

Understanding the Impact of Business and Market Based on Collapse of Sri Lankan Economy

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Abstract

Sri Lanka's economic crisis from 2019 to 2024 represents a profound case of macro-financial instability with direct implications for businesses, investors, and policymakers. Triggered by fiscal mismanagement, unsustainable borrowing, ineffective policies, and external shocks, the crisis resulted in hyperinflation, currency depreciation, severe shortages of essential goods, and social unrest, disrupting business operations and investor confidence. This research employs a mixed-methods design, combining quantitative analysis of key economic and financial indicators including GDP, inflation, debt, and foreign reserves with qualitative assessment of governance, policy interventions, and corporate environment impacts. Two detailed case studies, the 2022 sovereign debt default and associated social unrest, highlight the business, operational, and stakeholder implications of financial instability. By analyzing IMF and World Bank data, Central Bank statistics, scholarly literature, and media reports, this study identifies structural weaknesses in fiscal, monetary, and governance frameworks that amplified business and societal risks. Recommendations focus on corporate resilience, fiscal discipline, strategic risk management, and governance reforms, providing lessons for businesses and policymakers in emerging markets.

Introduction

Sri Lanka, strategically located in South Asia, has historically presented a promising environment for business and investment due to its diversified agricultural base, tourism potential, and growing services sector. Between 2010 and 2018, GDP growth averaged five to six percent annually, driven by exports of tea, garments, and tourism. However, by the late 2010s, structural vulnerabilities including high public debt, reliance on external financing, and fiscal deficits began to threaten business stability and investor confidence.

The period from 2019 to 2024 witnessed an unprecedented economic crisis that disrupted both public and private sectors. Key indicators illustrate the magnitude of the disruption. The Sri Lankan Rupee depreciated over fifty percent against the US Dollar, inflation peaked at nearly seventy percent, foreign reserves reached critically low levels, and shortages of essential goods impacted business operations and supply chains. The crisis also triggered social unrest, undermining workforce stability and consumer confidence.

Internally, fiscal mismanagement through tax cuts, excessive borrowing for infrastructure projects, and poorly planned subsidies strained government finances, while abrupt policy changes such as the 2021 fertilizer ban disrupted agricultural supply chains. Externally, the COVID-19 pandemic reduced tourism

revenues and remittances, while global commodity price shocks heightened operational costs for businesses.

This study addresses the following business-focused objectives. First, it identifies key drivers of the crisis and their implications for business risk and strategic planning. Second, it analyzes the economic, operational, and social impacts on businesses and stakeholders. Third, it evaluates policy responses, including IMF-supported programs and debt restructuring, for their effectiveness in stabilizing the business environment. Fourth, it examines two case studies, the 2022 debt default and social unrest, to draw lessons in risk management, corporate strategy, and stakeholder impact. Fifth, it proposes strategic recommendations for fiscal discipline, business resilience, governance, and risk mitigation in emerging markets.

By integrating macroeconomic data with qualitative analysis of governance and policy, this research provides a holistic business-oriented perspective, emphasizing strategic implications for private enterprises, investors, and policymakers.

Literature Review

Fiscal mismanagement and corporate risk exposure have been widely cited in the literature as key contributors to the Sri Lankan crisis. Athukorala in 2022 highlighted revenue shortfalls caused by reductions in value-added tax and corporate tax cuts, which restricted public funding and heightened operational risks for businesses that relied on government infrastructure and subsidies. Kelegama in 2014 emphasized that borrowing to finance large-scale infrastructure projects created debt obligations that strained national finances, increasing financial and operational risks for private sector partners and investors. Weerakoon and Jayasuriya in 2022 observed that debt servicing consumed nearly forty percent of government revenue, limiting support for programs that stabilize markets and thereby increasing vulnerability for firms and supply chains.

Monetary policy and inflation dynamics further affected business operations. Excessive expansion of the money supply to cover fiscal deficits drove hyperinflation, peaking at seventy percent in 2022, which directly increased business costs and reduced consumer purchasing power, according to the Central Bank of Sri Lanka in 2022. Currency depreciation, particularly against the US Dollar, elevated import costs for key inputs such as fuel and raw materials, disrupting production and pricing strategies for firms as reported by the World Bank in 2022.

