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DEBT ANALYSIS OF SRI LANKA: FACTORS AND FINANCES

Sugandh Kumar Choudhary
Assistant Professor, Department of Economics, S.S. Khanna Girl's Degree College Prayagraj, Uttar Pradesh

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ABSTRACT

Socio – economic condition in Sri Lanka has reached its bottom due to various social, political and Economic mismanagement. The tip of the ice berg has much more to do with extravagant public debt handling led by dynastic rulers of the tourist island. A fall in tax revenue collection, a spike in external debt to GDP, interest payments, and short-term debt are the underlying economic factors. Among the political factors, successive governments, to be in the government, resorted to short-lived and unsustainable remedies like borrowings from external creditors. The paper analyses series and sequences of debt crisis through the prism of economy, politics and ethnic issues plaguing Sri Lanka.

KEY WORDS: ***Tax GDP ratio, debt sustainability analysis, inflation, political stability***

INTRODUCTION

Public finance is the study of the revenue, expenditures, and fiscal situation of a country at various levels of the government (Chua et al., 2021). Efficient and prudent utilization of public funds is needed to ensure the sustainable growth and development of a country. Fiscal sustainability is important as it affects every citizen of the country. Non-citizens are also affected by fiscal management. The important components of fiscal management are tax collection, expenditures, national budget, deficit/surplus, and national debt (Ferrarini and Ramayandi, 2015).

Tax collections can be done majorly through direct and indirect taxes. Revenue generated from the proceeds of tax collection is used for various government purposes government. Expenditures include the details of government expenditures in a fiscal year.

The national budget is the combination of the above two – revenue and expenditures – in estimation over a specified period in the future (Bhowmick, 2022). A country's national budget is the calculation of expected income and expenditure during a fiscal year.

Deficit/surplus is the nomenclature used for the expenditure behavior of the government. If the government's total income exceeds its expenditure, the government is said to be in surplus (George et al., 2022). If expenditure exceeds revenue, then there is a deficit.

The national debt is the total amount of money borrowed by the government to fund the difference between its revenue and expenditure in a deficit situation. Various components of the national debt are – government securities, treasury bills, short-term borrowings, and external assistance (Paladino and Pradelli, 2022).

A country's fiscal situation needs to be evaluated based on the above parameters to ascertain its long-term fiscal sustainability (Mehta, 2022). The ongoing fiscal crisis in Sri Lanka is a critical case study in public debt management. The five parameters mentioned above are essential instruments of governance and public finance (Wang et al., 2022). The essay proceeds in three sections. Section I deals with the relevance of and suitability of Sri Lanka's case study to the topic of public debt management and the role of government. Section II studies the related factors and critical political and socio-economic variables that impact Sri Lanka's debt management. Section III studies one of the selected variables and its effect on Sri Lanka's public finance.

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SRI LANKA'S ECONOMIC CRISIS AND EXTRAVAGANT PUBLIC DEBT MANAGEMENT

Public debt is one of the paramount issues that has been discussed and debated in the academic circle quite often. As long the governmental set continues, the issue of the public debt shall arise (Hitchcock, 2022). One of the government's most important priorities is to be in government. To achieve this, the government must continue to increase the size of the cake in order to distribute the cuttings to the public to ensure their growth and development in perpetuity. Since growth and development is a continuous exercise that needs to be achieved, the funding of production, distribution, and even more production has to be ensured. In a resource-limited economy, the government often resorts to public borrowing (Melecky, 2021). Since public debt is a crucial instrument of governance, if go wrong may challenge the stability of the entire economy. If used irrationally and lackadaisically, public debt can push the economy towards a never-ending debt trap. The case of the Sri Lankan economy is for all to be seen. It should be a lesson for all governments and policy stakeholders and must be introduced in academics as a classic case study. Once a thriving economy propelled by tourism, Sri Lanka has been pushed into the public debt trap due to the nation's habitual borrowing tendencies (DeVotta, 2021).

It is common knowledge that borrowing is a double-edged sword that needs to be used rationally, economically, and judiciously. To prevent the economic fallout of poor public debt management, the World Bank has suggested *Debt Sustainability Analysis (DSA)* Framework to guide nations toward sustainable borrowing needs with their ability to pay.

