South-South Integration and the SDGs:
Enhancing Structural Transformation in Key Partner Countries of the Belt and Road Initiative

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Sri Lanka’s macro-financial developments: issues and challenges in structural transformation and lessons from China’s Experience

Abstract

The important lesson Sri Lanka can learn from China is that the latter pursued a consistent and predictable outward oriented economic development strategy, despite its large domestic market. As a result, China has built up a massive buffer in terms of external reserves enabling China to maintain a stable exchange rate regime. Another major lesson Sri Lanka can learn from the Chinese experience is to become more proactive in using macroeconomic tools to prevent potential distress in growth and stability of the economy instead of being compelled to use such tools reactively.

The major source of Sri Lanka’s macroeconomic imbalances has been successive governments running persistently high fiscal deficits causing external current account deficits, leading to repeated cycles of balance of payments distress. While the movement towards an inflation targeting regime has prevented expansionary fiscal policies generating high inflation such a regime cannot prevent expansionary fiscal policies generating distress in the balance of payments. Sri Lanka will not be able to prevent boom-bust cycles of economic growth and recurring distress in its balance of payments without addressing the root cause of macroeconomic instability which is persistently high fiscal deficits.

Key words: Macroeconomic management, Structural transformation, Monetary policy, Fiscal policy, Sri Lanka, China

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Introduction

Even before setting up the agenda for meeting the Sustainable Development Goals (SDGs) by 2030, Sri Lanka improved its standards of living and worked towards achieving sustainable growth and development under the Millennium Developments Goals (MDGs) by 2015 (United Nations, 2015). Sri Lanka had already obtained some positive results and stood far ahead of most of its neighbours in achieving MDGs. For example, Sri Lanka had more than halved its poverty rate, achieved universal primary education, reduced child mortality and improved maternal health. However, at the time of setting the agenda for the SDGs there were several areas where further improvements remained to be made. These included promoting gender equality and empowering women and ensuring environmental sustainability. Additionally, there are regional disparities and inequalities across socio-economic groups that require attention. The UN has attributed Sri Lanka’s strong performance on the MDGs to a long tradition of investment in education, health and poverty alleviation programmes (United Nations, 2015).

Although Sri Lanka has achieved considerable success in achieving the MDGs and has progressed well in attaining the SDGs so far compared to its regional peers in South Asia, according to Feng et al. (2020), China appears to have made much more significant progress in structural transformation during the last four decades in comparison to Sri Lanka. Feng et al. (2020) argue that the macroeconomic policy framework in China has played a crucial role in the structural transformation of the Chinese economy during the last four decades, since the country moved towards a market-oriented economy in 1978. For the purpose of comparative study between China and Sri Lanka, a comparison between their macroeconomic policy frameworks during the last four decades is very appropriate as Sri Lanka also moved towards a market-oriented macroeconomic framework commencing, in 1978, with a major liberalisation package towards a market-oriented economy. Empirical evidence clearly establishes the fact that China has achieved remarkable progress in structural transformation in comparison not only with Sri Lanka but also with all other developing and emerging market economies. This paper mainly focuses on comparing the role of macroeconomic policies with a view to understanding similarities and differences of structural transformation in China and Sri Lanka.

In undertaking this comparative study, one should highlight important differences between the contexts in which reforms were introduced for a command economy such as China and a highly dirigiste yet democratically answerable economy like Sri Lanka. The highly centralised Chinese system has enabled gradualist and finely calibrated economic policymaking. In Sri Lanka, a pluralist and highly adversarial polity makes it difficult to introduce and implement reforms. Therefore, the landslide electoral success of 1977 was seen as a singular opportunity to push through wide-ranging reforms. As a result, though both China and Sri Lanka introduced significant economic changes, in 1978, the reform path adopted by each country has been qualitatively different.

This paper is organised in the following manner: Section 2 provides a detailed analysis of Sri Lanka’s progress in structural transformation mainly focusing on sources of
economic growth and different strategies adopted for growth orientation. Section 3 mainly focuses on macroeconomic and financial developments, issues and challenges, with a view to learning lessons from the past and identifying key challenges going forward. Section 4 compares experiences between the two countries with a view to drawing lessons from China’s success based mainly on the findings in Feng et al. (2020). Section 5 concludes with lessons learnt and appropriate recommendations based on China’s successful reforms.

1. Progress in structural transformation and identification of key challenges

1.1. Human Development

Despite relatively weak economic performance compared to several of its peers, Sri Lanka’s achievements in the areas of human development have been far superior compared with South Asian neighbouring countries and comparable with those of economically advanced countries. As shown in figure 1, Sri Lanka’s Human Development Index (HDI) was only lower than that of Malaysia and higher than all South Asian neighbours as well as China, Indonesia, Thailand and the Philippines in the Asian region during the period 1990–2019.

**Figure 1: Human Development Index, selected economies, 1990–2019**

![Graph showing HDI of selected economies](image)

Source: World Development Indicators Database

1.2. Real economic growth

In analysing Sri Lanka’s economic performance in terms of growth in real GDP, this paper identifies two key structural changes which had significant impacts on outcomes. The first major structural change happened in 1977, when Sri Lanka introduced more liberal and market-oriented economic policies deviating from inward-looking import-substitution policies maintained from the mid-1950s up to 1977. The second structural change happened when the almost three decades-long war against terrorism, based on an ethnic conflict, decisively ended in 2009. Figure 2 compares economic performance in terms of growth in real GDP during these three periods: 1) Pre-liberalisation 1950–77, 2) Post-
liberalisation, including the conflict period 1978–2009, and 3) Post-war period 2010–2020. One common feature across all three periods is high volatility in economic growth. Sri Lanka’s growth in real GDP has not been steady during any of these periods due to various internal and external shocks reflecting a lack of resilience of the economy to various shocks. On average, during the period of the inward-oriented policy regime (1950–1977), annual average growth was recorded as only 3.7 per cent compared to an annual average growth of 5 per cent recorded during the period of a more liberal and market-oriented policy regime during 1977–2009, despite the prevalence of war during most of this period. The post-war period has recorded a lower average annual growth of 4.4 per cent per annum despite three years of exceptional high growth soon after ending the war in 2009. The high growth years may be attributed to the release of pent-up demand in the economy and recovery of economic activity in the conflict-affected areas in the immediate aftermath of the war, rather than improvements in the macroeconomic framework and structure of the economy. In addition, the end of the demographic dividend with the ageing of the population has also been a growth inhibiting factor in recent years. This has not been offset by reforms which enhance productivity.

Furthermore, it is noteworthy that unlike in China, where net exports (current account surplus) have driven growth in the earlier phase of economic transformation, growth in Sri Lanka has been more closely correlated to the size of the fiscal deficit. This has contributed to stop-go economic policies which have increased the volatility of economic growth.

**Figure 2: Sri Lanka: real GDP growth, 1950–2020**

Source: Annual Reports of the Central Bank of Sri Lanka

### 1.2.1. Period since independence up to 1977

Sri Lanka gained independence in 1948, after a long period of colonial administration by Great Britain, since 1815. During the early period after independence, Sri Lanka recorded strong per capita growth with significant improvements in living standards
compared to many peers in Asia. Agriculture was the dominant economic activity during this period contributing to more than 40 per cent of GDP while providing employment and livelihoods for an even larger proportion of the rural-based economy. Within the agriculture sector, the plantation sector comprising tea, rubber and coconut generated sufficient foreign exchange earnings which were more than sufficient to finance expenditure on imports under a very liberal trade regime during the early-1950s. Exports and imports declined from 70 per cent of GDP in the early 1950s to 36 percent in 1977. However, liberal trade policies were discontinued from the late-1950s. Following many emerging market economies at the time, Sri Lanka also pursued policies of import substitution under high import tariffs to promote local industries and agricultural activities. Increased government intervention and state regulation of economic activities continued from the late-1950s until 1977, except for a partial liberalisation attempt in the second half of the 1960s. Greater emphasis was placed on the redistribution of income and wealth rather than on economic growth, during the early 1970s up to 1977 (Central Bank of Sri Lanka, 2000).

Economic growth averaged 3.8 per cent during the 1951 to 1977 period with higher growth rates shown in the periods when an attempt was made to achieve partial economic liberalisation. Real GDP grew at an annual average rate of 5.3 percent during this period. Subsequently, the growth rate decelerated to 2.9 per cent during 1971–1977, when the government intensified its intervention in the economy with greater emphasis placed on wealth redistribution. During this period, the external environment also became unfavourable with the first oil price shock in 1973. By 1977, Sri Lanka could be characterised as a low investment, low growth and high unemployment economy.

1.2.2. Post liberalization until the end of War (1977–2009)

In November 1977, Sri Lanka embarked on major economic liberalisation, marking a paradigm shift from inward-looking restrictive policies towards a liberal regime under which trade and payments were liberalised to a great extent.

