

Debt Crisis and National Bankruptcy: Evidence from Sri Lanka

Qinghan Jiang

Abbotsford Christian school, Abbotsford V3G 0G1, Canada

Abstract. On May 19th this year, the central bank governor of Sri Lanka confirmed that the country could not repay its national debt due on April 18th in time (Jayasinghe & Pal, 2022). For the first time, Sri Lanka had defaulted on its sovereign debt since independence from Britain in 1948. It also announced its inability to continue paying for fuel (Jayasinghe & Pal, 2022). On July 6th, Sri Lanka declared national bankruptcy (Athas et al., 2022). This paper examined what led to Sri Lankan debt crisis and subsequent national bankruptcy and how the country could save itself from its situation. It analyzed secondary data from various published sources like news articles, journal articles, websites, and books. The study found that the country had high levels of external debt that outrun revenue. It also depends highly on imports to supply goods into the market. Its debt crisis was also influenced by economic shocks like the Russian-Ukraine war and the Covid-19 pandemic, which impaled production. Furthermore, the country's economic regulations were poor, making it unable to establish effective taxation, debt, and foreign reserve management systems. The company could improve its economic conditions by getting economic assistance from other countries and the IMF in the short term. Moreover, it also needs to restructure its foreign reserves and borrowings management systems.

Keywords: Debt Crisis; National Bankruptcy; Sri Lanka.

1. Introduction

On May 19th this year, the central bank governor of Sri Lanka confirmed that the country could not repay its national debt due on April 18th in time (Jayasinghe & Pal, 2022). For the first time, Sri Lanka had defaulted on its sovereign debt since independence from Britain in 1948. It also announced its inability to continue paying for fuel (Jayasinghe & Pal, 2022). On July 6th, Sri Lanka declared national bankruptcy (Athas et al., 2022). National bankruptcy usually indicates a country's poor economic health. It describes a situation where a government can neither pay its existing debt nor raise funds to facilitate its imports (Reuters, 2008). Bankrupt countries find it hard to provide their citizens with affordable necessities like food and healthcare (Athas et al., 2022). The declaration of state bankruptcy strips a country of any obligation toward loan repayment, allowing it to stabilize its economy and attend to its needs (Grigiene & Mockiene, 2010; Reuters, 2008). This paper examines what led to Sri Lankan debt crisis and subsequent national bankruptcy and how the country can save itself. It will analyze secondary data from various published sources like news articles, journal articles, websites, and books.

2. The reason for Sri Lankan debt crisis and national bankruptcy

2.1 Sri Lanka's High External Debt

Sri Lanka's excessive external borrowing is a primary cause of its debt crisis. Although Sri Lanka defaulted on its sovereign debt in 2022, its debt crisis was apparent much earlier. As shown in figure 1, the country's external debt drastically escalated in 2008. In recent years, the country's total external debt has accumulated above \$50 billion, a level higher than Sri Lankan foreign exchange reserve.

This accumulated external debt can be linked to the Sri Lankan Civil War. When this war ended in 2009, the Sri Lankan government borrowed money from foreign markets to develop domestic agriculture and rebuild damaged public infrastructures like airports and roads (Aneez & Roy, 2022). However, these investments could not get enough return in the short run, so Sri Lanka had to borrow new debt to repay old debt (Pasricha, 2022). As a result, Sri Lankan credit scores deteriorated, so the country had to borrow at higher interest rates and harsher terms, further increasing its debt burden

(Narayanan, 2022). In this way, Sri Lanka has been trapped in a vicious circle of borrowing, taking more financial resources out than its reserves.

