

On 12 April 2022, the Sri Lankan government announced that it would be defaulting on all its external debt totaling USD 51 billion. Basically, Sri Lanka has admitted it does not have enough foreign currencies, especially US dollars, to pay its external obligations and also to pay for imports of important items such as food and fuel.

For many months now, most of the 22 million Sri Lankans have been suffering from a host of problems including shortage of food and frequent electricity disruption. There have also been many protests organized against the government. So, the decision by the government was not really surprising. Sri Lanka is now in negotiation yet again with the IMF to seek financial help to overcome its problems. And the IMF issued the familiar statement, asking Sri Lanka to 'implement a credible and coherent strategy to restore macroeconomic stability'. This standard advice given by the IMF to countries seeking its help due to economic and financial crises is not difficult to decipher. Normally it means the government must remove or reduce subsidies, increase tax revenues and also increase interest rate in order to address inflation. Unfortunately, it usually means further hardship for the ordinary people in those countries.

In fact, sometimes the added hardship can lead to social and political upheavals, as what happened in Indonesia in 1998 during the Asian Financial Crisis. President Suharto's government was in a desperate situation during the crisis because of its huge external loans and the plunging rupiah. Suharto therefore was forced to seek financial help from the IMF. But the IMF imposed strict conditionalities for the loan given, including the removal of subsidies and the imposition of additional taxes. The subsequent hardship experienced by ordinary Indonesians led to violent and deadly riots in Jakarta and other big Indonesian cities and eventually the downfall of Suharto.

Whether the leaders of Sri Lanka are going to suffer the same fate due to the ongoing problems and the involvement of the IMF is difficult to predict because there are other factors that will come into play. The more important question to ask is why is Sri Lanka in the mess it is in? What are the main factors that led to the current serious financial crisis it is facing?

There are three main elements that contributed to its current problems, namely, corrupt and populist leadership, a debt-based system that encourages the government and society to go into debt, and the values of the people that want quick solutions to their problems and are unconcerned about the long-term danger of debts. These factors are also intertwined.

The presence of rampant corruption among the ruling clique in Sri Lanka is well known. People who are close to President Gotabaya Rajapaksa and his brother, Prime Minister Mahinda Rajapaksa will find it easy to obtain positions and opportunities. According to one report, they and a couple of close relatives oversee departments and agencies that collectively control nearly 70% of Sri Lanka's budget. The mega infrastructure projects using money borrowed from Chinese bank were also an opportunity for corrupt practices.

But this ruling political elite knows how to hang on to power and that is by implementing populist policies. An example is the 2019 decision to cut taxes. This predictably proved to be

very popular among voters and helped to ensure that their grip on power continues. And in order to continue to be popular, they also decided not to reduce government expenditure despite the reduced tax revenue to the government. This strategy may be effective in securing short term support, but it does not need an Einsteinian brain to figure out that sooner or later the government would be facing serious financial problems.

But the Sri Lankan economy was still functional then due to the popularity of the country for international tourists. Its pristine beaches still managed to attract European and American visitors in droves. But this is actually a two-edged sword because when a country is overly reliant on tourism for revenue, it will also be highly vulnerable if suddenly the number of tourists dropped, which was exactly what happened in 2020 due to the Covid pandemic.

The government's response to the reduced foreign exchange earning was a bit perplexing though. Instead of focusing on increasing exports of everything including agricultural products, it introduced a policy that created the opposite effect. That policy was to turn the country into an 'Organic Economy' by cutting the use of imported fertilizers in its agricultural sector. Granted that one of the main reasons for the policy was to reduce imports but its outcome was to drastically reduce the yield of its agricultural sector and consequently its exports of agricultural products thereby worsening its balance of payments.

In an economy where there is minimal debts, especially from external sources, any downturn in the economy will not necessarily result in an economic or financial crisis. Unfortunately, Sri Lanka is a debt-based economy where debts, whether in the household, private or public sectors, are treated as something normal and not something to be overly concerned with. Therefore, most Sri Lankans don't really care much about the amount of government debt, preferring to focus on the benefits they can obtain from government spending and subsidies.

Moreover, in a debt-based economy, a system where central banks create base money and commercial banks create loans which at the same time create new money, there need to be a strong control over the growth of debt and money supply. If they are not controlled, rapid growth in money supply will result in inflation. If the rate of inflation is perceived to be uncontrolled, it will result in money flowing out the country's monetary system, thereby putting downward pressure on the country's currency. In the case of Sri Lanka, inflation rate rose from 3.9% in April 2021 to 18.7% in March 2022. This contributed to a further fall in the value of the Sri Lankan currency from 181 Rupee per US Dollar in January this year to more than 336 Rupee currently, thus leading to imports becoming more expensive. This import-push inflation is causing more misery for the ordinary folks, especially those on fixed income or fixed pension.

It must be borne in mind that a debt-based system is only able to grow if the government, organizations and individuals continue to spend beyond their means.

This is exactly what happened in Sri Lanka. The people were always more concerned with quick solutions to their financial problems. Many borrow from banks or rely on handouts from governments. Since the government is led by populist leaders who are out to please

the people in order to get their votes, government expenditure kept growing. Government debt-to-GDP ratio increased from 68% in 2012 to 101% in 2020. But the people were unconcerned right until the point when the government is no longer able to pay back the loans and no longer able to provide the same level of services. Now the people are protesting against high prices of goods and services and poor government services. But unfortunately, this is already too late.

As mentioned earlier, Sri Lankan government is now negotiating with the IMF in order to obtain financial assistance to pay back the external loans. Regardless of whether the IMF agrees or not to provide the assistance, there is now no way to avoid the pain of the financial crisis for the majority of Sri Lankans. The only way to avoid implementing tough policies prescribed by the IMF is to avoid the situation of needing its assistance in the first place.

In conclusion, the main blame for the mess Sri Lanka is facing should be placed not only on the shoulders of the corrupt and self-serving leaders of Sri Lanka, but also on the people who elected them and who pressured them to behave in a corrupt and irresponsible way. The fact is, any country whose people are more concerned only about money in their own pockets, and who continually elect populist leaders that like to please the people by getting the government to spend for the rakyat using borrowed money, and subsequently get the government deeper and deeper into debts, will end up in the same trouble as Sri Lanka.

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