DSA has three goals:

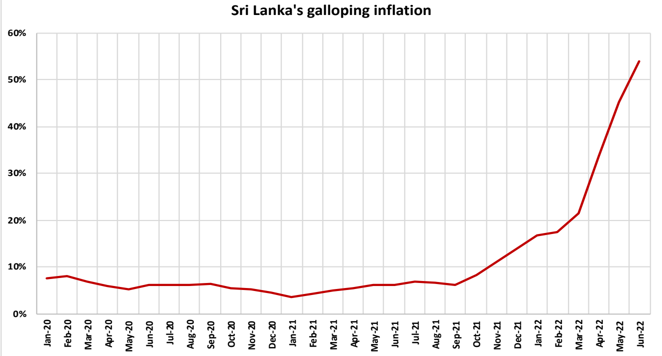
- Ensure the borrowing economy is on a sustainable development track
- Lenders must anticipate future risks and set terms of lending accordingly
- Guide countries with high borrowings to balance their debt with their capacity to service their debts (Laskaridis, 2021)

Considering the recent economic crisis in Sri Lanka, it is important to keep the records straight. The Sri Lankan government is accused of running populist macroeconomics and dynasty-run politics. Some of the evidence of glaring populism run by the family-run polity in 2019 include:

a) 6% reduction in the top marginal tax rate from 28% to 24%
b) 7% reduction in the rate of standard value-added tax from 15% to 8%
c) Abolition of nation-building tax
d) Tax-free allowance was raised from Sri Lankan (LKR) 5 00,000 to LKR 3 million (Statista, 2022).

This unwarranted generosity of the government resulted in the fall of tax revenue (percentage of GDP) from its peak of 12.5% in 2017 to 8.1% in 2020. Besides such populism, the COVID pandemic forced the government to announce economic stimulus, an increase in social safety spending, and a strong drive for universal COVID vaccination. Amidst all such forced expenditure on the government, the tourism sector, often labeled as Sri Lanka's 'growth engine', faltered badly during corona (Beddies et al., 2021). Earnings from tourism accounted for US$ 4,381 mn in 2018 and fell sharply to just US$ 682 mn in 2020. Such a drastic and unexpected fall in earnings from tourism proved to be an immediate trigger for the collapse of the Sri Lankan economy. This forced the government to borrow externally, even for daily operations of the government. External debt as a percentage of GDP increased from a comfortable 30.9% in 2013 to 40.4% in 2020 (Statista, 2022).

Thus, it is important that financial management should be essential to governance with the sole objective of sustainable debt and timely servicing of the borrowings. One of the most critical debates in academia is to what extent the government can borrow and spend. How can one agree upon the "quantum of borrowings" deemed sustainable? This debate often raises thorny questions for governments and Central Banks. It is challenging to measure future earning potential in the long run and ignore the populist tendency of governments that always want to be in power.



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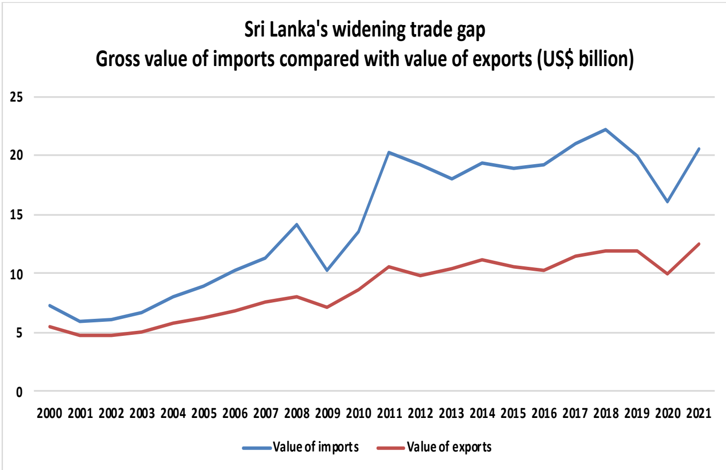
KEY VARIABLES AFFECTING SRI LANKA'S FISCAL MANAGEMENT

