Sri Lanka's Economic Crisis

The South Asian island of Sri Lanka, the mythological "Golden Lanka", ironically is facing an unprecedented economic crisis since its independence in 1948. With a history of economic policy swings with the periods of both liberalized economy and socialist policies, Sri Lanka has seen its fair share of economic downturns and economic expansion.

Spurts of economic growth due to increased privatization, economic reform, and the stress on export-oriented growth helped improve the economic performance, increasing GDP growth to an average of 5.2% throughout the 90s. However, the country that was gripped in Civil War for nearly 3 decades, with militant organization Tamil Tigers and the government in a constant struggle the economic growth was far from even. The nation of Sri Lanka closely averted bankruptcy in 2001 when the country was able to secure foreign loans due to a quick ceasefire between Tamil Tigers and the government. Up until then the national debt had reached 101% of the GDP also exacerbated by the global and domestic economic crisis, and terrorist attacks in Sri Lanka and US. With one of the highest per Capita GDPs (approx. $3700) among its Southeast Asian peers, the post-civil war period from 2009 up to 2014 Sri Lanka saw a boom in the economy driven by growth in its major sectors tourism, tea export, textile, and agriculture.

But, the cracks in the economic foundations of Sri Lanka started showing as early as 2015 and the blows of the populist agendas and poor economic policies have now caused the economic structure to crumble. The government which came into power in 2015 was made aware of the impending economic crisis and had been warned by the Institute of Policy Studies of Sri Lanka of a number of risks. The coalition government did not adequately address the economic warnings and emerging dangers, consuming itself in other government-related activities. Election-related economic decisions were pushed such as excessive distribution of freebies. As a result, the country is yet again beckoning an economic bust contributed by a sovereign debt crisis and depleting foreign exchange reserves causing soaring inflation, fuel and food shortage, and unrest in the nation.

The four Horsemen of the Economic Apocalypse

Tax Cuts & Money Creation (Economic Mismanagement)

During a 2019 election campaign, Rajapaksa and Co. promised deep tax cuts that were enacted months before the Covid-19 pandemic. VAT was reduced from 15% to 8% & Nation Building Tax (NBT- 8%) was abolished. Sri Lanka was now a country with one of the lowest Indirect Tax rates globally. However, these unprecedented changes to the indirect tax regime impacted negatively on government revenue. The country resorted to money printing to fund government expenses to cover up the lost Tax revenue. Sri Lanka printed 505.9 billion rupees in 2020 and 1.2 trillion rupees in 2021. Some of which was also spent on COVID refinancing. The Central Bank also purchased huge volumes of

Treasury bill to finance deficits. It had around Rs.566 billion in government securities by the end of 2020. In the two-year period, reserve money grew by 40% and the broad money supply by 40% despite weak economic growth, which triggered domestic inflation leading to rapid price rises. All but futile, the attempt to print new money to jump-start the COVID plagued economy, was mostly used for imports worsening the forex problem and adding to the inflationary woes. The consumer price index (CPI) rose to 17% over the two years and the food prices rose 40%.

Agricultural Crisis

A disastrous decision in hindsight, President Gotabaya Rajapaksa's decision to shift overnight to organic farming, implementing a complete ban on the importation and use of synthetic fertilizers, insecticides, and pesticides, wreaked havoc on the domestic agriculture production. The country's 2 million farmers were compelled to go organic but the domestic rice production fell 20% in just the first 6 months of the decision and fell by 13.9% in 2021-22 (April-March) and the average yield per hectare fell by 14.4%. Previously, self-sufficient in rice, Sri Lanka was forced to import $450 million worth of rice and other imports soared to a five-year high. The second-largest tea exporter in the world Sri Lanka saw its tea crops, the primary export product and a source of foreign exchange, suffer miserably amidst the ban on essential fertilizers. The decision regarding fertilizer use in tea crops was rolled back in November of 2021. Relief packages worth $349 million were also offered to farmers who incurred losses, but too little too late. The ripple effect of the ban impacted the entire country. Worsened by the pandemic, nearly half a million Sri Lankans have sunken below the poverty line.

