

An Economic Cataclysm—Sri Lanka's Financial Crisis

The island nation of Sri Lanka is currently facing the heavy consequences of its government's financial mismanagement and ill-timed decisions. A tremendous drop of 70 per cent in foreign exchange reserves has pushed the country to the verge of defeat. The coronavirus pandemic further dealt a massive blow to Sri Lanka's already crumbling economy. With \$7 billion to be paid in foreign debt obligations this year and just about \$2 billion left in foreign exchange reserves, Sri Lanka faces the unenviable dilemma of choosing between paying for crucial imports and repaying its foreign investors.

The ones that are suffering the most during this economic calamity are the families belonging to the low-income sector of society. The inflation rate in Sri Lanka has skyrocketed to 17.5 per cent, the highest in Asia. Food and medicine costs are surging like never before. The ongoing war between Russia and Ukraine has only added to the misery of the common man by [driving up the prices of oil](#). Four elderly men have lost their lives waiting in queues to buy fuel in the sweltering heat. Soldiers have been posted at hundreds of gas stations to prevent violence, stockpiling, and inefficient distribution. People have been forced to take up a second job, but the income from these is still not enough to sufficiently support their families and themselves. Paper and ink shortages mean students cannot give their exams. Hospitals are reporting shortages of necessary medical equipment. People are choosing to self-medicate instead of going to a doctor to get treated, which can only lead to higher morbidity rates. Electricity is also a rare commodity now, with daily ten to thirteen-hour power cuts becoming the norm. The drastic decrease in their quality of life has inevitably led to thousands protesting against the government and demanding change.



Sri Lankans waiting in a queue to refill their cooking gas cylinders in Colombo. [Credits: AP Photo/Eranga Jayawardena]

Sri Lanka's public debt is currently [estimated to be 119 per cent of its GDP](#). This means that the country owes more than it can produce through goods and services. The largest portion of its foreign debt comes from international sovereign bonds, which make up 36.4 per cent of the total debt. These are followed by loans from the Asian Development Bank, Japan, and China. [India has offered a \\$1 billion line of credit](#) to assist Sri Lanka in procuring essentials such as food, fuel, and medicine. In addition to this, India has also extended a \$400 million currency swap and \$500 million for 40,000 tonnes of diesel to help with severe fuel shortages. India has also deferred the payment of \$515.2 million by two months to the Asian Clearing Union.

This is the worst economic crisis the country has faced, since gaining independence in 1948. Sri Lanka is deep in debt with no single way to overcome it.

Who's responsible?

The Sri Lankan government began financing its investments through foreign borrowings and in 2007, issued its first international sovereign bond for \$500 million. A sovereign bond is a debt security issued by a government that can be denominated in both foreign and domestic currency. The buyer would be paid a given amount of interest for a stipulated number of years along with repayment of the face value on the maturity of the bond. The three-decade-long civil war with the Tamil militancy ended in 2009, following which the government focused on reconstruction and real estate. The nation was desperate to pay off foreign debt but didn't work much towards diversifying its exports, an important source of forex. In 2019, the Rajapaksa government cut value-added tax from 15 per cent to 8 per cent which caused revenue losses of more than 2 per cent of its GDP. The same year saw the devastating [Easter Sunday bombings](#) that also took a toll on the tourism industry.



Police fired tear gas and water cannon at hundreds of

university students who were trying to break through barricades near the town of Kandy. [Credits: Ishara S. Kodikara/AFP]

In 2020, the coronavirus pandemic caused Sri Lanka's unstable economy to take a turn for the worse. The vital tourism sector dried up. Lockdowns disrupted the informal sector, which accounts for about 60 per cent of the country's total workforce. Tax cuts from the previous year weakened the government's ability to deal with the public health crisis. Further, in 2021, the government announced a [ban on the import and use of chemical fertilisers and pesticides](#) in an attempt to promote organic farming, as well as to conserve quickly depleting forex, which only led to shortages in crop yield and inflation in food prices. Remittances from foreign workers, the nation's biggest source of dollars, also dropped by 22.7 per cent in 2021. That September, President Gotabaya Rajapaksa declared a state of economic emergency in the country to take control of the supply of basic food items and fix prices to control inflation. Due to the relentless protests of the citizens, the government has dissolved as all governmental authorities resigned except for Prime Minister Mahinda Rajapaksa and President Gotabaya Rajapaksa. [Even after the imposition of a social media shutdown](#), people still circumvented using VPNs and got to the streets to march against the administration. The next major challenge that Sri Lanka needs to tackle is the repayment of a [\\$1 billion bond maturing in July 2022](#).



