Crisis in an Island Economy*

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Sri Lanka's economy is sliding into chaos¬ afflicted with multiple crises¬, triggered by a steep fall in foreign exchange revenues during the Covid pandemic, a difficult to manage external debt servicing burden, a collapse in the volume of foreign exchange reserves, and finally the ripple effects of the war in Ukraine. Between January 2020 and mid-March reserves have fallen by as much as 70 per cent to around $2.4 billion. A collateral trend that compounds the crisis has been a sharp depreciation of the Sri Lankan rupee. At the end of the first week of March the central bank that was avoiding a devaluation, keeping the official exchange rate at 200 rupees to the dollar for months, gave in and devalued the currency by 15 per cent. Even that level was unsustainable, and the rupee was soon allowed to float setting off a fall to the 300 rupees to the dollar mark by end March.

Underlying the crisis was a set of accumulated weaknesses that were intensified by the pandemic which adversely affected tourism earnings and revenues from exports. As compared with earnings from tourism of $4.4 billion in 2018 and $3.6 billion in 2019, receipts fell to just $682 million in 2020 and $534 million in 2021 according to figures from the Central Bank of Sri Lanka. Export revenues fell from $11.9 billion in 2019 to $10 billion in 2021 and rose to just $12.5 billion in 2021.

The resulting foreign exchange earnings crunch has hit Sri Lanka particularly hard because of its large external debt of around $35 billion. Much of this is a historical legacy. Under the previous Mahinda Rajapaksa government, between 2004 and 2015, Sri Lanka borrowed externally to the tune of $14.06 billion. Sri Lanka's 2022 debt service payments are estimated at $6.9 billion dollars.

Combined with the fall in foreign exchange earnings, these large outflows on account of interest and amortisation payments on accumulated foreign debt have eaten into foreign reserves that fell to $2.8 billion at the end of July 2021. That figure was shored up for a short while with receipts of $780 million from the IMF's special SDR allocation as well as first disbursals from a currency swap arrangement between the Sri Lankan and Bangladeshi central banks, and rounds of support from China and India. It did not help that a final tranche of a standby line of credit under the International Monetary Fund (IMF)'s Extended Fund Facility negotiated in June 2016 was held back because of reported delays in completion of a review of performance. Driven by these factors, Sri Lanka has been severely short of foreign exchange and the Sri Lankan rupee has been depreciating significantly. The year 2022 began with just $1.6 billion in the kitty.

In response, for some time now, the government, not wanting to be seen as defaulting on external debt payments, has been curtailing imports. It announced a wide-ranging import clampdown in 2020 to reduce foreign exchange outflow, affecting goods ranging from motor cars to fertilisers, sugar and turmeric. Particularly contentious was the Rajapaksa government's decision to ban imports of chemical fertilisers and pesticides, justified as reflecting a commitment to organic farming, but influenced really by the foreign exchange shortage. Though subsequently rescinded, the import ban is expected to reduce domestic production of paddy and tea in the coming months.

For a country dependent on imports for a range of manufactured capital and consumption goods, the clampdown resulted in limited supplies of imported fuel with long queues of harried motorists at gas stations; power outages; hospitals running out of stocks of critical drugs; shortages of milk, food and cooking gas; suspension of examinations at educational institutions because of non-availability of paper to print question papers; and newspapers dropping print editions because of lack of newsprint. The fall in agricultural production following the ban on chemical fertiliser and pesticide imports has only increased dependence on imported supplies. Shortages have hit the poor and middle classes badly, and political observers argue that the country could experience food riots.

These outcomes feed into each other aggravating the situation. A falling rupee has increased the costs of imports and worsened inflation. The depreciating currency has also worsened the foreign reserves position because exporters are holding back on repatriating proceeds and Sri Lankan workers abroad are avoiding official channels for remitting funds back home, to benefit from the much better 'black market' conversion rates they get when using informal circuits. Thus far the government has privileged repaying foreign lenders over diverting foreign exchange to finance imports that alleviate shortages. In January 2022, when the Central Bank of Sri Lanka (CBSL) announced that it was allocating $500 billion for a debt repayment instalment, some of the country's leading economists urged the CBSL to default and divert that foreign exchange to access crucial imports.