External shocks intensified market vulnerabilities. The COVID-19 pandemic disrupted tourism, which accounted for five percent of GDP, and reduced remittances, constraining liquidity for businesses dependent on consumer demand and international transactions. Global commodity price volatility, especially in fuel and fertilizers, increased operational costs and threatened supply chain continuity according to the Asian Development Bank in 2023. Environmental shocks, including floods and droughts, further affected agricultural output, impacting firms that relied on domestic supply.

Policy failures and governance challenges created additional risks for business. Mismanagement of energy and fertilizer subsidies created shortages, black markets, and price instability, disrupting business operations and investor confidence. Delayed debt negotiations and reactive policy measures amplified economic uncertainty, reducing predictability needed for strategic business planning as reported by Al Jazeera in 2022 and The Guardian in 2022.

Socio-political implications also affected the business environment. High inflation, unemployment, and shortages triggered widespread protests in 2022, directly impacting workforce stability, logistics, and

market demand according to Reuters in 2022. Literature emphasizes that robust governance and social safety nets mitigate operational and reputational risks for firms during economic crises, as observed by Weerakoon and Jayasuriya in 2022.

Case studies provide actionable insights for risk management and strategic decision-making. This study examines the 2022 sovereign debt default for macro-financial implications on businesses and investors, and social unrest for its impact on human capital, operations, and stakeholders.

Existing literature often addresses macroeconomic or social factors in isolation, with limited focus on operational and strategic business implications. This study bridges this gap by integrating macroeconomic, social, and governance insights to offer a business-oriented framework for crisis management, strategic planning, and resilience in emerging markets.

Research Methodology

Understanding Sri Lanka's economic crisis requires a comprehensive methodology that integrates both quantitative and qualitative approaches. This mixed-methods design ensures a holistic analysis of the crisis, capturing measurable trends alongside contextual policy and social implications relevant to business and governance.

This study employs a mixed-methods approach that combines quantitative economic analysis with qualitative assessments of policy and societal outcomes. Quantitative analysis examines key economic indicators such as gross domestic product growth, inflation rates, foreign exchange reserves, debt-to-GDP ratio, unemployment statistics, and trade balances. Tracking trends in these metrics allows the study to assess the severity of economic decline, identify fiscal vulnerabilities, and understand their implications for business operations and investor confidence.

Qualitative analysis focuses on policies, governance decisions, and social consequences of the crisis. Government reports, media coverage, policy papers, and scholarly studies are analyzed to uncover the motivations behind policy decisions, implementation challenges, and societal responses. This combination of approaches provides a triangulated perspective that validates findings and enables a deeper understanding of complex interactions between fiscal policy, governance, and the business environment. The study relies primarily on secondary data sources. Reports from the International Monetary Fund and the World Bank provide insights into Sri Lanka's macroeconomic performance. Government publications, including Central Bank annual reports and Ministry of Finance documents, offer official data and policy context. Academic studies and journal articles focusing on fiscal policy, debt management, and social impacts provide analytical depth, while media sources document social unrest, public opinion, and political changes. These secondary sources allow for historical trend analysis and offer benchmarks for comparing Sri Lanka's situation with other emerging economies facing similar challenges.

The analytical framework applies distinct tools for quantitative and qualitative data. Trend analysis tracks changes in economic indicators from 2019 to 2024, correlation analysis examines relationships between variables such as debt levels, inflation, and currency depreciation, and comparative analysis situates Sri Lanka's economic performance within a regional context. Thematic analysis identifies recurring patterns in government reports, media coverage, and academic studies, including policy missteps, social unrest, and external shocks. Case study methodology provides in-depth insights into the crisis, focusing on the 2022 debt default and social unrest as representative events with direct implications for business, governance, and society.

Case studies were selected to capture the critical dimensions of the crisis. The 2022 debt default represents a financial turning point, illustrating the consequences of unsustainable borrowing and fiscal mismanagement. The social unrest and political instability case study highlights the socio-political effects of economic hardship, showing the human and governance dimensions of the crisis. Together, these cases encompass macro-level economic outcomes and micro-level social consequences, providing a comprehensive perspective.

This methodology is justified for several reasons. Combining quantitative and qualitative data ensures that both measurable economic and contextual business factors are captured. Using reliable secondary sources such as IMF and Central Bank reports ensures credibility, while case studies highlight real-world implications that inform strategic recommendations. Trend and correlation analyses allow Sri Lanka's experience to be compared with other emerging economies facing debt crises, such as Argentina and Pakistan. Limitations include restricted access to primary survey data, time lags in economic reporting for 2023–2024, and the lack of public documentation for some internal government decisions, which constrains a complete understanding of decision-making processes.

