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Current Economic Crisis In Shri Lanka

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Abstract

Sri Lanka is in the throes of the worst economic crisis it has seen in decades, collapsing under the weight of its debt. While neighbours India and China have assured President Gotabaya Rajapaksha of assistance, citizens of the island nation have deserted the sinking economy and are showing up in dozens at Indian coasts. The Sri Lanka Development Update (SLDU) notes that the country, hit with an unprecedented economic downturn due to the pandemic, is now on the road to recovery. Sri Lanka's economic growth is expected to recover to 3.4 percent in 2021, mainly due to foreign investments as well as normalizing tourism and other economic activities. However, the slow global recovery, coupled with continued trade restrictions, economic scarring from the slowdown, and the high debt burden may continue to affect growth.

Introduction

“As in countries around the world, COVID-19 has had an unprecedented impact on Sri Lanka's economy and people's livelihoods. But we are already seeing positive signs as the country enters the recovery phase,” said Faris H. Hadad-Zervos, the World Bank Country Director for Maldives, Nepal and Sri Lanka. “Through an enhanced focus on an export-oriented growth model that taps the full potential of private investment, Sri Lanka could increase its competitiveness and raise growth in a sustainable manner.”

The Update includes a special focus section, which discusses the impact of COVID-19 on poverty. With jobs lost and earnings reduced, especially in urban areas and among private sector employees and informal workers, the \$3.20 poverty rate is projected to have increased from 9.2 percent in 2019 to 11.7 percent in 2020.

The report notes that the current social protection system could support the reintegration of those who lost their jobs. It suggests that a more targeted social safety nets could help the authorities to scale up support to the poor and vulnerable quickly and effectively in times of crises. Investments in digital technologies and literacy can also help Sri Lankans find new economic opportunities.

Global Economic Crises And Implication And Prospectus

The longer-term consequences of the COVID-19 pandemic for the global economy are coming into focus. The pandemic is now recognised as having constituted the largest synchronised fall in global GDP in modern history, although its impact was quickly mitigated by governments which were guided by lessons learned from the global financial crisis in 2009. This time, governments have far more swiftly introduced stimulus programmes to counter recessionary forces. The European Union, for instance, facilitated joint debt issuance and created conditions for a powerful fiscal response to the crisis. The United States acted with very large spending packages to sustain demand and maintain income and employment. Massive government spending, however, has generated extraordinary levels of public debt. There are concerns that this could eventually trigger inflation. Prices have indeed begun to rise and interest rates may eventually follow—a trend that would have important negative consequences particularly for highly leveraged developing countries. Moreover, it is not yet clear how this mass of debt will ultimately be financed. This will remain a compelling challenge for hard-pressed governments over the medium and longer-term. There is clearly an element of systemic competition that has emerged during the current crisis, and this competition has an important strategic dimension. Several authoritarian actors have instrumentalised the pandemic partly to discredit democratic governance. China, for example, has incorporated the fight against COVID-19 into a broader national narrative of its “peaceful rise” and systemic superiority. It has sought diplomatic and public relations leverage from its contributions to the global fight against COVID-19. Countries that managed to contain the disease have also kept their economies more or less functioning, and this has invariably conferred a degree of strategic advantage. Meanwhile, the capacity to vaccinate populations quickly and to help other countries vaccinate has become a kind of diplomatic currency. Those leaders who have discounted the virus altogether have invariably learned that the disease does not follow political diktats.

The world appears slated to return to growth in 2021 albeit on a lower trajectory than was envisioned before the crisis. But there are several potential downside risks that might lead the global economy to underperform. These include: ongoing bottlenecks to global vaccination production and distribution, public anti-vaccination sentiments, the emergence of drug resistant strains of the COVID-19 virus and renewed infection surges. Debt defaults precipitated by rising interest rates could precipitate a financial market panic, which could spread rapidly given the huge debt burdens governments have assumed. Economies impaired by the recession have had to cope with shrinking tax bases and new borrowing requirements. On the upside, a ramping up of vaccination schedules could hasten the onset of so-called herd immunity, rapidly restore investor and consumer confidence, unleash pent-up demand, and thereby hasten a demand-led recovery. But developing countries require access to vaccines or this optimistic outlook will be undermined. The persistence of low interest rates and low inflation could lengthen the period in which governments are positioned to provide essential monetary and fiscal support to national economies as the green shoots of recovery take root. But there are now signs that a benign period of low interest borrowing may end sooner than was initially hoped.

