SRI LANKA'S FOREIGN EXCHANGE CRISIS: AN EXAMINATION OF CAUSALITY DYNAMICS, SHEDDING LIGHT ON SUGGESTIVE WAY-OUT STRATEGIES

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Abstract

The present research endeavoured to undertake a diagnostic analysis pertaining to the foreign exchange crisis faced by the Sri Lankan economy, intending to identify drivers of the crisis and to throw light on possible strategies to overcome the crisis. An extensive literature survey was conducted, followed by a descriptive analysis based on available data. Trend analysis, deploying graphical method, was adopted as the main analytical technique, and the results were interpreted using political economic reasoning. The outcomes of the study revealed that Sri Lanka has been experiencing persistent current account deficits as well as increasing foreign debt stock since 1977, the year in which economic liberalisation policies were implemented. In that respect, the Sri Lankan crisis closely resembled that of the Indian crisis more than those explained by the other crisis models found in literature. It could thus be inferred that the persistent trade and current account deficits owing to uncontrolled imports ever since liberalisation, and the resultant accumulation of foreign debt, have been the drivers of the foreign exchange crisis in Sri Lanka, while weak and undisciplined public finance policies, failure to move into high value-added and strategic industrialisation and wide income inequality would have been possible support factors. Therefore, the research outcomes yielded caution signals if policy makers consider availing further liberalisation of the economy as the remedial strategy to surmount the present crisis.

JEL: *E43, F41, G01, H63, O53, P51*

Keywords*: Economic Crisis Models, Exchange Crisis Recovery Strategies, Political Economic Analysis, Foreign Debt, Sri Lanka*

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INTRODUCTION

Sri Lanka is facing a severe economic crisis, possibly unprecedented, at least during the period of last 40 years. Policy discussions are being undertaken in view of formulating remedial measures, yet it is vital to properly diagnose the crisis dynamics prior to prescribing treatment. This is because, it is important to avert the possible risk of misdiagnosis which could lead to ill-conceived policies and strategic decisions which might even further aggravate the crisis.

Sri Lanka is not alone, having faced economic crises in the recent past. Many examples of such crises having been researched into in the past could be found in literature. Several emerging market economies (EMEs) such as Mexico, Thailand, Korea, Indonesia, Malaysia, Russia, Brazil and Argentina, have experienced financial crises in late 1990s and early 2000s. Tunisian currency crisis in 1987, Indian crisis in 1991, Sterling crisis in 1992 and South Korean currency crisis in 1997 are some other examples. Hence, the subject of economic crisis has been among the trending research areas globally during the past few decades. The importance of the theme persists due mainly to the timely requirement of knowing their causal dynamics, particularly in view of formulating remedial strategies. It is in the light of the above that the Sri Lankan crisis is examined in the present research.

It is pertinent to perceive at the very outset that the “crisis” as visible in the surface to the general public in Sri Lanka through shortages of essential supplies, corresponding queues and the resultant inflation, may not really be the “crisis” itself, but could be its consequences or symptoms. The real crisis could possibly be much more profound, and therefore, it would be futile if attempts are made to provide “pain-killers” as solutions to the present crisis. In short, mere alleviation of supply shortages or queues, would not mean that the problem was solved. The Roots of the crisis have to be correctly identified and have to be properly treated by appropriate remedial policy and strategic prescriptions and their effective and sustained implementation, if the malaise is to be deterministically cured.

This paper therefore is an attempt to deep dive into examining causal factors behind the current economic crisis in Sri Lanka through examination of relevant parameters and their evolution over the years, possibly pointing at plausible guidelines along which viable solutions could be formulated and implemented in view of overcoming the crisis and preventing recurrence in future.

LITERATURE REVIEW

Causes of economic crises have been researched globally by many scholars. First and foremost, it could be observed that the “level of foreign reserves” has been a key consideration, and subject to research by many scholars. Dania and Spillan (2007), for instance, researched on the foreign exchange reserves in emerging markets, and found that "the currency reserve level" had been identified by Fischer (2001) as an important interpreter and a forecaster of a currency crisis, which was evinced in the Asian financial crisis. In addition, they cited Kumar et al. (2003) as also having found international currency reserves being a significant indicator in issuing early warning signals of currency crashes in emerging markets. According to Kaminsky et al. (1998), international currency reserve level has been a crisis indicator significant in 10 out of 11 studies. This symptom of "rapid depletion of international currency reserve" has been observed as a common characteristic associated with financial crises in Mexico, Thailand, Russia and Brazil in the late 1990s and early 2000s (Bird and Rajan, 2003).[1] The importance of this indicator has been further underlined by Disyatat (2001) when he cited that the status of an economy would be positive, and the cost of external financing would be lower when its international currency reserve level was greater. It is noteworthy, at this stage, that this phenomenon of foreign exchange reserve level playing a significant role in precipitating the crisis was observed in Sri Lankan case as well.

Paul Krugman has been a pioneer in researching into crisis models. In 1979, he defined the 'First-Generation Model' as an economic crisis caused due to budget deficits (Krugman, 1979). Flood and Garber (1984) also subscribed to that definition, in which the irrepressible necessity that arises for the corresponding Governments to cover such fiscal deficit through seigniorage[2] would eventually lead to collapsing the fixed exchange rate system of the country, causing a speculative attack while foreign exchange reserves would fall below a critical level. Accordingly, Russian crisis of 1998 was identified by Krugman (1999) as having the features of the First-Generation Model, while Allsopp (2003), citing Eichengreen and Wyplosz (2003), presented the European crisis in 1992 also as yet another example of a crisis of the First-Generation type.

The Second-Generation Model, on the other hand, was suggested by several scholars, including Obstfeld (1986; 1994; 1996), Cole and Kehoe (1996) and Drazen (1998), as cited by (Liargovas & Dapontas, 2008), as a crisis that is based on the condition of attempting to defend an exchange rate parity. Accordingly, the Second-Generation type would be characterised by the conflict between a fixed exchange regime and the desire to implement an expansionary monetary policy; the Sterling crisis of 1992 being cited as an example.

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[1] However, Kumar et al. (2003), as cited by Dania and Spillan (2007), has been of the opinion that the financial crises of these countries were "unforeseen".

[2] Seigniorage signifies "money printing" by governments. It is counted as revenue for a government when the money it creates is worth more than it costs to produce (https://www.investopedia.com/terms/s/seigniorage.asp).

Eichenbaum and Rebelo (2001) identified the Asian currency crisis in 1997 as one of the critical events in the history which was of somewhat different characteristics; a main cause being large fiscal deficits necessitated as implicit bailout packages to failing banking systems. According to them, the collapse of the fixed exchange regimes in Asia was mainly due to the expectations of future deficits being financed through seigniorage revenues or through inflation taxes on outstanding nominal debt (Eichenbaum & Rebelo, 2001). They further claimed that the Asian crisis had few important characteristics as summarised below:

(a) The crisis could not be predicted on the bases of standard macroeconomic factors such as the government deficit or inflation rates: studying the fiscal balances of various Asian countries, it was noted that there were no major differences between crisis and non-crisis countries, thus suggesting that crisis could not have been predicted,

(b) The exchange rate crisis was preceded by a banking crisis, of which early signals were publicly available: studies revealed that the value of the banking sector had been declining well before the currency crises and also the value of the banking sector was deteriorating substantially compared to that of the non-financial sector,

(c) Financial sector failures associating with government deficits,

(d) Governments being unable or unwilling to raise the required finances to bailout the banks through strategies such as government expenditure cuts or increases in taxes: J.P. Morgan (1998), as cited by Eichenbaum and Rebelo (2001), has argued that the final pain of absorbing the bad loans of the banking system would eventually fall on the governments.

Therefore, it is evident that neither the First-Generation nor the Second-Generation models could fully explain the Asian crisis in 1997. Krugman (1999) also found that large deficits linked with implicit bailout packages to failing banking systems caused the collapse of the fixed exchange regimes in Asia. He labelled this crisis, caused due to the issues in the banking system, aided by the ability of companies to invest during crisis periods and also by the role played by capital flows affecting the real exchange rates, a “Third-Generation Model”.

The South Korean currency crisis had been studied by Cargill (1998), as cited by Zalewski (1999). Accordingly, the South Korean crisis was mainly due to the incomplete financial liberalisation, while weakened banking system due to regulatory forbearance, moral hazard and excessive risk-taking would also have been contributory factors. The increased uncertainty on defending Won retarded the renewal of short-term loans, thus increased the tension on the currency[3], helping precipitation of the currency crisis.

