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Sri Lanka and Pakistan, Two Neighbours of India are Facing the Worst Economic and Political Crisis Since their Independence: A Critical Comparison between Two Economies with Different Systems of Governance

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Abstract: ***The increasing worrying situation with respect to Sri Lanka and Pakistan resulted in hardship and turmoil for the citizens of the country. The reason behind this was the fact that the economies ignored the rising fiscal deficit and along with that, external factors led to runaway inflation. The solution is of course restructuring loans, following the policy measures that have been indicated in the IMF documents. The Sri Lankan government has been able to follow this and is emerging out of the crisis but the Pakistan government has to put its political unrest behind it before it can take these stringent decisions. Research question: The research paper will attempt to understand the crisis that both Sri Lanka and Pakistan are facing, economically, socially and politically. Are the reasons for the crisis embedded in past policies with respect to burgeoning fiscal deficit? Is it the lack of political will to take harsh decisions? Or is it a sudden change towards new innovative policy decisions which may have gone wrong given the world environment? These questions would be addressed in the course of the research paper.***

Keywords: Pakistan, Sri Lanka, Fiscal deficit, IMF, Governance, Inflation

1. Introduction

The recent crisis that both Pakistan and Sri Lanka have encountered, have disturbed both the political, social and economic foundations of both the economies. The social strife that the countries are going through is very hard on the citizens of that country as there does not seem to be an easy solution in trying to solve the problem without hurting the people of that country. Hard decisions are on the anvil. Both the countries have resorted to borrowing from the IMF (International Monetary Fund) to obtain money such that they can meet their import requirements. But borrowing from the IMF has its own set of regulations. The IMF only lends money if certain macro-economic parameters are followed. The IMF believes in continuously reducing the fiscal deficit and moving towards market forces on deciding the further course of action. It dictates certain strict conditionalities before dispersing the money.

Background functioning of borrowings from the IMF:

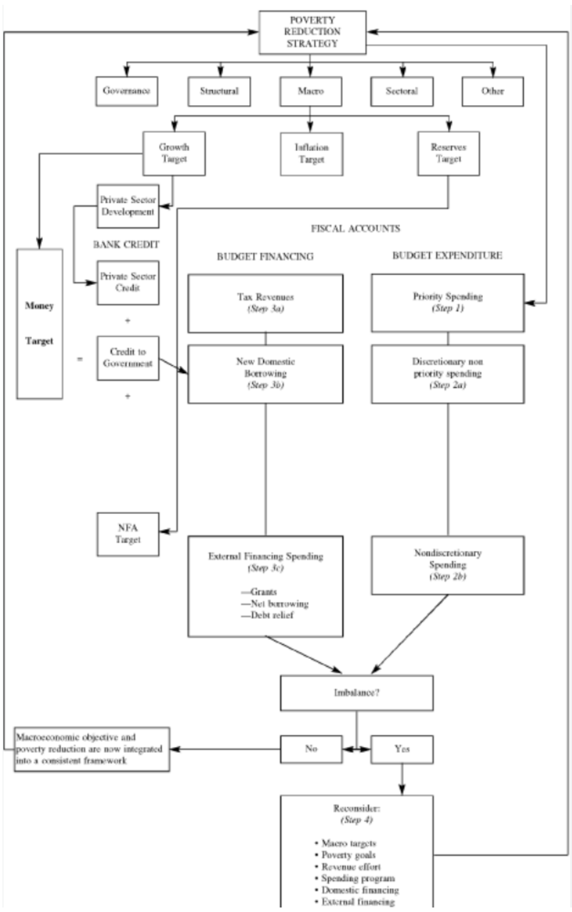

Figure 1: Graphical representation of the path followed by IMF to reduce poverty

Sources: Google image

- The conditionalities are solving balance of payment options without resorting to measures that harm national principles.

- They also want the country to follow measures so that the country who has asked for the loan manages to repay back money borrowed in the future.
- Member countries that borrow from the IMF have the main responsibility of selecting designing and implementing policies such that their economic programme is successful.
- The main aim is to restore or maintain balance of payment viability and macroeconomic stability such that the basis is set for sustained high quality growth.
- For countries like Sri Lanka and Pakistan which are low income countries, the additional objective is to reduce poverty.
- IMF financing is in parts and is conditional to the policy action of the borrowing country.

