



An Insight into the Sri Lankan Economic Crisis

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Abstract

A default can seriously damage investors' confidence in a country, making it harder for it to borrow money on international markets and threatening the value of its currency. Sri Lanka owes \$50bn (£40bn) to foreign creditors but says it cannot pay them. It is asking for a loan from the International Monetary Fund (IMF). Prime Minister Wickremesinghe has said the nation also urgently needs \$75m (£60.8m) of foreign currency in the next few days to pay for essential imports such as fuel. For months, Sri Lanka has lacked the foreign currency to buy all that it needs from abroad. Shortages of food and fuel have caused prices to soar. Inflation is now running at 30%. There have been power cuts, and a lack of medicines has brought the health system to the verge of collapse. People started protesting out on the streets of the capital, Colombo, in early April and the protests have spread across the rest of the island.

Introduction

The ongoing 2019–2022 Sri Lankan economic crisis is characterized by economic mismanagement, a rise in external debt, depleting foreign exchange reserves, a weakened currency, and rising prices¹. The crisis has been caused by multiple compounding factors such as tax cuts, money creation, a nationwide policy to shift to organic or biological farming as well as events such as the Easter bombings in 2019 and the impact of the COVID-19 pandemic. By March–May 2022, the ruling coalition had lost its majority and political turmoil increased including the resignations of cabinet ministers. The shift to organic farming was reversed following a drop in output and food shortages².

Sri Lanka had been earmarked for sovereign default, as the remaining foreign reserves of US\$1.9 billion as of March 2022 would not be sufficient to pay the country's foreign debt obligations for 2022, with US\$4 billion to be repaid. An International Sovereign Bond repayment of US\$1 billion is also due to be paid by the government in July 2022. According to Bloomberg, Sri Lanka has total due repayment of US\$8.6 billion including both local debt and foreign debt³.

In April 2022, the Sri Lankan rupee had plunged to a record low to become the worst performing currency in the world with US\$1 trading at Rs.315. On 12 April 2022, in a report published by the Government of Sri Lanka it indicated that it has taken steps to temporarily default all of its external debts worth US\$51 billion in order to avoid the hard default⁴. The announcement has also ended Sri Lanka's streak of having maintained an unblemished record of external debt service. CBSL Governor Nandalal Weerasinghe insisted that Sri Lanka will restructure the debt to avoid the hard default.

Background

According to W. A. Wijewardena, a former Deputy Governor of the Central Bank of Sri Lanka, the country was a long way into an economic crisis in 2015. The government which came into power in 2015 knew this and had been warned by the Institute of Policy Studies of Sri Lanka of a number of risks⁵. While Prime Minister Ranil Wickremesinghe in 2015 had presented a strong economic policy to address the situation, the coalition government could not get the policy pushed through Parliament which would eventually result in further policy confusion in the coming months. The government did not adequately address the economic warnings and new dangers emerging, consuming itself in other government related activities such as "constitutional reforms"⁶.

Certain practices, including those by the Ministry of Finance led by Ravi Karunanayake, were globally frowned upon. Election related economic decisions were pushed such as excessive distribution of freebies⁷. The Institute of Policy Studies of Sri Lanka's 2014 State of the Economy Report highlighted hot money, worrying borrowing practices, temporary and superficial quick-fixes and monopoly of FDI flow into one sector hospitality. In 2018 further political turmoil worsened the economic outlook⁸. Despite the turmoil by 2018 the government had carried out several reforms under an IMF supported program towards fiscal monetary consolidation and had successfully controlled inflation. These reforms included an automatic fuel pricing formula which significantly reduced fiscal risks posed by state-owned enterprises (SOEs), raised the for Value Added Tax (VAT) rate from 11 percent to 15 percent and broadened the VAT base by removing exemptions. Many of the reforms were reversed by the new government after the 2019 elections⁹.

Many experts compared Lebanon's economic situation with that of Sri Lanka and had warned that Sri Lanka too was on the way to defaulting on its sovereign bonds. Moreover, Sri Lanka was compared with Lebanon for having similar issues including how both countries had been running into deep economic crises after their successive governments managed to pile up unsustainable debts following the end of civil wars in their respective nations¹⁰.

