The Sri Lanka's Economic Fallout: Lessons for Pakistan

Narmeen Fayyaz Leghari
Basit Ali
Dr. Aneel Salman

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About the Authors

Narmeen Fayyaz Leghari is a Freelance Political Economist and her areas of expertise are Political Economy, International Relations and Macroeconomics.

Basit Ali is a Research Assistant at Islamabad Policy Research Institute (IPRI) and a Post Graduate Economist from COMSATS University Islamabad. His area of expertise are Macroeconomics, Economic Security, Environmental Economics and International Economics.

Dr. Aneel Salman is Behavioral Economist from the Rensselaer Polytechnic Institute in Troy, New York, USA. Currently he is the Chair Economic Security at Islamabad Policy Research Institute (IPRI). His areas of research expertise include climate change, behavioral, energy and development economics, institutional governance, international trade, and public policy.

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The Islamabad Policy Research Institute (IPRI) is one of the oldest non-partisan think tanks on all facets of National Security**,** including International Relations & Lawfare, Strategic Studies, Governance & Public Policy and Economic Security in Pakistan.

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Executive Summary

This policy brief analyses the economic situation in Sri Lanka and Pakistan. The study will examine and try to understand the reasons that led to the current economic crisis in Sri Lanka, so that such pitfalls may be avoided in the future by policymakers in case of Pakistan.

This study considers the key economic variables comparisons and commonalities between both the countries, future forecast and determines that debt accumulation, structural weaknesses, lack of diversity in exports, high inflation, high interest rate and populist policy decision-making without engaging with all stakeholders ultimately led to the current crisis. By underlining the challenges faced by both the South Asian countries, this policy brief will draw lessons from Colombo's economic fallout and provide recommendations to the policymakers.

Introduction

Economic and political uncertainty is unfolding across the South Asian region. With Sri Lanka facing a full-blown economic meltdown, Pakistan's economy is also facing a similar trajectory with its ballooning current account deficit and nose-diving exchange rate.

Pakistan, with a GDP of $314.6 billion, is ranked the 41st largest economy in the world, while Sri Lanka is ranked 65th with $88.9 bn. However, it is worth noting that Pakistan's population is 10 times that of Sri Lanka, while Pakistan's GDP per capita at $1.5K is a third of the GDP per capita of its South Asian counterpart at $4.1K, indicating a lower standard of living in Pakistan as compared to Sri Lanka.

Sri Lanka and Pakistan share salient commonalities with their over reliance on imports of essential items including petrol, gas and limited exports -- net coupled with years of resource mismanagement and unbalanced macroeconomic policies.[1] Pakistan's inflation rate is currently at 13.4 per cent, and it is the second highest in South Asia after Sri Lanka at 29.8 per cent. The World Bank (WB) has warned that Pakistan and Sri Lanka are at the highest on account of external debt repayment ratio to exports and remittances in the South Asian region.

