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Sri Lanka's Economic Crisis and Its Impact on India



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Introduction

On 31 August 2021, the Sri Lankan Government declared economic emergency. Rising food prices, together with reports of shortages of essential products such as milk powder, sugar, and kerosene, appear to have been the initial triggers. Hoarders, according to President Gotabaya Rajapaksa, are responsible for the rising prices. Army was called in to help manage the problem by rationing necessary items and taking action against hoarders. A former army general was appointed commissioner of essential services, who has the power to seize food items held by traders and retailers and regulate their prices.¹

Key Points

- The Easter Sunday terror attacks in April 2019 cost the tourism industry a significant amount of loss for the following few months.
- On 29 April 2021, the Sri Lankan Government imposed a ban on the import of chemical fertilisers and any other agrochemicals to make the Indian Ocean nation the first in the world to practice organic-only agriculture.
- Under a build-operate-transfer (BOT) contract, an entity—usually a government—grants a concession to a private company to finance, build and operate a project for a period of 20-30 years, hoping to earn a profit. After that period, the project is returned to the public entity that originally granted the concession.

Sri Lanka is yet to recover from the disastrous 4th wave of Coronavirus. September saw daily cases ranging from 3000 to 4000 and approximately 200 daily deaths. Since Sri Lanka has a population of 21 million people, the test positivity rate was high, and the government was focused on dealing with this problem.² Its chief strategy has been to widen the vaccine net.

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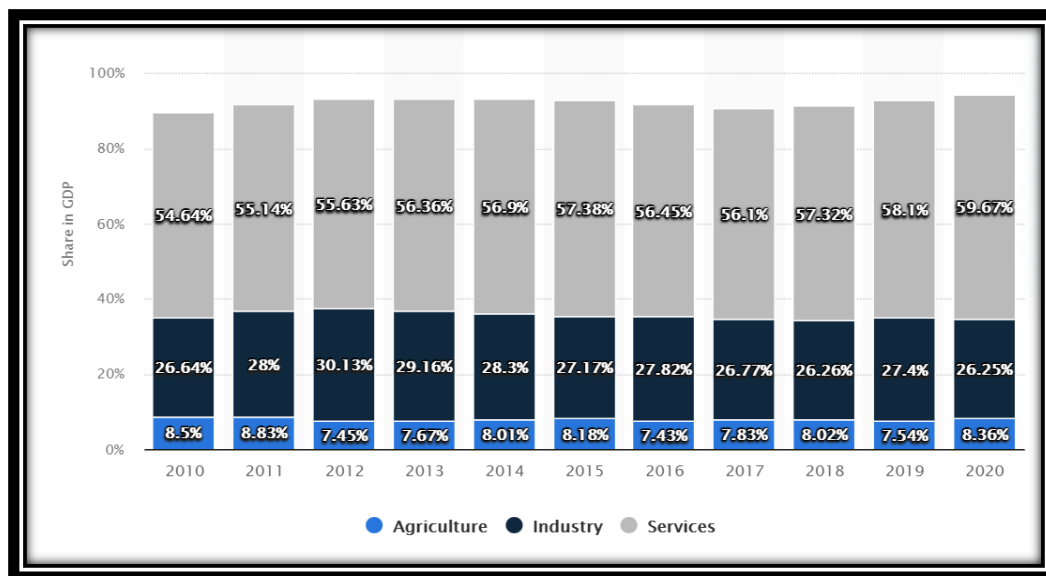
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Since last year, the economy has been strained to the breaking point. The Easter Sunday terror attacks in April 2019 cost the tourism industry a significant amount of loss for the following few months. Interestingly, by the end of 2019, Sri Lanka had recovered and increased its foreign reserves to 7.5 billion dollars.³ However, in early February 2020, Covid pandemic struck the country, putting immense strain on all industries and impacting the country's foreign exchange reserves. The total foreign ex reserves in July this year stood at \$2.8 billion dollars.⁴

Sector Wise Contribution to GDP

The graph (**Figure 1**) below shows the sector wise contribution from 2010-2020 to Sri Lanka's economy. In 2020, agricultural and industrial sectors contributed about 8.36 and 26.25 per cent respectively to the country's GDP, while services led contribution was about 60 per cent.