Causes

1. Tax cuts and money creation

The Government of Sri Lanka under president Gotabaya Rajapaksa made large tax cuts which affected government revenue and fiscal policies causing budget deficits to soar. The government increased the tax-free thresholds resulting in a 33.5% decline in registered taxpayers while the VAT was reduced to just 8% and the Pay As You Earn (PAYE) tax was entirely abolished. In 2021 P. B. Jayasundera stated that President Rajapaksa was aware of the loss of revenue but considered it an "investment" and have no plans to increase them for another 5 years¹¹.

To cover government spending the Central Bank began printing money in record amounts, ignoring advice by the International Monetary Fund (IMF) to stop printing money and instead hike interest rates and raise taxes while cutting spending, as well as another IMF warning that continuing money printing would lead to an economic implosion¹².

On 6 April 2022, the Central Bank allegedly printed whopping 119.08 billion rupees making it the highest reported amount printed on a single day by CBSL for the year 2022. The total money added to financial markets for the year 2022 thus increased to Rs. 432.76 billion¹³.

2. Tourism

The country's tourism sector represented over one tenth of the GDP of Sri Lanka. The sector was negatively affected by the 2019 Easter bombings, and the COVID-19 pandemic prevented recovery. According to the World Bank in April 2021, "Despite the heavy toll of the COVID-19 pandemic on Sri Lanka's economy and the

lives of its people, the economy will recover in 2021, though challenges remain." Positive signs of recovery are already being observed, proper taxation to build up self-dependence and to avoid high dependence on foreign debts in future has been highly encouraged. The current social protection initiatives to help those that have lost their jobs during the debt crisis have been deemed effective. Economists suggested that besides proper taxation, a more export-oriented growth would be necessary to uplift the Sri Lankan economy from the current debt crisis, and it was hoped that Sri Lanka would make a full financial recovery¹⁴.

3. Agricultural crisis

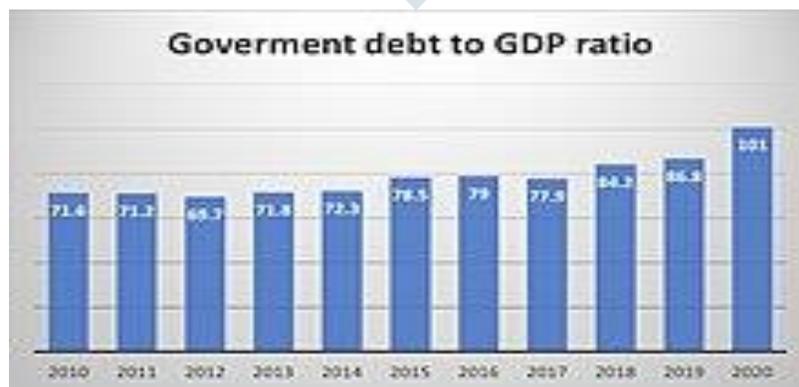
In April 2021, President Gotabaya Rajapaksa announced that Sri Lanka will only allow organic farming totally banning inorganic fertilizers and agrochemicals-based fertilizers. The drop in tea production as a result of the fertilizer ban alone resulted in economic losses of around \$425 million and created a 20% drop in rice production within the first six months alone reversing previously achieved self-sufficiency in rice production and the country was forced to import rice at a cost of \$450 million. The situation in the tea industry was described as critical, with farming under the organic program being described as ten times more expensive and producing half of the yield by the farmers.

The program was welcomed by its advisor Vandana Shiva, but it ignored criticism from the scientific and farming communities who warned about the possible collapse of farming, including a financial crisis due to devaluation of national currency, which pivoted around the tea industry.

The banning of the trade of chemical fertilizers and pesticides produced a severe economic crisis, since the population expects to remain without income and without food. In November 2021, Sri Lanka abandoned its plan to become the world's first organic farming nation following rising food prices and weeks of protests against the plan. The government cancelled some measures, but importing urea remains banned. Sri Lanka is seeking to introduce peacetime rationing of essential goods.

4. Russo-Ukrainian War

The repercussions of the ongoing tense situation between Ukraine and Russia due to the Russo-Ukrainian War is felt in the already sluggish economic conditions of Sri Lanka. The 2022 Russian invasion of Ukraine has further exacerbated the economic calamity of the country as Russia is the second biggest market to Sri Lanka in tea exports and Sri Lanka's tourism sector is heavily reliant upon these two nations as most of the tourist arrivals are from Russia and Ukraine. As a result, the Ukrainian crisis has put a halt to the path of economic recovery of Sri Lanka with both tea and tourism sector have been hit hard¹⁵.



