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Will Sri Lanka's new President be able to turn around its beleaguered economy?

At the core of the crisis is a dollar shortage caused by the island's high reliance on imports and the lack of the economic complexity to diversify exports into high value-added products or bring in sufficient dollar inflows.

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Ranil Wickremesinghe (File image)

Sri Lanka is in a state of political flux, with both the President and Prime Minister being forced to quit. It is still open to question whether the new president will be acceptable to the masses, given his close ties with the earlier regime. Moreover, will he be able to turn around the beleaguered economy?

Sri Lanka's political turmoil has clearly emerged from Sri Lanka's economic crisis that pushed its people to the edge, survival becoming a day-to-day struggle. The shortage of fuel for essentials that was being reported in the recent past was driving people to desperation: from children being unable to get to school to people using firewood to cook. This is something that no one would have expected to happen so quickly and so severely to a 'higher middle-income' country, a status that Sri Lanka reached in 2019, although it was demoted back to the 'lower middle-income category' in 2020. Even as the political crisis is yet to play out fully, it is important to ponder over the economic origins of the crisis.

The reason for Sri Lanka's predicament is rather unequivocal. As the former Sri Lankan Prime Minster and now President Ranil Wickremesinghe put it, 'the shortage of dollars actually contributed to this situation.' However, it is important to dig a little below the surface to understand what this 'shortage of dollars" actually implies and the policy options available to a new government in the short, medium and longer term.

The fundamental reason for Sri Lanka's dollar shortage arises from a situation where a country has a high standard of living but lacks economic complexity. The high standard of living, supported by government social sector initiatives, induces the country to import goods and services to sustain their desire to consume while the lack of economic complexity means that the country is neither able to diversify exports into high value-added products nor bring in sufficient foreign exchange (dollar) inflows through workers' remittances, borrowings by the domestic companies or foreign direct investment by international firms. The insufficiency of autonomous dollar inflows forces the government to fill the gap either by attracting development aid, foreign investments in or borrowings to fund infrastructure, or external sovereign borrowings in global forex markets. Inability or unwillingness to do so can lead to a depreciation of domestic currency, lowering imports and adversely impacting standards of living.

Even a cursory look at Sri Lanka's vital economic parameters reveals this narrative. Imports of goods and services account for more than 30% of its $ 84 billion GDP with the most important items being food and beverages, medical and pharmaceutical products, fuels (crude and refined oil, coal), textiles, and machinery and equipment. Its exports, which account for 22% of GDP, are also limited in range with almost 70% of them coming from just a few low value-added products: articles of apparel, coffee, tea, spices, as well as rubber.

The deficiency in trade balances is somewhat cushioned by Sri Lanka's foreign exchange earnings from tourism and workers' remittances. However, both these took a severe beating during the pandemic and are still struggling to recover, putting the country through a balance of payments crisis. Earnings from tourism declined from $ 4.3 billion in 2018 to just $ 261 million in 2021. Workers' remittances, which were at $ 7.1 billion in 2018 declined to $ 5.5 billion in 2021.

On the capital account, the domestic private sector has been weak in leveraging foreign borrowings for investment. Although some $ 21 billion of the $ 56 billion or about 35% of total outstanding external debt has been contracted by the private sector in **Sri Lanka**, it is significantly dissimilar from, say, **India** or **Turkey** where 80% and 65%, respectively, of total external debt is contracted by the private sector. Foreign direct investment (FDI) inflows into Sri Lanka have been tepid too, peaking at about $ 1.6 billion in 2018, but declining to just about $ 433 million in 2020. Overall, private sector investment spending has been around 20% of GDP since 2019.

The gap in dollar inflows to maintain the current account deficit has pushed Sri Lanka into relying on sovereign external debt as a significant source of foreign exchange. While development aid and low-cost borrowing from multilateral agencies were possible until the early 2000s when Sri Lanka moved into the 'middle income country' category, it has been compelled since then to depend on raising dollars through floating of International Sovereign Bonds (ISBs) in foreign exchange markets. By October 2021, Sri Lanka's ISBs reached $11.82 billion, accounting for 34.1 percent of total external debt. With regular sources of dollars drying up during the pandemic, Sri Lanka sank into a debt trap with yields on sovereign debt rising to almost 20%. Ultimately, in April 2022, it defaulted on its external debt. This has plunged the country into a balance of payments crisis, resulting in a complete dearth of foreign exchange and subsequently the inability to import even essential goods.

So, what is the way out of this dire situation for Sri Lanka? In the short-run, immediate relief will probably come with an International Monetary Fund (IMF) bail-out. However, as is usually the case, the IMF is likely to impose austerity measures on the government, forcing the economy to contract. Along with letting the Sri Lankan rupee depreciate, this will curb imports. In the medium-term, the best Sri Lanka can hope is for tourism to return to its glory days. The abating of the pandemic is a positive event although domestic political instability as well as power and food shortages may dissuade tourist inflows into Sri Lanka. Vulnerability to external shocks will remain high in the medium-term. In the longer term, the country will need to increase the complexity of both its export sector as well as its internal economy. This is an arduous process with no standard methods to ensure success.

The Sri Lankan crisis provides an important lesson that many countries have to learn, such as Saudi Arabia, Argentina, and Venezuela. Some have already embarked on their journeys to reduce their reliance on imports while increasing exports of value-added products. Sri Lanka must embark on its own path if it wishes to ensure long-term macroeconomic stability and sustained growth.

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Views are personal and do not represent the stand of this publication.

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