Besides the above, there are other measurable macroeconomic variables that are important and these are in the control of the country itself. They are:
- Monetary and credit aggregates
- International reserves
- Fiscal balances
- External borrowing

Definition:
To understand the impact of IMF lending on macroeconomic variables, it is important to analyse fiscal deficit. It is one of the most important indicators that pre warn an economy that it is entering into troubled territory. This is one indicator that has to be continuously monitored and kept within the controllable limits of the economists and the government.

Inflation is yet another aggregate which had to be closely monitored for any country. As the harmful impact of very high inflation is immediately felt on the standard of living of the people and eventually stifles growth. Both fiscal deficit and inflation are extremely relevant and important in understanding the health of an economy.

3.1 Fiscal Deficit

The difference between the total revenue and total expenditure of the government is called fiscal deficit. It indicates the total borrowings required by the government. A country's fiscal balance is measured by government's revenue vis-a-vis its expenditure in a given financial year. Thus when the expenditure exceeds the revenue of the government in a given financial year, it is known as fiscal deficit. Fiscal deficit could be calculated in terms of percentage of Gross Domestic Product (GDP) as well as in absolute numbers. Total revenue is the sum of revenue receipts, recovery of loans and other receipts of the government.

Fiscal deficit is based on two segments
- Income
- Expenditure

Income is made up of two variables
1) Revenue generated from taxes levied by the centre
2) Income generated from non-tax variables

The taxable income consists of the amount generated from cooperation tax, income tax, custom duties, excise duties, Goods and Services Tax (GST), etc. The non-taxable incomes on the other hand are that generated from external grants, interest receipts, dividends and profits as well as receipts from union territories.

Expenditure is incurred for several projects that is under taken by the department which includes payments of salaries, pensions, emoluments, creation of assets, funds for infrastructure, development and various other areas that the government thinks requires attention for example upliftment of the socially marginalized, distribution of grains via MGNREGA (Mahatma Gandhi National Rural Employment Guarantee Act)

Revenue deficit arises when revenue expenditures exceeds revenue receipts.