[3] To an extent, this reflects characteristics of the Second-Generation Model explaining crises.

Cerra & Saxena (2002) have critically studied the Indian currency crisis in 1991. Prior to liberalisation, India had been resorting to inward-looking development strategies where macroeconomic stability was obtained through low growth of money supply and moderate levels of public deficits, which in turn had pushed the inflation rates to be generally low. The country had a positive Current Account balance until mid-1980s and had a reasonable cushion of official reserves and capital inflows as well. This positive scenario took a different turn with economic policies shifting from the hitherto adopted import substitution emphasis towards an export-oriented growth policy, together with liberalisation of imports for exporters. The resultant imports, galloping much faster than exports, caused widened current account deficits, which had to be financed through non-resident worker remittances and also through borrowings on commercial terms. This, in turn, made India highly vulnerable to external shocks, including the international oil price hike amidst rise in its oil imports, and also to the falling economic growth in the United States of America, the country's largest export destination. Widening current account deficits and deteriorating foreign reserves thereby induced a negative impact on the investor confidence, which, along with the looming political uncertainties, resulted in the country's credit rating being downgraded. These characteristic features reflected that the Indian crisis was different and did not quite fit into either First-Generation, Second-Generation or Third-Generation models (Cerra & Saxena, 2002).

A careful look at the evolution of the Sri Lankan economy would enable observing its gradual movement towards a foreign exchange crisis ever since its liberalisation effected in 1977, even though the crisis got precipitated only towards late 2021 as shortage of supplies including gas, fuel, medicine, etc, and worsened by the first quarter of 2022 with lengthy power cuts and queues for essential supplies. In this respect, it could be observed that the crisis in Sri Lanka possessed similarities with the Indian crisis, although the size of the economy and the pre-crisis conditions differ between the two countries. Gunaruwan & Wickremaratne (2018), for instance, having traced the persistently high trade and current account deficits the economy was running in the aftermath of 1977, the growing factor payments abroad, and gradually accumulating foreign debt, foresaw the ill-effects, and alarmed, almost four years before, of the emergence of the current crisis.

It is in this light of findings from literature that a deeper examination of facets and patterns of evolution of Sri Lanka's macroeconomic indicators, in an attempt to fathom whether, and the degree to which, her present crisis could be explained by the standard crisis models, or whether any other causal factors could be revealed, becomes warranted.

METHODOLOGY

The study was mainly two-fold. Firstly, the observable features of the Sri Lankan crisis were compared with the different "crisis models" and experiences from other countries which faced similar crises learnt from the literature survey, to perceive whether, and the extent to which, the crisis drivers revealed therein could be hypothesised as relevant causes that could have been behind the Sri Lankan crisis. Secondly, the causes behind the conjunctures that led to the depletion of foreign reserves were attempted to be perceived objectively through macroeconomic parameters and their evolutions over the years. The patterns of Balance of Trade and Current Account balance with regard to international transactions, and also the fiscal deficit, were thus examined to fathom the extent to which those causes, hypothesised through the literature survey, could have triggered or stimulated the crisis.

It was also intended that the insights that would be drawn through such examination could help properly and intensively diagnose the malaise, thus, enabling prescription of strategic directions to surmount the crisis.

Required data to examine the evolutionary patterns were sourced mainly from the Annual Reports of the Central Bank of Sri Lanka. Trend analysis, deploying graphical method, was used as the analytical technique, and the results were interpreted using political economic reasoning.

RESULTS AND DISCUSSION

At the very outset, it was observed that the common characteristic, namely, the rapid depletion of international currency reserves has been relevant to Sri Lankan crisis as well. This was evinced through the fact that the crisis became "visible" in the latter part of 2021 and in early 2022 as supply shortages owing to the difficulty of finding adequate foreign exchange to purchase imported products. The causes behind the conjunctures that led to such depletion of foreign reserves were thus attempted to be examined, both by perceiving patterns of evolution of macroeconomic parameters and by relating the observations to crisis models identified in literature.

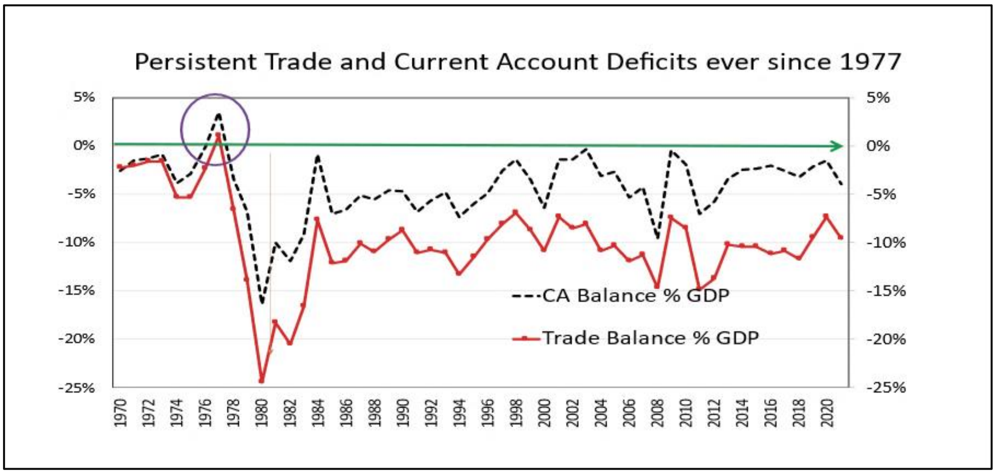
A Search for Causes of the Crisis in the Evolution of Economic Parameters

Learning from the findings in literature pertaining to crisis models and to international experience, the study, at the outset, ventured into examining the evolution of the Current Account balance and the Balance of Trade annually in the aftermath of independence. The accumulation of foreign debts, and also the patterns of reliance on short-term borrowings from international capital markets, also were examined. Besides, an attempt also was made to fathom the effect of fiscal deficits on foreign reserves by way of reconciling the budget deficits with the accumulated foreign debts of the nation.

(i) Persistent Trade and Current Account Deficit, and the Accumulated Foreign Debt

The Sri Lanka economy has persistently run substantial trade and current account deficits over the past four-and-a-half decades, as depicted in the Figure 1.

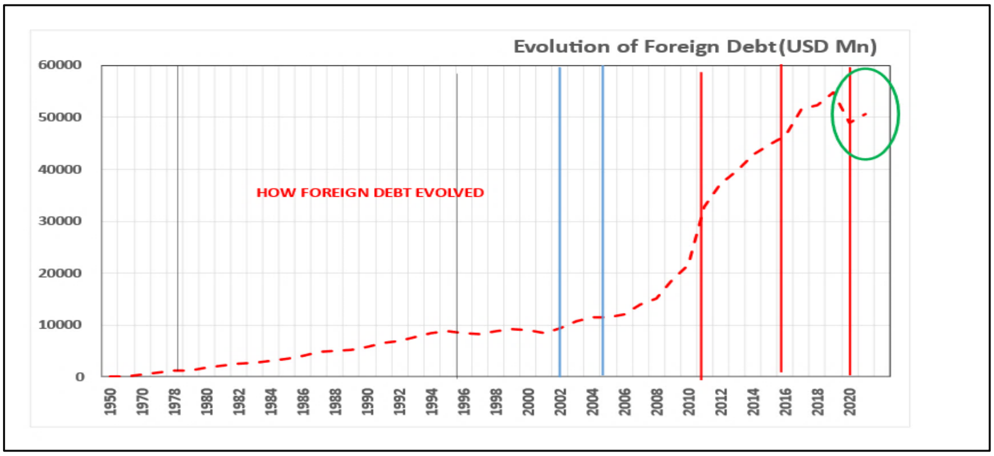
Figure 1: Evolution of Trade and Current Account Balance Since 1970



Source: Compiled by authors using data published by the Central Bank of Sri Lanka (various years)

At the first glance, this observation leads to hypothesise that trade liberalisation could have had a strong influence over the widened trade and current account deficits in Sri Lanka, as the last year in which the country has had a positive Trade and Current Account balances was 1977; the liberalisation policies were in force thereafter, leading to sharp decline in both parameters in 1978, and never recovered to favourable levels ever since. It is not a surprise that any economy would accumulate foreign debts when such trade and current account deficits persisted over a long period of time; a clear path-way towards an increasing pressure on foreign reserves to service such debts. Sri Lankan economy undergoing this pattern of foreign debt accumulation over the years is clearly perceived in the Figure 2, which has been observed by Nicholas (2023) as well.