Impact

In 2021, the Sri Lankan Government officially declared the worst economic crisis in the country in 73 years. In August 2021, a food emergency was declared. However the government denied food shortages. Sri Lanka's Energy Minister Udaya Gammanpila acknowledged the crisis could lead to a financial disaster. In early April 2022 the Governor of the Central Bank of Sri Lanka Ajith Nivard Cabraal was replaced by Nandalal Weerasinghe. On 5 April 41 members of parliament left the ruling coalition causing a loss of majority in the Parliament.

1. Electricity and fuel shortages

The economic crises has resulted in declines in electricity, fuel and cooking gas consumption, resulting from shortages. Finance Minister Basil Rajapaksa urged all government authorities to switch off all street lights at least up until the end of March 2022 in an attempt to conserve electricity. Nearly 1000 bakeries have been shut as a response to shortages of cooking gas. Long queues have formed in recent months in front of petrol filling stations. The surge in global oil prices further aggravated the fuel shortage. In order to conserve energy, daily power cuts have been imposed by the authorities throughout the country. On 22 March 2022, the government ordered the military to post soldiers at various gas and fuel filling stations to curb the tensions among people who line up in queues and to ease the fuel distribution. Casualties include four fatalities due to fatigue and violence¹⁶. Daily seven hour power cuts were seen throughout March 2022 and increased to 10 hours at the end of the month. The dailies *The Island* and *Divaina* stopped print publication due to paper shortages and related price escalation and switched to e-papers. Sri Lanka's hydroelectricity generation has also been affected.

2. Inflation

As of February 2022 inflation was 17.5%. The year on year increase inflation for food was 24.7% while non-food items saw a 11% rate. The year on year change (Feb 2021 to Feb 2022) for local red chilis increased by 60%, local potato's by 74.8% and Nadu rice by 64%.

3. Education

In March 2022, several schools in Sri Lanka announced that their term/mid-year examinations would be postponed indefinitely, due to paper shortages throughout the country mainly triggered by the lack of foreign reserves to import paper. The term test examinations were slated to be held island-wide on 28 March 2022 but due to the acute shortage of printing paper and ink ribbons, a decision was made to either fully cancel or postpone the exams to a later date¹⁷.

4. Health

On 29 March, all scheduled surgeries at the Peradeniya Teaching Hospital were suspended due to a shortage of medicines. Other state-run hospitals were also reported to be running out of life-saving medicines. On 8 April, the Medical Council of Sri Lanka issued a warning that there would be a catastrophic number of deaths, which is likely to be in excess of the combined death toll of COVID-19, the 2004 tsunami and the Civil War, unless a replenishment of supplies is made in a matter of weeks.

By 10 April, hospitals had begun to run out of endotracheal tubes for the ventilation of new-born babies, infants and children. Doctors requested that overseas Sri Lankan communities provide neonatal ETTs 4mm, 3.5mm, 3mm, 2.5mm, and 2mm in sizes. The Sri Lanka Medical Association said that all hospitals in the country no longer had access to imported medical tools and vital drugs¹⁸.

5. Tourism

In March 2022, the United Kingdom and Canada warned their travellers to be aware of the current economic situation in Sri Lanka.

6. Exports

The Economic Times of India reported that due to the prevailing economic crisis in Sri Lanka; leading textile brands including Zara, Mango and H&M have diverted their attention from Sri Lanka to India in order to place their orders. Following the worsening economic as well as political conditions in Sri Lanka, India has witnessed a sharp surge in overseas orders for textiles and tea products as export demand for India has increased greatly.

7. Entertainment and sports

Leading internet protocol television service provider in Sri Lanka, SLT PEO TV has temporarily stopped and suspended foreign channel telecast operations due to payment difficulties owing to dollar crisis and economic crisis in Sri Lanka. The 2022 edition of the Indian Premier League was also stopped midway due to inability to make payments to host broadcaster Star Sports. The plummeting of dollar reserves also hampered the livelihood of sportspeople in Sri Lanka and many national sports associations were unable to send their teams for international sporting events especially with multi-sporting events such as Asian Games and Commonwealth Games are around the corner¹⁹.

