

## Economic Crisis in Sri-Lanka: A Politico-Economic Perspective

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### Abstract

*Sri Lanka, a small island nation in South Asia, has a varied economy with strong emphasis on manufacturing, tourism, mining, and agriculture. However, the island nation is witnessing its worst economic collapse in years with unprecedented political and economic events unfolding. Consistent lockdowns due to COVID-19 pandemic paralyzed South Asian economies causing disruptions in supply chains that multiplied the economic challenges in the region. The upshot was enormous losses in trade, movement of commodities, FDI, tourism, cross-border migration, and the depletion of foreign reserves, which in turn led to shortages in the country's supply of fuel, food, medicine, cement, and other necessities. In this context the paper seeks to chart the trajectory of Sri-Lanka's recent economic crisis, examine its political and economic causes and evaluate the initiatives and way-outs taken for tackling the situation.*

**Keywords:** South Asia, Covid-19, Sri-Lanka, economic crisis, Disasters

### Introduction

Sri-Lanka's strategic location in the centre of the Indian Ocean has long been recognized as a significant element in endorsing greater inter-regional and investment links. Since it emerged as an independent nation in 1948, it has experienced periodic economic crises leading to a severe lack of necessities like food, medicine, cooking gas, gasoline etc. When the civil war ended in 2009, economic growth gradually picked up again. As a result, Sri Lanka's Gross Domestic Product (GDP) significantly increased in the post war period. Numerous socio-economic metrics also improved, with the unemployment rate dropping to 4 per cent in 2012 and the percentage of the population living in poverty increasing to 8.9 per cent in 2010. With the fiscal deficit continuing to decrease, macroeconomic environment's overall fiscal performance also improved, allowing for some price stability to exist. However, there was a large deterioration in the external trade balance, with widening deficit only being restrained by a rapid increase in interior remittances, which account for an average of 8 per cent of GDP and by increases in tourism-related revenue. However, when global commodity prices declined and imports surpassed exports, the economy began to deteriorate after 2013. A

counter-cyclical fiscal policy was ruled out, as the hands of the then Mahinda Rajapaksa government were tied by a US\$ 2.6 billion loan obtained from the International Monetary Fund (IMF) in 2009. The new coalition government led by the United National Party (UNP) asked the IMF in 2016 for another US\$ 1.5 billion loan for a three-year period from 2016 to 2019 due to the lack of improvement in growth of exports and the on-going depletion of foreign exchange reserves. The fiscal deficit had to be lowered to 3.5 per cent by 2020 following the IMF's conditionality. Other requirements included reforming tax administration and policy, reining in spending, commercialising public companies, allowing for exchange rate flexibility, boosting competitiveness, and creating a risk-free environment for foreign investment. The economic situation in Sri Lanka deteriorated as a result of these IMF conditions.

The COVID-19 pandemic had a devastating impact on Sri Lanka's revenue-generating sectors, including tourism, food and agriculture, exports of clothing and textiles, small and medium-sized enterprises, a sharp fall in the educational system, and countless other socio-economic failures. The whole economic system, including the manufacturing and agricultural sectors, suffered greatly during the lockdown. In addition, due to the weakening big-player global economy, the market for imported luxury goods from Sri Lanka, such as tea and cinnamon, has significantly shrunk. The huge expense of combating the pandemic will draw Sri Lanka's attention away from critical infrastructural and economic development. Sri Lanka is projected to endure significant unemployment, inflation and other issues as a result of the sudden economic debacle. According to a statement released by Human Rights Watch (2021), the economic crisis in Sri Lanka is driving millions of people into poverty and jeopardising their rights to health, education, and a living income. In order to create a new social security system, reduce debt; assure fair taxes and combat corruption at the highest levels of government, the Sri –Lanka should collaborate with key financial institutions and partners.