Figure 1: Contribution of different sectors to Sri Lanka's GDP between 2010 and 2020

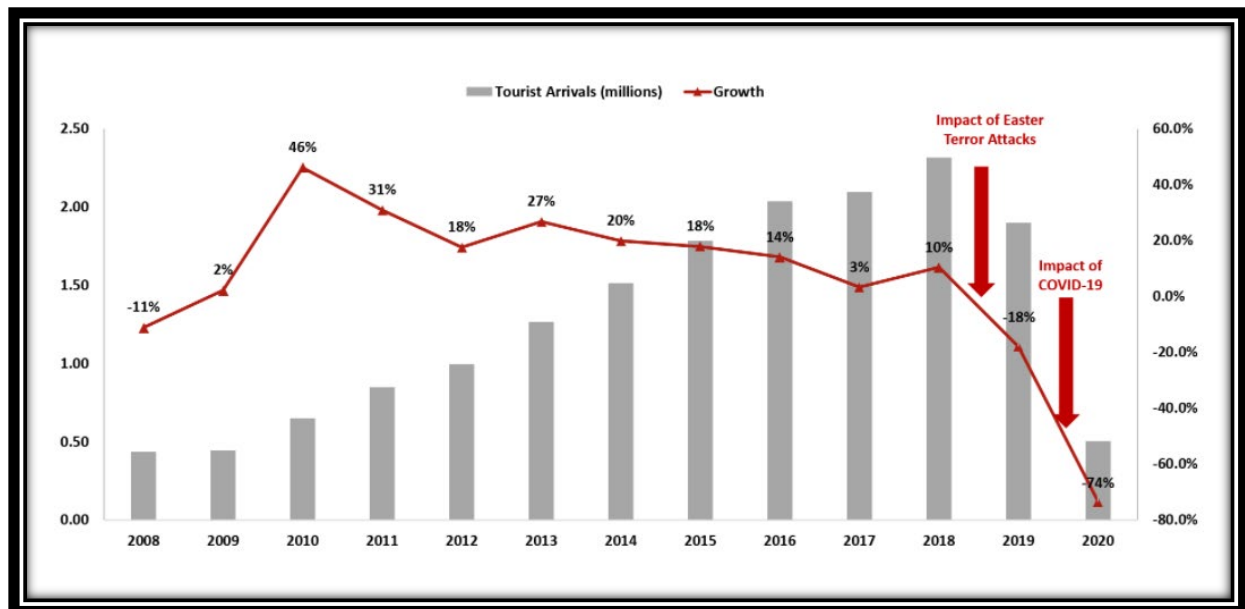


Source: <https://www.statista.com/statistics/728539/share-of-economic-sectors-in-the-gdp-in-sri-lanka/>

Tourism

Within the services sector tourism contributes about 12 per cent and worker remittances 8.25 per cent to the country's GDP. The tourism sector is the third largest foreign income earner in Sri Lanka. However, the terror attacks in 2019 had a significant impact on the country's tourist sector, which had been growing at a rapid speed. The Easter bombings in Colombo's commercial hub claimed the lives of over 250 people, including at least 45 foreign nationals. The explosions targeted Christians in three churches and visitors staying in three luxury hotels. For days after the attack, many businesses remained shuttered. Just when the sector was starting to recover towards the end of 2019, the COVID-19 pandemic wreaked havoc, severely crippling the travel and tourism sector in 2020.

Figure 2: Tourist arrivals in Sri Lanka from 2008 to 2020



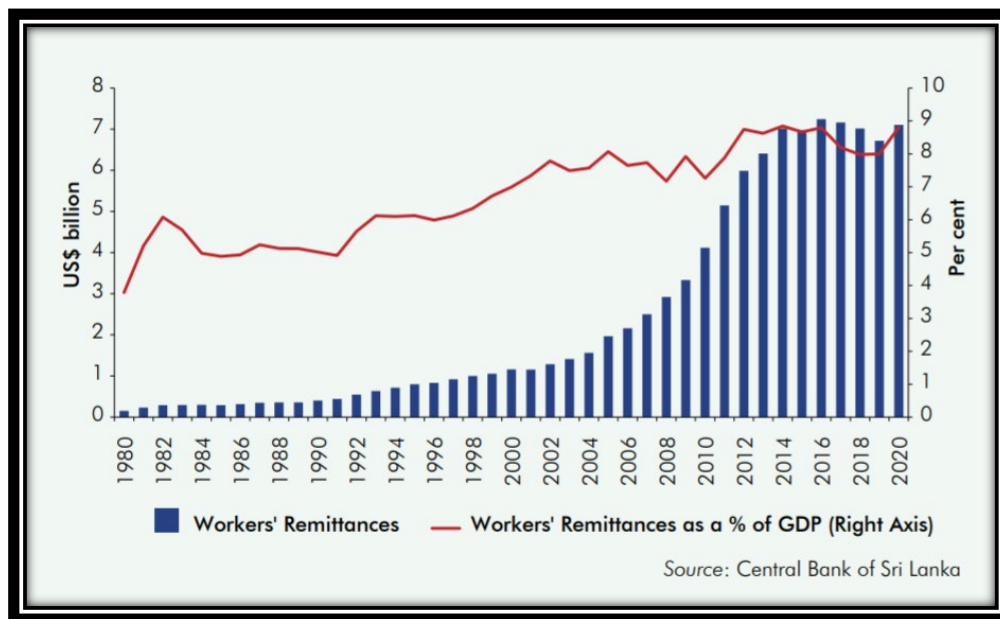
Source: <https://www.hvs.com/article/9113-HVS-Monday-Musings-Sri-Lanka-Tourism-The-Post-war-Growth-Story>