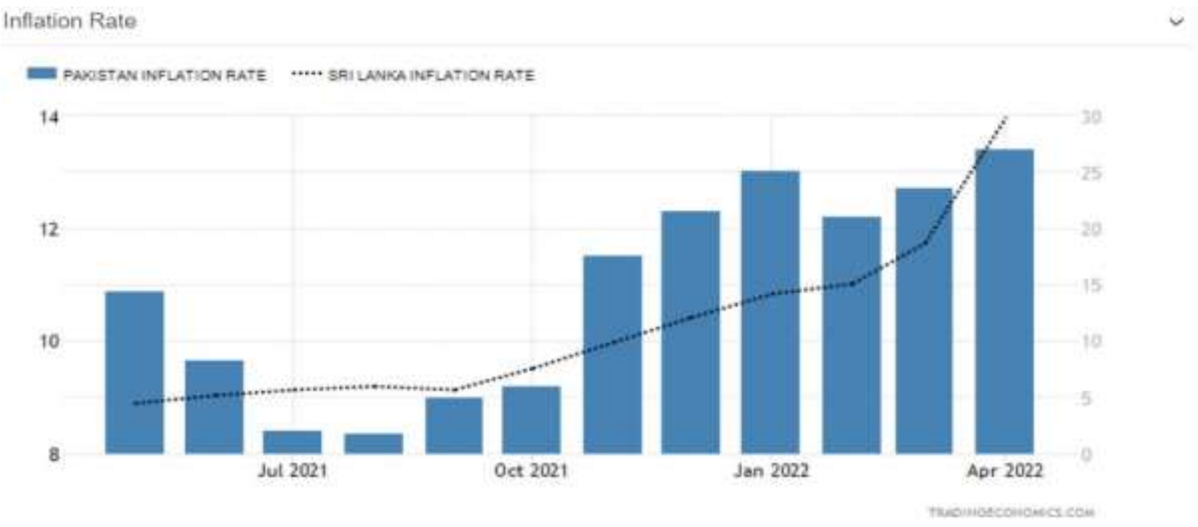

Figure 1. Pakistan and Sri Lanka Inflation Rate Comparison

Source: Economics, T. (2022). Pakistan inflation Rate April 2022 data - 1957-2021 historical - may forecast. Retrieved May 18, 2022, from https://tradingeconomics.com/pakistan/inflation-cpi

[1] editors, E. A. F., Weerakoon, D., Wijesinha, A., Wignaraja, G., Attanayake, C., Weeraratne, B., Arao, D. A., Jongwanich, J., Timur, F. B., & Sulaiman, Y. (2022, April 25). *Sri Lanka and Pakistan, brothers in crisis*. East Asia Forum. Retrieved May 19, 2022, from https://www.eastasiaforum.org/2022/04/25/sri-lanka-and-pakistan-brothers-in-crisis/

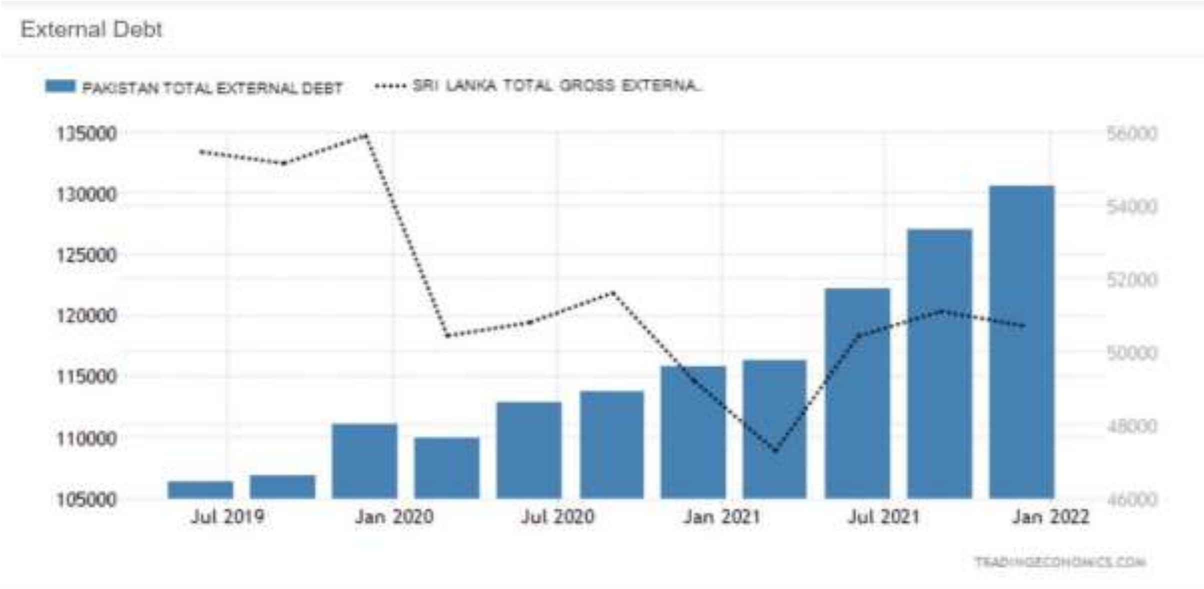

Figure 2. Pakistan and Sri Lanka External Debt Comparison

Source: Economics, T. (2022). Pakistan inflation Rate April 2022 data - 1957-2021 historical - may forecast. Retrieved May 18, 2022, from https://tradingeconomics.com/pakistan/inflation-cpi

Sri Lanka, has plunged into a deep economic crisis with more than $50 billion in external debt, while Pakistan's current account deficit is currently standing at $13.2 billion. Both countries are currently facing balance-of-payments crisis, also called a currency crisis that occurs when a nation is unable to pay for essential imports or service its external debt repayments.