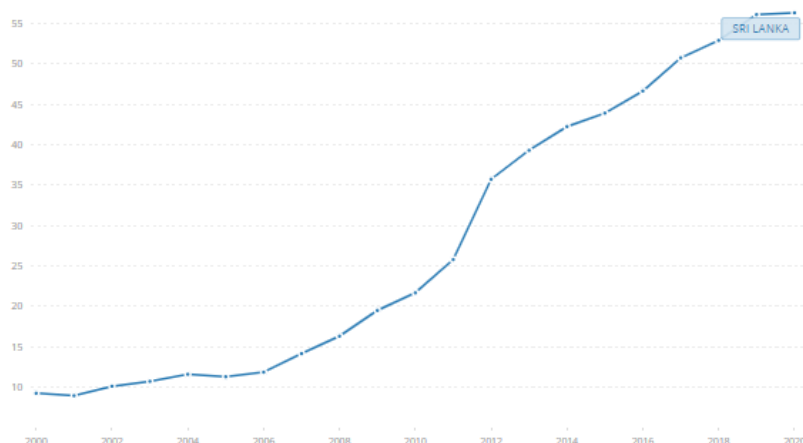


Figure 1. Total external debt of Sri Lanka (millions of US dollars)
Source: World bank (2022)

2.2 Factors that contributed to Sri Lanka's debt crisis and national bankruptcy

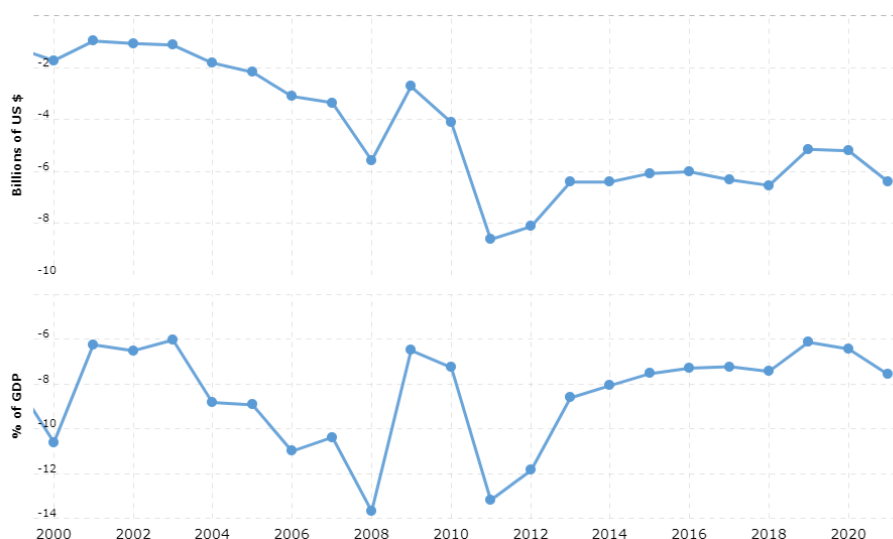


Figure 2. Sri Lanka's Balance of Trade (Unit: \$10,000 and a percentage of GDP)
Source: Macrotrends.net (2022)

Sri Lanka has maintained its heavy foreign debt burden for years, so what has accelerated its crisis in recent years? Several factors have influenced this acceleration of the debt crisis. First, the pandemic's impact on the tourism and service industries significantly shocked the Sri Lankan economy. The service industry accounts for more than 50% of Sri Lankan GDP, and the tourist industry accounts for more than 10% of GDP (O'Neill, 2022; Knoema, 2022). The service and tourism sectors were the hardest during the pandemic with the lockdown and travel bans. For instance, revenue from the tourism sector for the first eight months of 2021 dropped by \$3 billion compared to the same period in 2018 (Kenichi, 2021). In the process, Sri Lanka lost considerable revenue, which was necessary for paying its debts and imports.

Sri Lanka's foreign exchange risk exposure also increased due to the pandemic. Figure 2 shows that the Sri Lankan trade balance has decreased significantly in Sri Lanka's buying power. The United States and developed European countries have gradually tightened macro policies, significantly reducing revenue flow to developing countries (Loayza & Pennings, 2020). This accelerated the depreciation of the Sri Lankan currency and increased its debt pressure.

In detail, when the Federal Reserve raises the US dollar interest rate, capital will flow back to the US. At the same time, emerging economies such as Sri Lanka will experience capital outflows, so the Sri Lanka rupee (LKR) has depreciated sharply, increasing the country's debt pressure. Figure 3 illustrates that the Sri Lankan rupee has depreciated against the US dollar over recent months. In just six months, the currency's value per dollar has escalated from 275 to over 350. In particular, Sri Lanka's financial and trade system is excessively dependent on US dollars. Sri Lanka's international trade transactions mostly use the US dollar as the exchange currency (Belete, 2022). Therefore, Sri Lanka's finance and economy are related to the US dollars, meaning that the country is highly vulnerable to the adjustment of monetary policies by the Federal Reserve and the US dollar exchange rate fluctuation.

