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## **SRI LANKAN ECONOMY COLLAPSE TRIFACTOR: IMPACT OF THE PANDEMIC, POOR GOVERNANCE, AND UKRAINIAN-RUSSIA WAR**

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### **ABSTRACT**

Sri Lanka is currently experiencing an ongoing economic crisis that began in 2019. The nation is experiencing its biggest economic crisis since gaining independence in 1948. Unprecedented levels of inflation, a close to complete depletion of foreign exchange reserves, a shortage of medical supplies, and an increase in the cost of essential commodities are the results. According to reports, the crisis started because of several interconnected factors, including the development of a new currency, a national initiative to switch to organic or biological farming, the Easter bombings in 2019 and the COVID-19 pandemic's effects and now the impact of the Ukraine and Russia War. Sri Lankan protests in 2022 were brought on by the ensuing economic woes. This research paper will explain the trifactor and its impact on the SriLankan economy.

### **Introduction**

A government is a group of individuals organising or controlling a country. They are elected by the people and work for the people. The main functions of a government are to provide legalities that the economy operates on, maintain competition in the market to avoid market failure, provide public goods like defence, public parks and infrastructure and more importantly take crucial decisions and actions to stabilize the economy and avoid economic crisis. A country is declared in a state of economic crisis when there is severe economic contraction, high unemployment and near bank collapse. An economic crisis can happen due to several reasons such as poor governing, natural calamities, diseases and much more. Simply all factors that contribute to the lowering of output, demand, and growth in an economy. A stable economy on the other hand is one where there are low macroeconomic fluctuations as well as constant output and relatively stable inflation. In Sri Lanka, much of the government relies on a multi-party system and much of it was formed by the Rajapaksa family. Recently there has been rising tension spread across the news and daily activities have been affected shadowing the economic

well-being of the economy. Due to a lack of fuel imports, there has been an increase in the electricity outage in Sri Lanka, additionally, cooking gas can only be supplied once a week and it is seeing a substantial 1000-rupee increase. The crisis has impacted the newspaper and printing industry, and a lack of printing material is causing the cancellation of school exams. Most importantly individuals are unable to survive with their monthly expenses for common families of 3 going up from 30,000 to 83,000 Sri Lankan rupees. Moreover, the government confirmed a 57% inflation declaring officially the collapse of the Sri Lankan economy, leaving it unable to pay for essentials. These tensions and impacts are a result of an economic trifactor.

In this paper, I will look at the economic collapse trifactor which includes the effect of the pandemic, government decisions and the recent Ukraine-Russia war. I will evaluate the pandemic scenario and its effect on the daily economic habits of individuals, the government decision and their sudden impact and the Ukraine-Russian war which added adversity making the costs of importing essential goods like fuel more expensive.

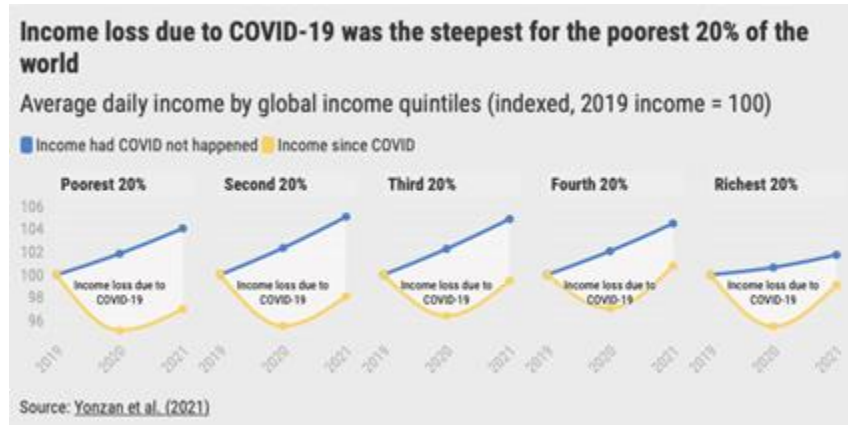
### **Pandemic: First Factor**

The Covid-19 pandemic originated in a Chinese city called Wuhan. In Wuhan, China, the virus first surfaced on a limited scale in November 2019, followed by the first significant cluster in December 2019. SARS-CoV-2 was initially believed to have transitioned to humans at one of Wuhan, China's outdoor "wet markets." People are now unintentionally contracting and spreading the coronavirus around the world. Covid-19 was declared a global pandemic in early 2020.