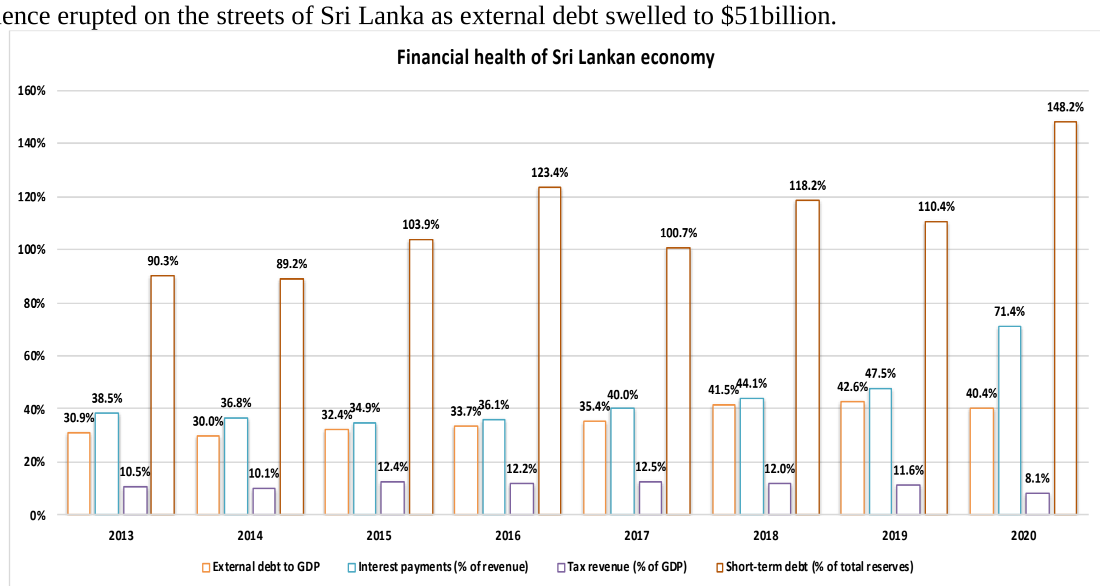
Economic Factors

The precarious economic situation in Sri Lanka is chiefly attributed to habitual borrowing and foreign debt obligations. The country, for the first time in history, defaulted on $78mn payments to external creditors of unpaid debt interest. External debt of more than $50bn is due to foreign creditors, to which the country is seeking urgent restructuring to make it manageable for payment (Madushanka and Sachitra, 2021). In a matter of a few months, the inflation rate astronomically rose from 6.2% in September 2021 to 54% in June 2022 (Indika and Gunasekara, 2021). As per the Central Bank of Sri Lanka, inflation will peak at about 70% over the next two months. The graph below shows the exponential growth in the inflation rate in Sri Lanka. One of the important reasons behind such high inflation is the fall in foreign currency reserves for imports of essential commodities for consumption. It is an irony that Sri Lanka dubbed commodities like milk, fruits, fish, and other 364 items as "non-essential" to stop their imports to tackle the economic crisis mainly triggered by the shortage of foreign exchange.

Sri Lanka's widening trade gap is evident from the adjacent graph. From a negligible gap between the gross value of imports and exports in 2000, the gap widened the most in 2021 (Illangakoon et al., 2022). The fall in export value resulted in the contraction of forex earnings in the country. Sri Lanka could have avoided the depletion of foreign currency by borrowing money from foreign creditors. But the country was already running into a huge foreign debt. Successive governments followed an easy money policy by borrowing from external sources and ran populist governance by propping up loss-making public utilities and funding infrastructure projects with excess capacities. However, Sri Lanka could have averted the forex crisis by buying its own currency using foreign reserves, but the country was already running short of it. The government banned the import of fertilizers to save forex, which led to another food crisis and spiraling inflation.



The overall economic health of Sri Lanka can be ascertained from the graph below. A fall in tax revenue collection, a spike in external debt to GDP, interest payments, and short-term debt are the underlying economic factors behind the burning of the President's house in the country on 9th July, 2022 (Walakumbura, 2021). Violence erupted on the streets of Sri Lanka as external debt swelled to $51billion.



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Political Factors

Election in Sri Lanka has always been fought on unrealizable promises such as tax cuts, salary hikes, free fertilizers, and subsidized rice, to name a few. Political parties distributed freebies to stay in power. Populist governments were voted to power by the voters without evaluating the credibility and economic viability of such tall promises. Elected governments found it difficult to fulfill their pledges as resources were shrinking due to cuts in taxes and an increase in subsidies. Successive governments, to be in the government, resorted to short-lived and unsustainable remedies like borrowings from external creditors. It proved to be a self-fulfilling prophecy for the economy. Higher the borrowings, the more the need to borrow. The approach followed by the political clan pushed the country into an unsustainable economic situation that has already been discussed earlier. After the country ran into a foreign exchange crisis, the government, in a bid to save forex, banned the import of fertilizers. It was marketed as the benefits of organic harvesting and chemical-free farming (Kulo et al., 2021). Most voters from rural areas were lured by the higher return from organic products, which usually were priced at higher levels. However, reduced fertilizer usage in agriculture caused a massive drop in food crop production. Vegetable prices almost doubled in a few weeks as farmers stopped cultivation due to low yield from organic farming. Farmers protested against the ban on imports of fertilizers by the government. Sri Lanka's annual import bill on fertilizers ran into $400 million (Reitemeier et al., 2021). Rising food costs fuelled protests all over the country against the government. Dynast ruling class crushed these protests with an iron hand resulting in many deaths and political killings in the island nation.

