“SRI LANKA’S MACROECONOMIC CRISIS: AN APPLICATION OF GLOBAL MICROECONOMIC CONCEPTS AND POLICY ANALYSIS”

Executive summary

Key Findings:

- The debt to GDP ratio in Sri Lanka was more than 119 percent (2021), resulting in fiscal stress and currency depreciation.
- The twin deficit, fiscal and current account was exacerbated by high imports and low exports.
- National savings were lower than investment needs which led to borrowing from the external.
- Due to the COVID-19 pandemic Tourism revenue decreased by more than 60%, cutting the GDP contribution by -3.6% in 2020.
- Inflation raised immensely, driven by the supply disruption and exchange rate depreciation.

Policy Prescriptions:

- Realise fiscal tightening by rationalising subsidies and developing tax base.
- Export diversification through ICT and agro-modernisation.
- Empower financial and energy industries to be resilient.

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1. Introduction

Sri Lanka is a developing middle-income nation located in South Asia and is widely famous for having a strong service sector, a high human development index and a renowned exporter of different agricultural goods. However, in the first quarter of 2020, the country experienced a severe macroeconomic crisis, which was provoked by a combination of domestic policy mismanagement and global economic shocks. The crisis was characterised by double-digit inflation, currency depreciation, exhausted foreign reserves, acute shortages of essentials and increased government debt that was more than 100% of GDP (Intelli News, 2025). This situation was captured as the worst economic downturn since the nation's independence, which also included severe societal and financial consequences. On the other hand, its economic conditions further deteriorated during the COVID-19 pandemic, causing an abrupt fall in tourism, remittances and other service sector inflows of foreign exchange (Tripathi et al., 2022). The Russo-Ukrainian War also intensified as the global supply chains were disrupted, leading to oil and commodity price hikes, which put further pressure on the country's balance of payments (Shahbaz & Muzaffar, 2025). Similarly, in the domestic market, chronic fiscal deficits, heavy borrowing and low national savings-built vulnerabilities, which made the economy vulnerable to external shocks. It was also observed that policy flows, such as controversies towards fertiliser bans and tax reductions, increased these challenges, affecting both consumption and production.

The main aim of the research is to demonstrate the reasons and effects of the crisis in Sri Lanka through the application of global microeconomic and macroeconomic concepts to the same. It analyses the impact of a high amount of debt, deficit, issues in savings-investment mismatch and the economic impact of COVID-19. The study also evaluates the net financial and development effects on the country, based on such theoretical frameworks as demand-supply analysis, fiscal policy analysis and savings-investment identity.

Highlighting the effectiveness of policy responses and influence on global economic factors, this task will also promote a deeper insight into the urgency of sustainable recovery.

2. Literature Review

2.1 Global Micro and Macroeconomic Perspectives Linked to Sri Lanka

The Sri Lankan economic crisis must be contextualised within the larger microeconomic and macroeconomic paradigms for better understanding. In the case of macro indicators, the most critical indicators are government debt, fiscal deficits, and current account imbalance. According to Mankiw (2022), the cumulative debts owed to the government can be defined to be the borrowing of the country, whereas a very high level can cause a serious interest rate, lack of scope for improving fiscal policy and loss of investor confidence. For instance, the macroeconomics hypothesis of twin deficits is linked with fiscal deficit, which is often transformed to a “current account deficit”, as higher government spending causes more domestic demand towards imports to worsen the balance of payments. Along with that, Chavarín et al., (2023) have shed light on the demand-supply framework as a microeconomic model that enlightens regarding the effect of sectoral shocks, such as rising oil prices or import restrictions. During a limited supply of valuable commodities and a high demand, prices increase, resulting in cost-push inflation to both households and firms. In contrast, Ibe (2024), stated that inequalities in national savings and investment effects also influence resource distribution, where the country has to borrow outside to fund domestic investment, further leading to the accumulation of foreign debt that leaves the economy vulnerable to currency risks. In this regard, global economic theory such as the Mundell-Fleming model can be applied to underpin how open economic countries like Sri Lanka are highly exposed to capital flows, exchange rate movements and foreign interest rates.

