

# Explaining Sri Lanka's Economic Crisis

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Sri Lanka is part of a line of exceptional cases of sovereign default over the past several decades. Like Argentina in 2001 and Greece in the aftermath of the 2008 global financial crisis, the country is experiencing tremendous political upheaval as it deals with the consequences of a balance of payments crisis. In Sri Lanka's case, this has made it difficult to repay its external debt denominated in dollars. But Sri Lanka's crisis is also singular in the extent to which it reflects the issues of a contemporary global order on the verge of breakdown. As many commentators have pointed out, external shocks, from the Covid-19 pandemic to the war in Ukraine, have created unprecedented pressures on Sri Lanka as well as other countries in different parts of the global South. These shocks exposed Sri Lanka's internal vulnerabilities. The latter are both structural, in terms of the country's overwhelming dependence on the external sector, and political, because of the profound failure of the government led by President Gotabaya Rajapaksa.

A real solution now depends on proper diagnosis of the causes. That means not only recognizing the scale of the economic depression, but also accepting far-reaching, progressive changes to the relationship between state and society that are required to pull the country out of the abyss. Meanwhile, Sri Lanka's economic collapse has given rise to a protest movement of a massive scale, as people across the island have come out onto the streets to demand Rajapaksa's resignation. Around the world, people are receiving news about the political fallout in the country, nearly two months since protestors converged on Rajapaksa's house in Mirihana, a suburb of the commercial capital of Colombo, on March 31<sup>st</sup>. The call for Rajapaksa to resign remains the central demand of the protest movement. Still, there is debate over the structural causes of the crisis. This conversation has been challenging because of the unwillingness of elites and the country's economic establishment to grapple with the consequences of the breakdown of the market. The problem has been further compounded by the intervention of hegemonic external actors, which most recently include the United States, India, and Japan.

These countries may be considering the possibility that Sri Lanka can become a laboratory for experiments to manage the effects of the global economic downturn on countries in the global South. Toward this end, they endorsed the appointment of Ranil Wickremesinghe to the post of Prime Minister after Rajapaksa's brother, Mahinda, vacated it on May 9<sup>th</sup>. Such political maneuvering is a worrying sign of the continued inability of the ruling class in Sri Lanka to accept the need for wealth redistribution and collective mobilization. Wickremesinghe was Prime Minister

in the past, and he currently represents a party with only one seat in parliament, after its drubbing in the last elections held in 2020. A wide section of Sri Lanka's elites has accepted the Faustian bargain of deflecting protestors' demand for Rajapaksa to resign in the interests of "economic stability." This decision is ostensibly for the purpose of negotiating an agreement with the International Monetary Fund (IMF). Combined with implicit and explicit repression, the protest movement demanding Rajapaksa's resignation faces herculean challenges.

Even more is at stake now, given that food shortages and potential famine-type conditions are fast approaching. Only far-reaching mobilization of the polity will be enough to stave off disaster. Because of the dizzying speed at which political developments are occurring, however, it is useful to start by approaching the questions raised by Sri Lanka's economic collapse from a longer macroeconomic perspective. The country's economic establishment has put forward several major explanations for the crisis. The two most prominent are that Rajapaksa's government engaged in money printing, or loose monetary policy, and that it pursued misguided tax cuts in 2019 when it came into power. Money printing supposedly caused inflation, while tax cuts undermined the country's revenue base, which paved the way for global ratings agencies to downgrade Sri Lanka's external debt.

The downgrading led to Sri Lanka getting locked out of international capital markets. With the onset of the Covid-19 pandemic in 2020 and the collapse in tourism revenues, it became impossible for Sri Lanka to roll over its significant external debt. The two arguments proposed by the economic establishment converge on the idea that ultimately the domestic budget deficit is responsible for the crisis. According to this narrative, Sri Lanka must follow an IMF program with strict conditionalities, which are being negotiated, to recover from collapse. If we are to push back against this solution that could make a terrible collapse even worse, and grapple instead with the real cause of the crisis—Sri Lanka's overwhelming dependency on the external sector, as reflected in the current account deficit—we must deconstruct the dominant explanations.