The economic reforms of 1977 towards an outward-oriented strategy created a new investment environment based on market principles. Investment increased to 27 per cent of GDP during 1978–1981 owing to heavy public investment. As national savings continued to remain low, Sri Lanka had to depend heavily on foreign savings to finance domestic investments, particularly for large infrastructure projects undertaken by the government. The economy grew by 6.5 per cent per year during the first four years after economic liberalisation.

After maintaining a growth rate of around 5 per cent during the next six years, the economy slowed down sharply during the three years 1987–1989, at the height of internal political conflict and sporadic civil disturbances as well a drought in 1987. The economy recorded a reasonably high growth rate of around 5 per cent during the 1990s with a pickup in private investment. During the post economic liberalisation period 1978–2009, the economy registered an annual average growth rate of 5 per cent and experienced a gradual structural transformation from an agriculture-based economy to a modern manufacturing and services sector-based economy. Had it not been for the need
to counter the continuous threat of terrorism, after 1983, which absorbed a sizable portion of country’s valuable resources, the economic performance of the country would have been far more impressive.

1.2.3. *Post-war period (2009–2020)*

Soon after ending the war in 2009, the economy recorded over 8 per cent of annual growth in three consecutive years mainly due to large public investment programs implemented by the government to rebuild the war-affected Northern and Eastern provinces together with major infrastructure development drive parallelly in other parts of the country. The pent-up domestic demand earlier suppressed by the conflict also boosted domestic aggregate demand. This resulted in the economy heating up beyond existing capacity leading to unsustainable external current account deficits. The subsequent macroeconomic stabilisation program slowed down economic growth after 2013 and internal and external shocks, which included extreme climate events such as floods and droughts, a constitutional crisis which affected sentiment and confidence, the Easter Sunday bomb attack by a terrorist group and the global pandemic, slowed down economic growth further towards the latter part of the post-war period.

1.3. **Structural transformation of sources of economic growth**

1.3.1. *Sectoral transformation of sources of growth*

During the period of a relatively closed economy from 1950 to 1977, although the share of agriculture shrunk from a dominant 45 per cent in 1950 to 31 per cent in 1977, the share of agriculture was still larger than the share of the industry sector until 1977 (figure 3). The share of the services sector had increased only marginally up to 40 per cent from 36 per cent in 1950. Structural transformation had been slow during the years of a relatively closed economy. In contrast, since liberalisation of the economy in 1977, the services sector has become by far the largest contributor to GDP, while the share of agriculture has shrunk to less than 8 per cent.

![Figure 3: Sri Lanka: sectoral transformation in the sources of growth, selected years](source: Annual Reports of the Central Bank of Sri Lanka)
Despite the declining share of agriculture in the economy, the share of employment in the agricultural sector has not declined and remained high relative to its contribution to overall economic growth. For example, in 2019, the share of employment in the agricultural sector was 25.3 per cent while shares of the industry and services sectors were around 27.6 per cent and 47.1 per cent respectively (figure 4). This implies that productivity in terms of output per labour was falling in the agricultural sector while productivity in the services sector has been improving. The share of employment in industry remains similar to its share in GDP. This implies no improvement in productivity in the industrial sector.

Source: Annual Reports of the Central Bank of Sri Lanka

1.3.2. Structural transformation from inward orientation to outward orientation

While the earlier section provides evidence for positive structural transformation of growth sources from the dominant but less productive agricultural sector to the more productive services and industrial sectors, this section examines whether this transformation has resulted from increasing contributions from tradable versus non-tradable sectors or a shift from an inward- to an outward-oriented growth strategy.

Export of goods and services as a percentage of GDP can be considered as one measure which indicates the degree of external or domestic orientation of growth. In 1978, soon after liberalization of the economy towards more market-oriented open trade policies, exports of goods and services as a share of GDP amounted to 33 per cent of GDP. However, this share gradually declined to around 26–27 per cent of GDP until around the early-1990s and reached a peak of 39 per cent in the year 2000. Thereafter this share declined steadily to around 23 per cent by 2019. This trend clearly indicates that Sri Lanka has been increasingly reliant on inward-oriented domestic sectors for growth and employment generation despite the period after 1977 being seen as a more market oriented open trade regime. The uneven trends in the data reflect a lack of consistency in policies with the reform agenda losing momentum over time.

Figure 5 compares Sri Lanka’s relative position, since 1978, with a set of peer countries which have embarked on more liberal trade and investment regimes at different points.
of time. If the ratio in 1978 is set at 100, Sri Lanka has been the worst performer, even below that of Pakistan. Sri Lanka’s index has moved above 100 only for the period between 1996–2002 with a peak level of 112 in the year 2000. Since then, the index has steadily declined to around 65 in 2019.

Even for countries like Bangladesh and India, which opened their economies much later, in the 1990s, their indices have increased above 200 and remained above 200 for long periods indicating sustainable long-term growth based on export orientation. China has been excluded in the sample as its performance is well above all regional peers. China’s index had reached closer to 800 in 2006 and is now settling well above 400.¹ This validates the fact that China’s very high and sustainable growth reflects its export orientation as the major source of this growth.

Figure 5: Export of goods and services as a share of GDP, selected economies, 1978–2020, index numbers (1978=100)

World Bank (2015) also finds evidence that growth during 2009-2014 (post-war period) has been mainly led by the non-tradable sectors within which construction, transport, domestic trade, banking and insurance and real estate contribute to 50 percent of the total growth. Reliance on non-tradable sectors for growth has made it difficult to sustain its momentum in the long run. At a time when external commercial borrowing also began to increase, this trend laid the foundation for subsequent debt sustainability challenges.

The share of exports in GDP has been steadily declining form its peak since the year 2000, reflecting Sri Lanka’s increasing reliance on non-tradable sectors as the major source of economic growth. In a small economy like Sri Lanka, potential growth has

¹ This index is derived from gross export of goods and services using data available in World Development Indicators Database. This index could be substantially lower if measured in terms of value addition by exports of goods and services. However, comparable data on value addition is not available.
severe limitations due to the limited size of the market available for non-tradable goods and services. Once domestic capacity is utilised, any efforts to push growth through macroeconomic stimulus would end up either with higher growth in imports leading to larger current account deficits and distress in the balance of payments, or higher domestic inflation eroding external competitiveness. Sri Lanka has experienced several such boom-and-bust cycles and sought IMF assistance to address balance of payment distress.

Sri Lanka’s poor performance in exports can be explained mainly by two reasons: 1) successive governments have implemented more inward-oriented trade and industrial policies even after the first wave liberalization in 1977, and 2) lack of diversification in export of goods and services for a long period.

On industrial and trade policies, there were two short periods of liberalization – first in 1977–1979 and then in 1990–1992. During the first period, the government created Export Processing Zones (EPZs) – industrial parks with preferential tax treatment and specific regulatory conditions aimed at attracting manufacturing FDI. During the second phase of reforms, EPZs were given greater prominence with the establishment of the Board of Investments (BOI) which was given special authority to promote export oriented FDI and to provide special income tax incentives, duty free access to raw materials and intermediate goods for export processing industries together with exemptions from tight foreign exchange controls applicable to domestic oriented sectors. This export-oriented industrial policy also enhanced industrialization of rural communities (targeting employment for rural youth). This resulted in the expansion of the apparel industry through the implementation of the 200 Garment Factories Program into rural areas where agriculture was the main source of employment. This move helped to move some excess and unproductive labour into more productive industrial activity. This export promotion strategy contributed to structural transformation of Sri Lanka’s exports from being a major exporter of agricultural commodities, such as tea, rubber coconut and spices, into more diversified manufactured exports, mainly garments, which became the single largest source of export income. Since the emergence of the apparel sector in the early-1990s, there has been a lack of dynamism with no new sectors beyond the traditional commodity and apparel exports for a long period. This reflects the anti-export bias that has tended to persist in Sri Lanka’s policy framework with trade policy and the exchange rate often disincentivising exports.

The Harvard Growth Lab’s Country Rankings assess the current state of a country’s productive knowledge, through the Economic Complexity Index (ECI)\(^2\). Countries improve their ECI by increasing the number and complexity of the products they successfully export. According to the ECI for a sample of peer countries as shown in figure 6, Sri Lanka’s economic complexity in a number of products is ranked well below China, Thailand, Malaysia, the Philippines, India and Indonesia. Sri Lanka is placed only above Pakistan and Bangladesh.

\(^2\) Harvard Growth Lab website: [https://growthlab.cid.harvard.edu/about#complexity](https://growthlab.cid.harvard.edu/about#complexity).
In addition to the lack of diversification in the export product basket, there has been a noticeable slide towards protectionism. Industrial policy has encouraged domestic enterprises since the mid-2000s. There has been an increase in para-tariffs in the past decade. This has not only significantly increased nominal protection and prices of imports but has also added to trade policy complexity. The combined system of the Most Favoured Nation applied tariff rate and the para-tariffs has made the present import regime one of the most complex and protectionist in the world. According to the World Bank (2015), implementing para-tariffs has effectively doubled the protection rates to 24 percent and para-tariffs’ dispersion has become worse leading to prices that distort production and consumption patterns. Higher rates of protection on final products than on inputs used in their production lead to high effective protection rates and an anti-export bias because producers have a strong incentive to sell goods domestically even though their domestic costs are higher than their opportunity costs through trade. This has adverse implications for the agricultural sector, given that a large share of the bottom 40 percent of the population continues to be agricultural producers. Trade barriers also
make it more difficult for local producers to access inputs, reducing their competitiveness and ability to integrate in global value chains. Thus, Sri Lanka has been largely excluded from the most dynamic component of the international trading system.

