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Economics Research Paper on Sri Lanka' Economic Crisis

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Abstract:
Sri Lanka's economic crisis (2022-2024) was both economic and geopolitical. Internally, a mix of poor policies which include but are not limited to tax cuts and bans on chemical fertilizers which left the economy vulnerable to external shocks. That vulnerability resulted in an economic collapse, record high inflation and social unrest. Externally, the crisis became an arena for a strategic competition between two giants; India and China. China showed support through project financing while India provided emergency relief and credit lines. This paper argues that Sri Lanka's economic crisis was not the result of China's debt trap diplomacy, but rather domestic mismanagement, while its strategic location in the Indian Ocean transformed the crisis into an unexpected opportunity to leverage. The suggested measures to take in this scenario would be for the country to restructure its debt, strengthen financial discipline and balancing its relationships among competing allies.

Introduction

2022 marks the year where Sri Lanka faced its worst economic collapse since independence and went down as one of the worst economic crises in history. The country defaulted on its loans, which was coupled with low foreign reserves, shortages of food, medicine, and fuel, and the resulting social unrest. By the end of April 2022, Sri Lanka's total outstanding external debt stood at approximately $34.8 billion. Moreover, inflation surged to roughly 70% in September 2022 as per the fiscal position report. Despite this, the government proceeded with a $500 million International Sovereign Bond repayment in January 2022, a decision that intensified the crisis. The moment that marked this event for the majority of the world were the pictures of long queues of people lined up with containers at petrol pumps and the news of President Gotabaya Rajapaksa resigning. The inflation rate surged to an unprecedented 59.2% by December 2022, with food prices escalating by over 69%, leading to widespread hardship and public unrest. On first glance, domestic mismanagement alone seems to be at the core of this catastrophe, such as the series of bad decisions like a ban on chemical fertilizers, constant borrowing, tax cuts, and an overdependence on tourism. However, because of its strategic location in the Indian Ocean from both a military and trade standpoint, Sri Lanka's economic crisis has evolved into an international relations issue or opportunity.

The Debate

In the pretext of this crisis, a debate arises where many believe that this has been the result of a deliberate ploy by China. According to this perspective, loans from China were intentionally approved by the Chinese to finance significant infrastructure projects like the Hambantota Port in Sri Lanka to amplify their financial burden, consequently resulting in the transfer of these critical assets. On the other hand, people think it was a result of poor governance and financial decisions. Regardless of the causes, the issue has drawn multiple key state actors into the landscape: India, to retard the spread of Chinese influence; the International Monetary Fund, the Western powers; and China.

Chinese loans in Sri Lanka were typically from the state policy banks like Exim Bank and China Development Bank. The interest rates of these loans were relatively higher, like the 6.3% interest rate imposed for the Hambantota Port. However, Sri Lanka had no choice but to accept the offer due to a lack of alternatives since Western donors and multilateral lenders already witnessed weak returns and did not want to pursue ambitious projects like Hambantota. Moreover, China in general does not demand policy reforms or austerity conditions, while the IMF or World Bank requires them. As a result, the Chinese loans were more convenient and perceived to be faster, which were why they financed roughly one-third of Sri Lanka's infrastructure between 2000–2010.

One of the major Chinese-financed projects was the Hambantota Port, which was built with roughly $1.4 billion in China Exim Bank loans. It was meant to leverage its proximity to the world's busiest East-West shipping lane and hoped to capitalize on this by diverting ships for refueling, repairs, and transshipment, bringing along jobs and investments to boost the economy of the less developed southern region. It struggled with low traffic and heavy losses and agreed to a 99-year lease with China Merchant Port Holdings by 2017.

Another broadly publicized project was the Mattala Rajapaksa International Airport. A major portion was funded through Chinese loans worth $190 million. In reality, it saw almost no traffic and became known as the "world's emptiest airport" due to its high maintenance cost and lack of demand.

China's Role

In light of these unsuccessful infrastructure projects, critics believe China had no intention of investing and taking over such unprofitable projects, while others warn that this gives China a new strategic foothold. However, research suggests otherwise: Chinese loans comprised only 9 percent of Sri Lanka government debt by 2016, portions of external debt at the time, and were mainly made by the Western-dominated financial markets. Moreover, the claim that China could use the Hambantota port as a naval base is completely erroneous, as the SLPA-CMPort agreement between the Sri Lanka Ports Authority and China Merchants Port Holdings assigned security over to an oversight committee that comprises the Sri Lankan navy and police. In summation, China was a willing lender to Sri Lanka's development plans; however, it was mainly Sri Lanka's mismanagement and other major international debt sources that largely determined the country's fate.