What Is A Financial Crisis?

In a financial crisis, asset prices see a steep decline in value, businesses and consumers are unable to pay their debts, and financial institutions experience liquidity shortages. A financial crisis is often associated with a panic or a bank run during which investors sell off assets or withdraw money from savings accounts because they fear that the value of those assets will drop if they remain in a financial institution.

Other situations that may be labeled a financial crisis include the bursting of a speculative financial bubble, a stock market crash, a sovereign default, or a currency crisis. A financial crisis may be limited to banks or spread throughout a single economy, the economy of a region, or economies worldwide.

What Causes a Financial Crisis?

A financial crisis may have multiple causes. Generally, a crisis can occur if institutions or assets are overvalued, and can be exacerbated by irrational or herd-like investor behavior. For example, a rapid string of selloffs can result in lower asset prices, prompting individuals to dump assets or make huge savings withdrawals when a bank failure is rumored.

Contributing factors to a financial crisis include systemic failures, unanticipated or uncontrollable human behavior, incentives to take too much risk, regulatory absence or failures, or contagions that amount to a virus-like spread of problems from one institution or country to the next. If left unchecked, a crisis can cause an economy to go into a recession or depression. Even when measures are taken to avert a financial crisis, they can still happen, accelerate, or deepen.

Financial Crisis Examples

Financial crises are not uncommon; they have happened for as long as the world has had currency. Some well-known financial crises include:

- **Tulip Mania (1637)**. Though some historians argue that this mania did not have so much impact on the Dutch economy, and therefore shouldn't be considered a financial crisis, it did coincide with an outbreak of bubonic plague which had a significant impact on the country. With this in mind, it is difficult to tell if the crisis was precipitated by over-speculation or by the pandemic.
- **Credit Crisis of 1772**. After a period of rapidly expanding credit, this crisis started in March/April in London. Alexander Fordyce, a partner in a large bank, lost a huge sum shorting shares of the East India Company and fled to France to avoid repayment. Panic led to a run on English banks that left more than 20 large banking houses either bankrupt or stopping payments to depositors and creditors. The crisis quickly spread to much of Europe. Historians draw a line from this crisis to the cause of the Boston Tea Party—unpopular tax legislation in the 13 colonies—and the resulting unrest that gave birth to the American Revolution.
- **Stock Crash of 1929**. This crash, starting on Oct. 24, 1929, saw share prices collapse after a period of wild speculation and borrowing to buy shares. It led to the Great Depression, which was felt worldwide for over a dozen years. Its social impact lasted far longer. One trigger of the crash was a drastic oversupply of commodity crops, which led to a steep decline in prices. A wide range of regulations and market-managing tools were introduced as a result of the crash.

- **1973 OPEC Oil Crisis.** OPEC members started an oil embargo in October 1973 targeting countries that backed Israel in the Yom Kippur War. By the end of the embargo, a barrel of oil stood at \$12, up from \$3. Given that modern economies depend on oil, the higher prices and uncertainty led to the stock market crash of 1973–74, when a bear market persisted from January 1973 to December 1974 and the Dow Jones Industrial Average lost 45% of its value.
- **Asian Crisis of 1997–1998.** This crisis started in July 1997 with the collapse of the Thai baht. Lacking foreign currency, the Thai government was forced to abandon its U.S. dollar peg and let the baht float. The result was a huge devaluation that spread to much of East Asia, also hitting Japan, as well as a huge rise in debt-to-GDP ratios. In its wake, the crisis led to better financial regulation and supervision.
- **The 2007-2008 Global Financial Crisis.** This financial crisis was the worst economic disaster since the Stock Market Crash of 1929. It started with a subprime mortgage lending crisis in 2007 and expanded into a global banking crisis with the failure of investment bank Lehman Brothers in September 2008. Huge bailouts and other measures meant to limit the spread of the damage failed and the global economy fell into recession.