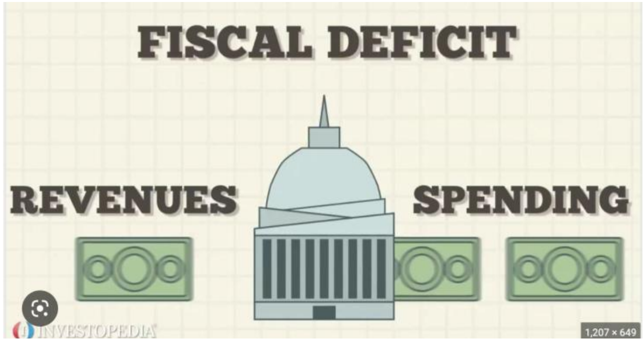

Figure 2: Picturisation of expenditure> revenue = Fiscal Deficit

Source: Google image

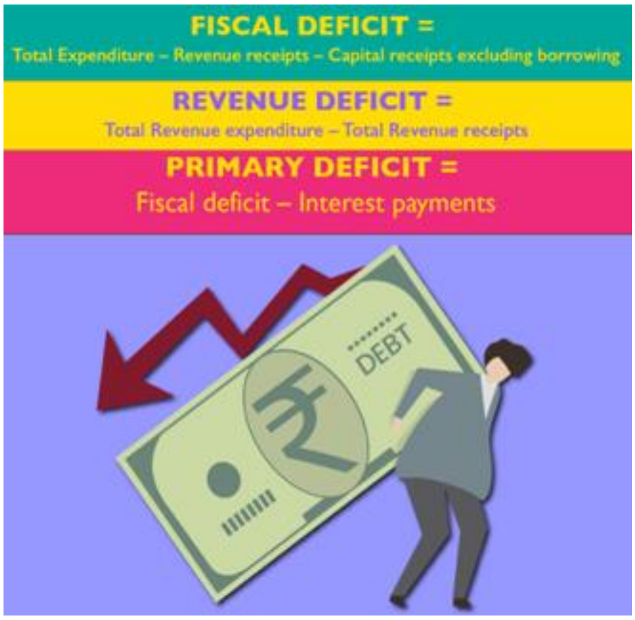

Figure 3: Difference between Fiscal, Revenue and Primary Deficit

3.2 Inflation

Inflation is a rise in prices which results in a decline of purchasing power over time. Normally this is due to an imbalance between demand and supply of money, or changes in production of distribution that causes an increase

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in the price of the products. As the price level increases, the value of currency reduces.

For consumers, the impact of high prices results in them demanding higher incomes. The government's major policy objective is 'inflation targeting'.

But not all inflation is bad as certain amount of price increase is important to give the required impetuses to the producers. This is the reason why most economies of the world work on 2-4% inflation targets. Some emerging economies fix a 6% inflation target. Beyond this, measures are taken both by the central bank and the government to control the increase in price.

At times inflation may not be due to domestic reasons but due to external factors, and sometimes due to a mixture of both. The present continuous increase in inflation levels in the world are a combination of both domestic and external factors. The domestic factors can be a result of economies trying to grapple with the adverse impact of the covid 19 pandemic and lockdown. To prevent the economy from entering into recession and subsequently depression, the government's thought it prudent to pump money into the economy such that demand would increase and it would act as an incentive in increasing supply, factors of production, incomes, savings, investments and consumption.

The world economy was getting back on its feet; the Ukraine-Russian crisis emerged. Both these economies are major suppliers to the world for wheat and fuel. The fact that they entered into a war led to the disruption of the above stated commodities. As the war progressed, a shortage resulted in increasing prices and inflation. They were main suppliers to the world and as the shortage continued, the prices of such commodities started increasing. This along with the easy money policy that had been adopted during the pandemic resulted in further aggravation of prices.

Most central banks of the world decided on tight money policy to control unprecedented inflation levels that developed economies were facing. Economies like the UK and the US, who were used to 1% or 2% inflation levels, were facing double digit inflations. Excessive inflation has a negative effect on the economy.