Core Problem Explanation

Sri Lanka's economic crisis resulted from a convergence of fiscal mismanagement, external shocks, and policy failures, each interacting to amplify the severity of the collapse. Fiscal mismanagement is widely regarded as the primary driver. In late 2019, the government implemented sweeping tax reforms, including reducing the Value Added Tax from fifteen percent to eight percent, cutting corporate taxes, and removing several indirect taxes. These reforms caused government revenue to fall by approximately thirty-three percent in the first year, leaving insufficient funds to finance essential public services such as healthcare, education, and social welfare without resorting to heavy borrowing or monetary expansion.

To cover fiscal deficits, Sri Lanka relied heavily on domestic and international borrowing. Between 2019 and 2021, public debt rose from fifty-five billion to eighty-four billion dollars, with external debt comprising nearly sixty percent of the total. Much of this debt financed large infrastructure projects, some of which were politically motivated but economically unviable. High-interest loans from foreign governments and institutions increased debt-servicing costs, consuming nearly forty percent of government revenue by 2021. Monetary expansion to cover fiscal gaps fueled hyperinflation, which peaked at over sixty percent by mid-2022. The depreciation of the Sri Lankan Rupee by over fifty percent against the US dollar further increased import costs and widened the trade deficit, intensifying operational risks for businesses and households.

External shocks compounded the crisis. The COVID-19 pandemic collapsed tourism, which contributed roughly five percent of GDP, and reduced remittances by about twenty percent in 2020, reducing critical foreign exchange inflows. Global commodity price shocks, particularly from the Ukraine conflict in 2022, caused oil and food prices to spike, disproportionately affecting Sri Lanka due to its dependence on imports. The country's fuel import bill doubled within months, straining limited foreign reserves, while rising fertilizer prices and domestic bans on chemical fertilizers led to crop yield reductions and heightened food insecurity. Adverse weather events, including floods and droughts, further disrupted agricultural output, exacerbating supply shortages and public discontent.

Policy failures intensified the economic collapse. The sudden 2021 ban on chemical fertilizers caused rice and vegetable production to fall by approximately twenty percent, creating staple food shortages and fueling inflation. Subsidies on fuel, maintained despite skyrocketing global prices, strained public

finances, while inefficiencies in distribution created long queues and black-market trading. Failure to negotiate debt restructuring early left Sri Lanka with unsustainable repayment obligations, ultimately resulting in the 2022 sovereign debt default. Reactive, short-term policy decisions lacking strategic foresight worsened both economic and social consequences.

The social and economic impacts were severe. Shortages of food, fuel, and medicine led to rationing and public panic. Hyperinflation eroded purchasing power, pushing over thirty percent of the population into poverty. Business closures and industrial slowdowns increased unemployment, particularly among young adults. Widespread protests against rising prices and shortages culminated in the resignation of the President in July 2022, illustrating the direct link between economic mismanagement, social unrest, and governance failures.

These factors did not operate in isolation. Fiscal mismanagement made the economy vulnerable to external shocks, while poor policy decisions amplified social consequences. The crisis represents a systemic failure, where political, economic, and social dimensions were deeply intertwined. Two critical events, the 2022 debt default and the social unrest with political instability, illustrate both economic and socio-political dimensions.

Case Study 1: The 2022 Debt Default

By 2021, Sri Lanka had accumulated external debt totaling approximately fifty-one billion dollars, more than sixty percent of GDP. Debt was contracted through sovereign bonds, bilateral loans from China and Japan, and multilateral institutions such as the World Bank and IMF. Much of this borrowing financed large infrastructure projects, including the Hambantota Port and Mattala Rajapaksa International Airport, which failed to generate expected returns.

By early 2021, foreign reserves fell below five billion dollars, and the government struggled to meet international obligations. Oil imports were deferred in March 2022, creating severe fuel shortages. On April 12, 2022, Sri Lanka officially defaulted on fifty-one billion dollars of foreign debt, becoming the first country to default on sovereign debt during the COVID-19 pandemic era. Negotiations with the IMF and creditor nations began in May and June 2022 to seek debt restructuring agreements.

