

THE SRI LANKAN CRISIS

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ABSTRACT

Sri Lanka is said to be going through its worst financial crisis which began three years ago. But for a country to reach a stage where it cannot import basic commodities for its people, it's difficult to believe that it happened overnight. There are various factors that hit together which results in the collapse of an economy but that does not happen overnight. Sri Lanka, in 2023, still facing the adversities of the economic and political turmoil it has experienced. In 2022 it was estimated that the national debt of Sri Lanka increased by \$39.5 dollars which is 3590 crores in Indian Rupees. There are frequent power outages and sizable street protests. The provision of emergency health services has been significantly hampered by the lack of power and medicines available in the market. This is not just an economic crisis of a country but a humanitarian cry for help. But how did this happen? What was the major cause behind all of this? This article dwells into the discussion of this crisis and also aims to answer the above questions.

Keywords - Crisis, Economy, Sri Lanka, Shortage, Government, Import, Debt.

INTRODUCTION

Sri Lanka is an island nation located just about 30 kilometers southeast of India. With a population of roughly 2.22 crores, the country is famous for its rich biodiversity, aesthetic scenic wonders, and textile exportation. Sri Lanka has a diverse culture with deep-rooted religious sentiments across the country. Sri Lanka's population, being a diverse country, is divided into different ethnic groups - ¹Sinhalese (74.9%), Sri Lankan Tamil (11.2%), Sri Lankan Moors (9.2%), Indian Tamil (4.2%), and others (0.5%). In 1948, when India was suffering the after-effects of the painful partition of India and Pakistan, the world had put its bets on Sri Lanka to rapidly develop into a strong economy due to its location in the Indian Ocean and relatively good infrastructure. Sri Lanka is also an open economy which means that it was well connected with the rest of the world in terms of trades of commodities and services

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and also financial assets. Over the years, Sri Lanka also became a globally favored tourist destination for having religious and historical places of significance that attract thousands of tourists every year. It's obvious for a country with so much to offer to flourish and emerge as a fast-growing country, as the rest of the world including Sri Lankans imagined. But everything seemed to go wrong since its independence from the British. And in 2022, the country was hit with its worst economic crisis which turned into a humanitarian crisis very quickly. A series of mass protests began in March 2022 across Sri Lanka against the government. The people criticised the government for mismanaging the economy which led to many problems that affected the daily life of its citizens. The conditions in Sri Lanka got so bad that people did not even have proper access to basic commodities.²Retail inflation in Sri Lanka reached 17.5% in February 2022, and food inflation increased by over 25%, pushing up the cost of food and cereal.³There was a major shortage of commodities in the market and prices of basic commodities like a kilogram of sugar spiked to Rs 240, a liter of coconut oil cost an outrageous Rs 850, one egg was Rs 30 and a kilogram of milk powder went up to Rs 1900 (Sri Lankan Rupees).⁴The conditions were so bad that the National Hospital of Sri Lanka in Colombo, the largest hospital in the nation, reportedly already stopped performing routine diagnostic procedures, and many surgeries all around the country were suspended due to a shortage of medicine in the market. The government also imposed power cuts that lasted up to 13 hours due to a lack of sufficient fuel to run the power generators.

The condition was so severe that the government announced they will turn off the street lights to save as much electricity as they can. Newspaper publications had stopped, schools had to halt their written exams and you could find military personnel at the petrol pumps to distribute fuel all around the country while the general public stood in long queues outside. If all of this wasn't enough, the people started protesting asking the then President of the country, Gotabaya Rajapaksa, and the Rajapaksa family to resign from the administration. Slogans like "go home Gota" and "go home Rajapaksas" were shouted by protesters. Sri Lanka imposed a curfew and declared a state of emergency to deal with the deteriorating situation as a result of the protests and the ensuing violence. To stop the violence, the government sent out the military with shoot-on-sight orders. The military personnel was also allowed to arrest the citizen as per their wish

² Saikiran Kannan, "Refugees, inflation and power cuts: How Sri Lanka walked itself into a mess" (India Today, 2022)

³ Business Today Desk, "Sri Lanka economic crisis: Soaring rice, milk, basic goods prices in Colombo" (Business Today, 2022)

⁴ Shweta Sharma, "Sri Lanka crisis: 13-hour daily power cuts as country faces worst economic collapse since 1948 | The Independent" (INDEPENDENT, 2022)

and restricted internet all over the country.⁵ But this social media ban backfired as the people still used VPNs to access apps like Facebook, WhatsApp and Twitter to trend hashtags like #GoHomeRajapaksas, and #GoHomeGota in countries like Singapore, Germany and the United States. Gotabaya Rajapaksa tried to halt the protests and make a coalition with the opposition but that was refused. In the end, the ministers resigned and Gotabaya Rajapaksa had to step down from the position of President.

