International Journal of Research in Engineering, Science and Management
Volume 4, Issue 10, October 2021
https://www.ijresm.com | ISSN (Online): 2581-5792

Multifaceted Challenges Led to Economic Emergency of Sri Lanka in 2021

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***Abstract*: Sri Lankan economy has weathered a rough patch in recent time. COVID-19 wreaked havoc on the tourism industry, which remained the economy's lifeline for a long time. Pandemic jeopardized regular economic activities due to lockdown, curfew, and stringent restriction measures. The sudden change in agricultural practices as per government directives reduced farm output and rural income. Shortage of food supply due to depleted farm output and ban on import led food inflation spiral high. Lack of tourism earning caused decline in foreign exchange reserve for import dependent nation. Remittance from Sri Lankan reduced sharply as many faced layoffs in overseas location. Credit rating agencies of world repute downgraded the sovereign rating of the nation. The economy of Sri Lanka dealt high debt burden and plummeting confidence of foreign investors. There was spike in prices for imported commodities. People stood in long queue to get basic supplies. Sri Lankan rupee depreciated severely in the face of high inflation and receding forex reserve. Economic emergency was declared by Sri Lankan government to tackle unprecedented crisis. Former major general of Army was appointed as Commissioner General of Essential Services to clamp down hoarding and ensure supply of basic necessities. Unless economic policy prescription is correct, economic recovery will get deferred.**

***Keywords*: Currency depreciation, Economic crisis, Forex reserve depletion, Market uncertainty, Pandemic repercussion, Soaring inflation, Social challenges.**

1. Introduction

Sri Lanka, formerly known as Cylon, is one of the significant parliamentary democracies of the south Asia. It had troubled past replete with 26-years long civil war. Before that economy reeled under the colonial past of the 16th century. Portuguese arrived in 1505 and pursued its European interest till 1658. Henceforth, Dutch rule persisted till 1796 and finally British took over the control. Entire nation fell under British administration in 1833 and continued under British rule for about 150 years. Cylon achieved full independence in 1948 and became member of United Nation in 1955. The name of the nation got changed to Sri Lanka in 1972. The nation had cultural exchanges with Indian subcontinent since ancient time owing to its locational proximity. The prominent civilization had influence of Buddhism since 6th century BCE and later got exposed to Hinduism and Islamic influences. Sri Lanka is small island nation in Indian Ocean endowed with diverse biodiversity, copious ecosystem, substantial natural resources. Agriculture had been the mainstay of economy for long time. It paid major focus on plantation crops such as tea, rubber, and coconut which assisted amply to earn foreign exchanges. The country maintains its membership of the Commonwealth and is also be part of the South Asian Association for Regional Cooperation(SAARC). Nation is favored with diverse environmental features and stunning scenic elegance. The nation is densely populated and majority of populace is poverty-stricken with agriculture as their means of livelihood. It followed liberal trade mechanism since independence and shifted to protectionism through import substitution in early 1960s due to rising balance-of-payment crisis. Till mid of 1970s, Sri Lanka remained as prominent inward driven regulated economy beyond the periphery of Soviet ruled central command economies. Sri Lanka experienced lackluster economic performance due to autarkic approach and transformed to open economy with implementation of liberalization policy in 1977 to be pioneer at south Asian region with this initiative. Long drawn civil war between local Sinhalese and minor Tamil group from 1983 to 2009 retarded economic growth and social upliftment. Free market approach that embraced privatization, deregulation, autonomy and advancement of private enterprise worked well for economy. Economy relied heavily on tourism, export of tea, rice, cloth and other agricultural products. Service sector went ahead by 2010s and contributed about 60 percent in national GDP, followed by industrial and agriculture sector. Provincial disparities were observed among leading western, northern and backward southern and central regions. As per World Bank estimate, Sri Lanka is lower-middle-income country with GDP value in current price remained as US$ 80.7 billion in 2020 and GDP-per-capita in current price was registered as US$ 3.68 thousand in the same year as per IMF record. This island nation witnessed rise in life expectancy at birth from 59.37 in 1960 to 76.98 in 2019(World Bank, 2019). There had been phenomenal improvement in the area of infrastructure, education and business standardization which triggered economic growth of 7 percent in 2015 and securing of higher rank in Global Competitiveness Index in 2014-15. Govt. of Sri Lanka put great focus on infrastructure development to make the nation an economic hub of south Asia. But this initiative drained govt.

