

# Sri Lanka's Economic Meltdown Sparks Political Crisis

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## Summary

*In late March 2022, Sri Lankans demanded President Rajapaksa's existing government and many of his family members to relinquish power. Over a hundred self-organised and unsponsored protests spread across the country for days leading to a massive resignation of Cabinet ministers. Sri Lanka, battling half-day long power cuts, fuel, gas, food and medicines shortages, and high inflation for months, is experiencing one of its worst political crises.*

## Introduction

Sri Lanka is facing its worst economic meltdown since its independence in 1948. With year-high balance of payment and foreign exchange deficits, the long-term dual deficit problem has finally caught up with the Sri Lankan economy. Frustrated, Sri Lankans who see no end to their financial burdens have taken to the streets echoing [slogans](#) like 'GoHomeGota' and 'GoHomeRajapaksas'. Protesters are demanding an end to the Rajapaksa family's power and a cessation of nepotism and cronyism plaguing the administration.

In an unprecedented move, all 26 Cabinet ministers resigned, turning Sri Lanka's economic meltdown into a political crisis. With 42 members of parliament (MPs) deciding to function as independents, the government is now [down](#) to 114 MPs for a simple majority.

## Delving into the Economic Crisis

The current economic crisis is the result of long-term economic mismanagement, the Gotabaya Rajapaksa government's ill-advised policies and the onset of recent global events.

### Long-term Economic Mismanagement

The Sri Lankan economy was built on the shaky foundations of decades of economic mismanagement. Years of prolonged unhealthy ratio of government revenue collection to gross domestic product (GDP) and an ever-growing debt have led to the current economic crisis.

Since the 1990s, revenue collected by the government via tax has been steadily declining due to poor policy decisions, specifically, tax exemptions granted ["to wealthy people, multinational corporations, local businesses, incomes and assets"](#) and continued by multiple political administrations. In 2021, the tax revenue only accounted for 9.6 per cent of GDP.

As of 2022, Sri Lanka [owes](#) US\$7 billion (S\$9.55 billion) in debt repayment. Contrary to the famous "Chinese debt trap" discourse, the bulk of the foreign debt owed is to the international capital markets ["in the form of sovereign bonds, term financing facilities and](#)

[foreign holdings of gilt-edged securities](#)". Consecutive Sri Lankan governments ["tapped into cheap debt markets to finance persistent fiscal and current account deficits"](#), entrapping the country in a ["vicious cycle of ever-increasing borrowings to repay past debts and finance ongoing deficits"](#).

### Rajapaksa Government's Ill-advised Policies

A series of ill-advised policies aggravated the unstable foundations of the economy. The adoption of a populist tax cut, as promised in the 2019 presidential campaign, and increased tax concessions during the COVID-19 pandemic impacted the already low government income. While Gotabaya's government justified this move to stimulate spending, it drastically reduced the already low supply of tax collection for government revenue. It had a [significant impact](#) on the present economic situation. The short-lived [chemical fertiliser ban](#) in April 2021 has also made a [lasting impact](#) on critical tea and rice crop yield this year.

### Recent Global Events and the Forex Crisis

The aforementioned factors were also exacerbated by global events, such as the COVID-19 pandemic and the Ukraine-Russia war.

Over the last two years, tourism and remittances, which were primary sources of foreign exchange earnings, have fallen drastically. In 2020, the global pandemic-induced international travel restrictions caused tourism revenue to take a massive hit. In comparison to 2018, a significant portion of Sri Lanka's US\$10 billion (S\$13.5 billion) trade deficit could only be balanced by the [estimated US\\$4.3 billion \(S\\$5.8 billion\) earnings from tourism](#). Similarly, as the value of the Sri Lankan rupee fell to the rate between LKR255 and LKR265 per dollar, [remittance flows via formal channels declined in 2021](#). Migrant workers and professionals preferred remitting money through unofficial channels which offered more attractive exchange rates.

The [Ukraine-Russia war](#) served as the final blow to the already frail Sri Lankan economy. The war sent shockwaves throughout the international economy, driving up fuel prices and other essential imported commodities. Additionally, the war affected Sri Lanka's tourism revenue as Russians and Ukrainians represented a considerable portion of tourists visiting the country.

### **What's Next?**

Sri Lanka has reached out to neighbouring countries like India and China for credit lines for essential items like food, fuel and medicine to provide immediate relief. However, this is not a long-term solution. The most feasible way out for the country is to negotiate with the International Monetary Fund (IMF) for a relief package. Only that will help it to regain international credibility and ensure continued bilateral and multilateral support.

In order to establish macroeconomic stability, the monetary board [implemented](#) a historic monetary tightening policy. The Ministry of Finance announced the [suspension of external debt servicing](#) until a more comprehensive debt restructuring proposal could be

drafted. Counsel has also been sought from financial experts for a [sustainable external debt management plan](#).

While such measures will facilitate establishing financial stability, Sri Lanka should improve its export and service industries. These can include the restructuring of state-owned enterprises, implementing necessary policy reforms to attract foreign direct investments, and providing a conducive investment environment for international investors.

Even if relief is provided to the citizens, political instability will still ensue as repeated instances of inefficiency have led to Sri Lankans losing faith in the politicians. The current crisis shows that Sri Lankans are not willing to sit back and tolerate the incompetency of the politicians. It further shows how political stability, economic development and national security are intertwined, and that failure to balance the three comes at a hefty price.

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