Conclusion

(a) Economic Status

1. Diplomatic relations

In January 2022, Sri Lankan High Commission in Nigeria, consulates in Germany and Cyprus were temporarily closed down due to lack of foreign reserves. In March 2022, Sri Lankan Embassy in Iraq, Sri Lankan Embassy in Norway and consulate in Australia were also closed due to lack of dollar reserves.

2. International Monetary Fund

Since 1950, Sri Lanka has been part of 16 loans arrangements with the International Monetary Fund. Recent bailouts were in 2009 and 2016. IMF did not accurately predict the severity of the following crisis.

Despite the growing concerns over the inflationary pressure, Ajith Nivard Cabraal, the Governor of the Central Bank of Sri Lanka (CBSL), said in January 2022 that Sri Lanka does not need International Monetary Fund (IMF) relief, as he was optimistic that Sri Lanka can settle its mandatory outstanding debt, including its international sovereign debts. As of February 2022, the foreign reserves of Sri Lanka fell to \$2.36 billion. Sri Lanka has foreign debt obligations of \$7 billion, including \$1 billion worth of sovereign bonds which is to be repaid by July 2022. The government is planning to hire a global law firm to provide technical support and assistance on debt restructuring. A delegation from the IMF made a visit to Sri Lanka from 7 December to 20 December 2021 in order to assess and review Sri Lanka's economic policies. The IMF's executive board had discussed Sri Lanka's economy after the end of the annual discussions which took place on 25 February 2022. As of 25 February 2022, the IMF had declared that the public debt of Sri Lanka is unsustainable and warned the Sri Lankan government to refrain from printing money to prevent monetary instability, but lauded the vaccination drive which had cushioned the impact of the pandemic. The IMF had assessed the prevailing

economic calamity of Sri Lanka by compiling an Article IV Consultation Assessment. In addition, the IMF predicted that the economy of Sri Lanka is expected to grow by 2.6 percent by 2022.

As of 7 March 2022, Ajith Nivard Cabraal reported that the regulator of the banking system was effectively devaluing its national currency with immediate effect, and the official rupee rate fell to a record historic low of Rs. 229.99 against the US Dollar. The devaluation decision is also seen as a massive step-up in the country's attempt to seek IMF assistance and bailout. The former deputy governor of the CBSL, W. A. Wijewardana, criticized the monetary policy decisions undertaken by CBSL, especially for its decision to fix the rupee to Rs. 230, indicating that the FOREX crisis cannot be solved unless the floating exchange rate is implemented. Opposition MP Harsha de Silva opined that the devaluation of LKR to Rs. 230 is still insufficient and not enough to avert Sri Lanka's foreign reserve crisis.

In March 2022 President Rajapaksa had made a statement that his government would work with IMF. On 7 April an expert presidential advisory group consisting of Indrajit Coomaraswamy, Shanta Devarajan, Sharmini Cooray was formed by the President to assist with the situation including proceedings with the IMF.

3. Monetary Policy

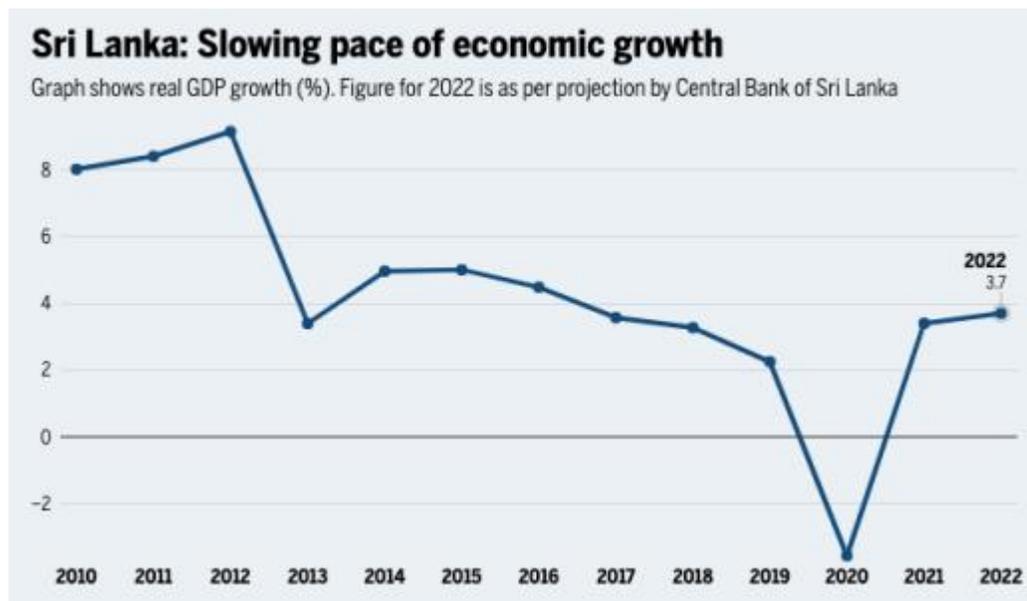
On 8 April 2022, the Central Bank of Sri Lanka further tightened the monetary policy (contractionary monetary policy) to curtail soaring inflation by raising both the Standing Lending Facility Rate and Standing Deposit Facility Rate by 700 basis points.