Similarly, Keynesians emphasise the government's role in responding to external shocks, yet unintended policies may facilitate the onset of economic vulnerability.

Year	GDP Growth (%)	CPI / Inflation (annual, % y-o-y)	Debt / GDP (%)
2018	2.3%	4.27%	83.59%
2019	-0.2%	4.3%	82.59%
2020	-4.6%	4.6%	96.88%
2021	4.2%	5.95%	102.67%
2022	-7.35%	45.2%	115.94%
2023	-2.30%	17.4%	110.38%
2024	+5.0%	1.2%	99.43%

Table 2.1.1: Key Economic Indicators of Sri Lanka (2018–2024)

(Source: Self-developed).

2.2 Empirical Studies and Country Comparisons

The strong empirical data presented in other nations is capable of demonstrating how elevated levels of national debt and twin deficits, as well as external shocks, can lead to a ruthless economic downturn. As an example, the Greek sovereign-debt crisis is a significant problem (2010-2012) in which chronic fiscal deficits and debt experienced severe deteriorations in gross domestic product (GDP), elevated unemployment rates, and numerous international bailouts (Mitchener & Trebesch, 2023). Argentina experienced recurrent delays on its debts in 2001 (Kämmerer, 2008). The inability to maintain minimum financial discipline and borrow on a massive scale without a credible payer weakened the confidence of the market in the national economy and caused serious currency crises. Conversely, developing nations such as Egypt and Pakistan have faced twin-deficit problems, which are exacerbated by the rising world oil prices and the declining export earnings, showing that the import-dependent nations are vulnerable to outside shocks (Hussain et al., 2024). These examples can be applied to the situation in Sri Lanka, where tourism, remittance, and commodity importation are the primary sources of revenue. Here, the relationships between the global microeconomic environment and the policy choices made by local authorities on macroeconomic stability can be observed. Empirical evidence also indicates that crises of this type are mitigable through active fiscal policy, effective management of debts and diversified export markets.

2.3 Application to Sri Lanka

Underpinning global microeconomic and macroeconomic knowledge on Sri Lanka shows the structural flaws that aggravated its economic crisis. The inability of the government to operate on a fiscally prudent basis and high risks of default are manifested in the high levels of public debt, which have consistently gone above 100% of GDP as of 2021, showing the ineffectiveness of Greece and Argentina (CEIC Data, 2022). According to the report, the confidence index, which is generally based on -100 to +100, highlighted Sri Lanka to be -83 and -96 in January 2022 to June 2022, respectively, showing consistently worsening economic conditions (Statista, 2024).