## **Reasons for the Current Economic Debacle**

### **Tax Reduction**

When Rajapakshe government took office in 2019, it promised to speedup economic growth. The government reduced the value-added tax by half and repealed some other levies in order to promote consumption and the economy. The tax cuts greatly strained the public finances of the already leveraged economy, creating increasing budget deficits and a loss of billions of rupees in tax revenue. Despite being aware of the 2021 revenue loss, Rajapakshe considered tax cuts as an 'investment' and did not intend to increase taxes for another five years (Lockett, 2022). IMF had already

cautioned Sri-Lanka's Central Bank to stop printing money; instead increase taxes, however, Central Bank of Sri-Lanka went ahead and printed 119.08 billion rupees on April 6, 2022, the highest amount reported on a single day for the entire year 2022 (News-Wire, 2022).

### **Foreign Debt**

After the civil war ended in 2009, government sought to develop the country's infrastructure. Rajapaksha government received finances for large number of projects from external financiers particularly China. Apparently, it looked like the country was developing, however, it was mostly done from external money leaving Sri-Lanka in huge debt to China and other financiers. In the decade from 2010-2020 Sri-Lanka's foreign debt has consistently increased. Between 2006 and 2020, Sri Lanka's debt rose from USD 11.85 billion to USD 56.83 billion (Kataria, Manur & Pradhan, 2022). During Rajapakshe Government, particularly, debt has sky rocketed. It stood at \$11 billion in 2005 and surpassed to \$56 billion by 2020 –of which 15 per cent was held by China (IMF Country Report, March 2022). As of 2021, Sri-Lanka owes 47 per cent of its debt to International Capital Markets, 22 per cent is held by international development banks, and 10 per cent by Japan. (Wignaraja, Attanayake, 2022).

### **Agricultural Crises: Turn to Organic Farming**

During the election campaign, Rajapakshe declared that if elected, the government would provide chemical free food, to people. After he assumed power in 2019, Rajapakshe outlined a ten-year transition period to complete organic farming (Jayasinghe, Ghoshal, 2022). The government in April, 2021 instituted a complete ban on importation and use of fertilizers and ordered farmers to go completely organic. Analysts argue that the real issue was deficient funding, not health. This sudden and drastic turn to organic farming impacted agricultural production. There was a sudden drop in tea production that alone amounted to the loss of millions of dollars. Rice production also dropped forcing the country to import rice. As the protests intensified against the soaring food prices, the government abandoned its plan to become the world's first organic-farming nation in 2021.

### **Easter Bombings and Covid-19**

Tourism provides livelihood to over a million people in Sri-Lanka and contributes 11 per cent to the total employment (Aneja, Shridhar, Maawi 2020). The Easter bombings of 2019 negatively impacted

the Tourism sector. It fell from USD 5.61 billion in 2018 to USD 4.66 billion in 2019 and USD 1.08 billion in 2020 (World Bank, 2020). After few months Covid-19 struck which further wreaked havoc on Sri-Lanka's economy. The national debt of Sri Lanka increased throughout the pandemic, from 94 per cent of GDP in 2019 to 119 per cent of GDP in 2022. Tourism sector is the backbone of Sri-Lankan economy. The Colombo Bomb Blasts in 2019 coupled with Covid-19 reduced tourism, which earlier contributed 10 per cent to the country's GDP, from USD 8 billion in 2020 to around USD 2.31 billion in the last two years, Sri Lanka's FOREX reserves have decreased by over 70 per cent (WTO, 2021).