Workers' Remittances

Workers' remittances as a proportion of GDP, which averaged approximately 5.7 per cent between 1981 and 2000, rose to about 8.0 per cent of GDP between 2001 and 2020, indicating the growing importance of remittances in relation to Sri Lanka's GDP. However,

with the exception of 2016 and 2020, remittances have been dropping over the past six years. However, workers' remittances increased significantly in the second half of 2020, with December 2020 recording the largest monthly remittances in history.

Figure 3: Workers' remittances



Source: https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/13_Box_04.pdf

Textile Industry

The total textile industry exports from the country stood at 679.8 million dollars in February 2020. Since March 2020, however, the export percentage has been falling. Sri Lanka's garment exports decreased by 27.6% as compared to 2019. The pandemic caused an unprecedented confluence of supply and demand-side disturbances, which resulted in this change. Despite a little improvement in the second half of the year, the sector is still reeling under pandemic led disruptions on a daily basis. These implications are especially troublesome for the industry's almost 350,000 employees.

Figure 4: Sri Lanka's Textile and Apparel Export 2019



Source: <https://www.fibre2fashion.com/industry-article/8551/consistent-improvement-in-sri-lanka-s-apparel-exports>

How Did Sri Lanka Find Itself in this Situation of Crisis?

The country's major exports include tea, rubber, and garments. The exports have decreased as a result of lower production. Second, worker remittances, primarily from west Asian nations, where many Sri Lankans were employed, abruptly ceased because the majority of the employees were fired and forced to return home. The third factor is tourism, which is another important source of foreign currency. Earnings plummeted from \$3.6 billion in 2019 to \$0.7 billion in 2020. Also, FDI inflows decreased from \$1.2 billion to \$670 million during the same period.⁵

The other aspect of the food crisis is related to imports. Being an Island nation, Sri Lanka is heavily reliant on several essentials such petroleum, sugar, wheat, pulses and some amount

of rice. One of the early policy decisions of President Gotabaya Rajapaksa was that of going for import substitution. The Government aimed to increase home production while banning non-essential commodities like automobiles.⁶ This was most likely done to preserve foreign reserves.

As a result of the restrictions on import of non-essential goods, other importers (involved in import of non-essential items) have had to diversify and get into essential commodity imports and that at a time when Sri Lankan rupee (SLR) has been falling. The SLR crossed the historic high of Rs. 231 to the US Dollar. The Government spent a lot of money on importing goods, and then there was a lot of stockpiling when the government tried to keep commodity prices under control. This meant that basic necessities were either difficult to get by or were expensive. And that is when the Government decided to bring in emergency regulation. The President has the power to bring such legislation. According to the Sri Lankan government, there is no food shortage in the country, but the public is concerned that there may be one.

The official narrative and statements by Government underscored the ambit of emergency regulations and said that it has to do with distribution of essential food items. Consequently, senior lawyers and constitutional law experts who have examined the regulation vis a vis the legal parent framework say that it is essentially a state of emergency for all practical purposes. It not only allows the Government to take action on those who attempt to hoard food items but also gives them wide ranging powers to stifle dissent or go after critics. So there is fear especially because these sort of emergency regulations are not new to Sri Lanka. They were invoked during the war several times and it came into prominence in 1983 anti-Tamil program.