Exchange Rate Movement-Rupees per USD

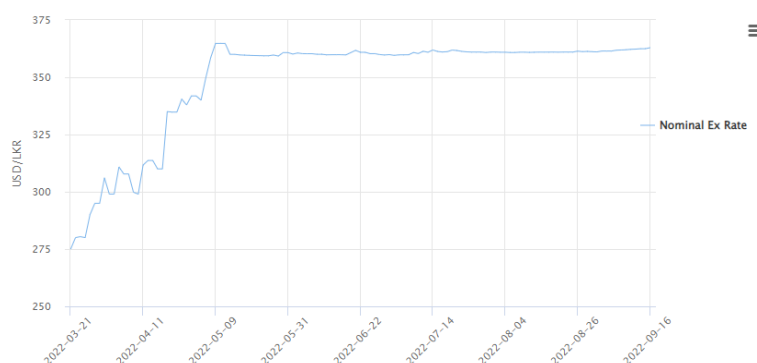


Figure 3. Exchange Rate Movement-Sri Lankan Rupee per USD

Source: (Central Bank of Sri Lanka, 2022)

Sri Lanka's focused on building an export-oriented economy that was temporarily halted by the pandemic (Priyankara, 2018). For instance, supply chain disruptions hit the textile industry hard, making it challenging to bring inputs for production and export. This also harmed Sri Lanka's revenue generation since the textile industry accounts for 6% of its GDP and 40% of its export (Kavindi et al., 2021). Moreover, the country's agricultural sector was also affected during the pandemic by supply chain disruptions and labor shortages due to movement restrictions and the lockdown. This reduced Kenya's volume of agricultural products significantly reduced (Rathnayake et al., 2022). In addition, the pandemic reduced the consumption ability of domestic residents, making them unable to purchase the products (Rathnayake et al., 2022).

Figures 3 and 4 show that Sri Lanka's imports exceed exports. This illustrates a high dependence on imports. Furthermore, the country relies on imports for necessities such as energy, various agricultural products, and medicines (World Integrated Trade Solution, 2022). The Sri Lankan economy has been significantly injured in the wake of the conflict between Russia and Ukraine. Commodity prices have significantly increased since Russia was the world's largest fertilizer, oil, and gas exporter (Chellaney, 2022). The war has slowed the production of these commodities, creating a shortage and leading to inflation as demand outruns supply. Countries like Sri Lanka, which depend on imports, have borne this cost by buying highly inflated commodities. In addition, due to the shortage of goods in supply, the price level in Sri Lanka has skyrocketed. Figure 6 shows that Sri Lanka's CPI has been soaring since the beginning of 2022, meaning that the price increase of a basket of goods has increased with the same magnitude.

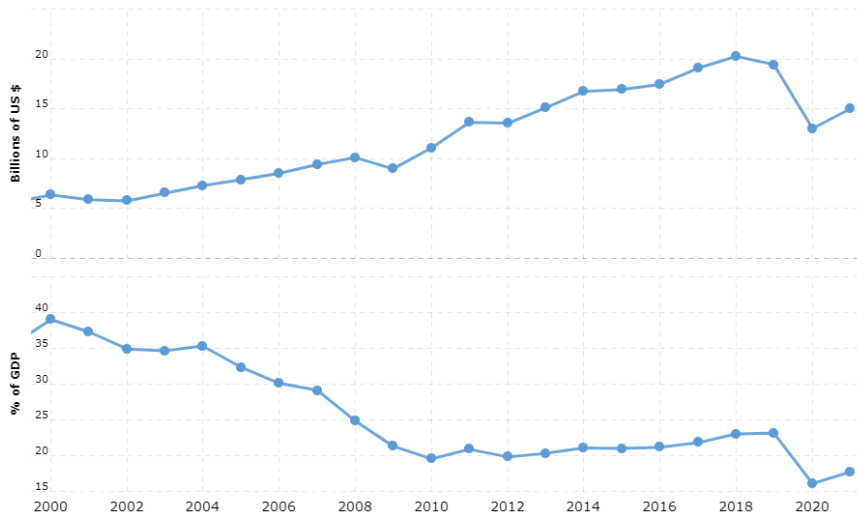


Figure 4. Sri Lanka's Exports rate
 Source: Macrotrends.net (2022b)