The pandemic has had a large scale impact throughout the world. Lockdowns led to decreasing economic activity, in the first four months of the pandemic there had been over 200,000 deaths. According to the United Nations, there had been a 9 per cent yearly fall in global production and manufacturing as a result. Moreover, commodity prices had fallen by 20.4% a record number. Additionally, unemployment had taken the worst hit with almost 305 million workers losing their jobs due to virus spreads, lockdowns, decrease in demand for goods and shutdowns of companies due to losses.

The following discussed are the more largescale impacts that affected households. Firstly, there had been excessive losses of income for the poorest 40%. Figure 1 shows the projected incomes for different households and how their incomes were shaped after covid.

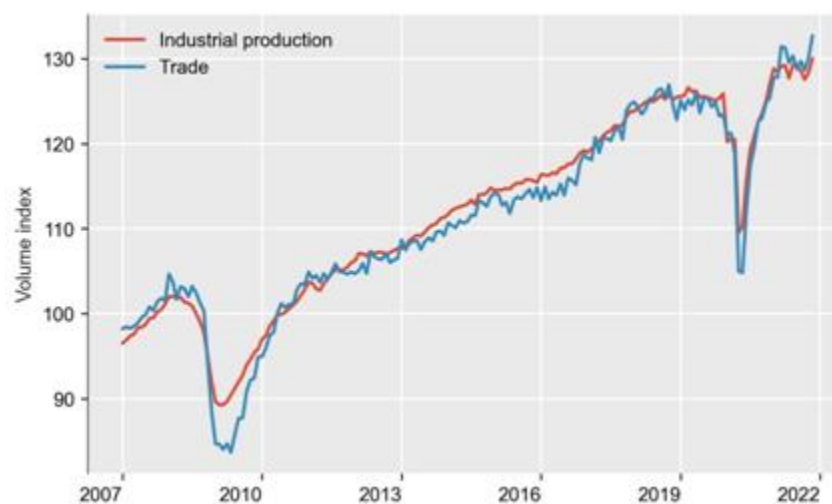
**Figure 1: Income Losses due to Covid-19**



Source: Yonzan et al. 2021

As seen in Figure 1 the richer households were affected relatively less as compared to the lower income bracket group. The income since covid shows a quicker recovery for the rich. In Sri Lanka, 42% of people are poor or live under \$5.50 a day (Macrotrends). Not only in Sri Lanka but worldwide a lack of jobs, office work and in general employment took a hit, it was challenging for individuals to earn and survive and more importantly this under spending caused the GDP to take a massive hit across the globe.

