

Analysis and Research on Sri Lanka's National Bankruptcy under the Superposition of Triple Backgrounds

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Abstract

In recent years, under the background of the raging of COVID-19, intensified regional conflicts and rising trade protectionism, global economic development has been seriously challenged. Many small countries with a single economic structure have been hit even more severely. Many of them are on the verge of economic collapse as domestic economic and social contradictions have intensified. This paper will analyze the reasons for Sri Lanka's national bankruptcy from three perspectives. It is hoped that more countries in a similar state can be warned and that international economic organizations can identify other countries that may be at risk of collapse more quickly and accurately and provide timely support to reduce economic losses and maintain national security. The paper will use methods such as literature analysis, data analysis and case analysis to try to explain the reasons for Sri Lanka's national bankruptcy. In the end, the article categorizes the reasons for Sri Lanka's bankruptcy into three points: a) unresolved domestic economic problems for many years, b) three policies implemented under the misjudgment of the new government, and c) the fuse of COVID-19 and the Russian-Ukrainian war.

Keywords: Sri Lanka; Bankruptcy; Government Negligence; COVID-19; Russian-Ukrainian War

Introduction

In 2022, the factors of instability in the international situation increase. COVID-19 is still raging around the world. The outbreak of the Russian-Ukrainian war has brought new challenges to regional stability and the international economy. The climate problem has become more apparent, and the temperature in many countries has hit new highs. Under the superposition of multiple complex backgrounds, Sri Lanka has become the first country to go bankrupt since the epidemic. Shockingly, Sri Lanka was not included in the International Money Fund (IMF)'s list of countries for particular concern, its bankruptcy caught everyone by surprise.

Therefore, studying the reasons for Sri Lanka's bankruptcy will help more countries pay attention to their own economic development and make timely adjustments, and help relevant international organizations to make more accurate judgments to help some countries on the brink of bankruptcy. These are of great significance for maintaining international economic and social stability.

This paper will analyze the reasons for (a) unresolved domestic economic problems for many years, (b) three policies implemented under the misjudgment of the new government, and (c) the fuse of COVID-19, and the Russian-Ukrainian war. The paper will use literature analysis, citing relevant articles and development reports of international economic organizations; use data analysis, directly showing the economic structure of Sri Lanka, etc.; use case analysis, analyzing Sri Lanka's bankruptcy as a typical case, adopt the case study structure and draw conclusions.

In the future, there will be more relevant studies to analyze Sri Lankan bankruptcy from more perspectives. This can provide warnings and recommendations for more developing countries with a complex international background. And will have positive impacts on countries adapting to the new international environment and maintaining world economic and social development.

Literature review

On March 20, 2022, Sri Lankan schools announced that they had run out of ink and paper and postponed examinations indefinitely. On March 31, the power plant announced the fuel emergency and shut down street lights across the country to save electricity. On June 14, the Sri Lankan government announced the national food shortage. Civil servants worked four-day every week and were forced to do agricultural labor on Fridays. On June 28, Sri Lanka only had fuel for one week and stopped providing fuel to private transportations, bringing the country to a standstill. On July 5, Prime Minister Ranil Wickremesinghe declared that Sri Lanka was bankrupt. Judging from the timeline of Sri Lanka's bankruptcy, this is an unexpected event. Therefore, the relevant research analysis is lacking.

Of the few articles that have looked at bankruptcy in Sri Lanka, the focus has mostly been on predicting or demonstrating the usability of relevant models. As Nireesh and Pratheepan stated, "Prediction of bankruptcy is crucial as the early warning may change entire complications and may avoid the high cost that is associated with distress. The main purpose of this study is to examine the likelihood of bankruptcy of the firms belonging to the Trading Sector in Sri Lanka. The research used data from the financial reports of seven trading companies for a period of the last five years from 2010 to 2014" [1].