Though this was what the Sri Lankan people wanted this situation only added further to the country's social and political crisis. The situation has deteriorated so much that hundreds of Sri Lankans are fleeing out of the country and seeking refuge in India. In a situation like this, not only did the lower classes of the economy suffer, but so did the middle class, and even those who had substantial wealth were affected by the condition of the country. It is important to understand how this poor management on the part of the government resulted in such a cry for help. The balance of payment crisis has plagued Sri Lanka's economy since the 1950s, and the country's foreign reserves are rapidly declining in the current times. Due to declining reserves and the country's high reliance on imports, there is a severe shortage of goods available on the market. However, there isn't one single factor responsible for this crisis. In fact, if we examine Sri Lanka's administration since 1948, the approach taken by its government, and then external factors like covid and debt have also contributed to the current situation.

TWIN DEFICIT

Journal of Legal Research and Juridical Sciences

Sri Lanka is a heavily import-reliant country. The economy is not diversified and is dependent on a few sectors like tea, rice, rubber, and textile and the forex reserves from tourism. The country imports food, fuel, paper, sugar, lentils, medicines, and transportation machinery. Sri Lankan economy completely collapsed due to the Balance of Payment crisis due to which the government could not even afford to import necessities for the citizen of the country. The main reason why the population of Sri Lanka is struggling to meet its ends today is that the country is facing the Twin Deficit problem. When an economy experiences both a fiscal and current account deficit, it is said to be in Twin Deficit. In such a situation, there is a simultaneous rise in both Current Account Deficit and Fiscal Deficit.

A fiscal Deficit in simple words is a budget shortfall. That's why it's also called "Budget Deficit". The difference between the government's total revenue and expenses for a fiscal year

⁵ "Social media ban backfires : Anti Govt slogans trends in other countries - NewsWire" (Newswire, 2022)

is known as a fiscal deficit. It is not an ideal state for an economy to be in because it shows how heavily the government depends on borrowing to fund its spending. If there's a fiscal deficit in the country, then that means the government is borrowing a lot of money to fund the necessary needs of the country which leads to the accumulation of debt and inflation. And that's exactly what happened in Sri Lanka. A country goes into a state of fiscal deficit due to a variety of reasons –

- The government expenses are more than their earnings.
- The total revenue of the government has decreased significantly.
- Situations like wars or disasters increase the expenses of the government.
- When government spends too much money on social welfare policies then its total expenses increase significantly which results in a deficit.
- In cases of repayment of the debt, the government has to bear payments of the high interest on those debts which may also lead to a deficit.

The current Account records the flow of goods and services of an economy and investment in and out of the country. If the value of imports exceeds the value of exports, the current account is said to be in deficit. The deficit in the current account is not always alarming as the current account only shows how the competitiveness of an economy but a high current account deficit is an indication that the economy is imbalanced and immediate actions need to be taken to restore the equilibrium of the economy. In Sri Lanka's case, the production of domestic goods and services had taken a big hit at a time when its imports were on the rise. Sri Lanka, being an island country, has a heavy dependency on fuel sectors for its revenue. Sri Lanka is also dependent on tourism, fisheries, and agricultural products like tea and rice. While the government was spending far more than it could afford, the domestic market was struggling. As a result of the government's excessive borrowing and use of its foreign exchange reserves to pay for imports while exports were so low, a balance of payments crisis in the country was inevitable. Now, this situation can be controlled if the government acts appropriately and quickly to prevent the nation from entering a state of emergency, but the Sri Lankan government repeatedly made the same mistakes by failing to recognize how negatively their poorly calculated decisions could affect the entire nation.

Twin deficit can be managed through various revenue generation and expenditure control measures. Now one such measure is increasing government revenue by imposing proper taxes and increasing exports of the country. And whatever policies are implemented should be done

by considering the long-term effects of those policies on the country. India, in 1991, had also faced a similar situation of the Balance of Payment crisis. At that time, Long-term policies to revive the economy were started by the government under PV Narasimha Rao, with Manmohan Singh serving as Finance Minister. Subsidiaries for exports were abolished for fiscal correction, industrial licensing was abolished, and Measures were taken to ease domestic supply constraints and spur investments. In Sri Lanka, the government always provided subsidies to its people in the name of social welfare. But in the long run, when the government is making less than its spending, it should have been abolished to maintain the economy a little bit. But the government kept spending money on social welfare, completely disregarding the consistent deterioration of the economy.