## **The Impact of Rising Prices**

Throughout the uneven recovery from the Covid-19 pandemic, many heterodox economists around the world have noted that inflation is an abstract and imprecise measure to capture what has been happening in terms of rising prices. In the case of Sri Lanka, as elsewhere, we must specify the causes. Looking at food prices, for example, we see that the phenomenon must be explained on its own terms. Sri Lanka imported about \$1.6 billion of food, or about 8% of its import bill, in 2021. Food prices increased by roughly 45% in April year over year. Meanwhile, the UN Food and Agriculture Organization's (FAO) Food Price Index indicates that global food prices increased by 30% from March 2021 to 2022. The food crisis is far more acute in Sri Lanka because the market has already broken down. Local factors compound rising prices, such as hoarding.

If rice mill owners, for example, expect prices to increase, they may refuse to sell, increasing scarcity and shortages. The government last year attempted to curtail the hoarding of rice by imposing price controls. But it lacked the political will to be able to enforce these measures on the mill owners, and it soon rescinded them. Moreover, the government failed to address domestic supply constraints, such as low investment in food production. Instead, debt moratoriums for big businesses and loose monetary policy only encouraged further speculation because these measures were not implemented as part of a concerted effort to spend in critical areas of the economy, especially food production. The government's mismanagement of the crisis, however, does not mean that money printing itself caused rising prices, although as an isolated policy, it clearly failed to ameliorate them.

Another example of such rising prices is fuel. The price per barrel rose from about \$25 shortly after the global Covid-19 pandemic was announced in March 2020, to over \$100 in the aftermath of the Russian invasion of Ukraine. Sri Lanka, as a country dependent on oil imports for its energy needs, was severely impacted by this increase. But its vulnerable position was also shaped by elite patterns of consumption, in which luxury high-rise development and private vehicle ownership has taken precedence over, for example, investment in the public transportation system.

### **Proposed Solutions and Their Effects**

The government of Gotabaya Rajapaksa made the economic situation more intolerable by banning chemical fertilizers overnight, in April 2021. It originally claimed its goal was to achieve organic agriculture. But the real purpose was conserving precious foreign exchange. This policy undermined Sri Lanka's self-sufficiency in food production, as opposed to creating a viable path for transforming the country's agriculture. It threw the food system into crisis, precisely when domestic food production became a critical need. The government further struggled to contain the balance of payments deficit, which widened to \$8 billion as imports increased by \$20 billion, compared to \$12 billion for exports in 2021, despite its rhetoric about import substitution.

The country also experienced the dramatic collapse of tourism revenue with the onset of the Covid-19 pandemic, which went from about \$3.5 billion in 2019, to less than \$1 billion in 2020. Migrant workers' remittances also declined from about six billion dollars in 2020 to about five billion in 2021, as external pressures made it more difficult to attract dollars. The result of these challenges is that the current account deficit widened from roughly 1.5% of GDP in 2020 to 4% in 2021. Sri Lanka's GDP is roughly \$80 billion. Before going into hard default on May 18<sup>th</sup>, the country was expected to service about \$7 billion in external loans this year alone. Rising debt servicing costs are further exacerbated by interest rate hikes by the US Federal Reserve. The worsening current account deficit and the depletion of Sri Lanka's foreign exchange reserves has made it impossible to import essential goods.

In the current volatile political moment, the President appointed a new Central Bank Governor in April, after the previous one, Ajith Nivard Cabraal, was forced to quit in disgrace. The Central Bank soon thereafter chose to raise interest rates, from about 6% to 14%. What such rate increases do in an economic crisis is put more pressure on small businesses and other borrowers. But all these efforts have stemmed from the belief that the problem was the previous Central Bank policy of money printing, as opposed to the actual cause, which was rising prices induced by external pressures. The Central Bank itself has recently acknowledged this cause and it may reconsider further rate increases. But in the meantime, such uncertainty will only exacerbate pressure in people's lives.

### **The Decline of Redistributive Taxation and the Shift to External Debt Financing**

Furthermore, the economic establishment has relied on the argument that the Rajapaksa government's tax cuts in 2019 undermined the proportion of revenue to expenditure, which led to the widening of the budget deficit. It is true that taxes are already low as a proportion of Sri Lanka's GDP, constituting 9%. Expenditure has been roughly 20% of GDP. But as political economists such as Mick Moore and Ronald Herring have long pointed out, the budget deficit in fact started widening to a far greater degree with the onset of economic liberalization in the late 1970s. Sri Lanka became a poster child for liberalization in the wider South Asian region by becoming one of the first

countries to adopt neoliberal policies in 1978 under JR Jayewardene. The framework included slashing import tariffs, cutting the food subsidy, floating the exchange rate, and generally pursuing trade and financial liberalization. As a result of tax concessions—which, supposedly, were incentives to attract foreign investors to, for example, Export Processing Zones—the country's revenue base was hollowed out.