Future Economic Projections for Pakistan & Sri Lanka

Despite political and economic uncertainty in both countries, when it comes to comparison of leading economic indicators and the future projections for FY2023, Pakistan's economic situation is likely to be more stable than Sri Lanka. The exchange rate will reach PKR 205.39 in 2023[2], although given inflationary pressure and fuel subsidies currently it is PKR 202; while in Sri Lanka, it will touch up to SRL 384.75 per dollar in 2023[3]. Pakistan's stock market is also likely to bounce back and the GDP growth will be 4.5 per cent, compared to Sri Lanka, which will be 4.2 per cent. Inflation is also projected to decline to 8 per cent, which is at present 13.4 per cent in the case of Pakistan, while for Sri Lanka, it will further decline from 29.8 percent to 6 per cent. Balance of Payment (BOP) and Current Account will further increase because of Pakistan's upward pressure on exchange and interest rate. At the same time, the Sri Lankan economy banned the imports of goods and services in the current situation. Debt obligations will increase from 87 per cent to 90 per cent, which is acceptable given the current economic situation, but it is above the threshold level. In the case of Sri Lanka, debt will further expand

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[2] TRADING ECONOMICS. "Pakistani Rupee". Accessed June 9, 2022 https://tradingeconomics.com/pakistan/currency

[3] TRADING ECONOMICS. "Sri Lankan Rupee". Accessed June 9, 2022. https://tradingeconomics.com/sri-lanka/currency

and touch 120 per cent. With a population of 220 million, Pakistan's external debt obligations are approximately $130 billion while Sri Lanka with only 20 million people has more than $50 billion. At the same time, the future forecast shows that the economy will recover in the coming year if well-thought policy measures are adopted. Table I provides a summary of key economic indicators for Pakistan and Sri Lanka:

Table 1 Key Economic Indicators Comparison

Key Indicators	Pakistan	Forecast-2023	Sri Lanka	Forecast-2023
Currency (Per $1)	200	198	351	397
Stock Market (Points)	42983	37357	8224	5923
GDP Annual Growth Rate (Percentage)	3.94	4.50	1.80	4.20
Unemployment Rate (Percentage)	4.40	9.00	4.60	4.50
Inflation Rate (Percentage)	13.40	8.00	29.80	6.00
Interest Rate (Percentage)	13.75	12.0	13.50	6.50
Balance of Trade (USD Million)	-3781.40	-3883.39	-762	-500
Current Account (USD Million)	-4078	-2588	-1139	-2000
Government Debt to GDP (Percentage of GDP)	87.00	90.00	101.00	120.00
Government Budget (Percentage of GDP)	-7.10	-5.00	-11.10	-7.00
Corporate Tax Rate (Percentage)	29.00	29.00	24.00	28.00
Personal Income Tax Rate (Percentage)	35.00	35.00	24.00	24.00

Source: TradingEconomics.com

Note: Figures from December 2022-May 2022

The imminent crisis calls on the ruling class to engage with all the stakeholders. Tackling economic challenges is not something that both the governments will be able to handle by themselves, for even the government to stabilize the economy with short-term solutions, the political uncertainty may morph into full-scale social unrest, thereby reversing the gains made by the government.

Crises Management Capabilities of Pakistan and Sri Lanka

Pakistan has faced several crises that have affected its national resilience and capabilities since its independence. These crises occurred either because of natural disasters or were manmade. The ones that had the most devastating or systemic, long-term impact included the refuge crises in 1947 and 1979, breakup of East Pakistan in 1971, earthquake in 2005, frequent regime changes, economic sanctions following nuclear tests in 1998, War against Terror, floods in 2010 and 2013.

More recently, in 2019 Pakistan was hit by the COVID-19 wave. According to the IMF and WHO, Pakistan managed the pandemic better than most developed nations, many of whom are still struggling with it. The pandemic tested Pakistan's crisis management capabilities, and the country performed well since the civil-military leadership came together to develop innovative plans such as smart lockdowns, country-wide vaccination drives, stepwise relaxation of COVID-19 free areas and many others. Be that as it may, Pakistan has not remained completely immune from the worldwide impacts of COVID such economic slowdown and supply chain disruptions. The more recent Russia-Ukraine war has also had global repercussions that have caused socioeconomic challenges such as increase in poverty and unemployment in Pakistan.