The Global Financial Crisis

As the most recent and most damaging financial crisis event, the Global Financial Crisis, deserves special attention, as its causes, effects, response, and lessons are most applicable to the current financial system.

Loosened Lending Standard-

A financial crisis can take many forms, including a banking/credit panic or a stock market crash, but differs from a recession, which is often the result of such a crisis.

The crisis was the result of a sequence of events, each with its own trigger and culminating in the near-collapse of the banking system. It has been argued that the seeds of the crisis were sown as far back as the 1970s with the Community Development Act, which required banks to loosen their credit requirements for lower-income consumers, creating a market for subprime mortgage of subprime mortgage debt, which was guaranteed by Freddie Mac and Fannie Mae, continued to expand into the early 2000s when the Federal Reserve Board began to cut interest rates drastically to avoid a recession. The combination of loose credit requirements and cheap money spurred a housing boom, which drove speculation, pushing up housing prices and creating a real estate bubble

Complex Financial Instruments

In the meantime, the investment banks, looking for easy profits in the wake of the dot-com bust and 2001 recession, created collateralized debt obligations (CDOs) from the mortgages purchased on the secondary market. Because subprime mortgages were bundled with prime mortgages, there was no way for investors to understand the risks associated with the product. When the market for CDOs began to heat up, the housing bubble that had been building for several years had finally burst. As housing prices fell, subprime borrowers began to default on loans that were worth more than their homes, accelerating the decline in prices.

Failures Begin, Contagion Spreads

When investors realized the CDOs were worthless due to the toxic debt they represented, they attempted to unload the obligations. However, there was no market for the CDOs. The subsequent cascade of subprime lender failures created liquidity contagion that reached the upper tiers of the banking system. Two major investment banks, Lehman Brothers and Bear Stearns, collapsed under the weight of their exposure to subprime debt, and more than 450 banks failed over the next five years.

Several of the major banks were on the brink of failure and were rescued by a taxpayer-funded bailout.

Response-

The U.S. Government responded to the Financial Crisis by lowering interest rates to nearly zero, buying back mortgage and government debt, and bailing out some struggling financial institutions. With rates so low, bond yields became far less attractive to investors when compared to stocks. The government response ignited the stock market, which went on a 10-year bull run with the S&P 500 returning 250% over that time. The U.S. housing market recovered in most major cities, and the unemployment rate fell as businesses began to hire and make more investments

New Regulations

One big upshot of the crisis was the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act, a massive piece of financial reform legislation passed by the Obama administration in 2010. Dodd-Frank brought wholesale changes to every aspect of the U.S. financial regulatory environment, which touched every regulatory body and every financial services business. Notably, Dodd-Frank had the following effects:

- More comprehensive regulation of financial markets, including more oversight of derivatives, which were brought into exchanges.
- Regulatory agencies, which had been numerous and sometimes redundant, were consolidated.
- A new body, the Financial Stability Oversight Council, was devised to monitor systemic risk.
- Greater investor protections were introduced, including a new consumer protection agency (the Consumer Financial Protection Bureau) and standards for "plain-vanilla" products.
- The introduction of processes and tools (such as cash infusions) is meant to help with the winding down of failed financial institutions.
- Measures meant to improve standards, accounting, and regulation of credit rating agencies.

Financial Crisis FAQs What Is a Financial Crisis?

A financial crisis is when financial instruments and assets decrease significantly in value. As a result,

businesses have trouble meeting their financial obligations, and financial institutions lack sufficient cash or convertible assets to fund projects and meet immediate needs. Investors lose confidence in the value of their assets and consumers' incomes and assets are compromised, making it difficult for them to pay their debts.

What Are the Stages of a Financial Crisis?

The financial crisis can be segmented into three stages, beginning with the launch of the crisis. Financial systems fail, generally caused by system and regulatory failures, institutional mismanagement of finances, and more. The next stage involves the breakdown of the financial system, with financial institutions, businesses, and consumers unable to meet obligations. Finally, assets decrease in value, and the overall level of debt increases.

Here's A Look At Key Points To Understand About This Crisis

What is happening in Sri Lanka?