CAUSES OF THE CRISIS

Mishandling the Economy: The primary reason why Sri Lanka got into a state of economic crisis is the mismanagement of the economy by the government. In Sri Lanka, the Rajapaksa family holds a very influential position in the country. Almost all of the Rajapaksa family is in politics and held high offices in the parliament. Dynasty politics refers to when several members of one family hold prominent political positions, giving that family a great deal of political sway over the nation. In south Asian nations, dynasty politics are common. The Gandhi family in India is one such example of dynasty politics in India. So it wasn't anything new when Mahinda Rajapaksa was the President of Sri Lanka from 2005 to 2015 and his brother, Gotabaya Rajapaksa was the Defense Minister. But in 2019 when Gotabaya Rajapaksa won the elections and was sworn in as the President of Sri Lanka, he quickly appointed his brother and former President, Mahinda Rajapaksa as the Prime Minister of the country. Following that, several members of the Rajapaksa family joined the same cabinet as ministers. Mahinda Rajapaksa's son, Nanna Rajapaksa, became the minister of Youth and Sports and state minister for digital tech and enterprise development. Chamal Rajapaksa, the third Rajapaksa brother, joined as the minister of irrigation. Chamal's son, Sashindra Rajapaksa was appointed as the minister of state for agricultural produce. Basil Rajapaksa, the fourth Rajapaksa brother, joined as the organiser-in-chief of the family and joined the cabinet as the Finance Minister. He is American-Sri Lankan and that's why Mahinda Rajapaksa amended the constitution of Sri Lanka to appoint him as a minister in the cabinet. The family not only took the influential positions in the government but also the lesser influential posts. The majority of the government was made up of the Rajapaksa family.

The Sri Lankan government, over the years, has always been weak in the fiscal management of the country. They've always failed to put appropriate attention to the priority areas and for the longest time, Sri Lankan economy was dependent on the tea and rubber sector. These were the areas where the government focused the majority of its funding, but in the 1950s, the nation's exports had sharply declined because the price of tea and rubber decreased in the international market, leading to a currency crisis. It meant that the majority of the foreign exchange reserves were being used for imports, increasing the country's imports while rarely generating enough income from their meager exports. The country was always in a budget deficit since its independence because a very less percentage of the import revenue was allocated to the development of the country and the majority of it went into fulfilling the short-term goals of the government. The government did not focus on the long-term development of the country. This hindered the growth of the Industrial sector of Sri Lanka and made the economy stagnant. In the 1980s, the infamous decades-long civil war of Sri Lanka started. The Liberation Tigers of Tamil Eelam (LTTE) which sought to create a separate state for the Tamil minority, and the government of Sri Lanka, which is dominated by the Sinhalese ethnic group, were the main parties involved in the conflict. ⁶The majority of ethnic groups in Sri Lanka are Sinhalese (74.9%) and Sri Lankan Tamil (11.2%). Significant linguistic and religious divisions can be seen between these two groups, with Sinhalese typically being Buddhist and Tamils typically being Hindu. In 1960, Sinhalese was declared the official language of the country. The minority also faced violence and discrimination from the government and the majority group due to their ethnic differences. This created a rift between the two groups and the Sri Lankan Tamils started to demand a separate state. This was the longest Asian war in history and ended in 2009 when the government successfully defeated the Liberation Tigers of Tamil Eelam (LTTE). It is interesting because Mahinda Rajapaksa was the President of Sri Lanka during this period (2005-2009) and played a role in this civil war. He launched the last phase of the civil war against LTTE and spent heavily on defense and security instead of prioritizing the development of the country.

But if a decades-long war is going on in a country, the government is not wrong to prioritize ending the war first. In such situations, it's also hard for a country to really develop. Due to this war, Sri Lanka did not even attract foreign investors who play a huge role in the development of the country. So for the country to really go on the road of development, it was

⁶ Nithyani Anandakugan, "The Sri Lankan Civil War and Its History, Revisited in 2020" (Harvard International Review)

necessary for the war to end. But the Sri Lankan government recklessly spent most of its forex reserves on its military and did little to no efforts to curtail the low exports and domestic development of the country. As a result, the money that the government had was only used for one single purpose - to end the civil war, and everything else was ignored.