India's Role

In response to the crisis and China's rising role in Sri Lanka's external financing, India acted with a combination of humanitarian aid and diplomatic financial negotiations. These interventions were a result of multiple motives, like humanitarian concern for a neighbor, ensuring regional stability, and countering China's growing influence around the region.

India's response under humanitarian aid involved fuel shipments through March and April 2022 to keep Sri Lanka's power plants and transport running. By 6th April 2022, India had supplied 270,000 tonnes of fuel to reduce the risk of immediate and continual blackouts. New Delhi also delivered emergency medical supplies and ambulances to hospitals facing shortages, with parliamentary records suggesting that tens of tonnes of drugs and other medical aid were sent. Beyond emergency aid, India also played a diplomatic role, helping Sri Lanka secure an IMF programme and provided assurances that helped them source multilateral support. India also provided several lines of credit while making it clear that they would not indefinitely underwrite Sri Lanka's debts. These actions are also in favor of SAGAR, an initiative announced by Prime Minister Narendra Modi that stands for Strategic and Growth for all in the region. It was erected in order to secure national security and economic interests at a time where geopolitical competition increased, like China's expanding maritime presence. Despite India's support having its own limitations, it had moral legitimacy due to its deep cultural ties and strategic aim, ensuring that any single external power like China does not gain leverage in a state that sits on vital Indian Ocean sea lanes. In a world that's connected with more depth and reach than ever before, a crisis in one island state is bound to resonate across the Indian Ocean and to countries beyond.

Sri Lanka as a Geopolitical Battleground

From the previous paragraphs, it is clear that Sri Lanka is quickly evolving to be a frontline for the rivalry between India and China. Not only due to its position in the Indian Ocean, but also due to the expansionist policies of China and India, Sri Lanka will benefit due to this rivalry as each side tries to counter the other's influence. However, they face a dilemma: which side do they lean on — China with their willingness to finance infrastructure projects, or India with their security concerns but close proximity, long-lasting ties, and support? Furthermore, they need to keep in view whether the allies of either of these countries are who they want to develop relations with and align with their global interests.

Opportunities Amid the Crisis

According to a proverb, "One man's loss is another man's gain." This crisis has highlighted a series of conflicts and challenges, but also opportunities for countries, institutions, companies, and individuals. India in particular can continue not just by providing aid but begin by deepening trade ties and investing in energy projects as it has already done in the Trincomalee Tripartite MoU. Other nations also have similar opportunities to invest in commercially viable projects, offer conditional but stable financing, and offer advice on public financial management and more, with an emphasis on deepening partnerships while exercising caution. Companies involved in logistics and shipping can utilize the underused terminals and ports, while companies involved in energy can establish themselves as LNG terminal operators and renewable energy plants and benefit from future energy hub plans and possible refinery projects. Industries like construction, tourism, agriculture, and financial services are all expected to grow post-crisis. Lastly, individuals have the opportunity to buy assets that are now a fraction of the price and invest in the stock market that plummeted during the crisis, which could result in high returns if recovery follows. Skilled professionals like engineers, project managers, hospitality managers, and IT professionals will also be in demand as recovery follows.

Conclusion

In conclusion, Sri Lanka's economic crisis was not the result of debt trap diplomacy but rather a mesh of uncontrollable external factors and mainly poor decisions such as the ill-timed tax cuts, poorly planned infrastructure plans, fatal policy errors like the sudden fertilizer ban, and the overreliance on tourism. This domestic crisis quickly evolved into an arena where India and China battled for influence. Its path forward requires debt restructuring in order to avoid defaulting on its current debt while not straining the country's finances in the long run. It must also restore fiscal discipline and focus on portraying the country as an ideal environment to invest in. Geopolitically, it should continue as a non-aligned partner to leverage support from China, India, and other relevant countries in the rest of the world.

When this has been achieved, Sri Lanka can transform itself into a version stronger than it was before the crisis. The recent crisis served as a reminder that in an interconnected world, the impact of an economic crisis is unequivocally international as well.

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