The island's foreign reserves have hit rock bottom, with commercial banks unable to secure dollars to finance imports of food, fuel and medicines. Sri Lanka... Sri Lanka was in a deep economic crisis when the Covid-19 pandemic hit, reducing foreign worker remittances and crippling the lucrative tourism sector -- a key source of dollars for the economy. The government imposed a broad import ban in March 2020... save foreign currency. The shortages pushed food prices up 25 per cent last month, with overall inflation at 17.5 per cent -- the fifth consecutive monthly record high. Sri Lanka is also facing five-hour rolling electricity blackouts as thermal generators have run out of fuel. Three international rating agencies have downgraded the island since late last year, on fears it may not be able to service its \$51 billion sovereign debt. The International Monetary Fund (IMF) in an analysis, pointed out that the country's "debt overhang," along with persistent fiscal and balance-of-payments shortfalls, "will constrain growth and jeopardise macroeconomic stability in both the near and medium term".

"Based on staff analysis, the fiscal consolidation necessary to bring debt d... down to safe levels would require excessive adjustment over the coming years, pointing to a clear solvency problem," the IMF said.

Sri Lanka's debt profile

Sri Lanka has to repay about \$4 billion worth of debt this year, including a \$1 billion international sovereign bond maturing in July. But its reserves dipped to \$2.31 billion as of end February, down around 70 per cent from...

The country, through repeated cycles of borrowing since 2007, has piled up \$11.8 billion worth of debt through sovereign bonds (ISB), which makes up the largest part - or 36.4 per cent - of its external debt. The Asian Development Bank (ADB) is in se... second place with a 14.3 per cent share, having lent \$4.6 billion. Japan is at 10.9 per cent and China at 10.8 per cent, with each having lent about \$3.5 billion each.

The China debt connection-

China is Sri Lanka's fourth-biggest lender, behind international financial markets, the Asian Development Bank (ADB) and Japan. Over the last decade China has lent Sri Lanka more than \$5 billion for the construction of highways, ports, an airport and a coal power plant.

But critics say the funds were used for white elephant projects with low returns, which China has denied. President Gotabaya Rajapaksa asked China to help restructure debt repayments when he met Chinese Foreign Minister Wang Yin in January, but China is yet to respond to the request.

Repayments to China are estimated at about \$400-\$500 million, a finance ministry source told Reuters.

Before the pandemic, China was Sri Lanka's main source of tourists and the island imports more goods from China than from any other country.

Sri Lanka is a key part of China's Belt and Road Initiative (BRI), a long-term plan to fund and build infrastructure linking China to the rest of the world, but which others including the United States have labelled a "debt trap" for smaller nations.

What do experts say?

Some experts believe Sri Lanka should restructure its debt and establish a three-year repayment structure. Doing so would save precious dollars and lessen the burden on Sri Lankan citizens who are facing shortages of imported goods such as milk powder, gas and fuel. "Sri Lanka is unreasonably committed to repaying its debt. It is more prudent to press pause on debt repayment and take care of critical economic needs," Verité Research Executive Director and Economist Dr. Nishan de Mel said.

Fitch estimates the Sri Lankan central bank will also need to arrange for \$2.4 billion to help state-owned and private firms in the country honour the debt obligations they have in 2022, over and above the \$4.5 billion central government debt. The country debt...

The country also needs around \$20 billion for essential imports such as fuel, food and intermediate goods for exports.

Reserves have been at a critical level for months but grew to \$3.1 billion at the end of December boosted by a \$1.5 billion yuan currency swap from China.

What caused the economic crisis?

Experts say the crisis has been years in the making, driven by a little bad luck and a lot of government mismanagement.

Over the past decade, the Sri Lankan government has borrowed vast sums of money from foreign lenders to fund public services, said Murtaza Jafferjee, chair of Colombo-based think tank Advocata

Institute.

This borrowing spree has coincided with a series of hammer blows to the Sri Lankan economy, from both natural disasters -- such as heavy monsoons -- to man-made catastrophes, including a government ban on chemical fertilizers that decimated farmers' harvests.

These problems were compounded in 2018, when the President's dismissal of the Prime Minister sparked a constitutional crisis; the following year, when hundreds of people at churches and luxury hotels were killed in the 2019 Easter bombings; and from 2020 onwards with the arrival of the Covid-19 pandemic

What does this mean for people on the ground?

