HOW DID SRI LANKA GO BANKRUPT? A RETROSPECTIVE ANALYSIS

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Abstract

Sri Lanka's economy has gone through several crises in its history but it has never gone bankrupt. In May 2022, the foreign reserves of Sri Lanka went down to just a few million US dollars which forced Sri Lanka to unilaterally stop making payments to international creditors, resultantly, the country was declared bankrupt. The existing literature on Sri Lanka's downfall has highlighted several reasons. Those reasons, however, are presented either in isolation or in a generic form. This paper contextualizes Sri Lanka's bankruptcy within five key causes; dependency on mega projects for economic prosperity, a super relaxed tax regime, the ill-thought-out organic experiment, delay in approaching the IMF, and the geopolitical constraints. Having discussed the above causes in detail, the study argues that Sri Lanka's economy is not likely to improve in the near future or perhaps it may take years or so to bring the economy back on track. Geopolitical constraints, political instability, lingering structural reform process, and the Ukrainian crisis are negatively impacting Colombo's tourism, agriculture exports, and the IMF settlements. The paper concludes that concerted efforts are needed to carry out structural reforms, improve governance, and enhance the quality of labor, without which the Sri Lankan economy could not make a breakthrough. The study carries important implications for the countries facing balance of payments issues.

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Colombo Defaults on Debt

Sri Lanka had been struggling with depleting foreign exchange reserves for the last two years. By the end of 2019, the foreign reserves of Sri Lanka were $7.6 billion[1] and the total external debt was $35.1 billion.[2] In December 2020, the reserves dropped to $5.6 billion and in 2021 further went down to $3.1 billion. In 2022, the reserves declined sharply. In just three months, from January to April, the reserves nosedived to $1.8 billion from $2.3 billion.[3] In May alone, they reached a disastrous level of just a few million US dollars (less than $50 million).[4] The government of Sri Lanka, in an emergency, unilaterally stopped debt repayments to save money for fuel and essential food items purchases.

Sri Lanka had to pay at least $78 million in April 2022 out of $7 billion due in 2022 to escape from bankruptcy.[5] Colombo, however, remained unable to make even a fraction of payments to its creditors. Owing to the fast-depleting foreign exchange reserves, the international creditors gave a 30-day grace period to the Sri Lankan government. The grace period also ended without any repayments. Gotabaya Rajapaksa's government made every effort to save the country from bankruptcy. But it was too late. For the first time in its history, the Island went bankrupt in May 2022. With that, it also became the first sovereign country in the Asia-Pacific that defaulted to international creditors.[6]

The Fallout

The burgeoning inflation, hours-long power outages, and severe shortage of fuel, grains, and medicines eventually kicked off widespread anti-government protests in the country. The protesters launched the 'Gota Go Home'[7] campaign in March to pressurize President Gotabaya Rajapaksa to step down. Protesters gathered in large numbers outside the president's office at Galle Face and demanded the immediate resignation of the president and the prime minister and the formation of a unity government. Protesters accused the Rajapaksa government of nepotism and corruption. They blamed the mismanagement of the Rajapaksa government for the demise of the economy.[8] To placate the angry mob, Gotabaya initially scapegoated four of his family members. Two of his brothers: Chamal and Basil Rajapaksa, and two of his nephews: Namal and Shahsheendra Rajapaksa, stepped down from the cabinet posts in mid-April. But this did not help much in dialling down tensions on the island.

The situation further intensified when the shooting incident happened that killed one protester and left two dozen injured.[9] On 6 May, Gotabaya declared a state of emergency in the country. Two days later, he enforced curfew with shoot-on-sight orders. However, the situation remained troubled. On 9 May, Gotabaya made another attempt to appease the protesters. He asked his elder brother, Mahinda Rajapaksa, then Prime Minister of Sri Lanka, to step down. But a few hours later, after Mahinda's resignation, angry protesters set on fire the ancestral home of Rajapaksas in Hambantota. In his last bid, Gotabaya appointed the opposition leader Ranil Wickremesinghe as the new Prime Minister of Sri Lanka. However, the uncertainty continued. Dozens of Rajapaksa loyalists' homes were set on fire by the angry mobs and at least 9 people were killed until 13 May 2022.[10]

The dramatic fall of the economic and political situation on the island has raised many questions. Since there had been early warnings of an impending crisis, why did the Sri Lankan government not pay any heed to them? There was no option left but to seek a bailout package from the International Monetary Fund (IMF). But why did the Sri Lankan government delay negotiations with the IMF? Gotabaya Rajapaksa has strong and longstanding ties with China. But why he could not reschedule its loans with China? It is pretty clear from the existing scholarship on the Sri Lankan crisis that the current turmoil on the island did not develop overnight. It is also true, however, that several factors and actors have played a role in the evolving situation.