The Sudden Decision to go Organic

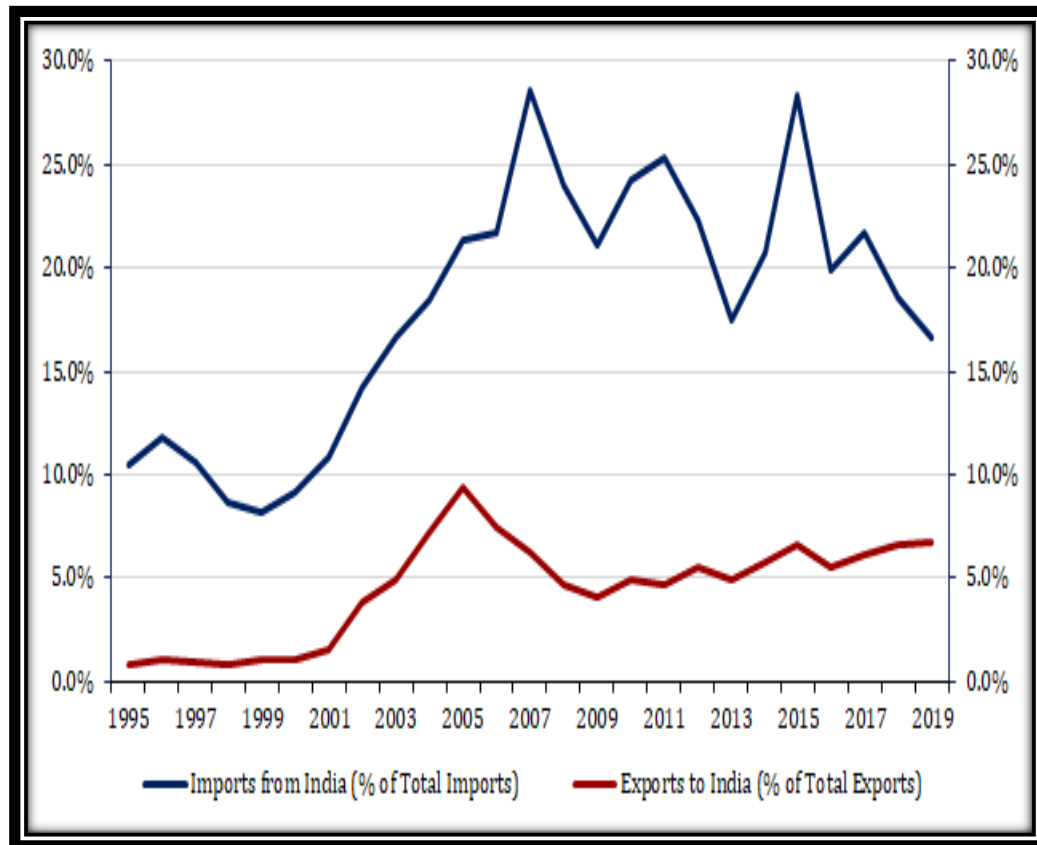
The current situation in the wake of Covid saw a steep increase in prices of essential commodities and that is attributed to hoarding but there are a lot of contributing factors to it. Sri Lanka shifted from chemical fertilisers to organic fertilisers in a very rapid way, which also impacted the economy.⁷ This shift came only recently and we will be able to know in the next harvesting season if it really impacted production. Paddy farmers anticipate a 25 per cent production slump, while growers of tea, which is a key foreign exchange earner for Sri

Lanka, fear a likely 40 – 60 per cent fall in output.⁸ Many farmers have expressed their dissatisfaction with the rapid change. They have been challenging the quick transition, citing the precedent of European countries where it took decades to implement organic farming.⁹ However, it appears that the Government has taken an emphatic position that it wants the country to go to organic farming immediately.

This decision to ban import of chemical fertilisers was justified by the fact that it reduced import costs.¹⁰ However, there were reports that organic fertilisers were being imported.¹¹ As a result, some people are questioning the double standards. While it is true that the import bill would have decreased slightly as a result of the prohibition on chemical fertilisers, it is uncertain whether this reduction is big enough, particularly given that Sri Lanka imports (most of) organic fertiliser components.