Sri Lankan soldiers walk past a bus burned by demonstrators at the top of the road of President Rajapaksa's residence in Colombo, Sri Lanka [Credits: Dinuka Liyanawatte/Reuters]

In the last decade, China has financially supported Sri Lanka by lending over \$5 billion to help with projects like building roads, ports, and an airport. According to critics, however, these funds were utilised for unnecessary ventures with low returns. President Gotabaya Rajapaksa has now asked [China to restructure its debt repayments](#), in addition to asking for concessions on imports from China, to help Sri Lanka tide over its financial crisis. President Rajapaksa also offered to allow Chinese tourists to return to Sri Lanka, a major move in the wake of the COVID-19 pandemic. Sri Lanka is a significant member of China's Belt and Road initiative, which is a long-term project focused on building infrastructure that links China with the rest of the world. This project has been called a "debt trap" for smaller nations with unstable economies.

How It Affects India

The port of Colombo is a major trans-shipment hub on which India is heavily dependent for global trade. While exports to Sri Lanka only amount to 1.3% of India's exports, 60% of India's cargo trans-shipments are handled by this port. Any disruptions at Colombo port leave India vulnerable to increased costs and congestion issues.

India is among the biggest drivers of Foreign Direct Investment in Sri Lanka. Investing in a wide range of sectors such as petroleum retail, hotels, real estate, manufacturing, telecommunication and banking services. [Many Indian companies have a significant presence in Sri Lanka.](#) Located at the centre of the Indian Ocean, Sri Lanka is a country of major military and geopolitical importance. In the last decade, Chinese influence in Sri Lanka has grown multifold, making China its largest import partner and one of its largest investors in public infrastructure projects. The Chinese presence in Sri Lanka is a cause of concern for India. However, Sri Lanka's debt crisis has created an opening for India to counter Chinese influence. In the last few months, India has provided monetary support as well as relief in the form of food and medicine.

So far, sixteen Sri Lankan Tamils have arrived at Indian shores seeking refuge. They fled due to severe food shortages. India has not granted refugee status to any Sri Lankan since 2012, after the civil war. The Chief Minister of Tamil Nadu, M K Stalin, conferred with Prime Minister Narendra Modi requesting him to allow the Tamil Nadu government to provide humanitarian aid to the Tamils living in the northern and eastern parts of Sri Lanka.

Overcoming The Economic Crisis

Sri Lanka is currently facing a shortage of foreign exchange to pay for its imports. The government is now borrowing from other governments and carrying out currency swaps to overcome

the forex deficit. However, these measures are not enough. The country has approached the IMF for help, to wade over this crisis. The [IMF has recommended some policy changes](#) to ensure that the most vulnerable are protected including but not limited to, reforming the revenue generation and collection system, increasing taxes to improve Sri Lanka's low tax-to-GDP ratio and ensuring a greater contribution from higher-income earners of the country, and leaving fuel and exchange rates to the market rates.

Sri Lanka's economic crisis has led to a spike in prices

The country's inflation increased by 13.3 percentage points in the year to February 2022, reaching its highest peak in a decade.

National Consumer Price Index, year-on-year change



CNN Source: Central Bank of Sri Lanka
Graphic: Natalie Croker, CNN

*Sri Lanka's inflation rate has increased to 17.5 per cent.
[Credits: CNN]*

The IMF has also proposed the need for a banking act giving the Central Bank of Sri Lanka more regulatory powers to aid the process of resolving the country's debt. Sri Lanka also desperately needs to diversify its exports as it is heavily dependent on tea leaves. The removal of import restrictions

can help encourage investments, bringing in the necessity for exports. There is a need for reforms to improve conditions and ensure financial security for the labour force in farming and non-farming sectors to ensure the people living at the edge are uplifted first.

Once revered as the radiant Pearl of the Indian Ocean, Sri Lanka's crippling economy has rendered it a husk of its former self. The congregations within the government can only do so much to restore financial stability. The country desperately needs international helping hands to resolve the crisis, and revive the tourism industry in the process. The several strategies in place could eventually create a strong momentum—one which can hopefully pave the way to rekindle the glory of Sri Lanka.

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