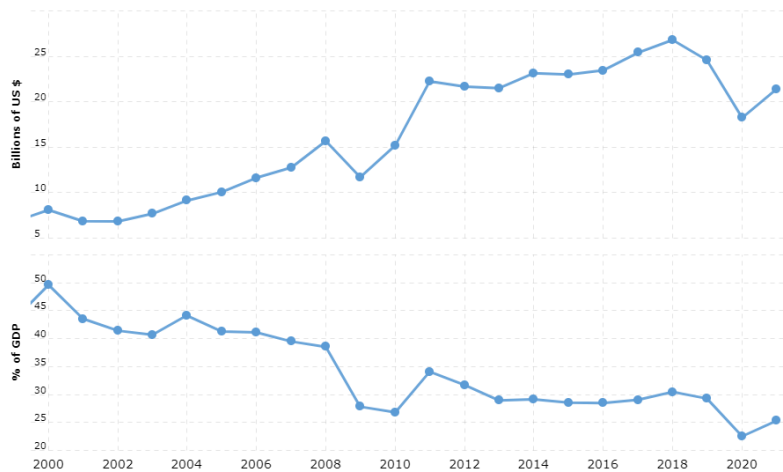


Figure 5. Sri Lanka's Imports rate
 Source: Macrotrends.net (2022c)

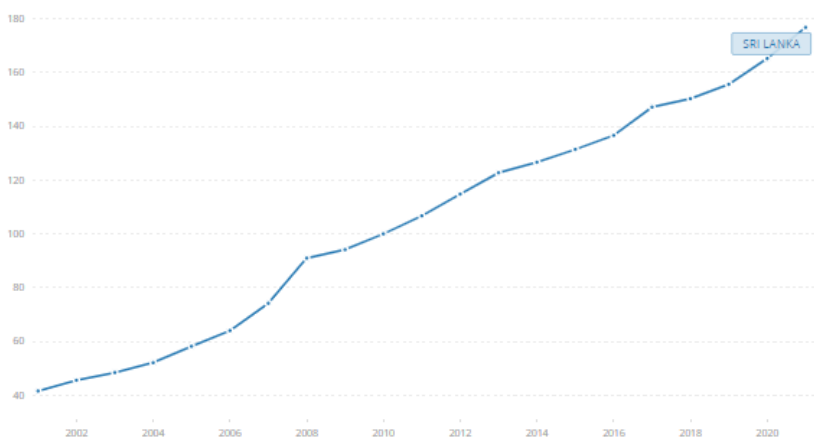


Figure 6. Sri Lanka's CPI Index
 Source: World bank (2022b)

The Sri Lankan government also reduced tax cuts, reducing the economy's performance. It also introduced a tax reduction policy in 2019 to boost domestic consumption (Shukla, 2022). However,

there was a massive gap between reality and expectation. First, the tax cut plan stimulated people's consumption and increased the country's purchase of imported goods. However, the revenue from these sales was not enough to cover the imports and still improve Sri Lanka's service delivery to its people (Shukla, 2022). In the process, the country's expenditure outran its revenue, leading to a debt crisis since it could not raise enough funds to cover its costs. Fiscal policy is the primary source of revenue, and tax cuts in Sri Lanka significantly reduced its revenue generation capability.

Sri Lanka's economy fell due to a lack of professional foreign debt management and foreign exchange reserves. In 2019, Sri Lanka had about \$7.6 billion in foreign exchange reserves; in 2020, this figure dropped to \$5.6 billion (Ondaatjie, 2022). By November 2021, Sri Lanka had only \$1.5 billion in foreign exchange reserves (Ondaatjie, 2022). This shows a reckless consumption of the funds stored in the Sri Lankan foreign reserves. Moreover, at the same time, the country's debt also increased, as demonstrated in figure 1. This led to a situation where the economy had many liabilities while its revenue could not support them.