In the report of the United Nations, many countries that may face bankruptcy in the future are reminded, but Sri Lanka is not included. In April 2022, the President of the World Bank Davide Malpass expressed his concern for developing countries, because the combination of COVID-19, the Russian-Ukrainian war and climate problems has led to a surge in the prices of commodities such as food and energy in the international market. If a country has a single economic structure and a lot of foreign debt, it will be very dangerous.

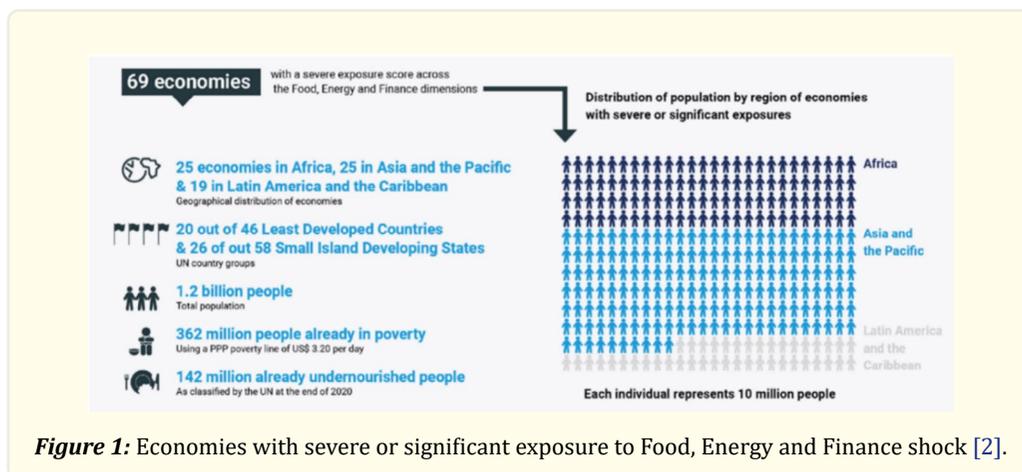


Figure 1: Economies with severe or significant exposure to Food, Energy and Finance shock [2].

Figure 1 shows that 69 economies will be exposed to the three shocks at the same time.

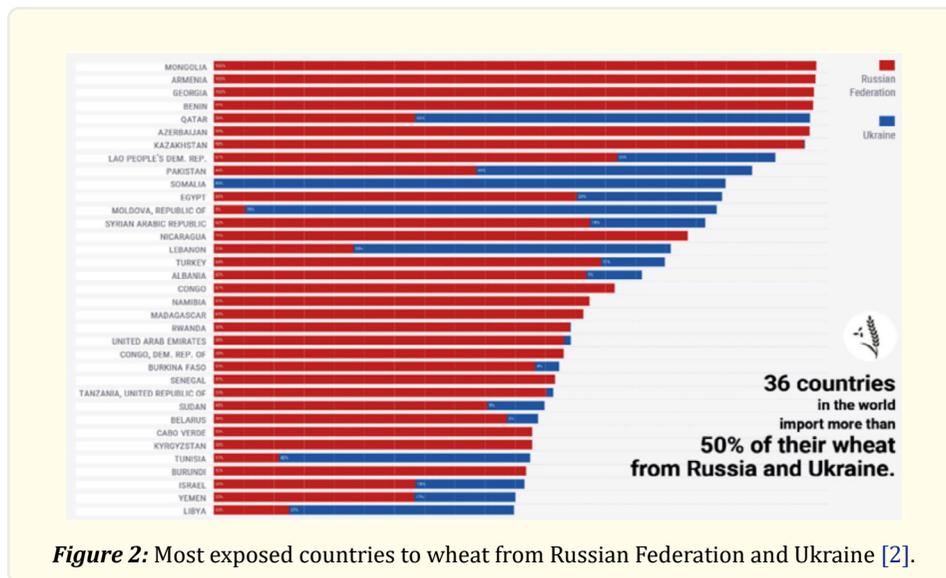


Figure 2: Most exposed countries to wheat from Russian Federation and Ukraine [2].