With agriculture production falling and cultivation turning non-viable, industrial units operating at less than full capacity because of lack of demand and/or restricted access to crucial inputs, and tourist arrivals low for two years now, the economic crisis is deep. In addition, the imported inflation resulting from rising fuel prices and a steeply depreciating currency are pushing up input costs that cannot be matched with increases in the prices of goods and services produced with those inputs. Finally, to the extent that firms have foreign exchange liabilities to service, the local currency costs of that commitment would be soaring. These trends can trigger a wave of bankruptcies. All these troubles had already afflicted Sri Lanka before the Ukraine invasion, which has made matters much worse, especially because Russia and Ukraine are important trade partners and sources of tourist arrivals. Meanwhile the government muddles through, keeping the economy afloat with aid and credit from neighbours, especially China and India, and is now wooing the IMF that it had shunned because of the conditions it imposes on borrowers.

Sri Lanka has been successful in the past to play the two neighbours against each other to maximise the bilateral support it receives. However, till recently Sri Lanka had leaned more on China than India, benefiting from projects under the Belt and Road Initiative and obtaining large bilateral foreign exchange swap arrangements with the Chinese central bank. In return Sri Lanka had favoured China, with the Rajapaksa government having cancelled a tripartite agreement with India and Japan to develop Colombo port's eastern container terminal and handed the contract to the Chinese government's China Harbour Engineering Company. This and other acts of the Sri Lanka government have upset India in the past, and the gesture of providing India's Adani a second port terminal near the original one has not smoothed ruffled feathers. Sri Lanka has also not shown much enthusiasm regarding a host of projects India was to initiate in the country based on a Memorandum of Understanding signed by former Prime Minister Ranil Wickremesinghe with the previous Modi government in 2017 during a visit to Delhi.

But matters seem to have changed recently, with signs of some tension between Beijing and Colombo. One factor that played a role was the Sri Lankan government's decision to cancel an order for organic fertilisers placed on China's Qingdao Seawin Biotech Co Ltd, after a consignment of 20,000 tonnes had reached Sri Lanka. Alleging that the consignment was carrying the Erwinia bacteria that can destroy crops, Sri Lanka refused to permit offloading of the consignment and make payments against the order. Sensing an opportunity India stepped in and provided emergency supplies of Nano Nitrogen to partially meet the demands of Sri Lankan farmers.

Sri Lanka has also decided to suspend the development of hybrid energy systems in three northern islands by Sino Solar Hybrid Technology, because of security objections raised by India regarding Chinese involvement in projects that were extremely close to its coastline. China has made clear that the projects were dropped due to third-party intervention. Substitute projects are now being supported by India.

It is not clear, however, how much further support China and India would between them provide to reduce domestic shortages and dampen inflation, as well as shore up Sri Lanka's foreign exchange reserves till such time dollar earnings revive. If that support is inadequate, the only other option is the IMF. The Rajapaksa government was wary of being subject to the IMF's conditionalities again but is now open to a discussion. If a deal is struck, the IMF is likely to demand strong measures that intensify the pain.

The problem is that the Sri Lankan government is not able to mitigate the effects of the crisis because its own fiscal position is strained. Even while burdened with legacy and newly accumulated public debt, the current Rajapaksa government decided in December 2019 to slash the Value Added Tax (VAT) rate to 8 per cent from 15 per cent, as well as offer other tax concessions like the abolition of the 2 per cent Nation Building Tax on domestic goods and services, and the Withholding Tax and the Capital Gains Tax on stock market gains. This tax bonanza is estimated to result in a loss of revenue equivalent to 4 per cent of GDP annually. This has aggravated the post-COVID collapse in revenues, and efforts to correct the error with a surcharge on the super-rich and a couple of other adjustments in the Budget for 2022 was too little too late.

However, the foreign exchange crunch is the focus of the Sri Lankan government's attention. If competing neighbours—China and India—and the rest of the international community do not roll over loans and hike assistance, a sovereign default is likely.

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