For Sri Lankans, the crisis has turned their daily lives into an endless cycle of waiting in lines for basic goods, many of which are being rationed.

In recent weeks, shops have been forced to close because they can't run fridges, air conditioners or fans. Soldiers are stationed at gas stations to calm customers, who line up for hours in the searing heat to fill their tanks. Some people have even died waiting.

What's happening with the protests

Protesters in Colombo took to the streets in late March, demanding government action and accountability. Public frustration and anger erupted on March 31, when demonstrators hurled bricks and started fires outside the President's private residence. Police used tear gas and water cannons to break up the protests, and imposed a 36-hour curfew afterward. President Rajapaksa declared a nationwide public emergency on April 1, giving authorities powers to detain people without a warrant, and blocked social media platforms.

But protests went ahead the next day in defiance of the curfew, prompting police to arrest hundreds of demonstrators.

Protests have continued in the days since, though they remained largely peaceful. On Tuesday night, crowds of student protesters surrounded Rajapaksa's residence again, calling for his resignation.

The emergency ordinance was revoked on April 5.

What has the government said?

President Rajapaksa issued a statement Monday but did not directly address the resignations, only urging all parties to "work together for the sake of all the citizens and future generations."

"The current crisis is a result of several economic factors and global developments," the statement read. "As one of the leading democratic countries in Asia, solutions should be found to this within a democratic framework."

Later that day, when announcing the cabinet reshuffle, the President's office released a statement saying Rajapaksa "sought the support of all the people to overcome the economic challenge faced by the country."

Previously, Rajapaksa has said he is attempting to resolve the issue, saying in an address to the nation last month that "this crisis was not created by me."

What's next?

Sri Lanka is now seeking financial support from the IMF and turning to regional powers that may be able to help.

During last month's address, President Rajapaksa said he had weighed the pros and cons of working with the IMF and had decided to pursue a bailout from the Washington-based institution something his government had been reluctant to do.

Sri Lanka has also requested help from China and India, with New Delhi already issuing a credit line of

\$1 billion in March - but some analysts warned that this assistance might just prolong the crisis rather than solve it.

There is still much uncertainty around what comes next; national consumer price inflation has almost tripled, from 6.2% in September to 17.5% in February, according to the country's central bank. And Sri Lanka has to repay about \$4 billion in debt over the rest of this year, including a \$1 billion international sovereign bond that matures in July.

India Aiding The Food And Energy Security To Sri Lanka's Economic Crisis:

1. Recently, India and Sri Lanka agreed to a four-pronged approach to discuss initiatives on food and energy security to help mitigate Sri Lanka's economic crisis.
2. Earlier in 2021, Sri Lanka declared an economic emergency amid rising food prices, a depreciating currency, and rapidly depleting forex reserves.
3. The country's heavy dependence on imports for essential goods like sugar, pharmaceuticals, fuel, pulses and cereals worsened the crisis.
4. The government's ban on chemical fertilizers last April as it looked to become the first country to fully adopt organic farming backfired.
5. A survey showed that 90% of Sri Lanka's farmers used chemical fertilisers for cultivation.
6. The move led to a drastic drop in domestic food production, pushing up food prices.
7. The decision was rolled back after months of mass protests by farmers but the damage was done.
8. Food inflation soared to 25.7% in February. The crisis is now starting to impact Indian exporters.
9. Thousands of containers sent from India to Sri Lanka, including for its own consumption as well as trans-shipment cargo, have been lying uncleared at Colombo port as authorities can't afford to transfer containers between terminals.
10. This, in turn, has led to some build-up of cargo intended for Sri Lanka at Indian ports. India also relies considerably on Colombo port for global trade given it is a transshipment hub.
11. 60% of India's trans-shipment cargo is handled by the port. India-linked cargo, in turn, accounts for 70% of the port's total trans-shipment volume

Sri Lanka Economic Crisis Solution

In a December speech in Parliament, MP de Silva said that the “only one way” to get the country out of the current crisis is to request help from the International Monetary Fund (IMF).

He said that domestic measures would be ineffective and that only the International Monetary Fund (IMF) could assist in rebuilding the country’s economy.