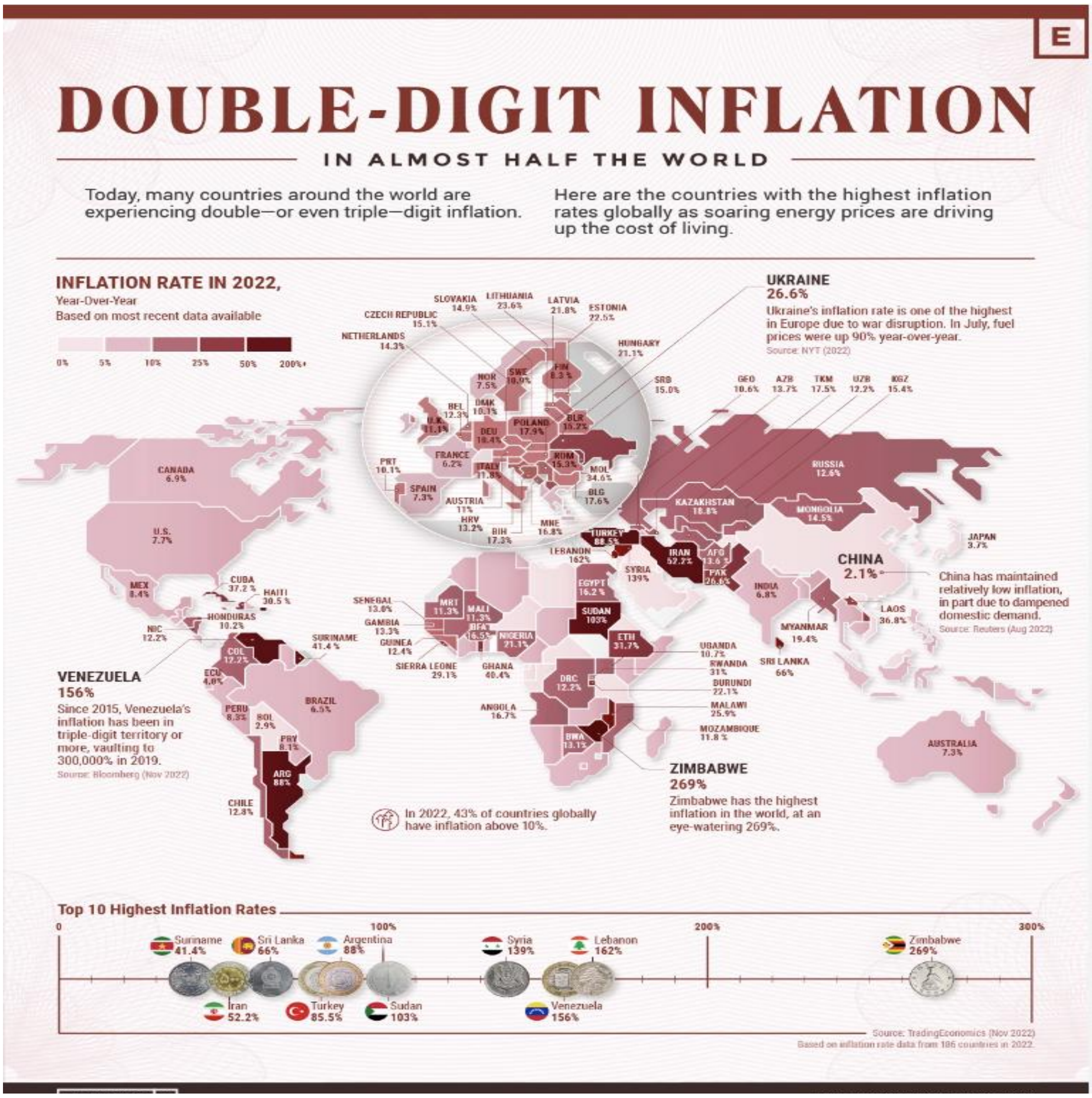

Figure 4: Excessive inflation being faced by world economies

Source: Visual Capitalist

4. Crisis of the Sri Lankan Economy

In July 2022, the disturbing picture of thousands of angry Sri Lankans entered the capital Columbo and chased its President Gutavaya Rajapaksa and his government from office. He fled from the country and tendered his resignation, leaving the governance to the Prime Minister. This led to the end of his family's decades of political domination. Some of the significant reasons which aggravated an already dismal situation were;

- Tourism being hit due to the pandemic
- War between Russia and Ukraine makinf imported fuel and food more expensive
- Years of mismanagement
- Continuous budget of mounting current account deficits
- Hyper inflation
- Devalued currency
- Huge sovereign debt

The first two factors resulted in inflation increasing to 50% a year. Due to the lack of foreign exchange reserves, the government could not import more fuel. The Economy, like India, is dependent on oil imports.

After the civil war ended in 2009, President Mahindra Rajapaksa borrowed from outside the country to pay for the war expenses and start high-end infrastructure to attract tourism. In the process, corruption reared its ugly head, and most of these projects went to the Cronies of the President, often known as 'Crony capitalism.'

As a result they could not pay their debt on time to the foreigners and the government further borrowed from the Chinese. Thus the Economy entered into a viciouscircle of debt. Their foreign reserves were already on the depleted side. Instead of implementing reforms to help the economy out of the crisis, the government decided to institute several price cuts for political gains.

External factors like the 'Easter bombing' and Covid-19 disrupted island tourism.

Figure 5: The map of Sri Lanka

Source: Google Image

After the civil war 2009, Sri Lanka focused on provision to the domestic market instead of boosting foreign trade. This resulted in income from exports declining while the import bill increased. The government insisted on farming by organic measures so that it could reduce the dependence on chemical fertilizers. The government wanted to reduce the import bill. Between fuel and chemical fertilizers, it felt that the emphasis on organic farming would increase the value of its agricultural products, enabling the Economy to realize higher export earnings.

