

Case Study

Sri Lanka faces an unsustainable debt and severe balance of payments crisis, which is having a very clear negative impact on the growth and poverty levels.

According to the latest South Asia Economic Focus and the Sri Lanka Development Update, Sri Lanka's real GDP is expected to fall by 9.2 percent in 2022 and a further 4.2 percent in 2023.

The fluid political situation and heightened fiscal, external and financial sector imbalances pose significant uncertainty for Sri Lanka's economic outlook. The growth outlook is subject to high uncertainty and will depend on the progress in fiscal consolidation, debt restructuring, and growth enhancing structural reforms. The current account deficit is expected to decline due to import compression. Additional resources will be needed in 2023 and beyond to close the external financing gap. Poverty is projected to remain above 25 percent in the next few years, which will be a great challenge to be faced as a country.

Key downside risks include a slow debt restructuring process, limited external financing support, and a prolonged recovery from the scarring effects of the crisis. Fiscal consolidation needs to be accompanied by tighter monetary policy to contain inflationary pressures. Significant debt restructuring is essential to restore a sustainable debt level. The financial sector has to be managed carefully given high exposures to the public sector. The necessary macroeconomic adjustments may initially adversely affect growth and poverty, but will correct the macroeconomic imbalances, help regain access to international financial markets, and build the foundation for sustainable growth. Mitigating the impacts on the poor and vulnerable remain critical during the adjustment. Reductions in poverty will require an expansion of employment in industry and services and a recovery in the real value of incomes.

Sri Lanka's economy was already showing signs of weakness before the COVID-19 pandemic. Growth and poverty reduction had slowed down in the last five years, 2017 - 2022.

Sri Lanka lost access to international financial markets in 2020, after credit rating downgrades. Without market access, Sri Lanka continued to service its external debt and pay for imports using official reserves and loans from the banking sector. Official reserves dropped from US\$7.6 billion in 2019 to less than US\$400 million (excluding a currency swap equivalent to US\$1.5 billion with China) in June 2022. Net foreign assets in the banking system also fell to US\$ -5.9 billion in June 2022. This severe forex liquidity constraint has been felt across the economy, particularly from the second quarter of 2022, with shortages of fuel, medicines, cooking gas, and inputs needed for economic activity.

Recent developments

The economy contracted by 4.8 percent year-on-year in the first half of 2022. All key sectors contracted, amid shortages of inputs and supply chain disruptions. High frequency indicators such as the purchasing managers' indices indicate a continued stress beyond the first six months.

Year-on-year inflation reached an unprecedented 64.3 percent in August 2022, due largely to high food inflation of 93.7 percent. This reflects the impact of rising global commodity prices, monetization of the fiscal deficit and currency depreciation. The ban on chemical fertilizers in 2021 and related impact on crop yields has also affected domestic food supplies, agriculture earnings and food security. Between January and July 2022, the central bank raised policy rates by a cumulative 950 basis points to curb inflation.

The goods trade deficit declined by 18.6 percent year-on-year in the first half of 2022 as exports, particularly textiles, grew faster than imports, which were largely financed by Indian financial support of approximately US\$3.8 billion. With declining remittances and limited tourism receipts, the current account deficit is expected to have widened in this period. Sri Lanka's central bank floated the Sri Lankan Rupee (LKR) in March and returned to a managed float in May after the currency depreciated by about 78 percent since the floating. Despite mandatory repatriation and conversion rules, it has been challenging to bring export earnings and remittances to Sri Lanka through formal channels due to low market confidence.

Although expenditures increased in the first four months of 2022 on account of additional support provided to social protection beneficiaries, public servants and pensioners, several revenue measures, such as a one-off tax imposed on large corporates, helped reduce the primary deficit. The overall deficit was financed primarily by the central bank and remained broadly unchanged, pertaining to the rising interest bill. To raise more revenue, the government increased the Value Added Tax rate from 8 to 15 percent and proposed additional tax measures in May, and through the Interim Budget in August.

(Content source: World bank org. SL.)

Task 01

With a clear understanding about the current financial situation of Sri Lanka, it is recommended by the economic experts to increase the medium and small-scale business contributions to share the foreign income levels in to total revenue. As an enthusiastic and creative young entrepreneur, you are given the opportunity to select a business model from the below list to execute. Describe your business proposal with reasons for your ideas, displaying your understanding about the current context, you may propose a name for your business and key business objectives to achieved in a specified timeline.

- a) Category 01 - Tourism industry
- b) Category 02 - IT industry
- c) Category 03 - Commodity Export industry

(Marks 30)

Task 02

You are supposed to carryout market research to understand the market demand for your proposed product and customer segments and the requirements of your selected customers. You may explain the complete process of market research with requirement of the types data for your study with relevant formats.

(Marks 35)

Task 03

Proper application of the complete marketing mix is surely a reason to make any business a success in this competitive environment. Discuss the submission of each element relating to the proposed business operation in the task one with relevant practical situations.

(Marks 35)