

# Analyzing the Root Causes of Sri Lanka's Economic Crisis: A Multi-faceted Examination

Candauda Arachchige Saliya

Department of Business Management, SLIIT Business School,  
Sri Lanka Institute of Information Technology, Malabe, Sri Lanka.  
Telephone: +94 11 7544642; Mobile: +94701649443  
Email: [saliya.a@sliit.lk](mailto:saliya.a@sliit.lk); [saliya.ca@gmail.com](mailto:saliya.ca@gmail.com)  
ORCID: <https://orcid.org/0000-0002-9239-1648>

## Abstract

The Sri Lankan economic crisis of recent years has drawn significant attention from scholars, institutions, and policymakers alike, prompting an in-depth analysis of its root causes and implications. This paper employs a comprehensive approach to dissect the crisis, drawing from a myriad of sources, including academic works, governmental reports, and the insights of renowned experts in the field.

The analysis categorizes the findings into eight key dimensions that structure the understanding of the crisis. These dimensions encompass policy initiatives, debt composition, political factors, foreign exchange challenges, resistance to IMF assistance, monetary policies, crisis management, and governance-related issues, including corruption and human rights concerns.

The paper underscores the critical lessons for the global economy that emerge from Sri Lanka's experience. It highlights the significance of maintaining robust central bank reserves as a buffer against tightening global financial conditions. The crisis also raises concerns of a broader emerging market debt crisis, with a substantial proportion of emerging economies at risk of debt distress. Additionally, the paper examines the complexities of sovereign debt restructuring when a major creditor like China is involved, demonstrating the intricate negotiation dynamics in such scenarios.

The analysis serves as a valuable resource for policymakers, economists, and scholars seeking to better understand the intricacies of economic crises in emerging markets and the lessons that can be drawn from Sri Lanka's experience.

**Keywords:** Corruption, Crisis, Debt stress, foreign reserves, Policy issues, Sri Lanka

**GEL:** D01, F45, F59, G10, G28, G38

# **Analyzing the Root Causes of Sri Lanka's Economic Crisis: A Multi-faceted Examination**

## **Introduction**

Many researchers emphasized the importance of asking the question "why" (or even "how") multiple times, possibly up to five times or more, until saturation is achieved (Saliya, 2021; 2022;2023). This approach encourages a thorough exploration of the root causes of a problem (Saliya, 2017; 2020).

There have been extensive analyses and discussions regarding the root causes of Sri Lanka's bankruptcy crisis. These investigations draw from a wide range of sources, including scholarly articles (Abeygoonasekara, 2022; 2023; Devapriya, 2022; Athukorala and Wagle, 2022; Saliya, 2022;2023), institutions such as UN, IMF, The World Bank, The Central Bank of Sri Lanka (CBSL), and the Institution of Policy Studies. Additionally, research institutions like Verité Research have contributed valuable insights, and newspaper articles from respected individuals who have transitioned from high-ranking positions to academia and research, such as Professors W.A. Wijewardene and Nikhil Sanghani, have added to the discourse (Wijewardene, 2022;2023, Sanghani, 2022).

## **Literature review and discussion**

The sources collectively offer a comprehensive understanding of the economic crisis in Sri Lanka, covering its causes, policy implications, external debt concerns, management strategies, and the involvement of international institutions like the IMF. The points discussed in these publications and press releases can be categorized into eight broad categories, helping to structure the analysis of the crisis.

- 1. Policy Initiatives (rather blunders) and Reversals:** A consensus emerged among many contributors to the discourse, highlighting that the crisis was exacerbated by substantial policy initiatives undertaken by the government (Abeygoonasekara, 2022;2023). These initiatives were deemed misaligned with the essential reform priorities necessary for a country burdened with high levels of public debt. The policy shifts, which notably included a strategic shift towards a combination of import substitution and export orientation, explicitly outlined in the CBSL annual report under the new Gotabaya-Cabral administration, along with increased state intervention in market guidance, were seen as inadequate in addressing the fundamental issues at the core of the country's debt problem (Saliya, 2022; 2023).

The government's policy blunders included a ban on synthetic fertilizers, which led to crop failures, and sudden changes in economic policies that eroded confidence in the business community.

