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Sri Lanka's Slippage into a Dark Alley of Economic Depression

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Abstract: Even as nations all over the world are yet to recover from a catastrophic impact of the covid-19 pandemic, most South Asian countries in recent time have been badly hit by multiple crises. From Afghanistan to Myanmar to Pakistan and now Sri Lanka, each nation's politico-economic landscape seems to be in a depressing situation. The 2019-2022 Sri Lankan Economic crisis, currently affecting the island nation, is referred to as a 'twin crises of a balance of payment and a sovereign debt crisis' and is attributed largely to the economic mismanagement by the incumbent government. The country of 22 million people is in the throes of an unprecedented economic crisis since its independence in 1948. The country's people are facing more than 12-hour power cuts, and an extreme scarcity of food, fuel and other essential items such as medicines. Inflation is at an all-time high of 17.5%. On April 1, President Gotabaya Rajapaksa declared a state of emergency. In less than a week, he withdrew it following massive protests by citizens over the government's handling of the crisis. A number of measures have been taken to deal with the situation including important steps like increase in Deposit and Lending interest rates by 700 basis points by the Central Bank, removal of ban on import of fertilizers, measures to encourage tourism, closing of some embassies and consulates in some countries temporarily, to save foreign currencies reserves etc. The country has also now entered into talks with IMF for immediate aid to tide over the situation. Restructuring of the debt has also been taken on hand to avoid sovereign debt repayment default. These measures are expected to improve the situation but with certain costs and consequences like depressed projected GDP growth.

Keywords: Sri Lanka, Economic Depression, Crisis.

INTRODUCTION

Why the Crisis? – The current Sri Lankan crisis is largely attributed to economic mismanagement by the incumbent government which has led to unprecedented levels of inflation, near depletion of the foreign exchange reserves, shortages of medical supplies and price increases in basic commodities. These have been caused by multiple compounding factors like tax cuts, money creation, enactment of law to impose ban on chemical fertilizers (however, later on it was withdrawn) and also events such as the Easter bombings in 2019 and the impact of Covid-19 pandemic. Moreover, there is a case of probable sovereign default, as the FOREX reserves had contracted to just USD 1.9 billion as of March 2022[1], which is not sufficient to meet the foreign debt obligations for 2022, with US$4 billion to be repaid. An International Sovereign Bond payment of US$1 billion is also due by July 2022.

The then Deputy Governor of Reserve Bank of Sri Lanka, W.A. Wijewardena stated that the Government which came to power in 2015 headed by the then Prime Minister R. Wickremesinghe, had been warned by the Institute of Policy Studies of Sri Lanka about the various financial risks through which the country was passing. Although a strong economic policy was framed to address these risks but the coalition government could not push it through the parliament. Hence the proposed reforms could not be implemented. Instead, election related economic decisions were pushed such as excessive distribution of 'freebies.' Further, the political turmoil of 2018 worsened the economic outlook. But by that time several reforms were done under the IMF supported program under fiscal and monetary consolidation and successfully controlled the inflation. These reforms included fixing fuel prices automatically, increase in VAT rate from 11% to 15% and also broadened its base by removing exemptions[2]. But many of these reforms were reversed by the new government after elections of 2019, e.g. the bill to grant independence to the Reserve Bank of Sri Lanka by excluding the Treasury Secretary and any member of the government from being on the Monetary Board of the Bank. But the new government under the Rajapaksa's discarded the bill as soon as they came to power.

Causes of the Crisis

Tax Cuts and Money Creation

The government under Rajapaksa's made large tax cuts that affected the government revenue adversely, causing the fiscal deficit to soar. This included the tax-free threshold resulting in 33.5% decline in the number of tax payers. The VAT was reduced again to 8% and the Corporate Tax from 28% to 24%. In addition, other tax cut measures included abolition of Pay-As-You-Earn (PAYE) tax and the 2% nation building tax, which used to

[1] "Sri Lanka Forex reserves drop to US$1.9bn in March 2022." *EconomyNext* (2022).

