

# **The Fallen Sri Lankan Rupee: Not Just Another Economic Crisis**

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## **Summary**

*For more than a month now, Sri Lanka's 21 million people have been facing 10-hour power cuts and a scarcity of food, essential items and medical facilities. They are living under much instability and economic insecurity as the government announced it will be defaulting on its outstanding debt of US\$7 billion (S\$9.6 billion) this year. The current condition has been attributed to Sri Lanka's massive current account deficit and depreciated foreign reserves. However, Sri Lanka's 'tale of twin deficits' has been in the making for years now. Today, the country is facing an unprecedented debt crisis and seeking an International Monetary Fund loan for the 17<sup>th</sup> time.*

## **Introduction**

In February this year, Sri Lanka's reserves were at US\$2.03 billion (S\$2.79 billion). They hit a new low of US\$1.73 billion (S\$2.38 billion) in March 2022 as the crisis began unfurling. The Sri Lankan Rupee (SLR) remains deeply depreciated at SLR1 equivalent to US\$0.0031 (S\$0.0043). Given these macroeconomic realities, a delegation from Sri Lanka is in the midst of negotiating a bailout from the IMF for US\$3 billion (S\$4.12 billion). However, questions remain as to how the growing current account deficit, depreciating reserves and inflation went undealt for the crisis to arise. The leadership has pinned the crisis on the Covid-19 pandemic and previous administration. However, fact remains there were systemic wrongs in the fiscal and monetary policy of the state which were made worse by the current government's policies. This insight aims to understand the weaknesses in Sri Lanka's fiscal plan, its negotiations with the International Monetary Fund (IMF) and the challenges that lie ahead in rebuilding the economy.

## **Current Situation in Sri Lanka**

On 12 April 2022, the Sri Lankan government announced a soft default; it will be defaulting on its debt of US\$51 billion (S\$70.09 billion) in the interim.<sup>1</sup> As of the third week of April 2022, a delegation led by Finance Minister Ali Sabry is in negotiations with the IMF for a 'Rapid Financing Instrument'. However, these talks are still at a preliminary level.

Meanwhile, protests continue in Colombo. People in Sri Lanka are protesting in light of the adverse economic conditions as the country's foreign reserves plummeted to US\$1.93 billion (S\$2.65 billion) in March 2022. Consequentially, food inflation rose to 30.7 per cent in March 2022. On 24 March 2022, the country's second largest gas supplier, Laugfs Gas,

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<sup>1</sup> Ministry of Finance, Sri Lanka, "Interim Policy Regarding the Servicing of Sri Lanka's External Public Debt", 12 April 2022, <https://www.treasury.gov.lk/api/file/54a19fda-b219-4dd4-91a7-b3e74b9cd683>.

raised prices for a 12.5kg cylinder to SLR4,199 (S\$17.21) from the earlier SLR2,675 (S\$10.93).<sup>2</sup> Last month, the country ran out of essential medicines and had to suspend all medical surgeries. Furthermore, the country must repay US\$7 billion (S\$ 9.62 billion) of foreign debt due later this year.

President Gotabaya Rajapaksa has defended his administration, claiming that the current crisis is a product of COVID-19, which has affected tourism, revenue and inward remittances. Experts, on the other hand, have termed the crisis as an “economic mismanagement by successive governments that amassed huge budget shortfalls and a current account deficit.”<sup>3</sup> Meanwhile, Sri Lanka seems to have also entered a political crisis. In the face of on-going protests, the entire cabinet, apart for Prime Minister Mahinda Rajapaksa, resigned. Gotabaya then put in place an interim cabinet, which has been harshly criticised by Sri Lankans. On 19 April 2022, in response to the continuing protests, the prime minister proposed to curb the president’s executive powers.

## How did Sri Lanka get here?

Sri Lanka is an export-oriented economy, with exports accounting for almost 23 per cent of its gross domestic product (GDP). However, unlike other export-oriented developing economies, the country has not been able to diversify its exports, and its portfolio of exports have remained limited to agricultural produce and garments. Sri Lanka, primarily remains an import-dependent country. Since 2012, the country has run a growing current account deficit. This was the first red flag for the current crisis.