Figure 2: Evolution of Sri Lanka's Foreign Debts



Source: Gunaruwan, T L, Presentation at University of Sri Jayewardenepura Seminar, May 7, 2022

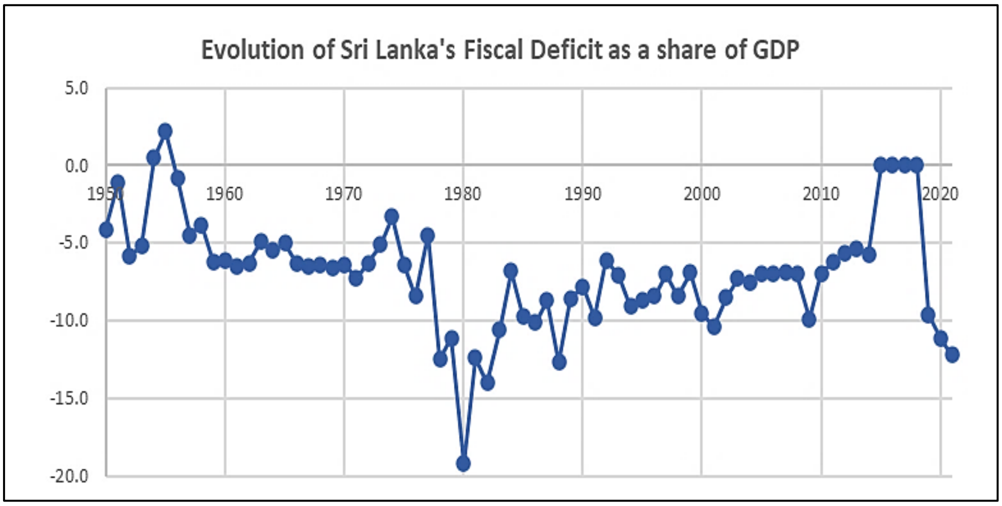
In this context, it is quite obvious that a moment would befall that the economy is unable to service foreign debts without borrowing further; running into foreign exchange related crisis thus becoming imminent.

It is important, at this juncture, to examine possible pathways that may have led the Sri Lankan economy towards persistent Current Account deficits. Three main dynamics were subject to analysis in this regard, namely, (a) persistent fiscal deficits, as also referred to in literature, (b) import-intensive consumption facilitated by open economic policies and income disparities, and (c) failure to embark on strategic industrialisation.

(a) Weak and Undisciplined Public Finance, leading to Persistent Deficits

Sri Lanka has run Government budget deficits ever since its independence, except in a very few years. Quite apart from capital expenses that were incurred for development purposes, the Government revenues, at times, were not adequate even to meet recurrent expenditures, reflecting a very weak fiscal discipline. The Figure 3 depicts the evolution of the overall budget deficit as a ratio of GDP, ever since 1950.

Figure 3: Fiscal Deficits and Evolutionary Patterns

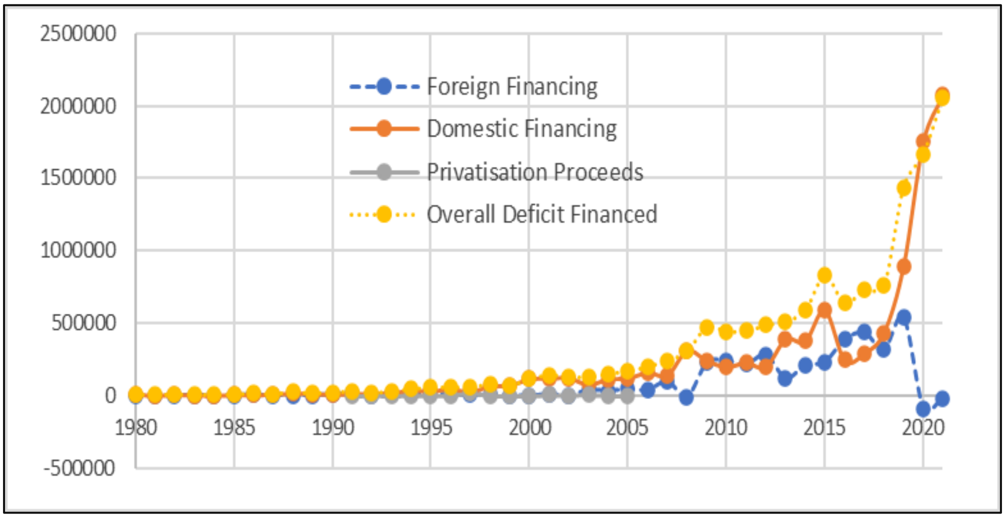


Source: Compiled by authors, using CBSL data

It is apparent, therefore, that the post-independent Sri Lanka has adopted an implicit policy of running deficit budgets. This persistent fiscal deficit condition would have faced another blow when the reduction of taxes, particularly the Pay-As-You-Earn (PAYE) on employment incomes and Value Added Tax (VAT) on several imports, effected towards end-2019. It would have inevitably deprived the Government of required financial resources, further widened the fiscal gap, and pushed it towards printing money, under the guise of "quantitative easing", a feature associated with both First and Second Generation crises (Krugman, 1999; Liargovas & Dapontas, 2008).

Nevertheless, how fiscal deficits could lead to foreign debts would be a pertinent question to address, because the direct impact on balance of payments or on foreign debt profile of a country would not be evident, particularly if the corresponding deficits were not financed through foreign borrowings. It was to fathom into this aspect that the foreign debt creating component of fiscal deficits run over the years were examined in the present study. Figure 4 depicts the evolution of fiscal deficit and the financing methods in the aftermath of 1980.

Figure 4: Fiscal Deficits, Financing Methods and Their Evolution Since 1980



Source: Authors' compilations using CBSL data

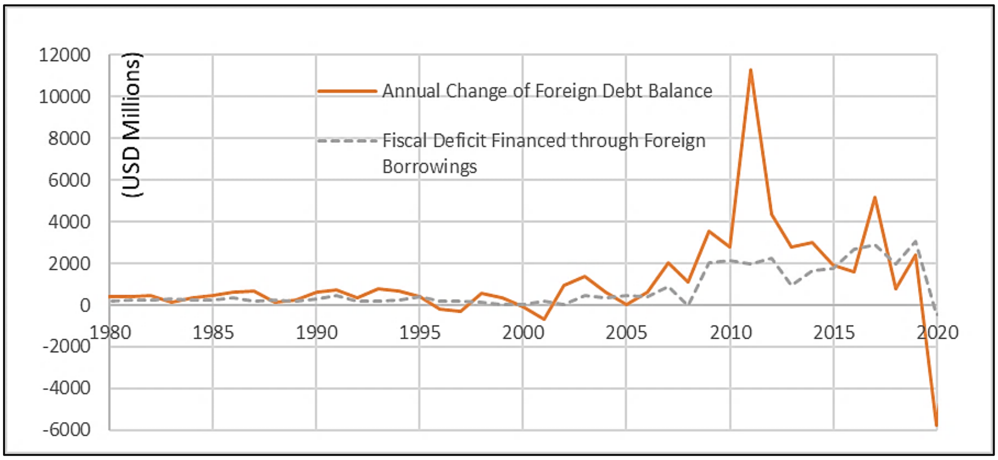
It becomes evident from the above analysis that successive Governments have resorted to rapidly increasing budget deficits ever since late 1990s, and particularly after 2005. While the reasons for fiscal deficits during the period of terrorist insurgency could possibly be explained on military expenses, the rapid escalation since 2009 appears curious. While the so-called "development financing requirements" on large scale projects could be advanced to justify capital expenses, economic viability and capital efficacy of several of those projects have been questioned (Gunaruwan & Jayasekara, 2020). Unless such capital investments, particularly when funded through foreign loans, yield adequate returns, preferably in terms of foreign exchange earnings or savings, to service the corresponding foreign debts, a medium to long term exchange crisis would become imminent. Besides, whenever such foreign debt financed fiscal expenditures are accrued for purposes other than public investment, the corresponding deficits would become incurred for financing recurrent expenses of the Government, a clear foreign debt burden on future generations. In this respect, the apparently exponential escalation of fiscal deficit period between 2016 and 2019 becomes questionable when not many large-scale development projects were undertaken, and when the proceeds of leasing

Hambantota Port for nearly USD 1 Billion also are said to be credited to the public coffers. Further research is warranted to investigate these apparently incongruent observations.

