Financial Crisis in Sri Lanka:

Impact of Institutional Factors on External Debts

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Abstract

This study analyzes the financial crisis faced by Sri Lanka and provides insight into the impact of four independent variables, namely political stability, government effectiveness, regulatory quality, and rule of law on external debts. The data was obtained from the World Bank database and the Central Bank of Sri Lanka, and the regression was conducted using an MS Excel spreadsheet. The article regression analysis conducted with one-year lag to capture the lag effect of independent variables on external debts. The author then discussed the results with political figures and scholars in the field, through over 30 discussions conducted both in-person and over the phone.

The statistical results indicate a strong association between the independent variables and external debts, with a high proportion of variance explained. The study highlights the positive impact of political stability and government effectiveness and the negative impact of regulatory quality and rule of law on external debts. However, the study has limitations, including the reliance on a limited number of expert interviews and the focus on the case of Sri Lanka. The study emphasizes the need for continued research into the complex factors contributing to external debt and economic crises and the importance of considering different sets of independent variables when formulating policy. The findings of this study could be useful for policymakers and politicians in managing external debt crises

Keywords: Bankrupt states; Corruption, Debts, Financial crisis; Government efficiency, Institutional efficiency, Liberalisation, Offshore borrowings, Stability.

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Introduction

Sri Lanka is currently experiencing a grave political and financial crisis, which has resulted in millions of people being unable to afford basic necessities such as food and medicine. The nationwide protests against the escalating cost-of-living crisis climaxed with the storming of the presidential palace in mid-July and the resignation of both the President Gotabhaya Rajapaksa and his Prime Minister brother Mahinda Rajapaksa. To mitigate the crisis, the Sri Lankan government has again sought assistance from the International Monetary Fund (IMF).

Prime Minister Ranil Wickremesinghe declared Sri Lanka as 'bankrupt' on 5 July 2022. The island nation has defaulted on $51 billion USD of foreign debt in May 2022. The Forex reserves have been fluctuating around US$2billion since March 2022, which is sufficient only for 10 days of imports.

According to normative theories of accounting, *bankruptcy* means a situation of having persistent negative *net-assets* (liabilities over assets) of an entity. On that basis and, according to the CGD estimates (2018) on debts and wealth of countries, no country can be classified as bankrupt including Sri Lanka which has an approximate debt ratio of only 12.72% (US$51 billion of debts as against US$401 billion of wealth; US$3,438 of debt per adult and US$27,040 of wealth per adult) (Saliya, 2022). However, with mere 10-days-imports worth of foreign reserves Sri Lanka is undergoing a severe liquidity crisis, an immediate cash requirement.

Because of the President's declaration that Sri Lanka is bankrupt, now Sri Lanka is participating in negotiations as a bankrupt country and, he confessed that this would be a difficult and bitter journey, (Wickramasinghe, 2022). Now, Sri Lanka has to face a more difficult and complicated situation than previous negotiations and therefore, such declarations would be; *serious*, hard to find helping hands – lenders in this context; e*xpensive*, even if we find lenders, commercially, the interest rates would be higher; *painful*, it may cause contraction of the economy hence *unproductive*.

After analysing and evaluating the current and future debt levels of 68 countries that hosted the China-funded projects, the Center for Global Development (CGD, 2018) has identified ten countries (Sri Lanka, Kyrgyzstan, Djibouti, the Maldives, Laos, Mongolia, Pakistan, Montenegro, Angola, and Tajikistan) as '*at risk of debt distress*'. However, against many predictions by industry experts, after imposing very painful conditions, IMF granted US$2.9 billion in March 2023. This much needed life-line has put breaks to deteriorating investor confidence, inflation and therefore, easing the increasing rates of interests for domestic debt instruments. Yet, the Central Bank of Sri Lanka increased its policy rates by further 100 basis points from 15.5% to 16.5% in March 2023 and sudden appreciation of Sri Lankan rupee was also observed (CBSL, 2023).

Further studies of similar experiences faced by the countries elsewhere revealed that, to arrest such crises, they had established political stability immediately (IMF, 2020; World Bank, 2021; Gerring & Thacker, 2004; Alesina, & Perotti, 1996; World Bank, 2006) and then implemented structural reforms towards liberalisation of markets (IMF, 2019; World Bank, 2018; Claessens, & Kodres, 2014; Bekaert et. Al., 2006; Blanchard, and Giavazzi, 2003; Fosu, 1992). The success of all other temporary patch-ups such as debt restructuring, selling state-assets, increasing taxes, controlling imports, encouraging inward remittances and reducing government expenses for welfare etc. seem inevitably depend on a peaceful socio-political environment and policies conducive for foreign direct investments.

