
Anatomy of a Collapse: Origins, Dynamics, and Consequences of Sri Lanka's Economic Crisis

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Abstract

Sri Lanka has struggled for many years with instability, economic stagnation, and a volatile business environment and also struggled with the macroeconomic issue of a double deficit, which includes a fiscal deficit as well as a balance of payments, foreign exchange, and deficit due to years of poor economic management and government corruption. This study analysed the reasons behind Sri Lanka's economic debt crisis and also explained the debt trap of the Chinese economy, focusing on. The qualitative research method was used with the help of secondary data sources. The findings show the underlying elements that are the primary causes of this situation, including Sri Lanka's excessive reliance on Chinese economic aid and loans, redundant policies of the Sri Lankan government, rising foreign debt to Sri Lanka and also how India assisted Sri Lanka during its crisis and what is the measure taken by the government to fight back the crisis.

Keywords: Sri Lanka crisis, debt trap, economic crisis, Sri Lanka government, foreign debt.

JEL Classification: E60, F34, H63, O23, O53, K42, P48.

Introduction

Sri Lanka is experiencing a severe economic crisis, with reserves dwindling and the government unable to cover the cost of essential imports. Due to rising food prices, a sinking currency, and rapidly depleting forex reserves, the Sri Lankan government declared an economic emergency on April 1, 2021. Protests have been started in the month of April and after that people have been struggling with the daily power cuts, shortages of food supply and inflation running more than 50%. Sri Lanka is experiencing an acute economic crisis as a result of the depletion of its foreign reserves, which has resulted in shortages of fuel, food, medicines, cement, and other essential items. Sri Lanka is crumbling. Its economy is on the verge of collapse. There is a severe economic and political crisis going on right now. To get out of this financial disaster, India has promised Sri Lanka a loan of at least \$ 1.9 billion and the World Bank has agreed to contribute \$ 600 million. From an analysis of Sri Lanka's current deteriorating economic situation and government policy measures, financial relief for the Sri Lankan people will soon be available unless a strong government is rebuilt there. It is clear that will not come.

The Sri Lankan government is optimistic that with the policy measures implemented thus far and the improvement in the COVID-19 situation, the crisis will be resolved soon. The situation on the ground, as well as investigations of the government's arrangement measures, and worldwide international monetary advancements, including the aftermath of the Russia-Ukraine war, all suggest that Sri Lankans will not feel financial assistance any time soon. Resistance and public analysis against the government's treatment of the emergency are heightening in Sri Lanka. (Gulbin Sultan, 2022).

The island nation of Sri Lanka is in the midst of one of the worst economic crises it's ever seen. It has just defaulted on its foreign debts for the first time since its independence, and the country's 22 million people are facing crippling 12-hour power cuts, and an extreme scarcity of food, fuel and other essential items such as medicines. The country relies on the import of many essential items including petrol, food items and medicines. Most countries will keep foreign currencies on hand in order to trade for these items, but a shortage of foreign exchange in Sri Lanka is being blamed for the sky-high prices (Indian Express, 2022). The Sri Lankan economy has been facing a crisis owing to a serious Balance of Payments (BoP) problem. Its foreign exchange reserves are depleting rapidly and it is becoming increasingly difficult for the country to import essential consumer goods. Job losses have become a common phenomenon in almost every household. Besides, a fall in earnings has led to a rise in poverty rates.

According to World Bank data, the share of the poor based on a daily income of \$3.20 was estimated to be grown to 11.7% in 2020 or by more than half a million people from 9.2% a year before (Times of India, 2022). The island nation of 22 million people has been experiencing a painful downturn on record, with months of blackouts, acute food and fuel shortages, and skyrocketing inflation. Sri Lanka has often been cited as an interesting case of a developing country whose level of social progress has been quite high relative to the country's per capita income Level 1 (Isenman 1980, Sen 1981). According to Asian Development Bank, fiscal dominance, high deficits and governmental debt, has characterized Sri Lanka's macroeconomic landscape. Sri Lanka's economy has been described as "a tale of two deficits". The most recent debt sustainability analysis for Sri Lanka identifies no imminent threats to external debt sustainability; however, currency depreciation, insufficient reserve coverage, and deleveraging all pose risks (IMF 2018).

1. Literature Review

Fonseka & Ranasinghe (2008) found that the public debt of Sri Lanka has become high and therefore debt management is becoming a challenge for the country. They suggested short and long-term measures needed by the country. Importantly, the results of the study are largely relevant.

Sen (2011) examines the effect of an increase in government debt as a result of increased transfers to the elderly generation on steady-state welfare within the framework of a two-sector overlapping generations model with zero population growth. Under certain conditions, the study's key findings indicate that the debt policy could improve welfare in the new steady-state equilibrium of the economy. However, the first older generation that received the transfer may be the losers, but from generation one onward, everyone benefits.

Kumara & Cooray (2013) argued that the debt growth relationship in Sri Lanka is ambiguous and based on ideological preferences with circumstantial evidence. According to their econometric analysis, the non-linear negative effect of public debt on GDP growth per capita. However, they did not study the relative impact of external and internal debt on economic growth. There was very little evidence found by Kourtellos, Stengos, & Tan (2013) for the non-linear effects of public debt on growth. In addition, their research suggests that the relationship between debt and growth is influenced by the institution's quality. Debt increases growth when a nation's institutions are below a certain quality level. On the other hand, debt has no effect on growth if the institutions are of sufficient quality.

According to Mahmood, Arby, & Sherazi (2014), the public debt in Bangladesh, India, Pakistan, and Sri Lanka has reached an unsustainable level, which may be a serious problem. As a result, some policy measures to correct structural imbalances are most needed.

Rahman et. al (2019) in their systematic review of the impact of public debt on economic growth find out that public debt can be positive or negative on the economic growth of the country. Excessive public debt can also become an economic collapse for the country in the long run if fiscal and monetary policies are not properly implemented.