Unravelling the Crisis: Causes behind Sri Lanka's Fall

Dependency on Mega Projects

To begin with, a collective mistake made by all the politicians was relying on the development of mega projects for Sri Lanka's economic prosperity. Unfortunately, most of the billion-dollar projects could not yield the desired results. For instance, the Hambantota Port, since operationalisation, was running into losses. It could generate only LKR 132 million (around $367,000) in the first year which was far below the target of LKR 500-600 million (around $1.4-$1.65 million) set by the Sri Lankan Port Authority (SLPA).[11] The Hambantota Port, under the SLPA (2012-16) remained unsuccessful in earning sufficient revenues to meet its loan obligations borrowed mostly from the Import-Export Bank of China. The then government of Ranil Wickremesinghe eventually had to hand over the southern part of it to the China Merchants Port Holding Company Limited (CMPort) on a 99-year lease in 2017.[12] The lease amount of $1.12 billion was later used to cover the Balance of Payments issues.[13]

Similarly, the Colombo Port City (CPC) Project of $1.4 billion (that later increased to $1.9 billion) is struggling with several legal and environmental challenges. The project envisioned by the Mahinda Rajapaksa regime back in 2005 was formally announced by President Xi Jinping on his visit to Sri Lanka in 2014. The project is one of the flagship projects of China's Belt and Road Initiative (BRI). It is expected that the CPC would generate thousands of jobs for the locals. However, it would only be possible if Sri Lanka is able to provide the requisite expertise to its labour and improve its internal governance structure. Moreover, the slow pace of work combined with intermittent suspension is costing losses in millions to Sri Lanka's national exchequer annually. Several other projects were strictly under-demanded, however, millions of dollars have been dumped on them.

The under-conceptualized large-scale infrastructure projects tainted with corruption and poor governance hit the economy very hard. The cost of highways, airports, towers, port cities, etc., had led to an enormous increase in external debts. In fifteen years, between 2005 and 2015, for instance, the debt increased to LKR 8,503.2 billion ($23.6 billion) from LKR 2,222.3 billion ($6.2 billion). See Table 1 below:[14]

Table1:

Government Debts 2005-15

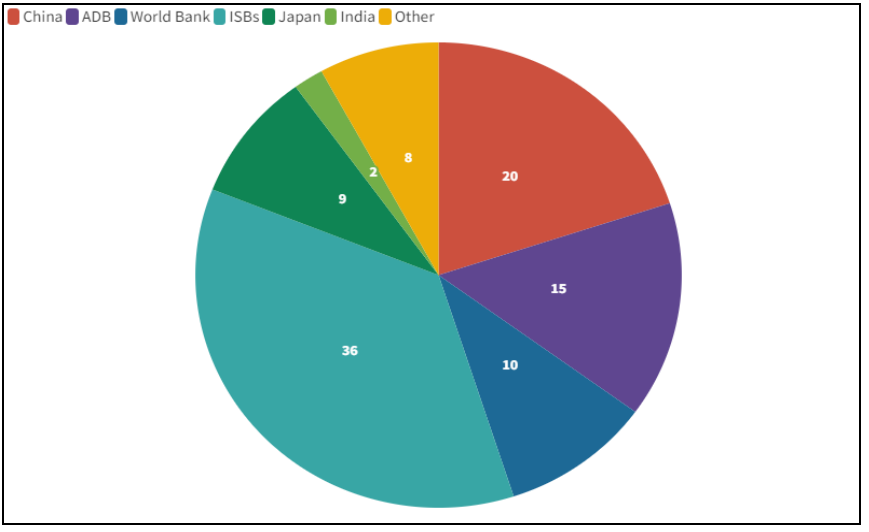
Year	Rupees (Million)
2005	2,222,343.00
2006	2,582,648.00
2007	3,041,685.00
2008	3,588,962.00
2009	4,161,423.00
2010	4,590,245.00
2011	5,133,365.00
2012	6,000,113.00
2013	6,793,250.00
2014	7,390,899.00
2015	8,503,227.00