Stagnating product diversification and weak export performance has come on the back of an industrial policy orientation in the past decade that does not promote competition and aims to protect domestic industries. Although successive governments, after 1977, carried out ad hoc import substitution policies, such policies did not have a significant aggregate impact on trade policy. The decade since 2005 has been seen as the period when the most extensive measures were adopted, where the focus noticeably tilted towards promotion of domestic agriculture (with generous subsidies and guaranteed prices), domestic industries (with specific tax breaks and tariff protection), and wide-scale public infrastructure programs (particularly connective infrastructure like highways and ports).

1.4. Trade and current-account balances and the role of worker remittances

As a result of inward oriented growth strategies, Sri Lanka has been running persistently high trade and current account deficits even during short episodes of outward oriented regimes after 1977. The trade deficit has been significantly high at around an annual average of 11.3 percent of GDP during 1977 to 2019, while the annual average current account deficit has been around 4.8 per cent of GDP during the corresponding period. Since liberalisation of the economy in 1977, worker remittances have been a major source of foreign exchange inflows which have helped to finance a major part of high trade deficits. However, remittance inflows have never been sufficient to finance the full deficit in the trade account and hence Sri Lanka has run current account deficits throughout, except for a couple of years in the early-1950s, when there were trade surpluses arising from commodity price booms. However other peer countries such as the Philippines and Bangladesh, which have also been recipients of relatively large remittance inflows, have been able to generate current account surpluses boosting national savings available to fulfil domestic investment needs thereby relying less on foreign debt or equity capital.

2. Macroeconomic and financial sector developments, issues and challenges

2.1. The twin deficit hypothesis

There is sufficient theoretical and empirical evidence in the literature supporting a phenomenon termed as the twin deficit hypothesis (TDH). Accordingly, in an open economy, a government budget deficit could lead to a current account deficit. Salvatore (2006) contends that there is a strong positive relationship between a national economy’s current account balance of the balance of payments (BOP) and the government budget balance (figure 7).
The theoretical explanation for the TDH is based on the well-known Mundell-Fleming framework (Fleming, 1962; Mundell, 1963). According to this model, an increase in the budget deficit induces upward pressure on interest rates that in turn triggers capital inflows and appreciation of the exchange rate. In particular, a debt financed expansionary fiscal policy raises interest rates and given that most countries adopt a free capital movement policy, the rise in interest rates makes it attractive for investors to invest in that country’s financial market. This raises the demand for the country’s currency causing it to appreciate which would, in turn, make imports cheaper and exports more expensive relative to the prices of foreign goods. Hence, the appreciation of the domestic currency will lead to an increase in imports and ultimately in a current account deficit (Leachman and Francis, 2002; Salvatore, 2006). Analysing data on Sri Lanka’s current account and fiscal deficits, as depicted in figure 7, demonstrates that there is a strong correlation between these two variables. Perera and Liyange (2011) provides a very useful literature review on TDH and the paper also tested TDH for Sri Lanka based on the two theoretical underpinnings explained above. They find that there is strong empirical evidence to support that TDH is valid in explaining Sri Lanka’s persistent macroeconomic imbalances during this period.

This finding explains a major part of the macroeconomic imbalances experienced, in Sri Lanka, and provides important policy implications. First, persistent large fiscal deficits cause indebtedness due to borrowing internally and externally and hence, impose a burden on future generations. At the same time, current account deficits coupled with increases in budget deficits and the resultant inflation could lower the country’s sovereign ratings and trigger capital flight thereby creating external financing difficulties. Also, growing fiscal and current account imbalances cause macroeconomic imbalances and hence, affect the long-term economic progress of a country. The next section of this paper uses this phenomenon to understand how persistent current account deficits have been financed and its implications for inflation, exchange rate stability, fiscal policy and sustainability of external debt.

![Figure 7: Sri Lanka: twin deficits, 1978-2020 (percentages of GDP)](image-url)
2.2. Financing External Current Account Deficits

Analysis of how large and persistent external current account deficits have been financed provides insight into the structural transformation of Sri Lanka’s external financing. As shown in figure 8, out of four major sources of financing current account deficits: namely 1) net external borrowings by the government, 2) net FDI and portfolio investments, 3) net external inflows to commercial banks and 4) decreasing official external reserves, external borrowings by the government have been the single largest source of financing for the country’s external current account deficits throughout the period. This has serious implications for overall macroeconomic stability. Since successive governments have been moving towards inward oriented growth, a major part of public investment appears to have been diverted towards promoting non-tradable sectors. Such investments have not generated sufficient foreign exchange earnings to meet external debt service obligations. As a result, successive governments have been compelled to borrow more to service maturing external debt service obligations in addition to financing new fiscal deficits generated every year, for a long period. As a result, the country has now got into a vicious cycle of large fiscal deficits and unfavourable debt dynamics.

Figure 8: Sri Lanka: sources of financing current account deficits, 1978–2020

If a large part of the current account deficits had been financed through non-debt creating FDI coming to export-oriented industries, as happened in most successful emerging market economies in Asia, the outcome could have been different. Sri Lanka’s performance in attracting FDI to foreign-exchange-earning sectors is poor relative to peer countries as shown in figure 9.
2.3. Role of FDI in financing current account deficits

FDI remained below 2 percent of GDP for the five years after the end of the conflict in 2009. The decline in openness and stagnating FDI took place when the rest of the world was integrating more strongly, and global trade was accelerating.

FDI is needed as a foundation for economic diversification, but Sri Lanka’s performance has been disappointing. In addition to boosting investment necessary for growth and providing long-term balance of payments financing, FDI can help enhance the sophistication of Sri Lankan products and exports through introduction of new technologies and production processes. It can also give rise to positive spill overs through improvement of skills and introduction of new management practices. Finally, FDI can enhance access of Sri Lankan producers to global production networks and facilitate the development of new activities within existing value chains (increasing value added in production). However, FDI in Sri Lanka has been lower than in peer countries in spite of Sri Lanka’s comparative advantages, such as its location and access to major markets.

According to World Bank (2015), FDI inflows to Sri Lanka have been largely focused on infrastructure (inclusive of real estate development), with a relatively small proportion reaching sectors of the economy that are associated with global networks of production.

2.4. Role of fiscal policy in structural transformation

Sri Lanka has a poor record of maintaining macroeconomic stability in terms of running persistently large twin deficits leading to a low level of external reserve adequacy, high rate of currency depreciation, high inflation turning into a vicious cycle, relatively high domestic interest rates, higher expenditure on interest payments and boom and bust cycles of economic growth. Sri Lanka is one of the very few countries in Asia which has had to seek assistance from IMF several times for both short-term balance of payment financing as well as programs that support structural reforms. Sri Lanka has sought IMF
financial assistance 16 times, since 1965, of which very few were successfully completed. Many of the programs have been suspended halfway through due to successive governments’ failure to implement structural reforms envisaged in the programmes. As shown in the previous section, the major source of macroeconomic vulnerability has been arising from the large and unsustainable fiscal deficits successive governments have been running for long periods.

There are four structural weaknesses in the government’s fiscal position: low and declining fiscal revenues; increasing rigidity of expenditures; insufficient spending on key public goods and services, particularly for human and infrastructure development; and inefficiencies in the public sector. Preserving fiscal balance will become increasingly challenging owing to an extremely low revenue base combined with long-term expenditure commitments, including a very large public service. If the current trends continue, the government will have increasingly limited fiscal space to facilitate development.

2.4.1. Low and declining fiscal revenues

Sri Lanka now has one of the lowest tax revenue-to-GDP ratios in the world, and it has been on a declining trend for decades. The country’s tax revenue-to-GDP ratio amounted to 24.2 percent, in 1978, after which it declined to 14.5 percent in 2000 and to 11.6 percent in 2013. The fact that revenues have not kept pace with economic growth and barely kept pace with inflation in absolute terms is a continuing constraint on the budget. Successive governments have signalled the need to reverse this trend in almost every budget. Each year, plans have been announced for a significant improvement in the tax revenue-to-GDP ratio over the medium term. However, projections of revenue targets have never been materialized. Extensive tax exemptions have been one of the major causal factors for explaining the poor revenue performance. Such exemptions were more justifiable as a means of incentivising investment when there was a high war-risk premium attached to the economy. More than a decade after the war, the current level of revenue expenditure is contributing to a structural weakness in fiscal outcomes.