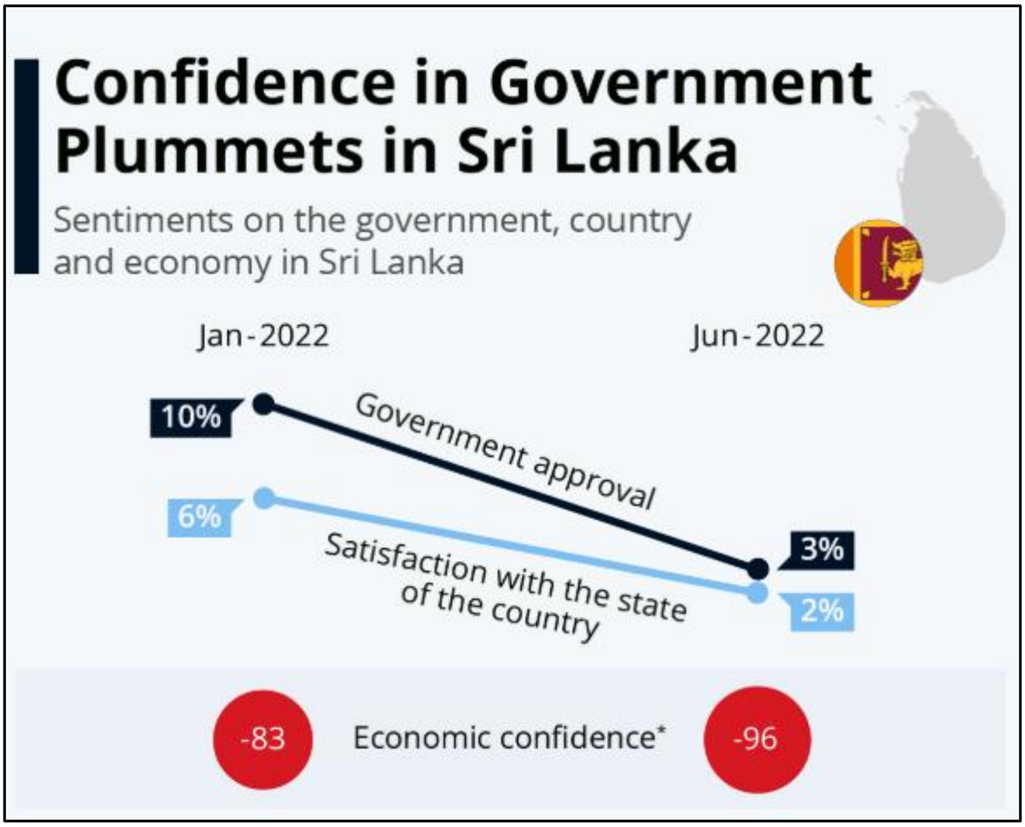

Figure 2.3.1: Sri Lanka's economic crisis

(Source: Statista, 2024)

Twin-deficit problem, which was observed by both long-term fiscal deficit and current account deficit, aggravated the depreciation and inflation due to the increased government expenditure increased the demand to import goods, whereas the earnings of the export market were decreasing (Rajakaruna et al., 2021). The savings of the country are low compared to the investment needs in Sri Lanka, which forced the country to over-borrow, particularly from China and the international bond markets. This international dependency exposed the economy to foreign shocks in the world interest rates, oil price shocks, and geopolitics, such as the Russia-Ukraine conflict (Nath, 2023). Cost-push inflation that was occasioned by microeconomic disturbances, including the banning of fertiliser and supply disruptions that affected households and firms, also reflected the economic demand-supply equation.

3. Research Gap

Despite the existing literature providing information on high levels of debt, fiscal imbalances and external shocks in the emerging markets, it also fails to focus on the integration of microeconomic performance with macroeconomic performance in the example of Sri Lanka. The most relevant indicators of the macro indicators of the GDP, debt-to-GDP ratio and inflation are widely-used measures in most research, though it does not discuss the magnifying impact of household consumption, firm-level investment choice and sector-specific supply demand dynamics on the systemic vulnerabilities. In this regard, the similarity between Greece, Argentina and other emerging economies can show the effects of mismanagement of fiscal policies but these effects cannot show the overall impact of the global shocks, domestic policy failures and structural limitations specific to the Sri Lankan situation, such as over-dependence on tourism, remittances and foreign commodities. This research has bridged these gaps through linking the theoretical models such as the twin-deficit hypothesis, savings-investment identity and the demand-supply analysis, to the Sri Lankan empirical evidence.