- 2. Debt Composition, interest cost and liquidity management:**

Composition of External Debt: Sri Lanka's external debt composition shifted from multilateral and bilateral loans to more costly private market debt, including

International Sovereign Bonds (ISBs). This compositional shift increased the cost of servicing external debt.

**Expensive Debts:** The mounting burden of costly commercial debts, notably the International Sovereign Bonds (ISBs) and short-term, high-cost borrowings intended to settle maturing long-term loans, and bilateral swap arrangements with regional economies, imposed a substantial financial strain on the nation. Consequently, it became increasingly difficult to fulfill debt servicing obligations. This predicament resulted in a scenario where debt repayments and interest payments started to consume a significant portion of the country's earnings derived from both exports of goods and services and government revenue (Athukorala, 2022).

**Banking sector: State-Owned Banks' Contribution to External Debt:** Although there was some decline in the share of government external debt with the increase in the share of state-owned banks in the banking sector, this did not significantly alleviate the external debt burden, as banking sector debt was effectively considered government debt.

Chinese loans played a pivotal role in funding substantial infrastructure ventures in Sri Lanka, encompassing the construction of highways, an airport, and a port. It's worth noting that numerous of these projects, although critical for development, have encountered financial non-viability and economic infeasibility, as they do not generate sufficient revenue (cash) to service the loans that facilitated their realization. Consequently, these undertakings have faced challenges in terms of financial sustainability (Saliya, 2019).

### **3. Political and Socio-Political Factors:**

**Political Instability and Socio-Political Factors:** The crisis led to socio-political instability, which complicated the process of debt restructuring and negotiating stabilization and structural adjustment programs. Political decisions, such as large tax cuts and policy reversals, affected the country's fiscal situation (The World Bank 2022).

**COVID-19 Management:** The government's response to the COVID-19 pandemic included various measures such as loose monetary policy, stringent import controls, and bilateral swap arrangements with regional economies. These actions, while intended to address the economic impact of the pandemic, had limited effectiveness in managing the debt crisis.

### **4. Foreign Exchange and Reserves: Foreign Currency Shortages:** Sri Lanka's chronic trade imbalance, where imports exceeded exports, contributed to a shortage of foreign currency reserves. The ban on chemical fertilizers and reliance on organic alternatives further strained the country's export income (crop failure) and food supply and worsened the foreign currency shortage (IMF, 2022).

Sri Lanka's usable foreign reserves fell from USD 7,642 MN in 2019 to USD 1,579 MN by the end of 2021. When compared with Sri Lanka's regional peers during the pandemic, the decline in its reserves appears to only have happened to Sri Lanka,

while its other Asian countries have seen an increase in their reserve balances (Publicfinance, 2022).