Indirect taxes account for 80 percent of Sri Lanka’s tax revenue. The country has lower-than-expected revenues from taxes on income, profits, or capital (direct taxes) and higher collections from international trade and from good and services (indirect taxes) than its peers. The dependence on indirect taxes, mostly VAT, excise and customs revenue, limits the country’s capabilities to expand the tax base and raises issues regarding the equity of the system and how the tax burden is distributed among social groups.

The decline in tax revenue can be traced to trade liberalization, shortcomings in recent tax reforms, numerous exemptions, and difficult tax administration. Trade liberalization and a gradual reduction of external trade taxation, in particular taxes on exports, have lowered tax revenues from international trade. This effect was exacerbated by measures introduced to curb imports whenever the balance of payments is in distress. Tax reforms initiated, in 2011, streamlined import taxes, unified VAT rates, and abolished some “nuisance” taxes to improve the transparency and efficiency of the tax system (World
A new Inland Revenue Act was enacted, in 2017, which introduced some reforms in tax policies and increased income tax rates and VAT rates with a view to enhance tax revenues. As a result, tax revenue as a percentage of GDP reversed its declining trend from 2016. However, from end-2019, both income tax and VAT rates were brought down drastically, and some other taxes were removed. VAT was imposed at a lower rate, and corporate and income tax rates were lowered without a commensurate broadening of the tax base. At the same time, the authorities have reintroduced numerous tax exemptions and holidays to boost foreign investment or support specific activities, which will erode the tax base further. Such tax exemptions have made tax administration more difficult, discouraged tax compliance, and created demand for new exemptions. As a result of the latest reforms and changes to tax rates, the revenue to GDP ratio is now in a declining trend again; from 14.1 percent of GDP in 2016 to 9.5 percent of GDP in 2020. Some decline of tax revenues can also be attributed to negative real economic growth, in 2020, due to the pandemic. Low tax revenues are also caused partially by problems with tax administration allowing for weak compliance. The country ranks 142nd out of 189 countries in paying taxes due to the high number of payments, time taken and tax rate, according to the World Bank’s Doing Business 2020 Report.

2.4.2. Expenditure

Low tax revenues, combined with an expenditure profile that is effectively non-discretionary, has led to a lean, rigid budget. Sri Lanka’s overall revenues and expenditures are among the lowest in the region. There is little flexibility, in the short term, on the expenditure side of the budget. Eighty percent of expenditure, in 2020, was on items that the government cannot readily reduce: interest payments (5.4% of GDP), salaries and wages (5% of GDP), and transfer payments, including subsidies (3.5% of GDP). Nearly two-thirds of transfer payments are pensions for civil servants, which are a commitment that must be met, with the remainder being fertilizer subsidies, social protection payments and other transfers. Furthermore, Sri Lanka has had a large expansion in the number of public servants since 2005, growing from 646,000 in 2004 to more than 1.5 million in 2019 (Ministry of Finance, 2019). This growth reflects explicit policies to provide public service jobs, especially for university graduates. These trends will only grow the wage/allowance and pension burdens. Funding this non-contributory pension scheme is an inter-generational time-bomb.

Sri Lanka will also need to finance infrastructure needs to keep pace with increasing demand. Sri Lanka’s infrastructure compares favourably to its South Asian neighbours in terms of accessibility, and soon after ending the war in 2009, the government embarked on a major expansion of public investment in infrastructure, particularly in the war affected Northern and Eastern provinces. However, Sri Lanka’s needed investment remains high in order to keep pace with the changes underway in the country. Due to declining revenue to GDP ratios, public investment is on a declining trend again. Public investment as a percent of GDP has been maintained around 5-6 per cent on average, since 2009. However, the ratio has been reduced drastically to 2.6 per cent of GDP, in 2020, partly due to delays in implementation of projects during the pandemic. Government envisages a recovery of this ratio back to around 5 per cent of GDP in the
medium term. This would essentially require realising the ambitious and challenging revenue targets set out in the medium-term fiscal policy framework. Sri Lankan fiscal authorities have a very poor track record of meeting fiscal targets set out in their medium-term fiscal policy frameworks. It is quite a common practice to revise annual fiscal targets every year on a rolling over basis after failing to meet the targets set out for the current year.

In 2013, the Fiscal Management Responsibility Act was introduced with a view to preventing regular occurrence of such failures, but this Act has become highly ineffective in improving the credibility of the fiscal authorities. The Act only requires providing an explanation to the Parliament on why there was deviation from the previous year without any effective commitment to correct fiscal slippages.

In the past, the pressures on financing capital investment were eased by waves of concessionary donor funding that has diminished gradually because Sri Lanka has graduated to middle-income status. Consequent to a deteriorating security situation and political instability, the international donor community substantially limited official development assistance (ODA) to Sri Lanka throughout the 1990s. Given that Sri Lanka has achieved middle-income status, earlier levels of funding are not likely to materialize going forward, highlighting the imperative for domestic revenue mobilization.

2.4.3. Medium-term debt sustainability

The to date most recent published debt sustainability analysis (DSA) is available in Annex II of the IMF’s Country Report 19/335, published in November 2019 for the completion of the sixth review for the arrangement under the Extended Fund Facility (IMF, 2019). This DSA is based on actual data as at end 2018 and macroeconomic projections and assumptions of the IMF staff at that point of time. This DSA covered three major components of public debt: 1) Central Government domestic and external debt (90% of GDP), 2) government guaranteed debt issued by state owned enterprises (SOEs) (5.2% of GDP) and 3) financial obligations of SOEs (14.6% of GDP). Accordingly, overall public debt and contingent liabilities stood at 109.8% of GDP as at end 2018. According to the IMF analysis, Sri Lanka’s debt to GDP ratios were significantly higher than the median for emerging economies (53 per cent), excluding major oil exporters.

<table>
<thead>
<tr>
<th>Table 1: Key assumptions and actual outcomes of debt sustainability analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
</tr>
<tr>
<td>Inflation (Annual average %)</td>
</tr>
<tr>
<td>Fiscal balance (% of GDP)</td>
</tr>
<tr>
<td>Primary balance (% of GDP)</td>
</tr>
<tr>
<td>Current Account balance (% of GDP)</td>
</tr>
<tr>
<td>Central Government Debt (% of GDP)</td>
</tr>
</tbody>
</table>


According to the IMF’s projections based on actual data in 2018, if the fiscal consolidation path envisaged under the EFF program was implemented, the ratio of public debt would come down to below 80 per cent of GDP by 2024 from 90 per cent in 2018. The reduction
in the debt to GDP ratio beyond 2019 was projected assuming a negative interest-rate- and-growth-differential and continuous primary surpluses in fiscal accounts. Analysing actual performance, in 2019 and 2020, together with announced fiscal targets for 2021 indicates unsustainable debt dynamics moving the debt to GDP ratios above the threshold levels required to maintain medium term debt sustainability. Major deviations are arising mainly from much lower realisation of real GDP growth in 2019 and 2020, as well as expansive policy in terms of larger overall fiscal deficits and primary deficits. Moreover, the relatively high share of foreign currency-denominated debt (at 46 percent of the total central government as of 2019) also creates a vulnerability to currency depreciation. Central government debt has increased to 102 percent of GDP as at end 2020 compared to the IMF projection of 82.4 percent in the DSA mentioned above. Primary surpluses and a positive growth/interest rate differential over the medium term are required to stabilise Sri Lanka’s debt dynamics.

The low level of fiscal revenue, the still high level of public debt and persistent fiscal deficits leave little room for counter-cyclical fiscal policy. Government guarantees given to state-owned and private establishments have risen sharply from 1.6 percent to 8.7 percent of GDP between 2006 and 2020 and could pose a further risk to the fiscal position. The government is now seeking to increase the limit for these contingent liabilities from 10 per cent to 15 per cent of GDP. Revenue based fiscal consolidation remains a challenge for the fiscal authorities.

More generally, twin deficits in the fiscal and current accounts are mirrored by low national savings, with a persistent savings-investment gap being financed mostly through increasingly costly debt-creating flows over the last decade. National savings has averaged about 25 percent of GDP, since 2010, while national investment was as high as 31 percent of GDP. Most of this gap has been covered by debt-creating flows, as opposed to FDI, over the last decade. The high investment ratio has not generated comparable growth in output indicating low productivity in some investments. With relatively low GDP growth, the external debt amounted to about 66 percent of GDP at end-2019 which is the highest ratio since 1995.

2.5. Monetary policy, inflation and exchange-rate management

Sri Lanka’s monetary policy framework has also evolved from a currency board arrangement before the establishment of the Central Bank of Sri Lanka in 1950. From 1950 to 1977, Sri Lanka’s monetary policy framework was largely based on maintaining a fixed exchange rate regime in terms of fixing the value of Sri Lanka rupee first to the sterling pound and then to the US dollar. Under this fixed exchange rate regime, domestic inflation was linked to foreign inflation and therefore there was no need for an explicit monetary anchor to manage inflation. The Central Bank did not have much leeway to control domestic inflation as the fixed exchange rate was the anchor to manage

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3 This section draws on Weerasinghe (2018).
inflation. This system worked well as long as Sri Lanka earned sufficient foreign exchange to meet expenditure on imports without any restriction.