Meanwhile, Sri Lanka’s economic growth rate has gradually fallen over time, from seven per cent in 2015 to two per cent in 2019.<sup>4</sup> Taxes, as a source of government revenue, have been declining for almost two decades. Presently, the taxes are as low as 9.2 per cent of the GDP.<sup>5</sup> This was the second red flag for the current crisis. Tax concessions and government subsidies have been a consistent policy measure under all Sri Lankan governments. As a result, the nation has also been running a budget deficit for years. In 2021, the deficit reached a peak of 10.51 per cent of the GDP.<sup>6</sup> This revenue shortfall has been supplemented with increased government borrowing. Sri Lanka’s debt-to-GDP ratio has been rising over the years. Currently, it stands at 104 per cent.<sup>7</sup> Thus, the majority of government revenue has been used for debt repayments.

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<sup>2</sup> Ibid.

<sup>3</sup> Rehana Tohfeek, “Correcting the Course of Sri Lanka’s Economy”, *South Asian Voices*, 18 February 2022, <https://southasianvoices.org/correcting-the-course-of-sri-lankas-economy/>.

<sup>4</sup> Vagisha Gunasekara, “Crises in the Sri Lankan Economy: Need for National Planning and Political Stability”, Institute of South Asian Studies (ISAS) Working Paper, November 2021, <https://www.isas.nus.edu.sg/papers/crises-in-the-sri-lankan-economy-need-for-national-planning-and-political-stability/>.

<sup>5</sup> Ibid.

<sup>6</sup> Aaron O’ Neil, “Sri Lanka: Budget balance between 2016 to 2026 in relation to GDP”, *Statista*, 16 November 2021, <https://www.statista.com/statistics/728525/sri-lanka-budget-balance-in-relation-to-gdp/>.

<sup>7</sup> Nicholas Gordon, “How COVID and a nationwide pivot to organic farming pushed Sri Lanka’s economy to the brink of collapse”, *Fortune*, 9 April 2022, <https://fortune.com/2022/04/09/sri-lanka-debt-crisis-inflation-rajapaksa-protest-imf-ukraine/>.

Notwithstanding the dual deficit, Sri Lanka continued with debt-financed infrastructural investment and borrowing from the Central Bank of Sri Lanka (CBSL) to clear these debts. Essentially, the country's growth has been two pillared – government expenditure fed domestic consumption and large debt-financed infrastructure projects.<sup>8</sup> However, poor economic planning, failing trade policy and mounting debt are not the reasons alone for the present crisis. Notably, Sri Lanka has a history of IMF bailouts. The pattern of borrowing and running dual deficits that has gone unchanged in subsequent governments helps to explain Sri Lanka's financial predicament. Evidently, there must be more red flags for the current crisis.

Sri Lanka's leadership is a unique one. The Rajapaksa family holds most of the leadership and cabinet positions, making accusations of corruption inevitable. By 2015, Sri Lanka's external debt had grown by 25 per cent with no new large-scale infrastructure projects.<sup>9</sup> During the 2016 IMF bailout, it was revealed that state-owned enterprises in the country were used to take out additional loans on behalf of the government.<sup>10</sup> The domestic economy has been under continuous strain, which became evident again during the 2018 constitutional crisis.<sup>11</sup> Leadership induced political instability caused a loss in tourism revenue, currency depreciation and loss of investor confidence in the country. Foreign reserves were hit once again. By the end of the political episode, Sri Lanka's foreign reserves declined to US\$6.9 billion (S\$9.4 billion)<sup>12</sup> from US\$ 7.5 billion in 2017.<sup>13</sup> Tourism in Sri Lanka amounted to US\$4.4 billion (S\$6 billion) in 2019. However, the April 2019 Easter attack<sup>14</sup> led to an 18 per cent decline in incoming tourists.<sup>15</sup> The COVID-19 pandemic worsened this.

The 2019 elections that brought Gotabaya to power promised a better economy to the people. However, short-sighted tax exemptions, faulty domestic policies and the pandemic adversely impacted the situation. Sri Lanka's economic health suffered severely during the

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<sup>8</sup> Rehana Tohfeek, "Correcting the Course of Sri Lanka's Economy", *South Asian Voices*, 18 February 2022, <https://southasianvoices.org/correcting-the-course-of-sri-lankas-economy/>.