4. Findings and Discussion

4.1 High Levels of Debt *and* Their Consequences

The government debt is defined as the total financial obligations of a nation to both local and foreign creditors. Whereas the government can finance their public spending and the investment in their infrastructure through borrowing, excess debt can be a major crisis in the long and short term. In Sri Lanka, state debt became extremely large, reaching over 119 per cent of GDP in 2021, with a lump sum amount of foreign bond debt, and multilateral, bilateral lenders, such as China and India (IMF, 2022). The tax cuts of 2019 decreased fiscal revenue and created an unsustainable fiscal situation due to the debt structure. The effects of high debt in Sri Lanka were experienced immediately in the form of short-term repercussions. The interest payments were consuming a large percentage of government incomes that the government could not make any financial scope to offer the essential services delivered, such as healthcare, social welfare and education. Inability of the government to earn sufficient foreign money resulted in a shortage of imported goods, including food, fuel, medicines and others (Sharma et al., 2022). Currency depreciation fell to 48.7% in March 2022 and further increasing the burden of servicing foreign debt and imported goods, affecting cost-push inflation (Ekanayake & Dissanayake, 2025). Moreover, it harmed the overall confidence of global investors, reducing foreign direct investment and causing further liquidity decline in the domestic economy.

On the other hand, long-term consequences have also been observed, which include structural vulnerabilities. Depending on foreign loans exposure to international shocks, including increased oil prices and international interest rates. The rising debt of Sri Lanka poses risks of defaulting on its sovereign debt, as experienced in the default of its sovereign debt of $1.25 billion of international bonds in mid-2022 (LSEG, 2025). The presence of constant high debt may result in IMF bailouts, which might provide short-term relief, but demand austerity measures, which restrict the growth rates and social spending in the long run. At the microeconomic level, government's massive debt level declines the market conditions by attracting private investment (Wu et al., 2023). This inclination toward government borrowing of the domestic interest rates makes financing firms expensive, hence reducing productive investment and the level of economic growth. Moreover, it can be underpinned that high debt levels of the country are further complicated by fiscal constraint, low investor confidence, inflationary pressure and limited ability to absorb external shocks.

In order to address this, disciplined management of fiscal resources and a better balance of the debt profile are required to maintain long-term sustainability and stability.

4.2 The Issue related to Dual Deficits

Fiscal deficit occurs when the amount of expenditure a government makes exceeds its amount of revenues within a specified period (Kryeziu & Hoxha, 2021). It shows that the government is dependent on borrowing to finance its spending, which is higher than its income through taxation and other sources of revenue. The current account deficit arises when importation of goods and services in the country and capital imported exceeds the export of the products and services and capital to the foreign markets where the country is experiencing an outflow of its local currency to the foreign markets. These two deficits also point towards the possible economic vulnerability, especially for nations dependent on external financing such as Sri Lanka. According to Sharma et al., (2024), the twin-deficit hypothesis can be described as the relationship between 'Current account deficit' and 'Fiscal deficit'. The consequence of the high-level government borrowing to fund budget deficits is a rise in domestic spending, which in most instances translates to an increase in the demand for imported goods and services. The case of Sri Lanka led to increased imports with no relevant growth in exports due to continued fiscal deficits, which were aggravated by tax cuts in 2019 and unproductive government expenditure (George et al., 2022). This was also an imbalance that contributed to the growth of the current account deficit, which strains financial exchange and results in currency depreciation.

Through the cause-and-effect framework, the chain of events can be evaluated, such as:

- High fiscal deficit: It refers to the situation when the government spends more than its revenues and acquires debts locally and internationally.

- Raised domestic demand: Government expenditure raises the consumption and investment, and much of this investment is based on imported goods since production is so low.
- Current account deficit: It considers increased imports in comparison to the same growth in exports, resulting in an increased current account deficit.
- Currency pressure: It involves the funds in the domestic currency being spent on imports and settling foreign debt because of depreciation.
- Inflation and investor concern: The depreciation of the currency increases the prices of imports, which is a major factor causing inflation. This minimises the inflows of capital because it lowers the confidence of the investors.