Considering Sri Lanka, which has been struggling to manage its financial crises since its birth, and recently the ADB declared the country as "pre-emptive default" because it is unable to pay its external debt owing to the severe economic crises in the country. Debt-servicing is one of its challenges, which is unsustainable because of its economic and political instability. The crisis arises because of the external and internal shocks, and insufficient policy steps such as substantial tax cuts and relying on the tourism industry, which is uncertain these days. The conflicts between Russia and Ukraine added more to the crisis through higher import bills, as Pakistan faces too, leading to double-digit inflation (30 per cent) in Sri Lanka. Furthermore, the thirty years of civil conflicts, which ended in 2009, added more to widen the fiscal and current account deficit. The tax cut, which reduces the government revenue, imports banning chemical fertilizers without informed policy steps led to increase in food prices, expansionary monetary policy and persistent fixed exchange rate without having reserves to support it. The public debt ratio rose by 119 per cent from 91 per cent between 2018 and 2022. The situation is so severe that the ruling party resigned along with the President and the Prime Minister because of public protest over higher inflation and economic mismanagement. This concludes that the crisis management capabilities and the inappropriate policy measures adopted by the Sri Lankan government were feeble to cater to the situation.

Reasons behind Sri Lanka's Economic Collapse

Pakistani policymakers need to examine the reasons that led to the Sri Lankan economic catastrophe. On April 12, 2022, amidst widespread protests due to economic-social unrest, all 26 members of the Sri Lankan cabinet resigned. The economic crisis become so grave that the Sri Lankan government ran out of dollars and even defaulted on its external debt. With the opposition no longer interested in bringing a vote of no-confidence against the Sri Lankan President Rajapaksa, in fact, they also rejected his offer to be part of the national government.[4] With two finance ministers changed within a span of two weeks, in addition to the volatile Sri Lankan Rupee (SLR) which now stands at 360 SLR against a US dollar, after keeping it artificially strong at 200 SLR. Similar policy intervention can be observed in Pakistan too when PKR was kept artificially strong. Both countries are now facing depleting foreign exchange reserves amidst plunging revenue collection and widening budget deficit.

Rajapaksa came into power in 2019 with populist claims and idealistic promises of reducing inflation and taxes. Instead of addressing long-standing structural, political and economic weaknesses, the Sri Lankan policymakers have been implementing short-term solutions to save dollars in a knee-jerk reaction, for instance, banning the import of chemical fertilizers (in the

[4] Mashal, M., & Gunasekara, S. (2022, May 14). A ruling family on the run as Sri Lanka plunges into economic ruin. Retrieved May 19, 2022, from https://www.nytimes.com/2022/05/14/world/asia/sri-lanka-rajapaksa.html

name of promoting organic farming): a decision that was reversed after it devastated the nation's tea crop, its primary export and prime source of foreign exchange.[5]

Moreover, Sri Lanka's over reliance on China for upscaling of its mega infrastructure projects under the BRI has also contributed to its debt accumulation accounting to $8 billion, further dragging Sri Lanka in to political and economic abyss.[6] They say that the insecurity breeds insecurity. In both countries, the intertwined nature of politics and economics has led to 'economic crisis and political instability'.

Lessons drawn from Sri Lanka

Colombo's ongoing economic challenges have lessons for us. Throughout history, Sri Lanka and Pakistan have been seen implementing half-baked solutions to save their economies; for example, banning imports of luxury items to restore their balance of payments instead of adopting a sustainable approach.

Pakistan's economy is currently grappling with high inflation, high global commodity prices, an unstable exchange rate and rising imports. The new government under Prime Minister Shehbaz Sharif has been facing a dilemma: should it use populist tactics like the predecessor government (fuel and energy subsidies, tax amnesty scheme) or take the required action and increase the energy prices? Gaining political popularity at the cost of macroeconomic stability will lead to a vicious 'boom-bust cycle'. It was the right but hard decision of reversing the fuel subsidy and this may ease the much needed IMF negotiations. The populist tactic of fuel and energy subsidies would have put Pakistan on a similar trajectory like Sri Lanka, potentially leading to a macroeconomic collapse.

Can Pakistan suffer the same fate as Sri Lanka?

