

Socio Economic Crisis in Sri Lanka

Introduction

The Sri Lankan economy is currently suffering from an unprecedented economic crisis caused in large part by the ruling party's economic mismanagement and compounded by factors such as the financial impact of the COVID pandemic. The Civil War from 2009-2015 left the Sri Lankan economy hobbled by high budgetary deficits. This was followed by years of political instability and flawed decision-making at the centre. The political consensus that should have been developed to make the tough decisions required to correct the course of the economy, was never reached. The pandemic and consequent travel restrictions intensified the shortage of foreign exchange reserves until the country could not afford to pay for the import of staple foods and fuel.

History

The emergence of the financial crisis can be traced to the global financial crisis of 2008 and the long civil war which squeezed remittances to Sri Lanka. Foreign exchange reserves fell to historic lows, thereby compelling the country to borrow an additional US \$2.6 billion from the IMF in 2009 and \$1.5 billion in 2016. Instead of adopting a counter-cyclical fiscal policy to boost aggregate demand and production in the economy, the President instead opted to make populist decisions. To fulfil his pre-election promises, President Gotabaya Rajapaksa cut tax rates in December 2019: the Value Added Tax (VAT) rates were cut from 15 to 8 percent, corporate tax rates were reduced by 4 percent and indirect taxes such as nation-building tax, pay-as-you-earn tax and economic service charges were removed altogether. These wide-ranging cuts caused serious harm to the economy.

When the Covid pandemic struck in 2020, Sri Lanka was hit harder than many other countries, due to its heavy reliance on the tourism industry. As the tourism sector was devastated and foreign currency inflows from Sri Lankans abroad fell sharply, the imbalance between the demand and supply of foreign exchange grew until the foreign exchange reserves fell below critical levels.

REASONS FOR THE CRISIS

i. Political reasons and corruption:

In April 2019, Colombo was rocked by a series of bomb blasts in churches and luxury hotels, known as the Easter Bombings. These blasts had an immediate impact on tourism and revenues fell by up to 80%. The Easter bombings were exploited by the Rajapaksa family, which was then

in opposition, to stoke an anti-minority sentiment. This, coupled with their protest against reforms, such as tax hikes and increase in fuel prices, helped them win the popular vote and come back to power. Mahinda Rajapaksa and his brother Gotabaya Rajapaksa, the defence secretary, were earlier credited with ending Sri Lanka's civil war in 2009, though the methods used were heavily criticised in many quarters.

The new government under President Gotabaya Rajapaksa, inexplicably, given the economic situation, decided to cut taxes. With its tax-to-GDP ratio already very low, the corporate tax holidays and lower tax rates for the wealthy, exacerbated the economic problems. The economy that was already in poor shape, was soon in free fall. The government chose to ignore the deep structural problems that beset the economy and instead, indulged in cronyism and encouraged anti-minority and sectarian divisions. Furthermore, the Rajapaksa government rendered critical institutions, such as the National Audit Office and the Commission to Investigate Allegations of Bribery or Corruption, effectively toothless by passing the 20th Amendment, on the basis that the president needed more executive power to conduct his duties.

ii. Economic reasons and the role of the International Monetary Fund:

Sri Lanka's macro economic problems stemmed from chronic mismanagement since the 1990's. Imports had historically heavily outpaced exports, leading to balance of payment issues. An imprudent fiscal policy made the situation worse. Tax breaks were given to corporations and the wealthy. Value-added tax rates were cut from 15% to 8%. Other indirect taxes such as the nation building tax, the pay-as-you-earn tax and economic service charges were abolished. Corporate tax rates were reduced from 28% to 24%. About 2% of the gross domestic product was lost in revenues because of these tax cuts. The government seemed to be taking on more and more debt just to be able to pay the interest on outstanding loans.

Then in March 2020, COVID-19 struck and tourism took a nosedive. Foreign exchange reserves fell further, In an attempt to conserve the precious foreign exchange, all fertiliser imports were completely banned. Sri Lanka was declared a 100% organic farming nation. The consequent shortfall in essential food production led to food shortages and ended up causing a further increase in the import bill. The production of export items, such as tea and rubber, was also negatively impacted. This policy was withdrawn in November 2021. However, by then the damage had been done and inflation rose to 17.5%.

iii. The Rajapaksa brothers and the 2019 easter killings:

Following the 2019 Easter bombings, Rajapaksa campaigned on a platform of national security. In a Buddhist-majority country, his anti-Muslim rhetoric proved successful in the backdrop of the recent terrorist attacks. He tried to run the country like a dictator, weakening institutions and passing sweeping reforms to consolidate his power. However, his strong man tactics failed to

prevent an uprising against him when the economy collapsed, the government failed to deliver justice for the victims of the Easter Attacks and alienated minorities by forcibly cremating Muslims and Christians who died of COVID-19, causing mass social unrest.