Maitra et. al (2021) their research study with the use of the ARDL model proved that foreign debt and FDI are not beneficial for growth, but their excessive use has detrimental effects. While domestic investment encourages both short- and long-term income developments. The study concludes that Sri Lanka's economic development would be hindered by excessive reliance on foreign financial resources.

Gamage & Khattri (2024) provide a comparative examination of Sri Lanka's structural reform trajectory following the 2022 debt default. By juxtaposing these reforms with parallel processes in India, the authors underscore how demands for system change, and not mere stabilization, have shaped both policy orientation and democratic renewal in Sri Lanka.

The World Bank's October 2024 *Sri Lanka Development Update* highlights sustained macroeconomic recovery, driven by tourism, industrial activity, and structural reforms, and argues that continued reform will be essential to fortify growth, boost investments, and reduce poverty.

2. The Reason Behind Sri Lanka Economic Crisis

The crisis in Sri Lanka can be explained in a variety of ways. There is a problem in the nation. Beyond policy, there are political factors that Sri Lanka cannot control. People refer to these political factors as fate. The Sri Lankan populace also holds China accountable for a large number of the country's issues. A significant problem exists in Sri Lanka. When spending outpaces income and imports outpace exports, a trade deficit occurs in the nation. A budget deficit is also present. Two debts are present. It's the perfect storm waiting to happen. This disaster's response from Sri Lanka was a complete failure. The debt has increased rather than the deficit being reduced. Colombo took out loans from international organisations and nations totalling a sizable sum of money. Sri Lanka currently owes more than it produces, as indicated by its debt-to-GDP ratio of 111%. This problem was raised in 2019 by the Asian Development Bank. It asserted that the nation's national expenditures exceeded its national income and that it produced insufficient tradeable goods and services.

When Sri Lanka emerged from its 26-year-long civil war in 2009, the country initially experienced strong economic growth. According to World Bank data, the post-war GDP growth rate averaged 8–9% per annum until 2012 (World Bank, 2013). However, from 2013 onwards, the average rate of growth declined sharply, almost halving, as a result of falling global commodity prices, a slowdown in exports, and a rise in imports (Bandara, 2021).

Fiscal imbalances had already been a persistent feature of the Sri Lankan economy during the war years. The global financial crisis of 2008 further exacerbated these challenges by draining the country's foreign exchange reserves. Consequently, in 2009 Sri Lanka sought external assistance in the form of a US\$2.6 billion loan from the International Monetary Fund (IMF, 2009). A second request for financial support was made in 2016, when the government negotiated a US\$1.5 billion loan. However, the conditionalities associated with this agreement arguably contributed to a further deterioration of the country's economic health.

Subsequent economic shocks compounded these vulnerabilities. The Easter Sunday bombings of April 2019, which resulted in 253 casualties in Colombo, precipitated a dramatic decline in tourist arrivals and foreign exchange inflows (BBC, 2019). Later that year, the government led by Gotabaya Rajapaksa implemented extensive tax reductions and subsidies for farmers. Although these measures had been politically appealing campaign promises, their hasty implementation undermined fiscal stability and aggravated existing structural weaknesses. The outbreak of the Covid-19 pandemic in 2020 further intensified the crisis. Key export sectors such as tea, rubber, spices, and garments contracted sharply, while the tourism sector suffered additional losses (UNCTAD, 2021). Simultaneously, rising public expenditures caused the fiscal deficit to exceed 10% in 2020–2021, and the debt-to-GDP ratio escalated from 94% in 2019 to 119% in 2021 (Central Bank of Sri Lanka, 2021).

An additional turning point occurred in 2021 with the imposition of a nationwide fertilizer ban. The government abruptly prohibited all fertilizer imports, declaring an immediate transition to 100% organic agriculture. This abrupt policy shift severely disrupted food production and supply chains. As a consequence, the Sri Lankan President was compelled to declare an economic emergency in response to rapidly increasing food prices, currency depreciation, and the accelerated depletion of foreign exchange reserves (Reuters, 2021).

The lack of foreign currency, coupled with the disastrous overnight ban on chemical fertilizers and pesticides, has sent food prices soaring. Inflation is currently over 15% and is forecast to average 17.5%, pushing millions of poorer Sri Lankans to the brink. One of the causes of Sri Lanka's economic crisis was a lack of foreign currency. The country's economy will suffer greatly as a result of the trade balance crisis. This has resulted in a significant decrease in the importation of essential goods. The country now lacks the funds in its forex accounts to purchase all of this for its citizens. The crisis is so severe that the island nation is unable to organise exams for students due to a lack of papers. Due to a lack of crude oil stocks, the government recently halted operations at oil refineries.

Sri Lanka is basically dependent upon Tourism Sector and Agricultural Sector. Sri Lanka is significantly reliant on imported goods. Among other necessities, it imports fuel, food, paper, sugar, lentils, medications, and transportation equipment. Due to a lack of foreign cash, the country is unable to purchase (import) certain goods. Imports are so crucial that the government had to postpone exams for millions of pupils due to a lack of printing paper. The current Sri Lankan economic crisis is the product of the historical imbalances in the economic

structure, the International Monetary Fund (IMF)'s loan-related conditionality and the misguided policies of authoritarian rulers.

Several structural weaknesses and policy missteps have collectively contributed to the severe deterioration of Sri Lanka's economy, including the following:

- The pandemic has taken a toll on the country's tourism economy, which accounts for 10% of GDP. Due to the foreign exchange problem, several countries, including Canada, have recently issued travel restrictions to their citizens on visiting the island country. Such advisories from other countries are having a negative impact on business. The United Kingdom, India, and Russia are the main sources of inbound tourism to the island nation.
- Sri Lanka's reliance on imports for essential goods like sugar, pulses, cereals, and pharmaceuticals has compounded the country's issues, as the country lacks foreign currency to pay for import expenditures.
- A massive foreign debt burden of approximately \$5 billion with China alone is a major contributor to this crisis. Sri Lanka is repaying a \$1 billion loan acquired from Beijing in 2021. It also owes a large sum of money to India and Japan. The country's foreign currency reserves were approximately \$1.58 billion as of November, down from \$7.5 billion when Gotabaya Rajapaksa took office in 2019.
- The supply of foreign exchange was harmed when forex reserves fell from more than \$7.5 billion in 2019 to roughly \$2.8 billion in July 2021, increasing the amount of money Sri Lankans had to pay to buy the foreign exchange required to import goods. As a result, the value of the Sri Lankan rupee has plummeted.