3. The solutions for the plight of Sri Lanka

3.1 Appeal for financial aid from other countries

The Sri Lankan government should actively negotiate with other countries and appeal for various economic assistance. First, Sri Lanka can request some countries to provide favorable conditions for goods exported to Sri Lanka, including providing necessary export credit and insurance. In this way, related foreign trade enterprises may export more goods to Sri Lanka, and the shortage of necessities and upward pressure on prices can be alleviated to some extent. This strategy worked well for Iceland when it hit bankruptcy during the 2008 financial crisis. The country got over 10 billion dollars from European countries (Valdimarsson & Suoninen, 2008). This helped in enhancing productivity and elevating the country's economic situation. Up to now, many countries have given a helping hand to Sri Lanka. In detail, China has provided above \$40 million in humanitarian aid and is expected to inject \$4 billion into the Sri Lankan economy (Mushtaq, 2022). Australia has also spent \$50 million to alleviate the food crisis in Sri Lanka (Australian Government, 2022). The United States has provided aid worth \$11.75 million (USAID, 2022). However, the country has to make sure that it remains relentless in seeking grants from developed and well-performing economies since the current donations are still below the huge finances it needs for debt repayment and importation.

3.2 Appeal for emergency financial assistance from the International Monetary Fund

The Sri Lankan government could turn to the IMF for emergency funding. One of the IMF's duties is to provide emergency financial assistance and loans to member countries in difficulty (IMF, 2022). However, the Sri Lankan government must agree to harsh terms to get funding from the IMF. First, the Sri Lankan government must cut fiscal spending, raise taxes, liberalize exchange rate controls to allow the currency to float freely, and sell critical state assets to private investors (IMF, 2021). In essence, these terms sacrifice some of Sri Lankan economic prospects. In detail, reducing fiscal spending means the government cannot use expansionary fiscal policy to stimulate the economy. Raising taxes suppresses investment and consumption to some extent. Relaxing controls on the exchange rate will lead to higher exchange rate risk. Selling important state-owned assets means that the government will lose some revenues. As a result, if Sri Lanka accepts these terms, the country is overdrawing 'future development potentials' for 'present survival opportunities. However, these measures will also regulate the Sri Lankan economy to foster more significant growth.

These measures may only be short-term, but the most important thing for Sri Lanka is getting out of the current predicament. If Sri Lanka can get out of the mire, it may get some lessons from the crisis. For example, the country should pay more attention to managing foreign debts and foreign exchange reserves and promote the diversification of foreign exchange reserve allocation and the diversification of trade settlement currencies. This would lead to a more stable economy able to

withstand economic shocks. There is also the need for an elaborate plan that increases production to make its exports outrun its imports.

4. Conclusion

From the case of Sri Lanka, it is possible to understand the factors that lead to a debt crisis and state bankruptcy. The first of them is high levels of external debt that outrun revenue. The country depends highly on imports to supply goods into the market. It has also been influenced by economic shocks like the Russian-Ukraine war and the Covid-19 pandemic. Furthermore, the country's economic regulations have been poor, which has been unable to establish effective taxation, debt, and foreign reserve management systems. The company could improve its economic conditions by getting economic assistance from other countries and the IMF in the short term. Moreover, it also needs to restructure its foreign reserves and borrowings management systems.

