BIPSS Commentary
www.bipss.org.bd
May -2022
BIPSS Towards a Secure World

The Crisis in Sri Lanka [1]

By Uditha Devapriya and Zeenath Ayub

From February to April, the sun beats down hard on Sri Lanka, depriving it of rain and water. Towards the end of March the Sri Lankan government ran out of foreign reserves to import diesel, furnace oil, and other types of fuel for power generation. With hydropower plants reduced to half their capacity and with no dollars to import required fuel stocks, it had no choice but to impose daily power cuts of 10 hours.

Since February the country had been assailed with regular blackouts. Initially proposed for 90 minutes, these soon increased to six hours. The latest spate of blackouts left people, particularly those dependent on a continuous electricity supply for their work, with just 14 hours of power. Ordinarily this wouldn't have been a problem, except that with dwindling foreign exchange the country had run out of diesel for generators too.

What aggravated Sri Lankans more than anything was that while the entire island had been enduring power cuts, the personal residence of the President in Mirihana, a suburb located around six miles from the capital Colombo, had been spared. On the night of the 31st, a group of people hailing from different backgrounds drove to the area, demonstrating against and venting out their fury at the President. By the early hours of April 1, one person had been severely beaten and several others, including journalists, detained.

The roots of the crisis in Sri Lanka are economic, though commentators differ as to what exactly is to blame for it. Many Sri Lankans, however, see it more as of a political crisis, to do with the flaws of the political system. One week after the encounter at Mirihana, several anti-government protesters congregated at Galle Face, a coastal front in the capital, and set up camp. They vowed not to leave until the President did. To emphasize their point, they built an entire model village, constructing makeshift tents, water tanks, and even a library. They named their village Gotagogama, a not-so-subtle hint at their objective of getting the president out. That village continues to flourish and stand today.

Two years after Gotabaya Rajapaksa assumed office as President, the country lies in ruins. Supermarkets are running out of basic food items, fuel stations have no fuel, and queues have become a way of life for every other essential item. When Mr Rajapaksa began his term, the country had foreign reserves of USD 7.5 billion. By January last year these had reduced by USD 3 billion. Over the following six months reserves reduced by a further USD 2 billion. By November 2021, they had come down to a paltry USD 1.6 billion.

Economists are divided on why the situation deteriorated so quickly. Some argue that the crisis was years in the making. An export-oriented economy heavily dependent on imports,

---

[1] The commentary is by FACTUM, which is a key think tank based in Sri Lanka that offers key insights, critical analysis and unbiased perspectives on global politics. FACTUM is also a partner organization of BIPSS in Sri Lanka.

Sri Lanka has been recording deficits for decades. Its main sources of income are exports of commodities like tea, remittances, and tourism. Successive governments financed whatever deficit it ran up on its balance of payments by issuing sovereign bonds and borrowing from other countries, prominently China, and multilateral institutions like the ADB. The bulk of the debt, however, lay with Western banks, financial institutions, and hedge funds, which in 2021 held over 40 percent of the island's external debt.

The COVID-19 pandemic helped shoot up the country's debt-to-GDP ratio from 42 percent in 2019 to 104 percent two years later. As of now, Sri Lanka has more than USD 51 billion of debt left to service. The warning signs were in place as early as 2020, when lockdowns and restrictions reduced tourist arrivals and remittances, not to mention exports. Though tourist arrivals began to improve steadily in early 2022, most arrivals were from Russia and Ukraine. The Russia-Ukraine War hence put an end to any hopes for a revival.

Making matters worse, global supply chain disruptions from the War put an upward pressure on fuel prices, putting a strain on an already strained economy. Then the country's Central Bank decided to float the rupee: from around 200 to a dollar in March, it lost more than 70 percent of its value, stabilizing at around 365. The rupee is now officially the world's worst performing currency. Furthermore, Sri Lanka's dependence on imports for everything, from mobile phones to needles for its apparel sector, pushed up prices of consumer and intermediary goods by more than 100 percent. This had a devastating impact on inflation, which officials estimate at nearly 30 percent in April.