And figure 2 shows that 36 countries in the world import more than 50% of wheat from Russia and Ukraine. The IMF focused on Egypt, Tunisia, Pakistan, Ghana and Kenya, etc., and was ready to provide timely support, but not Sri Lanka. No one expected Sri Lanka to collapse first. So, it is necessary to study how Sri Lanka suddenly collapsed without the special attention of international organizations.

All in all, since bankruptcy in Sri Lanka is a sudden event, there is a lack of relevant research. And previous papers and reports from international organizations have not paid much attention to the bankruptcy risk in Sri Lanka. Therefore, it is necessary to conduct relevant research to fill the gap in this field.

First Background: Unresolved Domestic Economic Problems

Civil War and Recession

The Sri Lankan Civil War was a military conflict between July 23, 1983 and May 18, 2009, which occurred between the nationalities of the Democratic Socialist Republic of Sri Lanka, the government army and the anti-government army. The warring parties were mainly the Sri Lankan government and Liberation Tigers of Tamil Eelam (LTTE) [3]. Years of civil war resulted in the deaths of more than 80,000 people and consumed a lot of human and material resources. Sri Lanka's economy has suffered a severe recession, especially in the war zones in the north and east, with severe economic and social damage. As Sarvananthan said, "the single most important cause of the economic and social decline in Northern and Eastern Provinces was the economic embargo imposed by the Sri Lankan government between 1990 and 2001. Following the Ceasefire Agreement signed in February 2002, economic repression by the LTTE, including illegal tolls on vehicle traffic, customs duties, and sales taxes—along with the earlier expulsion of the entrepreneurial Muslim community—seriously impeded economic recovery before renewed hostilities broke out in December 2005 and the formal end of the ceasefire in January 2008" [4]. After the war, Sri Lanka borrowed money from the IMF many times for economic recovery, so it owed a large amount of foreign debt, which made the country's economic burden increasingly heavy.

It can be seen that due to the years of civil war in Sri Lanka, a greater burden has been placed on the already fragile economic system, which has become the existing national condition of this country. Once the external environment undergoes great changes, the country alone is likely to be unable to withstand such a shock, and bankruptcy is inevitable at a certain level.

A Tale of Two Deficits

The first deficit is a foreign trade deficit. Against the backdrop of a trade deficit, Sri Lanka itself has struggled to make profits from international trade. However, the country has not committed itself to develop domestic industries in order to promote the development of the domestic supply side. Instead, the country has allowed its citizens to fall into the trap of consumerism and continue to frantically buy foreign goods. In 2021, Sri Lanka's exports were about US\$15.1 billion, far less than the total imports of about US\$20.6 billion [5].

The second deficit is the government budget deficit. The domestic economy of Sri Lanka is not developed, and the total amount of tax revenue is not large. But the government still borrows a lot of foreign debt for construction, and even donates money to other countries.