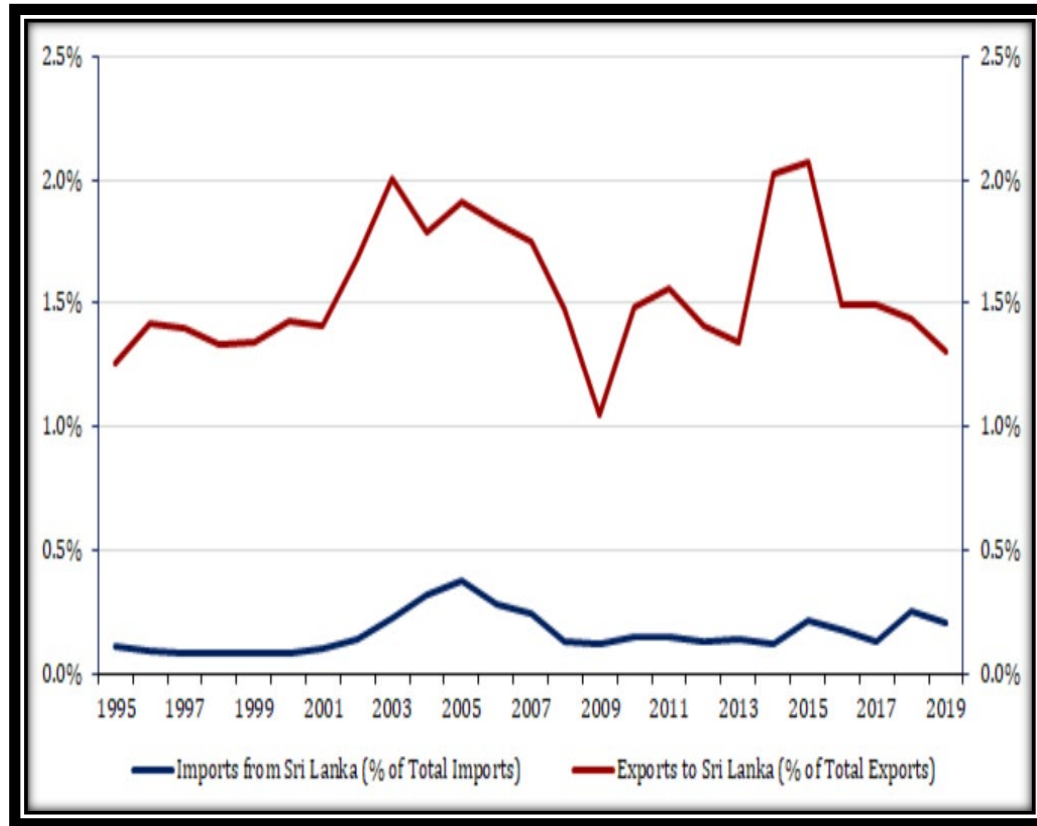
India-Sri Lanka Economic Relations

With India's 'Neighbourhood First' policy the economic cooperation with Sri Lanka did witness an increase. After the United States and the United Kingdom, India is Sri Lanka's third largest export market.¹² The India-Sri Lanka Free Trade Agreement, which came into effect in March 2000, benefits more than 60 per cent of Sri Lanka's exports.¹³ India is also one of Sri Lanka's biggest investors. India's development cooperation with Colombo has traditionally been demand-driven, with projects including social infrastructure such as education, health, housing, clean water and sanitation, as well as industrial growth. Recently, India handed over 1200 houses constructed and one educational facility to Sri Lanka as part of its infrastructural support for the country.¹⁴

Figure 5: Sri Lanka's Merchandise Trade with India 1995-2019

Source: <https://lki.lk/publication/sri-lanka-india-relations-opportunities-for-a-new-connectivity-strategy/>

Between 2005 and 2019, India's FDI in Sri Lanka totalled roughly to \$ 1.7 billion, with investments in retail petroleum, hotels and tourism, real estate, and manufacturing, as well as telecom, banking, and financial services.¹⁵

Figure 6: India Merchandise Trade with Sri Lanka

Source: <https://lki.lk/publication/sri-lanka-india-relations-opportunities-for-a-new-connectivity-strategy/>

However, it is important to note that India's relations with Sri Lanka have not been so good over the last one year. Sri Lanka pulled out of a tripartite cooperation with India and Japan for the Colombo Port's East Container Terminal (ECT) Project in February this year, citing persistent protests by port workers unions, nationalist groups, and Buddhist monks who adamantly opposed any foreign engagement in a critical national asset.¹⁶ The cancellation of the ECT agreement by Colombo caused significant diplomatic tension. Soon after, in early March, the cabinet decided to collaborate with India and Japan to establish the West Container Terminal (WCT) in the Colombo Port. Adani Ports was been "nominated" by India.¹⁷ It was on 30th September that the Adani Group signed a Build Operate Transfer (BOT) agreement with Sri Lanka's largest listed company, John Keells Holdings, and the Sri