During the period of Sri Lanka’s fixed exchange rate regime, successive governments did not pursue export-oriented policies continuously. There were short episodes where policies focused on export promotion, but there were more times of policy reversals towards encouraging import substitution and inward looking policies. From a long-term perspective, such polices were inconsistent with the need to maintain a fixed exchange rate regime. Under these circumstances, the key challenge the Central Bank had to face was how to defend the exchange rate peg amidst policies which did not promote exports. The only choice available for the Central Bank at the time was to restrict the use of available foreign reserves and impose severe exchange control restrictions.

In addition to pursuing inward-looking economic policies, successive governments also ran high budget deficits. Such budget deficits, even at moderate levels, caused more demand for imports during weak export performance, creating continued current account deficits, while the Central Bank was required to maintain a fixed exchange rate regime. This was an impossible task for the Central Bank. As a result, the Central Bank, from time to time, either devalued the rupee or maintained a dual exchange rate along with severe restrictions on the use of foreign exchange. This monetary policy framework lacked credibility and created severe distortions in market pricing.

2.5.1. Monetary policy framework since 1977

To be consistent with the new liberal regime introduced in 1977, the Central Bank abandoned the fixed exchange rate regime and moved to a more market-based system of exchange rate management. On 15th November 1977, the prevailing dual exchange rates were unified at an initial rate of Rs. 16 against the US dollar. This was an overnight devaluation of the basic exchange rate by 120 per cent. The rupee was then allowed to float under a managed exchange rate regime. This sharp devaluation addressed the overvaluation of the rupee observed under the fixed regime. The subsequent managed exchange rate regime allowed some flexibility to determine the value of the currency largely based on market demand and supply, while attempting to prevent the overvaluation of the rupee by maintaining the real value of the rupee against movements of a basket of major currencies.

2.5.2. The aftermath of the managed float

The introduction of the managed floating exchange-rate regime resulted in new challenges to the conduct of monetary policy, particularly as the exchange rate was no longer available to anchor inflation expectations as in the past. The Central Bank also had to face a new challenge, as the government started to run extremely large fiscal deficits funded mainly by concessional external funding to develop public infrastructure. Annual fiscal deficits averaged 13.3 per cent of GDP between 1978 and 1983, External current account deficits averaged 10.8 per cent of GDP between 1979 and 1983. Year-on-year inflation averaged 15.6 per cent during February 1978 to January 1985, with a peak of 32.5 per cent in August 1980.
2.5.3. **Beginning of monetary aggregate targeting in Sri Lanka and evolving exchange rate system**

The relationship between monetary expansion in terms of the amount of money held by the public and inflation has been well recognised in Sri Lanka from the beginning of central banking in the country. Having taken into consideration the real growth, the estimated rate of price increase and increased monetisation of the economy, the desired monetary targets were set in the plan with a view to maintaining consistency between financial and real output flows in the economy. The monetary targets were then translated into a permissible level of credit to the private sector by commercial banks after allowing for the impact of the behaviour of the external sector and the credit requirements of the government. While monetary aggregate targeting remained the framework for the conduct of monetary policy, in Sri Lanka, the exchange rate regime also underwent a gradual evolution. The managed floating exchange rate system broadly remained a crawling band arrangement as the margin associated with the foreign exchange transactions was increased from time to time. The degree of Central Bank intervention in the foreign-exchange market varied over time with balance of payments developments and the view of the Central Bank on the direction of the exchange rate. Under this monetary targeting framework with a crawling exchange rate, achieving price stability proved challenging, as successive governments continued to run high fiscal deficits even after the completion of the accelerated hydro power generation/irrigation scheme, in order to finance large scale housing and road development programmes. In addition, the three decades of ethnic conflict required successive governments to spend a large amount of money on defence expenditure. In order to maintain competitiveness of the rupee, the Central Bank had to let the currency depreciate to, at least partly, compensate for the inflation differential between Sri Lanka and its trading partners under the crawling peg system. Even though this arrangement helped to alleviate the adverse impact on exports to some extent, higher domestic demand created through excessive fiscal deficits led to large current account deficits in the balance of payments, making it difficult to maintain the crawling peg without a sharp depreciation.

By the year 2000, Sri Lanka experienced a significant decline in its official international reserves, as a result of the considerable increase in expenditure on imports. The increased demand for foreign exchange placed tremendous pressure on the exchange rate. Within the managed floating exchange rate regime, this naturally resulted in increased pressure on international reserves. In order to defend the managed float, the Central Bank raised its policy interest rates to unprecedented levels, which later proved not only to be an unsuccessful exercise but also a costly experiment, which largely contributed a negative annual real GDP growth rate for the first time in 2001.

This prompted the Central Bank to revisit its exchange rate policy. On 23rd of January 2001, the Central Bank took the major step of allowing the commercial banks to determine the exchange rate depending on the supply and demand of foreign exchange in the domestic foreign-exchange market. With this move, the Central Bank refrained from announcing daily buying and selling rates of foreign exchange, thus allowing freer foreign exchange transactions. The change in the exchange rate regime resulted in an
overshooting effect within the first three days, but a relatively quick stabilisation of the exchange rate followed.

As the use of monetary policy to defend the foreign exchange rate was no longer necessary under the floating exchange rate regime, the Central Bank of Sri Lanka was able to conduct monetary policy with an increased focus on achieving the Bank’s objective of price stability. However, maintenance of price stability came under heavy pressure under this regime whenever aggregate demand was excessive as a result of expansionary fiscal policies.

Therefore, at times of such excessive domestic demand through fiscal dominance, the Central Bank of Sri Lanka intervened in the foreign exchange market to defend the exchange rate from depreciation. Although this was done with an intention of smoothing out excess volatility in the exchange rate at difficult times, experience repeatedly showed that managing the exchange rate extensively was always associated with a substantial loss of international reserves followed by a large depreciation.

2.5.4. 12 consecutive years of single digit inflation

Despite these modifications to the framework of conducting monetary policy over time, Sri Lanka continued to suffer from double digit inflation until 2009 as a combined outcome of high budget deficits and loose fiscal policy, reactive rather than proactive monetary policy, frequent domestic supply disruptions and international commodity price shocks. In June 2008, inflation increased to 28.2 per cent, the highest level of inflation since the 1980s. In order to manage this situation within the monetary targeting framework, the Central Bank used strict quantitative monetary targets with increased policy interest rates while also imposing restrictions on access to the Central Bank reverse repurchase facility. In a display of the effectiveness of monetary targeting, the Central Bank was able to bring down inflation from the peak to near zero levels within a 12-month period. It was the sharpest disinflation in the history of Sri Lanka, but it must also be noted that the weak global commodity prices also contributed to this decline to some extent.

Nevertheless, the intent of the Central Bank to maintain inflation at mid-single digit levels, which was made clear through action as well as through communication, enabled the Central Bank to change the mindset of the people that Sri Lanka is typically an economy with double digit inflation. The change in the mindset was visible in improving inflation expectations. Since February 2009, inflation has remained in single digits, and 12 consecutive years of single digit inflation is considered a major achievement in the recent history of central banking in Sri Lanka.

Sri Lanka’s achievement of single digit inflation for last 12 consecutive years had little to do with monetary aggregate targeting. Instead, it was a result of the Central Bank’s ability to anchor inflation expectations, by repeatedly emphasising its utmost desire to maintain inflation at mid-single digit levels while incorporating key features of inflation targeting regimes into monetary policy framework. During effective monetary targeting framework prior to last 12 years, average inflation was around 12 per cent compared to mid-single
digits of inflation during subsequent years up to now. The main reason for higher inflation during monetary targeting regime was the fiscal dominance under which the Central Bank had to accommodate excessive monetary expansion arising from monetising fiscal deficits financed directly by the Central Bank or indirectly through commercial banks. Since the new monetary policy framework has anchored inflation expectation well now such fiscal dominance leads to higher current account deficits causing regular occurrence of distress in balance of payments by way of volatility in the external value of the Rupee or insufficient levels of external reserves.

2.5.5. Inflation targeting as an alternative

Without a formal announcement, the Central Bank of Sri Lanka, like many other central banks in the world, has moved to a monetary policy framework governed by expectations and credibility, rather than by monetary aggregates or exchange rates. In the global economy, such a monetary policy framework that emphasised the role of expectations and credibility existed, and it was known as “inflation targeting”. Inflation targeting is generally characterised by an announced inflation target; an inflation forecast, which facilitates forward looking monetary policy decision making; and a high degree of transparency and accountability.