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coffer in 2016 and International Monetary Fund had to dole out fund worth US$1.5 billion to bail out economy which was on the verge of bankruptcy. Economic woes aggravated since 2016 with increase of domestic as well external debt. Neighbor China came forward and assisted in debt repayment in 2020 to fulfill its vested interest of having superior control over south Asian market. Sri Lanka also opted for currency swap option with China and India to deal with mounting debt burden. Pandemic in 2020 ravaged fragile economy which was already troubled with debt burden and fiscal imbalance.

2. The Gravity of Economic Crisis and its Consequences

Economy was deeply affected due to outbreak of COVID 19 and real GDP growth reduced by 3.6 percent annually in 2020. Spread of delta variant in August 2021and its continuation till September 2021 brought overwhelming stress for healthcare system and economy bore the burn due to extended lockdown. Tourism was badly hit due to travel restriction. Decline in tourism earning pestered economic performance as tourism contributes more than 10% of country's GDP. The downfall of economic performance is expressed in following graphical presentation.

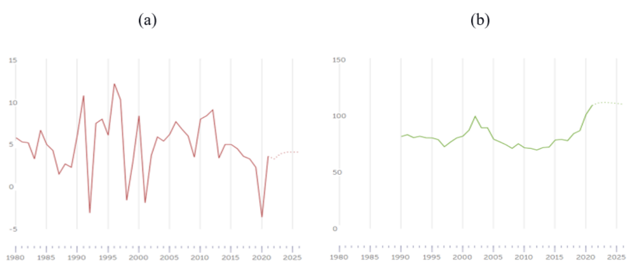

Fig. 1. a) Real GDP growth (Annual percent change); b) General government gross debt (Percent of GDP) (in US dollar term)
Source: IMF data mapper, Sri Lanka datasets (October 2021)

The decline in real GDP growth rate from 9.1 percent in 2012 to 2.3 percent in 2019 to -3.6 percent in 2020 speaks volume about deterioration of economic condition. Productivity was hampered almost in every sector as lockdown brought everything to a standstill with outbreak of COVID 19. Debt repayment became difficult for pandemic ridden nation as tourist earning reduced to zilch and earning of foreign remittance became few and far between. General govt. gross debt soared from $101.2 billion in 2020 to $109.3 billion in October 2021 as it is illustrated in diagram 1(b). Deficit in current account balance turned unsustainable as export reduced substantially in 2020 but import didn't diminish much. Current account deficit registered 3.2 percent of GDP in October 2021 from 1.3 percent in 2020. There was shrunk of foreign exchange reserve at an alarming rate and it depleted to the level $2.36 billion by July 2021 from $6.93 billion in August 2020. The decline in forex reserve reached a level where it was not adequate to cover imports of two months. There had been outflow of foreign investors from Sri Lankan bond market and it led to depreciation in foreign exchange rate. Acclaimed credit rating agencies such as Fitch and S&P had to slash down rating from B+ to B. US based Moody also reduced sovereign rating to alert investors about vulnerability of Sri Lankan economy. Considerable debt has undermined macro-economic stability. The perennial problem of hefty budget deficit and scanty tax revenue plagued the economy vehemently. Raising of funds through bilateral network, commercial borrowing and foreign currency swap became tough due to fragile economic condition. Feeble external buffer dimmed revival prospect of the economy and poverty alleviation as well. Agriculture faced sudden draconian directive as government of Sri Lanka ordered ban on use of chemical fertilizer and suggested cent-percent organic farming for agricultural products. This new rule troubled tea producers severely and also affected services related to tea business and financial sector gravely. Businesses of other plantations were also affected with the implementation of new rule to enforce organic farming. Farmers fell prey to misfortune with decline in income triggered by adherence to new instruction. Tea is the main component in export basket of Sri Lanka which draws more than $1.25 billion per annum and constitutes more than 10 percent in country's export earnings. By the time govt. realized the mistake and relieved the farmers through relaxation in policy measure, damage to economy became irrevocable.

