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Sri Lankan Economic Crisis: Lessons for India

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Abstract- The Sri Lankan economic crisis, culminating in a sovereign default in April 2022, was driven by fiscal mismanagement, unsustainable debt accumulation, balance-of-payments stress, and policy missteps such as sweeping tax cuts and sudden organic-farming initiatives. This study explores its causes, impacts on India, and key lessons for safeguarding India's economy. Methodology includes literature review of academic articles and policy reports, analysis of macroeconomic trends, and synthesis of expert recommendations. It finds critical importance in restraining fiscal deficits, diversifying exports, avoiding populist policies, and maintaining prudent reserves. Policy recommendations for India include bolstering domestic revenue, cautious infrastructure debt, gradual policy rollouts, export diversification, and regional financial cooperation.

Keywords- fiscal deficit, debt sustainability, foreign reserves, populist policies, export diversification.

I. Introduction

Sri Lanka experienced an unprecedented economic crisis between 2019 and 2024, triggered by a combination of structural vulnerabilities and external shocks. Years of sovereign borrowing—including high-cost commercial financing and debt tied to large infrastructure projects such as Hambantota Port and Colombo Port City—burdened the economy. Rampant fiscal mismanagement, sweeping tax cuts, and a controversial ban on chemical fertilizers further destabilized the nation's finances. The COVID-19 pandemic devastated its tourism sector and remittances, leading to a sharp collapse in foreign exchange reserves and eventual sovereign default in April 2022.

Inflation surged, fuel and food shortages became widespread, and the government was forced into debt restructuring under IMF guidance—marking one of the most severe crises in Sri Lanka's modern history .India's proximity and evolving geopolitical concerns made it a frontline responder: New Delhi extended over US$4 billion in credit lines, currency swaps, and aid in 2022 and 2023 to stabilize Sri Lanka's balance of payments, energy supplies, food imports, and social services .While these interventions exemplify India's "Neighborhood First" policy, they also spotlight domestic vulnerabilities—especially related to fiscal rules, export diversity, governance, and strategic dependence—that could similarly undermine India's economic resilience if left unchecked .

This research explores the architecture of Sri Lanka's crisis: diagnosing its root causes, tracing its escalation under exogenous shocks, examining recovery mechanisms, and distilling actionable lessons for India. The goal is to highlight how India, despite stronger fundamentals, must continue enforcing fiscal discipline, diversify exports, rationalize populist policies, and deepen institutional capacity to avoid Sri Lanka's missteps—thereby strengthening its own economic and strategic autonomy.

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II. Objectives

- Analyze macroeconomic causes of Sri Lanka's crisis.
- Investigate policy missteps and economic mismanagement.
- Assess spillover effects on India.
- Derive policy lessons relevant to India's economic agenda.
- Formulate targeted recommendations for India's fiscal and trade frameworks.

III. Methodology

This study adopts a qualitative, secondary data research design .It synthesizes peer-reviewed articles, expert commentaries, news reports, and institutional analyses. Sources include Journal of Financial Stability, contributions from IDSA and ICRIER, plus news outlets Reuters and The Hindu. Quantitative data on GDP, fiscal deficits, debt ratios, and reserves are referenced. A thematic content analysis identifies recurring policy mistakes and derives actionable guidelines for India. The data were systematically reviewed to identify recurring themes and policy lessons, then synthesized into a structured argument.

IV. Review Of Literature

Structural and Policy Causes
Sri Lanka's fiscal vulnerabilities traced back to decades of rising debt: public debt-to GDP rose from ~91 % in 2018 to 119 % by 2021, with external debt and debt servicing becoming unsustainable. Repeated IMF programs (2009, 2016–19) failed to deliver sustainability, despite conditions requiring deficit reduction, reforms, and revenue increase .Populist tax cuts (e.g. GST from 15 % to 8 %, removal of PAYE and NBT), drastically reduced registered taxpayers by ~33 % and shrunk government revenues .A premature nationwide ban on chemical fertilizers in favor of organic agriculture led to a 30 % drop in agricultural output, exacerbating food imports and FX depletion.

External Shocks
The COVID 19 pandemic devastated tourism (13 % of GDP) and remittances, sharply denting FX receipts and increasing import dependency .The Russia Ukraine war escalated global fuel and food prices, hitting Sri Lanka's import bill and contributing to inflation and exchange rate collapse.