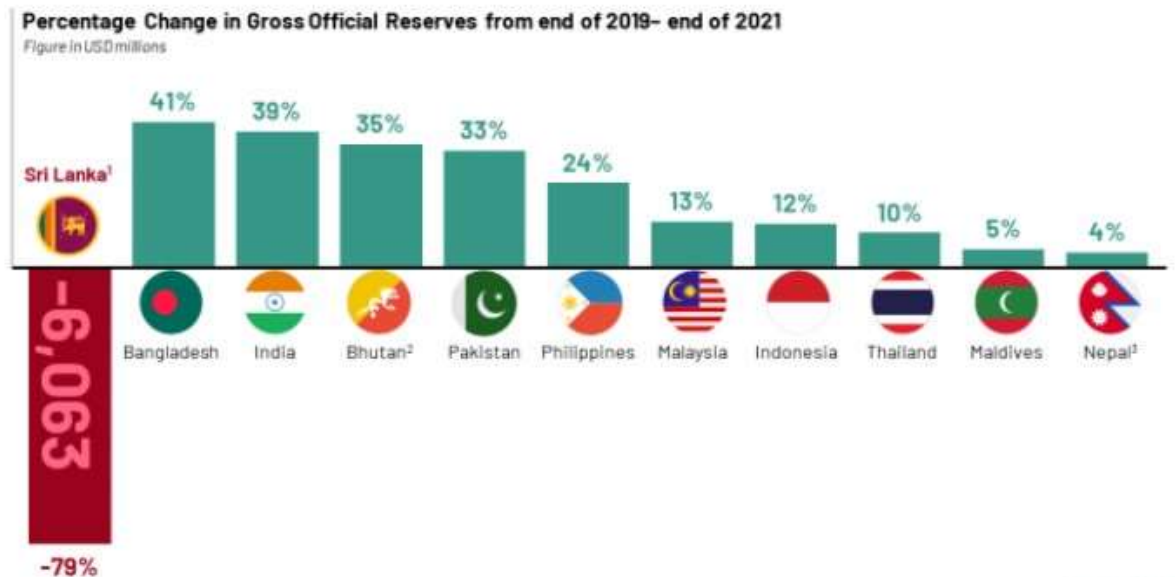


Figure 1: Comparison of Foreign Reserves of selected South Asian Countries

Source: Publicfinance, 2022

Exchange Rate Issues and Remittances: A fixed exchange rate policy, followed by a sudden float, resulted in the emergence of a thriving black market for foreign exchange. This, in turn, led to a diversion of funds from the official market to the black market. These exchange rate issues affected remittances from Sri Lankan workers abroad.

5. **Resistance to IMF Assistance:** The government hesitated to seek assistance from the International Monetary Fund (IMF) for an extended period, delaying potential solutions. The resistance to entering an IMF-supported stabilization program was partly ideological and fueled by concerns about the impact of IMF conditionality on fiscal reforms (Wickramasinghe, 2022).
6. **Money Printing, tax-cuts and inflation:** The Central Bank of Sri Lanka resorted to money printing, leading to concerns about inflation (Figure 2). Ill-advised tax cuts affecting government revenue and access to overseas markets Critics argued that excessive money printing led to increased demand for goods and services, contributing to inflationary pressures (Saliya 2022).