Source: www.newsfirst.lk

This megastructure culture also negatively impacted the growth of medium- and small-scale enterprises. Most of the time and energy of the business class was wasted in establishing linkages of their businesses with the development of mega projects and thus little attention was given to the local industry. Resultantly, the local industry especially the construction industry was left unprepared to absorb the large inflows. To argue, a lack of professional manpower with several governance issues (born out of nepotism and corruption), led to outsourcing the Hambantota port management. There is a lesson for other port countries in the region, such as Pakistan and Iran, to pay attention to the twin challenges of improving governance structure and developing a skilled and technical labour force.

Figure 1:

Percentage of Outstanding Loans, End 2021[15]



Source: www.srilankabrief.org

The Super-Relaxed Tax Regime

Structural reforms in the economic sector were desperately needed. The political crisis of late 2018, combined with the multiple terrorist attacks which killed close to 270 people in early 2019, seriously undermined the potential gains of the IMF deal of 2016. Considering the appalling condition of the economy at the time, then Prime Minister Ranil Wickremesinghe committed to the IMF in 2019 to bring necessary structural reforms. Those reforms were primarily targeted at fiscal consolidation through high-quality revenue measures and, for that purpose, the Sri Lankan government required time. For that, the Ministry of Finance made a formal request to the IMF for a one-year extension in the 36-month Extended Fund Facility (EFF) program that was expiring on 2 June 2019 which the latter agreed to.[16]

Amid the reform process, however, a change of government took place. In November 2019, Gotabaya Rajapaksa was elected the President of Sri Lanka and his brother Mahinda Rajapaksa as the Prime Minister. Soon after coming into power, Gotabaya rolled back the reform process by introducing various tax incentives and subsidies. He introduced a super relaxed tax regime with increased tax holidays for big corporations.

In his first cabinet meeting held on 27 November 2019, Gotabaya announced massive tax reductions in the VALUE Added Tax, income tax on the construction industry, Telecommunication Levy, etc. He also abolished several taxes such as Pay As You Earn Tax (PAYE), Nation Building Tax (NBT), Withholding Tax on interests, the Debit Tax, Capital Gains Tax, and Debt Services Tax.[17] The tax-exempted slab of LKR 1 million was increased to LKR 25 million. The income tax imposed on the construction industry was also cut by half (from 28 per cent to 14 per cent). The new low-tax regime of Gotabaya caused an annual loss in the tax revenue of LKR 600 billion to 800 billion ($1.6 billion-$2.2 billion).[18]

Ironically, just three months after the introduction of the new tax regime, the Sri Lankan government had to close its border due to the worsening Covid-19 situation in March 2020. The tourism industry, which is the backbone of Sri Lanka's economy, suffered a huge loss during the 10-month travel ban. Millions of dollars in revenue from tea export and the apparel sector fell to almost zero. Foreign remittances also nosedived as the considerable number of Sri Lankans working in the Middle East, South Korea, and Italy were under the Covid-19 lockdowns.[19] Sri Lanka witnessed a historic Rupee depreciation during the pandemic. The stock market also collapsed. Thus, the low-tax regime and Covid-19 combined put a serious dent in the economic reforms crucial for revenue collection.