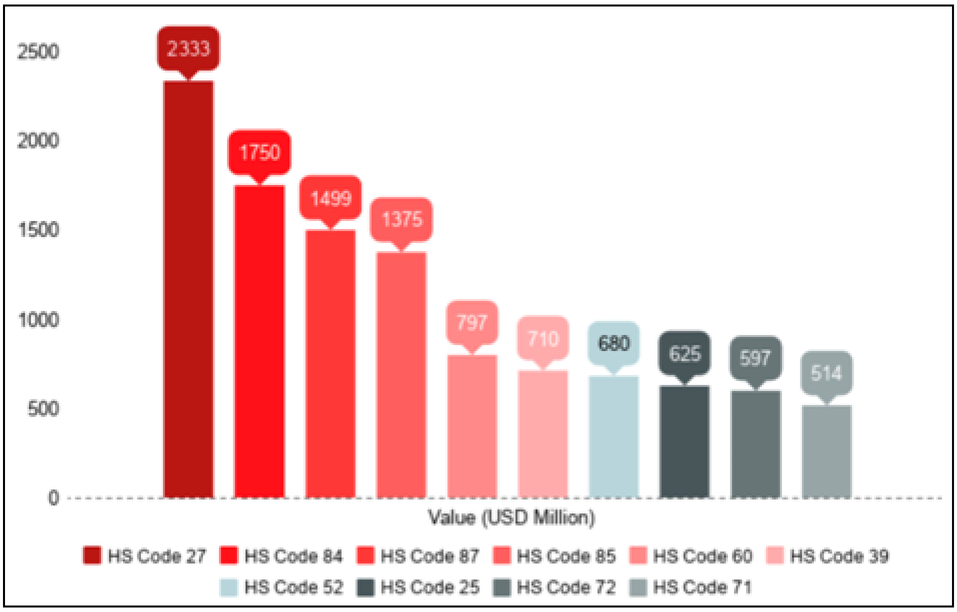

Figure 6: Major items of goods imported by Sri Lanka in 2016

Source: https://www.exportgenius.in/blog/what-are-the-major-imports-of-sri-lanka-sri-lanka-import-products-list-223.php

From the figure above, it is apparent that the Sri Lankan Economy depends on imported petroleum for the requirement of petrol and diesel. The significant components of imports are related to petroleum products, which are essential for the economy to grow.

Looking at the exports of the Economy, the major ones are textiles and tea. Sri Lanka managed to enter the world's textile market due to the availability of cheap labour. Tea has always been essential in earning foreign exchange for the country. With the emphasis on organic farming, the price of this product would have registered a sharp increase resulting in declining demand by countries that are price driven.

The policy decision by the Sri Lankan government to move to organic farming may have been for two reasons. One is to reduce the import bill, and the second is to move towards sustainable and environment-friendly products. This backfired as the world entered the pandemic, adversely affecting exports. The external factors, along with high prices, did play havoc with the balance of payment situation of the Economy.

Along with the pandemic, the Russian-Ukrainian crisis further added to the runaway inflation situation, adversely impacting an already worsening fiscal deficit scenario.

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Table 1: Merchandise Export Performance

Values in US$ MN's

Exports of Goods	Jan 2020	Jan 2021	Jan 2022	% Growth (21-22)
Apparel & Textile	472.07	421.28	514.41	22.11
Tea	99.73	100.99	91.23	-9.66
Rubber-based	72.89	84.16	87.1	3.49
Coconut-based	49.05	54.18	68.28	26.02
Diamond, Gems & Jewellery	28.20	28.94	25.08	-13.34
Electronics & Electronic Components	28.23	31.85	35.87	12.62
Spices and Concentrates	19.54	42.22	34.97	-17.17
Processed Food & Beverages	27.01	31.35	30.74	-1.95
Seafood	23.66	16.90	24.11	42.66
Ornamental Fish	1.45	0.88	1.78	102.27
Vegetables	2.63	1.70	2.36	38.82
Fruits	3.84	2.86	3.15	10.14
Other Export Crops	8.19	2.47	5.34	116.19
Flowers & Foliage	1.05	1.09	1.22	11.93
Boat Building	0.40	0.05	0.17	240.00
Petroleum Products	35.64	0.46	34.02	7295.65
Others	131.32	115.32	102.80	-10.86
Total Merchandize Exports	**1,004.9**	**936.70**	**1,062.63**	**13.44**

Figure 7: Major items of goods exported by Sri Lanka

Source: Sri Lanka Export Development Board

The only alternative presently for the Sri Lankan Economy is to take a loan from the IMF to import essential commodities.

