispricing of these energy products also leads to inefficient usage, which unduly increases the burden on the balance of payments. Due to such reasons, other countries allow frequent repricing of domestic petroleum and electricity supplies, while promoting low cost and more sustainable sources of energy within a competitive environment. Governments play a facilitative role than being a market player in such efficient economies. Not only the SOEs in the petroleum and electricity sectors, but also many others are often being used by political authorities to provide secure employment to their supporters, thereby contributing to public sector inefficiencies and burdening the general public further. Therefore, well-crafted reforms to streamline the government's role in relation to SOEs are desirable in protecting true public interests.

Secondly, it is well known that Sri Lanka has one of the lowest revenue-to-GDP ratios in the world. On the other hand, historically, the country has been recognized for its welfarism. Therein lies the paradox facing Sri Lanka today. The government has taken steps to increase tax revenues while curtailing expenditure through various means. Enhancing tax revenue must priorities direct tax collection and tapping the informal economy, as high indirect taxes will burden the poor disproportionately. Once again, these measures have faced criticism and resistance, even from those who can afford to pay higher taxes. However, it must be understood that, inefficiencies apart, without enhancing revenues, the country can no longer afford to maintain the welfare measures that the general public has taken for granted. The rigid expenditure structure on salaries and pensions, including spending on education, health, defense and the maintenance of physical infrastructure, cannot be sustained without revenue enhancement measures. Unless revenues are increased, large fiscal deficits and high debt levels will continue. Repercussions will be severe if revenue enhancement and fiscal consolidation are not carried out urgently, particularly as Sri Lanka's deficit financing sources have been mostly reduced to inflationary financing by the Central Bank.

Finally, on monetary policy tightening through interest rate adjustments, central banks across the global often come under criticism for increasing interest rates and tightening liquidity conditions, as such action would have an impact on borrowers, including businesses and households. It is essential to understand that monetary policy is tightened mainly to control inflation. While central banks are well poised to manage demand-driven inflation, persistent high inflation, whether caused by demand- or supply-side factors, must be promptly addressed, as such inflation is more harmful to the economy than any adverse consequences of brief periods of higher interest rates. With historically high levels of inflation, the Central Bank of Sri Lanka is pursuing a tight monetary policy stance at present, which would aid in bringing inflation back to single digit levels in the period ahead. Simultaneously, institutional reforms are essential to ensure that the Central Bank is empowered and held accountable to maintain a more conducive inflation outcome in future on a sustainable basis.

Analyzing the three aforementioned policy solutions, this paper delivers a singular key message: Implementing unpopular policy measures is difficult, but these measures are essential to stabilise the economy in the short run and place it on a stronger footing. Despite the tendency of various pressure groups to highlight only some aspects to suit their own agendas, these solutions need to be understood holistically.