### **Politico-Economic Dimension**

As the economic crises unravelled in the past couple of months, protests intensified throughout the island nation. Analysts interpret the crises in diverse ways; while some blame external factors like Covid-19 and Russia-Ukraine war; others; specifically, opposition put the blame on the government and on its different measures like tax cuts, the sudden shift to organic farming etc. Whatever the cause, this economic crisis has snowballed into a political crisis and one can't look away its political dimension. In February this year, Sri-Lankan protesters took to streets demanding resignation of the President and his government. They succeeded in their aim after a three-month long struggle, with Rajapakshe becoming the first President in the Post-independence period to be forced out of office and to flee due to a popular uprising. The crisis in Sri-Lanka is fundamentally connected to politics. Sri-Lanka's two main political parties the Centre-Left Sri Lanka Freedom Party (SLFP) and the Centre-right United National Party (UNP), compete with each other since the last 70 years, on issues mostly focused on employment, free education and raising subsidies on taxes. However, like other South Asian countries, Sri-Lanka is no stranger to dynastic politics. Since 2005, Rajapakshas have dominated the Sri-Lankan politics. They helped and successfully suppressed decades-old Tamil insurgency which consolidated their grip on power. In the post-war period, Gotaba Rajapakshe gradually made his family's way into the government. After appointing Mahinda Rajapakshe as PM, his government passed a controversial amendment in 2020, allowing another brother Basil Rajapakshe to enter Parliament. It became more a familial and dynastic politics where Gotabaya was only theoretically President and his brothers were the actual actors and doers. Rajapaksha's have gradually accumulated and centralised power over the period of last 20 years. This centralisation of power led to the weakening of bureaucracy and other critical institutions like the Central Bank of Sri-Lanka. Also, since Rajapaksha came to power in 2005, corruption at the governmental increased.

Public offices have been used for personal and party gains with the government increasingly relying on patronage politics. Therefore, the protests are also a response against corruption and nepotism of the familial and dynastic politics dominating Sri-Lankan politics.

### **Impact of the crises**

The crises have impacted every person whether rural or urban. Unemployment has become a typical occurrence in practically every home. It has also led to decrease in earnings. Fuel shortages have resulted in long queues at petrol stations. Multiple thermal power plants have been forced to close due to a severe lack of diesel, resulting in rolling power outages across the country. In the health sector, people have turned to self-medication increasing morbidity among people. The deteriorating situation would induce the native Sri Lankans to migrate to other countries like India, Maldives etc. for better opportunities and a stable environment. Sri Lanka is unable to import the goods it needs. It has also failed to make an interest payment on its foreign loans for the first time ever, harming its standing with the investors and making it more difficult to borrow the money it requires on global markets.

The majority of Sri Lanka's economy depends on imports, including gasoline, diesel, food, sugar, lentils, paper, and pharmaceuticals. Without the ability to buy or borrow foreign currency, the Sri Lankan government is unable to import fuel and basic foods, which drives up domestic prices. Remittances from Sri Lankans who work overseas have also decreased. Because of this, the country now imports much less of the necessities than it used to. The situation turned so worse that there is a fear of rise in acute malnutrition cases from 13-20 per cent, and the cases of severely malnourished children is expected to double from 35,000 to 70,000 (Vaidyanathan, 2022). Thus, millions of people are being pushed to poverty, endangering their rights to health, education, and a living wage, according to a statement released today by Human Rights Watch (De Silva, 2022). In order to deal with the crises, Sri Lankan government needs to work with relevant financial institutions and partners to establish a new social protection system and obtain debt relief, adopt measures to ensure fair taxation, and address corruption at the highest levels of government. Since both Ukraine and Russia are significant markets for Sri Lankan tourism, the deepening of the conflict between Russia and

Ukraine will have an impact on Sri Lanka. Russians made up 15.8 per cent of all visitors to Sri Lanka this year until February 11; Ukrainians made up 8.7 per cent of all visitors. The tourism industry will be affected if there are fewer visitors from these nations as a result of the conflict. Further, the conflict between Russia and Ukraine has already increased the price of oil globally, which would make it more difficult for Sri Lanka to acquire gasoline for its daily needs. Since Russia and Ukraine are significant markets for Sri Lankan tea, the deteriorating situation due to war between the two countries may also have an effect on exports. Prior to the pandemic, Sri Lanka was heavily dependent on Chinese tourists. Sri Lanka welcomed 1,67,863 Chinese tourists in 2019. It is unclear when will China ease restrictions on peoples' mobility.

