Proceedings of the 2nd International Conference on Financial Technology and Business Analysis
DOI: 10.54254/2754-1169/82/20230951

The Analysis of Country Insolvency in Sri Lanka

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Abstract: In July 2022, Sri Lanka officially declared national bankruptcy. The bankruptcy seems to result from the outbreak of COVID. In fact, Sri Lanka's economic structure was already very fragile. In March of the same year, the United states opened the most substantial and dense cycle of interest rate hikes since 1981, which quickly led to a global spike in the cost of funds, disrupting the order of global financial markets and directly exacerbating the risk of a debt crisis in Sri Lanka. With the internal and external combined impact, the economic crisis expanded into a food crisis, debt crisis, and went bankruptcy step by step. Nowadays the current global economy is in a recessionary stage. Sri Lanka is the first country to fall, but not the last one. Other emerging market countries are facing the same problem. This paper combs through the process of Sri Lanka's national bankruptcy, deeply analysing the reasons for its bankruptcy and the pulse of its economic operation, and tries to put forward some useful suggestions and insights.

Keywords: Sri Lanka, national bankruptcy, foreign exchange reserves, debt crisis

1. INTRODUCTION

Sri Lanka is located in the centre of the Indian Ocean shipping channel, east of the Bay of Bengal, and west of the Arabian Sea. The location is so good that Sri Lanka has the world's busiest trade routes. In 2009, Sri Lanka vigorously develop a labour-intensive processing industry after the end of the civil war. According to the World Bank statistics, Sri Lanka's GDP growth rate reached 8% in 2010, 8.4% in 2011, and 9.1% in 2012. However, Sri Lanka's domestic industrial structure is simple, and the country's overall economic resilience is becoming weaker, with GDP growth falling to 3.4 percent in 2013 and only 2.3 percent in 2019.

Since 2020, Sri Lanka has been widely hit by multiple factors. The outbreak of the COVID epidemic not only directly jeopardized the lives and health of the people, but also indirectly caused economic recession in Sri Lanka. The employment situation was tough, and the GDP growth rate declined or even turned negative. The outbreak of the Russian-Ukrainian conflict in 2022 resulted in the rupture of the supply chain of commodities, and the shortage of international energy and food, which have had a serious negative impact on Sri Lanka. In March of the same year, the Federal Reserve opened the most substantial and intensive cycle of interest rate hikes since 1981, which quickly led to a global spike in the cost of funds, disrupting the order of global financial markets and directly exacerbating the risk of a debt crisis in Sri Lanka[1].

The impact of many factors has plunged Sri Lanka into debt default and national bankruptcy. On July 6, 2022, Sri Lankan Prime Minister Ranil Wickremesing declared to the parliament that "the

DOI: 10.54254/2754-1169/82/20230951

country is bankrupt", and on the morning of July 11, President Gotabhaya Rajapaksa formally announced his resignation. This is the worst economic crisis in Sri Lanka since independence in 1948. How did Sri Lanka fall deep into a debt crisis step by step? This paper tries to analyse Sri Lanka's bankruptcy performance, internal and external influences, fiscal policy, and monetary policy and tries to make recommendations.

2. MANIFESTATIONS OF INSOLVENCY IN SRI LANKA

2.1. Devaluation of the national currency and increased inflation

On March 7, 2022, the Sri Lankan rupee took a nosedive against the US dollar, falling from the previous session's close of 200.75 to the day's close of 227.60, a daily depreciation of more than 10%. Subsequently, the Sri Lankan rupee depreciated rapidly, reaching a low of 370.86 on May 12 of that year.

Inflation in Sri Lanka is at 69.8% as of September 2022. Power outages happened. The lack of medicines has brought the health system to the brink of collapse. Food prices are at least 30% higher than last year. According to the latest report by the World Food Program (WFP), 6.26 million people in Sri Lanka are facing food shortages and other problems.

In terms of internal economic management, the government has continued to increase money printing, with data showing that between December 2019 and August 2021, in less than two years, Sri Lanka's money supply increased by 42%. Especially after the outbreak of the epidemic in 2020, Sri Lanka's money supply had a significantly accelerated growth process.