When Mahinda Rajapaksa was elected as the President in 2005, the government started to take loans for the development of the country but a very less percentage of these loans were used for development. Most of it was spent on importing commodities and the defense sector. Had the government done something for domestic development, maybe the exports of the country would have increased in some way. Sri Lanka has a very strategic location in the Indian Ocean due to being located in between the lucrative shipping lanes of the Suez Canal and the Malacca Straits, Sri Lanka connects Asia and Europe. Every year, the route is reportedly used by 36,000 ships. However, Sri Lanka only had one significant port, the Port of Colombo, at that time which could accommodate a large number of ships. Being a small island, it was important to make use of its location for the development of the country. That's why the Sri Lankan government decided to develop the Hambantota Port which was close to international shipping routes. The Sri Lankan government had borrowed so much money in the past, but they still did not have enough funds to pay for this project. Sri Lanka requested financial assistance from India and the United States for the development of this port, but both nations turned it down because it would not be very beneficial to their respective economies.⁷ Finally, Sri Lanka got assistance to develop this port from China, providing Sri Lanka with a \$307 million loan with a 15-year term and a 6.3 percent interest rate to build the port. But China also put forth some conditions such as -

1. Only Chinese companies will get the contract for such developmental projects. In this case, China Harbour Engineering Company and Sinohydro Corporation were involved. This means that whatever money China has lent to Sri Lanka to fund this project will flow back into the Chinese economy through these companies but on paper, Sri Lanka has to repay the debt along with the hefty interest.

⁷ Saptarishi Basak, "Interest Rates & 'White Elephants': Why is Sri Lanka Buried in Chinese Debt?" (Thw Quint, 2022)

2. ⁸China also demands that the borrower country must keep a certain amount of cash on hand in an account located abroad that China has access to. So if the borrower fails to repay the money, China can simply withdraw the money from this account.

So Sri Lanka had to keep some amount of money in a Chinese-controlled bank that allowed China to withdraw the money if Sri Lanka fails to repay the loan along with the interest. China also charged higher rates of interest than institutions like the world bank. While China charged an interest of 6.3 percent, the World Bank lenders give out loans at the interest rate of 1-2 percent for 28 to 30 years.

⁹Unfortunately, even after the port was constructed, Sri Lanka was forced to borrow an additional \$757 million at a 2 percent interest rate from China because Hambantota was not producing the expected returns. As a result, Sri Lanka was unable to pay back the loan they had taken from china. In exchange for \$1.1 billion, the government agreed to lease the port for 99 years to China. The fact that a port was leased to China, especially if we consider the tense relations between India and China, is of concern to India for security reasons.

Agriculture crisis

In 2021, the Rajapaksa government banned chemical fertilizers in order to move the country towards organic farming. ¹⁰Sri Lanka was set to save \$400 million annually on synthetic fertilizer after the agrochemical ban. Gotabaya Rajapaksa claimed that using chemical fertilizers and pesticides had "adverse health and environmental impacts" and went against the nation's history of "sustainable food systems."

But instead of making things better for Sri Lanka, this ban made things even worse. A sudden shift from Chemical fertilizers to Organic farming was an expensive move for Sri Lanka. The country that had been self-sufficient in rice production in the past had to spend a lot of money on rice imports as a result of the agrochemical ban because the sudden change to organic farming reduced rice production by 20% in the six months after it was put into effect. The biggest export from Sri Lanka and its literal cash crop, tea, saw an 18% decrease in production. To make up for the productivity loss, the government had to spend a lot of money again on subsidies and payments to farmers. It is important to consider that Sri Lanka is a small country

⁸ Kai Wang, "China: Is it burdening poor countries with unsustainable debt?" (BBC, 2022)

⁹ Saptarishi Basak, "Interest Rates & 'White Elephants': Why is Sri Lanka Buried in Chinese Debt?" (The Quint, 2022)

¹⁰ Kapil Komireddi, "A Reckless Dynasty Has Brought Calamity to Sri Lanka" (The New York Times, 2022)

and while chemical fertilizers pose a threat to the environment, it was the duty of the government to truly investigate whether or not this change will benefit a country like Sri Lanka. Chemical Fertilizers are bad but they also help farmers grow more on a small land. And that is important for a small country like Sri Lanka. Chemical fertilizers are faster and bigger. also help the crops grow Although the government allowed the tea farmers to use fertilizers after some months, the damage was already done to the economy of the country.