The second-largest export market for Sri Lanka is the EU. The Generalized Scheme of Preferences (GSP+) of the EU makes it easier for Sri Lankan goods to enter the EU duty-free. The EU Parliament has threatened to revisit the GSP+ programme that was granted to Sri Lanka by a vote in June 2021 if it is not happy with Sri Lanka's human rights records. It adopted a resolution and called for a repeal of Sri-Lanka's Prevention of Terrorism Act to improve its human rights records. The flow of aid from the Western nations, mainly from the EU, to deal with the economic crisis would be determined in the following days by Sri Lanka's attitude toward those measures and proposals. In January 2022, the Sri Lankan government of President Gotabaya Rajapaksa published a bill to amend the act. However, the proposed amendments leave the most often abused provisions of the law intact, and if enacted, will do little to bring the PTA into compliance with Sri Lanka's international human rights obligations. (Human Rights watch, 2022).

EU's withdrawal of the GSP+ facility from Sri Lanka will be a significant barrier to the expansion of the export sector. At the domestic level also, the government has to face the wrath of common people, opposition parties and even disappointment of some of the coalition partners because of its handling of the economic crisis, pandemic, overall governance and foreign affairs. All these factors cumulatively will pose serious challenges for Sri Lanka to overcome the current crisis. Even though the government as of now has refused to approach the IMF for assistance, it might be compelled to do the same at a later date.

### **Measures for combating the Economic crisis**

Sri-Lanka's way of handling the crisis is being criticised by economists and the opposition parties. They contend that instead of taking a comprehensive approach to the overall economic situation, the administration is concentrating on short-term solutions in specific areas. Although it is suggested

that temporary import restrictions may have improved the trade balance by reducing spending, a continued ban on imports would also have an impact on exports since Sri Lanka's export economy is heavily reliant on the import of intermediate capital goods. Many importers have suffered as a result of the import prohibition. The growth in smuggling and unlawful trade of goods subject to import restrictions has led to price increases. The government has historically utilised selective import controls whenever there has been a decline in export revenue, from 1948 through the 1960s. However, it merely provided temporary relief and did little to help the nation's overall economic predicament. The government's decision to outlaw chemical fertilisers has also drawn harsh criticism because it will have an impact on agricultural output and potentially worsen the nation's food insecurity and shortages.

The Sri Lankan government believes that the current foreign exchange reserves crisis is the result of previous governments' policy of importing more than they collected in income over time. The country's financial woes have also been attributed to loans obtained from multilateral institutions. Additionally, the COVID-19 pandemic has made the issue worse. As a result, cutting import spending is one of the government's top policy concerns. Other "homegrown measures" have also been started to strengthen the foreign reserves by reducing capital outflow and increasing input. To address the issue of settling import and debt, the government has approached bilateral partners for a loan, credit, and currency swap facility. Moreover, special emphasis is being paid to restoring investors faith while navigating the crisis by maintaining debt service obligations.

**Import Restrictions:** To curtail the outflow of foreign currency, the Sri Lankan government has prohibited the entry of high-end cars, chemical fertilisers, and food staples like turmeric. Beginning in May 2021, the Sri Lankan government will impose import restrictions on chemical fertilisers and agrochemicals (insecticides and herbicides). Although the government claims the restriction is necessary to encourage organic farming in the nation, the strategy to limit the import of chemical fertilisers was also motivated by the need to stop the flow of foreign funds. Prior to the embargo, Sri Lanka used to import fertilisers for about \$400 million a year and turmeric for more than \$7 million. A total of US\$1.5 billion was spent on importing vehicles in 2018. (Ganesh 2021, 12).

**Restrictions on forward contracts of foreign exchange:** The CBSL has instructed the licenced commercial banks to refrain from entering into forward contracts of foreign exchange for a period of three months in order to prevent excessive volatility in the foreign exchange market.

**Enhancing Remittance Inflow:** The government has proposed a number of policy initiatives to increase remittance inflows to the nation, including: establishing a contributory pension plan for migrant workers; paying Sri Lankan rupees 2 per dollar above the standard exchange rate for foreign exchange remittances converted at authorised banks. The foreign employment market is currently largely dependent on Middle Eastern nations. To increase the number of remittances coming into the country, a Special Deposit Account programme has also been implemented.