[2] November 30, 2019, "Sri Lanka to abolish fuel price formula." (2022).

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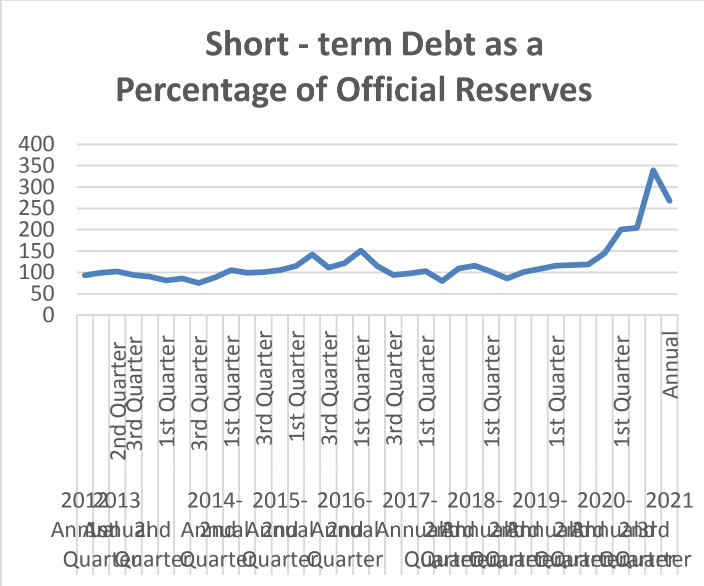
finance the infrastructure development[3]. All these measures resulted in resulted in drastic decrease in the government revenue and to cover it, the Central Bank started printing money in record amounts. On April 6, 2022, CBSL allegedly printed 119.08 billion rupees, making it the highest reported printing in a single day and the total money added to the financial markets in 2022 spiralled to Rs. 432.76 billion[4]. Despite opposition of tax cuts by the then Finance Minister M. Samaraweera these tax cuts predicting that the country may go bankrupt and warnings by IMF regarding fiscal tightening, the government went ahead with the cuts and the current crisis was the result. Many experts compare the crisis of Sri Lanka with Lebanon and Venezuela's crisis. These countries also had similar issues including deep economic crisis and accumulation of unsustainable sovereign debt and took decades to recover.

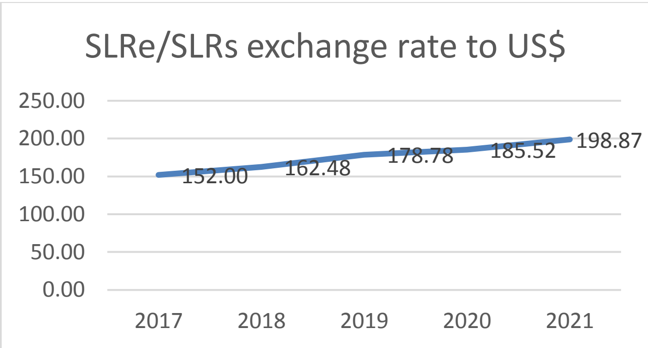
External Debt

Since 2010, the foreign debt more than doubled between 2010 and 2020. In 2019 the foreign debt was 42% of GDP which rose to 119% of GDP in 2021[5]. The country is due to pay US$4 billion to debtors in the year 2022, whereas in April 2022, the gross International Reserves amounted to only US$2.3 billion. Sri Lanka lost access to international market in 2020, prompting a decline of international reserves to critically low levels and large-scale direct lending to the government by CBSL. External debt repayments and a widening current account deficit led to severe FX shortages, while official exchange rate was de facto kept fixed since April 2021. The Graph-1 shows the trend of Gross International Reserves since 2017, Graph-1a is depicting the Short-term debt as percentage of Official Reserves and Graph-2 shows the change in exchange rate during the same period. It can be seen that the reserves decline sharply whereas the external short-term debt as percentage of Official Reserves has risen very high in 2020 and 2021. Similarly, the Sri Lankan Rupee also declined drastically. (Data published by Asian Development Bank, 2022).