The government's decision to prohibit the use of chemical fertilizers to transition agriculture to 100% organic had a negative economic impact. Experts predict that this legislation would have a tragic effect on agricultural development because organic farming reduces output by half. Moreover, the increased cost of staples like rice and sugar, allegedly due to "food mafia" hoarding, has exacerbated challenges.

3. Legal Governance Deficiencies Underpinning Sri Lanka's Economic Collapse

Although Sri Lanka had the Fiscal Management (Responsibility) Act 2003 (FMRA), compliance was minimal due to weak enforcement mechanisms, no required corrective action, and escape clauses. The broader Public Financial Management (PFM) system was dispersed across various laws (FMRA, Finance Act 1971, Annual Appropriation Acts, Financial Regulations 1992), lacking a cohesive legal backbone to ensure transparency and accountability (IMF, 2023a). This fragmentation enabled discretionary spending, opaque investment approvals, and limited fiscal discipline, heightening corruption risks and fiscal mismanagement (IMF, 2023a).

In late 2019, laws amended VAT, corporate income tax, and other tax statutes, slashing VAT from 15% to 8%, abolishing PAYE, Nation Building Tax, Economic Service Charge, and raising exemption thresholds (IMF, 2022). These legal changes slashed the tax-to-GDP ratio to a world-low ~8.1% by 2020, crippling revenue generation (IMF, 2022; NUS-ISAS, 2023). This left no legal buffer or anchor to sustain revenue during the COVID-19 shock (ORF, 2022; Frontline, 2022). As several scholars highlight, tax cuts at such a juncture were especially damaging given Sri Lanka's historically low revenue base (Asel, Fernando & Rathnayake, 2022; Hettiarachchi et al., 2022).

The Monetary Law Act No. 58 of 1949, which governed the Central Bank pre-2023 reforms, lacked strong insulation from fiscal dominance. This regulatory gap enabled sustained central bank lending to the government, effectively monetary financing, without adequate legal restraint. The irony: laws designed to separate monetary and fiscal domains failed to prevent deficit monetization, leading to runaway inflation and currency collapse (IMF, 2023a).

Sri Lanka's public debt framework was similarly scattered across outdated laws like the Registered Stock and Securities Ordinance, Local Treasury Bills Ordinance, and the Foreign Loans Act. There was no single consolidated law to define borrowing limits, risk management norms, or maturity/FX mismatch policies. IMF technical assistance recommended developing a unified Public Debt Management Act, but the absence of such legislation meant unchecked borrowing and exposure vulnerabilities (IMF, 2023a).

Under the Import and Export Control Act, the government imposed sweeping bans (e.g., fertilizer and agrochemical imports in 2021) via gazette notification. While technically legal, these lacked forward planning or transition safeguards, resulting in sudden agricultural productivity collapse and reduced exports, devastating foreign exchange earnings during the crisis (Time, 2022).

3.1. Synthesis of Legal Gaps and Economic Impact

Sri Lanka's economic vulnerabilities have been closely tied to several underlying legal and institutional weaknesses. A weak Fiscal Management Responsibility Act (FMRA) and Public Financial Management (PFM) framework have contributed to persistent budget deficits and unaccountable public spending, gradually eroding fiscal discipline and limiting the state's ability to implement corrective measures.

The introduction of legislated tax cuts without adequate buffers further deepened fiscal fragility. This policy not only triggered a collapse in revenue collection during times of crisis but also eliminated the government's capacity to build fiscal resilience, leaving the economy highly exposed to shocks. In addition, central bank lending permitted under the outdated Monetary Law Act (MLA) became a structural fault line. Such practices fuelled inflationary pressures, currency depreciation, and foreign exchange stress, thereby undermining monetary stability and weakening investor confidence.

Compounding these issues, the fragmented legal framework governing public debt facilitated borrowing overreach and increased risk exposure. The absence of coherent debt management legislation contributed to weak oversight mechanisms, which in turn accelerated the deterioration of debt sustainability. Finally, reliance on policy enacted through emergency gazettes reflected a pattern of ad hoc economic governance. This reliance undermined predictability and institutional accountability, while also generating negative externalities such as export and production shocks and additional losses in foreign exchange reserves.

Collectively, these legal inadequacies created a governance structure that magnified the impact of exogenous shocks, such as the Easter bombings, the COVID-19 pandemic, and global terms-of-trade squeezes, driving Sri Lanka toward sovereign default and macroeconomic collapse (IMF, 2023a; NUS-ISAS, 2023; ORF, 2022; Hettiarachchi et al., 2022).

Table 1: Selected macroeconomic variables of the Sri Lankan economy

GDP Growth (2020)	(-)3.6%
GDP Per Capita (2020)	3,682.04 USD
Exports of goods and services (% of GDP)	16.58%
Import of goods and services (% of GDP)	22.93%
Fiscal Deficit (2022)	11.1%
BOP Deficit	3.9 billion US\$
Trade Deficit as % of GDP	(-)6.36%
Currency Depreciation % Change from 30 th June 2021	40.7
Unemployment Rate (2022)	5.2%

Source: Central Sri Lanka, 2022

Table 1 presents Sri Lanka's economic performance in 2020 and, where available, 2022. It reveals a mixed picture with some positive signs but also significant challenges:

- **Negative GDP Growth (2020):** The economy contracted by 3.6% in 2020, likely due to the impact of the COVID-19 pandemic.
- **High Trade Deficit:** Sri Lanka imports significantly more than it exports, with a trade deficit of 6.36% of GDP. This raises concerns about external vulnerabilities.
- **BOP Deficit (2022):** The Balance of Payments (BOP) also shows a deficit of 3.9 billion USD in 2022, indicating the outflow of foreign currency exceeds incoming resources.
- **Fiscal Deficit (2022):** High government spending resulted in a fiscal deficit of 11.1% of GDP in 2022, raising concerns about national debt sustainability.
- **High Currency Depreciation (2021-2022):** The Sri Lankan Rupee experienced a significant depreciation of 40.7% between June 2021 and June 2022, which can contribute to inflation and make imports more expensive.
- **Positive Signs: Relatively Low Unemployment Rate (2022):** Compared to many other countries, Sri Lanka boasts a low unemployment rate of 5.2% in 2022; **Decent GDP Per Capita (2020):** The GDP per capita of 3,682.04 USD in 2020 indicates a middle-income economy; **Export Potential:** While there's a trade deficit, the percentage of exports to GDP (16.58%) suggests some export potential in Sri Lanka's economy.