**Figure 2: Industrial production and trade**

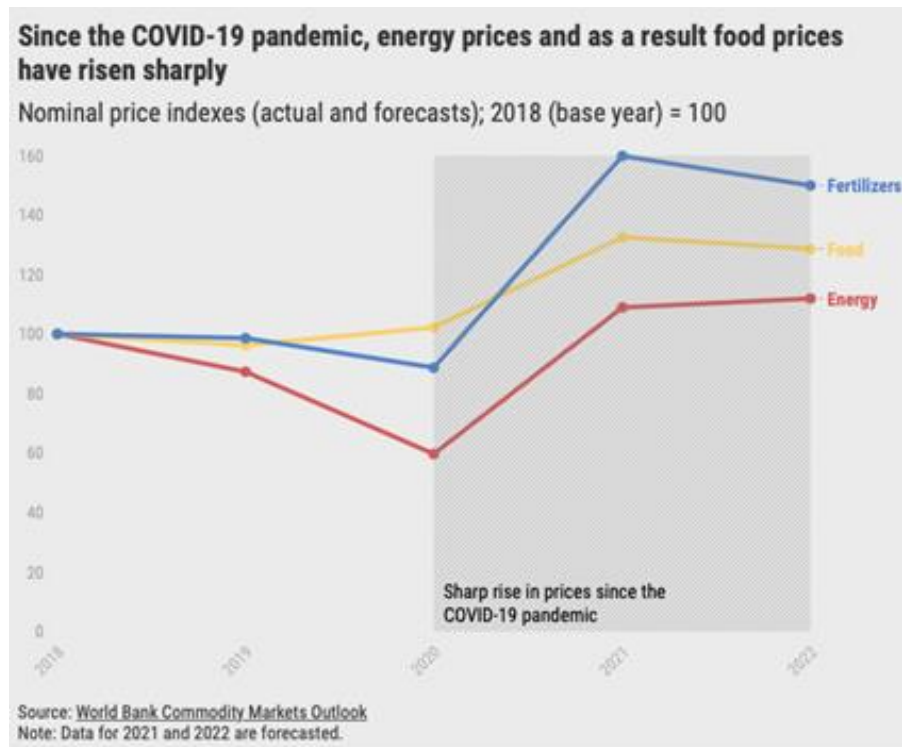


Source: OECD

Trade and Industrial production were other sectors that took a hit during the pandemic. Trade is important to importing good that is essential or cheaper from other countries, not doing so increase the gap between demand and supply leading to high pricing. For example, if oil is imported from Saudi Arabia to Sri Lanka and trade decreases due to Covid the prices of oil increase due to scarcity. Figure 3, released by the OECD, reveals the drop in trade and industrial production in 2020. Similarly, a decrease in Industrial production leads to declining jobs, goods, and services and in the general circulation of money in the economy. This may lead to an undesirable outcome like cost-push or demand-pull inflation which means a rise in prices due to excessive costs to suppliers or excessive demand by consumers. This is one factor that explains Sri Lanka's 57% inflation whereas the desirable inflation is 4% and below.

Commodities are raw materials used in the production to manufacture final goods (The balance) for example oil, sugar, rice, and fuel. Commodity pricing had been affected by the pandemic. Figure 3 reveals this.

**Figure 3: Commodity pricing**



Source: World Bank Commodity Markets Outlook

High commodity costs again were due to the supply shock and labour to produce these items. Essentially as many were not working there was underproduction of commodities challenged by the high demand and this led to an increased price to match the demand of consumers. This affected the production of many final goods and services and acted as a ripple effect nearly everywhere. In addition to this the government has spent more of their money investing in hospitals – high opportunity cost for spending buffer stocks and commodity production – and preparing healthcare facilities to treat the unwell there are untrained staff and the training required for doctors is costly and time-consuming.

One of the main reasons for the loss of revenue or declining GDP is the service sectors involved with tourism in Sri Lanka which accounts for approximately 57.52 per cent of the GDP (Statista). As the pandemic discourage or made travelling difficult for everyone the services sector in Sri Lanka took a hit and a large share of its GDP was hurt.

The discussed are some of the factors that cause minor economic shocks around the world factors such as supply shocks prices of goods increased and exponential decay in jobs has led to household struggles to purchase goods and services. Moreover, a decreased GDP, payroll and shutdowns have happened because of the pandemic. This is the first factor that contributed to the collapse of the Sri Lankan economy.

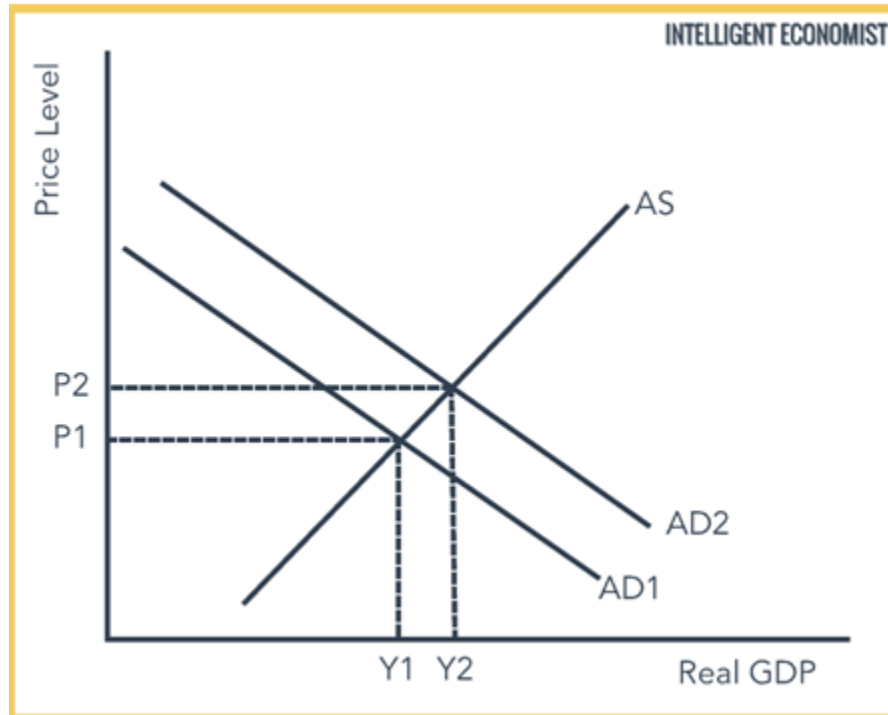
### **Government Decisions: Second Factor**