With regards to Sri Lanka, many studies have been conducted on financial mismanagements, especially on credit management by banks, at corporate level (see Saliya, 2010; Saliya and Jayasinghe, 2016a; 2016b; Saliya and Yahampath, 2016; Saliya, 2019; Saliya and Hooper, 2020) but country level studies are rare. Therefore, this study investigates the nature of the financial crisis that Sri Lanka is undergoing and, attempts to explore the impact of certain political and/or institutional factors on the crisis.

Mixed method methodology was employed using quantitative analysis by estimating the impact of several institutional factors on external debts and foreign reserves using regression analysis. The results were discussed with a few scholars and political activists by way of interviews.

Therefore, the research problem of this study is articulated as "whether institutional factors are playing crucial role in influencing external debts and foreign reserves in Sri Lanka, and if so, what factors and to what extent?"

Literature Review

Economic crisis in Sri Lanka is a matter of ongoing debate, but there is widespread agreement that the country's high levels of foreign debt are a major contributing factor (Publicfinance, 2023), 2021). This has been compounded by external factors such as the COVID-19 pandemic, which has hit the country's tourism industry hard, as well as internal factors such as corruption and mismanagement of public funds (IMF, 2022).

A long-standing stern debate prevails between *left* and *right* camps in the political arena as well as in the academia on structural reforms towards liberalization. The main arguments of the *left* camp are that liberal policies could stimulate corruption and discrimination, obstruct inclusion, empower the elite-class to accumulate wealth disproportionately, increase inequalities and, also could bring adverse effects to certain traditions and sociocultural values of people. In contrast, right wing argues that liberal policies stimulate economic development by removing certain traditional barriers, enable nations to create more wealth which will *trickle down* to everyone else, hence improve living standards in general by translating individual greed into collective good and also it would ensure law and order towards justice and diversity.

According to Former prime minister/ current president Mr. Ranil Wickramasinghe, Sri Lanka is "bankrupt," he has highlighted that the country is suffering its worst level of financial crisis in past decades, and millions of people struggling with acquiring required essential items. Wickremesinghe further said that lawmakers are negotiating with the IMF going for the reviving the country's "collapsed" economy are "difficult," . The major highlight was due to the discussion of bankrupt country without introducing developing country is a considerable issue (CNN Report, 2022).

A team of IMF officials visited Colombo in June 2022 and discussions with Lankan officials on ***economic reforms and policies*** that could be supported by an IMF Extended Fund Facility arrangement (IMF, 2022)

External debts

It is widely accepted that the crisis is attributed to the burden of international debt on the country stimulated by deteriorating of foreign reserves. To manage the crisis, the Sri Lankan government has again sought assistance from the IMF. Although some argue that international loans, including those from the IMF (Perera, 2022), IMF facilities are less stressful with longer tenure and free of interest.

Continuous large offshore borrowings can deteriorate foreign reserves leading for defaulting debt servicing obligations. The servicing of a large debt increases the expenditure of the government and leads to further deficits and borrowing. The cyclic relationship of the two leads to serious difficulties in containing either and results in economic instability and may even lead to a national financial crisis as happened in Sri Lanka in 2022. The United States, the world's largest economy has the largest public debt. It is able to sustain this deficit as it enjoys the special circumstance of the rest of the world being willing to hold its debt in dollars. Sri Lanka and other countries are in no such position (Sanderatne, 2011). The Figure 1 shows accumulation of foreign debts from 2000 to 2022.

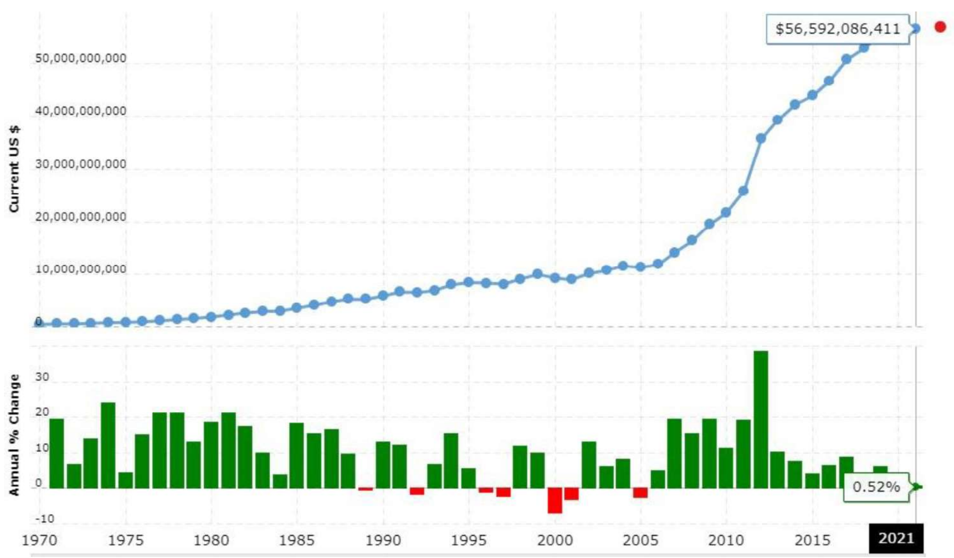


Figure 1: Accumulation of foreign debts from 2000 to 2022.