3.2. China's Debt Trap Diplomacy

Sri Lankan–Chinese relations in the twenty-first century can be considered the era of China-centric infrastructure development. Sri Lanka's falling into the debt trap of China begins with huge investments made by China in several major development projects in Sri Lanka. The Norochcholai Power Station, Mattala Airport, Hambantota Port, Southern and Katunayake Expressways, Nelum Pokuna (Lotus Pond) Theatre, the Lotus Tower in central Colombo, the Colombo Port City (now renamed the International Financial City), and the Northern Road Rehabilitation Projects have all been funded by China (Deyshappriya, 2019).

The best illustration of China's political debt trap approach is Laos, where China built a railway line project named the China-Laos Rail Network, in which China owns 70% of the shares. Laos was so badly in debt to China, having borrowed \$480 USD from a Chinese bank, that it had to sell a portion of its power grid for \$600 USD to pay off Chinese financial creditors. This project has locked Laos in China's debt trap, and Laos is still responsible for 45% of China's debt Sri Lanka signed the first Memorandum of Understanding (MOU) with AIIB on

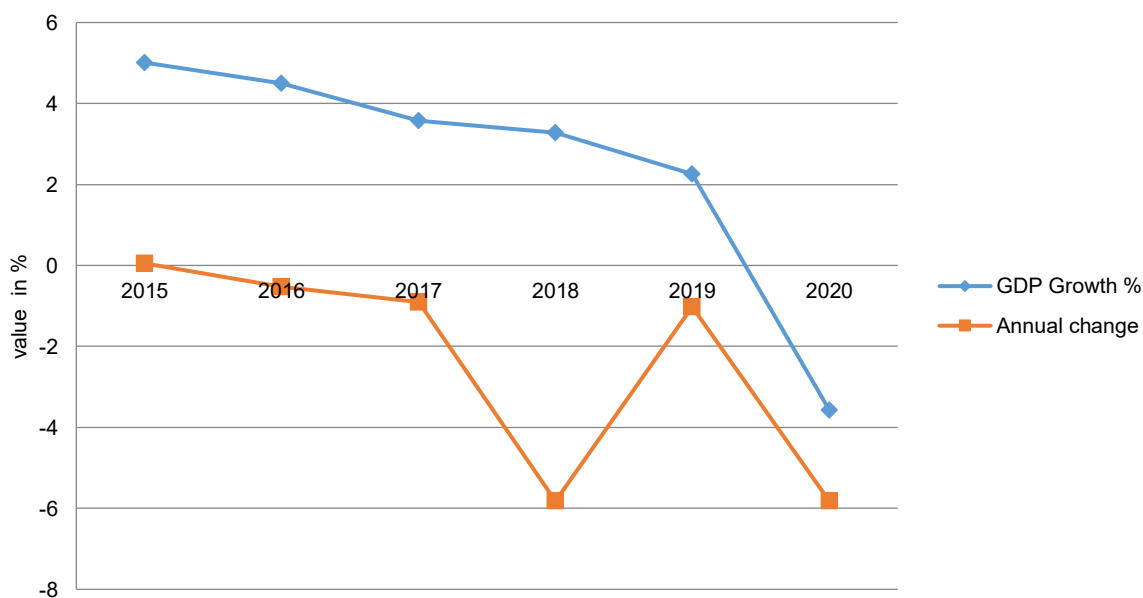
October 24, 2014. It became a member of the AIIB on 29 June 2015 and ratified its membership on 22 June 2016 as a founding member. By the end of 2019, China owned a little over 10% of Sri Lanka's outstanding foreign debt stock. Chinese loans thereafter were obtained to support budgetary and BOP deficits. In early 2021, the Sri Lankan government secured a 10 billion renminbi (RMB) currency swap facility from China to address the country's ongoing foreign exchange shortage.

The China Development Bank provided Sri Lanka with a \$1 billion Foreign Exchange Term Financing Facility (FTFF) in 2018 and another \$500 million in March 2020. Sri Lanka signed another FTFF agreement with CDB for \$500 million in early April 2021. All these availed debt facilities express Sri Lanka's dependence on China to avoid external sectors like the BOP issue and, Foreign Exchange Fund¹. Several geopolitical experts cite Sri Lanka as an example of China's "strategic trap diplomacy" or "debt-trap diplomacy". Though China's share in Sri Lanka's debt officially stands at 10%, the same as Japan's, it is not an accurate picture of the situation. Most Chinese debts are off-the-book. These are commercial lending and are never shown in the government record available for public information.

3.3. Sri Lanka Economic Condition

According to the IMF, Sri Lanka's real GDP growth rate is -3.6%. GDP at current prices is about 34.3 thousand billion US Dollars in 2020. Figure 1, shows that Sri Lanka's GDP rate has continuously declined since 2015. It was about 5.01% in 2015 and declined to 4.49 % with an annual change of -0.52%. Similarly, the GDP growth rate for 2020 was -3.57% a 5.82 % decline from 2019.