Yet, what is pertinent to perceive in relation to the question addressed is that only a portion of the total fiscal deficit has been financed through foreign borrowings. The privatisation proceeds that had constituted a means of financing appeared not forthcoming between 2005 and 2015; possibly a reflection of "abandoning" the privatisation strategy hitherto resorted. Foreign borrowings had increased in 2007, but had receded significantly thereafter, until accelerating once again in 2009; the slowed-down implementation of foreign loan funded public investment projects owing to escalated internal armed conflict and also a difficulty in sourcing foreign capital to fund military expenses that would have had to be incurred, could possibly be hypothesised as causal factors behind this pattern between 2007 and 2009.[4] The noteworthy acceleration has been in "domestic borrowings" to finance the fiscal deficit during that period, and almost the entirety of the fiscal deficit in 2008 appears to have been domestically financed, as reflected in the Figure 4.

In this backdrop, the extent of contribution by the fiscal deficits to cause escalated foreign borrowings became a matter of importance to study in detail. The study was thus extended to compare the annual changes perceived in the outstanding foreign debt stock with that share of the fiscal deficit financed year-by-year through foreign borrowings in the aftermath of 1980; the outcome is graphically depicted in Figure 5.

Figure 5: Annual Change in Foreign Debt Stock and Fiscal Deficit Financed Through Foreign Borrowings Since 1980



Source: Authors' estimates using data published in the CBSL Annual Reports (various years)

[4] Further research is needed to conclusively establish the influence of these conjunctural factors

It became evident from this examination that the changes in the outstanding foreign debt stock, except in a few years, have been significantly greater than the amount of fiscal deficit funded through foreign loans. Given that the fiscal deficit would have automatically captured the debt service payments, because Sri Lanka has been servicing her foreign debt quite regularly until the debt-default announced in 2022, it becomes evident that Sri Lanka had been resorting to foreign borrowings more than what would have been required to finance the relevant share of fiscal deficit. This observation is further supported by an analytical estimation that the total foreign financing of fiscal deficits ever since independence, even if the entirety is assumed borrowings and still remains unpaid and accumulated over the years as foreign debts, the present foreign debt balance could not be explained through such borrowings for fiscal deficit financing alone at any reasonable implicit average dollar-denominated interest rate that could be assumed as effective over the past 70 years. Therefore, it is clear that the accumulation of foreign debt could not be fully explained through borrowings to finance fiscal deficits alone.

Yet another path, in addition to the direct effect of financing through foreign borrowings, along which the fiscal deficits could give rise to worsening balance of payment situations, is their encouragement of aggregate expenditure through which imports could be incentivised (Nicholas, 2023). Accordingly, financing of fiscal deficits would give rise to the necessity of printing money, which would increase the money supply (M1 and M2), ultimately augmenting the aggregate expenditure. If such is spent on imports, it could cause, inter-alia[5], trade and current account deficits. Such deficits, when persisted over decades, could have given rise to Sri Lanka having to borrow from abroad, eventually leading to accumulated foreign debts and thereby to liquidity crises in regard of meeting foreign payments including those pertaining to servicing foreign debts.

Besides, the part of fiscal deficits, corresponding to public capital expenditures financed through foreign borrowings, but with no or inadequate capacity to earn or save foreign exchange through corresponding project outputs, also could explain, at least partly, how Government's fiscal deficits could have given rise to long term balance of payment difficulties and foreign debt accumulation. Even though an explicit policy of running fiscal deficits may not necessarily be "harmful", particularly if accrued on account of viable and capital efficient public investments (International Monetary Fund, 2006) which could (α) augment the capital stock helping build the economy's future productive capacity, and (β) create "effective demand", as advocated in Keynesian economic prescriptions, such capital expenditure-driven fiscal deficits could cause balance of payment difficulties gradually leading to accumulated foreign debt whenever the relevant "investments" are foreign loan funded but without the necessary viability attributes of adequately saving or earning foreign exchange through their corresponding outputs. It is

[5] Increasing inflationary pressures as well.

for this reason that any explicit effort to create effective demand through budget deficit financing should necessarily be accompanied by interventions to ensure that the intended effective demand would be created for local enterprise, thus paving the way for public expenditures incurred to be ploughed back into the national economy. However, such strategic approach has been grossly absent in the Sri Lankan case, except during the period of pre-liberalisation prior to 1977, as import substitution strategies were not advocated under liberal economic regimes. The resultant effect of fiscal deficits run by Governments has been merely debt-creating with no or inadequate growth impetus or export promoting effect. In fact, such spending would have become “economic leakages” (Aiginger, 2010) as those would have further incentivised imports, facilitated through enhanced purchasing power in the local economy.

The above analysis yields suggestive evidence to infer that, while fiscal deficits could have had a bearing over the foreign exchange crisis in Sri Lanka, that alone could not have given rise to the accumulated foreign debt to the scale witnessed, and also to the resultant liquidity crisis whenever no more foreign borrowings were forthcoming. Moreover, the fiscal deficits would not have caused such severe balance of trade problems if not for the prevalent policy of liberalised imports which enabled aggregate expenditure driven imports. Therefore, the currently experienced foreign currency liquidity crisis in Sri Lanka is likely to have had more causal factors than the mere fiscally undisciplined Government. It is for this reason that an explanation of Sri Lanka’s crisis within the frameworks of “First Generation” crisis model, though a possibility to a certain extent, could only be partial or incomplete.

(b) Import-Intensive Consumption facilitated by Trade Openness and Income Inequality

The revelation in the preceding section points at the possibility of the presence of foreign exchange demand creating avenues quite outside the fiscal deficit financing requirements. The need to maintain an adequately sound level of foreign currency reserves is one such very crucial requirements creating demand for foreign exchange. Given that the ability to maintain a healthy level of foreign reserves have been recognised by Fisher (2001) as a critical precursor of a developing country’s capability to avoid economic crisis (Dania & Spillan, 2007), any failure in earning adequate foreign exchange to maintain the required reserves levels, or any inability to save on foreign expenditures such that the required reserve levels could be lowered, would give rise to foreign reserve shortfall, a common denominator that was observed in all crises.

It is in this respect that the trade openness, effected as a result of introducing economic liberalisation policies in 1977, becomes pertinent. Liberal economic policies so introduced opened the gates for acquiring imported products by those having sufficient purchasing power. This effect would have been incentivised by the highly skewed income distribution patterns that have been prevailing in the society; richest 10% of the population securing 36% of the household income (Department of Census and Statistics, 2019), while the share of household income accrued to the poorest 10% being just 1.6% (Center for Poverty Analysis, 2021). In such a context, it is natural that a class of consumers emerges, whose purchasing power would be high enough to enjoy "above-average" consumerist lifestyles, which could be highly "import-intensive".

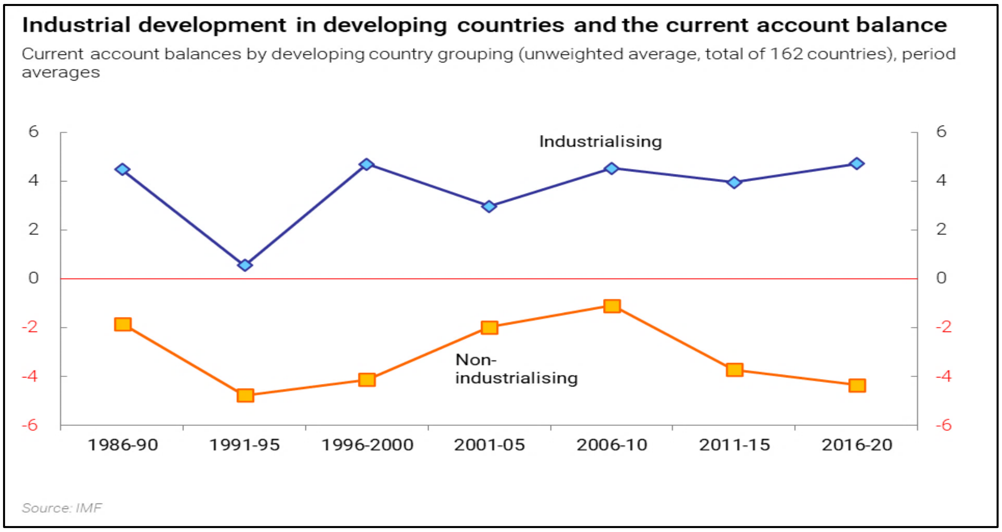
It is these "relatively rich" who burn imported fuel for private automobiles, particularly the four-wheeler passenger vehicles, who spend dollars for imported furniture, fittings, vehicles, and appliances for luxurious living, and who consume imported conspicuous consumables, but not the low-income earners in the society who barely manage to meet their basic needs. Moreover, it is possible, in such a context, that the middle-income groups also are tempted, may be through borrowings, to emulate those wealthier consumers in a "bandwagon" spree of conspicuous demand tendency. Their purchasing power, enabled through credit schemes offered by banks and credit cards in particular, could lead to a high-risk scenario, both in regard of "indebtedness of masses", and of import-intensity of consumption in the society at large. That could also be a factor stimulating accelerated growth of imports in the economies which have graduated to lower middle-income category, and have faced "retarding effects" in regard to securing the required economic growth rates to advance further into upper middle-income category, a phenomenon defined as "middle-income trap" (Felipe, 2012). Therefore, it is evident that the widened income inequality, coupled with free or relatively uncontrolled importability of consumables, could have acted as significant drivers behind the foreign reserve crisis caused by Sri Lanka's persistent current account and trade deficits.

