

SRI LANKA

ROAD TO ECONOMIC RECOVERY

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INTRODUCTION

In September 2024, the left-leaning Anura Kumara Dissanayake was elected as the president of Sri Lanka in a watershed election—the first since the country declared bankruptcy in April 2022. Sri Lanka had plunged into an economic crisis, arguably the worst in the annals of its history, due to years of mismanagement, corruption, and weak governance. A number of internal and exogenous shocks compounded this crisis: the residual effects of the civil war that ended in 2009, the Easter bombings and sweeping tax cuts in 2019, the COVID-19 pandemic's severe impact on tourism, an abrupt shift to organic farming in 2021, and the Russia-Ukraine War, among other.

In the immediate aftermath of the 2022 economic crisis, violent protests, known as *Aragalaya* or the people's revolution, were triggered in response to shortages of food, fuel and other essential commodities, which resulted in the resignation of then-president Gotabaya Rajapaksa, with a fresh political crisis gripping the country.

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In June 2022, the United Nations warned that the dire situation in Sri Lanka could escalate into a “full-blown humanitarian emergency”, launching a US\$47.2 billion aid programme to assist 1.7 million of the country’s most affected citizens.¹ In July 2022, Rajapaksa fled the country to the Maldives, with Ranil Wickremesinghe, the six-time prime minister, taking up the reins. He brought in some measure of stability through implementing the necessary austerity measures, but given the painful nature of such reforms, Wickremesinghe was riding on a wave of unpopularity that ultimately cost him the coveted presidency.

In April 2024, the Asian Development Bank (ADB) warned that Sri Lanka’s economy could face a potential decline, citing the “uncertainty” surrounding its upcoming elections, which could put a downer on its fiscal policy and reform implementation, as seen in the run-up to previous election cycles.² As the dust settles, the new premier has much to live up to, especially since the elections were predominantly fought on economic issues, and Sri Lanka continues to face several challenges even as it is on the road to recovery. The Central Bank of Sri Lanka (CBSL) has forecast 4 per cent growth for 2024, marking a significant recovery from the -7.8 per cent Gross Domestic Product (GDP) contraction in 2022.³ On the other hand, the World Bank’s latest bi-annual report titled “South Asia Development Update” projected an expected growth rate of 2.2 per cent in 2024 and an anticipated 2.5 per cent in 2025.⁴ The report attributes this improvement to: an increase in remittances, recovery

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1. “Sri Lanka Risks Full-Blown Humanitarian Emergency, UN Agency Says”, Reuters, June 10, 2022, [https://www.reuters.com/world/asia-pacific/sri-lanka-risks-full-blown-humanitarian-emergency-un-agency-says-2022-06-10/#:~:text=GENEVA%2C%20June%2010%20\(Reuters\),\(OCHA\)%20said%20on%20Friday.&text=%22Sri%20Lanka%20is%20facing%20its,crisis%20since%20independence%20in%201948.](https://www.reuters.com/world/asia-pacific/sri-lanka-risks-full-blown-humanitarian-emergency-un-agency-says-2022-06-10/#:~:text=GENEVA%2C%20June%2010%20(Reuters),(OCHA)%20said%20on%20Friday.&text=%22Sri%20Lanka%20is%20facing%20its,crisis%20since%20independence%20in%201948.) Accessed on October 5, 2024.
 2. Uncertainty About Forthcoming Elections may Jeopardise Sri Lanka’s Economic Recovery: ADB”, *Business Today*, April 13, 2024, <https://www.businesstoday.in/latest/world/story/uncertainty-about-forthcoming-elections-may-jeopardise-sri-lankas-economic-recovery-adb-425388-2024-04-13>. Accessed on May 2, 2024.
 3. Ganeshan Wignaraja, “How President Dissanayake can Steer Sri Lanka to Economic Prosperity”, *The Indian Express*, October 1, 2024, <https://indianexpress.com/article/opinion/columns/president-dissanayake-sri-lanka-economic-prosperity-9597559/>. Accessed on October 6, 2024.
 4. The World Bank, “Sri Lanka’s Economy Shows Signs of Stabilization, but Poverty to Remain Elevated”, April 2, 2024, <https://www.worldbank.org/en/news/press->

in tourism, declining inflation, accumulation of foreign reserves, and improvement in the current account balance. The economy, however, remains plagued by elevated poverty levels, income inequality, a decline in labour force participation—particularly among women—and an increase in household debt for sustenance.