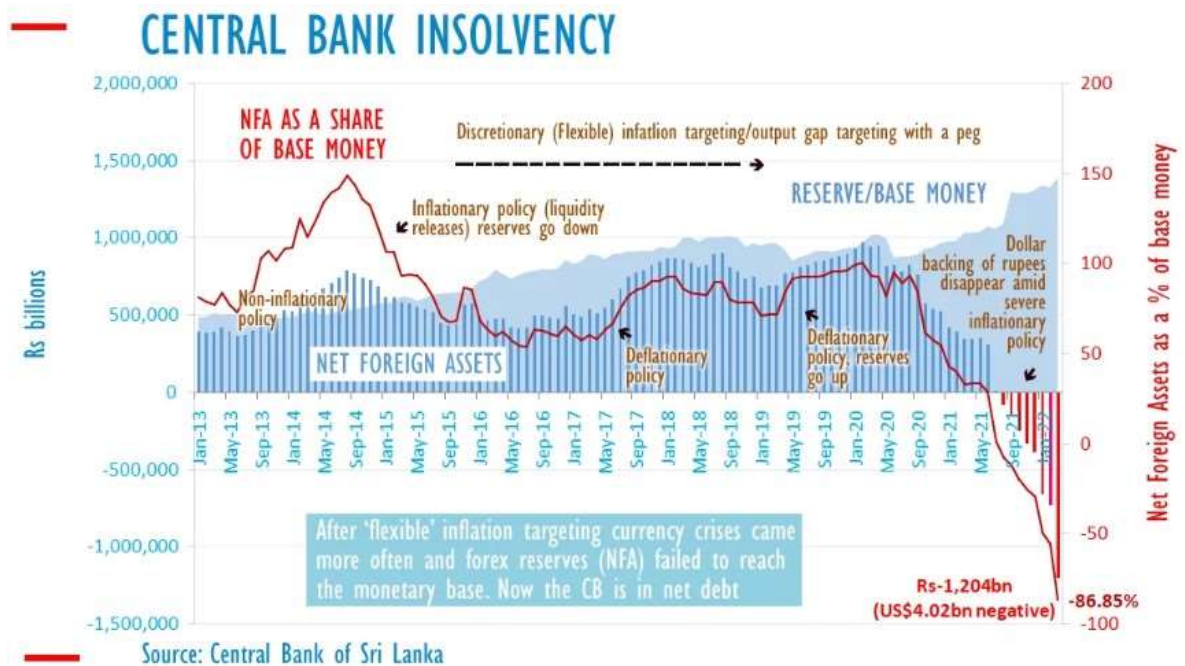


Figure 2: Money printing and Net Foreign Assets

Source: Economynext

7. **Crisis Management:** Ineffective Crisis Management: The government's crisis response was considered ad hoc and inadequate, focusing on short-term measures like import controls and exchange rate policies rather than addressing the root causes of the crisis (The CBSL).
8. **Corruption, application of law and human rights issues:** the UN report on Sri Lanka highlights a "devastating" economic crisis in the country, attributing it to issues like "impunity" for past and present human rights abuses, economic crimes, and corruption. It also underscores the necessity of ending reliance on draconian security laws, reducing militarization, and delivering security sector reform (UN, 2023). Furthermore, governance factors, including the rule of law, institutional quality, and transparency issues related to corruption, were also prominent aspects that came under scrutiny (Saliya, 2022; 2023).

Nevertheless, as we continue to probe further by repeatedly asking "Why" and "How," we eventually arrive at a critical juncture where the heart of the country's economic crisis lies, rooted in the depletion of foreign exchange reserves and the initial reluctance to seek assistance from the IMF. The IMF has emerged as the pivotal entity that has stepped into salvage Sri Lanka and is now instrumental in guiding its economic recovery.

If we delve even deeper into the analysis and inquire further, the responsibility for this situation ultimately falls upon the ruling party. The economic fallout includes inflation, food and fuel shortages, public outrage, and ultimately the ousting of the president.

## Conclusions

The discussion highlights three key lessons for the global economy:

1. **Central Bank Reserves:** Central bank reserves play a crucial role in providing a buffer for countries facing tightening global financial conditions.
2. **Debt Crisis:** Sri Lanka's situation raises concerns that it may be the first domino to fall in a broader emerging market debt crisis. The IMF warns that nearly a third of emerging market economies face debt distress due to the challenging global economic environment.
3. **Sovereign Debt Restructuring:** Sri Lanka's crisis tests how sovereign debt restructurings are resolved when a major creditor like China is involved. Past instances, such as China taking control of Hambantota Port, demonstrate China's tough stance in negotiations. This complicates the prospects of reaching a new IMF deal and dealing with private.

Sri Lanka's crisis serves as a case study with broader implications, highlighting the importance of central bank reserves, the potential risks of an emerging market debt crisis, and the complexities of sovereign debt restructurings involving major creditors like China.

## References

- Abeyagoonasekera, A. (2022), "Fighting economic crime during the pandemic: a Sri Lankan perspective", *Journal of Financial Crime*, Vol. 29 No. 2, pp. 764-769.
- Abeyagoonasekera, A. (2023), *Teardrop Diplomacy: China's Sri Lanka Foray*, Bloomsbury, London.
- Athukorala, P. and Wagle, S. (2022). *The Sovereign Debt Crisis in Sri Lanka: Causes, Policy Response and Prospectus*. Policy Paper. UNDP Regional Bureau for Asia and the Pacific. <https://www.undp.org/sites/g/files/zskgke326/files/2022-11/UNDP-Sovereign-Debt-Crisis-in-Sri-Lanka-Report-2022.pdf>
- CBSL, (2022). *Annual Report 2022*. The Central Bank of Sri Lanka. Colombo.
- Devapriya, U. (2022). *The Crisis in Sri Lanka: Economic and Political Dimensions*. *Journal of Indo-Pacific Affairs*, August 2022. Air University Press.
- Economynext (2022). *Sri Lanka Maha 2021 rice harvest drop 40-pct due to fertilizer ban*. Accessed 03 March (2023). <https://economynext.com/sri-lanka-maha-2021-rice-harvest-drop-40-pct-due-to-fertilizer-ban-95750/>
- IMF. (2023). *Transcript of IMF Press Briefing in Sri Lanka*. Accessed 03 March 2023 <https://www.imf.org/en/News/Articles/2023/05/16/051523-imf-press-briefing-sri-lanka>