(c) Failure to Venture into High Value-Added and Strategic Industrialisation

The Sri Lankan economic path has been identified by some researchers as marked with no coherent or sustained effort to strategically industrialise (Nicholas, 2023). This would have been a repercussion of the pro-liberal economic strategies pursued over the past four decades. Those strategies encouraged labour intensive soft industries, including those import-intensive and less technology driven economic activities such as garments, tourism and commercial ventures, in which the country was believed to have had comparative advantage. Relying on those, instead of strategically stepping into high-value added and technology intensive production processes in agricultural and industrial sectors, also would have deprived the economy of the opportunity of developing a strong export base over the years.

This pattern appears to be quite in contrast to the path adopted by the developing nations such as Viet-Nam and Malaysia in the recent past, and South Korea and Taiwan in the latter half of the 20th Century. The countries which had embarked on strategic industrialisation, particularly the export-oriented production, have successfully avoided foreign exchange crises (Figure 6).

Figure 6: Current Account Balances of Industrialising and Non-Industrialising Countries



Source: Nicholas (2023)

It is futile to believe that the market mechanism alone would provide adequate signals towards strategic industrialisation. Specific focus, through an interventionist approach, is necessary for a nation to leap-frog to invention, innovation and technological advancement. There were strategic niches which Sri Lanka could have exploited, particularly using her resource base, strategic location as well as her highly trainable human resources. Many opportunities for such strategic direction appear to have been foregone or purposefully ignored, possibly under the liberal economic ideological premise. The outcome has been the economy being lagging behind, depending largely on conventional crop export earnings, other than, possibly, the garments, a few IT-based products, and tourism. It is therefore not a surprise that the economy did not manage to upgrade its export impetus, and persistently faced current account deficits, leading to, and further aggravating, the foreign exchange crisis.

(ii) Other Potential Causes Behind the Crisis

Many other factors also could have either stimulated Sri Lanka's current economic crisis or prevented averting its precipitation; desire to defend the exchange value of the local currency to control inflation ("Second Generation model"), failure to weigh the impending crisis to resort to preventive or mitigative measures, and the Corona pandemic, figure among those.

First, the conflict between a fixed exchange rate regime and the desire to expand money supply, the characteristics of the "Second-Generation Model", appears bearing relevance to the pre-crisis conditions of Sri Lanka as the monetary authorities were reluctant to float the Sri Lankan rupee, while the effective demand stimulation was being explored via tax cuts and public spending, justified through, inter-alia, Corona pandemic-related necessities. This trend suggests that the Sri Lankan rupee would have been kept over-valued, possibly to maintain low levels of domestic inflation that could otherwise have been resulted owing to import price driven of cost-push factors (Nicholas, 2023). This reluctance to depreciate the local currency in the pre-crisis period and the resultant absence of import controlling effect of an otherwise depreciated local currency could therefore be recognised as another possible cause behind the dynamics leading to the foreign exchange crisis in Sri Lanka.

Second, the Government appears to have under-estimated the scale and ramifications of the emerging crisis in its formulation of strategic intervention, particularly in the aftermath of 2019. Already vulnerable foreign exchange reserve position, plagued largely by increased foreign debt dependence, should have been seriously taken note of by the policy makers when choosing strategies. While providing a boost to the already sluggish economy to promote growth through stimulating effective demand could be considered a credible strategy according to Keynesian economics, significant reduction of Value Added Tax rates and PAYE tax rates appears to have produced negative implications, both by reducing fiscal revenue, thus worsening budget deficit, and by providing signals for international credit rating agencies to down-grade Sri Lanka in 2020. The former effect would have yielded an added impetus to already activated "First" and "Second Generation" type crisis drivers (discussed above), and the latter would have compromised the country's ability to approach international financial markets when credit was badly needed to avert an imminent foreign exchange liquidity crisis.

Moreover, Corona pandemic driven restrictions disrupted even the usual economic activities including foreign tourism, making the management of the foreign exchange position further difficult, and thereby accelerating the precipitation of the liquidity crisis.

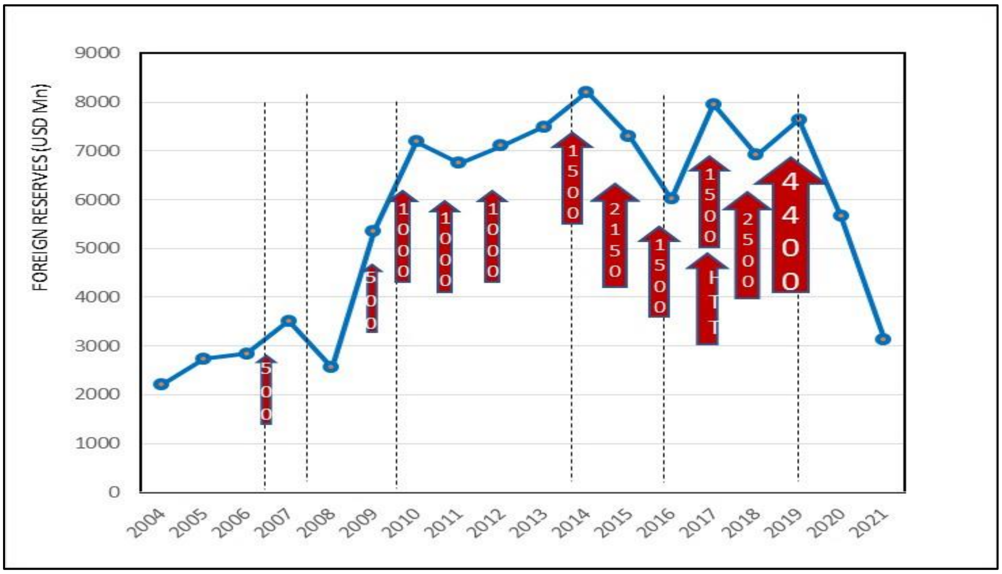
It appears that there has been a lack of foresight in the ranks of policy makers to properly assess the evolving dynamics of the impending crisis and also to manage it so that its implications would not emerge into surface as shortages of essential supplies that befell negatively, both in economic and political domains, on the incumbent Government. If not, the Government in power could have been recognised as the first ever regime since 1977 under which the outstanding foreign debt balance declined substantially and noticeably in 2020 (Figure 2), a commendable stride vis-à-vis national economic sovereignty, a supreme objective of any independent nation.

The Outcome: A Foreign Debt-Ridden Economy Vulnerable to External Shocks

The combined effect of all hitherto identified causes appears to have given rise to exponentially increased and unsustainable foreign debt stock. It is ironic that this rapid growth of external debt was experienced particularly in the aftermath of the defeat of terrorist insurgency in 2009, when, in fact, the end of the conflict should have eased pressures, both on fiscal expenditure and on the balance of payments; the former by way of not having to spend on warfare thereafter, and the latter through enhanced remittances and service incomes such as those from tourism. Yet, such a favourable effect could not be perceived when the patterns of evolution of foreign debts were perused (Figure 2).

Particular alarming trend was observed when the debt composition was examined; an increased reliance on international commercial borrowings from capital markets, termed as International Sovereign Bonds (ISBs), as depicted in Figure 7.

Figure 7: International Sovereign Bonds as Prop-Ups for Foreign Reserves



Source: Gunaruwan, T L, Presentation at University of Sri Jayewardenepura Seminar, May 7, 2022

The instability of foreign reserve level the Sri Lankan economy has been facing, particularly visible after 2014, is amply evident from this analysis. These ISBs, quite in contrast to borrowings for development projects, have been obtained essentially to finance balance of payment deficits, and have left no capital assets, thus with no or little growth impetus, but only liabilities. Besides, even those increasing amounts of ISBs, since of late, appear to have been unable to prevent collapsing of foreign reserves. Proceeds of leasing Hambantota Port for 99 years in 2017 also appear have been used to prop-up foreign reserves; yet ISBs in excess of USD 4 Billion had befallen required for the purpose, once again, in the single year of 2019.