Global experience has also shown that in adopting inflation targeting, a country needs to fulfil several prerequisites, particularly in terms of the legal and institutional framework. These include central bank independence and a strong mandate for price stability, a robust fiscal position with freedom from fiscal dominance, a flexible exchange rate regime, a well-developed financial system, a sound technical infrastructure for inflation forecasting, and transparent policies to build accountability and credibility of the central bank. Regarding fiscal dominance, other countries had developed mechanisms to stop monetary financing of fiscal deficits. The Central Bank of Sri Lanka has also introduced key features of inflation targeting gradually into its monetary policy framework which is the main reason for Sri Lanka’s ability to maintain mid-single digit inflation for 12 years consecutively so far. Some work remains to be done to institutionalise greater independence for the Central Bank to contain fiscal dominance and conduct an autonomous monetary policy to achieve its core objective of price and economic stability.

In this regard, inflation targeting was recognised as the potential monetary policy framework for Sri Lanka in early 2000. Since then, the Central Bank of Sri Lanka has been modifying the monetary policy framework gradually by incorporating key features of inflation targeting into it. In January 2017, the Central Bank formally announced its intention to recognise a flexible inflation targeting regime as the monetary policy framework in its Road Map for 2017. As the final step of the implementation, in April 2018 the Cabinet of Ministers approved to amend the existing law and a new bill for central banking in Sri Lanka was submitted to the Parliament in late 2019. In addition to the adoption of flexible inflation targeting as the monetary policy framework, the new bill also incorporated provisions to improve governance and strengthen central bank independence while restricting monetization of fiscal deficits by the Central Bank. The new bill also incorporated provisions to maintain fiscal and monetary policy coordination while maintaining central bank independence and strengthening the macroprudential
policy framework. With the dissolution of the Parliament after the Presidential election in November 2019, there has been a delay in considering the new bill in the new Parliament.

3. Comparison between China and Sri Lanka

This section tries to compare performance between the two countries with a view to drawing lessons from China’s success based mainly on the findings in Feng et al. (2020). Accordingly, China has been able to maintain a relatively stable macroeconomic environment during the structural transformation from a centrally planned to a market-oriented economy. Feng et al. (2020) examines stability of the macroeconomic environment in the following areas namely, 1) real economic growth and 2) inflation. The relative success in macroeconomic stability is attributed to factors, such as proactive management of potential macroeconomic fluctuations with a view to preventing excessive overheating or recessionary conditions.

3.1. Real GDP growth

China has been able to maintain much higher rate of real GDP growth than Sri Lanka during the period 1978–2019 as depicted in figure 10. Table 2 compares the volatility of GDP growth for a sample of selected Asian countries, and data confirms the fact that China has been able to maintain the lowest volatility in GDP growth in the sample. Sri Lanka has fared reasonably well compared to several other countries, in Asia, although with higher volatility than that of China. It reflects the fact that the Sri Lankan economy has demonstrated reasonable resilience to external and domestic shocks. One reason for the similarity in this resilience to external shocks can be attributed to the gradual opening up of the capital account in both countries, compared with many Asian peers such as Indonesia, the Republic of Korea, Thailand and Singapore where capital accounts were liberalised at a faster pace.

Figure 10: Annual real GDP growth (percentages)

Source: World Development Indicators Database
Source: Author's computation, based on World Development Indicators Database. The numerator of real GDP volatility is the standard deviation of the detrended GDP growth rate calculated by HP filter \((\lambda = 6.25)\) while the denominator is the trend of GDP growth adjusted by HP filter \((\lambda = 6.25)\).

### 3.2. Inflation

China’s success in maintaining stable economic growth and inflation is attributed to the Chinese government’s interventions by way of limiting excessive investment, controlling the size of infrastructure construction, and putting a lid on inflation when the economy was about to overheat. Similarly, when the economy was about to go into a recession, the Chinese government accelerated the exit of outdated capacity, drove capacity clearing and simultaneously expanded infrastructure construction stimulating aggregate demand. According to Feng et al. (2020), the Chinese authorities have used three kinds of policy tools namely 1) market approaches using fiscal and monetary policy to control aggregate demand, 2) administrative orders by way of controlling new investment projects and 3) controlling land approvals and credit granting and restricting house purchasing in real property markets of key cities.

In comparison, Sri Lankan authorities have also used similar tools in managing booms and busts to address macroeconomic cycles from time to time. But Sri Lanka has implemented such policies more as reactive measures to come out of boom-bust cycles rather than as proactive measures to prevent potential macroeconomic imbalances which could arise as a result of ongoing polices. One such episode happened, in the early 1980s, after the opening of the economy in 1978, with the government’s ambitious and massive infrastructure development projects, mainly to develop irrigation systems to provide water to agricultural areas in dry zones together with major hydropower generation projects. Due to severe capacity constraints relative to the required capacity to implement such mega projects in a short period, the economy experienced overheating in terms of exceedingly high real economic growth of around 8–9 per cent per annum together with high double digit inflation rates leading to sharp depreciation of the rupee. As a result, the Central Bank had to tighten monetary policy by way of increasing domestic interest rates to high double-digit levels to curtail excessive aggregate demand. A similar episode of a boom-bust cycle was observed again soon after the end of the war in 2009, when the government implemented large infrastructure investments.

<table>
<thead>
<tr>
<th>Country</th>
<th>Volatility of Real GDP growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>0.20</td>
</tr>
<tr>
<td>China</td>
<td>0.18</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.79</td>
</tr>
<tr>
<td>India</td>
<td>0.38</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>0.54</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.30</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.49</td>
</tr>
<tr>
<td>Pakistan</td>
<td>0.30</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.25</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.54</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.63</td>
</tr>
</tbody>
</table>

Table 2: Fluctuations of real GDP growth, selected economies, 1978–2019
projects, not only to develop the war-affected Northern and Eastern provinces but also in other parts of the country, to develop public infrastructure such as highways, ports, airports and power plants. Some of public infrastructure, such as health, education and roads, were partly funded by multilateral agencies, such as ADB and World Bank on concessional terms, while for ports, airports and power plants, external financing was provided on less concessional terms by export credit agencies, mainly from China. Since this external financing required counterpart funding, the Government had to borrow such funding on commercial terms from both local and global capital markets. Again, the Central Bank had to tighten monetary policy and impose certain restrictions on imports and credit expansion to cool down the overheated economy and the resulting balance of payment distress.

3.3. Investments and Export Friendly Monetary Policy

3.3.1. Interest rates

Feng et al. (2020) argues that under investment friendly monetary policy, China has deliberately maintained an investor-biased interest-rate policy by maintaining average lending and deposit rates below market rates even after it moved to a market-oriented monetary policy framework after 1978. In comparison, Sri Lanka's real lending rates measured in terms of 3-months Treasury bill rates (figure 11) have been relatively higher than that of China except for very high inflation episodes, in the early 1980s and during a major part of 2000–2010 when Sri Lanka again had a relatively high inflation episode. The 3-month Treasury Bill rate is the only available rate that can be used as a benchmark, in Sri Lanka, for a long period. Other lending rates available for the private sector are generally higher than this benchmark rate depending on risk assessment of different types of borrowers. In general, it can be concluded that Sri Lanka's investors have faced much higher real interest rates than those of China. One of the key explanatory factors for Sri Lanka's relatively higher real interest rates is the very low domestic savings ratio. Historically, Sri Lanka's savings-investment gap, as reflected in the current account deficit of the balance of payments, has been persistently high. In such a low savings environment, low real interest rates would encourage more aggregate domestic demand leading to further worsening of external current account balances and less domestic savings. Therefore, Sri Lanka has not been able to afford low real interest rate regimes, unless significant increases in foreign exchange earnings through export of goods and services or long-term non-debt creating inflows, such as FDI, materialises to fill the domestic savings-investment gap in a sustainable manner. China has experienced favourable trends in relation to both factors after the opening up of the economy. Both exports and FDI inflows increased substantially making it easier to run low real interest rate regimes for a long period. Therefore, China's experience provides a useful lesson for Sri Lanka that a market oriented small open economy needs to promote exports and FDI to maintain sustainable growth with macroeconomic stability. Promoting inward-oriented growth policies with a limited pool of domestic savings cannot achieve either steady high economic growth or macroeconomic stability by way of low inflation and low current account deficits.
Since Sri Lanka’s domestic savings have always been much lower than required for investments in large public sector driven infrastructure projects, successive governments had to rely on external borrowings to finance these projects, increasing the central government’s external debt to elevated levels. In the 1980s, Sri Lanka had access to generous volumes of concessionary loans. However, later, following graduation to low-middle income status, the Government had to rely more on commercial based external borrowings for such projects. Since such projects were mainly promoting domestic-oriented sectors, such as agriculture, construction, transport, wholesale and retail trade, these non-tradable sectors were growing at a faster rate than export-oriented sectors, failing to generate sufficient foreign-exchange earnings to service future external debt obligations. Even the low levels of FDI were mainly flowing to telecommunications and real estate developments rather than export-oriented industries. Such trends led to increasing deficits in the external trade and current account balances; regular occurrence of distress in the balance of payments; and faster depreciation of the rupee. Sri Lankan authorities have been more reactive to such situations. Though they have used similar tools to overcome such distress, they have not been proactive like the Chinese authorities. The major lesson Sri Lanka can learn from Chinese experience is to become more proactive in using such tools to prevent volatility in growth and inflation without using them reactively to stabilise macroeconomic imbalances.