Graph-1



Graph-1a



Graph-2

In September 2021, an economic emergency was announced as the already worsened situation was aggravated by the falling exchange rate of SLRe and soaring inflation as a result of rising food prices and pandemic restrictions in tourism. This brought Sri Lanka almost to the brink of bankruptcy due to foreign reserves further falling to US$1.9 billion as of March 2022, this being insufficient to service foreign debt of US$4 billion in 2022. The inflation trend of Sri Lanka as per data published by the Asian Development Bank is as depicted in Graph-3 below. Further, the rate of inflation further increased to 17.5% in February 2022.

[3] "Erosion of the Tax Base: A 33.5% decline in registered Taxpayers from 2019 to 2020." *publicfinance.lk* (2022).
[4] "Sri Lanka prints 119.08 billion rupees yesterday." *NewsWire* (2022).
[5] Sharma, Samrat (4 April 2022). "Sri Lankan economic crisis explained in five charts". *India Today* (2022).

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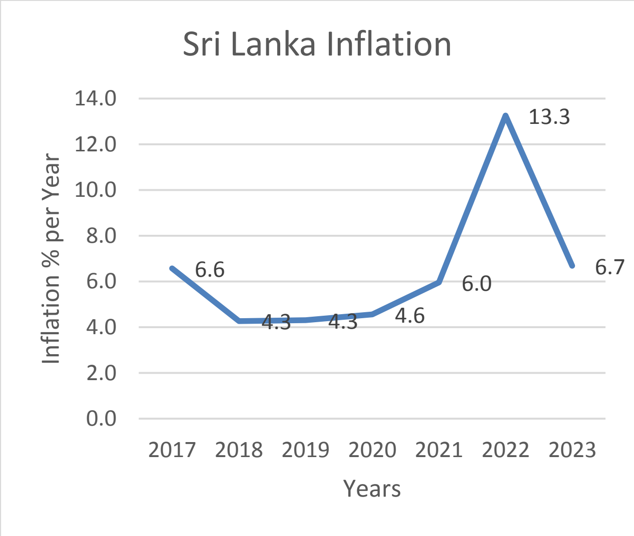
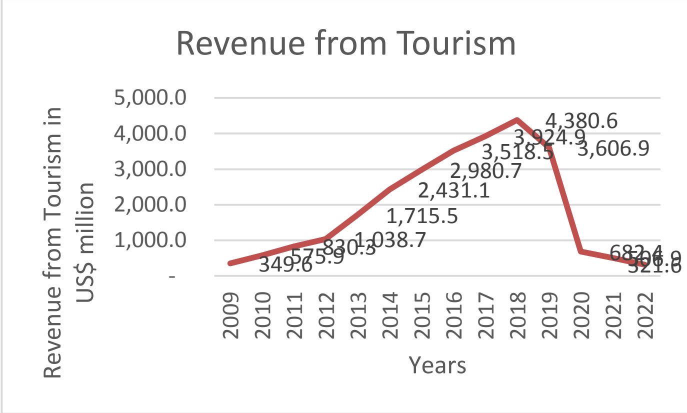


Graph-3

Fall in Foreign Remittances
Sri Lankan Reserve Bank kept LKRe pegged to US$ while heavy money printing and thus the value of LKRe declined drastically. Although the Central Bank kept the pegged currency within LKRe 200 to the USD, the unofficial market flourished where the value of the USD was exceeding 248 LKRe to a USD. Thus, foreign workers started sending through unofficial channels and the foreign Remittances revenue crashed with a 61% reduction in official remittances in January 2022[6]. These practices indicate dismantling of role of the Central Bank's power to regulate FOREX movement.