THE INTERPLAY OF FOREIGN AND ECONOMIC POLICIES

The elections were held amidst Sri Lanka's ongoing 17th agreement with the International Monetary Fund (IMF)—a 48-month Extended Fund Facility (EFF) programme worth US\$2.9 billion, aimed at stabilising its economy. Upon its approval in March 2023, the first tranche of US\$333 million was immediately disbursed, while the second tranche of US\$337 million was cleared in December 2023, followed by the third instalment of US\$336 million in June 2024. The IMF's Executive Board approved the program after receiving assurances from Sri Lanka's key bilateral creditors and sovereign bondholders that they would restructure its debt. Among them, China, as Sri Lanka's largest bilateral creditor, reached an agreement in October 2023 through its Export-Import (EXIM) Bank to restructure US\$4.2 billion of its outstanding debt.⁵ In November 2023, Sri Lanka signed an 'agreement-in-principle' with the Official Creditor Committee (OCC) of the Paris Club, formed in May 2023 by 17 countries to restructure its debt.⁶ Formalising this provisional arrangement, Sri Lanka sealed a final restructuring deal for US\$5.8 billion of its debt with the OCC on June 26, 2024.⁷ Similarly, in early July 2024, close on the heels of the OCC agreement, Sri Lanka

release/2024/04/01/sri-lanka-s-economy-shows-signs-of-stabilization-but-poverty-to-remain-elevated. Accessed on May 2, 2024.

5. "Sri Lanka Says it Has Deal with China EXIM Bank Covering \$4.2 Billion of Debt", *The Economic Times*, October 12, 2023, <https://economictimes.indiatimes.com/news/international/business/sri-lanka-confirms-major-debt-deal-with-china/articleshow/104360379.cms?from=mdr>. Accessed on May 3, 2024.
6. "Agreement in Principle Between the Official Creditor Committee and Sri Lanka", Paris Club, November 29, 2023, <https://clubdeparis.org/en/communications/press-release/agreement-in-principle-between-the-official-creditor-committee-and-sri>. Accessed on May 4, 2024.
7. MeeraSrinivasan, "SriLankasealsdebtdealwithOfficialCreditorCommitteeafterfinancialcrisis", *The Hindu*, June 26, 2024, <https://www.thehindu.com/news/international/sri-lanka-finalises-debt-restructuring-agreement-after-financial-crisis/article68335968.ece>. Accessed on July 10, 2024.

secured a debt restructuring deal with its international sovereign bondholders, which accounts for US\$12.5 billion of the country's total external debt of US\$37 billion.⁸

It is worth noting that the OCC is co-chaired by India, Japan and France, alongside other Paris Club creditors, with China deciding to maintain an observer status on this platform despite being Sri Lanka's biggest bilateral lender. It was then speculated that China would cut a surreptitious bilateral deal with Sri Lanka on favourable terms for itself while exposing the latter to its 'debt trap diplomacy'. However, Sri Lanka sought to placate these fears by stating that no creditor would get preferential treatment. Notably, Sri Lanka received its largest single investment from China in November 2023, when Sinopec, a Chinese state-owned oil giant, was granted permission to build a US\$4.5 billion refinery in Hambantota.⁹ As such, Chinese investments in this island nation have often been subjected to scrutiny, since they are seen as attempts to acquire strategic assets in the event of Sri Lanka defaulting on its debt repayments to China. The 2017 Hambantota port deal, in which Beijing obtained an 85 per cent stake in the port through a 99-year lease, is a case in point.

INDIA'S ROLE: REGAINING GROUND

When China seemed to distance itself from Sri Lanka at a critical juncture, New Delhi stepped in as the first responder, providing nearly US\$4 billion in multi-pronged assistance and becoming the first to assure the IMF on debt restructuring, all of which earned India appreciation across party lines.¹⁰ In addition to being a lender of last resort, India has complemented its assistance by facilitating investments from Indian firms in the country. In 2023, India's Adani

8. "Sri Lanka Strikes Private Debt Restructuring Deal with Bondholders", *The Hindu*, July 4, 2024, <https://www.thehindu.com/news/international/sri-lanka-strikes-private-debt-restructuring-deal-with-bondholders/article68366151.ece>. Accessed on July 10, 2024.

9. Cissy Zhou, "Sri Lanka's China 'Debt Trap' Fears Grow as Beijing Keeps Investing", *Nikkei Asia*, January 2, 2024, <https://asia.nikkei.com/Spotlight/Asia-Insight/Sri-Lanka-s-China-debt-trap-fears-grow-as-Beijing-keeps-investing>. Accessed on May 4, 2024

10. "India says it will Continue to Support Sri Lanka in Overcoming its Financial Crisis", *The Economic Times*, July 9, 2023, <https://economictimes.indiatimes.com/news/india/india-says-it-will-continue-to-support-sri-lanka-in-overcoming-its-financial-crisis/articleshow/101608849.cms?from=mdr>. Accessed on May 5, 2024.