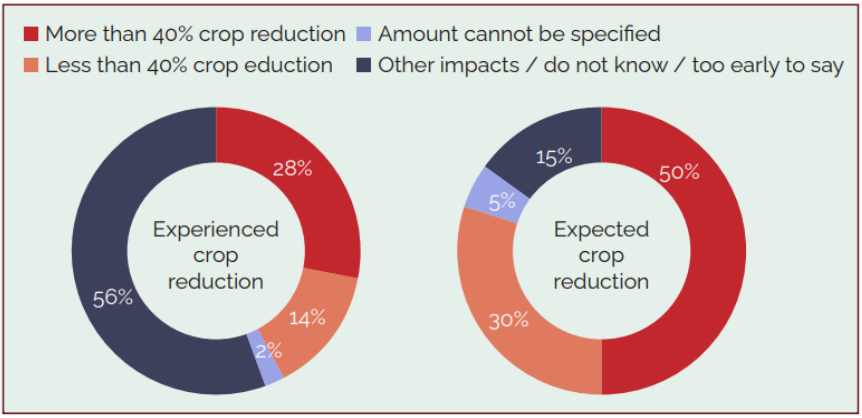
The Ill-Thought-Out Organic Experiment

The organic experience also proved to be a big mistake, especially at a time when the world was struggling with the Covid-19 shocks and the subsequent food shortages because of extremely little to no supplies of fertilizers. The idea was good to brand Sri Lanka as the 'world's first 100 per cent organic food producer', however, the timing was not right. President Gotabaya imposed a complete ban on the import of fertilizers and pesticides in May 2021. The ban was imposed primarily for two purposes: reducing the environmental and health hazards of the inorganic food cycle and reducing the import bill which is around $400 million annually.

There are more than 2 million farmers in the country and up to 70 per cent of the country's population is directly or indirectly dependent on agriculture. After the imposition of a ban on the import of fertilizers, a farmer's pulse survey was conducted by Verité Research, a Colombo-based think tank in July 2021 that predicted a sharp decline in the harvest. In that survey, nearly half of the farmers claimed that the chemicals ban had negatively impacted their current harvest and 85 per cent of the farmers predicted the future decline of their agricultural productivity.[20]

Figure 2:

Crop Reduction (current and the future)



Source: www.veriteresearch.org

Although the sample was too small (1,042 farmers out of a total of roughly 2 million farmers), it broadly sketched the existing and future crop reductions. The Verité Research survey was an early warning but the government was not ready to allow the import of fertilizers for at least the existing crops. Resultantly, the abrupt ban without adequate supplies of organic fertilizers led to extremely low agricultural productivity, especially in maize, paddy, tea, rubber, and coconut.[21] The paddy and the tea were amongst the highest dependent on chemical fertilizers, 94 per cent and 89 per cent, respectively.[22] Sri Lanka was self-sufficient in rice, but it had to import rice worth $450 million as the production fell to 20 per cent within 6 months after the imposition of the ban.[23] Owing to the rapid decline in the harvest and rising farmer protests in the country, the government of Sri Lanka had to allow the private sector to import fertilizers but the damage had already been done Later, the government had to provide direct compensation and subsidies to the farmer who incurred losses in their crops.

Delay in Approaching the IMF

A deliberate attempt to avoid the IMF for financial assistance was another of the Gotabaya regime's mistakes. The Sri Lankan government wasted a lot of time deliberating upon home-grown solutions to uplift the economy. President Gotabaya was confident that the government would successfully handle the debt crisis as he had not yet fully exploited all options and alternate strategies. Echoing what Gotabaya said, Ajith Nivrad Cabraal, then governor Central Bank of Sri Lanka, in an interview with the CNBC, said, "We don't need relief if we have alternate strategy."[24] He also claimed that Sri Lanka was able to finance its debt without troubling its creditors.[25]

Basil Rajapaksa, a brother of President Gotabaya and then Finance Minister, first tried to take all the bondholders on board. The international sovereign bonds had the largest chunk of total debts, which the government had to repay. However, Basil's attempt remained unsuccessful as he received mixed and ambiguous responses.

President Gotabaya then moved to China and India for assistance. Initially, he requested China for readjustments of the loans. China, however, was reluctant in doing so as it did not want to set that precedent as it could negatively impact its ongoing transactions and lending with other countries.[26] Later, the Sri Lankan government decided to seek another loan from Beijing to repay debts to Chinese banks. However, China responded by extending a $31 million 'urgent emergency humanitarian aid' to Colombo which included medicines, rice, and other supplies.[27] Beijing also provided a currency swap worth $1.5 billion.[28]

India on its part, provided a one billion US dollars line of credit to purchase essential items.[29] Later, it provided a separate line of credit worth $500 million to purchase petroleum products. New Delhi also provided a $400 million currency swap and over $1 billion under the Asian Clearing Union Framework.[30] With that, the total assistance that New Delhi provided Colombo reached over $3 billion by May 2022.