The Sri Lankan government made some undesirable decisions that added weight to the disruption of the pandemic leading to an economic downfall. Here, I will look at the half vat fiscal policy, public debt situation, agricultural decisions, black markets as well at the pyramid debt or borrowing situation

#### **1. Fiscal policy: Tax reduction**

Firstly, in an attempt to recover from the Covid-19 pandemic and spur growth the government decided to employ a fiscal policy wherein the VAT tax was decreased from 15% to 8%. Essentially when a tax is reduced it leads to an increase in the disposable income or actual pre-tax money available to spend. With this individuals have a higher propensity to consume and therefore increase their spending on more goods and services. This leads to a rightward shift in aggregate demand as shown in the figure below.

**Figure 4: Fiscal policy aim**



Source: Inteligent economist

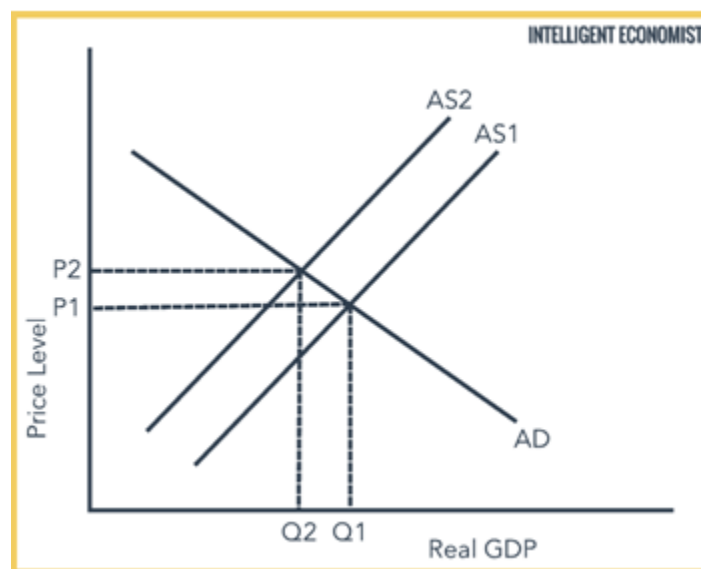
On figure 4 at P1 and Y1, the equilibrium is originally presumed. Real GDP rises from Year 1 to Year 2 as a result of an increase in aggregate demand, but at the expense of an increase in the rate of inflation. It demonstrates that growth can be boosted when inflation rises. In theory, this is what the policy leads to and the case was the opposite in Sri Lanka. Due to a lack of consumer and business confidence, there was no substantial increase in spending and the GDP had barely been affected it had dropped to 7.7% from 9.1% in 2020. With this being said, the government revenue took a large toll on taxpayers decreasing from 1,550,000 to just over 400,000 people which reflects in their spending habits as well. After this calamity Finance Minister Sabri realised called this a ‘historic mistake, he said that the tax percentage should have been increased so that they could support people after the pandemic. (Economic Times). This was one decision that the government made and it weakened their economy

2. The decision to ban fertilisers for sustainable agriculture

Another decision that the government made and I believe is incorrect or undesirable at the time of pandemic recovery. The government made a stand on chemical-free farming and instantly banned fertilisers even after discouragement from food scientists in Sri Lanka (Al Jazeera).

Aiming to achieve natural farming the government wanted to use organic alternatives. This supply stoppage caused essential crops to not grow properly, which led to a shortage of essential goods a loss of money for farmers and more importantly protests. Amidst this fight, the government still didn't pay attention to this and instead blamed other political parties. This self-interest led to avoiding and taking instant action as well as affection the primary sector of a developing economy.