Deficits and External Debt

Sri Lanka has a twin deficits problem meaning that country has negative Current Accounts (CA) and follows budget deficits. Similarly, while inspecting available data on trade recorded by the Central Bank (CB) of Sri Lanka, it can be seen that Sri Lanka is also a country that is hugely reliant on trade and it is also an import oriented country. As per data, in the pre-COVID period i.e. in 2018 trade deficit was around $10.34 billion and during COVID, it constricted to $7.99 billion and in the post-COVID period, it could be anticipated to have been increased significantly.

The fiscal deficit of Sri Lanka is high for its size of economy i.e. an average budget deficit was around 7.4% of GDP. Inferences can be drawn from the ratio of recurrent expenditure being around 76% of total budget expenditure and mean capital expenditure being around 23% that this is a similar problem that was seen during Greece's debt default where the government had spent massively on unproductive sectors rather than productive ones. For such a greater deficit financing, the government required higher financial resources but despite such a situation, the Sri Lankan government had reduced taxes and opted for external debt. According to the 2021 numbers, China accounts for more than 10 percent of

Sri Lanka's $35 billion total foreign debt and is owed around $4 billion. It is Sri Lanka's largest bilateral lender and its fourth-biggest overall lender, behind international financial markets, the Asian Development Bank (ADB), and Japan. The majority of Sri Lanka's external debt stock is owed to international capital markets, which accounted for 47%. Another 22% is held by multilateral development banks, followed by Japan having 10% of Sri Lankan external debt.

Hence, the payment of these debts have put pressure on foreign exchange reserves for quite some time and in recent periods, nearing debt payment schedules dismantled the forex reserves, bankrupting Sri Lanka; causing Sovereign bonds repayment defaults. Therefore, through these inferences, it can be said that the current scenario of Sri Lanka was not absolutely caused by negative current account balance and trade deficits but it was more of a fiscal deficit problem.

Tourism & Easter Bombings in 2019

Sri Lanka’s Tourism sector contributed 6.4% of Gross National Product bringing in $5.61 billion dollars in foreign currency in the year 2018. The country saw its highest number of arrival of 2.52 million tourists that year. Tourism authorities estimated Sri Lanka would hit 2.5 million tourist arrivals in 2019 too. The tourism industry is the third-largest foreign exchange earner on the South Asian Island, and the country depends heavily on the industry – behind worker remittances and the apparel industry.

But on 21 April 2019, Easter Sunday, three churches in Sri Lanka and three luxury hotels in the commercial capital, Colombo, were targeted in a series of coordinated suicide bombings. A total of 269 people were killed including at least 45 foreign nationals. The bombings resulted in over 250 people being killed, and over 500 injured. After the event, the number of tourists plunged steadily.

The tourist arrival fell by more than 20% in 2019. The coronavirus pandemic that followed in 2020 was particularly distressing with just 540,000 tourists visiting the country. Arrivals fell drastically with zero tourists from April through November 2020. Tourism revenue shrunk to $1.08 billion, about 80% less compared to the 2018 revenue. There were no signs of recovery until 2021, which too just had 194,495 tourists visiting Sri Lanka.

Further, the Russia-Ukraine War threatened to turn off the tourist inflow as about 30% of tourists in 2021 were from Russia, Ukraine, Poland, and Belarus. The war further exacerbated the economic calamity of the country as Russia is the second biggest market (worth $140M in 2020) to Sri Lanka in tea exports. Petroleum products accounted for about 20% of Sri Lanka imports, and the costs jumped heavily due to Russia-Ukraine Crisis. The increase in oil prices added to the burden of Sri Lanka’s currency reserve.

All these factors severely aggravate the foreign currency reserve status causing the reserves to dwindle to less than 1.1 months' worth of import affordability in Jan 2022 and 1 month as of April 2022.

Nepal and Sri Lanka: Comparing Apples to Oranges, or is it?

Opinions divide among economists and experts, media, and the general public regarding the current plight of Sri Lanka and whether Nepal is following in the footsteps of the island nation.