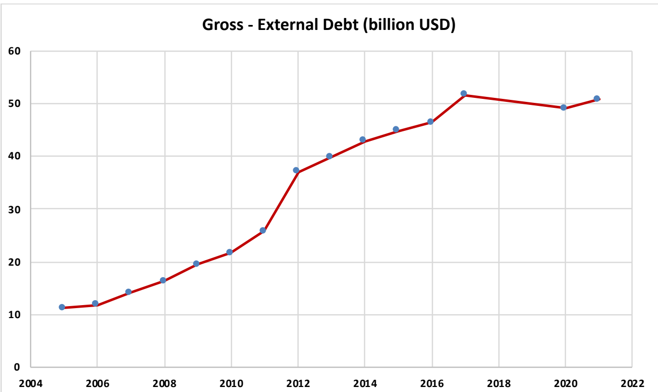
External Factors

Sri Lanka has entered one of the worst financial crises since its independence in 1948. The country defaulted on its creditors and failed to pay for essential imports. In June 2022, the government allowed four working days a week so that the fifth day could be used by its citizens for agricultural activities and growing food. The newspaper publishing house had to be shut down due to the shortage of printing papers and ink. Amidst such an economic crisis, the role of external factors cannot be ignored (Hewage and Amarasekara, 2022). Sri Lankan government was led by Mahindra Rajapaksa, in his zeal to make Sri Lanka a financial powerhouse like Dubai and Singapore. Easy loans coming from China were seen as a quick fix for the government's financial need that could be used to create infrastructure and global standard airports and ports. However, green pastures from China dried up soon. The government seemed to forget that there was no free lunch.

China refused large-scale monetary assistance to Sri Lanka amidst the crisis and denied their pleas to defer repayment of Chinese loans. China pushed infrastructure building projects at two ports, the Hambantota deep sea port and Mattala airport in the Hambantota district, that were commercially unviable in the long run. Heavy investment in these two projects proved to be white elephants with minuscule revenue generation for the government. China took over Hambantota port in 2017 for 99 years lease as Sri Lanka defaulted on a $1.4 billion loan to the Chinese. China's economic colonization of Sri Lanka was sealed with the accession of 15,000 acres of land surrounding the airport (Ravindran and Kengatharan, 2021).

On the other hand, Mattala international airport was built with a $210 million loan from China on high-interest commercial loans. Mattala airport was built to handle one million passengers annually. Such massive excess capacity creation on high-interest loans proved to be an economic disaster. Airport revenue could not even pay the electricity bill.

The bird view of the external debt of Sri Lanka shows that it spiked between 2005 and 2015. External debt rose from $ 11.3 billion in 2005 to $ 44.83 billion in 2015. In 2021, the external debt stood at $ 50.72 billion. Sri Lanka took heavy loans worth $ 40 billion in the last 16 years; surprisingly, 25% of the loan came from Chinese generosity. According to Sri Lanka's Department of External Resources (ERD), "The amount of loan funds obtained from China from 1971 to 2004 was very marginal, and it significantly increased after 2005." At the end of 2021, China accounted for 20% of total Sri Lanka's loans, out of 14% was Chinese debt stock, and 6% was in term loan facilities (Dissanayake et al., 2021). To add salt to the injury, China and Rajapaksa decided to start a land reclamation project and build an artificial island of 269 hectares. It was supposed to be made by China and considered Sri Lanka's "economic game changer".



Ethnic Issues

Most of Sri Lanka's population are Sinhalese Buddhists, who constitute 70% of the population. Politicians like Wickremesinghe and Rajapaksa have been put in power by the majority of Sinhalese people in the country. The country has a long history of discrimination against minorities in Sri Lanka. The discrimination began in 1956 with the implementation of the Sinhala Only Act by S.W.R.D. Bandaranaike - the fourth Prime Minister of the island nation. The bill forced Tamils out of the key employment sectors, making Sinhalese the official language of the country. Such provisions in the bill were vehemently opposed by the Tamil-speaking minorities, and the country witnessed massive rioting and civil war (Wimalana and Koswatte, 2021).