References

- [1] Aneez, S., & Roy, A. (2022). Sri Lanka's political crisis trigger major economic concerns. Reuters. Retrieved September 17th 2022, from <https://www.reuters.com/article/uk-sri-lanka-politics-economy-analysis-idUKKCN1N327X>.
- [2] Athas, I., Gonzalez-Roman, D., Liakos, C., & Mogul, R. (2022). Sri Lanka is 'bankrupt,' Prime Minister says | CNN. CNN. Retrieved September 17th 2022, from <https://edition.cnn.com/2022/07/05/asia/sri-lanka-bankrupt-fuel-crisis-intl-hnk/index.html>.
- [3] Australian Government. (2022). Support for Sri Lanka. [foreignminister.gov.au](https://www.foreignminister.gov.au). Retrieved September 17th 2022, from <https://www.foreignminister.gov.au/minister/penny-wong/media-release/support-sri-lanka#:~:text=Australia%20will%20provide%202450%20million,of%20food%2C%20medicine%20and%20fuel>.
- [4] Belete, P. (2022). Why Sri Lanka is Having an Economic Crisis. Walta Info. Retrieved September 17th 2022, from <https://waltainfo.com/why-sri-lanka-is-having-an-economic-crisis/>.
- [5] Central Bank of Sri Lanka. (2022). Exchange Rate Movement-Rupees per USD. Central Bank of Sri Lanka. Retrieved September 17th 2022, from <https://www.cbsl.gov.lk/en/rates-and-indicators/exchange-rates/usd-lkr-Indicative-rate-chart>.
- [6] Chellaney, B. (2022). Ukraine war hastens Sri Lanka's economic meltdown. Nikkei Asia. Retrieved September 17th 2022, from <https://asia.nikkei.com/Opinion/Ukraine-war-hastens-Sri-Lanka-s-economic-meltdown>.
- [7] Grigiene, J., & Mockiene, A. (2010). Can a sovereign state declare bankruptcy?. *Baltic journal of law & politics*, 3(1), 125.
- [8] IMF. (2021). IMF Conditionality. [imf.org](https://www.imf.org). Retrieved September 17th 2022, from <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality>.
- [9] IMF. (2022). What is the IMF?. [imf.org](https://www.imf.org). Retrieved 17 September 2022, from [https://www.imf.org/en/About/Factsheets/IMF-at-a-Glance#:~:text=The%20International%20Monetary%20Fund%20\(IMF,%2C%20and%20economic%20well-being](https://www.imf.org/en/About/Factsheets/IMF-at-a-Glance#:~:text=The%20International%20Monetary%20Fund%20(IMF,%2C%20and%20economic%20well-being).
- [10] Jayasinghe, U., & Pal, A. (2022). Sri Lanka to default on debt, no money for fuel, minister says. Reuters. Retrieved September 17th 2022, from <https://www.reuters.com/world/asia-pacific/sri-lanka-default-debt-no-money-fuel-minister-says-2022-05-18/>.
- [11] Kavindi, B., Priyasath, G., Perera, L., Anuradha, R., Weligodapola, H. W. M. C., & Karunarathna, K. (2021). The effect of the covid 19 on overall firm performance in Sri Lanka. *International Journal of Business, Economics and Law*, 24(3), 71-78.
- [12] Kenichi, Y. (2021). How can Sri Lanka recover from COVID-19? By Promoting Integrated Rural Development - Kenichi Yokoyama. Asian Development Bank. Retrieved September 17th 2022, from <https://www.adb.org/news/op-ed/how-can-sri-lanka-recover-covid-19-promoting-integrated-rural-development-kenichi>.