Source: Macrotrends (2023)

In addition to the heavy borrowings, unprecedented corruption including policies to please political henchman and cronies seem significantly contributed for the crisis. These policies included tax cuts for the wealthy, import duty manipulations and irrational exchange rate fixing. Unfortunately, the COVID-19 pandemic hit the country's already fragile, debt-laden economy, which had a severe impact on key industries such as tourism, plantations, and garment exports (IMF, 2022).

For the past 40 years, Sri Lanka has spent three-quarters of its time in the IMF's "macroeconomic stabilization programs" (Publicfinance, 2022). These programs involve providing countries with high level of debt burdens, which can perpetuate poverty and inequality in Global South countries. However, they also come with conditions and directives to implement specific economic austerity policies. Unfortunately, this means that a country's debt repayments must take priority over social security schemes or investments in public services that would benefit ordinary people. In Sri Lanka's case, over 40% of government spending in recent years has gone toward paying off interest on its foreign debts, perpetuating a vicious cycle of debt servicing (Publicfinance, 2022).

As of 2021, Sri Lanka's foreign debt was equivalent to 64.2% of its Gross Domestic Product (GDP) and its total debt amounted to a staggering 119% of its GDP (IMF, 2022) (Figure 2). This high level of debt has led Sri Lanka to focus its economic strategies on sectors that bring in foreign currency, primarily export industries. These industries include the production of clothes for US and European markets (which account for 52% of all Sri Lankan exports), tea, coffee, and spices for export, and tourism development (Reuters, 2022) Unfortunately, the COVID-19 pandemic has decimated these industries, which are also major sources of employment, pushing an additional half a million people into poverty (IMF, 2022).

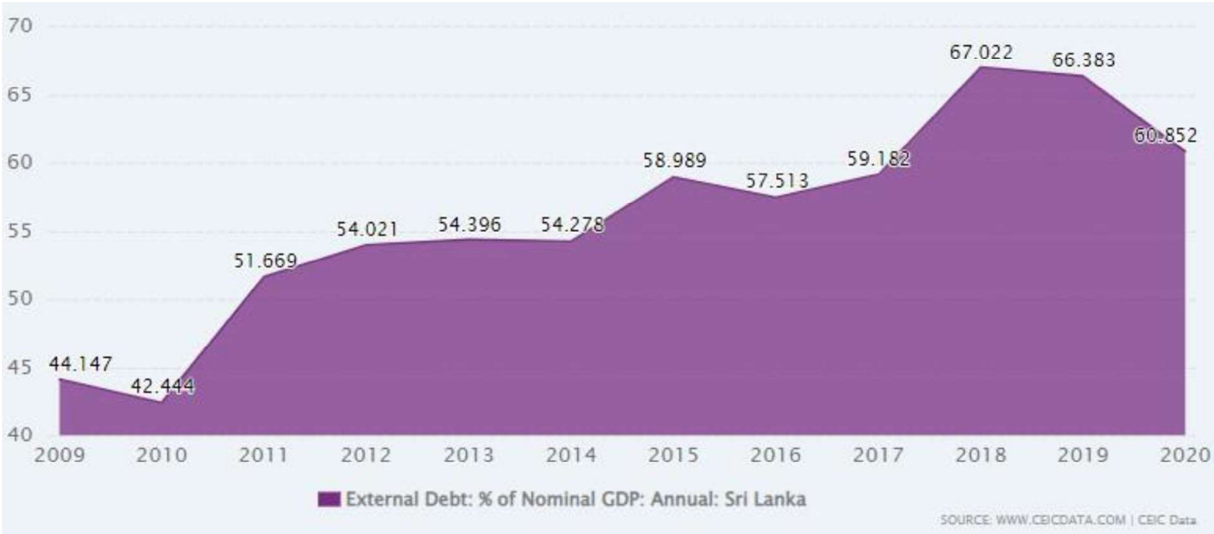


Figure 2: External Debts as a % of GDP

Source: (CEIC DATA, 2021)

Consequently, the country is caught up in a vicious cycle of debt. This means that funds are not available for other essential expenditure. Nevertheless the government has undertaken an ambitious programme of infrastructure development through foreign and domestic borrowing, this increases the foreign debt further (Figure 3).