Figure 1: Sri Lanka GDP growth rate



Source: World Bank

¹ The Economics of the China-India-Sri Lanka Triangle from <https://thediplomat.com/2021/05/the-economics-of-the-china-india-sri-lanka-triangle/>

According to the Economic Complexity Index, Sri Lanka was the number 66 economy in the world in terms of GDP (current US\$), number 83 in total exports, number 82 in total imports, number 125 in terms of GDP per capita (current US\$), and the number 82 most complicated economy in the world in 2020 (ECI). Sri Lanka had a total export of \$11.3 Billion and a total import of 16.2 billion. USD leading to a negative trade balance of 4.9\$. The trade growth of Sri Lanka is about 3.72% compared to a world growth rate of 5.68%. Sri Lankan exports of goods and services account for 23.13% of GDP, while imports of goods and services account for 29.25%.

Table 2: Major export and import trade partners of Sri Lanka

Nations	Share of Major Export partners of Sri Lanka (in %)	Nations	Share of Major Import partners of Sri Lanka (in %)
United States	24.87	India	21.8
United Kingdom	8.88	China	19.65
India	6.72	UAE	7.34
Germany	4.66	Singapore	6.06
Italy	4.53	Japan	4.87

Source: World Bank

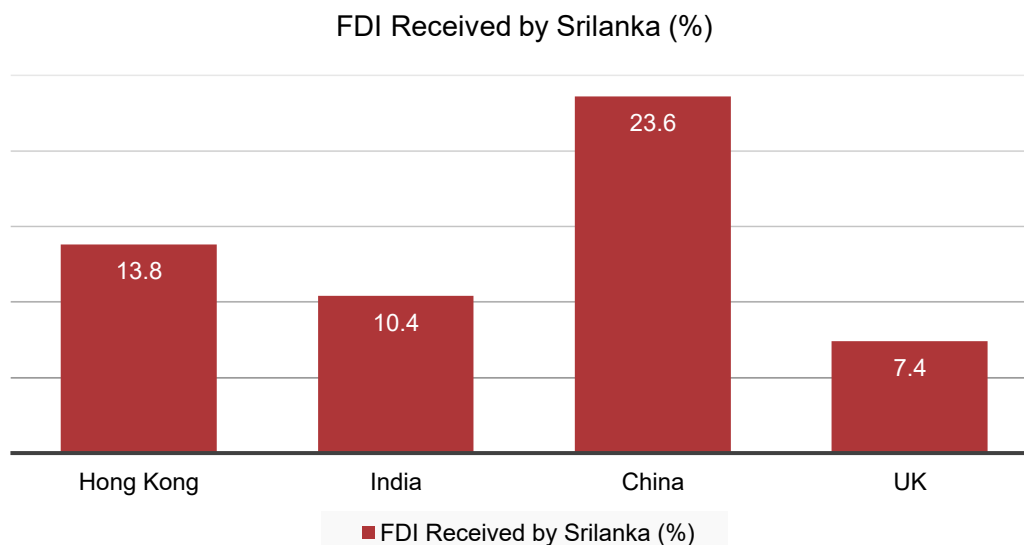
Sri Lanka's exports have increased by \$133 million in the last five years, from \$11.2 billion in 2015 to \$11.3 billion in 2020. Sri Lanka's imports decreased by -\$5.59 billion in the last five years, from \$21.8 billion in 2015 to \$16.2 billion in 2020².

FDI is important for the investment relations, with FDI playing an important role as a source of economic growth, especially in developing countries. Chinese investments have also contributed significantly to Sri Lanka's economic development. During the decade 2010-2020, China was Sri Lanka's greatest foreign investor. However, in the early 2000s, FDI flows from China to Sri Lanka were limited. The FDI inflows from China to Sri Lanka were just US\$ 61.7 million during the years 2003–08 (Samaranayake, 2011). But now China has become the third largest foreign direct investor in the world.

Figure 2 shows the changing landscape of Foreign Direct Investment (FDI) in Sri Lanka between 2015 and 2023. We see a significant rise in FDI from China, likely surpassing Hong Kong as the primary contributor. India's FDI contributions have remained relatively stable. In contrast, Hong Kong shows a decline, and the UK has a fluctuating pattern. For a more detailed analysis, we'd need the specific percentages and identify the sectors where these investments are directed. In 2015, Chinese private investments reached \$338 million, accounting for 35% of total FDI in Sri Lanka. Recent FDI in Sri Lanka has flowed mainly into real estate, mixed-use developments, ports, and telecommunications, with China as the largest source, followed by Hong Kong, India, Malaysia, and the UK. However, large Chinese investments have failed to generate sufficient foreign exchange, depleting reserves and leaving Sri Lanka struggling to meet debt obligations. The crisis reflects a debt trap driven by structural imbalances, rising debt, and heavy interest payments. FDI rose from 1.089% of GDP in 2015 to 1.835% in 2018, but without easing external vulnerabilities.

² See more at Sri Lanka (LKA) Exports, Imports, and Trade Partners
<https://oec.world/en/profile/country/lka>

Figure 2: FDI Flow



Source: World Bank

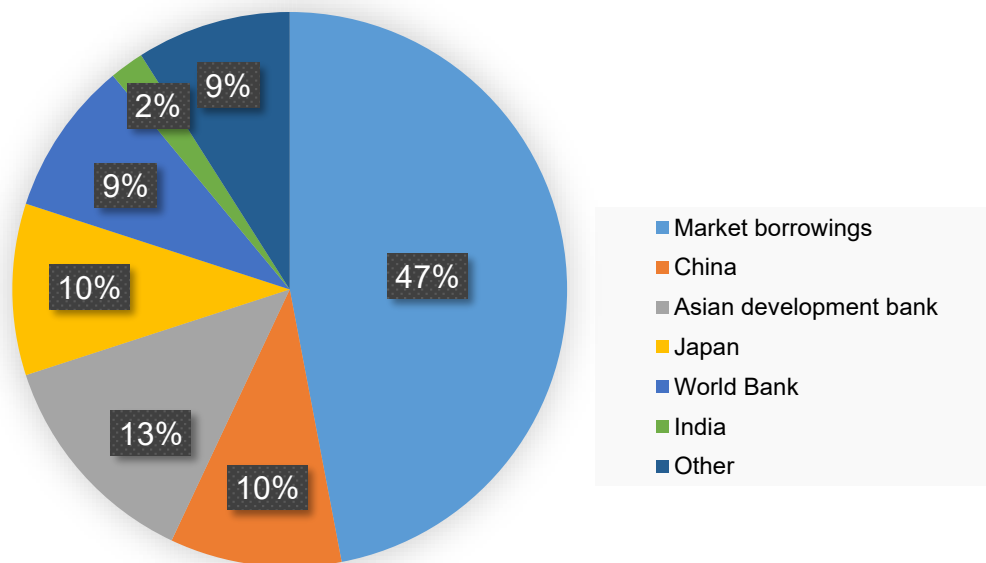
However, due to the COVID-19 outbreak, FDI continued to drop, reaching 0.885% and 0.538% in 2019 and 2020, respectively. Sri Lanka's foreign direct investment (FDI) fell to \$548 million in 2020, falling from \$793 million in 2019 and \$1.6 billion in 2018.