### 3.3.2. Exchange Rate Management

Reforms in exchange rate management in both China and Sri Lanka have undergone similar phases, since moving to market-oriented economies in 1978. The first phase was the correction of an overvalued exchange rate resulting in a depreciation of both the RMB and rupee from 1978. The rate of depreciation was sharper in the Rupee compared to the RMB, during the first phase. The initial correction helped both countries to maintain competitiveness in export industries to a certain extent though the two countries faced different macroeconomic challenges. In parallel to maintaining external competitiveness in currencies, China promoted a more export-oriented growth model with large FDI inflows to expand the export-oriented industrial base. With such a trend, China was able to accumulate enough external reserves so that they were able to switch to a credible fixed exchange rate regime from 1994 to July 2005. Under the fixed exchange regime, with continuous export-led industrial growth resulting in current account surpluses, China was able to accumulate more external reserves and subsequently moved to more flexible
exchange rate regime starting with a managed floating regime, allowing gradual appreciation of RMB against the US dollar. In the last phase, with a significantly more comfortable level of external reserves, China adopted more flexibility, allowing the RMB to fluctuate in both directions with the Peoples Bank of China intervening, as and when necessary, to smooth out excess volatility. Sri Lanka also implemented a similar path to move from a fixed exchange rate to a more flexible and managed floating regime over the same period. The Rupee continued to depreciate at different speeds at different time periods due to the changing direction from outward orientation to inward looking strategies with protection provided to non-tradable sectors.

The lack of consistency of the policies, in Sri Lanka, constituted a marked contrast to the evidence-based policy-making in China. As a result, Sri Lanka continued to run large current account deficits which were mainly financed through external borrowings by the government instead of export oriented FDIs. Due to this strategy, Sri Lanka was never able to accumulate a sufficient level of external reserve buffers to maintain stability in managing the value of the Rupee against the US dollar. Now, exchange rate management has become even more difficult as debt service payments arising from past external borrowings have become a major part of external financing needs in addition to financing required for recurring current account deficits. China’s success in managing exchange rate stability provides a few key lessons for Sri Lanka. First, a country needs to attract foreign savings to fill the domestic savings-investment gap and if such inflows are not used to generate or save sufficient foreign exchange earnings, at least to be able to meet external debt service payments, the country concerned will not be able to achieve stability in exchange rate management.


China has developed the domestic financial system at a rapid pace by implementing a strong set of reforms within a relatively short period while maintaining financial stability. According to Feng et al. (2020), China had a highly centralised financial system, before 1978, with the Peoples Bank of China playing the roles of central bank and commercial banks. Functions of commercial banks and the central bank was separated only in 1983. By end-2018, China had formed a multi-tier banking system, consisting of one national development bank, two policy banks, six very large commercial banks, 134 city commercial banks, 39 foreign banks and thousands of rural commercial and cooperative banks.

Development and reestablishment of capital markets began even later in the early 1990s with opening up of stock exchanges, in the early-1990s. Now China has a multi-tier capital market which is playing an important role in financial intermediation, particularly in the reform of state-owned enterprises and the growth of the private sector. A proper institutional framework for regulation of financial services was established in the early 1990s for regulation of capital markets and insurance sectors. In this connection, the China Banking and Regulatory Commission was established only in 2003. Rapid transformation of China’s financial system and the level of financial deepening through
successful implementation of financial reforms can provide important lessons for any developing country to develop their financial systems.

In comparison, Sri Lanka has a longer history of a well-established banking system, stock exchange and regulatory institutions. Despite this, financial deepening and financial sophistication remain much lower than what China has achieved in a relatively short period of time. Sri Lanka has a long history of established commercial banks. At independence, in 1948, Sri Lanka already had established 9 foreign banks which dominated business in export of primary commodities and supporting the plantation sector. The first local commercial bank (Bank of Ceylon) was established, in 1934, and later another state-owned bank, the Peoples' Bank was established, in 1961. Now these two state-owned banks are holding about 34 per cent of assets. However, they are continuously losing their share to newly established private banks. Even proper regulation of the banking system commenced very early with the establishment of the Central Bank in 1951 (Central Bank of Sri Lanka, 1990). As at end 2019, Sri Lanka had 26 commercial banks and 6 specialised banks. Out of 26 commercial banks, there are 13 branches of foreign banks, and two large state-owned banks and the others are private commercial banks. Commercial banks still dominate and hold 62% of the assets of the financial sector while superannuation funds, including the Employees Provident Fund, which is the single largest superannuation fund, hold only 15%. Non-bank financial institutions and the insurance sector hold only 8% and 3% respectively. Despite a long history of establishing financial sector institutions and regulatory bodies, Sri Lanka’s transformation into a much more diversified financial services sector has been much slower than that of China and several other peers in the region.

Credit to the private sector by banks is one measure which indicates the extent of financial deepening through the banking sector. Figure 12 compares Sri Lanka’s performance with peer countries, including China. Accordingly, Sri Lanka’s ratio has increased closer to 50% of GDP from around 20%, in 1978, whereas China’s ratio increased from 50 per cent, in 1978, to over 160 per cent by 2019. This trend confirms the fact that reforms in the banking sector has improved the financial intermediation process and funded the high GDP growth achieved by China, whereas the contribution by the Sri Lankan banking sector in funding significantly lower GDP growth has been much lower.

![Figure 12: Credit to the private sector as a share of GDP, selected economies, 1978–2020, percentages](source)

Source: World Development Indicators Database
3.4.1. Role of equity market in financial deepening

In capital markets, the equity market usually plays an important role, other than the banking sector, in financial deepening and facilitating the financial intermediation process. Figure 13 compares Sri Lanka’s performance against peer countries in terms of market capitalization of listed domestic companies during the 2005–2019 period for which comparable data is available in World Development Indicators. In this regard, China and Sri Lanka have had a similar starting point of around 20% of market capitalisation, in 2005 and by 2019 China’s ratio has reached around 60% whereas Sri Lanka’s ratio remained stagnant around 20% of GDP. In fact, Sri Lanka’s performance in financial deepening through the equity market is worse than any other country in the sample selected, as shown in figure 13. Even within Sri Lanka, the relative contribution by the equity market compared to the banking sector has been diminishing over the period.

One of the major structural transformations which explains the significant differences in financial deepening and progress in financial intermediation between Sri Lanka and China is China’s transformation into one of the best gross domestic saving economies when compared to all regional peers, whereas Sri Lanka’s position remains one of the lowest as depicted in figure 14. In fact, Sri Lanka’s position was only second to China, in 1982, within the sample, but by 2019 the two countries had moved in completely opposite directions.

![Figure 13: Market capitalization of listed domestic companies as a share of GDP, selected economies, 2005–2019](image)

Source: World Development Indicators Database
Supply and availability of a large domestic savings pool beyond the requirement of a country’s gross domestic capital formation would help different types of financial intermediaries to prosper without crowding out each other’s share of business. In the case of Sri Lanka, gross national savings have never been sufficient to finance the required gross capital formation even under a much lower growth path, as mirror imaged in persistent negative external current account balances. Therefore, any progress to be made in one channel of the financial intermediary process would have to be realised at the cost of other channels, unless such channels were able to attract foreign savings. In Sri Lanka’s experience, the equity market, insurance and the corporate debt market have never been able to attract significant amounts of foreign savings for their expansion. Government borrowing has been the major source of bringing in foreign capital and to a small extent the banking sector has been able to bring in short-term foreign capital. In addition, with relatively high real interest rates the banking sector has a comparative advantage in the financial intermediation process compared to insurance, equity market and other debt market instruments. This is one of the reasons why the banking sector still dominates and is increasing its share in the financial intermediary process. Sri Lanka can learn several lessons from China’s experience on how to fast track reforms in the financial sector to make the financial intermediary process much more efficient and improve financial deepening within a relatively short period.

In terms of maintaining financial system stability, Sri Lanka has a good track record of maintaining a stable financial system without any failure of major financial institutions. Even during the Asian Financial Crisis, in 1997, and the Global Financial Crisis, in 2008, there were several collapses and restructuring of financial institutions in emerging markets as well as advanced economies, whereas Sri Lanka did not experience such episodes, partly due to the partial opening of the capital account as a result of which Sri Lanka’s financial institutions were not so integrated and exposed to global capital markets and the volatility in global financial markets. While this insulation can be a
positive factor at the time of crises, Sri Lanka has also missed several opportunities to attract much needed foreign capital when capital and liquidity was widely available in global markets. As a result of less integration to global capital markets, Sri Lanka has not been able to attract enough inflows to the private sector by way of FDI and portfolio inflows to finance large current account deficits through non-debt creating sources.