පහත ඉන්ධන වර්ගයන්හි මිල ගණන් නොවෙනස්ව පවතින බව සලකන්න.

නිෂ්පාදන සංකේත අංකය	ඉන්ධන වර්ගය	ලීටරයක වර්තමාන මිල
A0013L99	ලංකා සුදු ඩීසල්	රු. 405.00
A0018L99	ලංකා පෙට්‍රල් 95 ඔක්ටේන් යුරෝ 4	රු. 510.00
A0016L99	ලංකා සුපිරි ඩීසල් 4 ස්ටාර් යුරෝ 4	රු. 510.00
A0017L99	ලංකා භූමිතෙල්	රු. 355.00
A0012L99	ලංකා කාර්මික භූමිතෙල්	රු. 464.00

Figure 8: Press release by the Sri Lankan government on increase in fuel prices 2023.01.02

Source: Government of Sri Lanka

5. Crisis of the Pakistan Economy

Figure 8: Map of Pakistan

Source: Geology.com

Pakistan is facing one of its worst economic crises. This results from long-term and short-term policies and the fact that they have followed a path of political appeasement. Their policy initiatives have been towards spending a large sum on the military and giving a lot of 'subsidies.' The fact that they have an unstable political environment has not helped the Economy. Most decisions were taken in political interest rather than economic interest.

This has been the trend for several years, and its sympathetic followers have bailed out the Economy. When the Ukraine-Russian crisis emerged, this country, already dependent upon imported fuel, faced further hardship. The country imposed a tax on fuel, which was the government's primary revenue source. When the prices increased manifold due to the war, they kept the fuel prices low in the name of political appeasement. This increased the pressure on the budget and the finances.

Most of the infrastructure built in Pakistan was based on foreign loans. A classic example of this is China's Belt and

Road Initiative. This is also known as One Belt One Road (OBOR). This was adopted by the Chinese government in 2013, which seeks to connect Asia with Africa and Europe via land and maritime to improve regional integration, increase trade, and stimulate economic growth. China invests in the countries that are a part of this initiative. The money invested is in the form of a loan. It creates a vast network of railways, energy pipelines, highways, etc. The largest is the China-Pakistan economic corridor. Experts have predicted that China's expense over the life of this corridor could be as much as eight trillion. Of course, China has an economic and political agenda to stamp its supremacy in the world. The loans it has dispersed to the countries are close to the market interest rate, and it expects that they will be fully repaid.

Since the covid-19 pandemic and the Russian invasion of Ukraine, low-income countries which are part of the corridor, like Pakistan and Sri Lanka, have struggled to repay their loans, initiating a wave of debt crisis, resulting in criticism of this initiative.

The imports required to be a part of this initiative had led to furthering the debt crisis in Pakistan.