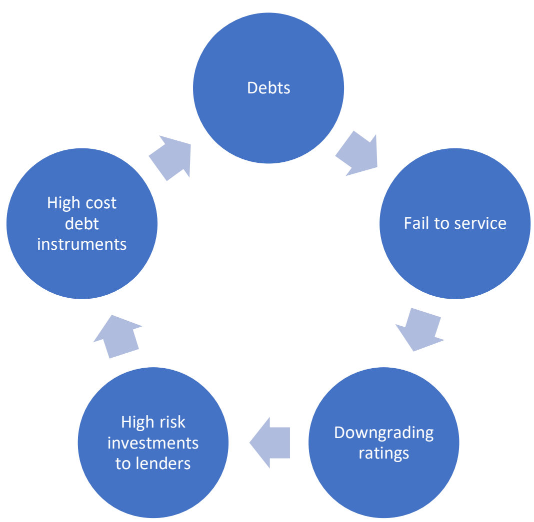


Figure 3: The vicious cycle

Source: Saliya, 2023

Political stability

In the early part of 2022, Sri Lanka witnessed a remarkable uprising that reached its climax on July 9th, resulting in the expulsion of then-President Gotabhaya Rajapaksa and his elder brother, Prime Minister Mahinda Rajapaksa, who was widely admired as a war hero and an uncrowned king among the Sinhala community. The uprising, known as *Aragalaya* (the struggle), was a gradual movement triggered mainly by fuel, fertilizer, and energy shortages. The fuel shortages created long lines of people waiting for their fuel rations, with some waiting on the roads for 2-3 days. Import restrictions on fertilizer and agro-chemicals, which were imposed by the president on ill advice from experts in other fields such as medical physicians and Buddhist monks, created huge unrest among farmers. These import restrictions resulted in a reduction not only in domestic essential crops but also in export earnings on products such as tea, which accounts for 11% of national export income. This was further aggravated by a pegged exchange rate to the US dollar, which discouraged all sorts of exporters. The cumulative outcome was *Aragalaya*, a kind of revolution never before witnessed in the world (Figure 4).

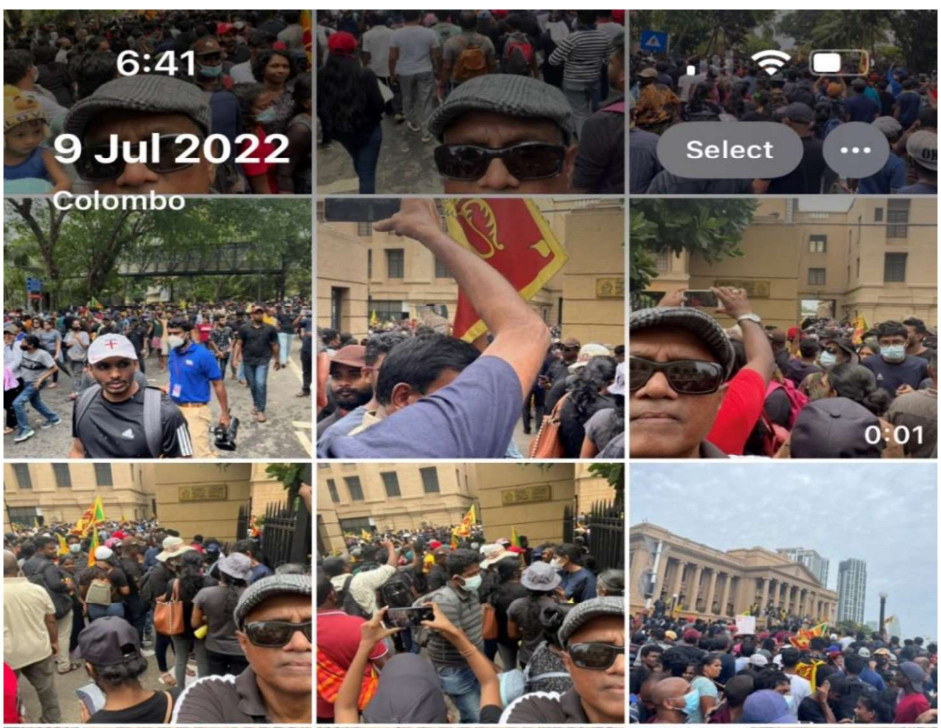


Figure 4: The *Aragalaya* (the struggle)

Source: The author

Total reserves comprise holdings of monetary gold, special drawing rights, reserves of IMF members held by the IMF, and holdings of foreign exchange under the control of monetary authorities. The gold component of these reserves is valued at year-end (December 31, FOR 2022-31 OCTOBER) London prices (The World Bank, 2022).