Burden of Foreign Debt and Exchange Rate

Sri Lanka's economy contracted 3.6% in 2020. The borrowing data reached an all-time high of 36.32 USD Billion in NOV 2020. Borrowing from the capital market is the largest source of foreign debt. As of the end of April 2021, the government's total outstanding external debt stood at \$35.1 billion. There was a total debt service payment of \$981.0 million from January 1 to April 30, 2021. Principal payments for \$520.6 million and for interest payments of \$460.4 million were owed. Exchange rates in Sri Lanka are at an all-time high. 310 rupees buy 1 US Dollar, but in the black market, it is more than 310 rupees. By the end of April 2021, the total outstanding external debt of the Government was US\$ 35.1 billion. Total debt service payments from 1st January to 30th April 2021 amounted to USD 981.0 million, of which USD 520.6 million was in lieu of principal repayments and the balance USD 460.4 million for the payment of interest as we can see in the given pie chart.

Figure 3 presents the distribution of Sri Lanka's major lenders, both in US\$ million and as percentages of total borrowing. The World Bank emerges as the dominant creditor, accounting for nearly half of Sri Lanka's total borrowing at 47%. The Asian Development Bank (ADB) follows with 13%, while Japan contributes 10%. India and China each provide 9%, reflecting their significant role in Sri Lanka's external financing. The remaining 2% is sourced through market borrowings, which, although relatively small, highlight Sri Lanka's reliance on a diverse mix of bilateral and multilateral partners to sustain its financing needs.

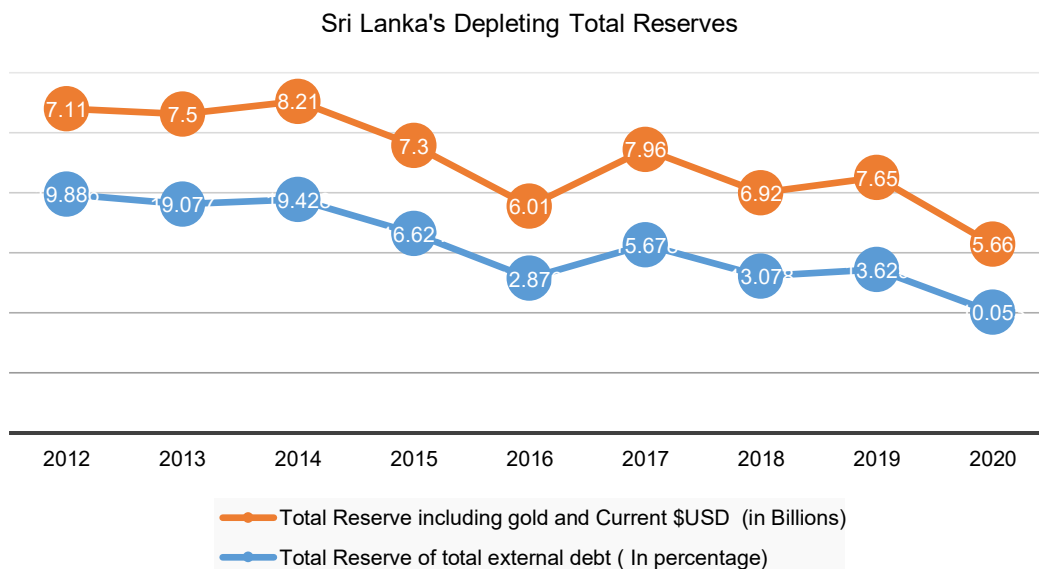
Figure 3: Debt stock (by major lenders, US\$ million)



Source: Department of External Resource

Figure 4 shows a comparison of Sri Lanka's Total Reserves over time. The data appears to span from 2012 to 2020. The reserves generally declined from 2012 to around 2016-2017, then experienced an increase. Notably, they saw peaks in 2013 and 2019. There's a second line on the graph which might represent the total reserve in relation to external debt; this would require knowing the legend to interpret fully.

Figure 4: Sri Lanka's Total Reserves



Source: World Bank

Inflation

Sri Lanka was already experiencing the highest inflation rate in Asia due to lockdown measures during the COVID-19 pandemic and the decline in the tourism industry. Sri Lanka's inflation rate increased to 18.7% in March, up from 15.1% in February, reaching the highest level since October 2008. Since 2008, Sri Lankan inflation has remained in the single digits. Until today, food inflation has never surpassed 15%. Diesel prices have expanded by 76% and petrol prices by 96% in the last 3 months.