Government actions

I. Foreign Aid:

Despite the deteriorating economic situation, the Rajapaksa government tried to delay approaching the IMF. Despite being urged by financial experts for months, the government resisted in the hopes that conditions would improve as COVID-19 subsided. Eventually, India and China, the regional power players, stepped in to stabilise the situation. Sri Lanka was eventually forced to hold talks with the IMF and despite outside support, fuel shortages have caused long queues at filling stations, as well as frequent blackouts, with some crucial medicines also running low. Inflation rose to as high as 54.6%.

II. Monetary and Fiscal policy:

On 8 April 2022, the Central Bank of Sri Lanka further tightened the monetary policy to curtail soaring inflation by raising both the Standing Lending Facility Rate and Standing Deposit Facility Rate by 700 basis points. On 30 April 2022 Finance Minister Ali Sabry claimed that the government was looking to increase taxes, accepting that the tax cuts in 2019 were a mistake. The 8% VAT was termed "definitely not sustainable" for Sri Lanka and claimed that the rate should be around 13-14%.

III. International aid:

The G7 group of countries - Canada, France, Germany, Italy, Japan, UK and the US - had said it supports Sri Lanka's attempts to reduce its debt repayments. The World Bank has agreed to lend Sri Lanka \$600m, and India has offered at least \$1.9bn.

The International Monetary Fund (IMF) is discussing a possible \$3bn (£2.5bn) loan. However, it would require a stable administration that could raise interest rates and taxes before a bailout deal can be reached.

SRI LANKA, CHINA AND ITS “DEBT TRAP DIPLOMACY”

“Debt-trap diplomacy” is a term coined in international finance which describes a ‘creditor country or institution extending debt to a borrowing nation partially, or solely, to increase the lender's political leverage’. The creditor country is said to extend excessive credit to a debtor

country with the intention of extracting economic or political concessions when the debtor country becomes unable to meet its repayment obligations.

Some foreign policy experts believe that loans to Sri Lanka by the Exim Bank of China to build the Hambantota International Port and the Mattala Rajapaksa International Airport are examples of debt-trap diplomacy. In 2007, the state-owned Chinese firms China Harbor Engineering Company and Sinohydro Corporation were hired to build the port for \$361 million. After the project began losing money and Sri Lanka's debt-servicing burden increased, the government decided to lease the project to state-owned China Merchants Port on a 99-year lease for cash. The \$1.12 billion lease to the Chinese company was used by Sri Lanka to address balance of payment issues. This raised red flags in the United States, Japan and India that the port might be used as a Chinese naval base against the country's rivals. It was feared that the Chinese government might foreclose on the project. The current Sri Lankan prime minister, Mahinda Rajapaksa, has denied any such possibility and rejected the country's debt trap image, adding that "China provided concessionary loans for many infrastructure projects [during the post-conflict development]." In regards to the Hambantota Port, he added, "The Hambantota Port is not a debt trap." Rajapaksa dismissed the view that Sri Lanka was forced to enter a 99-year lease with a Chinese company because of a failure to pay the project's debts, stating that the project is commercially viable and is transforming Sri Lanka's overall port infrastructure.

IMPACTS OF THE SRI-LANKAN ECONOMIC CRISIS:

I. Electricity and fuel shortages

Sri Lanka is facing the worst economic crisis of its 73 years history, with basic commodities in short supply. Finance Minister Basil Rajapaksa urged all government authorities to switch off all street lights in an attempt to conserve electricity. Many shops have suspended operations due to lack of electricity. Nearly 1000 bakeries have been shut as a response to shortages of cooking gas. Long queues are a norm in front of petrol filling stations. The surge in global oil prices further aggravated the fuel shortage. In order to conserve energy, daily power cuts have been imposed by the authorities throughout the country. On 22 March 2022, the government ordered the military to post soldiers at various gas and fuel filling stations to curb the tensions among people who line up in queues and to ease the fuel distribution. Casualties include four fatalities due to fatigue and violence. Daily seven hour power cuts were seen throughout March 2022, increased to 10 hours at the end of the month and again increased to 15 hours in early April. Sri Lanka's hydroelectricity generation has also been affected.