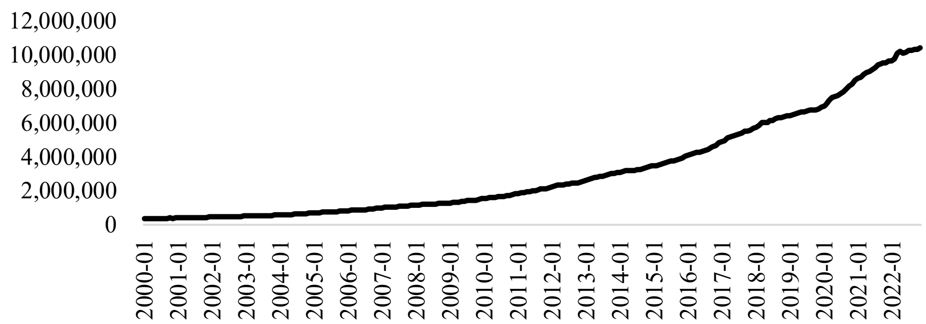

Figure 1: Sri Lanka Money Supply/Million Sri Lanka Rupees (Source: WIND)

2.2. The real economy was weak and the stock market plunged until it closed

Sri Lanka's real economy was very weak and has even experienced consecutive negative growth. As can be seen from the chart below, after the second quarter of 2021, Sri Lanka's real GDP year-on-year growth rate took a sharp turn for the worse, with year-on-year growth rates of - 1.61%, - 8.45%, and - 11.79% for the first, second, and third quarters of 2022, respectively. Three consecutive quarters of negative real GDP growth indicate that Sri Lanka's economy has lost momentum and is in recession. The President of the country has indicated that Sri Lanka's GDP growth will be in the range of -3.5% to -4% in 2023.

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Figure 2: Real GDP of Sri Lanka

Sri Lanka's stock market plummets and terminates trading[2]. In 2022, when the Federal Reserve started to raise interest rates, the global stock markets plummeted to varying degrees and Sri Lanka witnessed an exodus of international capital from the country. With CSE index slashing from a high of 13,593 to 6,884, a fall of up to 49%. The stock market crash hit Sri Lanka's capital markets hard and the housing market also plummeted. On March 31, 2022, the Colombo Stock Exchange (CSE) announced that it would reduce its daily trading hours from 4.5 hours to 2 hours. In April, the CSE announced that it would be closed from the 18th. On the first day of market reopening, the Sri Lankan Blue Chip Index fell by 12.6% and the Colombo Stock Exchange All-Share Index fell by 6.7%, and trading on the Sri Lankan Stock Exchange was again suspended.

2.3. The poor employment situation, the shortage of goods, and the anger of the masses

The job market in Sri Lanka has also been very depressed due to the economic crisis. As can be seen in the graph below, Sri Lanka's unemployment rate has been rising since 2017, rising to 5.50% in 2020, and has remained high since then. By early 2022, over 200,000 people were unemployed in the country, with an annual unemployment rate of 5.25% in 2022. More than 300,000 Sri Lankan citizens have gone overseas for employment through official channels. The effects of economic contraction and inflation have ultimately been passed on to the lower classes. The World Bank estimate that more than half a million Sri Lankan people have slipped back into poverty during this period.

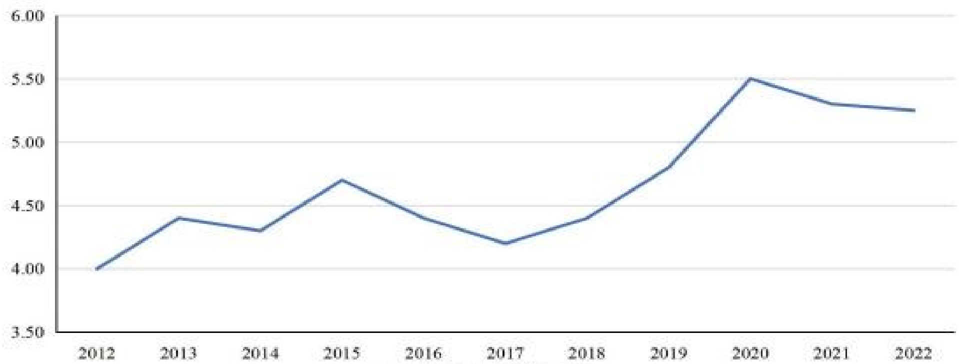

Figure 3: Unemployment rate in Sri Lanka

While the labour market is depressed, Sri Lanka's goods are also in a state of extreme shortage. The food crisis is aggravated and the people do not have enough food. The power supply is insufficient and enterprises are having difficulties in production. Sri Lanka's health care system is in a deep plight, and some surgeries and even cancer treatments have to be stopped. In a word, Sri Lanka is facing a serious humanitarian crisis in the country.