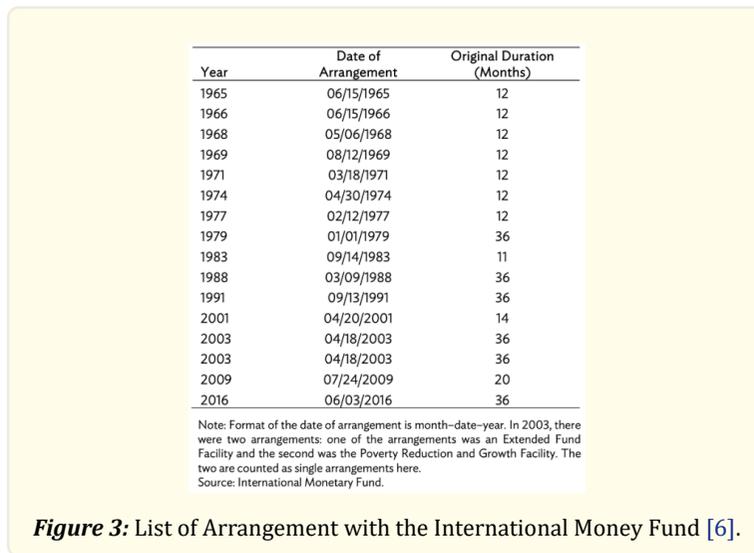
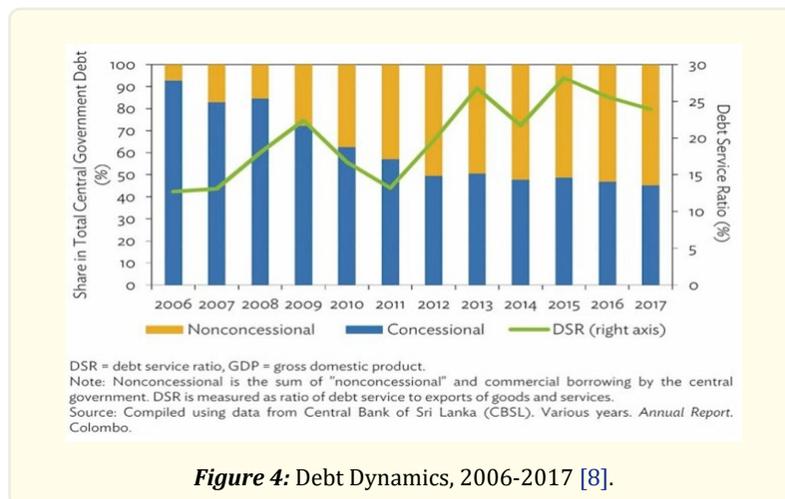


Figure 3 shows that from 1965 to 2016, Sri Lanka spent 52 years borrowing money from the IMF for 15 times and owes a lot of foreign debt. Ultimately, the entire country is highly dependent on foreign capital. Data also shows that Sri Lanka's total foreign debt is expected to reach US\$51.72 billion by the end of 2017, accounting for 79.1% of GDP [7]. Sri Lanka has borrowed foreign debts in such a large amount and many times. If it has a good debt repayment ability, it will not go into a state of bankruptcy of the country. Therefore, it is necessary to analyze the repayment ability of the country.



The green line in figure 4 is the debt service ratio, which is the ratio of national debt to national exports. The higher the ratio, the worse the country's ability to repay. Sri Lanka's debt service ratio is at a high level of more than 40% all year-round, which means that the country lacks the ability to repay while borrowing heavily.

Second Background: Three Policies Wrongly Implemented by the Government

A Series of Tax Cuts

In 2019, when Gotabhaya Rajapaksa ran for president, he announced that if he were elected, he would pursue a series of tax cuts. Measures include raising the tax-free threshold, lowering corporate income tax and value-added tax (VAT), etc. Finally, lured by tax cuts, he was elected president with 52% of the vote. When elected president, he delivered on his promise to implement these tax cuts. In a bid to simplify the tax system, certain taxes were abolished, namely, Nation Building Tax (NBT) with effect from 1 December 2019, Economic Service Charge (ESC), and the Debt Repayment Levy (DRL), effective 1 January 2020. He also announced to reduce VAT to 8% and corporate tax from 28% to 24% [9].

This series of tax cuts successfully allowed him to be elected president, but the pressure on the treasury increased sharply, and the government's fiscal deficit was getting higher and higher. Figure 5 shows that Sri Lanka's total tax revenue in 2020 has fallen by about 50% compared to 2019, exposing the less wealthy country to a greater capital crisis.