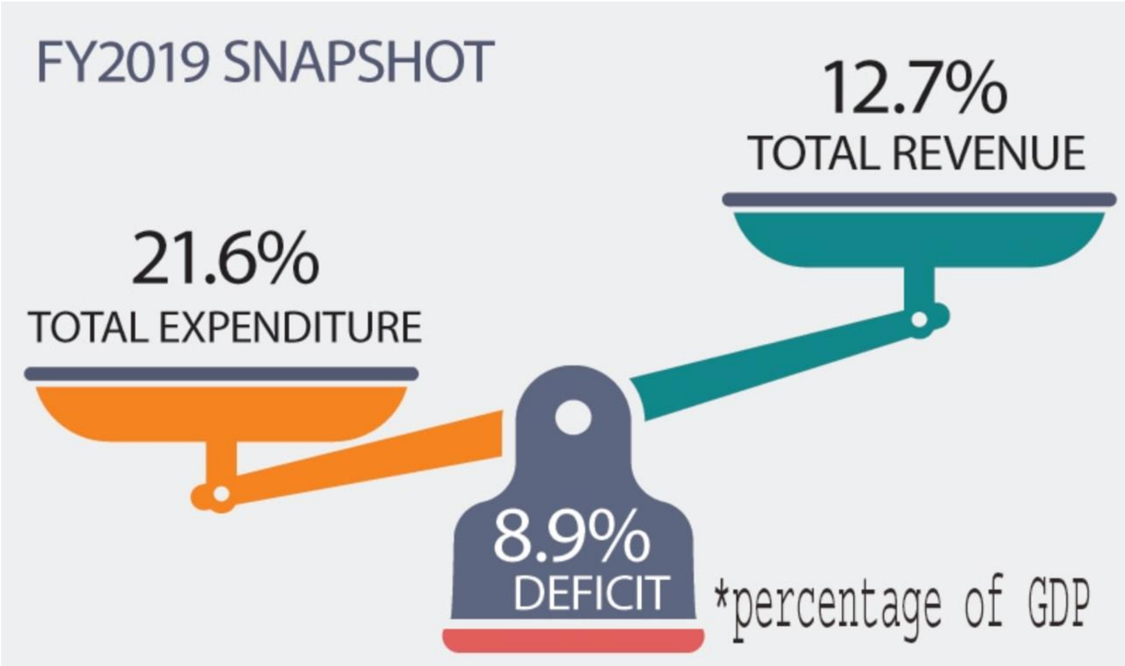

Figure 9: Image of the Fiscal Deficit Crisis of Pakistan (2021-2022)

Source: DAWN.com

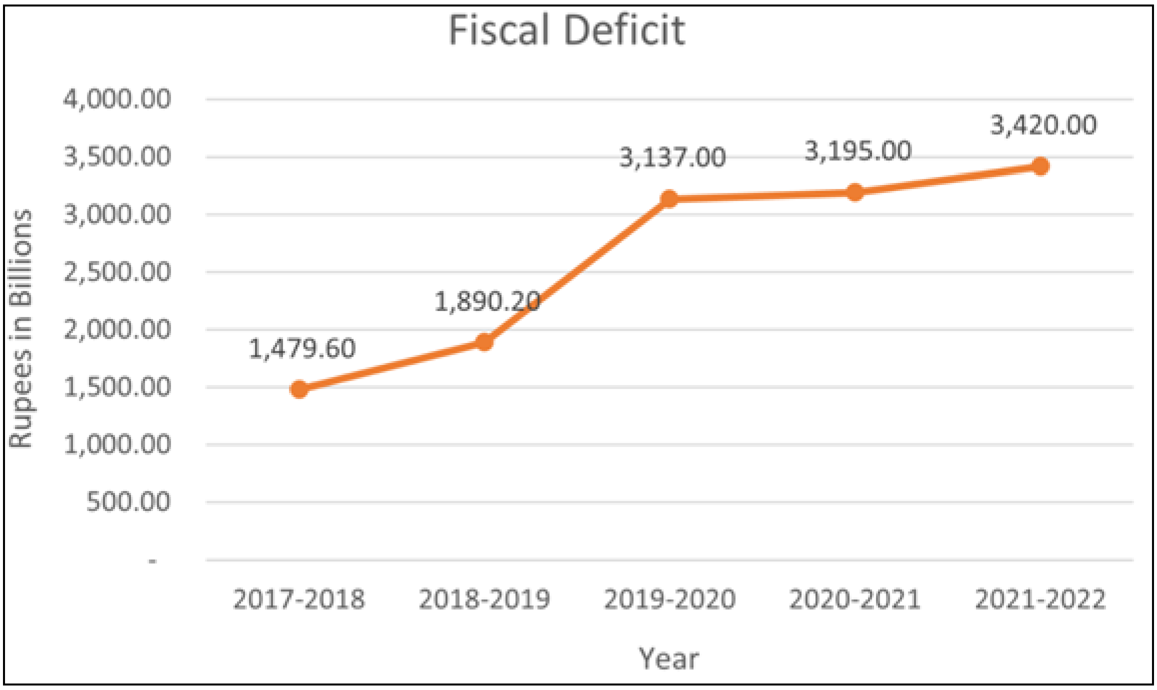

Figure 10: Fiscal Deficit at a glance
Source: Budget in Brief (2017-2021)

Both figures indicate an ever-increasing fiscal deficit. One of the reasons for the increasing expenditure on the OBOR is that China is also committed to environment-friendly non-renewable energy investment. This has increased the cost of the project.