The default was driven by chronic fiscal deficits due to tax cuts and revenue shortfalls, declining foreign exchange reserves, and external shocks such as the pandemic and global fuel price spikes. Immediate effects included a fifty percent depreciation of the Rupee, inflation peaking at nearly seventy percent, and severe limitations on essential imports such as medicines, fertilizers, and fuel. The IMF approved a three-billion-dollar Extended Fund Facility in March 2023, while bilateral creditors negotiated rescheduling and interest deferrals. Long-term implications included loss of investor confidence, ongoing debt servicing consuming government revenue, and catalyzing socio-political unrest.

Case Study 2: Social Unrest and Political Instability

Economic hardships due to shortages of fuel, food, and medicine directly affected citizens' daily lives. Dissatisfaction with governance and lack of transparent policy-making fueled widespread protests. Protests began in Colombo in March 2022, intensified through April and May, and spread to other cities and rural areas. On July 9, 2022, President Gotabaya Rajapaksa fled the country, and on July 13, the Prime Minister resigned. A transitional government was formed to implement emergency economic reforms.

Persistent inflation and shortages, perceived mismanagement and corruption, and inadequate social safety nets caused social unrest. Public protests reflected growing civic engagement and demands for long-term

governance reforms, including accountability in economic policymaking. Businesses faced disruptions due to strikes, reduced consumer spending, and supply shortages. Policy responses included temporary price controls, fuel subsidies, and IMF-backed economic reforms. Lessons from this crisis indicate that economic mismanagement can escalate into political instability, while coordinated fiscal, monetary, and social interventions are critical to restore public trust.

Comparative Insights

The two case studies demonstrate that economic collapse is rarely caused by a single factor. The debt default created immediate financial shock, while social unrest revealed the human and governance consequences of policy failures. Together, these cases provide a comprehensive understanding of Sri Lanka's multidimensional crisis, illustrating the interplay between macroeconomic mismanagement, business disruption, and societal impacts.

Policy Responses and Reforms

In response to the economic crisis, Sri Lanka implemented a combination of international assistance programs, domestic fiscal and monetary reforms, and structural adjustments aimed at stabilizing the economy.

International assistance was primarily coordinated through the International Monetary Fund (IMF), which approved a four-year, three-billion-dollar Extended Fund Facility in March 2023 to support macroeconomic stabilization. The program aimed to restore fiscal stability, control inflation, rebuild foreign exchange reserves, and facilitate structural reforms. Conditionality measures included fiscal consolidation measures such as broadening the tax base and reducing subsidies, reforming state-owned enterprises to improve efficiency, and promoting transparent governance and anti-corruption practices. The IMF package provided immediate liquidity support, preventing the collapse of essential public services and encouraging bilateral creditors and investors to engage in debt restructuring discussions.

China and India also played a significant role by renegotiating loan terms, offering debt rescheduling and interest deferrals, which eased immediate repayment pressure. Multilateral development institutions such as the World Bank and Asian Development Bank extended emergency grants and low-interest loans to stabilize the healthcare, agriculture, and energy sectors.

Domestic policy reforms focused on fiscal, monetary, and structural measures. Fiscal reforms included the reintroduction and adjustment of Value Added Tax and corporate taxes to enhance government revenue. Subsidy rationalization involved gradually reducing fuel and fertilizer subsidies to align domestic prices with global market rates, while government expenditure was reprioritized toward essential social services and debt repayment. Monetary measures included interest rate adjustments to curb hyperinflation and interventions in the foreign exchange market to stabilize the Rupee, supported by IMF and bilateral funding. Structural reforms targeted inefficiencies in state-owned enterprises, promotion of export-oriented industries such as tea, apparel, and IT services, and the introduction of policies to encourage foreign direct investment, including tax incentives and simplified regulatory procedures.

Evaluation of Policy Effectiveness

In the short term, these interventions stabilized foreign reserves and prevented a total collapse of essential imports. Inflation began to moderate from a peak of seventy percent to approximately forty-five percent by early 2024. However, long-term challenges remain. Public debt continues to consume a significant

portion of government revenue, social discontent persists due to reduced subsidies and rising living costs, and economic recovery is slow, dependent on successful structural reforms and renewed investor confidence. Lessons from the crisis emphasize the necessity of coordinated fiscal, monetary, and social policies, the critical role of international assistance, and the importance of transparency and governance reforms to restore public trust and economic stability.

Impact of the Economic Crisis on Businesses and Markets in Sri Lanka

The Sri Lankan economic crisis had profound and far-reaching effects on the nation's business landscape, market dynamics, and overall investment climate. The combination of currency depreciation, hyperinflation, supply shortages, and policy uncertainty created one of the most challenging environments for firms in recent decades.