### 3.5. Capital Account Liberalization

Both Sri Lanka and China followed similar and cautious paths in relaxing controls on foreign exchange transactions in both the current and capital accounts. Before 1977, Sri Lanka had extremely strict controls on all foreign exchange transactions due to severe balance of payment distress arising from an inward oriented policy regime, since the mid-1950s. Even after opening the economy, in 1977, under more flexible exchange rate policy regimes, full convertibility of current account transactions was permitted only in 1994 on accepting obligations under Article VIII of the IMF Articles of Agreement. Full convertibility of current account transactions still remains intact, but liberalisation of the capital account has moved in different directions depending on persistent balance of payment distress Sri Lanka faced from time to time. Like China, Sri Lanka first liberalised FDI inflows by relaxing some foreign ownership restrictions at the beginning and later removed ownership restrictions in most sectors except for security and environmental reasons. Sri Lanka is one of the few countries in the South Asian region which liberalised ownership restrictions for FDI inflows. Sri Lanka also allowed portfolio inflows to publicly listed equities from the 1990s and permitted portfolio investments in rupee denominated government securities from 2005 onwards on a gradual basis. However, portfolio inflows to listed equities have not been significant due to the small size of the market and lack of very liquid stocks listed in the Colombo Stock Exchange. Foreign inflows and outflows to the government securities market has been mixed and volatile despite some limits imposed on outstanding stocks held by foreigners, at any point of time. Such inflows are dependent on internal factors such as domestic interest rates, volatility in the exchange rate and external factors such as capital flight to safety due to global financial crises and monetary policy cycles in advanced countries. Despite attempts made by Sri Lankan authorities to attract portfolio inflows to both debt and equity markets by way of offering several incentives, Sri Lanka has not become an attractive destination for such inflows and in fact during the last couple of years there have been continuous outflows creating volatility in the exchange rate and exerting pressure on the limited amounts of external reserves. The Sri Lankan experience has highlighted the instability that can be caused by volatile portfolio capital flows in a twin deficit country where domestic risks serve to compound the effects of shifts in risk appetite in the global economy.

As discussed in a previous section, Sri Lanka’s FDI performance has been extremely poor compared to other peers in the region and is well below China’s performance. An important lesson Sri Lanka can learn through a comparative analysis between China and Sri Lanka is that although both countries have applied a similar cautious approach in removing controls in foreign exchange transactions, the outcome has been vastly different due to various other reasons, such as macroeconomic stability, ease of doing business, size of the domestic market, flexibility in labour laws, availability of land and labour in abundance etc.
3.6. China’s Exchange Rate Regimes and External Reserves

According to Feng et al. (2020), the Chinese authorities have placed greater importance in maintaining stability in the exchange rate with a view to encouraging external trade and to minimising adverse impacts of external financial crises, such as the Asian financial crisis and the global financial crisis, on the domestic economy. When levels of external reserves were low, China had used several controls on imports by way of licensing quotas, high tariffs and duties to curtail demand for imports, while maintaining dual exchange rate mechanisms favouring exporters. In return, exporters were required to repatriate and surrender at least a portion of their export proceeds at favourable rates. In addition, when the exchange rate seemed to be overvalued, Chinese authorities carefully let the value of the RMB to depreciate to correct overvaluation. One lesson Sri Lanka can learn from China’s exchange rate management strategy is that such a strategy always has an export-bias and the authorities always ensured that exporters were not at a disadvantageous position as a result of maintaining a relatively stable exchange rate regime. This strategy is one of the main reasons why China became a powerhouse of manufacturing exports to the world and was able to maintain large current account surpluses for a long period. China was able to pile up huge external reserve buffers with the help of large current account surpluses together with large FDI inflows. With the build-up of sufficient external reserves, China has now moved into a more market determined exchange rate regime, while encouraging overseas investment by Chinese residents. This strategy would prevent overvaluation of the RMB due to large net inflows and any overvaluation can be addressed by more accumulation of external reserves as seen in the recent past. With such levels of external reserve buffers, China is now able to maintain stability in the exchange rate as they wish irrespective of any external shocks.

4. Conclusions on lessons to be learnt from China’s experience

To learn appropriate lessons for Sri Lanka from China’s vastly more successful economic transformation, one needs to recognise significant differences between the two countries beyond macroeconomic management. For example, China has the biggest domestic market in terms of population and domestic resource availability as well as a very stable centrally planned administration which has made it easier to maintain consistent and predictable policies throughout the period. In contrast, Sri Lanka is a small island economy with a population of 21 million compared to the over one billion population in China. In addition, Sri Lanka has a long history of having democratically elected administrations changing power between right-wing liberal versus left-oriented socially inclined ideology. With changes in administrations, strategies adopted for economic development have been moving in different directions, based on popularity of mandates gained through democratic processes. As a result, even after opening the Sri Lankan economy to a more market-oriented approach from 1978, the development strategy has been switching between export-oriented outward-looking policies and inward-oriented policies favouring non-tradable sectors or an attempted mix of these two ideologies.
Such changes make macroeconomic policies highly unpredictable, making it difficult to formulate medium to long-term investment decisions with certainty. This is one of the reasons why Sri Lanka has never been able to achieve a high ratio of gross investment or the high level of FDI required for long-term sustainable growth. Even during some years of high investment ratios, the incremental capital output ratio seems to be lower compared to China because such investments have been responsive to short-term changes in tax and investment incentives targeting different sectors at different time periods. Once policies are changed such investments become less productive and viable.

The other major difference in economic management between the two countries is that Sri Lanka had to manage a civil war based on an ethnic conflict for nearly three decades, commencing from the early-1980s. This conflict not only constrained economic activity covering one third area of the country in the Northern and Eastern provinces, but also successive governments had to allocate a significant amount of resources to manage the civil war. The civil war also eroded foreign investors' confidence in Sri Lanka as a safe place to conduct business due to sporadic terrorist attacks that took place from time to time in key economically active provinces in the Southern part of the country as well. The war risk premium attached to the country during the conflict years severely constrained its development prospects. Despite its size and diversity, China has been able to maintain a high degree of political and social stability.

Despite the above differences between the two countries, the important lesson Sri Lanka can learn from China is that the latter pursued a consistent and predictable outward oriented economic development strategy, despite its large domestic market. As a result, China became a key manufacturing base for global production and a key centre for global supply chains. This strategy helped improve per capita incomes and living standards of a large portion of the population, eradicating poverty at a rapid pace through utilising massive foreign exchange earnings generated from export and FDI biased policies. As a result, China has built up a massive buffer in terms of external reserves. This has enabled China to maintain a stable exchange rate regime. Sri Lanka, on the other hand, has never been able to build up sufficient buffers in external reserves compared to its external financing needs, compelling the authorities to seek assistance from the IMF on a regular basis.

Despite Sri Lanka’s comparative advantage in terms of a strategic location, well-educated labour force and higher status of human development in terms of HDI rankings, Sri Lanka’s inward-looking policy strategies protecting and supporting non-tradable sectors, despite a small domestic market, has been the barrier which has prevented the country from capitalising on its comparative advantages. Sri Lanka has been unable to promote an outward-oriented growth strategy like what China pursued for a long period on a consistent basis. Such inward-looking policy strategies prevented Sri Lanka’s foreign exchange earnings from diversifying beyond traditional sectors, such as tea, rubber, coconut and apparels. Instead, the country became highly dependent on foreign remittances through exporting labour to finance large and expanding trade deficits. In contrast, China provided opportunities for surplus labour to enhance the country’s capacity to earn foreign exchange.
With regard to financial reforms and financial deepening, Sri Lanka can learn several lessons from China's experience on how to fast track reforms in the financial sector to make the financial intermediation process much more efficient and improve financial deepening within a relatively short period.

Another major lesson that Sri Lankan authorities can learn from the Chinese experience is to become more proactive in using macroeconomic tools to prevent potential distress in growth and stability of the economy instead of being compelled to use such tools reactively. To be able to use macroeconomic policies proactively, China appears to have developed the necessary institutional capacity to identify such potential distress in advance as well as efficient mechanisms to implement necessary remedial measures proactively rather than reactively.

The major source of Sri Lanka's macroeconomic imbalances has been successive governments running persistently high fiscal deficits causing external current account deficits. This has led to repeated cycles of balance of payments distress. In addition, such twin deficits have led to public debt sustainability issues, in particular external debt sustainability, as discussed earlier under the section on the role of fiscal policy in the structural transformation of the Sri Lankan economy. While the movement towards an inflation targeting regime in monetary policy implementation has prevented expansionary fiscal policies generating high inflation, such a regime cannot prevent expansionary fiscal policies generating distress in the balance of payments. Sri Lanka will not be able to prevent boom-bust cycles of economic growth and recurring balance of payments distress without addressing the root cause of macroeconomic stability which is persistently high fiscal deficits.
References