This evolution is reflected in Table 1; the total Foreign Reserves by end-2019 having become inadequate even to settle the outstanding ISBs alone, quite in contrast with the position by end-2014, clearly indicating the vulnerability of the economy nearly two years prior to the precipitation of the foreign exchange liquidity crisis.

Table 1: Foreign Debts, International Sovereign Bonds (ISBs) and Foreign Reserves

As at Year-end	Foreign Debts (USD Bn)	Outstanding ISB Balance (USD Bn)	Foreign Reserves (USD Bn)
2007	16.5	0.5	3.5
2010	24.8	2.0	7.2
2014	42.9	5.3	8.2
2019	55.9	15.2	7.6

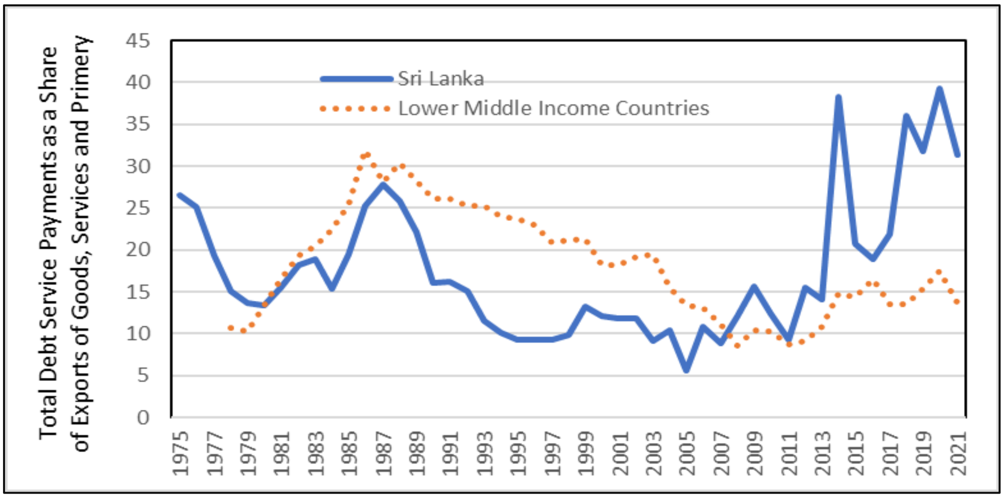
Sources:

(a) Annual Reports of the Central Bank of Sri Lanka (2019, 2015, 2011),

(b) (Cabraal, 2022), pp. 54-59

This accumulated foreign debt, particularly in the form of ISBs, was attributed by Nicholas (2023) as the proximate cause of Sri Lanka's economic crisis. Quoting Nicholas and Illanperuma (2023), he further recorded that, even though the percentage of ISBs as a share of total borrowings of the country was 36% by 2021, the majority of interest payments (70% of the total interest payable) stemmed from ISBs. Thus, according to him, the disproportionate shift to foreign borrowings in the form of ISBs was largely responsible for pushing Sri Lanka towards the foreign exchange crisis precipitated towards end-2021, which would possibly have been contributed by the Corona pandemic-related issues as well (Nicholas, 2023). The result, as could be perceived in Figure 8, has been a rapid augmentation of Debt Service Payments, which rose to more than one-third of the economy's export earnings and primary income in the aftermath of 2011, in a sharp difference from the evolution of the ratio experienced, in average, by Lower Middle-Income Countries.

Figure 8: Total Debt Service Payments as a Share of Exports and Primary Income



Source: Authors' construct based on the World Bank database

It is clearly observable in this analysis that the burden of debt service payments has followed somewhat similar patterns until late 1980s, and Sri Lanka has evolved much better than the lower middle-income countries, in average, until around 2005. As such, the rapid deterioration observable after 2011 period, and particularly since 2015, is a marked difference in the pattern of evolution of the "debt serviceability", a clear sign of the economy entering into a period of debt-driven foreign exchange crisis. This is tantamount to the "debtor's syndrome", indicating that the economy's bankruptcy de-facto occurred when more borrowings became required to service old debts; in other words, long before the de-jure declaration of bankruptcy by the Central Bank of Sri Lanka on 12th April 2022 (Cassim, 2022)

ANALYTICAL INFERENCES

Crisis Causality Dynamics: Roots Found in Economic Liberalisation

The outcomes of the present research brought to surface ample evidence to infer that the crisis in the Sri Lankan economy would have been caused largely by the uncontrolled trade openness, particularly adopted since 1977. This resembles closely to the Indian crisis in 1991 identified as resulted from current account deficits driven by faster growth of imports than exports in the aftermath of economic liberalisation (Cerra & Saxena, 2002). Liberalisation-driven acceleration of imports and the inadequacy of export impetus to earn foreign incomes to meet exchange liquidity requirements would have created increased foreign exchange deficits.

Therefore, it is evident that the persistent current account deficits the economy was running ever since liberalisation, leading to foreign exchange liquidity shortfall, and thereby to foreign borrowings and accumulated foreign debt, would have been among the root causes of the Sri Lankan economic crisis. The "mode of borrowings" in the form of ISBs would have further aggravated the problem. This would have gradually deepened the country's vulnerability to external shocks. The foreign reserves would have been badly hit when no more borrowings were possible, particularly from international capital markets, instigated particularly by further weakened ability to service debts and also by the gradual down-grading of the country's credit rating; thus, precipitating the crisis.

It is noteworthy that liberalisation policies implemented appear to have deprived the economy of the required manoeuvrability to (i) administer adequate protection to local produce to substitute for non-essential and substitutable imports, and also to (ii) incentivise Sri Lankan industries to develop in view of conquering export markets, a long-lasting negative implication. The removal of import restrictions induced imported products invading the local market, thus leading, on the one hand, to increased expenditure on imports, and on the other hand, to imported products gradually capturing the domestic market hitherto occupied by local industries causing the Sri Lankan producers to run out of business. This twin attack on local economic forces has proven quite critical; an observation that could be made through the closure of many an industrial operation in Sri Lanka including textiles, paper, chemicals and sugar, and some others being bought over by foreign entities. The expenditure on imports, in the meantime, was continuously increasing. The composite effect has been a sharp deterioration of trade and Current Account balances in the aftermath of liberalisation effected in 1977. The Sri Lankan economy could not so far escape from this trap (Figure 1), and possibly will take a long time to recover.

Other Causes: Relevance to Other Crisis Models

Apart from the main cause identified, namely, the liberalisation induced balance of payment difficulties, both in the forms of uncontrolled imports and inadequate export-oriented industrialisation, an attempt was made to relate to the Sri Lankan crisis those crisis models identified in literature. First, Second and Third Generation models, and experiences observed in some other countries which did not appear quite explained by such models, were therefore compared against the patterns observed in Sri Lanka during the years preceding the precipitation of the crisis towards late 2021 and early 2022.

As already discussed (Figure 3), Sri Lankan crisis appears to have had some relevance to fiscal deficit driven causality, as successive Governments have been running substantial fiscal deficits, at times even at the current account level. This reflects the persistent necessity to borrow, and possible inflationary pressures on the economy. Yet, as stated by Krugman (1999) in analysing the Asian crisis, not all countries which ran high fiscal deficits had to face exchange crises. Besides, persistent fiscal deficits need not inevitably lead to crises, at least in theory (Keynes, 1936), because such deficits, if not financed through foreign borrowings, and if used to finance productive and viable public investments capable of (a) yielding medium-term to long-term returns in adequate scales, and of (b) creating effective demand within the national economy, particularly during periods of recession, could stimulate growth and thus could not possibly lead to economic crises. Therefore, it is likely that the potential of "First-Generation Model", though is relevant, in explaining the causes behind the Sri Lankan crisis is likely to be limited.

Regarding the "Second-Generation Model", as discussed under the preceding section, the reluctance to depreciate the local currency could have been a possible causal factor behind the foreign exchange crisis in Sri Lanka. Yet, the fact that the Government let the rupee depreciate, ending its value almost half that prevailed a year before the crisis symptoms emerged, puts in question the degree of desire that had been present to "maintain fixed exchange rate", at least towards the latter part of the crisis precipitation. Thus, even though the Sri Lankan crisis could possibly have had a significant influence from the political desire to defend the rupee to dollar parity value while resorting to expansionary monetary practices, attributing the crisis fully to the "Second-Generation Model" would not be appropriate.