Ethnic differences have allowed the majority Sinhalese Buddhist ideology as a significant consideration for voting in elections. With such ideological regards and complete disregard for political acumen, economic efficiency, and other factors by the majority of Sinhalese voters, the position of powers has allowed extra space to its leaders for massive corruption and mismanaging the economy. The country ultimately stands bankrupt and is facing one of the worst economic crises since independence (Hettiarachchi et al., 2021). No country can progress unless there is political stability. With inherent instability in Sri Lanka due to racial and ethnic discrimination, the government has witnessed the longest civil war from 1983 to 2009, mainly led by the Liberation Tigers of Tamil Eelam (LTTE). The group fought to create an independent Tamil state. The group was crushed and defeated with brute force by Sri Lanka's government but not before pushing the country into a more profound social and ethnic divide that raised serious questions for its people and the society. More than half of its post-independence history is marred by a long and bloody civil war with catastrophic impacts on its ordinary people.

SRI LANKA – A CLASSIC CASE OF A TWIN DEFICIT ECONOMY

The twin deficit is the most critical economic issue faced by many governments. It refers to fiscal deficit and current account deficit. An economy faces a *fiscal deficit* issue when the government incurs a high expenditure not supported by income generation to fund their expenses. Governments take recourse to borrowings to bridge the gap between income and spending. The current account deficit (CAD), on the other hand, is the gap between the income received by selling products abroad and the money spent on the purchase of goods and services from foreign countries (Banday, 2021). In plain and simple terms, the current account deficit (CAD) implies that the money outflow of a country through imports is more than the inflow of money into the country. When both the deficit – fiscal deficit and current account deficit – occurs simultaneously, it is called a twin deficit.

The twin deficit problem overpowered an island nation with a 22 million population. The cascading effect of deep economic mismanagement forced the nation into a severe twin deficit problem that was never seen before in the history of Sri Lanka's economy (Damayanti and Gunawarshana, 2021). Prolonged power cuts and soaring inflation dealt a double blow to the government's effort to tackle the economic crisis, which soon spiralled into a widespread humanitarian crisis. Badly timed tax cuts, sudden COVID pandemic, and Ukraine war, along with corrupt political dynast at the helm of affairs at the highest level, severely undermined any effort to revive the faltering economy. Among numerous such factors that pushed the economy into the crisis, this part of the essay focuses on the problem of the twin deficit in the country.

TWIN DEFICIT: CAUSES AND CHALLENGES

Twin deficit challenges signify that the economy's fiscal deficit and current deficit move in tandem in the same direction with a high degree of correlation. A consistently high level of current account deficit signifies a deep-rooted problem in the economy of living beyond its means with heavy borrowings in the external market. The twin deficit in the economy points towards a consumption-driven economy mainly led by high debt. But there is another side to the coin. A high current account deficit is not necessarily bad for the economy, provided a high current account deficit is utilized for imports of investment goods that may generate necessary returns in the economy. But the case of Sri Lanka is starkly different. The current account deficit was mostly used for funding consumption goods which did not generate needed returns. Reliance on foreign debt increased. It exposed the Sri Lankan economy to external shocks like the COVID pandemic and the Ukraine war.

The COVID pandemic and Ukraine war inflicted a critical blow to Sri Lanka's potential to earn foreign currencies through tourism. Structural transformation undertaken by the government proved to be inadequate to address savings – investment gaps. The government was left with no leg space to manoeuvre funds for public investment purposes (Manohraran, 2021). Persistent current account deficit and government debt servicing in the form of interest rates resulted in the value erosion of Sri Lanka's currency. The domestic currency (LKR) depreciated steadily, hitting the economy hard in terms of payments for imports. In the desperation to bail out itself from the deepening economic crisis, Sri Lanka's central bank allowed to depreciate LKR further with a rate limit of LKR 230 to US dollar. Failure to deliver deep structural reform by the successive governments, frequent availing of easy credit by foreign creditors, which had its own cost, the tendency to postpone immediate economic issues, and resorting to short-lived remedies caused periodic economic crises necessitating intervention from the IMF as the lender of the last resort for the country.