Impact on Domestic Businesses

Local enterprises faced severe cost pressures as the Sri Lankan Rupee depreciated sharply against major currencies, making imported raw materials significantly more expensive. Manufacturing firms in sectors such as textiles, food processing, construction materials, and pharmaceuticals reported major disruptions due to limited access to foreign exchange, forcing many to delay production or shut down operations temporarily. Small and medium enterprises (SMEs), which form the backbone of the Sri Lankan economy, were disproportionately affected; many lacked the financial resilience to absorb rising input costs, higher interest rates, and falling consumer demand.

Electricity shortages and fuel rationing further intensified operational challenges. Businesses dependent on logistics, transportation, and delivery faced substantial delays and increased costs, reducing their competitiveness. The tourism sector — a key revenue generator — experienced a collapse in demand due to political unrest, negative global perception, and lack of basic services, resulting in widespread layoffs and business closures.

Impact on Consumer Markets

Hyperinflation drastically eroded purchasing power. Essential goods such as food, medicine, and fuel became unaffordable for much of the population, leading to a sharp decline in discretionary spending. Retailers and wholesalers struggled with stock shortages, fluctuating prices, and reduced footfall. This shift in consumer behaviour forced businesses to scale down product lines, reduce inventories, and adopt survival-oriented pricing strategies.

The collapse of consumer confidence also reduced demand for durable goods, technology products, automobiles, and luxury segments. Market contraction in these categories signaled a long-term shift toward low-cost and necessity-driven consumption.

Impact on Financial and Capital Markets

Sri Lanka's financial sector experienced significant strain as rising non-performing loans (NPLs) weakened banking stability. With interest rates increasing sharply to curb inflation, borrowing became difficult for both households and firms, leading to reduced investment activity. The Colombo Stock Exchange saw declines in investor confidence, reduced foreign participation, and heightened volatility. Debt restructuring negotiations created additional uncertainty in bond markets, discouraging fresh capital inflows.

Impact on Foreign Investment and Trade

Foreign direct investment (FDI) declined as investors perceived Sri Lanka as a high-risk environment. Companies considering expansion postponed investments due to unpredictable tax policies, logistical disruptions, and political instability. Export-driven industries such as apparel struggled due to higher production costs and shipping delays, reducing their global competitiveness. Import restrictions, implemented to conserve foreign reserves, created bottlenecks for businesses dependent on foreign machinery, chemicals, and essential inputs.

Overall Market Outlook

The crisis fundamentally reshaped the business ecosystem, pushing firms toward cost-minimization, supply-chain diversification, and digital transformation. While some export-oriented enterprises adapted by shifting to cost-efficient models, long-term recovery remains tied to macroeconomic stabilization, debt restructuring, and renewed investor confidence.

Conclusion

Sri Lanka's economic crisis between 2019 and 2024 was driven by interconnected factors, including fiscal mismanagement, external shocks, and policy failures. The combined effect of these elements led to hyperinflation, currency depreciation, debt defaults, and widespread social unrest. Fiscal mismanagement, particularly excessive borrowing and ill-timed tax cuts, rendered the economy vulnerable. External shocks, including the COVID-19 pandemic and global commodity price fluctuations, intensified the crisis, while abrupt policy decisions, especially in agriculture and subsidies, exacerbated social and economic consequences.

Analysis of the 2022 debt default and subsequent social unrest highlights the complex interaction between economic collapse and political instability. IMF-supported programs and debt restructuring provided immediate relief, but sustainable recovery requires long-term structural reforms. Fiscal discipline, monetary prudence, and diversification of exports are essential for future resilience, while strengthening governance, transparency, and public accountability is critical to prevent policy missteps and maintain social stability.

Key recommendations include maintaining prudent fiscal policies with sustainable debt levels, aligning domestic prices and subsidies with market realities while protecting vulnerable populations, promoting economic diversification to reduce dependence on sectors such as tourism and tea, implementing robust social safety nets to buffer citizens against future crises, and fostering transparent governance and institutional reforms to regain public and investor confidence. Sri Lanka's experience serves as a cautionary example for emerging economies, demonstrating the consequences of fiscal irresponsibility, inadequate planning, and delayed responses to external shocks. Recovery is achievable, but it requires strategic, coordinated, and long-term efforts to restore stability and promote sustainable growth.

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