Financial assistance from both China and India, however, could not be used to pay back the outstanding debts. Thus, the problem remained unresolved. Amid the worsening economic situation and the rising country-wide protests, Gotabaya finally decided to approach the IMF and publicly acknowledged his twin mistakes of delay in approaching the IMF and putting a ban on chemical fertilizers.[31]

China's reluctance in giving more loans seemed justified as it has been accused of the so-called 'debt-trap' policy vis-à-vis Colombo, particularly after the Hambantota Port lease case. The fact of the matter is that China's share in the total debt is between 15-20 per cent. On the contrary, the major chunk is borrowings through sovereign bonds which is around 36 per cent (see Figure 1). Secondly, China did not want to become a party in the ongoing global polarisation following the Ukraine crisis. Given that, Beijing wanted to keep a low profile in its engagement not only with Sri Lanka but also with other countries in South Asia such as Pakistan, Nepal, Maldives, and Afghanistan.

The Geopolitical Constraints: The Island's Achilles' Heel

Last but not least, geopolitical constraints played a major role in Sri Lanka's economic and political turmoil. It was obvious that Gotabaya Rajapaksa had a close relationship with China. It was also pretty clear that after coming into power Gotabaya would restore Sri Lanka's ties with China that had gone down in Mahinda Sirisena's tenure (2015-19).[32] So, the very first move that Gotabaya Rajapaksa made was the cancellation of the tripartite agreement signed between India, Sri Lanka, and Japan, to construct the East Container Terminal (ECT) at the Colombo Port.[33]

The cancellation, hardly three months after his ascendency as the President of Sri Lanka, heightened India's strategic and economic concerns on the island. The decision to terminate the tripartite agreement was made after the Port Union protested. The Port Union was demanding no role of foreign investment in ECT. Amidst rising pressure from the union, the cabinet decided to develop the strategic terminal on its own through the Sri Lankan Ports Authority. India and Japan both reacted sharply to the unilateral decision. India claimed that China was behind the Port Union protest, which forced the Minister of Ports and Shipping to submit the proposal for cancellation of the tripartite agreement. However, it seemed that Gotabaya was trying to compensate for the Chinese concerns as he promised in his election campaign.

India's sharp reaction was justified as almost 70 per cent of the shipping business in the ECT was linked to India.[34] Japan's contribution to the project was also considerable. Since Colombo has always been vulnerable to Sino-Indian competition that also involves the United States, Gotabaya had to change his decision. The cabinet in a meeting held just two days after the cancellation of the Tripartite agreement, decided to give the west terminal of Colombo Port to India and Japan in a public-private partnership.[35]

Under due pressure, Sri Lanka also cancelled an energy project (three hybrid power plants: solar, wind, and hydro) with China. First, these projects were given to Sino Solar Hybrid (Beijing) Technology Co. Ltd. but were later awarded to India, citing that India had offered a 75 per cent grant instead of the loan that Sri Lanka was seeking from the Chinese firm earlier.[36] However, India on its part, was trying to get China off of this project as the project sites (three islands in Jaffna: Delft, Nagadeepa, and Analthivu) were close to India's coastline (Tamil Nadu) and, thus, it was a security concern for New Delhi (see Map 1 below). The Chinese company, however, rejected this concern as ridiculous, as the three islands are separated by the sea.[37]

Map 1:

Geographical Proximity, Sri Lanka-India

Source: The Economist

After clearance from China, India formally signed an agreement with Sri Lanka in March 2022. A little earlier, India signed two agreements of 100-megawatt solar energy production at Sampur and 500 megawatts of renewable energy project at Mannar and Pooneryn.[38] Prime Minister Modi helped facilitate the Adani Group (an Ahmedabad-based Indian multinational corporation) and the National Thermal Power Corporation to get their hold on several other energy projects in Sri Lanka.