Udith Jayasinghe, the Agriculture Secretary, also warned reporters in late December that the government may have to seek international assistance to help feed the poor and hungry.

“We may need to borrow crops from friendly nations, such as maize, and consider rationing food to ensure pregnant women and those with illnesses are fed. Others may be required to make concessions.” He stated this only hours before another government official removed him.

According to the AFP news agency, his dismissal was not explained by the president’s administration. On the other hand, the central bank issued a request for foreign cash, including any loose change that individuals may have with them after returning from in. It had previously restricted dealers from exchanging more than 200 Sri Lankan rupees for a US dollar and engaging in forwarding currency contracts earlier in the calendar year. Since then, the administration has instituted interim measures to alleviate the situation.

How Did Sri Lanka Reach This Economic Precipice?

Sri Lanka was under a civil war from 1983-2009 where the economy barely made any progress. In

the **period from 1970 to 2020, the share of** agriculture declined from 28 percent of GDP to 7.7 percent, the share of industry has remained stagnant at 17-19 percent, and the share of services has risen from 54 percent to 73 percent. Within services, share of trade, hotels and transport has comprised 30-35 percent of GDP.

The economy is highly-dependent on imports for essential items such as food, and oil. The economy finances these imports mainly via agricultural exports (tea, rubber, and coconut), industrial products (textiles), and remittances from abroad. The revenues from exports, and remittances have not covered the cost of imports, and Sri Lanka has always been in a current account deficit (CAD). The average CAD in 2010-19 was around 1.2 percent of GDP.

The CAD has been met mainly by the government borrowing from abroad. As the government borrowing from abroad has been larger than the CAD, the balance has been pegged to the foreign exchange reserves. What can one make of an economy where the forex reserves consist of mainly borrowings from abroad!

Apart from a large CAD, the government also ran large fiscal deficits. The average fiscal deficit in 2011-20 has been **~6.2 percent of GDP**. The government was financing fiscal deficits through both domestic and foreign sources. As foreign sources dried up, it resorted to borrowing domestically by issuing bonds and taking advances from The Central Bank of Sri Lanka. The

government also

lowered tax rates to check high tax evasion.

The twin deficit Sri Lankan economy was under enormous pressure in the 2010-19 period, but somehow managed to run the show. The conditions were ripe for an economic wildfire, and all that was needed was a spark.

In 2020, COVID-19 was more than a spark, and completely sucked out the air from the Sri Lankan economy. The pandemic led to a global recession curtailing global demand. Sri Lanka's exports dipped and imports (mainly goods for survival) went up, and adding to this Sri Lanka's tourism sector came to a grinding halt. The GDP declined by 3.5 percent, the CAD touched 7.9 percent of GDP, and the fiscal deficit climbed to 11.1 percent.

Before the economy could stabilize, in April 2021 the government decided to stop the use of chemical fertilizers and go 100 percent organic. While the intentions cannot be questioned, it's the timing that matters. At ~2 percent of the import bill, fertilizers is a marginal expense. This shift in an important sector such as agriculture pushed inflation from 5.7 percent in July 2021 to 15 percent in February 2022.

The Sri Lanka official reserves as of end January 2022 was provisionally estimated at \$2.4 billion, equivalent to 1.3 months of imports. The country is struggling to import oil, and is facing power cuts for **more than 10 hours per day**. The central bank is firefighting the crisis by raising policy rates, and has also asked the government to take measures to improve its finances. The Russia-Ukraine war only added to woes as tourists from Russia and Europe could not travel to Sri Lanka. Sri Lanka's economic crisis reminds one of India in 1991. The seeds of India's 1991 economic crisis were sown in the 1980s when we saw a rise in both fiscal deficits and current account deficits. Unlike Sri Lanka today, India followed a highly-restrictive trade policy where forex reserves were scarce due to policy design. By 1989-90, on the eve of the crisis, India's forex reserves had declined, and were equivalent to just 1.9 months of imports. The economy was precariously placed, and the West Asian oil crisis acted as a shock for the economy.