Falling Tourism industry revenue
The tourism industry has been hit hard by the 2019 Easter Blasts followed by the covid-19 pandemic. According to World Travel and Tourism Council, more than 2 lakh people lost their jobs in the travel and tourism industry. The loss of foreign revenue from the sector has been substantial as shown in the Graph-4 below. Many depend on the $4.4 billion tourism industry, which slumped 70% in May, 2019 due to terror attack. The Russia-Ukraine war also had a negative impact on the number of tourists coming from these countries, which constitute about 11% of the total number of tourists on an average.

Even UK and Canada issued advisories to their travellers in March 2022 to be aware of the economic crisis in Sri Lanka, in view of the violent protests taking place in Sri Lanka.



Graph-4

Agricultural Collapse
The agricultural crisis started in Sri Lanka with the announcement of banning the import of fertilizers and emphasizing organic farming in Sri Lanka in April, 2021. The organic farming had imposed far more cost on the agriculture with output of rice production reduced by 20%. Production of tea also dropped as a result of fertilizer ban, resulting in economic losses if around $425 million. These measures caused severe shortage of food and income in the country. Violent protests, therefore, started in the country against the Rajapaksa's family. As a result, PM of Sri Lanka resigned and was replaced by R. Wickremesinghe. Hence in November 2021, Sri Lanka abandoned its plans to become the world's first organic farming nation. Important to mention here is that Sri Lanka had already become self-sufficient in rice production but for the decision to ban import of chemical fertilizers. Therefore, rice had to be imported at a cost of $450 million[7].

Russian-Ukraine War
The repercussions of Russia-Ukraine War on almost all countries of the world are like-wise affecting Sri Lankan economy with fuel shortage. Moreover, Russia and Ukraine are biggest importers of Sri Lankan tea as also they contribute the maximum to the revenue of tourism industry in Sri Lanka. These factors have hit Sri Lanka very hard and accentuated the already grim situation of the economy, reducing drastically the earning of foreign exchange.

The Major Impacts on the Economy
Some of the major areas of impact of the above causes of the crisis have been identified as follows:

[6] "Sri Lanka remittances down 61-pct in January 2022 amid parallel exchange rates". *EconomyNext* (2022).

[7] Nordhaus, Ted; Shah, Saloni (5 March 2022). "In Sri Lanka, Organic Farming Went Catastrophically Wrong". *Foreign Policy* (2022).

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Food, Fuel and Electricity shortages: - The crisis resulted in shortages of electricity and fuel. The daily electricity cuts exceeded 10 hours which increased to 15 hours daily in April, 2022. Moreover, queues at gas and fuel stations swarmed and to reduce the inconvenience to the public, the government ordered to post soldiers at various gas and fuel stations.

Inflation: - As of February 2022 inflation was 17.5%, in which the year-on-year increase of inflation (February 2021 to February 2022) in food items was as high as 24.7%, while in case of non-food items, it was 11%. Inflation is on the rise due to both supply side factors and mounting aggregate demand pressure.

Education: - Shortage of paper and ink ribbons, as the country couldn't import them due to depleted foreign exchange reserves, resulted into cancellation of examinations.

Health Sector: - An acute shortage of medicines and medical equipment's in the country due to lack of foreign reserves, resulted in total chaos in the country. Even emergency drugs were in short supply.

As discussed earlier, the tourism sector was severely affected.

Textiles and Tea were the major export items that could not be exported and hence demand for import of these items from India surged.

To save on the foreign exchange, the High Commission in Nigeria and the consulates in Germany and Cyprus were temporarily closed down in January 2022. Similarly, Sri Lankan Embassy in Iraq and Norway and the consulate in Australia were closed in March 2022 following the crisis.

Measures Taken and their Effects so far

The Monetary Board of the Central Bank of Sri Lanka significantly tightened the monetary policy by increasing the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR) of the Central Bank by 700 basis points to 13.50% and 14.50%, respectively, effective from 08 April 2022[8]. Having noted the inflationary pressures that could further intensify in the period ahead built up by domestic and foreign supply disruptions, exchange rate depreciation, and elevated commodity prices globally, the Monetary Board suggested that this increase in interest rates would help curb the demand-side inflation pressure and the correction of the exchange rate to some extent. However, it has to earn and re-build foreign exchange reserves. For supply-side correction in the field of agriculture, steps need to be taken to increase use of chemical fertilizers and pesticides, which can result in increased production of rice and tea which was negatively impacted due to ban on chemical fertilizers.