- Publicfinance (2022). Is the Pandemic the Sole Cause for the Depletion in Sri Lanka's Foreign Reserves? <https://publicfinance.lk/en/topics/is-the-pandemic-the-sole-cause-for-the-depletion-in-sri-lanka-s-foreign-reserves-1646912468>
- Saliya, C. A. (2010). *The Role of bank lending in sustaining income/wealth inequality in Sri Lanka*. PhD Thesis, Auckland University of Technology, New Zealand. <https://openrepository.aut.ac.nz/handle/10292/824>
- Saliya, C. A. and Yahanpath, N (2016), Petty-Bourgeois Nationalism – A case study. *Qualitative Research in Financial Markets*, 8(4), pp. 359 – 368. <http://www.emeraldinsight.com/doi/full/10.1108/QRFM-04-2016-0013?mobileUi=0>
- Saliya, C. A. (2020), Dynamics of credit decision-making: a taxonomy and a typological matrix, *Review of Behavioral Finance*, <https://doi.org/10.1108/RBF-07-2019-0092>
- Saliya, C A, (2022). Is Sri Lanka Bankrupt? Is There a Way Out? 4th International Research Symposium on Social Sciences and Humanities (IRSSSH) 2022 SRI LANKA IN CRISIS: SEARCH FOR A WAY OUT , <http://dx.doi.org/10.2139/ssrn.4317329>
- Saliya, C. A. (2019). Credit capital, employment and poverty, *International Journal of Money, Banking and Finance*, 8(1), pp.4-12. Accessed 03 March 2023. <https://search.proquest.com/docview/2249669069?pq-origsite=gscholar>
- Saliya, C. A. (2021). Driving Forces of Individual Investors in Stock Market Participation, *Review of Economics and Finance*, 19(2). 73-79. <https://refpress.org/ref-vol19-a8/>
- Saliya, C. A. (2023). Integrated-Flexible Research Methodology: An Alternative Approach. In C. A. Saliya (Ed) *Social Research Methodology and Publishing Results: A Guide to Non-Native English Speakers*. DOI: 10.4018/978-1-6684-6859-3.ch001
- Saliya, C. A. (2023). Financial Crisis in Sri Lanka: Impact of Institutional Factors on External Debts. *35<sup>th</sup> Asian FA 2023 Annual Conference. 26-27 June 2023*. University of Economics HCMC, Vietnam.
- Saliya, C. A. and Jayasinghe, K. (2016). Creating and Reinforcing Discrimination: The Controversial Role of Accounting in Bank Lending. *Accounting Forum*, 40(4), pp. 235-250. Issn:0155-9982,
- Saliya, C. A. and Jayasinghe, K. (2016). Cultural Politics of Bank Lending for Development Financing in Sri Lanka *Journal of Accounting in Emerging Economies*, 6(4), pp. 449 – 474. <https://doi.org/10.1108/JAEE-10-2011-0040>
- Saliya, C. A., Hooper, K. (2020). The Role of Credit Weapon and Income/Wealth Inequality: A Sri Lankan Case Study. *Journal of Applied Economic Sciences*, Volume XV, Summer, 2(68): 425 - 436. Accessed 03 March 2023. [http://cesmaa.org/Docs/JAES%20VolumeXV%20Issue2\(68\)Summer2020.pdf](http://cesmaa.org/Docs/JAES%20VolumeXV%20Issue2(68)Summer2020.pdf)
- Sanghani, N. (2022). Sri Lanka crisis shows why reserves matter, OMFIF. <https://www.omfif.org/2022/07/sri-lanka-crisis-shows-why-reserves-matter/>

The World Bank (2022a). The World Bank In Sri Lanka.  
<https://www.worldbank.org/en/country/srilanka/overview>

UN. (2023). Security Council Meeting Coverage. 9315<sup>th</sup> Meeting. 3 May 2023. Accessed on 31 May 2023. <https://press.un.org/en/2023/sc15273.doc.htm>

The World Bank. (2022b). Global Economic Prospects.  
<https://www.worldbank.org/en/publication/global-economic-prospects>

Wickramasinghe, R. (2022). Sri Lanka says it is 'bankrupt' as financial crisis ravaging the country deepens. Accessed on 31 May 2023.  
[https://www.businessinsider.com/sri-lanka-says-bankrupt-financial-crisis-ravages-country-\\$Debt-default-2022-7](https://www.businessinsider.com/sri-lanka-says-bankrupt-financial-crisis-ravages-country-$Debt-default-2022-7)