Type of Tax	2020 Revenue Collection Rs.	2019 Revenue Collection Rs.	Increase/ Decrease of Collection as a %
Income Tax	252,941,572,901	371,795,681,316	-31.97%
Capital Gain Tax	357,594,125	602,439,115	-40.64%
Value Added Tax	233,786,120,184	443,877,131,612	-47.33%
Debt Repayment Levy	3,002,271,834	28,673,572,980	-89.53%
Betting & Gaming Levy	1,428,071,291	2,435,982,807	-41.38%
Share Transaction Levy	2,347,277,681	1,023,443,599	129.35%
Migrating Tax	5,853,185	5,008,044	16.88%
Stamp Duty	11,354,837,819	14,863,016,823	-23.60%
Economic Service Charge	14,950,042,437	55,301,397,165	-72.97%
Nation Building Tax	3,740,463,661	105,185,802,597	-96.44%
Goods & Services Tax	226,221	17,036,964	-98.67%
Turnover Tax	16,257,541	29,626,965	-45.13%
National Security Levy	2,399,368	9,045,921	-73.48%
Construction Industry Guarantee Fund Levy	636,657	1,219,286	-47.78%
Vehicle Entitlement Levy	-	1,498,601,586	-100.00%
Remittance Fee	-	-	-
Total Revenue Collection	523,933,624,905	1,025,319,006,780	-48.90%

Figure 5: Revenue Comparison of Year 2020 with 2019 [9].

The tax cuts also had a series of follow-on effects. As the downward pressure on the country's economy further increased, many authoritative international rating agencies downgraded Sri Lanka's credit rating.

Credit rating	Standard & Poor's: ^[22]
	CC (Fx)
	Outlook: Negative
	Moody's: ^[23]
	Caa2
	Outlook: Stable
	Fitch: ^[24]
	C
	Outlook: None at this level

Figure 6: Sri Lanka's Credit Rating [10].

Figure 6 shows that many famous rating agencies like Standard & Poor's and Fitch set Sri Lanka's credit rating to a low level. As a result, a warning was issued to investors in Sri Lanka, leading to a large number of investors abandoning Sri Lanka and investing in countries such as India and Vietnam. This makes it more difficult for Sri Lanka to earn foreign capital, further increasing the economic burden.

Speed up Money Printing

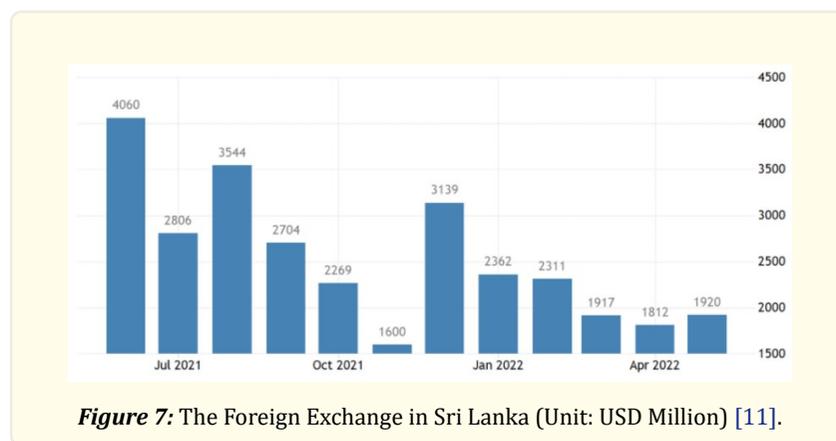
Under the circumstance that the domestic economic pressure is already great, the Sri Lankan government still chose to speed up the printing of money. IMF had advised the Sri Lankan government to stop printing money and increase interest rates and taxes while reducing spending. But Sri Lankan government did not heed the advice and continued to print money. On April 6, 2022, the central bank of Sri Lanka created a record of printing 119.08 billion rupees in a single day. The monetary volume of the Sri Lankan financial market to reach 432.76 billion rupees in 2022.

The result of the accelerated money printing has been a spike in inflation in Sri Lanka. The inflation rate in Sri Lanka jumped to a record high of 60.8% in July of 2022, as a political crisis, state of emergency, and weak currency added further pressure on prices. The biggest upward contribution came from food costs which jumped at an all-time high of 90.9%, namely food commodities (29.5%). Prices of non-food items increased 46.5%, led by transport, restaurants and hotels, and housing and utilities [12]. High inflation has caused serious trouble in people's lives. The prices of commodities in the market have skyrocketed, but people's wages have not risen. If this situation continues, it is likely to bring great challenges to the social stability of Sri Lanka.