PERSISTENT INFLATIONARY TENDENCY DUE TO MACROECONOMIC INSTABILITY

With little input from monetary policy, the government often resorted to random fiscal austerity measures. Rising inflation was mainly due to non–existent production capacity. Private investment almost dried up. As a short-term relief from inflation, the government kept prices down artificially by announcing price caps and administered price controls. The anti-export policy of the government added more problems than solutions to an already overstretched fiscal situation of the economy. With a high rate of inflation, private investment no longer remained an attractive option for investors due to value erosion and poor demand. Generally, high interest rates tend to crowd in private investment but were not enough to materialize into a real investment at the ground level (Ha et al., 2022). High inflation and poor macroeconomic policy lead to excessive reliance on foreign funds. In the short term, it helped to finance public investment without an additional burden on domestic financial sectors. Long run impact of such short-term measures led to currency risk with ballooning external debt. Fiscal expenditure often correlated with election cycles as political parties made unviable promises to their vote banks. Every party worked to out-compete their political opponents in announcing freebies and tax cuts if returned to power. Elected politicians were morally bound to fulfill their promises as their political career depended upon the fulfillment of tall commitments made during the election. Whenever the economy faced cycles of high inflation, price rises were suppressed as immediate relief to the public.

Ethnic conflict accentuated the economic situation of the country. With widespread violence, the dominance of Sinhalese Buddhist ideology ignoring other minorities, prolonged civil war, with the absence of genuine effort from the political class to address these issues led the economy into a vicious cycle of high inflation – exchange rate risk, and high fiscal deficit. Family-run government at the top had little intent to hand over the regime to a truly democratically elected government. The Rajapaksa government has been accused of obtaining personal kickbacks from Chinese investment in the country (Rudd, 2022). Whenever common people led street protests against the government's inability to efficiently run the country, the government declared an emergency, imposing a curfew in the name of crushing the extremists in the public interest. Prolonged political instability and macroeconomic disturbance would further worsen the economy of the country. Huge unemployment in the economy has done little to channel youths of the country toward productive activity. Paradoxically, Sri Lanka's high ranking on the Human Development Index puts a completely different picture that is totally opposite to the ground realities in the country (Coenen et al., 2021). Political instability and macroeconomic soundness should be included in the human development index. Otherwise, the reliability of such indices is questionable and not in sync with the reality on the ground.

CONCLUSION

The essay dealt with the current economic situation in Sri Lanka in detail. However, there is more to it that could have been addressed. Issues like ethnic apartheid, racial discrimination, and discrimination on the religious ground need special focus from various stakeholders in the country. The role of civil society needs to be stressed and highlighted. The word limit of the essay has constrained foray into dealing with such sensitive but prominent issues.

However, it is aptly clear that the overall macroeconomic situation in Sri Lanka is disturbing and unwarranted. The political class has held the entire economy at ransom due to their personal interest and lack of motivation to undo the historical wrongs committed against their citizens, especially against the minorities. The country must address the issue of dynastic rulers, and constitutional amendments to empower and implement real democracy should be the right approach. Constitutional limits to the announcement of populist promises during elections and freebies must be enforced. Widespread fiscal mismanagement must be curtailed by forming a committee responsible for the Fiscal Responsibility Management Act. Approval for obtaining external credit must be obtained from the parliament of the country and should not be left in the hands of the party in power. Monetary policy has been rendered ineffective in Sri Lanka due to an over-emphasis on fiscal policy. The Central Bank of Sri Lanka must be empowered to manage currency risk and exchange rate risk and must be allowed complete autonomy in deciding monetary policy. A massive drive for employment and export-led growth should be encouraged to boost export competitiveness in the country. Private players and corporate houses must be allowed to have greater say in the economic progress of the country. A step towards inclusive development accommodating ethics and religious differences are warranted from the oldest democracy in Asia. The government, people of the country, and civil society have a high stake in the country and are responsible for the overall progress of the economy and human development. A huge responsibility lies with them to justify

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their high ranking in the human development index. No economy can progress without active participation from civil society and people. It is high time that the country realizes that

the government is of the people, by the people, and for the people and not the other way round. A robust mechanism for checks and balances at each level is the need of the day, and all political parties must reach a unanimous agreement to uproot the corruption that has ensued in the political class of the country. Only then can Sri Lanka enjoy the fruits of real growth, inclusive development, and prosperity. Gandhian principle of focusing on rural development should be the starting point of economic reform that will address issues related to liberty, equality, and fraternity as a prerequisite to the basic structure of a well-ordered society.

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