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Srilankan Economic Crisis

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Abstract

Sri Lanka's economy was already showing signs of weakness before the COVID-19 pandemic. Growth and poverty reduction had slowed down in the last five years. A restrictive trade regime, weak investment climate, episodes of loose monetary policy and an administered exchange rate had contributed to external imbalances. Sustained fiscal disparities, driven primarily by low revenue collections, combined with tax cuts in 2019, has contributed to high fiscal deficits, large gross financing needs, and a rapid growth in unsustainable debt.

The Sri Lankan economic crisis is an ongoing crisis in the island country of Sri Lanka that started in 2019. It is the country's worst economic crisis since its independence in 1948. It has led to unprecedented levels of inflation, near-depletion of foreign exchange reserves, shortages of medical supplies, and an increase in prices of basic commodities

Keywords: Economic crisis, Pandemic, Inflation

Introduction

The economy that evolved in Sri Lanka under British rule consisted of a modern sector, whose main component was plantation agriculture, and a traditional sector comprising subsistence agriculture. Manufacturing was an insignificant segment of the economy. Banking and commerce were, for the most part, ancillary to plantation agriculture. Nearly all foreign earnings were derived from the three staple plantation crops—tea, rubber, and coconut. The country depended on imports for nearly three-fourths of its food requirements and almost all of its manufactured goods.

During the first three decades after independence, development policy focused on two themes, equity through social welfare and substitution of imports with local products. Government price subsidies on food, statutory price controls on consumer goods, and the provision of free education and health services by the government were the principal measures guided by equity considerations. Stimulating local production to cater to an increasing share of domestic consumption and imposing diverse restrictions on imports were the main elements of the import substitution policy. The pursuance of these policies required increased government intervention in the economy.

The social welfare policies achieved a measure of success in lowering mortality rates and in increasing life expectancy and literacy rates to levels seldom matched by other developing countries. However, the restrictive impact that the policies had on domestic capital accumulation and investment retarded economic growth, leading not only to soaring unemployment but also to the persistence of low incomes. The achievements of the import substitution policies were even less tangible, except perhaps in the production of rice and subsidiary food crops. Industry, starved of imported inputs and domestic investment and often mismanaged under state control, failed either to grow or to achieve acceptable standards of product quality or to remain commercially viable. The policy focus on import substitution also meant the relative neglect of plantation agriculture, which, nevertheless, had to carry a heavy burden of taxation.

After the late 1970s there was a shift away from the earlier policies toward ones aimed at liberalizing the economy from excessive government controls. The new policies were designed to accelerate economic growth by stimulating private investment and to increase the country's foreign earnings by promoting export-oriented economic activities.

The liberalization policies succeeded initially. Stimulated by a substantially enhanced level of foreign aid and investment, the economy became buoyant, recording, up to about 1984, real growth rates of about 6 percent per annum . Thereafter, however, there was a marked deceleration of growth, caused mainly by the disruptive effects of the ethnic conflict on economic activity.

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Objectives

To study the causes of Sri Lankan economic crisis

To analyse the impact of Sri Lankas economic crisis on India

To give suggestions to stabilize the Sri Lanka economy

Methodology

Secondary data like journals, newspapers and the internet have been used to analyse Sri Lankan economic crisis

Factors that caused the economic crisis in Sri Lanka were:

- PandemicCovid-19 had impacted the tourism industry. It accounted for 10% of Sri Lanka's GDP
- Fallof the forex reserve (from $7.5 billion in 2019 to $2.8 billion in July 2021).
- High cost in importing of essential items, including food.

- A depreciated currency, high dependence on imports and hoarding led to a steep rise in food prices in Sri Lanka.
- Hambantota port was a project by the present government to shorten its economic woes. Instead, it only further increased the debt problem that Sri Lanka faced as it had taken $1 billion from China.
- The ongoing Russo-Ukrainian Conflict also is a factor which is affecting the already precarious economic condition of Sri Lanka.
- Russia is also the second biggest market to Sri Lanka when it comes to tea exports.

The government blamed the Covid pandemic, which badly affected Sri Lanka's tourist trade - one of its biggest foreign currency earners. It also says tourists were frightened off by a series of deadly bomb attacks in 2019.However, many experts blame President Rajapaksa's poor economic mismanagement. At the end of its civil war in 2009, Sri Lanka chose to focus on providing goods to its domestic market, instead of trying to boost foreign trade. This meant its income from exports to other countries remained low, while the bill for imports kept growing. Sri Lanka now imports $3bn (£2.3bn) more than it exports every year, and that is why it has run out of foreign currency. At the end of 2019, Sri Lanka had $7.6bn (£5.8bn) in foreign currency reserves, which have dropped to around $250m (£210m).Mr Rajapaksa was also criticised for big tax cuts he introduced in 2019, which lost the government income of more than $1.4bn (£1.13bn) a year.

Impact on India

India relies heavily on the port of Colombo for global trade. Approximately 60% of India's transhipment cargo is handled by the port at present, thousands of containers sent to Sri Lanka from India have been lying uncleared at the port as the concerned authorities are unable to transfer containers between terminals. This, in turn, has resulted in a build-up of cargos intended for Sri Lanka at the Indian ports. Any disruption in operations at the Port of Colombo has a direct impact on India which leads to an increase in costs and congestion issues.

Thus, India's growing need for getting a transhipment hub gets another push with the Sri Lankan crisis. Any instability in Sri Lanka also impacts the interests of several Indian companies such as Airtel, Indian oil, Taj hotels, Dabur, Tata Communications, Asian Paints, etc that have invested in Sri Lanka. India being the closest neighbour of Sri Lanka, a large-scale humanitarian crisis also impacts India. With the shortage of essential commodities such as food, medicines, and growing political instability, India finds itself in a position of massive responsibility to prevent the crisis through all possible aid. It is believed that India's assistance at this time of need will only lead to better relations with the island nation that has been leaning more towards the Chinese camp.