**Figure 5: Supply shock diagram**



Source: Inteligent economist

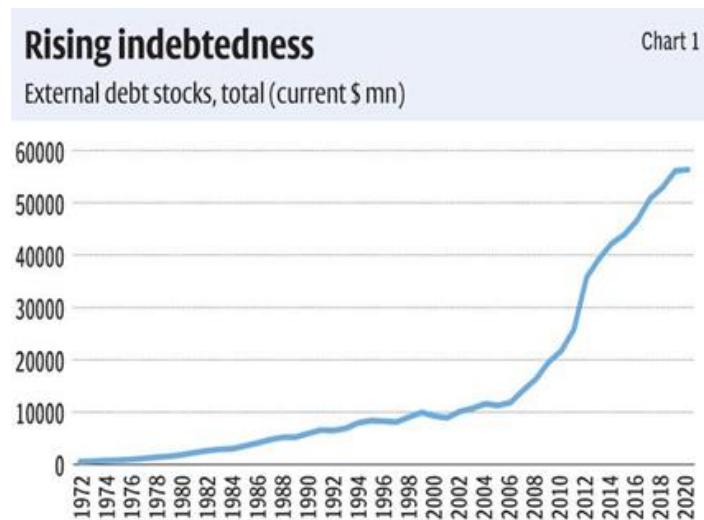
Figure 5 shows the supply shock due to this overnight decision of banning a key element of farming. This causes the AS1 to shift leftward towards AS2. This causes a decrease in the quantity in this case crops and increases the price as well. The prices of crops increase substantially and only some people can afford this essential good. Moreover, this leads to the formation of black markets for crops. This cost-push inflation due to shortage, market failure and protests all impacted the GDP of the agriculture dependant nation.

### 3. Pyramid debt and foreign reserves

A huge part of the economic collapse was due to the depletion of foreign reserves and the way that the Sri Lankan government handled its foreign debt. A smart way to make and spend money but very wrong employed led to the worst economic crisis ever. The government's decision of borrowing does not reflect the previously discussed government's role of working for the people. Sri Lanka currently has debt that is 119% of its GDP and this is because imports are more than

exports therefore spending is higher than on these imports and they are in a trade deficit or owe money. Most countries run deficits, and it is not bad, they borrow to make up for this, however, for years Sri Lanka has been employing a pyramid scheme where in they take loans topay old pending ones and this trap had to capture them off guard one day. Sri Lanka to date spends 83% of its revenue paying off loans.

Figure 6: Sri Lankan debt



The diagram above reveals the rise in indebtedness even in a time of low government revenue through taxes and decreasing aggregate demand. Knowing this, the government shouldn't have increased its spending as consequently, it was going to lead to the depletion of foreign reserves through payments.

For foreign reserves, Sri Lanka was unable to continue selling bonds because it lost access to international markets. It had lost a significant supply of foreign currency that was necessary for making debt payments. Sri Lanka began to deplete its stockpile. This led to yet another issue because paying for imports—all the goods that governments buy from other countries—is the second major way that they use their foreign currency. The Sri Lankan government began limiting the importation of some products, including furniture, wine, and mobile phones, to prevent its foreign reserves from being too depleted. However, during the pandemic time, the demand for such goods was still there and I believe that this led to protests and further unnecessary money spent to calm the protests. \$7.9 Billion reserves in 2019 fell to \$1.6 Billion in 2021, Due to this Sri Lanka's Central bank overvalued their money to maintain that artificial exchange rate to maintain economic well-being and make imports less expensive.



These decisions, borrowing, overspending and over-valuing all led to Sri Lanka's inevitable economic collapse. Next, the external factors that compounded the issue are explained.

**External: Third Factor**

External situations like the Russia-Ukraine war and bombings were factors that added more weight to the already declining Sri Lankan economy. As discussed, commodity prices rose due to supply shocks and excessive demand, Due to the Russia-Ukraine war, there have been added impacts. Sri Lanka, an import-reliant country, imports approximately US\$274 Million worth of goods from Russia yearly and these include essentials like salt, cocoa, oils and more. The war caused disruptions in the trade channel between Russia and essentially all countries. This made resources imported resources scarce and prices rose as a result. Sri Lanka could have imported from different countries, however, this would not make up for their need as well as increased demands all over the world. Figure X represented some of the goods Sri Lanka imported in 2021 from RussiaUS\$174.46 million a drop from pre-pandemic and war.