The following institutional factors have been used in numerous studies in finance and economics field (Saliya, 2021; Matadeen, 2019; Ho, 2017; 2019; Yartey, 2008; 2010).

- Political Stability and Absence of Violence/terrorism
- Government Effectiveness
- Regulatory Quality
- Rule of Law

These institutional factors measure perceptions of the likelihood of existence of them. by an aggregate indicators, in units of a standard normal distribution. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5 (The World Bank, 2022). For example, Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism.

Therefore, I hypothise that;

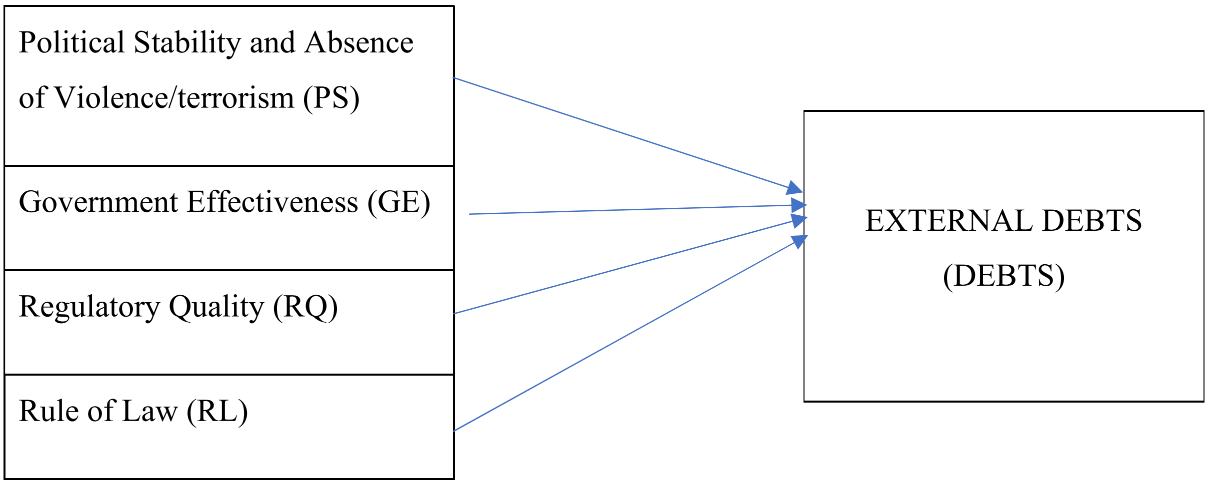
- H1: Political Stability and Absence of Violence influence external debts (X_1).
- H1: Government Effectiveness influences external debts (X_2).
- H1: Regulatory Quality influences external debts (X_3).
- H1: Rule of Law influences external debts (X_4).

Methodology

To capture the lag effect of the independent variables on the external debts, the regression was conducted with one year lag, so that, for example, the 2021 Political Stability score is regressed on the external debts of 2022. Therefore, the regression equation would be as follows.

$$\text{Ext. DEBT}_t = \alpha + \beta_1 X_{1(t-1)} + \beta_2 X_{2(t-1)} + \beta_3 X_{3(t-1)} + \beta_4 X_{4(t-1)} + e$$

Conceptual framework



Method

To conduct the regression analysis, data was collected from the World Bank database covering the years 1996 to 2021. Additionally, the amount of external debt for the year 2022 was obtained from the Central Bank of Sri Lanka (CBSL, 2022) and included in the analysis. The regression was conducted using an MS Excel spreadsheet. Afterwards, I discussed the results with several prominent political figures and scholars in the field. There were over 30 discussions, conducted both in-person and over the phone. Some of these chats were only 5-10 minutes long, while others extended to 1-2 hours, during lunches or dinners, and so on. The Figure 5 shows this framework, and the Figure 6 illustrates the whole process in detail.

The regression analysis on reserves was excluded from the study, due to a very high correlation of 0.824 between external debts and foreign debts.