Since January 2022, when the economic crisis began in Sri Lanka, India has extended nearly $3 billion help. On May 22, a ship carrying 9000 metric tons of rice, 50 metric tons of milk powder, and 25 metric tons of drugs and other essential pharmaceutical supplies arrived in Colombo. This consignment is estimated to be over $5.5 million.

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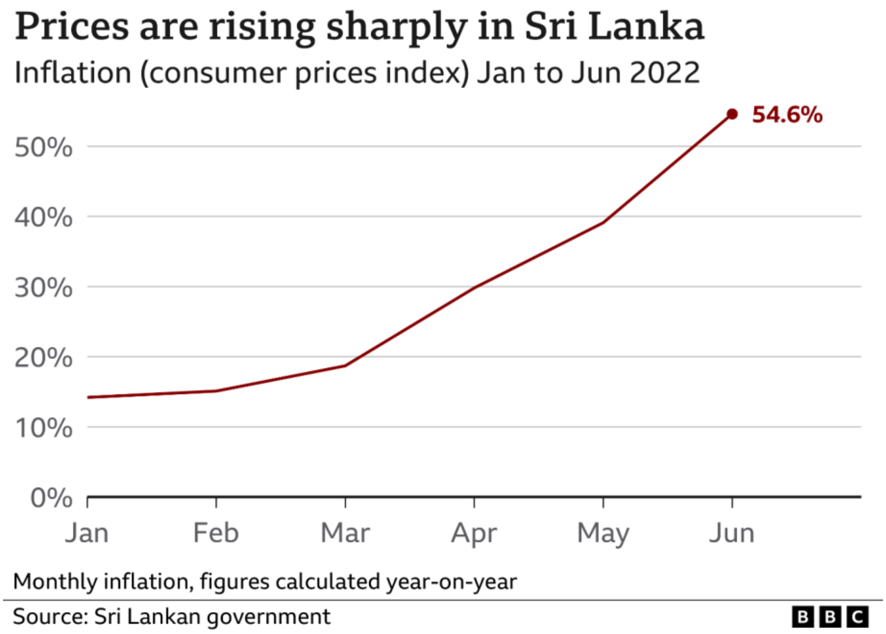
Sri Lanka is unable to buy the goods it needs from abroad and in May it failed to make an interest payment on its foreign debt for the first time in its history. Failure to pay debt interest can damage a country's reputation with investors, making it harder for it to borrow the money it needs on international markets. This can further harm confidence in its currency and economy.

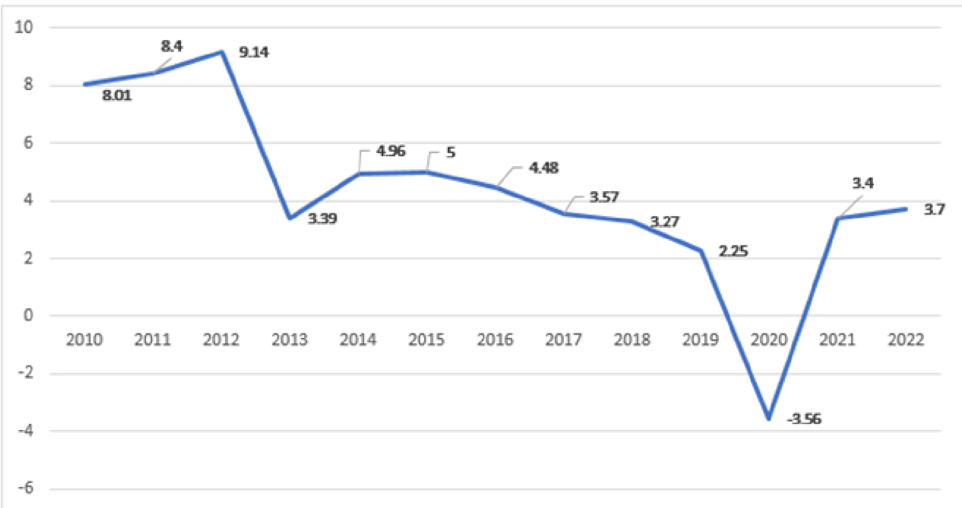
Chart - I



The above Chart – I shows the sharp increase of prices in Sri Lanka which shows the inflation rate from January 2022 to June 2022

Chart -II

Sri Lanka's Real GDP Growth Rate (2010-2020)



Source: *World Bank, 2022 Projection by Central Bank of Sri Lanka*[3]

The above Chart – II shows the Real GDP Growth Rate of Sri Lanka. There has been a severe dip in 2020 to -3.56.

Conclusion

Sri Lanka to emerge from the current economic crisis and improve long-term growth prospects, will take time. Sri Lanka needs to enhance fiscal and debt sustainability, and implement growth enhancing structural reforms. Measures need to be accompanied by tighter and more consistent monetary policy to contain inflationary pressures.

The country still has a long way to go to come out of this crisis, which has been a long time in the making. Decades of fiscal deficits, current account deficits, a bloated public sector, diminishing tax revenue, and subsidized prices have led to this state. Currently, the country is looking at IMF for help, for which it needs to restructure its debt. Debt restructuring can be complicated, especially with China, which prefers to refinance loans instead of restructuring approaches. One of the international sovereign bond holders taking the Sri Lankan government to courts sets a dangerous precedent for the country.

As the economy teeters on the brink, navigating the crisis will require long overdue extensive economic reforms, which could very well be the silver lining to Sri Lanka's economic recession.

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