Sri Lanka's refusal to receive the much-needed organic fertilizers ship from China also needs to be viewed from the prism of geopolitical constraints. After the imposition of a ban on chemical fertilizers and pesticides in April 2021, Colombo signed an agreement with China's Qingdao Seawin Bio-tech group for supplying organic fertilizers. In September 2021, the Chinese ship Hippo Spirit carrying the first consignment of 20,000 tons (out of 99,000 tons) of organic fertilizer was stopped by Sri Lankan port authorities. The National Plan Quarantine Services of Sri Lanka claimed that the consignment was carrying live bacteria that were harmful to plants.

The cargo incident triggered a rare diplomatic row between the two countries. Beijing reacted strongly. It blacklisted Sri Lanka's People's Bank for not honouring the payment and also launched an international arbitration for compensation for the loss of reputation. The row ended in China's favour as Sri Lanka not only agreed to pay 70 per cent of the total cost of the shipment but also agreed to make fresh orders.[39] The organic fertilizer spat between the two countries reveals how a small island nation could not withstand Chinese pressure. On the other hand, Sri Lanka compensated India by allowing fertilizer import to the private sector. The partial lift enabled India to send emergency supplies of 65,000 metric tons of urea to Sri Lanka.[40]

Polarization at the global level followed by the Ukraine crisis also played a negative role in the whole situation. China maintained a low profile amidst rising polarization for obvious reasons discussed earlier. However, it provided New Delhi with an opportunity to regain its lost strategic space on the island and New Delhi has been successful in that to a great extent as is evident from the discussion here. Prime Minister Modi encouraged Mahinda Rajapaksa to approach the IMF but the latter was reluctant in doing so. However, the situation changed when Gotabaya, amidst rising pressure from the people, had to appoint the opposition leader Ranil Wickremesinghe as the Prime Minister. Wickremesinghe was the preferred choice of New Delhi and the West. He is known as liberal, pro-West, and an experienced person in dealing with the IMF. After Wickremesinghe came into power, New Delhi played its card and helped facilitate bringing the IMF closer to Sri Lanka.

In a nutshell, the geopolitical constraints, combined with the island's fragile balancing approach, have cast a negative shadow on its economy. Ironically, Colombo had to relinquish several ongoing projects amidst mounting pressure and several new projects had to be launched. The inconsistency in the foreign policy approach has also led to political instability and polarization on the island. That was the very reason Sri Lanka has not been able to exploit its geopolitical significance to its advantage so far.

Back to the Future

The above retrospective analysis shows how Sri Lanka, the island of paradise, got trapped in its worst economic crisis. It reveals how dependency on mega projects with little to no focus on local industrial growth, low-tax regime amidst soaring debt, ban on fertilizers amidst rising food insecurity in the post-Covid-19 times, delay in approaching the IMF despite repeated warnings, and the geopolitical constraints played a catastrophic role in pushing Colombo towards bankruptcy. Indeed, there are lessons for debt-ridden countries in the region and beyond.

Talks continue with the IMF for the 17th rescue programme worth $3 billion.[41] Prime Minister Ranil Wickremesinghe has almost totally reversed the low-tax regime that President Gotabaya introduced back in 2019. The cabinet has also passed the 21st amendment to the Constitution to curtail the president's powers. Other measures and economic reforms are underway. However, the credibility of the current government is questionable since political tensions in the country persist.

If history is any guide, the 17th rescue programme of the IMF will not be without challenges. Sri Lanka and the IMF had been at odds over the former's inconsistent approach to conditionalities set by the IMF which eventually led to a serious trust deficit between them. Gotabaya Rajapaksa after coming into power in 2019, brushed aside the fiscal and monetary conditions imposed by the IMF in its 16th programme of 2016.

Given that, one cannot say for sure whether the new political setup in Sri Lanka will continue with the reform process or not and whether the IMF deal will be honoured or not. Sri Lanka's economic future, thus, looks grim. Political instability, lack of transparency and accountability in the existing governance system, and inconsistency in the state-led or state-owned projects will continue to cast a negative shadow on Sri Lanka's economy. The geopolitical constraints on the other hand will continue to limit Colombo's foreign policy choices as has been the case since its independence.

The solution lies in addressing the underlying governance problems in the country. More importantly, there is a need to enhance the professional capacity of the labour to absorb large inflows so that the trickle-down effect of foreign investments can be felt across the country.

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