Economists believe that external conditions alone aren't to blame for the crisis. Soon after coming to power, for example, the government enforced drastic tax cuts. Economists estimate that this decision cost the Treasury billions of rupees. Though these pro-business policies did help secure massive profits for blue-chip companies and gains for the Stock Exchange, they widened already unsustainable budget deficits, compelling the Central Bank to resort to deficit financing or money printing. Although practically every government has engaged in printing money during the pandemic, in Sri Lanka's case it led to the rupee losing its value. When Sri Lanka ran out of foreign reserves with which to defend the rupee, hence, it had no choice but to float the currency and let prices skyrocket.

Without a doubt, the roots of the crisis also lie in the country's economic makeup. A plantation enclave for 150 years, Sri Lanka has attempted to shift to industrial activity since independence. These attempts have not been successful. With very few foreign inflows, consequently, the country began experiencing volatile fluctuations over its terms of trade. Commodity markets are intrinsically sensitive to global market conditions, and Sri Lanka has not been an exception there: while it enjoyed a modest boom in terms of trade owing to the Korean War, its balance of payments deteriorated not long after. By 1965, the situation had worsened so much that it was compelled to resort to IMF assistance.

Other factors have been singled out as well. Last year, the government imposed a ban on chemical fertilizers in an attempt to shift completely to organic agriculture. Supported by certain environmental activists, the decision was criticized by economists and agronomists. Interestingly, in every other interview by foreign news outlets, local farmers have contended that while they preferred organic agriculture, they felt the decision had been imposed too hastily. The results have been devastating: experts expect yield drops of up to 70 percent. In a bid to compensate for this, the government has been importing food through credit lines and aid while providing chemical fertilizers at subsidized prices.

Long adamant that it would not go to the IMF, the Rajapaksa administration turned around last April. Appearing live on television, a visibly shaken Gotabaya Rajapaksa said that it would seek IMF assistance, after weighing its pros and cos. For many anti-government protesters, however, this was far too little and far too late. A series of protests in early May led to the resignation of the Prime Minister, Mahinda Rajapaksa, who happens to be the President's elder brother. He has since been replaced by five-time Prime Minister, and the sole sitting MP from his party, Ranil Wickremesinghe. Wickremesinghe has pledged to reverse the country's misfortunes, warning of worse times ahead.

Given all this, what awaits Sri Lanka's future? While former Finance Minister Ali Sabry entered into negotiations with the IMF, any financing instrument or extended fund facility will have to wait for at least six months. During this period the government will have to impose austerity measures, while putting together a team of lawyers to negotiate debt restructuring and obtaining bridging finance from other countries.

Some of these measures have already been enforced, to disastrous results. In April, for instance, the State-owned Ceylon Petroleum Corporation hiked fuel prices by more than LKR 80 (or 25 US cents), forcing protesters in the village of Rambukkana to halt a fuel bowser, demand fuel at earlier prices, and engage in a skirmish with the police which left one person dead. The new Prime Minister has warned of further hikes, flagging them as necessary. To secure much needed funds, he has proposed an international aid consortium, similar to the IMF's Ceylon Aid Group of 1969 and the Tokyo Donor Conference of 2003.

As of now there is a broad consensus that Sri Lanka must engage in comprehensive reforms via the IMF. The IMF record in other countries, including Argentina, Ecuador, and West Asia, however, makes it clear that the transition from a debt laden to a debt sustainable economy will not be easy. Moreover, the country officially defaulted on its debt last week, when the grace period for a USD 78 million coupon payment expired. Still, prospects aren't entirely dim: almost right after the default, JP Morgan added an "overweight" to Sri Lankan bonds, in effect a buy recommendation. The bank cited "recent political changes" as paving the way for stability as well as closer engagement with the IMF.

Such a declaration has never been issued by a similar bank in the aftermath of defaults elsewhere. Interestingly enough, *Bloomberg* reports that following the default, Sri Lankan bonds recorded a slight uptick. All these may point to recovery in the not-so-distant future. Recovery, naturally, is what Sri Lankans from all backgrounds are hoping for, and even if it doesn't come next month, they are hopeful that it will come someday, soon.

Uditha Devapriya is the Lead Analyst - International Relations at Factum and can be reached at uditha@factum.lk. Zeenath Ayub is a student researcher at Factum and can be reached at zeenath@factum.lk

Factum is an Asia-focused think tank on International Relations, Tech Cooperation and Strategic Communications based in Sri Lanka accessible via www.factum.lk