In terms of comparing the two major foreign exchange revenue sources for both the countries namely tourism and remittances; the contribution of tourism was about 12% and 7.9% of the total GDP for Sri Lanka and Nepal respectively. For Sri Lanka, tourism comprised about 35% of the foreign currency revenue, and in the case of Nepal 9.9% of the same. Both the countries have seen the tourist inflow severely impacted due to COVID and post COVID recovery of this sector is yet to be seen. On the other hand, remittance contribution to the total GDP of Sri Lanka is only 8.85% (2020), and in the case of Nepal, it's 24.9% of GDP Nepal (2020). Major reliance on the remittance inflow for foreign currency earning seems to have sustained Nepal's reserves for the time being.

Unlike Sri Lanka whose foreign currency earnings also relied on exports, Nepal does not seem to have the backing of its exports earnings, which is virtually nonexistent with only 3.31%, just a sliver slice of the whole GDP pie.

Primarily some stark differences emerge between foreign debt-laden Sri Lanka and Nepal. Sri Lanka's Debt to GDP ratio stood at 104% at the end of 2021, of which foreign debt accounts for about 40%. Sri Lanka has $8.6 billion in debt payments due this year, yet, as of March, the country has only $1.94 billion in its reserves. Whereas Nepal has significantly less debt burden, with outstanding debt to GDP of 40.51% and the foreign debt accounting for half of it. Foreign currency reserve is at $9.59 billion and debt payment of approx. $258 million for the upcoming year.

Unlike Sri Lanka, Nepal is not under severe pressure to meet its foreign debt obligation as of yet. However, parallels can be drawn too; and the picture suddenly starts to look worrisomely similar. The "then Sri Lanka" to make up for its severely impacted government revenue raised its debt portion significantly in the span of just two years, from 42% (2019) to more than double 104%(2021) debt to GDP. Nepal's debt portion has followed a similar trajectory in the last 5 years as Nepal's debt to GDP ratio in 2016 stood at 22.48% and now it is at 40.51%.

Nepal's budget comprises 32% debt and 64.36% revenue financing of which a major portion of internal revenue is derived from customs on imported goods. With the import restriction placed by the Central Bank and Nepal government struggling to meet its revenue targets, the government raising debts to accommodate for the balance sheet deficit in the near future looks eminent, which might increase the foreign debt portion too.

The size of the Gross Domestic Product of Sri Lanka is 2.4 times that compared with Nepal at the current period. According to statistics published by the Ministry of Finance of Nepal, the current account deficit as of 2020/21 stands at Rs.3.34 trillion (around $28.15 billion) which has been widening since 2016/17 prior to this the current account was at a deficit in 2010/11 which was minimal around Rs.12.94 billion. Hence this mega surge in CA while observing 2010/11 and 2020/21 data, the major reason for a huge current account deficit is due to a diverging gap between import and export, while in 2010/11 trade deficit was around Rs.3.32 trillion ($45.39 billion) but it has escalated to Rs.13.99 trillion ($118.02 billion) in 2020/21.

Therefore, this shows that our economy is gradually being reliant on imports, and the size of imports has been growing significantly, this is an alarming circumstance for a developing country like Nepal. If the imports were industrial products for the production process that could be a positive aspect of supply-side economics, unfortunately, a major portion of imports were for consumption purposes rather than value additive production goods. The trade deficit in dollar terms is worse in Nepal as compared to that of Sri Lanka. The current account deficit was around $1.089 billion, this also connoted that the current account balance of Nepal is worse off too.

In the case of Nepal, the average budget deficit is around 6% of GDP (a 10-year average). The recurrent expenditure is around 67% of total expenditure and capital expenditure is around 25% of total expenditure. Thus, Nepal's budget is not significantly lower than that of Sri Lanka. Hence, this shows that in terms of government revenue and expenditure, Nepal is following a similar path that has been followed by Sri Lanka.

In order to steer the economic ship away from the crisis iceberg, the central bank of Nepal (NRB) and the Government of Nepal have set out to preserve the foreign exchange reserves. Jolted by the predicament of its SAARC counterpart, NRB has started to implement stern measures, from limiting non-essential goods imports through Letter of Credit restrictions, completely halting the import of vehicles to incentivizing inflow of remittance through formal and legal channels.

But with the recent rift among the two captains of the financial ship of Nepal, owing to which the Governor of NRB was suspended by the Cabinet recommended by the Finance Minister, uncertainties loom large regarding the resolution of Nepal's financial quagmire through the implementation of these policies.