Lanka Ports Authority (SLPA) to jointly develop the Colombo West International Container Terminal (CWICT) at the strategically advantageous Colombo Port, which is located amidst one of the world's busiest shipping routes. But this is more of a private deal than a G2G deal.¹⁸

Figure 7: Design of the Colombo Port



Source: The Institute of Engineers Sri Lanka. <https://iesl.lk/SLEN/47/colombo%20fort.php>

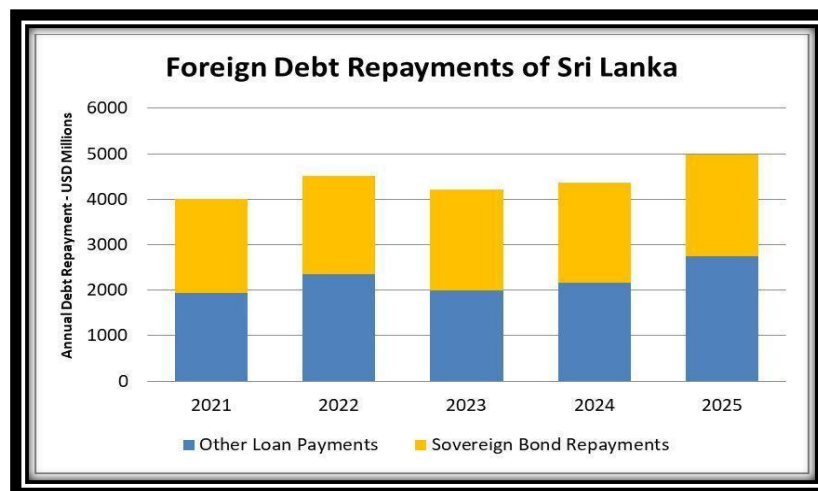
In July 2020, the Reserve Bank of India had signed an agreement with the Central Bank of Sri Lanka (CBSL) under the SAARC Currency Swap Framework 2019-22, wherein the latter could make withdrawals up to \$400 million.¹⁹ It was in February this year that CBSL settled the currency swap facility.²⁰ Despite the fact that the agreement was valid till November 13, 2022, India refused to renew it in the absence of an IMF programme to resolve Sri Lanka's present macroeconomic imbalances.²¹ The Sri Lankan media speculated that the abrupt cancellation of the agreement is fallout of Colombo's decision to break out of the 2019 deal to create a Colombo Port terminal jointly with India and Japan. Sri Lanka's government, however, didn't seek a bailout from the IMF. Instead, it has requested both India and China for further loans.

In recent months, there have been a series of talks with Sri Lanka, starting with talks between foreign ministers of the two countries on the side-lines of the UNGA meeting in October this year. The foreign secretary of India and Chief of Army Staff were in Colombo last month to further push for regional stability and security.

The China Factor in India- Sri Lanka Economic Relations

According to Central Bank Data, Sri Lanka's pending foreign debt repayments – \$ 6.8 billion this year – and a drop in gross official reserves to \$ 5.6 billion as of December 31, 2020, predict another difficult year.²² Sri Lanka owes China \$5 billion and \$ 960 million to India in debt payments.²³ In 2020, the external debt-to-GDP ratio was 62 per cent, with the public sector owing the majority of the debt. In the next two years, more than \$2.7 billion in foreign currency debt will be due. China's loans to the Sri Lankan public sector accounts for 15% of the central government's external debt as of June 2019, making it the country's largest bilateral creditor.²⁴ Sri Lanka lost the unviable Hambantota port to China for a 99-year lease in 2017 due to its inability to repay its debt.²⁵