Initially, the deficit was not as much of an issue because Sri Lanka could obtain foreign aid and concessional financing. But in the absence of a redistributive tax system to fund public services, non-concessional loans, which included not only bilateral funding but also significant borrowing on financial markets, became a much larger proportion of external debt. The country issued its first sovereign bond, for example, in 2007. Fast forwarding to today, we can see that sovereign bonds in fact constitute roughly 40% of external debt, which in total is about 60% of GDP. Despite claims about the “Chinese debt trap” promoted in international media, the reality is that debt owed to China constitutes around 10% of external debt. Sri Lanka's financial crisis is the outcome of a history of liberalization policies that have now been exposed by the breakdown of the country's economy.

For the economic establishment, however, rhetoric about the domestic budget deficit has offered an opportunity to push for compliance with potentially stringent IMF conditionalities. If an agreement is ratified, it is likely to hinge on hiking interest rates, raising indirect and direct taxes, slashing the public sector, and implementing “cost recovery energy pricing,” or increasing energy prices, to make loss-making State-Owned Enterprises, such as public utilities, profitable. Raising taxes on income and corporations, of course, as opposed to indirect taxes on essential goods, is necessary in the long run. But when incomes are falling across the board in an economic crisis, as Ahilan Kadirgamar has consistently pointed out in the case of Sri Lanka, there must be a wealth tax on property and assets instead.

Additionally, the economic establishment has proposed cash transfers to the poor and vulnerable. But such transfers will not be effective if both large sections of the population are becoming immiserated—as witnessed by the increasing participation of the middle class in protests—and the price of essential goods is skyrocketing. Instead, as the Feminist Collective for Economic Justice has emphasized, the public distribution system must be revived. But to do so, the rural infrastructure that, despite political rhetoric, has largely been ignored—including the Paddy Marketing Board, Cooperative Wholesale Establishment, and the Lanka Sathosa chain of subsidized retail outlets—requires massive and immediate investment. Those efforts hinge on financing through domestic borrowing in rupees, to prioritize the needs of marginalized communities in the rural and urban periphery.

## **The Urgent Need for Self-Sufficiency**

Typically, these issues have been downplayed. Underlying the IMF's proposals, and the Sri Lankan elite's shared interest in them, is the goal of further liberalizing trade, despite the widening current account deficit. This contradiction has become the crux of the matter. To confront the problem, we must distinguish rhetoric around the budget deficit from the current account deficit, which implies the critical need to prioritize imports. Such efforts, however, will require far-reaching democratic mobilization to change Sri Lanka's economy in the direction of self-sufficiency, with an egalitarian emphasis on transforming social relations. The Rajapaksa government ignored this project. Instead, it focused on consolidating its own power through authoritarian methods and divisive Sinhala Buddhist nationalist politics during the time period between when it came to power in 2019 and the current economic collapse.

While the causes for the government's failure were its own, however, Sri Lanka is also representative of bigger challenges on a global level. As the UN Conference on Trade and Development noted in an update to its annual report this year, the ratio of external debt to GDP in developing countries rose from 57% in 2020 to 70% in 2021. Similarly, the ratio of external debt to exports has increased from 176% to 252%. Calling for further trade liberalization, then, will not do countries like Sri Lanka any good. Instead, the need of the hour is to re-embed food security in the paradigm of self-sufficiency so that people can be insulated from external shocks. With the ongoing deterioration of the global environment, Sri Lanka's economic collapse could be a forerunner of trends across other parts of the global South.

To resolve these issues, progressives abroad should support efforts to actively prioritize a solution that puts the needs of people in places such as Sri Lanka first. Solidarity from abroad must grapple with the fact that even ongoing global campaigns to cancel odious debt and reform the global debt architecture work on a medium to longer term timeline. In the short term, and in the most urgent sense, solidarity with working people's protests in Sri Lanka means pushing back against imperial intervention by powerful actors that may attempt to rescue a highly unequal, decaying neoliberal system, even while they try to frame the crisis in terms of intensifying geopolitical competition between hegemonic powers in the region. Now, more than ever, we must democratize the global order by heeding the demands put forth by movements on the ground in places like Sri Lanka, where people are experiencing the severest effects of the crisis.

*This article is a revised and expanded version of a talk given for the webinar "What's Happening in Sri Lanka?" co-sponsored by Internationalism from Below and Haymarket Books.*