2.4. Insufficient foreign exchange reserves to pay external debt and declaration of national bankruptcy

Sri Lanka has a perennial deficit in international trade and needs to keep borrowing from the World Bank or other countries. The country's external debt continues to climb rapidly. According to the International Monetary Fund, the ratio of Sri Lanka's total government debt to GDP was as high as 130.53% at the beginning of 2022.

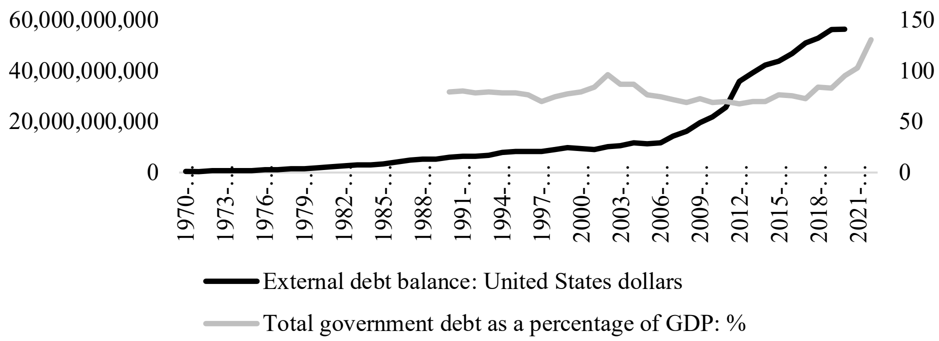

Figure 4: Sri Lanka's External Debt Balance and Government Debt (Source WIND)

On April 1, 2022, the President of Sri Lanka, Gotabhaya Rajapaksa, declared a state of public emergency, which was faced with a number of problems such as a shortage of electricity and high prices. According to the World Bank, Sri Lanka had a debt balance of US$56.592 billion at the end of 2021, of which US$8.622 billion of short-term debt need to be repaid by 2022, while its foreign exchange reserves at the end of 2021 amounted to only US$2.772 billion. By June 2022, before the country went bankrupt, it had only $1.746 billion left in foreign exchange reserves, which was insufficient to cover the required debt repayments for that year[3]. The country declared bankruptcy at the beginning of July, stating that it would consult with the IMF for a bailout. A large number of protesters took to the streets on July 9, the third day after the "bankruptcy of the state", so President Gotabhaya Rajapaksa was forced to flee his home.

3. ANALYSIS OF THE CAUSES OF INSOLVENCY IN SRI LANKA

3.1. Domestic economic landscape with a homogeneous industrial structure

Under the century-long colonial rule, Sri Lanka's economy has long depended on the export of gemstones and the cultivation of tropical cash crops, such as rubber, coconuts, rice, coffee, and other tropical cash crops, as well as Ceylon black tea, which has become the most important export product. At the same time, under the wave of economic globalization and tourism development, Sri Lanka has become a tourist destination for the world. Raw material exports and tourism are the two pillars of the Sri Lankan economy. In contrast to the boom in raw material exports and tourism, Sri Lanka has a weak manufacturing sector. Sri Lanka imports most of the raw materials, but its own industrial resources are very scarce, so a large number of industrial products need to be imported from other countries.

Therefore, Sri Lanka’s shows industrial structure is homogeneous obviously. First of all, its economic dependence on the international market seems too strong, and many necessary commodities of production and living are highly dependent on imports; at the same time, tourism as Sri Lanka's

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advantageous industries also have fatal weaknesses. Once the international economy is in crisis, the tourism industry will be greatly affected, affecting Sri Lanka's internal economy accordingly.