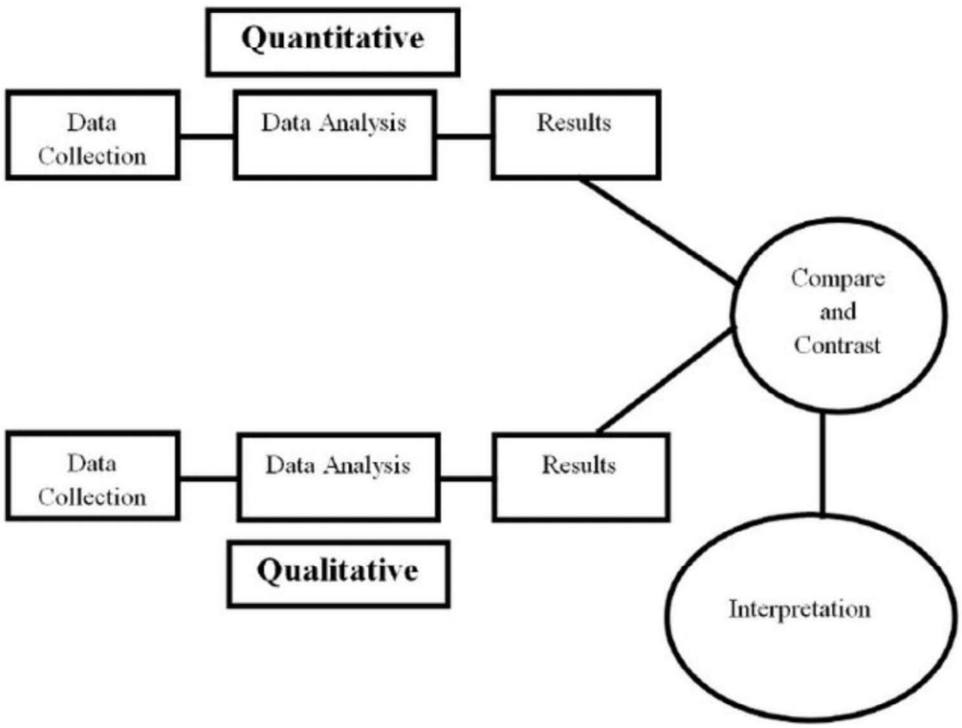


Figure 5: Method framework

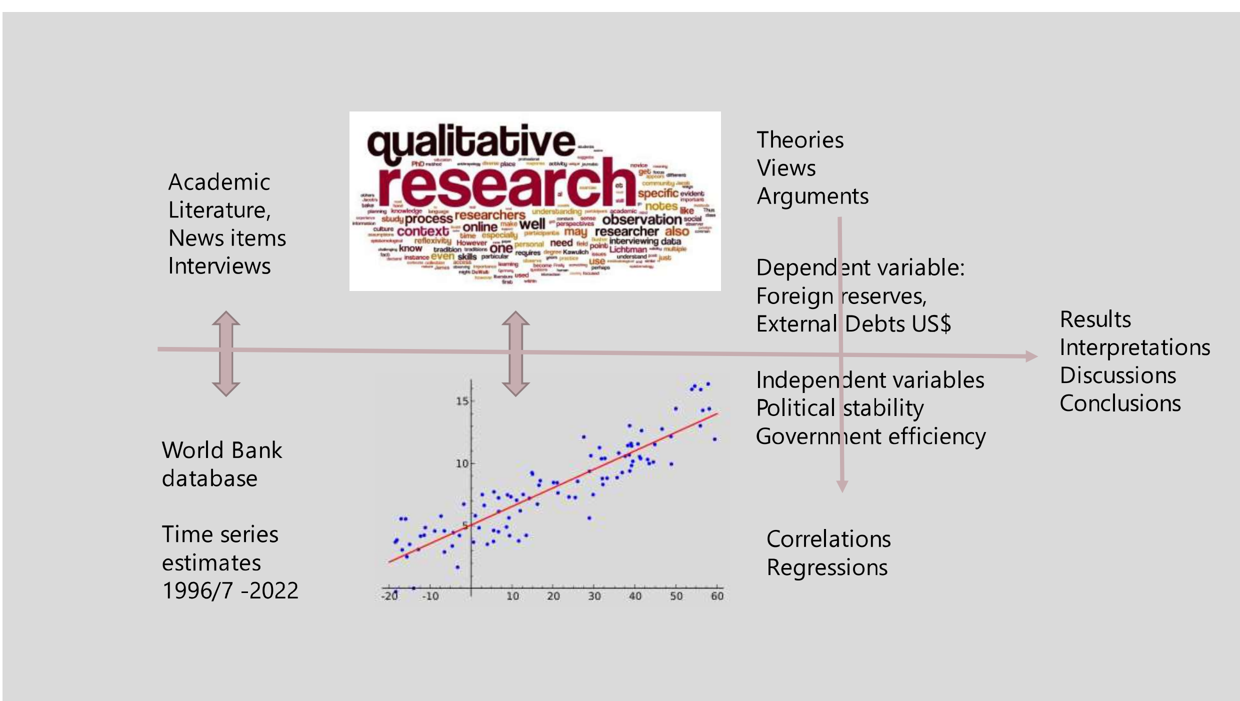


Figure 6: Method procedure

Results

As shown in the Table 1, all four independent variables show very strong associations at 99% significant levels with very high coefficients. The interesting observations are that while PS and GE show positive impact on DEBTS, RQ and RL show negative impact on DEBTS. Proportion of variance of the dependent variable by the independent variables is 92.27% (R Square).