4. Reactions

Local newspapers have depicted cartoons of Sri Lanka pleading for cash from neighboring SAARC countries. On 7 April 2022, the private sector of Sri Lanka collectively in writing made a request to restore political stability in order to foster the economy. Around 38 organizations collectively representing exporters, importers, manufacturers, shipping and logistics sector and tourism sector have appealed to the parliament to resolve the economic crisis to prevent catastrophe. On 7 April 2022, the Chamber of Young Lankan Entrepreneurs (COYLE) had also made an appeal to the government to solve the current economic and political crisis and had warned that if the issue had not been addressed with due diligence it could lead to closure of businesses.

Former justice minister Ali Sabry had pleaded for political stability and insisted that Sri Lanka needs an immediate bailout or a moratorium from multilateral agencies such as the IMF, World Bank and Asian Development Bank. He also insisted that there are no other options except to seek assistance from multilateral agencies to cope up with the crisis and especially he called on the government to restructure the US\$1 billion ISB bond repayment which matures around July 2022.

On 8 April 2022, former World Bank official Shanta Devarajan had warned that the biggest risk Sri Lanka is going to face is the social unrest and turmoil. He highlighted that cash transfer program can be initiated aiming at helping the poor people in addition to reduction in subsidies on food and fuel in order to avoid the collapse of the economy. Moody's Investors Service had warned that the wave of resignation of cabinet ministers would only heighten policy uncertainty and as a result it will make hard when obtaining or borrowing external finance.



(b) International Scenario

Since 2010, Sri Lanka's foreign debt more than doubled between 2010 and 2020. While foreign debt was about 42% of the GDP in 2019, it rose to 119% of its GDP in 2021. By the end of 2022, the country is due to pay US\$4 billion to debtors, whereas in April 2022, government reserves amounted for US\$2.3 billion.