Table 3: The cost of basic necessities items in comparison to March 2019

Items	Price as of March 2019	Price as of March 2022	% Hike in prices
Potato	156.7/kg	26.67/kg	66%
Onion	79.8/kg	158/kg	98%
Coconut	50.4/ each	91.39/each	81%
Tomato	105.2/kg	310.42/kg	195%
Rice	84.1/kg	162.52/kg	93%
Flour	94.33/kg	155.24/kg	65%
Turmeric	659.9/kg	358.33/kg	443%
Bread	64.4/450g	80/450g	28%
Chickpeas	239.6/kg	377.55/kg	58%
Chicken	445/kg	690/kg	55%

Source: Department of Census and Statistics Sri Lanka

Fuel and Cooking Oil Prices

Table 3 shows that the state-owned Ceylon Petroleum Corporation hiked the price of a litre of petrol from Rs 137 to Rs 254 in March (from \$2.04 to \$3.86 per gallon in 2021). Diesel prices have also risen from Rs 104 per litre a year ago to Rs 176 per litre (increased from \$1.54 per gallon in 2021 to \$2.63 in 2021). In 2021, the price of a normal domestic 12.5 kg LPG cylinder jumped from Rs 1,493 (\$4.9) to Rs 2,750 (\$9) in 2022. Cooking gas has become prohibitively expensive for many Sri Lankans; therefore, many are turning to firewood and kerosene as alternatives.³

3.4. Social and Political Impact of the Crisis

Troubled by all these problems millions of people have come out on the streets through anger and compulsion, protesting against the government and demanding solutions to the economic problem. According to UNDP finally, the Sri Lankan economic crisis is now turning into a humanitarian crisis. An Unprecedented shortage of food, medicine and fuel has forced people to protest. According to World Bank estimates, since the outbreak began in Sri Lanka, about five lakhs of people have fallen into poverty. "A huge setback similar to five years' worth of growth" was called by the World Bank. All 20 ministers of the Sri Lankan cabinet have resigned.

³ Info graphic: Sri Lanka's economic crisis and political turmoil, <https://www.aljazeera.com>

According to the World Bank's 'South Asia Economic Focus Reshaping Norms: A New Way Forward,' the area will grow by 6.6% in 2022 and 6.3% in 2023. The 2022 forecast has been lowered by 1.0 percentage points from the January projection, owing primarily to the impact of the Ukraine conflict. The necessary modifications, according to the World Bank, may initially harm growth and degrade poverty, but they will correct significant imbalances, laying the groundwork for strong and sustainable growth as well as access to international financial markets. It will be necessary to mitigate the negative effects on the poor and vulnerable.⁴ Sri Lanka's government now has opted to default on all of its foreign debt and is awaiting IMF assistance worth \$51 billion.

Sri Lanka is a developing economy largely dependent on agriculture, services, and the light industry. The main economic sectors of the country are tourism, tea export, apparel, textile, rice production and other agricultural products. The following are the major sectors affected adversely:

After the series of terrorist bombings in Colombo in 2019, tourism was already on the decline. The COVID-19 epidemic exacerbated the situation. As a result, the foreign currency-earning sectors of the economy were decimated, resulting in a decrease in the inflow of foreign currency, which is utilised to make import transactions. The tourism industry has been hit hard by the pandemic. The loss of foreign revenue from the sector has been substantial. From over \$7.5 billion in 2019, the forex reserves had dropped to around \$2.8 billion in July 2021, The Hindu reported in September last year. With the Sri Lankan rupee depreciating, the price of food items has risen too. For even its basic food supplies, the island nation depends heavily on imports.

Sri Lanka contributes about 7.4% to the national GDP. Sri Lanka's primary food crop is rice. About 75% of those working in agriculture are engaged in the production of tea, rubber and coconuts. The three crops comprise nearly 60% of Sri Lanka's agricultural land. Sri Lanka has been slow to adopt mechanized farming. The government wants to increase the mechanization of farming. The government wants to increase mechanization and grow higher-value cash crops such as fruit, flowers and other export-oriented crops. The lack of private investment in agriculture due to uncertain policies limits the expansion of the sector. The Sri Lanka government banned the usage of chemical fertilizers in April 2021 to make the farming environment friendly. This led to yields going down by 20% to 25% across crops and led to a sharp surge in food prices. This in turn led to widespread protest because it led to a shortage of food and high inflation.

Beginning January 2022, India has been providing crucial economic support to island countries in the grip of a severe dollar crisis that, many fear, might have led to sovereign default and a shortage of essentials in the import-reliant country. The relief extended by India from the beginning of 2022 totalled over USD 1.4 billion, a USD 400 currency swap, a USD 500 loan deferment and a USD 500 line of credit for fuel imports. More recently, India extended a USD 1 billion short-term concessional loan to Sri Lanka to help the country as it faces an unprecedented economic crisis.

⁴ Sri Lanka's economic outlook uncertain, needs urgent measures: World Bank, <https://www.business-standard.com/>

3.5. Steps Taken to Combat the Economic Crisis

To mitigate the unfolding economic crisis, Sri Lanka adopted a series of domestic measures aimed at stabilizing the economy and addressing immediate shortages. The government-imposed import restrictions on a range of “non-essential” commodities, while school examinations were postponed indefinitely due to a paper shortage. In response to mounting public protests over fuel scarcity, troops were dispatched to gas stations to manage crowd control.

The Central Bank of Sri Lanka intervened by raising interest rates to curb inflationary pressures and devalued the rupee by up to 15%, setting a new exchange rate ceiling of 230 rupees per dollar compared to the previous ceiling of 200–203. In December, the Central Bank also introduced further incentives, such as an additional 10 rupees per dollar to encourage remittances. However, the impact was limited, with remittances falling by 61.6% in January 2022 compared to the same period in the previous year.

On the international front, the government sought external financial support to ease debt and foreign exchange pressures. Sri Lanka formally requested China to restructure its debt obligations and simultaneously initiated discussions for an additional US\$ 2.5 billion in credit assistance. In parallel, Colombo turned to India, securing a US\$ 1 billion credit line and requesting an additional US\$ 1 billion facility soon after. Furthermore, India extended a US\$ 400 million currency swap arrangement and an additional US\$ 500 million credit line dedicated to fuel imports. These measures underscored Sri Lanka’s growing reliance on bilateral support to meet immediate financial needs.