Table 1: Regression results; Dependent variable (DV)- External debt stock in US$

Independent variables (IVs)	*Coefficients*	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*
Intercept	21415114501	770656883.5	27.7881311	0	1.9812E+10	2.3018E+10
Political Stability/Absence o	**3346573895**	612221662.8	5.46627814	0	2073389249	4619758541
Government Effectiveness	**8627113693**	2987050952	2.88817092	0.009	2415201177	1.4839E+10
Regulatory Quality	**-8583497262**	2165531900	-3.96369006	0.001	-1.3087E+10	-4080027142
Rule of Law	**-17434478157**	2698059192	-6.46185903	0	-2.3045E+10	-1.1824E+10
R Square	0.922734205	(Proportion of the variance of the DV explained by the IVs is 92.3%)				

Table 2 displays the correlation among all the variables, revealing that DEBTS and reserves have a significantly high correlation. In addition, PS and RL also show a correlation coefficient greater than 0.7 with DEBTS, whereas GE and RQ exhibit correlations of 0.67 and 0.63 with DEBTS, respectively.

Table 2: Correlation between all the variables

	RESERVES US$	DEBT US$	Political Stability	Government Effectiveness	Regulatory Quality
DEBT US$	0.82383856	1			
Political Stability and Absence of Violence(	0.56912213	0.72190879	1		
Government Effectiveness(Lagged)	0.51043336	0.67027141	0.53832954	1	
Regulatory Quality (Lagged)	-0.41500529	-0.63830928	-0.27213705	-0.41586066	1
Rule of Law (Lagged)	-0.70690507	-0.71468924	-0.29508926	-0.275376053	0.37192706

Table 3 displays the descriptive statistics of all variables, and the kurtosis and skewness values are within the parameters of a normal distribution.

Table 3: Descriptive statistics

	DEBT US$	*Political Stability and*	*Government Effectiveness*	*Regulatory Quality*	*Rule of Law*
Mean	27838716493	-0.942114839	-0.18121515	-0.112260725	0.058310351
Standard Error	3599544490	0.131665546	0.028162314	0.03549563	0.02735093
Median	20594205908	-0.888052642	-0.159374237	-0.128546111	0.062543081
Standard Deviation	18354147593	0.671365187	0.14360019	0.180992907	0.139462925
Sample Variance	3.36875E+20	0.450731214	0.020621014	0.032758433	0.019449907
Kurtosis	-1.670005198	-1.412967455	-0.24172868	-1.047791764	-0.023671407
Skewness	0.362617634	0.004403903	-0.503201141	0.1189122	-0.377743214
Range	48235635777	1.994480811	0.536344767	0.582142711	0.604440302
Minimum	8106316372	-1.904112697	-0.462085247	-0.423394442	-0.265588671
Maximum	56341952150	0.090368114	0.07425952	0.158748269	0.338851631
Count	26	26	26	26	26

Discussion

The factors contributing to crises are varied and complex, including both domestic and external factors. Domestic factors may consist of inappropriate fiscal and monetary policies leading to large current account deficits, high levels of public debt, and fixing an exchange rate at an inappropriate level, which can reduce competitiveness and have a negative impact on reserves. A weak financial system can be considered a root cause of economic booms and busts. Additionally, the regression results indicate a significant positive impact of political stability on external debts, meaning that an increase in political stability would stimulate more external debts. Many experts believe that political instability and weak institutional practices can also accelerate crise.

Owing to globalization, sudden changes occur in market can make the result in volatility of capital flow. Even sound countries can also be severely affected through the economic crises. The COVID-19 pandemic acted as the one example for the external shock, and it has been affected countries around the world. The IMF offered numerous financial assistances for helping countries to prevent and recovering (2023). But some of the interviewees argue that these programs involve providing countries with high level of debt burdens, which can perpetuate poverty and inequality in Global South countries. However, they also come with conditions and directives to implement specific economic austerity policies. Unfortunately, this means that a country's debt repayments must take priority over social security schemes or investments in public services that would benefit ordinary people. In Sri Lanka's case, over 40% of government spending in recent years has gone toward paying off interest on its foreign debts, perpetuating a vicious cycle of debt servicing.

The Sri Lankan government is now negotiating with the IMF to resolve the debt crisis. However, civil society in Sri Lanka has criticized the lack of public information and involvement in these negotiations. Many Sri Lankans fear that the IMF and World Bank will enforce the same policies that caused and fueled the current crisis, including further deregulation, cuts to public services, privatization, and lower poverty wages (Publicfinance, 2023).