3.2. Integrated role of national policies

3.2.1. Fiscal policy: tax cuts under election promises exacerbate risk of debt crisis

The election promising of a new president to push through huge tax cuts is a promise to the nation but a key factor in accelerating Sri Lanka's bankruptcy. During the 2019 presidential election in Sri Lanka, 73-year-old Gotabhaya Rajapaksa was elected as president. The new president began his tenure by pushing for a massive tax cut. In November 2019, he announced an across-the-board tax cut. He said maybe 33.5% of taxpayers would pay no tax, reducing the value-added tax (VAT) from 15% to 8%. He promised broader social benefits and increased the amount of government purchases of imported goods. The reduction in domestic tax revenues and shrinking international trade has forced the Sri Lankan government to opt for massive money printing to repay domestic and foreign loans. Sri Lanka's credit rating was downgraded in 2020, making it difficult for the country to access international financial markets for foreign capital.

3.2.2. Monetary policy: massive money-printing is a recipe for disaster, and the debt burden is growing by the day

When Gotabhaya Rajapaksa took office in 2019, Sri Lanka became the first country in the world to formally recognize and use Modern Monetary Theory (MMT), which states that if a country has full monetary sovereignty, it has no financing constraints on spending and does not have to worry about the fiscal deficit. Sri Lanka's money supply accelerated markedly after 2019, increasing by 42% between December 2019 and August 2021, but it failed to consider its own ability to absorb money and ignored the strict assumptions of modern monetary theory. Massive money issuance eventually translated into inflation, a wild devaluation of the local currency, an increased burden on people's livelihoods, and a sharp rise in the cost of external debt.

As mentioned earlier, Sri Lanka's trade and fiscal "twin deficits" have made it very dependent on external funding, but sources of liquidity are increasingly tightening. In 2019, fiscal revenues at the time of tax cuts pursued by the new president for the implementation of the policy fell sharply, and large import purchases also consumed more foreign exchange reserves. in order to support the economy to function properly, Sri Lanka can only be caught in the vicious cycle of "borrowing new debt to repay old debt"[4].

3.2.3. Industrial decision-making: The timing of the decision to develop organic agriculture was maybe not so good

The economic crisis was exacerbated by the Sri Lankan government's poor decision-making in agriculture. In 2021, the Sri Lankan government decided to develop organic agriculture to save the foreign exchange needed for importing chemical fertilizers. In 2021, Sri Lanka was already in economic difficulty, but on April 9 of that year, influenced by the international trend of going green and low carbon, the Sri Lankan government decided to ban the import of chemical fertilizers and other agrochemical (pesticides). The President of Sri Lanka believes that measure can save about 200 million dollars in foreign exchange.

However, the serious consequences of the ban on imported fertilizers were immediately apparent. In the first half of 2021, Sri Lanka's rice production fell by 20 percent, the domestic price of rice rose by 50 percent, and the country, which had long been self-sufficient in rice, was forced to import US$ 450 million worth of rice. In November of the same year, Sri Lanka's tea production fell, with direct

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economic losses amounting to US$425 million, and the production of chili peppers, cinnamon, and vegetables fell by 30 percent. May 2022, Sri Lanka announced the official end of its "green agricultural revolution." It is clear that this policy was not adapted to local conditions and that local agricultural conditions were not ripe. Although the policy was declared to be over, its broken growth capacity will not be restored in the short term.

3.3. Analysis of external factors

3.3.1. The COVID epidemic had a huge impact on Sri Lanka's tourism industry

Sri Lanka is known as the "Pearl of the Indian Ocean" and tourism has always been its mainstay in terms of foreign exchange earnings. The 2020 outbreak of the COVID Epidemic was undoubtedly a hit to the already declining Sri Lankan tourism industry. The surge in the price of international flights and strict measures to control COVID led to a sharp decline in the number of inbound tourism arrivals in Sri Lanka in 2020 and a sharp drop in tourism revenue. The annual international tourism revenue of 2020 was US$107.6 billion. It's a decrease of 76.92% compared with 2019. Tourism revenue share of total exports dropped to 8.22% in 2020, which is a record low since 2009. The successive downturns in agriculture and tourism have led to a serious imbalance in Sri Lanka's balance of payments, an accelerated decline in foreign exchange reserves, and an inability to repay short-term debt, putting the country on the brink of collapse.