The "Third Generation Model", on the other hand, explains crises as essentially caused by the Governments having to bail-out banks running into difficulties; the Asian crisis in 1997 being cited as an example. In the Sri Lankan case, however, the study could not find any evidence to suspect the foreign exchange crisis being originated from any fiscal expenditure made to bail-out banks in difficulty. Therefore, the "Third-Generation Model" that underscored the Asian crisis could not be recognised as a significant causal factor, though there could have been some impact in the "reverse direction" making the banking system undergoing pressure in responding to international payments as a result of the general inadequacy of foreign exchange liquidity in the economy.

There could be other explanations as to how economic crises would have been originated or supported, including, inter-alia, the capital inflow-based reasoning and the hypothesis of incomplete liberalisation; examination of their respective contributions to the Sri Lanka's economic crisis may be undertaken through extended research in the future.

Causality of the Sri Lankan Crisis: A Structured Summary

Based on the findings of the present research, undertaken through an analysis of core macroeconomic factors and their evolutions during the pre-crisis years, the potent drivers of the Sri Lankan economic crisis, which mainly emerged as a rapid depletion of foreign currency reserves, and their corresponding degree of influence, could be perceived.

A comparative structured summary of the main crisis paths and their models recognised in literature, and their suggestive degree of relevance to the Sri Lankan crisis, inferred as an outcome of the present research, are presented in Table 2.

Table 2: Analytical Inference on Causality of Sri Lanka's Crisis Emergence

Crisis Causality Drivers found in Literature	Countries of Relevance and Sources	Relevance to Sri Lankan Crisis[#]
Failure to prevent rapid depletion of foreign currency reserve levels	Common denominator found in almost all crises Sources: Bird & Rajan (2003), Dania & Spillan (2007), Fischer (2001), Kumar et al. (2003), Disyatat (2001), Kaminsky et al. (1997), Calafell & Bosque (2003), Nicholas (2023), Guidotti-rule, Greenspan (1999)	Very high
Economic policy shift, from an import substitution to export-orientation, with liberalised imports galloping much faster than exports	Featured in the Indian Crisis Sources: Cerra & Saxena (2002), Chwieroth (2010), Dreher & Walter (2010), and Gunaruwan & Wickremaratne (2018).	High / Very high

Foreign capital inflows, causing boosts in imports more than promoting exports	Varied country experiences, including Latin American countries, Bangladesh, China, etc. Sources: Massell et al. (1972), Ahmad (1989), MacBean (1996)	Moderate / High
"Budget deficits" leading to public debt and credit expansion, and foreign reserve depletion	*First Generation Model* In Russian and European crises Sources: Krugman (1979), Allsopp (2003), Eichengreen & Wyplosz (2003)	Moderate
Conflict between a fixed exchange regime and the desire to implement an expansionary monetary policy	*Second Generation Model* Corresponding to Stirling Crisis Sources: Obstfeld (1994), Cole & Kehoe (1996) and Drazen (1998)	Moderate
Incomplete financial liberalisation, with weakened banking system due to regulatory forbearance, moral hazard and excessive risk-taking	Reflected in South Korean Crisis Sources: Zalewski (1999), Cargill (1998)	Low
Issues of the banking system, added by the ability of companies to invest during crisis periods and also by the role played by capital flows affecting the real exchange rates	*Third Generation Model* Characterised in the Asian Crisis Sources: Krugman (1999), Eichenbaum & Rebelo (2001),	None / Weak

Assessment by authors

Source: Compiled by Authors, based on the literature and on analytical results

Insights for Contemplating Remedial Strategies

At the outset, it could be suggested that formulating strategies to overcome the present economic crisis, and also to prevent recurrence of such crises in the future, should take into account the crisis causality drivers and paths identified in the present research, which could shed light on the comparative strengths and weakness of such strategic options considered.

The outcomes of the present study suggest that the Sri Lankan economic crisis, which surfaced as an acute deficiency of foreign currency reserves, has been caused by the surge of imports as a result of unchecked liberalisation of the economy leading to persistent deficits in trade and Current Account balances, and thereby to unsustainably high foreign debt burden. This would have had an added impetus from unplanned fiscal deficits, incurred on Government's recurrent expenses more than on public investment, and also could possibly have contained elements of waste and leakages as well, thus becoming merely debt-creating with no or inadequate growth creating or export promoting effect.

Open economic policies, anchored dogmatically on the concept of comparative advantage, appear to have prevented the Governments from resorting to industrial stimulations, particularly in promoting exports, in substituting for imports, as well as in providing domestic preferences to local producers, wherever feasible, particularly in public procurements. The desire to maintain low levels of import cost-push inflation would have induced successive Governments to sustain over-valued rupee against foreign currencies, which would have prevented the economy of securing automatic encouragement of export oriented and import substituting industries inherent in depreciating conjunctures. The composite outcome was a sluggish industrial sector, with inadequate support base in terms of technological advancement and development financing incentives. The capability of producing for export markets and for import substitution thus would have been weakened, preventing any balance of payment support coming significantly from productive activities. The highly skewed income distribution would have enabled those rich with purchasing power to buy imported products, the availability of which was facilitated by the liberalised imports; the ultimate outcome being a surge of imports, and the resultant aggravation of current account deficits.

It is evident, therefore, that the liberalisation policies adopted since 1977 has not only been among the main root causes driving the Sri Lankan economy towards the presently experienced foreign reserve crisis, but also has been, directly or indirectly, behind almost all other crisis-push factors which would have significantly aggravated the crisis. It is thus imperative that any remedial policies and strategies to overcome the crisis, as well as to prevent any recurrence in the future, will have to be carefully examined for their possible relevance to crisis causality drivers and paths identified through this research.

(i) IMF Bailout Package as a Way-Out

The bailout package offered to Sri Lanka by the International Monetary Fund (IMF) has to be perceived and examined in the light of these inferences. Even though a liquidity boost-up is necessary at the present stage of crisis, any such support, if coming with conditionalities attached, will have to be carefully reviewed by the policy makers to ensure that the country's path towards economic sovereignty, an uncompromisable goal, is not obstructed through such conditionality-tagged bailout support.

The IMF support is not a "grant", but a repayable loan. That monetary relief, though would temporarily ease the nation's foreign currency liquidity shortfall, will not only add to the already high foreign debt balance and have to be serviced, but also will not resolve, by itself, the root causes behind the economic malaise. Therefore, any breathing space, if obtained through the IMF bailout package, will have to be used strategically to put the economy back on the right track, so that the forward march will avoid the pitfalls in which the economy fell in the past. It would only be catastrophic if the IMF sanction is considered a "gate pass" for accessing international capital markets for further commercial borrowings; clearly the same path which brought the country to its present economic doldrums.

IMF's bailout package appears to contain five main strategic conditionalities (International Monetary Fund, 2023), namely, (a) fiscal consolidation, including institutional reforms, cost-recovery based energy pricing and stronger social security nets, (b) debt restructuring to ensure debt sustainability and stable financing of Government's operations, (c) price stability and exchange rate flexibility to alleviate burden of inflation, to rebuild reserves, to foster investment and growth, and to ensure ability to purchase from abroad, (d) financial sector stability to ensure that the sector could play its key role in supporting economic growth, and (e) structural reforms to abate corruption and enhance growth. While "good housekeeping practices" such as strengthening public investment efficiency, raising Government revenues, and abating corruption[6], have to be implemented by any futuristic Government regardless of whether stipulated those as conditionalities by any relief provider or not, many of the conditionalities in the IMF bailout package do not appear conforming to the crisis recovery directions indicated through the results of the present research.

If fiscal consolidation, for instance, is to be sought by further curtailing public investment, in the absence of any explicit mention of saving on wasteful recurrent expenditure such as those to maintain unproductive and duplicating different layers of governance and people's representatives, such cannot be considered growth friendly. Besides, the package appears to have not included the need to close the main door of resource leakage, namely the unchecked imports of locally substitutable non-essentials, a factor identified through the present research as an important cause of the exchange crisis.

Cost recovery pricing of energy can be a progressive step forward, only if the space is not blocked for strategic price differentiation among product variants and customers. Relative prices of diesel and petrol, for instance, could be strategically determined, within an overall cost recovery framework in the petroleum sector; diesel being growth related and public transport feeding, could be considered candidate for cross-subsidisation from petrol which is largely for private transportation and thus less associated with positive externalities. It is not clear whether the IMF bailout package has left room open for such manoeuvring by the policy makers.