According to some interviewees, prioritizing people and upholding human rights are crucial for finding solutions to manage the escalating debt crisis. However, it remains uncertain whether the new political leadership of the country will be able to navigate a course out of this predicament that will be beneficial for the working people of Sri Lanka. It is also widely discussed that, like many countries in the Global South, Sri Lanka's position in the world is determined by the rules of the global economy. Its large foreign debt, weak national currency, and high dependency on stronger foreign currencies such as the US dollar, combined with the unequal nature of global trade rules, make it highly susceptible to fluctuations in the global economy and multinational corporations withdrawing their investments. As a result, Sri Lanka and other Global South countries are more vulnerable to economic crises.

A left-leaning political expert argued against the IMF's involvement, stating that "over the past 40 years, Sri Lanka has spent three-quarters of its time in the IMF’s macroeconomic stabilization programs, which involve providing countries with high levels of debt burdens. This can perpetuate poverty and inequality in countries of the Global South”. However, they might impose conditions and directives to implement specific economic austerity policies. The same expert continued to criticize the IMF's role in debt management, stating that "unfortunately, this means that a country's debt repayments must take priority over social security schemes or investments in public services that would benefit ordinary people”. In Sri Lanka's case, over 40% of government spending in recent years has gone toward paying off interest on its foreign debts, perpetuating a vicious cycle of debt servicing.

An expert suggested that the UK should advocate for the establishment of a transparent and binding multilateral framework for resolving debt crises, as well as the creation of a UN entity to revise global tax regulations. They expressed the opinion that these measures would ensure that countries of the Global South can participate on an equal footing in shaping international tax standards.

Another viewpoint was that more than half of Sri Lanka's debt, approximately 55%, is owed to private lenders and is governed by English and New York state law. The proponent proposed that the UK has a unique opportunity to enact legislation that would compel private lenders to participate in debt restructuring as a temporary measure, ultimately leading to debt cancellation. Over the past 70 years, partial and complete debt cancellations have been implemented at least 30 times for various nations, ranging from Germany to Ghana.

Conclusions

In conclusion, the statistical results show a strong association between the four independent variables and the dependent variable, with a high proportion of variance explained by the independent variables. The positive impact of political stability and government effectiveness and the negative impact of regulatory quality and rule of law on debts are interesting observations. The correlation analysis indicates a very high correlation between debts and reserves, and moderate correlations with the other independent variables. The descriptive statistics demonstrate that all variables have normal distributions. However, it is important to acknowledge that the study is limited by the use of secondary data, potential omitted variable bias, and the focus on only four independent variables, which may not capture all factors contributing to debt crises. Therefore, caution should be exercised when interpreting and generalizing the results.

The economic crises such as the one faced by Sri Lanka are often caused by a combination of domestic and external factors, including weak financial systems, inappropriate fiscal and monetary policies, and sudden changes in global markets. While the IMF has provided financial assistance to many countries, the conditions and directives that come with it have perpetuated poverty and inequality in Global South countries. The Sri Lankan government is now negotiating with the IMF to resolve the debt crisis, but civil society has criticized the lack of public involvement in these negotiations. It is essential to prioritize human rights and people-focused solutions to manage the spiral of debt. Additionally, a transparent and binding multilateral framework for resolving debt crises and a UN entity to revise global tax regulations can ensure that countries of the Global South participate on an equal footing in shaping international tax standards. Lastly, enacting legislation that compels private lenders to participate in debt restructuring as a temporary measure, ultimately leading to debt cancellation, can help countries facing a debt crisis. It remains to be seen if Sri

Lanka's new political leaders will navigate a path out of the crisis that benefits working Sri Lankans.

The left and right camps hold divergent views on the impact of liberalization on society, with the left emphasizing potential negative consequences on inclusion, inequality and sociocultural values, while the right highlights its potential to boost economic development, improve living standards, and promote justice and diversity.

One limitation of this research is that it relies on a limited number of expert interviews, which may not be representative of the broader range of perspectives on Sri Lanka's debt crisis. Additionally, the research is focused solely on the case of Sri Lanka, and therefore, the findings may not be generalizable to other countries facing debt crises. Another limitation is the potential for bias or subjective interpretations of the data by the researcher, as the interviews were conducted and analyzed by a single individual. Furthermore, the study is limited by the availability and quality of data, particularly regarding the specific details of Sri Lanka's debt obligations and negotiations with international financial institutions. Finally, the research does not consider the broader geopolitical context and power dynamics that shape debt negotiations, which could have significant implications for the outcome of debt crisis management.

The findings of this study could be valuable for policymakers and politicians, providing insight into the significant impact of different independent variables on external debts. The contrasting associations observed between PS and GE, and RQ and RL, suggest that there is room for further exploration in this area. This study highlights the need for continued research into the complex factors that contribute to external debt and economic crises, as well as the importance of considering different sets of independent variables when formulating policy.

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