3.3.2. Geopolitical conflicts exacerbate debt crises

Since February 2022, with the Russia-Ukraine conflict, the global economy and trade were greatly affected. International crude oil prices, food prices, and commodity prices gradually climbing. In less than two years, the price of crude oil has doubled. From the perspective of international finance, the rise in crude oil prices has increased Sri Lanka's import costs and widened the trade deficit, leading to a significant decline in foreign exchange reserves, currency depreciation, and increased pressure on foreign debt servicing. From the perspective of the domestic economy, high oil prices have led to an increase in the cost of living for the population and pushed up inflation in the country. In June 2022, faced with energy and food shortages, the Sri Lankan government prohibit selling gasoline and diesel fuel to non-essential vehicles, causing serious disruptions to the local people.

3.3.3. Fed rate hikes were the last straw in the debt crisis

In response to domestic inflationary pressures in the United States, from March 2022, the United States began a series of interest rate hikes, which increased the exchange rate of the U.S. dollar, but also caused the depreciation of the currencies of other countries. Some countries dependent on imports are facing greater foreign exchange pressures and currency depreciation pressures. Sri Lankan is the most typical. Maintaining exchange rate stability must have sufficient foreign exchange reserves, but the Central Bank of Sri Lanka does not have the capital. In order to stabilize the value of the currency and deal with the increasing inflationary pressure, Sri Lanka decided to raise interest rates. As a result, the annual interest rate on residential loans soared from 11.19% on March 31 2022 to 16.53% on December 31, 2022. However, the high-interest rates further worsened the already depressed economic fundamentals of Sri Lanka and reduced domestic investment. The vicious cycle of continued capital outflows and accelerated currency depreciation led to an eventual currency crisis and debt crisis [5].

4. CONCLUSION

By looking at the whole process of Sri Lanka's national bankruptcy, we may find that Sri Lanka's national bankruptcy was the result of the COVID epidemic, which caused Sri Lanka's most important tourism industry to be hit hard. However, from the perspective of the whole process of national bankruptcy, Sri Lanka's long-term financial deficit caused the foreign exchange reserves to fall sharply, and lost the ability to maintain the value of the currency [6]. The payment risk was pushed up, and food shortages and inflation increased dramatically. Finally, Sri Lanka is trapped in the depths of the vicious circle, and the COVID only accelerated this process. From the perspective of the government of Sri Lanka, there are maybe three lessons to be learned from this case:

4.1. Accelerate the construction of industrial architecture

Since the end of the civil war in 2009, Sri Lanka's economy has rebounded rapidly, with a GDP growth rate of 9.1%. However, the government has failed to implement economic reforms, which failed to upgrade its industrial structure. So far Sri Lanka mainly exports agricultural products such as rubber and tea, and the textile industry is being replaced by Bangladesh. Even Sri Lanka's major means of production and daily necessities are highly dependent on imports. The Sri Lankan Government is struggling to position itself in the global industrial chain and has a long way to overcome the "middle-income trap".

4.2. Expanding domestic demand to attract capital

The government of Sri Lanka probably needs to expand the domestic demand market and prevent capital outflows. The government might increase the purchasing power of consumers and encourage people to spend more by raising the minimum wage and increasing social security[7]. Secondly, the government could consider increasing investment in infrastructure and upgrading industries, to attract more investment from domestic enterprises and increase economic vitality. Furthermore, the Government might spend much more on education, health care, culture and, other public utilities, which would raise the level of social security, enhance people's happiness, further stimulate domestic demand, increase employment, and boost domestic demand.

4.3. Importance of the independent monetary policy

The crisis has amply reflected the importance of independent national monetary policy. The establishment of an independent monetary policy can ensure the flexibility and adaptability of monetary policy. It could help the country to cope with various economic fluctuations, such as inflation and recession, and to achieve economic stability by regulating interest rates and adjusting the money supply. If monetary policy is not independent, the government may use it to achieve political objectives, which inevitably brings the risk of political intervention and jeopardizes the country's economic development.

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