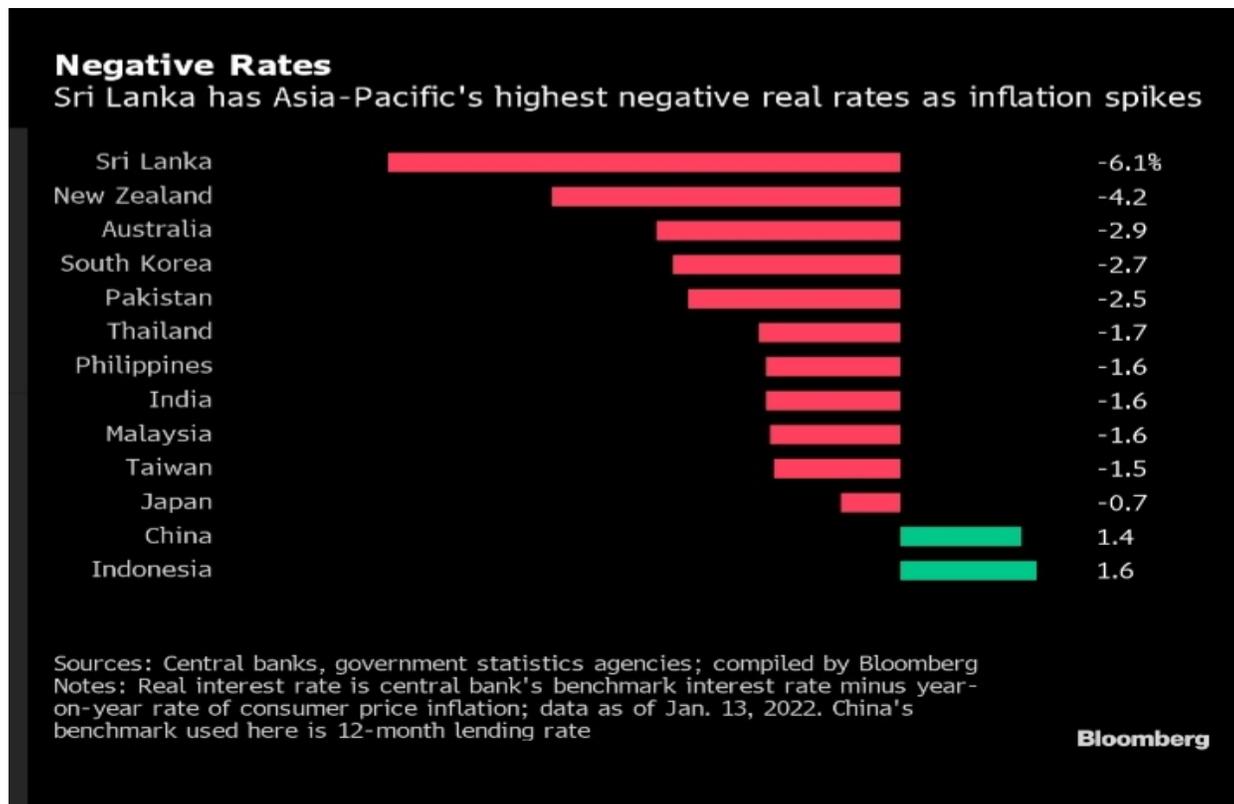
Despite commentaries blaming China for the debt crisis, the Australian Lowy Institute pointed out that Sri Lanka was "not engulfed in a Chinese debt trap", because external debt owed to China was only about 10% of the debt stock in April 2021. Instead, the majority of Sri Lanka's external debt stock is owed to international capital markets, which accounted for 47%. Another 22% is held by multilateral development banks, followed by Japan having 10% of Sri Lankan external debt. In January 2022, President Gotabhaya Rajapaksa's office stated that it would appeal to China to reschedule its debt burden during talks with the Chinese foreign minister Wang Yi. As of March 2022, there has been no official response from China.

In 2020, a New York-based agency said Sri Lanka's existing funding sources did not appear sufficient to cover its debt servicing needs, estimated at just over \$4.0 billion in 2021. According to the agency Bellwether, "To solve Sri Lanka's 'budgetary problem' in repaying debt, Treasuries auctions have to succeed. When that is done, the 'transfer problem' of foreign exchange will be automatically solved... Instead, with failed Treasury bill auctions filled with printed money, the country is slipping deeper into debt." To resolve the debt crisis, Bellwether noted that Sri Lanka would need a credible fiscal plan and monetary policy, taxes have to be hiked in order to repay debt, and interest rates and opening of imports would allow taxes to flow back to the Treasury. While it is possible to raise rates and generate dollars to repay the foreign debt by curtailing domestic credit, it is not practical to do it on an ongoing basis for many years. If investors see foreign reserves going up after debt repayments, confidence may come back but it is a painful affair, which may or may not work given the current ideology.

In September 2021, the government announced an economic emergency, as the situation was further aggravated by the falling national currency exchange rate, inflation rising as result of high food prices, and pandemic restrictions in tourism which further decreased the country's income. This drove Sri Lanka to the brink of bankruptcy due to foreign reserves falling to US\$1.9 billion as of March 2022, this being insufficient to pay the foreign debt obligations of US\$4 billion and an International Sovereign Bond (ISB) payment of US\$1 billion for the year 2022. The national inflation rate increased to 17.5% in February 2022, according to the National Consumer Price Index.

The government repaid US\$500 million International Sovereign Bonds which was due in January 2022 despite growing opposition came from economic analysts and experts who all advised the government to postpone the ISB payment in order to preserve the foreign reserves.

On 12th April 2022, Sri Lanka announced that it will be defaulting on its external debt of \$51 billion.



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