A Bold Policy: Organic Farming

In April 2021, the President began fulfilling his pledge to make healthy food available to all Sri Lankans and to stop all imports of fertilizers, pesticides and herbicides. He also announced that he would make Sri Lanka the world's first organic farming country. The policy has been opposed by many agricultural experts. Because the implementation of organic agriculture requires not only a lot of economic and technical support, but also professional training for farmers. More than 30 agricultural experts wrote to the president against implementing the policy, but the president did not take the experts' advice. As a result of the policy implementation, farmers found that organic farming costs dozens of times more than conventional farming. Moreover, due to the absence of pesticides and herbicides, pests and diseases are rampant, and the final yield is only about half of that of traditional cultivation. Due to the government's wrong decision, farmers suffered a lot of losses, many farmers gave up production, and a lot of lands were abandoned.

The real purpose of the Sri Lankan government to abandon the import of chemical fertilizers is not so much to develop organic agriculture as to save foreign exchange.



The picture shows that overall, Sri Lanka's foreign exchange reserves are trending down and reserves are running low. Such a small amount of foreign exchange reserves simply cannot support Sri Lanka's import trade, so it can only stop buying products from abroad. Before it stopped importing fertilizers, Sri Lanka had stopped imports of cars, air conditioners, clothing, etc.

Stop importing chemical fertilizers to develop organic agriculture. The country thought that it would save 400 million US dollars in foreign exchange, but it did not expect that this move would lead to a more serious food crisis. Due to the wrong decision of the state, farmers suffered a lot of losses, many farmers gave up farming, and a lot of lands was abandoned. As a result, the country can only consume 450 million US dollars of foreign exchange to import food. In the end, instead of saving foreign exchange, it consumes more. The aggressive development of organic agriculture has also become one of the important drivers of Sri Lanka's bankruptcy.

The Third Background: COVID-19 and Russian-Ukrainian War

Sri Lanka is a country with a relatively single economic structure, which mainly relies on the service industry to develop the economy.



Figure 8 shows that in 2020, the contribution rate of the service industry to GDP reached 59.2%. Among them, the contribution rate of tourism is very high. In 2019, the contribution rate of tourism to GDP reached 12.9% [12]. Therefore, tourism is an important way for Sri Lanka to earn foreign exchange and repay its foreign debt. However, in 2020, the new crown epidemic swept the world, causing a devastating blow to Sri Lanka's tourism industry.

At the same time, the Russian-Ukrainian war also had a huge negative impact on the Sri Lankan economy. Russia is an important market for Sri Lankan tea exports. In 2020, Russia is the largest market for Sri Lankan tea exports [13]. The Russian-Ukrainian war has caused Russia to greatly reduce the import of tea from Sri Lanka, and Sri Lanka has lost another way to earn foreign exchange.

The severe impact of COVID-19 on Sri Lanka's tourism and the Russian-Ukrainian war has led to restrictions on tea exports, which have had a serious adverse impact on Sri Lanka's economy. These two events have also become important fuses for Sri Lanka's bankruptcy.

Conclusion

This paper takes the sudden incident of Sri Lanka's bankruptcy as an entry point and analyzes and studies the reasons for Sri Lanka's bankruptcy. Ultimately, the article attributes Sri Lanka's bankruptcy to three points. First, unresolved Domestic Economic Problems; Second, three Policies Wrongly Implemented by the Government, which include a series of tax cuts, speeding up printing money and organic farming; Third, the impact of COVID-19 and the Russian-Ukrainian war. However, due to the suddenness of the incident, there is currently a lack of papers and related references that directly study the bankruptcy risk in Sri Lanka. The author only gives three reasons and the main time point of the study is limited to 2019-2022. In the future, researchers can extend the time and dig deeper into the reasons for Sri Lanka's bankruptcy from more angles. In addition, after analyzing the reasons, researchers can further think about the warning effect of Sri Lanka's bankruptcy on other countries, and what new understandings of the world market and economic globalization have been obtained. These will have practical significance for the peace and stability of the world economy and society in the future.

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