Tax Policy of Rajapaksa government

In 2019, the Rajapaksa government under Gotabaya Rajapaksa made another ill-advised decision. In order to retrieve the economy back by boosting growth, the government announced tax cuts. Value-added tax (VAT) was reduced by the Cabinet from 15% to 8% and abolished Capital Gains Tax, VAT on condominiums, Nation Building Tax on domestic production, Economic Service Charge, Bank Debit Tax, Pay as Earn Tax (PAYE) and Withholding Tax on interest. But this also backfired and impacted the government revenue. Due to this one action, the country lost access to overseas markets which prompted rating agencies to downgrade Sri Lanka. Whatever policies and promises the Rajapaksa government had made had no economic logic rather they were made to win the elections despite the grave situation of the Sri Lankan economy. But the government still pursued these policies which resulted in the fiscal deficit increasing.

Tourism

Tourism in Sri Lanka accounts for almost 12 percent of the country's Gross Domestic Product (GDP). Sri Lanka is known for its scenic wonders and world-famous tourist spots. The Dambulla cave temple is the largest temple complex in the country and is one of the top tourist spots. But in 2019, Nearly 270 people were killed in a series of bombings carried out on Easter Sunday by the local militant group National Thowheed Jamath (NTJ) that targeted three opulent hotels and three churches across the country. This made Sri Lanka a risky country for western travelers and hence affected tourism to a great extent but if this wasn't enough, the world was hit with a global pandemic in 2020 which shut down the entire world for the next two years. This affected Sri Lanka adversely as its economy was heavily dependent on the tourism sector. This also affects the nation's ability to pay its debt and get the economy back on track. The pandemic not only affect the tourism sector but the government had to bear additional expenses when they were barely making anything in return. Due to the pandemic,

many Sri Lankan workers lost their jobs and the government had to pay foreign remittances to those people. And lastly, health expenditure also increased due to the pandemic.

Russia-Ukraine conflict

Russia invading Ukraine and their subsequent war affected millions of people living in Ukraine. People had to leave behind their entire lives and fled their own homes in order to stay safe. But this ongoing war also had a big impact on the rest of the world. The conflict has disrupted global supply chains and the prices of oil increased exponentially. This made it very difficult for Sri Lanka to import oil as they did not have enough forex reserves. The lives of average Sri Lankans are negatively impacted by such astronomical inflation.

Sri Lanka was just left with around \$2 billion in forex reserves when they needed double the amount of money to repay the loans they have taken in the past. This is why imports had to be stopped which created a massive shortage of all essential commodities. This was the point at which the ordinary people started protesting against the government's recklessness.

THE NEXT STEP

Since Sri Lanka was completely unable to even import basic commodities for its people, the new Sri Lankan government had to do everything in their power to get the country back on its feet. In 2022, India extended financial aid worth 3.9 billion to help Sri Lanka sustain itself for some time and meet its necessities. India also signed an agreement for the supply of petroleum products worth 500 million from the Indian Oil Company to meet Sri Lanka's fuel shortage. This was extended by an additional 200 million worth of petroleum products later on. State Bank of India extended export credit facilities to Sri Lanka for the import of essential commodities. China, the bilateral creditor, and partner of Sri Lanka has also provided it with humanitarian aid of \$74 million. In Jan 2023, the cabinet of Sri Lanka announced that it would reduce recurrent budget spending by 6% in 2023 and is seeking assistance from the International Monetary Fund (IMF). The government has adopted cost-effective tariff plans after suggestions from the Internal Monetary Fund. The country is currently awaiting the IMF's formal approval of a \$2.9 billion bailout package over four years. Despite the worst economic crisis the nation has ever experienced, President Ranil Wickremesinghe urged patience from the country and promised better days ahead. As of February 2023, the power supply is back in the country and with the help of the assistance Sri Lanka has gotten from countries like India and China, they're managing to sustain a decent lifestyle.

CONCLUSION

Despite getting decent financial help, Sri Lanka still has a long way to go. Its condition as of February 2023 has not improved that much. There's still a lot of work for the government to do in order to ensure nothing like this ever happens in the country again for decades to come. If there is anything other nations should learn from this is, as citizens, it is our duty to keep full track of what the government is doing. There is no reason why the Sri Lankan government kept taking bad decisions since its independence which resulted in such a big crisis today. It is also important that people who have appropriate knowledge, for example, economists, agriculture specialists, etc should be given more importance than the government's personal opinion and decisions because one wrong move can severely affect the country. Lastly, it is important for us to ensure that the officials that are elected take their responsibilities seriously which is difficult but not definitely not impossible.