The IMF conditionalities also appear having taken a stance that price stability and inflation control are essential attributes of a recovery strategy, a clear reflection of its

[6] "Governance Diagnostic Assessment" pertaining to Sri Lanka (IMF, 2023) has highlighted the problem of corruption in the Sri Lankan economic management as a priority issue to be addressed. For example, the cost of constructing highways in Sri Lanka, according to the report, is three time higher than the corresponding global average. This reflects capital deployment inefficacy in the State sector (Gunaruwan, 2023).

neoliberal conceptual foundation. The financial sector institutional reforms, explicit in the bailout package, appears to be targeting this objective via Central Bank's autonomy and quasi-isolation from fiscal administration; a possible path towards alienating the citizens, and their representatives in the legislature mandated as the authority of public finance, of the sovereign right to determine monetary policy. This purported isolation of the Central Bank from the national authorities cannot be considered as conducive towards developing Sri Lanka as an economically sovereign nation.

Structural reforms proposed appear to include restructuring of State-owned enterprises; a direction which could be considered progressive only if such are confined to making the establishments profitable and efficient, and not extended to alienation of their ownership to private hands, and particularly to foreign capital. If the reforms earmark building up foreign reserves by alienating national assets to foreigners and earning foreign exchange, such is tantamount to nothing but attempting to enable reserves for foreign purchase requirements by impoverishing the nation's future generations.

In an overall sense, it can be inferred that the IMF bailout package falls far short in recognising and addressing the core causes identified in this research, which have been plaguing the Sri Lankan economy over the last few decades and have led the economy towards the present crisis. Its implicit strategic direction appears to have been anchored on the neoliberal ideological framework, which in fact has been instrumental in causing the crisis, as inferred through the outcomes of the present research. Following such liberal foot-steps would only bring Sri Lanka towards another, possibly worse, crisis in the years to come; the foreign borrowing requirements in terms of ISBs in 2027 planned in the IMF Staff Report on Sri Lanka (International Monetary Fund, 2023) could be a reflection of continuing foreign debt dependence, and thus, persistence of an uncured malaise.[7] Along that path, Sri Lanka could evolve nowhere near to an economically strong and sovereign nation to which the future generations of her citizens would endeavour to belong.

(ii) Suggestive Ingredients in a Recovery Strategy

It is crucial that strategies for Sri Lanka's emergence out of the crisis be founded on proper understanding of its causal dynamics. In that respect, the findings of this research on crisis causality drivers enabled shedding light on broad strategic directions for Sri Lanka to recover from the present crisis, and to prevent recurrence of such crises in the future. These suggestive policy directions, summarised in Table 3, need to be studied in detail and validated prior to acceptance for implementation and before preparing strategic action plans; such will require much detailed and refined further research.

[7] Nicholas (2023) also was critical of the IMF package for its deemed ignorance of the disproportionate costs of Sri Lanka's ISBs being a proximate cause of the crisis, and for recommending more of such borrowings.

Table 3: Identified Causality of Crisis and Suggested Remedial Strategies

Causal Factor Identified	Corresponding Direction of Suggested Remedial Strategies
Foreign reserve shortages and foreign debts resulted in, due to persistent Current Account deficits in the aftermath of liberalisation	Any recommendation for deeper or broader liberalisation should be perceived with caution. Intervene through import substitution policies, and control non-essential imports. Prevent from running trade and current account deficits any longer.
Defending the exchange rate of the Rupee	Conducive exchange rate policy to promote exports and economise on imports.
Skewed income inequality	Intervene through policy, including fiscal instruments, to narrow-down the income inequality.
Fiscal inefficiencies and deficits	Improve efficiency in the public sector to reduce its recurrent and capital expenses. Accord, wherever feasible, local preference in public procurement, to reduce import intensity. Ensure that any effective demand sought via Keynesian Push (through fiscal deficits) is accrued to the national economy, and not leaked as imports. Avoid, wherever possible, borrowing from foreign sources, and ensure that fiscal deficits are bridged, to the maximum possible extent, through domestic financing.
Inadequate emphasis on strategic industrialisation	Resort to strategic industrialisation, both in export promoting and import substituting domains. Accord fiscal and monetary supports, by way of facilitation of capital and material inputs, and of technological knowhow.

Source: Compiled by Authors, based on the literature and on analytical results

It is however likely that these broad strategic directions could be perceived as "not in conformity" with the liberal economic agenda, and therefore, may not be endorsed by international monetary authorities. Yet, Sri Lanka would not be able to successfully emerge out of the present crisis without compromising her national economic sovereignty, while sustainably preventing recurrence of such crises in the future, if the policy makers do not resort to a strategic voluntarist approach, the outlines of which are proposed in the above summarised framework.

CONCLUSIONS

The outcomes of the present research enabled several important and interesting revelations. At the outset, it could be inferred that, even though the current economic problem has surfaced recently as a foreign exchange liquidity crisis, the root causes are likely to be found much deeper having evolved over a longer period of time, and those should be identified and comparatively assessed prior to contemplating remedial policy interventions. The foremost root cause thus identified was the failure to maintain adequate foreign currency reserves, possibly given rise to by unchecked liberalisation policies introduced in 1977, which, as in the case of the Indian crisis in 1991, had caused a deep trade and current account deficits ever since (Cerra & Saxena, 2002). This has necessitated foreign borrowings, particularly those in the form of ISBs, and when more and more borrowings became needed, even to service existing debts, the economy became vulnerable to external shocks. The result was inadequate foreign reserves to meet the payments in foreign exchange to import essentials, thus surfacing the crisis.

The research also identified several other crisis-supportive factors, such as (a) weak and undisciplined public finance (characteristic of the “First Generation” crisis model) necessitating to borrow from foreign sources, (b) the desire to defend the exchange value of the local currency (reflecting the features of the “Second Generation crisis model”) giving rise to inappropriate incentives vis-à-vis import substitution and export promotion, (c) the income inequality in the society enabling high-income earners having purchasing power to indulge in import intensive consumption of non-essential and luxurious goods and services, and (d) the failure to move into high value-added and strategic industrialisation. Not only that these factors have supported the apparent foremost root cause, but those also appear to have been reinforced by the conjuncture created by the said root cause.

The study also enabled the conclusion that the Corona pandemic, though would have contributed to the crisis, and possibly advanced it which otherwise would have occurred few years later, could not be diagnosed among the main root causes behind the present economic crisis surfaced as a “foreign reserve shortage” constraining importation of essentials.

Given that the economic liberalisation was perceived as one of the main drivers of the Sri Lankan crisis, it could consequently be concluded that the present crisis could not possibly be resolved through any further liberalisation of the economy. In fact, such deepening or broadening of liberalisation could potentially aggravate the crisis, and therefore, any remedial strategies recommended along that direction should be perceived essentially with caution.

It is this context that the relief package agreed upon with the International Monetary Fund (IMF), which compels the policy makers to implement more far-reaching and intensive economic liberalisation strategies, has to be re-appraised. If one of the foremost effective causes behind the crisis was the adoption of liberalisation policies disregarding national economic value addition requirements, and the necessity to overcome excessive and conspicuous consumption of imported goods and services, any further liberalisation would not stand a credible remedial treatment to cure the present crisis. Such strategic direction would only lead to a postponement of the crisis temporarily on re-acquired liquidity through the IMF relief. It could even lead to further aggravation of the economic malaise. The latter possibility cannot be ignored by the policy makers if they are concerned about safeguarding the economic sovereignty of the nation, which has been under threat due to unsustainable foreign debt the country has accumulated over the years, particularly in the aftermath of liberalisation of the economy in 1977.

In conclusion, it may be pertinent to underline that the gradual emergence of the present foreign exchange crisis in Sri Lanka was not a surprising occurrence to analysts who had alarmed the policy makers about the inappropriate strategies and policies that were being resorted to, and also about the danger of such policies and strategies possibly paving the way towards an eventual crisis (Gunaruwan & Wickremeratne, 2018). Unfortunately, such alerts went unheard. It is imperative that Sri Lanka's economic pathway be corrected if the country is to be sustainably taken out of the present crisis. The findings of the present research pertaining to crisis causality dynamics and the remedial strategic directions proposed based on its analytical outcomes may be duly considered, upon their validation through detailed impact analyses undertaken in future research, by the policy makers in formulating policies and action plans in view of overcoming the present crisis as well as of preventing their recurrence.

If such an objective is not set and a concerted strategic approach is not adopted without delay, the present crisis could persist longer or aggravate further; and even in an event of overcoming it eventually, the chances of emerging a worst crisis in the future could not be confidently excluded.

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