Group secured approval to develop two wind power plants in Sri Lanka's Mannar and Pooneryn regions and received a US\$553 million investment from the US to aid the development of the Colombo port's West Container Terminal.¹¹ This provided a fillip to Sri Lanka's historically low Foreign Direct Investment (FDI), which saw a further decline in 2022 but reportedly rebounded in 2023, due in large part to Indian investments.¹² This also speaks well for the country's investment stability that could attract more investors in the future.

Moreover, initiatives in connectivity, tourism, and culture, such as air links between Chennai and Jaffna, the resumption of ferry services, grants to promote Buddhist ties, and solar electrification of religious places, etc., have played a pivotal role in reversing Sri Lanka's economic downturn.¹³ The launch of Unified Payment Interface (UPI) services in Sri Lanka in February 2024, followed by a tie-up between PhonePe and LankaPay in May, is poised to enhance the overall travel experience for Indian tourists by making their payments quicker and more seamless.¹⁴

These initiatives demonstrate India's credentials as a reliable regional partner in consonance with its Neighbourhood First Policy and Security and Growth for All in the Region (SAGAR) outlook. India's Foreign Minister S Jaishankar visited Sri Lanka in early October 2024, the first foreign ministerial visit to Colombo following the recently concluded elections, and discussed a range of collaborative opportunities. This visit underscores continuity

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11. Rajni Gamage and Muhammad Saad Ul Haque, "Sri Lanka's 2022 Debt Default Crisis: Geopolitics and Foreign Policy Developments", Institute of South Asian Studies, April 23, 2024, https://www.isas.nus.edu.sg/papers/sri-lankas-2022-debt-default-crisis-geopolitics-and-foreign-policy-developments/#_ftn14. Accessed on May 3, 2024.
 12. Uditha Jayasinghe, "Sri Lanka Expects FDI to Jump to \$1.3 bln with India Taking Lead", Reuters, May 24, 2023, <https://www.reuters.com/markets/asia/sri-lanka-expects-fdi-jump-13-bln-with-india-taking-lead-2023-05-24/>. Accessed on October 8, 2024.
 13. "How India Helped Sri Lanka Overcome Economic Turmoil: A Review of 2023", *The Economic Times*, December 26, 2023, <https://economictimes.indiatimes.com/news/india/how-india-helped-sri-lanka-overcome-economic-turmoil-a-review-of-2023/articleshow/106286887.cms?from=mdr>. Accessed on October 5, 2024.
 14. "You Can Use PhonePe on Your Next Trip to Sri Lanka", *The Economic Times*, May 17, 2024, <https://economictimes.indiatimes.com/nri/invest/you-can-use-phonepe-on-your-next-trip-to-sri-lanka/articleshow/110207818.cms?from=mdr>. Accessed on October 5, 2024.

in India-Sri Lanka relations, despite qualms about an otherwise scenario, considering that Dissanayake's Marxist-leaning party is ideologically closer to China and has historically been anti-India. It also indicates that the new government will seek to pragmatically balance its ties between India and China.

On a broader scale, Sri Lanka has signalled its interest in strengthening ties with regional economies to augment its own economic growth, particularly by signing Free Trade Agreements (FTAs) with Association of Southeast Asian Nations (ASEAN) countries. In February 2024, Colombo signed an FTA with Thailand, making it the second FTA with an ASEAN nation, the first one being with Singapore back in 2018. The then Foreign Minister, Ali Sabry, had noted that FTAs with India, Indonesia, Malaysia, Vietnam and China are in the works and will be consummated by this year's end.¹⁵ Sri Lanka has also submitted a letter of intent to join the Regional Comprehensive Economic Partnership (RCEP), which constitutes the world's largest trading bloc. These are steps in the right direction, given that Sri Lanka, with a population of 22 million, remains one of the most protected economies in the world.

DOMESTIC REFORMS AND DEVELOPMENTS

In July 2023, to curb deep-rooted corruption and tax-related evasions, Sri Lanka passed an Anti-Corruption Bill in tandem with the IMF's governance diagnostic exercise, making Sri Lanka the first Asian country to undergo this process. In the same month, the cash-strapped nation passed the Central Bank Act, bestowing a higher degree of independence and accountability on the CBSL so that it can ensure price stability and depoliticisation of monetary policies.¹⁶ In October 2023, Sri Lanka approved a hike in its Value Added Tax (VAT) from 15 per cent to 18 per cent, which took effect from January 2024, to broaden

15. "Free Trade Agreement with India by Year-End says Sri Lankan Foreign Minister," *The Economic Times*, February 07, 2024, <https://economictimes.indiatimes.com/small-biz/trade/exports/insights/free-trade-agreement-with-india-by-year-end-says-sri-lankan-foreign-minister/articleshow/107475720.cms?from=mdr>. Accessed on May 3, 2024.