II. Inflation

In February 2022 inflation was 17.5%. The year on year increase in inflation for food was 24.7% while non-food items saw an 11% rate. The rise in prices for commodities is once again responsible for the rampant food scarcity and rise in hunger levels within Sri Lanka. Last month the inflation rate rose to 54.6% and it could reach 70%.

III. Education

The economic crisis in Sri Lanka has affected basic rights of the population, including access to education. The foreign exchange reserves fell to such low levels that there was a ban on the import of paper. In March 2022, several schools in Sri Lanka announced that their term/mid-year examinations would be postponed indefinitely due to paper shortages. The term test examinations were stated to be held island-wide on 28 March 2022, but due to the acute shortage of printing paper and ink ribbons, a decision was made to either cancel or postpone the exams to a later date.

IV. Health

On 29 March, all scheduled surgeries at the Peradeniya Teaching Hospitals were suspended due to a shortage of medicines. Many other hospitals have also apparently suspended routine surgeries and have also reduced a large number of laboratory tests. Other state-run hospitals were also reported to be running out of life-saving medicines. On 8 April, the Medical Council of Sri Lanka issued a warning that there would be a catastrophic number of deaths, which is likely to be in excess of the combined death toll of COVID-19, the 2004 tsunami and the Civil War, unless a replenishment of supplies is made in a matter of weeks. Singapore Red Cross Society issued a warning declaring Sri Lanka's medical crisis as an "unprecedented humanitarian crisis".

Doctors are reported to have been forced to reuse old and used medical equipment to treat the patients due to the shortage of new equipment. Furthermore, Doctors in rural areas have also been forced to stitch wounds in the dark due to rolling power cuts. The emergency drugs to treat heart attacks are also reported to be in short supply.

V. Political unrest and protests

In March 2022, spontaneous and organised protests by both political parties and non-partisan groups were reported in several areas, demanding that the government resign over its mishandling of the economy.

Tens of thousands of supporters of the opposition party, the United People's Force led by Sajith Premadasa carried out protests on 16 March, in front of the President's office demanding that the president quit. On 31st March, a large group of protestors gathered around the residence of

Gotabaya Rajapaksa, was attacked by the police with tear gas and water cannons. A curfew was imposed in Colombo and arrests were made.

In May 2022 the Rajapaksa family home was set on fire by protestors. Amidst the protests Mahinda Rajapaksa resigned as Prime Minister in May 2022, but Gotabaya Rajapaksa refused to resign from the position of President and the protests continued. Defying the imposition of a nationwide curfew and thousands of troops on the streets, protesters chanted slogans to press their weeks-long demand that President Gotabaya Rajapaksa quit. On July 9, 2022, tens of thousands of protestors stormed the President House and set fire to the Prime Minister's residence, finally forcing Gotabaya Rajapaksa to resign and flee to Singapore.

THE ROLE OF THE IMF:

The World Bank is planning to disburse USD 700 million to debt-ridden Sri Lanka by repurposing its existing loans, a move that will help the island nation grappling with an unprecedented economic crisis much-needed breathing space till a bailout package with the IMF is worked out.

The World Bank Country Manager Chiyo Kanda met Sri Lankan Foreign Minister last week and assured him that the agency will work with the Asian Development Bank (ADB), Asian Infrastructure Investment Bank (AIIB) and the UN office to repurpose their already committed projects. Earlier this month, the International Monetary Fund (IMF) said it remains committed to assisting Sri Lanka in line with its policies. Although the International Monetary Fund may present viable solutions, delegates must consider its limitations and its failures to cater to the social, humanitarian and cultural issues currently unfolding in the region.

PAST UN ACTIONS AND RESOLUTIONS:

1. On 23rd March 2021, The Human Rights Council adopted resolution 46/1 “Promoting reconciliation, accountability and human rights in Sri Lanka”. (A/HRC/46/209).
2. On 1st October 2015 30/1, The Human Rights council adopted resolution 30/1 “Promoting reconciliation, accountability and human rights in Sri Lanka”. (A/HRC/RES/30/1).
3. Oral Update on the human rights situation in Sri Lanka, 48th session of the Human Rights Council - Statement by Michelle Bachelet, UN High Commissioner for Human Rights. 4. Report of the OHCHR Investigation on Sri Lanka (OISL)