Failures in Governance and Institutions
Sri Lanka lacked strong fiscal rules, central bank independence, and effective crisis institutions. Crisis management was fragmented across overlapping committees, and public communication was poor, fueling misinformation. Central bank appointments remained political; monetary policy was often captive to political whims

Debt Restructuring and Recovery
Sri Lanka deferred and defaulted in April 2022, restructuring around \$25–\$30 billion under IMF oversight—including domestic and external debt. Official creditors coordinated under committees chaired by India, France, and Japan; domestic debt was

restructured by lengthening maturities rather than nominal haircuts to preserve social stability. Resulting reforms delivered: inflation brought under control, FX availability restored, GDP growth rebounded to 5 % in 2024 with projected 4–5 % in 2025. Fiscal revenues rose significantly as share of GDP, central bank gained autonomy, and governance improved.

V. Discussion & Analysis

Sri Lanka → India: Macro Fiscal Discipline
Sri Lanka's unchecked borrowing for low return infrastructure (e.g. Hambantota port leased to China 99 years) illustrates the hazard of debt fuelled megaprojects without clear payback .In contrast, India has maintained structural reforms, diversified FDI across services, manufacturing, pharmaceuticals, and agriculture—less vulnerable to sectoral shocks. India must continue to cap states' and centre's fiscal deficits under Fiscal Responsibility legislation, limiting debt to GDP ratios, and ensure new borrowing finances value creating assets.

Diversification & Self-reliance
Sri Lanka's excessive reliance on tourism, tea exports, and imported food left it exposed. Its abrupt shift to organic farming critically reduced food output, triggering import dependency and rupee depreciation. India's agriculture remains resilient, and schemes like Atmanirbhar Bharat and production linked incentives (PLI) promote local self-sufficiency; these must continue to minimize import exposure during shocks.

Political Economy & Populism
Sri Lanka's populist policies—subsidy rolls, tax cuts to win votes—sacrificed long-term fiscal health. Several Indian states mirror similar patterns (freebies, guaranteed pensions, electricity, etc.) that may pressure state debt burdens and revenue quality. India must rationalize welfare schemes targeting genuine need, avoid across-the-board freebies, and calibrate policies that ensure fiscal sustainability.

Institutional Reform & Governance
Sri Lanka's recovery was contingent on central bank independence, fiscal governance reforms, and public financial management overhaul—as advanced under IMF recommendations. India should continue to strengthen RBI autonomy, reinforce fiscal rules, and build crisis management architecture (like an economic advisory council), plus improve transparent public communication to build trust and defuse misinformation.

Timely Use of International Support
Sri Lanka waited too long to approach the IMF (18 months after COVID onset), relying on ad hoc domestic remediation that failed, compounding the crisis. India—while holding large forex reserves—must prudently manage its access to swap lines, IMF facilities (e.g. Contingent Reserve Arrangement), and diversify bilateral relations, but avoid over-dependency that leads to policy inflexibility.

VI. Conclusion

Sri Lanka's economic crisis unfolded from unsustainable debt accumulation, loss of fiscal control, flawed populist policies, policy missteps in agriculture, and vulnerability to external shocks. Political dysfunction and weak institutions aggravated the collapse. Recovery has been substantial thanks to decisive debt restructuring, institutional reform, and IMF support—but required significant economic pain and sacrifice.

For India, Sri Lanka's experience offers clear warnings: maintain fiscal prudence; diversify exports and domestic production; avoid unsustainable populism; continually reform institutions; and build crisis-resilient governance and communication structures. India's relatively stronger economic fundamentals, structural reforms, and greater resilience must be preserved and enhanced through forward-looking policy.

Recommendations

- Enforce strict fiscal rules at both Centre and state levels, with debt to GDP limits (< 60 %), and curb populist liabilities that cannot be funded by revenue.
- Improve economic diversification—continue incentives for manufacturing, pharma, electronics, IT, agriculture, and balance between tourism and other export sectors.
- Strengthen institutional frameworks: cement central bank autonomy, set up a national crisis monitoring and advisory council, reform public financial management and public sector enterprises.
- Calibrate policy caution in good times, building buffer reserves, managing FX, disallowing rapid debt accumulation during expansion.
- Avoid abrupt reforms (e.g. mass organic farming), pilot experiments and gradually shift, while ensuring food security and sector readiness.
- Enhance transparent, credible public communication in crisis, to prevent misinformation and maintain public trust—especially important in highly polarized political environments.

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