Thirty-one years later, Sri Lanka is in a similar economic situation. However, there is one key difference: While New Delhi had leaders such as (late) PV Narasimha Rao and Manmohan Singh to rely on, there are none visible so far in Colombo. Public anger is largely towards the Rajapaksas (and rightly so, because seven family members are part of the government, including President, Prime Minister and Finance Minister). In this regard, Sri Lanka's economic crisis is a lot like the Arab Spring during the beginning of the last decade, where people protested against leaders in the backdrop of an economic crisis

Sri Lanka's economic crisis, yet again, draws attention to politics in South Asia. Questions are being raised about Sri Lanka heavily relying on China, and Beijing's 'debt trap' politics (the effects of which are now also being discussed in many African countries). Pakistan, an of India's neighbours and China's 'all-weather friend', is undergoing a political and economic turmoil.

Amidst all these developments, India stands out as a ray of hope for keeping its economic buoyancy stable despite testing times.

Shri Lankas Economic Crisis Poses Challenges For India-

Our Neighbourhood First policy had led to increased economic cooperation with Sri Lanka but its economy is in deep trouble and India's relations with it have taken a turn for the worse this year.

India's 'Neighbourhood First' policy towards Sri Lanka had resonated with Sri Lanka's 'India First' foreign and security policy in 2020. India is Sri Lanka's third largest export destination, after the US and UK. More than 60% of Sri Lanka's exports enjoy the benefits of the India-Sri Lanka Free Trade Agreement, which came into effect in March 2000. India is also a major investor in Sri Lanka. India's development partnership with Colombo has always been demand-driven, with projects covering social infrastructure like education, health, housing, access to clean water and sanitation, besides industrial development. Concessional financing of about \$ 2 billion has been provided to Sri Lanka through various Indian government-supported Lines of Credit across sectors (for railway connectivity, infrastructure, supply of defence equipment, security, and counter-terrorism and solar projects, among others). Foreign direct investment (FDI) from India amounted to around \$ 1.7 billion over the years from 2005 to 2019 and went into retail petroleum, hotels and tourism, real estate and manufacturing, apart from telecom, banking and financial services.

However, relations between the two neighbours seem to have plummeted since the beginning of this year. In February, Sri Lanka backed out from a tripartite partnership with India and Japan for its East Container Terminal Project at the Colombo Port, citing domestic issues. Later, the West Coast Terminal was offered under a public private partnership arrangement to Adani Ports and Special Economic Zones Ltd

Last July, the Reserve Bank of India (RBI) had signed a currency-swap agreement with the Central Bank of Sri Lanka (CBSL) under the Saarc Currency Swap Framework 2019-22, for withdrawals of up to \$400 million. The CBSL settled the scheduled facility with RBI in February 2021. Even though the agreement was valid till 13 November 2022, India declined any further renewal of it in the absence of an International Monetary Fund programme to address Sri Lanka's current macroeconomic imbalances

On 31 August 2021, Sri Lanka declared a state of economic emergency, as it is running out of foreign exchange reserves for essential imports like food. The CBSL was the first Asian central bank to increase policy rates after the covid pandemic in response to rising inflation in August 2021 caused by currency depreciation. Tourism, a big dollar earner for Sri Lanka, has suffered since the Easter Sunday terror attacks of 2019, followed by the pandemic. Earnings fell from \$3.6 billion in 2019 to \$0.7 billion in 2020, even as FDI inflows halved from \$1.2 billion to \$670 million over the same period.

Sri Lanka's fragile liquidity situation has put it at high risk of debt distress. Its public debt-to-GDP ratio was at 109.7% in 2020, and its gross financing needs remain high at 18% of GDP, higher than most of its emerging economy peers. Following an international sovereign bond settlement of \$1 billion in July 2021, its gross official reserves slipped to \$2.8 billion, which is equivalent to just 1.8 months of imports. The external debt-to-GDP ratio stood at 62% in 2020 and is predominantly owed by its public sector.