Looking ahead, the way forward requires a comprehensive restructuring of domestic economic governance alongside strengthened international cooperation. Domestically, the government should prioritize raising tax revenue and reducing excessive expenditure to minimize reliance on sovereign borrowing, particularly from external sources. Reversing or redesigning the 2019 tax reductions, legally restoring PAYE and VAT structures, and introducing statutory revenue floors to safeguard the tax-to-GDP ratio are critical steps (Abeysekera, 2024). Equally important is the restructuring of subsidies and concessions, coupled with stronger institutional accountability. This includes empowering CIABOC and audit institutions legislatively, improving judicial integrity, and adopting anti-corruption measures to strengthen the rule of law (Ramesh & Vinayagathan, 2024). A legally underpinned inflation-targeting regime has also been recommended, with Monte Carlo simulations indicating its effectiveness in reducing volatility (Paranavithana et al., 2021). Moreover, exchange rate regime choices should be grounded in transparent and legally consistent institutional frameworks, thereby avoiding ad-hoc policy reversals (Siyara & Perera, 2023).

In terms of regional cooperation, India’s role is particularly important. It would be strategically unwise for New Delhi to allow Chinese influence to deepen unchecked in Sri Lanka. India can instead provide financial aid, policy guidance, and entrepreneurial investment to help stabilize Colombo’s economy. By fostering deeper supply chain integration in goods and services, from tea exports to IT outsourcing, India and Sri Lanka could create mutually beneficial economic interdependence. Moreover, the current crisis should serve as a catalyst to strengthen bilateral ties by addressing longstanding issues such as the Palk Bay fisheries dispute, which has been a recurring source of friction.

Finally, preventing unintended spill overs of the crisis is equally crucial. The state of Tamil Nadu has already reported the arrival of Sri Lankan nationals through irregular migration, echoing the refugee influx of the 1980s. Authorities in both countries must prevent the escalation of smuggling, trafficking, and politically charged narratives that could destabilize bilateral relations. Given its size and regional role, India bears the greater responsibility to exercise patience, extend support, and expand people-centric development initiatives while avoiding interference in Sri Lanka's domestic politics. Ultimately, the crisis presents both a challenge and an opportunity: with coordinated domestic reforms and constructive regional engagement, Sri Lanka could lay the groundwork for long-term economic recovery and stability.

Conclusion

With the anticipated inflows from bilateral partners and non-debt-creating foreign currency inflows in the coming days, the Sri Lankan government is hopeful that the foreign exchange situation will improve soon. The tourism industry's foreign exchange earnings and remittances are expected to rise soon. In March 2020, the COVID-19 pandemic struck. In April 2021, the Rajapaksa government made another fatal gaffe. To prevent the drain of foreign exchange reserves, all fertilizer imports were completely banned. Sri Lanka was declared a 100% organic farming nation. This policy was withdrawn in November 2021, led to a drastic fall in agricultural production and more imports become necessary. It can be said with encouragement that the present government in Colombo is effectively recovering from the ill effects of several government policies suddenly imposed on the people in the past political chaos, and it has been sovereign sovereignty due to its dependence on China in the past.

In the present situation, Sri Lanka is going through it urgently needs to recognize its structural weaknesses. Domestic revenue collection can be strengthened only by reducing the fiscal deficit. Sri Lanka also needs to focus on finding viable alternatives to restore debt stability, given the horrific mountain of current debt. Sri Lanka needs to be monitored for the proper implementation of the financial sector. In all possibilities, Sri Lanka will now obtain a 17th IMF loan to help it get through the current crisis, which will come with new conditions. A deflationary fiscal policy will be implemented, limiting the prospects for economic recovery and exacerbating the suffering of the Sri Lankan people. Sri Lanka's economic collapse can be meaningfully interpreted through the lens of institutional economics, which emphasizes the role of formal rules, enforcement mechanisms, and governance quality in shaping economic performance.

North (1990) argues that weak or poorly enforced institutions create high transaction costs, encourage rent-seeking, and undermine long-term growth. In Sri Lanka's case, fragmented fiscal rules, weak central bank independence, and arbitrary policy shifts (e.g., fertilizer import ban) represent institutional failures that eroded credibility and resilience, consistent with the institutional economics perspective (Acemoglu & Robinson, 2012).

Public choice theory emphasizes that economic policies are often shaped by political incentives and interest groups, prioritizing short-term gains over long-term welfare. In Sri Lanka, the 2019 tax cuts illustrate this dynamic, as they were politically motivated to gain electoral support despite creating fiscal imbalances. Likewise, delays in adjusting fuel and electricity tariffs reflected populist pressures to avoid public backlash, even though such measures undermined efficiency and sustainability. These examples reinforce the public

choice argument that policy distortions frequently stem from political expediency rather than sound economic reasoning.

Together, these frameworks suggest that Sri Lanka's crisis was not merely the result of external shocks but rather the outcome of institutional fragility and political economy dynamics that systematically undermined fiscal discipline, monetary credibility, and economic resilience. By situating the Sri Lankan case within institutional and public choice theory, the paper contributes to broader debates on how governance and incentive structures shape the trajectory of developing economies in crisis situations.

Sri Lanka's economic collapse demonstrates how fragile institutions, weak enforcement of fiscal rules, and politically motivated policy decisions can combine to produce systemic failure. The analysis grounded in institutional economics and public choice theory shows that institutional fragility and political incentives distorted fiscal and monetary policies, undermined debt sustainability, and eroded public trust. Preventing future crises requires not only macroeconomic adjustments but also deep legal and governance reforms.

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Both authors contributed significantly to the research, reviewed the final manuscript, and approved it for submission. The corresponding author affirms that the contribution descriptions are accurate and agreed upon by both authors. Pooja Sahu: Data Curation; Formal Analysis; Visualization. Pooja was responsible for statistical data collection, analysis, and preparation of graphs and visual representations. Akanksha Singh: Writing – Original Draft; Writing – Review & Editing; Literature Review. Akanksha was responsible for conducting the review of literature and preparing the main written content of the manuscript.

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Conflict of Interest Statement

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No datasets were generated or analysed during the current study.

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