**Figure 7: Sri Lankan imports from Russia**

Sri Lanka Imports from Russia	Value	Year
Mineral fuels, oils, distillation products	\$35.14M	2021
Iron and steel	\$31.87M	2021
Salt, sulphur, earth, stone, plaster, lime and cement	\$27.24M	2021
Cereals	\$18.46M	2021
Paper and paperboard, articles of pulp, paper and board	\$13.95M	2021
Inorganic chemicals, precious metal compound, isotope	\$12.29M	2021
Rubbers	\$7.95M	2021
Coffee, tea, mate and spices	\$4.15M	2021
Lead	\$3.98M	2021
Pearls, precious stones, metals, coins	\$3.87M	2021
Pharmaceutical products	\$3.64M	2021

Source: <https://tradingeconomics.com/sri-lanka/imports/russia>

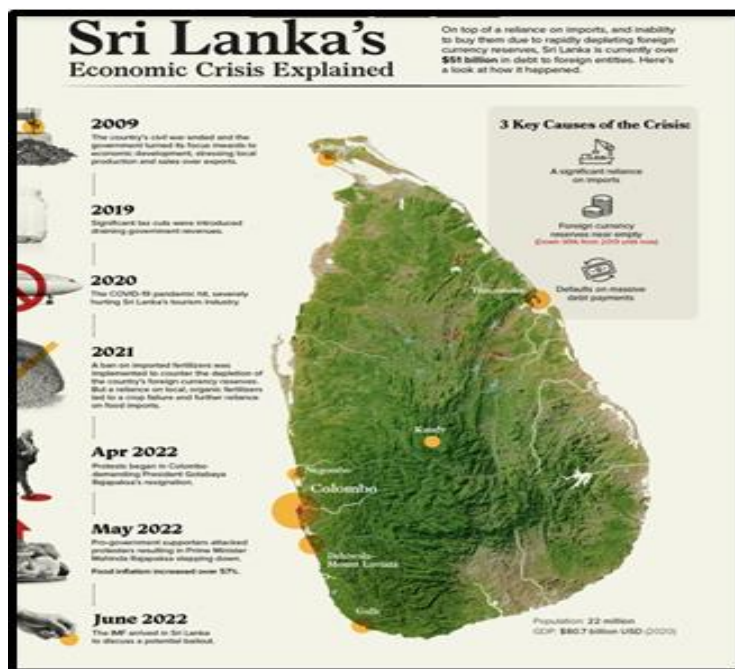
In 2020 there was an event of easter bombing in Sri Lanka. These bombings knocked out tourism over scares and as discussed, much of the Sri Lankan economy relies on tourism this act of terrorism added to the image of Sri Lanka. In this bombing out of the 269 people injured 45 were foreign nationals and hate messages began to spread on social media platforms like Facebook which essentially deleted the tourism industry. This adversely affected the image of Sri Lanka - fewer countries were willing to give aid – and its GDP was torn.

**Collective Impact, Limitations and Scope**

In this essay, the collective impact of the pandemic, government decisions, and the war factors or trifactor that led to this economic crisis have been discussed. After these unfortunate bombings and decisions hate messages have started to circulate in Sri Lanka through Facebook. This is making people lose confidence in the Sri Lankan government and its economy. For instance, the IMF or the international monetary fund have found Sri Lanka as an undesirable country to loan money to due to the political turmoil, and social media messages about Sri Lanka's ability to return loans. Moreover, investors in and out of the country have lost business confidence in the Sri Lankan economy and investing has decreased. The Rajapaksa government fled from Sri Lanka amidst all this activity. In July of 2022, their government resign and now a new government has been formed. As the news, protests and spotlight on Sri Lanka have decreased I believe everything will fall into place. Recently the IMF has agreed to loan \$ Sri Lanka 2.9Billion(IMF). Investors and individuals will work together and gain confidence in the new government. This unfortunate series of uncontrollable events demolished Sri Lanka and its economy, however, the government's decisions were the most fatal and the only factor out of the three that could have been controlled. Sadly it wasn't controlled.

## Conclusion

Figure 8: Summary infographic by visual capitalist



Infographic credit: <https://www.visualcapitalist.com/explained-the-economic-crisis-in-sri-lanka/>

In summation, the trifactor – the pandemics, series of poor government decisions and the external impacts –caused an excessive decline in the Sri Lankan economy with the consumer price index increasing by nearly 50%, drops in the GDP, the shutdown of the services sector and added impacts due to the war and bombing incidents. However, post-pandemic tourism is starting to return to normal, the situation is improving and the government should weigh out any costs and impacts before employing new policies to improve the situation. As individuals and people from different countries, it would be wise for us to donate and help out the individuals who have suffered through this roller coaster of finance and trauma.

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