More than \$2.7 billion of foreign currency debt will be due in the next two years

Sri Lanka's economic crisis may further push it to align its policies with Beijing's interests. This comes at a time when India is already on a diplomatic tightrope with Afghanistan and Myanmar. Other South Asian nations like Bangladesh, Nepal and the Maldives have also been turning to China to finance large-scale infrastructure projects. Nurturing the Neighbourhood First policy with Sri Lanka will therefore be important for India, albeit with due caution, to preserve its strategic interests in the Indian Ocean region. The Colombo port is crucial for India as it handles 60% of India's trans-shipment cargo. Regional platforms like the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation and the Indian Ocean Rim Association could be leveraged to foster cooperation in common areas of interest like technology-driven agriculture and marine sector development, IT and communication infrastructure, renewable energy, and transport and connectivity. Both countries could also cooperate on enhancing private sector investments to create economic resilience.

Colombo Battling With High Debt And Low Foreign Exchange Reserves

However, the problem did not start in 2020. Since the end of ethnic war in 2009, the island nation is struggling to keep its economy afloat. It started taking up loans and issuing bonds to keep its foreign exchange reserves intact. In 2018, it took debt worth \$1 billion from China. Sri Lanka leased its Hambantota port to China which helped it to boost foreign currency reserves and bridge its fiscal deficit.

In April 2020, after the pandemic hit, it took another \$500 million loan from Beijing in order to strengthen its forex reserves. It also upsized that loan. India has also helped the country to finance its essential needs. India offered \$ 1 billion in credit lines to supply essential commodities for procurement of food, medicine and other essential items. In February, it signed a \$500 million credit line with India to import fuel

The country relies heavily on tourism revenues. In fact tourism accounts for 10% of its GDP. But attacks in the country in 2019 dented its tourism sector. Tourism dropped by 50% after the Easter bombings.

And to add to the fire, with the pandemic hitting the world, tourism further came to a standstill. "Since early 2020, the Sri Lankan economy has suffered significant losses in foreign exchange earnings; revenue from tourism alone dropped by \$3 billion over the first eight months of 2021, compared with the same period in 2018," according to Asian Development Bank report.

Sri Lanka, through repeated cycles of borrowing since 2007, has piled up \$11.8 billion worth of debt through ISBs, which makes up 36.4% of its external debt, according to a Reuters report. While, Foreign direct investment (FDI) into Sri Lanka decreased to \$548 million in 2020, compared to \$793 million in 2019 and \$1.6 billion in 2018, according to the International Trade Administration.

Global Rating Agencies Cut Sri Lanka's Sovereign Rating To Junk

Amid its balance of payment crisis, global rating agencies such as Moody's, S&P and Fitch have all downgraded Sri Lanka's sovereign ratings. In January, S&P Global Ratings cut Sri Lanka's sovereign credit rating deeper into "junk" territory, to 'CCC' with a negative outlook, citing rising repayment pressures and "uneven access" to financing. Last year both Fitch and Moody's downgraded Sri Lanka's sovereign ratings to junk category on increased probability of a default event in coming months.

Fitch said it downgraded Sri Lanka in the light of Sri Lanka's worsening external liquidity position, underscored by a drop in foreign-exchange reserves set against high external debt payments and limited financing inflows. While Moody's said last year, the country had failed to come up with a comprehensive debt repayment plan.

Why Is Colombo Not Seeking IMF's Help To Restructure Its Debt?

Sri Lanka has so far relied on loans from countries such as China, India, and Japan, and institutions such as the Asia Development Bank and World Bank. Though rating agencies as well as experts suggest that the way out for Sri Lanka is to seek debt restructuring from the International Monetary Fund (IMF), which the country has refused to do so far. This is because if the country agrees to get its debt restructured, it would have to comply with IMF directives on increasing income tax and having an independent central bank. However, last week, Sri Lanka said it will work with the IMF to take action to increase its foreign exchange reserves. The central bank clarified that help would not be in the form of debt restructuring. "I have decided to work with them after examining the advantages and disadvantages," the country's President Gotabaya Rajapaksa said in an address to its 220 lakh people, according to Reuters.

Conclusion

"We must take action to increase our foreign exchange reserves. To this end, we have initiated discussions with international financial institutions as well as with our friendly countries regarding repayment of our loan installments," he added.

"The outlook (of Sri Lanka) is subject to large uncertainties with risks tilted to the downside. Unless the fiscal and balance-of-payments financing needs are met, the country could experience significant contractions in imports and private credit growth, or monetary instability in case of further central bank financing of fiscal deficits," the IMF said earlier this month