<sup>9</sup> Iromi Dharmawardhane, "Responding to Sri Lanka's economic crisis", *East Asia Forum*, 27 May 2016, <https://www.eastasiaforum.org/2016/05/27/responding-to-sri-lankas-economic-crisis/>.

<sup>10</sup> Wade Shepard, "Sri Lanka's Debt Crisis Is So Bad The Government Doesn't Even Know How Much Money It Owes", *Forbes*, 30 September 2016, <https://www.forbes.com/sites/wadeshepard/2016/09/30/sri-lankas-debt-crisis-is-so-bad-the-government-doesnt-even-know-how-much-money-it-owes/?sh=6f9e498a4608>.

<sup>11</sup> Andreas Johansson, "The 2018 Political Crisis and Muslim Politics in Sri Lanka", ISAS Insight No. 526, 13 December 2018, <https://www.isas.nus.edu.sg/wp-content/uploads/2018/12/ISAS-Insights-No.-526-The-2018-political-crisis-and-Muslim-politics-in-Sri-Lanka.pdf>.

<sup>12</sup> "Sri Lanka 'coup' cost US\$1bn in reserves, credit downgrade: PM", *Economy Next*, 10 January 2019, <https://economynext.com/sri-lanka-coup-cost-us1bn-in-reserves-credit-downgrade-pm-12742/>.

<sup>13</sup> "Press Release, External Sector Performance October 2017", *Central Bank of Sri Lanka*, 29 December 2017, [https://www.cbsl.gov.lk/sites/default/files/press\\_20171229\\_External\\_Sector\\_Performance\\_October\\_2017\\_e.pdf](https://www.cbsl.gov.lk/sites/default/files/press_20171229_External_Sector_Performance_October_2017_e.pdf).

<sup>14</sup> Chulanee Attanayake, Nazneen Mohsina and Roshni Kapur, "Easter Attacks in Sri Lanka: Failure of the Security", ISAS Brief No. 655, 26 April 2019, <https://www.isas.nus.edu.sg/wpcontent/uploads/2019/04/ISAS-Briefs-No.-655.pdf>.

<sup>15</sup> Rehana Towfeek, "Tourism in Sri Lanka: One step forward, two steps back", *Aljazeera*, 25 March 2022, <https://www.aljazeera.com/economy/2022/3/25/hold-tourism-in-sri-lanka-one-step-forward-two-steps-back>.

pandemic, with the country losing more than US\$3 billion (S\$4.12 billion) in the first eight months of 2021 due to a decline in tourism revenue.<sup>16</sup> When Gotabaya assumed presidential power in November 2019, Sri Lanka was US\$34.4 billion (S\$47.29 billion) in debt. He further worsened the budget deficit by slashing value-added tax to eight per cent, eliminating seven other taxes and distributing relief packages.<sup>17</sup> Though he intended to boost economic growth, the new tax regime began eating off necessary revenue. It led to the old repetitive pattern of increased government borrowing from the CBSL.

The borrowing from the CBSL intensified after April 2021 due to Gotabaya's failed policy of 'organic drive'. His ban on the import of synthetic fertilisers and pesticides resulted in a decline of crops. Rice production plummeted by 20 per cent, and Sri Lanka was forced to import rice worth US\$450 million (S\$618 million) to meet its immediate needs. Tea, which comprises 17 per cent of Sri Lanka's exports, suffered as well. Government policies have snowballed into an endless money pit which was being supplied by the CBSL to make ends meet. Between August 2021 and March 2022, the CBSL supplied an unprecedented US\$1,800 million (S\$2,474 million) for the import of essential items.<sup>18</sup> How did these mistakes go unchecked for so long? The answers lie in the poor governance and centralised domestic structures of the country.

Interestingly, a March 2022 report by the CBSL assessed that a substantial part of the economic crisis was due to the COVID-19 pandemic; inflation was caused by the Russia-Ukraine war; and debt amassed by the previous regimes. However, the domestic institutional structures of Sri Lanka offer a better explanation. The CBSL, though a financial adviser of the state, has little to no autonomy as its appointments are made by the government. Similarly, the 20<sup>th</sup> constitutional amendment enacted after the 2019 elections bestowed considerable executive powers on the president. These included the power to appoint people directly to government offices and to surpass cabinet decisions. As a result, decisions in Sri Lanka have not been devoid of political affiliation. The current crisis thus does not have mere economic undertones alone. As Mahinda moves to curb executive powers and introduce broader constitutional reform, it is clear that Sri Lanka has entered into an era of political uncertainty. The opposition is fragmented and wary of taking responsibility in the middle of a debilitating crisis.