16. Talal Rafi, "Sri Lanka's Central Bank Act Will Drive Fiscal Discipline", IMF PFM Blog, December 4, 2023, <https://blog-pfm.imf.org/en/pfmblog/2023/12/sri-lanka-central-bank-act-will-drive-fiscal-discipline#>. Accessed on May 4, 2024.

its tax base and, subsequently, increase its tax revenue.¹⁷ Although this is a requisite measure, it still risks constraining the purchasing power of households, particularly among the poor and vulnerable, which, in turn, will force them to acquire debt to meet their day-to-day requirements. Furthermore, in 2024, the parliament approved two key pieces of legislation—the Public Financial Management Act and Public Debt Management Act—which are expected to improve fiscal discipline and promote better debt management.

There has been an expansion of agricultural productivity, which is a refreshing turnaround, especially after Rajapaksa's ban on the use and importation of chemical fertilisers in 2021 proved disastrous for the agricultural sector. Though the ban was lifted in November 2021, it thrust the traditionally rice self-sufficient nation into spending millions on rice imports.¹⁸ For instance, in the second quarter of 2023, while the industrial and services sectors declined, agriculture registered an expansion, albeit by the second quarter of 2024, the former two sectors picked up pace.¹⁹ Meanwhile, Sri Lanka's promising economic recovery is manifest in its real GDP growth. The first quarter of 2024 saw a 5.3 per cent growth, as opposed to a -10.7 contraction in the first quarter of 2023, and in the second quarter of 2024, the economy grew by 4.7 per cent compared to a -3.0 contraction in Q2 2023.²⁰

Evidently, then, the raft of measures, consistent with the IMF bailout conditions, have resulted in relative macro-economic stabilisation, best exemplified by the drop in inflation rates. Inflation had peaked at 70 per cent in September 2022 but in March 2024, it fell to 0.9 per cent and is expected to remain within the 5 per cent target set out by the CBSL.²¹ In July 2024, inflation witnessed a

17. "Sri Lanka Approves VAT Hike to 18% in Push for IMF Targets", *Nikkei Asia*, October 31, 2023, <https://asia.nikkei.com/Economy/Sri-Lanka-approves-VAT-hike-to-18-in-push-for-IMF-targets>. Accessed on May 3, 2024.

18. Kenny Torrella, "Sri Lanka's Organic Farming Disaster, Explained", *Vox*, July 15, 2022, <https://www.vox.com/future-perfect/2022/7/15/23218969/sri-lanka-organic-fertilizer-pesticide-agriculture-farming>. Accessed on May 5, 2024.

19. Statistics Department, Central Bank of Sri Lanka, "National Accounts Estimates - Quarter 2, 2024", https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/statistics/20240913_national_account_estimate_q2_2024_e.pdf.

20. *Ibid.*

21. Uditha Jayasinghe, "Sri Lanka's Key Inflation Rate Falls to 0.9% in March", *Reuters*, March 28, 2024, <https://www.reuters.com/markets/asia/sri-lankas-key-inflation->

tangential increase, standing at 2.4 per cent, but dropped to 0.5 per cent in August and further declined to -0.5 per cent in September, marking the first deflation since September 2015, as per the Colombo Consumer Price Index. While deflation means a general decline in the prices of goods and services—a phenomenon that could boost the purchasing power of citizens, thus providing some measure of reprieve—prolonged deflation is as unfavourable as high inflation. It may indicate reduced economic growth, which would undoubtedly bode ill for the Sri Lankan economy.

GOING FORWARD

Dissanayake primarily garnered votes by capitalising on reform-induced grievances, vowing to reverse steep tax hikes, promote transparency, root out corruption, and, most importantly, renegotiate the IMF agreement to ease the burden on citizens. In reality, however, the tough austerity measures prescribed by the IMF are what will keep Sri Lanka on the road to recovery, as the agreement not only provides Sri Lanka financial credibility but also helps in securing external financing.²² And, in any case, the IMF is unlikely to budge on the core elements of the agreement, given its importance in sustaining the country's hard-won economic recovery. In the meantime, the newly elected government must sustain the momentum of structural reforms while providing targeted concessions to the most vulnerable through various social assistance programmes.

Additionally, ratcheting up and diversifying engagement with the regional countries while maintaining a neutral stance between its two key economic partners, India and China—both of whom Sri Lanka needs—becomes crucial to maximise the benefits of the seeds of economic integration it has already sown and to avoid becoming a geopolitical battleground at the expense of its economy. Ultimately, to sustain signs of stabilisation amid debt restructuring for short-term recovery and long-term growth, Sri Lanka must cater to its domestic interests while also addressing the concerns of its international creditors.

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22. Wignaraja, n. 3.