This is unlikely because Pakistan is a food-producing country (even though it faces shortages), capable of covering basic requirements, unlike Sri Lanka which is import-dependent for essentials. However, Pakistan's foreign reserves have halved over the past 8 months (from ~$20bn to <$10bn USD), due to much more expensive imports (primarily petroleum and gas). The figure 3 below shows the import of Pakistan for last 12 months.

The need of the hour is political stability based on stakeholder consensus so that economic priorities can be given full attention. These include measures to manage imports (the recent ban by the government is a positive move); oil payment deferral arrangements; negotiations with the IMF; and re-evaluating subsidies on fuel and food (removing petroleum subsidies was inevitable as the earlier decision to provide those were politically motivated to keep the public content rather than on sound economic policies).

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[5] Nordhaus, T., & Shah, S. (2022, March 05). In Sri Lanka, organic farming went catastrophically wrong. Retrieved May 19, 2022, from https://foreignpolicy.com/2022/03/05/sri-lanka-organic-farming-crisis/

[6] Times, G. (2022). Accusations over China creating a 'debt trap' in Sri Lanka an organized smear by the West and India against Bri. Retrieved May 19, 2022, from https://www.globaltimes.cn/page/202204/1258752.shtml

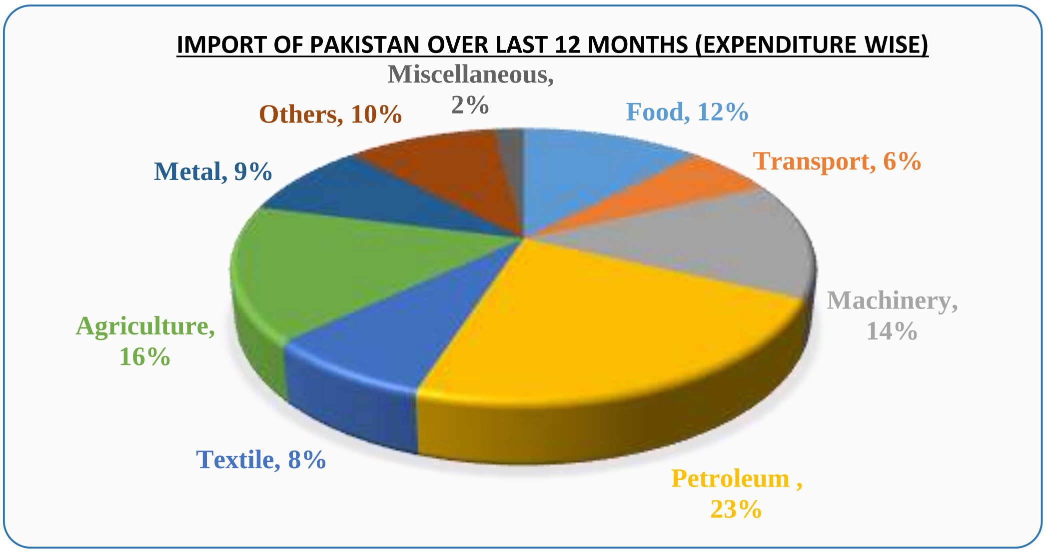

Figure 3. Imports of Pakistan

Source: SBP

We as a nation need to ask ourselves where we are headed in terms of our socio-economic performance and how we can strengthen the fabric of our society. Ist is, for some, the silence before the storm, which in Pakistan's current climate, cannot be heard amidst all the noise in political rallies and allegations of unfairness between political stakeholders. The real storm, which could be right around the corner, is purely economic in nature. All one has to do is look south to the island nation-state of Sri Lanka.

Policy Recommendations

- The Sri Lankan experience tells us that populist measures will lead us to an economic-political catastrophe. Pakistan should focus on resolving its structural issues of economy, improving the macroeconomic indicators and safeguarding the vulnerable during the current crisis.
- The policymakers need to address the socio-economic issues and engage with all of the stakeholders. Economic stabilization in Pakistan will not be sustainable unless it is supported by a wider political consensus.
- All political parties must realize that they cannot sustain power unless they resume the desperately needed IMF bailout package to save the economy from an abysmal situation. Rather than focusing on their own party benefits and embroiling themselves in blame games, it is crucial to focus on containing the fiscal deficit.

Conclusion

Pakistan needs an inclusive economic system free from the political interference. A charter of economy is direly needed to create a stable economic base.