

# Sri Lanka teeters on economic edge, from pandemic-fueled financial crisis and Ukraine war spillovers

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An [unprecedented economic crisis](#) is unfolding in Sri Lanka. And while the country's problems have been brewing for years, spillovers from the crisis in Ukraine [have sent the island nation over the edge](#).

The Sri Lankan rupee [has plunged to a record low](#) against the U.S. dollar. [Annual inflation is in the double digits](#). [Import controls are in effect](#). And the country is [teetering on the edge of default](#).

As a result, [power blackouts are routine](#). Fuel, food and medicine – [most of which are imported](#) – are scarce, and rising prices are putting what remains out of reach for many Sri Lankans. Even [printing paper is hard to come by](#), forcing schools to cancel exams. The problems [have sparked the biggest protests](#) seen here in years. Troops [have been sent in to quell them](#).

Sri Lanka is now turning to foreign assistance for help, including its [two biggest trading partners](#). China is considering [offering US\\$2.5 billion more](#) over the [\\$2.8 billion](#) already extended, and India has put up [\\$2.4 billion](#). And President Gotabaya Rajapaksa's government [is currently in negotiations](#) with the International Monetary Fund and the World Bank for a bigger aid package – something he had [previously resisted](#), to avoid the often onerous terms they require.

## Analysis of the world, from experts

As an [economist and former official](#) at the Central Bank of Sri Lanka, I saw firsthand many of the policies that led to the current crisis. And now the economic, financial and political stability of [Asia's oldest democracy](#) are all at risk if the government doesn't find a sustainable way out.

## From civil war to wild growth

Sri Lanka, which gained its independence from Britain in 1948, only recently emerged from a [deadly and costly 26-year civil war](#).

The war was fought between the government military of this majority Sinhalese country and armed separatists from the Tamil-speaking minority. [Civilians and civil properties were frequent targets](#).

Toward the end of the war, in 2006, the government [tried to jumpstart growth](#) by borrowing heavily and attracting foreign capital by propping up the rupee. In the short-term, the strategy worked. The economy boomed, causing the per-capita gross domestic product to surge from \$1,436 in 2006 to \$3,819 in 2014 – [vaulting Sri Lanka past](#) Ukraine, the Philippines and Indonesia. This [lifted 1.6 million people out of poverty](#) – 8.5% of the population – and gave rise to a large middle class. By 2019, Sri Lanka [ascended to the ranks](#) of the World Bank's "upper middle-income" countries.

The designation lasted [only for a year](#), however, because all that growth came at a cost. [Sri Lanka's external debt](#) tripled from 2006 to 2012, pushing [total public debt to 119% of GDP](#).

Those policies were suspended for a time in 2015, which stabilized the economy at a lower rate of growth, but the [debt continued to accumulate](#).

### **Pandemic and war**

Then the COVID-19 pandemic hit.

Tourists, who spent \$5.6 billion in 2018 and played a big role in balancing Sri Lanka's [\\$10 billion trade deficit, disappeared virtually overnight](#).

This dealt a massive blow to the economy, especially considering a large [tax cut the previous year](#) depleted government coffers. Simply paying interest on that large debt took up [72% of government revenue in 2020](#), requiring the central bank to print more cash to avoid default, thus fueling inflation.

Fortunately for the government and its citizens, Sri Lankans overseas [continued to send home](#) a vital lifeline of remittances, or about \$7 billion a year.

But in 2021, as many [economists and analysts urged](#) Sri Lanka to seek international aid, the central bank instead [focused on borrowing from its neighbors](#), maintaining the value of the rupee and restricting imports.

The export controls caused shortages of essential goods like cooking gas and milk, and defending the currency [drained Sri Lanka's foreign reserves](#). Moreover, [remittances began to drop](#) as the black market value of the rupee fell, leading people to avoid converting dollars to rupees at the official rate or by official channels. Annual inflation [has been estimated](#) at as much as 55%, compared with the official rate of 14%.

By March 2022, reverberations from the war in Ukraine, which [drove up international prices](#) of oil, wheat and many other commodities, finally forced the government to change course. Beyond the effect on the cost of imported goods, the war also further threatens Sri Lanka's tourism industry as [flights to Moscow are now suspended](#). Before the war, [Russians frequently made up the biggest share](#) of Sri Lankan tourists, with Ukrainians not far behind.

Sri Lankan authorities had few other options than to allow the rupee to depreciate – which [is expected to save billions](#) of dollars a year – and seek IMF assistance. Sri Lanka [will likely also have to restructure](#) its large debt load – by asking foreign bondholders to accept less than 100% of the value of their investments – to make it more sustainable.

### **A perilous situation**

The [strategy may be working](#), but the cost to Sri Lankans will be high for a long time.

Over 350 “non-essential” [items are now banned](#) for import, including milk, oranges and household appliances.

And the limited supply of goods that remain are getting more expensive every day. The price of cooking gas, for example, is almost [three times higher](#) than it was [just five months ago](#).

Securing loans from the IMF and the World Bank, along with short-term credit from China and India, may stabilize Sri Lanka's economic and financial situation. But with protests growing and the austerity

measures demanded by the lenders likely to prove unpopular, the government may find it hard to survive for long.