Figure 8: Foreign Debt Repayments of Sri Lanka

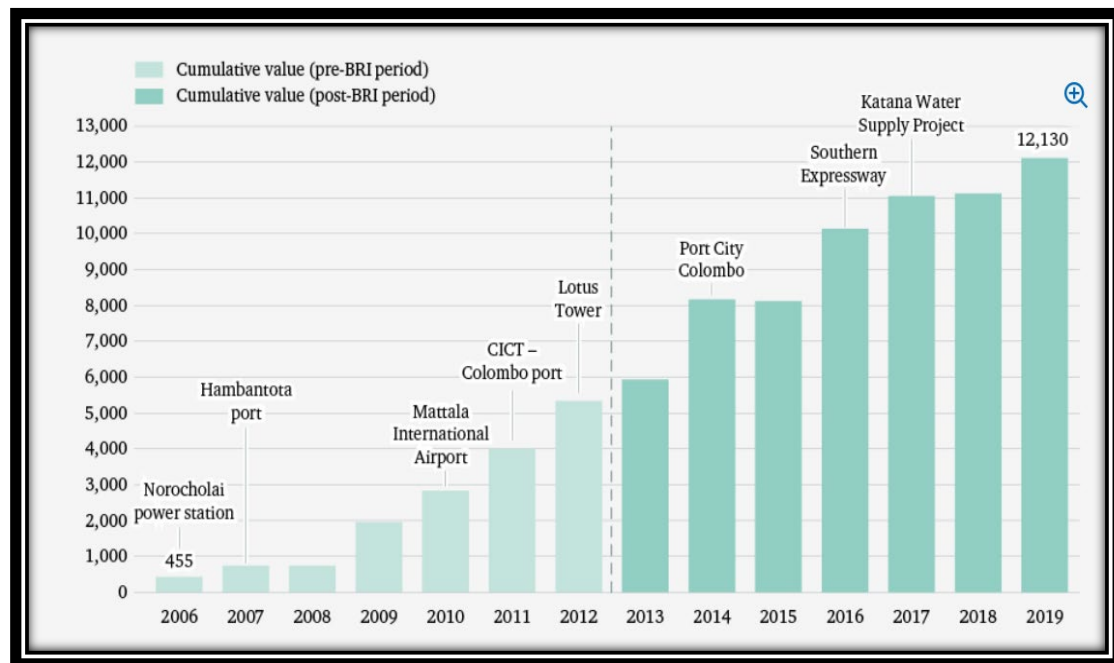


Source: The Diplomat <https://thediplomat.com/2020/10/sri-lankas-changing-relationship-to-chinese-loans/>

In 2020, China's exports to Sri Lanka surpassed India's; totalling \$3.8 billion (India's exports were \$3.2 billion).²⁶ Due to Sri Lanka's strategic location, China has made major investments in the country's infrastructure (estimated at \$12 billion between 2006 and 2019).²⁷ Further,

in May this year the Sri Lankan parliament passed the 'controversial' Colombo Port City Economic Commission Act, which establishes a special economic zone around the port, as well as a new economic commission, both being funded by China. As a result, Sri Lanka's foreign policy has developed a 'China tilt' over time. The tilt was at show at the recent 48th UN Human Rights Council session where Sri Lanka backed China's human rights claims, saying that "foreign forces should not seek to meddle in Xinjiang and Hong Kong, which are integral parts of the People's Republic of China (PRC)".²⁸ The defence of China's human rights violations at a global forum is a part of its 'debt trap' policy.

Figure 9: Value of Chinese development finance to Sri Lanka (\$ million)

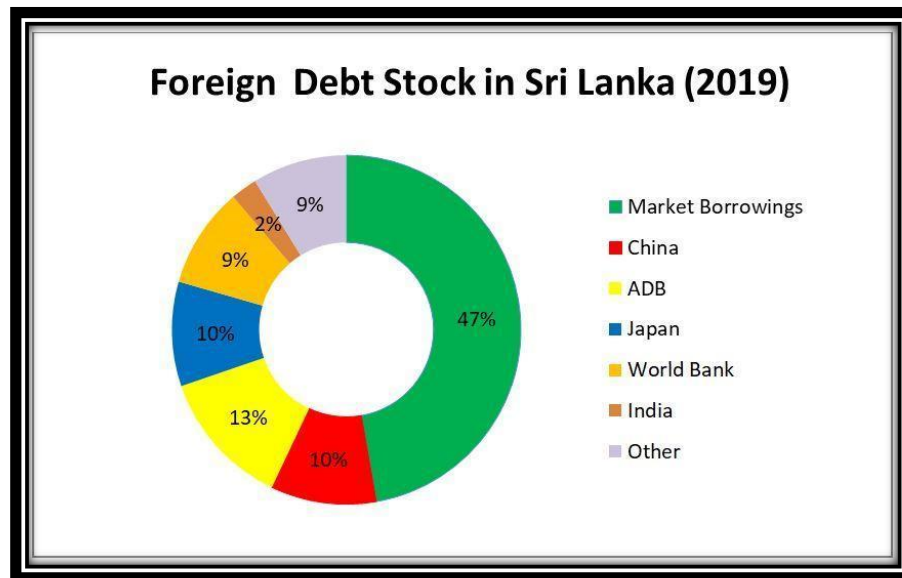


Source: Calculations based on data provided by the Central Bank of Sri Lanka, Department of External Resources, Ministry of Finance, Sri Lanka; Board of Investments, Sri Lanka, and various interviews with key persons. <https://www.chathamhouse.org/2020/03/chinese-investment-and-bri-sri-lanka-0/2-economy>