- [13] Knoema. (2022). Tourism - Sri Lanka - knoema.com. Knoema. Retrieved September 17th 2022, from <https://knoema.com/atlas/Sri-Lanka/topics/Tourism/Travel-and-Tourism-Total-Contribution-to-GD>.
- [14] Loayza, N., & Pennings, S. M. (2020). Macroeconomic policy in the time of COVID-19: A primer for developing countries. World Bank Research and Policy Briefs, (147291).
- [15] Macrotrends.net. (2022). Sri Lanka Trade Balance 1960-2022. Macrotrends.net. Retrieved September 17th 2022, from <https://www.macrotrends.net/countries/LKA/sri-lanka/trade-balance-deficit>.
- [16] Macrotrends.net. (2022b). Sri Lanka Exports 1960-2022. Macrotrends.net. Retrieved September 17th 2022, from <https://www.macrotrends.net/countries/LKA/sri-lanka/exports#:~:text=Sri%20Lanka%20exports%20for%202020,a%206.17%25%20increase%20from%202017>.
- [17] Macrotrends.net. (2022c). Sri Lanka Imports 1960-2022. Macrotrends.net. Retrieved September 17th 2022, from <https://www.macrotrends.net/countries/LKA/sri-lanka/imports#:~:text=Sri%20Lanka%20imports%20for%202021,a%205.51%25%20increase%20from%202017>.
- [18] Mushtaq, M. (2022). Sri Lanka hopes for \$4bn in China aid 'soon' as envoy defends ties. Nikkei Asia. Retrieved September 17th 2022, from <https://asia.nikkei.com/Spotlight/Sri-Lanka-crisis/Sri-Lanka-hopes-for-4bn-in-China-aid-soon-as-envoy-defends-ties>.
- [19] Narayanan, K. (2022). Sri Lanka's foreign debt default: Why the island nation went under | DW | 14.04.2022. DW.COM. Retrieved September 17th 2022, from <https://www.dw.com/en/sri-lankas-foreign-debt-default-why-the-island-nation-went-under/a-61475596>.
- [20] Ondaatjie, A. (2022). Sri Lanka's FX Reserves Dwindle to \$1.82 Billion in July. Bloomberg.com. Retrieved September 17th 2022, from <https://www.bloomberg.com/news/articles/2022-08-05/sri-lanka-s-fx-reserves-dwindle-to-1-82-billion-in-july#:~:text=Official%20reserves%20dropped%20to%20%241.82,rise%20to%20a%20certain%20level>.
- [21] O'Neill, A. (2022). Sri Lanka - share of economic sectors in the gross domestic product 2011-2021 | Statista. Statista. Retrieved September 17th 2022, from <https://www.statista.com/statistics/728539/share-of-economic-sectors-in-the-gdp-in-sri-lanka/>.
- [22] Pasricha, A. (2022). As Crisis-Hit Sri Lanka Counts Cost of Chinese Projects, India Moves to Recover Influence. VOA. Retrieved September 17th 2022, from <https://www.voanews.com/a/as-crisis-hit-sri-lanka-counts-cost-of-chinese-projects-india-moves-to-recover-influence/6611703.html>.
- [23] Priyankara, E. A. C. (2018). Services exports and economic growth in Sri Lanka: Does the export-led growth hypothesis hold for services exports? *Journal of Service Science and Management*, 11(04), 479.
- [24] Rathnayake, S., Gray, D., Reid, J., & Ramilan, T. (2022). The impacts of the COVID-19 shock on sustainability and farmer livelihoods in Sri Lanka. *Current Research in Environmental Sustainability*, 4, 100131.
- [25] Reuters. (2022). FACTBOX: Iceland crisis: what does "national bankruptcy" mean? Reuters. Retrieved September 17th 2022, from <https://www.reuters.com/article/us-financial-iceland-factbox-idUSTRE49D5D020081014>.
- [26] Shukla, A. (2022). No choice but to raise sales tax: Sri Lanka finance chief Ali Sabry. BBC News. Retrieved September 17th 2022, from <https://www.bbc.com/news/business-61267369>.
- [27] Tewari, S. (2022). Sri Lanka crisis is a warning to other Asian nations. BBC News. Retrieved September 17th 2022, from <https://www.bbc.com/news/business-61976928>.
- [28] USAID. (2022). The United States Announces Nearly \$12 Million in Assistance to Respond to Sri Lanka's Deteriorating Food Security and Economic Crises | Press Release | U.S. Agency for International Development. Usaid.gov. Retrieved September 17th 2022, from <https://www.usaid.gov/news-information/press-releases/jun-21-2022-united-states-announces-nearly-12-million-assistance-respond-sri-lanka-crises>.
- [29] Valdimarsson, O., & Suoninen, S. (2008). Iceland gets \$10 billion in aid. Reuters. Retrieved September 17th 2022, from <https://www.reuters.com/article/us-financial-iceland-idUKTRE4AJ23G20081120>.
- [30] World Integrated Trade Solution. (2022). Sri Lanka Trade | WITS | Text. Wits.worldbank.org. Retrieved September 17th 2022, from <https://wits.worldbank.org/CountrySnapshot/en/LKA/textview>.