What we see in Sri Lanka today is not a situation created by a single misguided policy. It is a crisis caused by policies gone wrong at the hands of populist jibes by consecutive governments. Tax concessions offered as pleasantries to garner support and poorly regulated monetary policy have ballooned to a lasting budget deficit.

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<sup>16</sup> Kenichi Yokoyama, "How can Sri Lanka recover from COVID-19? By Promoting Integrated Rural Development", *Asian Development Bank*, 13 October 2021, <https://www.adb.org/news/op-ed/how-can-sri-lanka-recover-covid-19-promoting-integrated-rural-development-kenichi>.

<sup>17</sup> "Timeline | Sri Lanka's economic crisis was in the making from November 2019", *Firstpost*, 4 April 2022, <https://www.firstpost.com/world/timeline-sri-lankas-economic-crisis-was-in-the-making-from-november-2019-10515461.html>.

<sup>18</sup> "Presentation by the Governor of the Central Bank Ajith Nivard Cabraal at the All-Parties Conference", *Central Bank of Sri Lanka*, 23 March 2022, [https://www.cbsl.gov.lk/sites/default/files/cbslweb\\_documents/press/notices/notice\\_20220328\\_Governors\\_speech\\_in\\_all\\_party\\_conference\\_e.pdf](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/press/notices/notice_20220328_Governors_speech_in_all_party_conference_e.pdf).

## Sri Lanka's Near Future

Currently, Sri Lanka needs US\$20 billion (S\$27.29 billion) for the import of essential items such as fuel, food and intermediate material to initiate exports.<sup>19</sup> In light of this, the government declared on 12 April 2022 that it will seek an IMF bail-out and repay all its pending debt of US\$25 billion (S\$34.37 billion) after completing a restructuring programme with the IMF. At this point, the IMF has clarified that the 'debt sustainability' of Sri Lanka is imperative to any arrangement. At the same time, Sabry's recent statements hint that Sri Lanka is aiming to avoid a hard default rather than solving the debt problem in the long run. The government is seeking a US\$3 billion (S\$4.12 billion) loan from the IMF to restore supply chains and essential items to the country. However, the reality remains that Sri Lanka needs a long-term strategy to fend off this economic crisis and avoid repeating old patterns of borrowing and defaulting.

The IMF's involvement will be accompanied with stringent economic conditions for Sri Lanka. Increasing taxes, controlling expenditure and debt restructuring, are some of the few expected immediate actions by the IMF. Simultaneously, the country has also approached the World Bank for assistance. The next few months will be challenging for Sri Lanka, both economically and politically. Intervention by the IMF may lead to increased unrest among the populace who are already weary of high prices. As Sri Lanka has a large public sector employing 45 per cent of its domestic workforce, the IMF may propose additional revisions such as privatisation policies and deduction of subsidies, among other revenue increasing measures. To ease in these changes to the public, the Sri Lankan government must carefully mitigate the brewing political crisis.

## Implications for South Asia

Sri Lanka has managed to provide for essential items in the interim owing to good bilateral relations with its neighbours. China, Bangladesh and India have come to Sri Lanka's aid in this time of crisis with currency swap arrangements, credit lines and food and fuel supplies. However, it is not just this state in South Asia that is going through economic difficulties.

While Sri Lanka's current crisis has been in the making for a few years, the Russia-Ukraine conflict has also contributed to its woes. This impact can also be felt in Pakistan and Nepal. Currently, Pakistan faces declining foreign reserves affecting its purchasing power. Similarly, Nepal has adopted a restricted import strategy to ensure stability to its foreign reserves. These are indeed tough times for South Asia.

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<sup>19</sup> Chandrashekar Srinivasan, "Explained: Sri Lanka economic crisis and India's \$2.5 billion line of credit", *Hindustan Times*, 29 March 2022, <https://www.hindustantimes.com/world-news/explained-sri-lanka-economic-crisis-101648545840320.html>.

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