3. The Fact of the Matter

Sri Lanka is south Asian island nation surrounded by Indian ocean with land area about 25000 square miles and population strength of 21.92 million as on year 2020 (IMF data). Although country's size is small but it is enriched with wide diversity of natural wealth ranging from coastal and marine ecosystem, grassland, river to freshwater bodies, wetland. Govt. tried to diversify economy with policy measure in last couple of decades to lessen over dependence on agriculture and address the pressing challenge of unemployment and poverty. Country had long been troubled by negative trade balance, fiscal deficit and debt burden. President of Sri Lanka, Gotabaya Rajapaksa, famous for ruthless dynamism brought military approach to tackle pandemic with deployment of army alongside medical personnel. Lofty target of turning country's agriculture into organic farming overnight backfired agro-based economy. The intended agriculture revolution with prohibition of chemical fertiliser and ban on agrochemical imports didn't help agriculture much during COVID crisis. New agriculture strategy not only affected tea production but also slashed down export revenue earning in 2021. This island nation is touted as world's fourth largest producer of tea and export of this cash crop contributes to about 1.5 percent of GDP. The revolution of organic cultivation with prohibition on use of chemical fertiliser hit farming adversely as 90 percent of farmers apply chemical fertiliser and all can't switch to organic in short span of time. It caused inconvenience to common people when general inflation escalated to 6 percent in September 2021 and food inflation spiked to the level of 11 percent in the same time. The vulnerability of economy got exposed when global commodity price soared high, foreign reserve depleted to pay necessary imports. Cap on domestic retail price led to scarcity of essential commodities like milk powder and sugar. President declared nationwide emergency to control the situation and seize stockpiled merchandises. Initially price ceiling was imposed to make basic necessities available at nominal price but it led to faster exhaustion of stock. As ceiling was lifted, food grain inflation spiralled high. Despite trade deficit as high as 42 percent of GDP, govt. had to permit some imports to redress acute scarcity. The dire straits of the Sri Lankan economy got reflected in dwindling forex reserve which went down to $2.6 billion in October 2021 when govt. had the liability to service foreign debt worth $7 billion. Majority of credit rating agencies declared country's sovereign bond as junk, when debt to GDP ratio went beyond 100 percent and about 80 percent of govt. revenue got disbursed in interest payment. Borrowing from global capital market appeared bleak and tough. COVID rendered a loss of about $ 8.6 billion to economy as earning from tourism declined enormously. On an average tourism used to fetch earning of $3 to $4 billion per annum for nation with exotic scenic beauty and marvelous tourist attractions. About 35 percent decline in remittance from Sri Lankans located abroad caused insult to injury for beleaguered economy.

4. Conclusion

Sri Lanka is low-income country in south Asia. It has a gruesome past of ethnic violence and civil war where majority Sinhalese fought against Tamil minority in the north and east. Economic resources and manpower wasted in 25 years of civil war ended in defeat of Liberation Tigers of Tamil Eelam. Agriculture and tourism remained mainstay of the economy. Maritime link with India through Indian ocean resulted in overbearing influence of old civilization since ancient time. Capital Colombo remained as hub of commercial activity since time of British rule. Exquisite landscape made Sri Lanka world's one of the most scenic destination for tourism. The wide variety of flora and fauna, right climate for plantation and cultivation, vibrant wildlife in deciduous forest garnered attention of global tourist over decades. Country had been fraught with ethnic tension and non-compromising attitude among different religious groups. Sri Lankan economy was heavily inclined on agricultural production, forestry and fishing. Special focus had been on three plantation crops such as tea, rubber, and coconut which assisted in export earnings. Manufacturing had never been core competency for the island economy. Majority of food requirement and need of manufacturing goods were fulfilled through import. Country had always struggled with current account imbalance. Initially principles of socialism remained evident in economic policy prescription. Since economy embraced free market approach, transition in the economy noticed in factor-driven stage to efficiency-driven practices. Economic transition also reflected in improvement in social life, business sophistication, innovativeness and market efficiency. There had been phenomenal improvement in literacy rate and human development index since civil war ended but doubt persists about its continuity as social hardship intensified with economic deceleration. Infrastructural inadequacy had always been a shortcoming for the economy. Govt. expenses to upgrade infrastructure caused serious trouble in fiscal measure. Betterment of infrastructure facility resulted in sharp hike in debt burden in 2016. Country failed to overcome this debt crisis. Pandemic in 2020 caused a serious setback in recovery measure. Finally, draconian directive of organic farming made a terrible blow to agriculture sector. COVID restriction brought significant damage to export earnings and receipt of foreign remittance. Foreign exchange reserve declined sharply to meet import requirements. Inflation soared high and currency depreciated massively. Suffering of people became acute owing scarcity of basic necessities. State emergency was declared to bring situation under control and take necessary step to turn around economy tottering on the brink. Unless export oriented growth is resumed and flow of foreign remittance regularize economic woes would not be dispelled. There is dire need of right policy measure to maintain fiscal balance, reduce debt burden, strengthen current account balance and sustain economic growth.

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