**Assistance from Bilateral Partners:** The government of Sri Lanka is requesting assistance from bilateral partners in the form of loans and currency exchange facilities to address the present economic crisis. Bangladesh has extended a currency swap facility worth US\$ 200 million. China extended a swap facility worth US\$1.5 billion. China Development Bank also gave Sri Lanka 700 million dollars. India has already agreed to provide US\$ 2.4 billion in financial assistance, which includes: (a) US\$ 400 million under the SAARC currency swap agreement; (b) a two-month delay in the payment of the A.C.U. settlement of US\$ 515.2 million; (c) US\$ 500 million for the import of fuel from India; and (d) US\$ 1 billion for the import of food, necessities, and medicine.

India has also agreed to positively contribute to enhancing Sri Lanka's energy security as part of the financial assistance package by signing an MoU to jointly develop the Trincomalee oil tank farms and by offering various forms of assistance to attract Indian tourists to strengthen Sri Lanka's tourism sector and increase Indian investments in Sri Lanka. The offer of assistance has also been accepted by Pakistan and Qatar. In order to import cement, basmati rice, and medications made in Pakistan, Pakistan has agreed to grant credit lines totalling \$200 million USD. The two nations have not yet agreed on the details of the same. According to reports, the CBSL has started talking with the Qatar Central Bank about getting a swap for more than \$1 billion.

**Boosting investors' confidence:** The government has included provisions for Special Deposit Accounts in order to increase investor confidence. Despite the lack of foreign currency, the government is committed to upholding its debt servicing obligations. The government has chosen not to ask the lender to renegotiate the debt payment, despite repeated requests from the opposition parties.

**No to International Monetary Fund (IMF) Bailout:** According to the government, Sri Lanka is reluctant to approach the IMF for a bailout because the conditions of the IMF's help would add to the burdens already placed on its citizens by the pandemic and the current economic crisis. The current administration also believes that the IMF programmes occasionally carried out in Sri Lanka made the



nation's economic issues worse. Although the government is certain that it can manage the situation without an IMF bailout, statements from the leaders of the ruling party imply that the government may seek technical guidance from the IMF.

### **Bilateral assistance from India, China and Bangladesh**

The bilateral support from Bangladesh, China, and India in the form of a currency swap facility has helped Sri Lanka marginally increase its gross official reserves and made it easier to pay off debt service that was due in the month of January 2022. Dealing with the fuel shortages has also been made easier with Indian support. In order to pay for the import of food and medications, Sri Lanka primarily depends on the US\$ 1 billion provided by India. The completion of ministerial level requirements is necessary for India's help to be fully realised. This month, the Sri Lankan finance minister is most likely to travel to India for similar purposes. Regarding Sri Lanka's request for a loan to pay back Chinese loans, China has not yet officially committed. The Sri Lankan ambassador to China claims that this topic is currently the subject of advanced conversations with the Chinese.

Although the current administration is optimistic, Sri Lanka cannot entirely rely on bilateral help to resolve this situation. It is important to note that although the help is enabling Sri Lanka some breathing room to manage the debt servicing and settlement of import bills with limited foreign reserves, these assistances are arriving in the form of loans. The current economic climate is anticipated to last for at least another two or three years. Sri Lanka requires financial assistance in the form of long-term, low-interest loans with a grace period that is long enough to last through the current economic climate. Many academics and opposition parties in Sri Lanka urge the government to approach the IMF as reliance solely on bilateral aid is insufficient.

### **Conclusion**

Sri-Lanka's current economic collapse can be traced to a variety of factors - external debt, dynastic politics, growing nepotism and corruption coupled with the inability to begin a much-needed political transition. Its roots are not only economic but political and social as well. The economic mismanagement due to different government policies that are fundamentally based in a number of political factors that include corruption, nepotism, bad governance, etc. increased the potential for crises in the long run. To prevent the crises from snowballing into an acute macroeconomic depression, a practical solution is required. It includes a promising developmental model assuring economic, political, and institutional reforms. Also, there is a severe need of establishing an

independent and accountable bureaucracy based on merit, along with a clear separation of the legislative and executive branches of the government.

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