It has resulted in a need for more foreign exchange and revenues even to import the basic requirements for its citizens. The only alternative left for the Economy is to lean towards the IMF and increase the fuel price to be in synchronization with the rate at which it imports the commodity. This is a politically tough decision.

Islamabad the 15th February, 2023

PRESS RELEASE

Government of Pakistan has decided to revise the existing prices of petroleum products. The new prices effective from 16th February, 2023 are as follows:

(Rs. / Liter)

Product	Existing Prices w.e.f 29.01.2023	New Prices w.e.f 16.02.2023	Increase/(-) Decrease
MS (Petrol)	249.80	272.00	22.20
High Speed Diesel (HSD)	262.80	280.00	17.20
Kerosene (SKO)	189.83	202.73	12.90
Light Diesel Oil	187.00	196.68	9.68

Increase in price is due to Pak Rupees devaluation applicable for the calculation of current pricing period.

Figure 11: Increase in fuel prices in Pakistan
Source: Government of Pakistan (Press release)

The figures above indicate very high fiscal deficits, which the Pakistan Economy cannot sustain. This requires harsh measures in the form of increasing taxes, reducing expenditures, and increasing prices of fuels such that they match the imported price.
All these things must be in place before the IMF decides to lend to the Economy.

6. Policies followed to get the Economies back on track

Both the economies need to urgently address the inflation and fiscal deficit issues to reduce the hardship for the citizens of the country.

6.1 Sri Lanka

A democratically elected government runs the Sri Lankan Economy with a presidential system of governance. They decided to follow all the dictates stated by the IMF. In return, the IMF is lending $3 billion to help it deal with its worst crisis since independence. Sri Lanka owes about $7 billion to China and $1 billion to India. Both these countries have agreed to restructure the loans giving Sri Lanka more time to repay. Due to this, the IMF has extended its loan. One way the Sri Lankan government plans to reduce its debt is by privatizing its airlines. The government has already increased income tax rates and other indirect taxes on fuel and food. These steps are helping the Economy to get back on track.

6.2 Pakistan

On the other hand, Pakistan is governed by a so-called democracy, but essentially, it is the military that 'calls the shots.' The IMF is reluctant to disperse money as it feels the government needs to do more to reduce the fiscal deficit. The Economy was embroiled in political mayhem in which two political party's hurled accusations at each other, resulting in unrest. Under this problematic political scenario, the government is not able to take drastic steps, which has further increased inflation levels along with the IMF delaying its disbursement. Thus, creating increasing hardship for the citizens of the country.

7. Conclusion and the way forward ahead for both the countries

Both the countries, Pakistan and Sri Lanka, are facing severe fiscal deficit issues, very high inflationary conditions, and meagre reserves in foreign exchange, which have forced the economies to go to the lender of the last resort, the IMF. Before it approves a loan, the IMF expects that the Economy follows certain strict conditions with respect to controlling macroeconomic aggregates like fiscal deficit, inflation, and controlling expenditure by the government. These are tough decisions politically, but if the Economy has to pull itself out of the mess that it is in, these complex decisions would have to be undertaken.

These are challenging times for the citizens of these countries, but there is no option as the IMF will only release the tranche if there is a serious commitment by the governments. No political freebies would be allowed in either of the economies. The Sri Lankan economy has managed these tough economic decisions, and the IMF 'tranche' disbursement has begun. On the other hand, Pakistan's Economy is still trying to grapple with serious political issues and unable to fulfil the requirements stated by the IMF.

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