However, the external sector is still facing continued heightened challenges. Although the momentum in export sector continues with earnings exceeding US$ 1 billion for several consecutive months, increased expenditure on imports have led to continued widening of the trade deficit. Tourist arrivals have also shown some signs of improvement, however, the existing geopolitical tensions and the slow pace of domestic economic recovery marked by supply-side shortages of food and fuel could weigh on this recovery to some extent. Workers' remittances are showing some recovery signs due to minor exchange rate adjustments and increased worker migrations. Nevertheless, excessive depreciation of SLRe against USD amid lacklustre performance of foreign exchange inflows warrants certain policy actions.

Market interest rates are also adjusting gradually upwards in response to the tight monetary policy adopted so far. However, adjustments in deposit rates are inadequate to attract liquid money from the market into the banking system. Partially, this is due to the fact that as a result of failed agriculture, many households have been pushed into poverty. Moreover, due to increased cost of borrowing funds, the demand may get reduced for luxury items. Nevertheless, it should not be forgotten that this increase in the cost of funds may affect investment adversely and resultantly GDP growth would also be affected adversely.

The data published by the Department of Census and Statistics (DCS), show that Sri Lankan economy grew by just 1.8%, year-on-year in the last quarter of 2021.

The Sri Lankan government and the Central Bank have also started working closely with IMF to formulate a sustainable solution to overcome the macroeconomic challenges faced by the country as at present. Negotiations to obtain bridging financing have already commenced with the

[8] Monetary Policy Review: No. 03—April 2022, Press Release Central Bank of Sri Lanka, Economic Research Department.

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interested counterparties. A proposal to issue a Rapid Financing Instrument (RFI) is also being considered by the IMF on request from India.

Efforts for debt restructuring have also started. Moreover, India has given aid amounting to $1 billion to Sri Lanka to handle the internal situation, specially to support the humanitarian efforts.

CONCLUSION

All these efforts are expected to have a reason for the Sri Lankan government and the Central Bank to believe that they would gradually reinforce greater stability in prices as well as in the external, monetary and financial sectors, while restoring the stakeholders' confidence. However, Sri Lanka's debt burden is huge and its debt service obligation from July 21 to 2026 is about US$ 29 billion[9]. EU is the second largest market for Sri Lanka's exports. EU's Generalised Scheme of Preferences (GSP+) facilitates duty-free entry of Sri Lankan goods to EU. But unsatisfied with the human rights records of Sri Lanka, EU Parliament has threatened to review the GSP+ scheme extended to Sri Lanka through a resolution in June 2021. Sri Lanka was requested to improve its human rights record including abolishing the Prevention of Terrorism Act (PTA). A report presented in UNHRC in its 49th Session asked the government to take "further steps to address the fundamental problems with the PTA and undertake deeper, legal, institutional and security sector reforms that are critically needed to put an end to impunity and prevent any recurrence of past violations[10]". Although Sri Lanka termed it as 'discriminatory', nonetheless, withdrawal of GSP+ facility will greatly hinder progress in the exports sector. Hence it is difficult to project the future of the crisis in nearby period of time looking to the mountain of problems still standing in the way of economic recovery of Sri Lanka. We have to wait and see how the effect of these measures unfolds and triggers economic recovery.

[9] "Rating Reports Sri Lanka (https://www.fitchratings.com/research/sovereigns/srilanka-02-07-2021)." No. 11.

[10] "Human Rights Council Holds Separate Interactive Dialogues on the Human Rights Situations in Eritrea and in Sri Lanka (https://www.ohchr.org/en/NewsEvents/Pages/DisplayNews.aspx?NewsID=28212&LangID=E)." United Nations Human Rights Office of the High Commissioner (2022).

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