The present government in Sri Lanka has been criticized for its autocratic attitude.²⁹ Basil Rajapaksa, President Gotabaya Rajapaksa's and Prime Minister Mahinda Rajapaksa's brother was sworn in as Sri Lanka's Minister of Finance in July, making him the fourth Rajapaksa brother and fifth member of the first family to join the Cabinet.³⁰ The Govt. has been criticised for having deviated from democratic norms of governance. The compromised

democratic institutions in the country will be in favour of China. The CCP's Leninist model will navigate easily in nations that have suppressed liberal democratic values.

Figure 10: Foreign Debt Stock in Sri Lanka (2019)



Source: *The Diplomat* <https://thediplomat.com/2020/10/sri-lankas-changing-relationship-to-chinese-loans/>

With Rajapaksa's coming to power in 2020, India hoped for renewal of ties with Sri Lanka in the face of mounting Chinese debt, which was exacerbated following Beijing's taking over the Hambantota Port.³¹ In his book, "The Emperor's New Road: China and the Project of the Century", Jonathan E. Hillman rightly observes that "If Chinese loans were cigarettes, Sri Lanka's Hambantota Port would be the cancerous lung on the warning label".³² The Chinese strategic dimension was largely overlooked by Sri Lanka's administration. China will invade South Asia through authoritarian regimes such as Sri Lanka, just as it did in Europe, where it established a 'Balkan Backdoor' to enter the European Union through the Balkan states.³³ With Adani's entry into Sri Lanka, India will have "some presence" at the Colombo port than nothing at all in such a strategic location.

Challenges for India

Sri Lanka's strategic location in the Indo-Pacific borders some of the busiest sea lanes in the world through which maximum energy trade to nations east of the Malacca Straits viz China,

Japan, South Korea, Singapore and many others. Therefore, it is essential for all of these countries to ensure that the safety and security of these sea lanes, as well as the ships passing through them, are not jeopardised. With Hambantota having been leased to China, a strong PLA Navy presence in the region will allow the PLA to not only safeguard its own transport, but also disrupt, impede, or damage trade and energy flows to its opponents. From an Indian point of view it is not encouraging news. Clearly, China's efforts to befriend India's neighbours have put extra pressure on New Delhi.

Recommendations

- The first thing that India needs to do and guard against is that it should not get into competition with China rather focus on its own strengths. It has strong people to people and cultural relations with Sri Lanka. Sri Lanka being a geographically smaller country, it is natural for her to have a relationship with suspicion. In such a situation, informal regular exchanges and dialogue is the way forward.
- Located strategically at the peninsular tip of India, relationship with Sri Lanka is the most critical among all. There have been challenges in this relationship which do happen when there is such proximity. Some manageable challenges persist which require active measures from both sides.
- Strategic interests of any country reflect interests of that country first and anybody else later. Therefore, Sri Lanka's inclination to economic activities by China should not make India feel that their security is jeopardised.
- The inability to complete infrastructural projects in Sri Lanka and other nations in a time bound manner is a key impediment to the country's desire to provide infrastructure aid. This is an area that needs to be improved.
- India should proceed with formal diplomatic negotiations and discussions. For instance, take the case of Bangladesh. It is interesting to see how Bangladesh is doing the fine balancing act well; it has a good relationship with India, which is growing, and it has maintained an equally good relationship with the Chinese when it comes to conducting business and boosting its economy.
- India also needs to buckle up when it comes to moving ahead with some of the regional initiatives. When India goes for bigger initiatives like the Quad, the question

that arises is what it is doing for its immediate neighbourhood? SAARC is a good initiative; it took off well but was caught in a dilemma because of the issues between India and Pakistan. In such a situation India can move ahead without Pakistan for the time being.

- Bangladesh, Nepal, and the Maldives are among the South Asian countries that have turned to China for large-scale infrastructure financing. To protect its strategic interests in the Indian Ocean area, it will be critical for India to maintain its 'Neighbourhood First' policy with Sri Lanka, but with caution. Regional platforms such as the BIMSTEC and the Indian Ocean Rim Association could be used to promote cooperation in areas of mutual interest such as technology-driven agriculture and marine sector development, IT and communication infrastructure, renewable energy, and transportation and connectivity. Both nations may also work together to boost private sector investment in order to boost economic resilience.

End Notes

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²¹ Ibid.

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