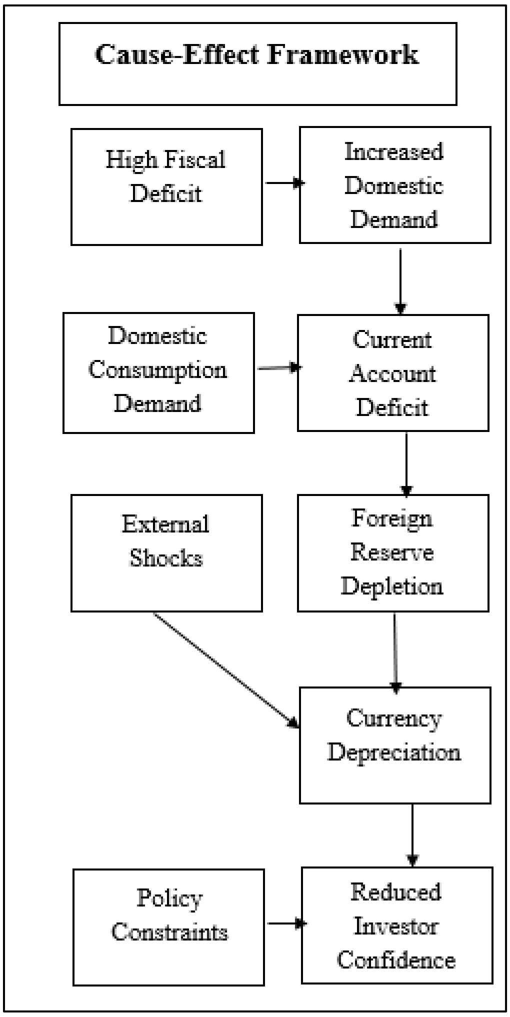

Figure 4.2.1: Cause-Effect Framework

(Source: Self-developed)

In Sri Lanka, this situation was aggravated by the global shocks, such as the COVID-19 pandemic, higher oil prices, and the Russo-Ukrainian war, which raised the prices of exports and reduced foreign inflows through the tourism sector and other remittances (Pitigala, 2022). The interaction of the fiscal and the current account deficits is also significant in the response of the policy. Moreover, twin deficits can be mitigated through fiscal policy, limited expenditure, greater domestic revenue collection, and export diversification, which would stabilise the economy.

4.3 Structure for Investment and Savings

The national saving and investment trends are a crucial aspect of determining the economy of any nation and its development (Matyushok et al., 2021). One of the major reasons for the rising level of external debt and the trade issues that have persisted in Sri Lanka has been the existence of chronic savings investment imbalances. It has also been noted that national savings, corporate savings, household savings, and government savings are not adequate cater to domestic investment needs. This disparity has created the necessity to borrow foreign funds to finance the infrastructure, state expenditure and investment in the country by the private sector, which has made the country reliant on external funds. Savings-Investment identity states that the deficit in current account is a result of domestic savings being lower than corresponding investment level, given this the excess demand must be financed by receiving inflow funds (Arabyat et al., 2023). This lack of saving in the household sector and diabolical government spending and proud edifice construction in Sri Lanka. This resulted in chronic and recurring deficits that had to be closed on foreign debts. This reliance on foreign borrowing predisposed the country to some global shock such as increased oil prices, reduced remittances, and impediment of trade due to the geopolitical wars and COVID-19 desease.

The low-saving trend also affected the private investment. Massive state borrowing crowded out local credit, driving up interest rates and the cost of funds for companies. This limited productive expenditure and therefore economic expansion, but stimulated demand for short-term consumption. High reliance on foreign borrowings also made it vulnerable to the currency risk of devaluation since it had to service external debt with massive outflows in hard currencies (Rastogi, 2023). Sectoral imbalances further compounded these issues. While the sector contributed significantly to GDP, where productivity was low and heavily exposed to external shocks. Agriculture, which was affected by policies such as fertiliser ban, recorded low productivity, leading to the country importing food and other agricultural inputs as well as a growing deficit in the trade balance (Drechsel et al., 2025). Moreover, the chronic gap of national savings and investment created a dependency-generating cycle of external dependence, trade imbalances and financial instability. These challenges can only be addressed with policies that result in domestic savings, investment efficiency and lower dependence on foreign public borrowing for “long-term financial sustainability” amid the shocks of the integrated global economy.

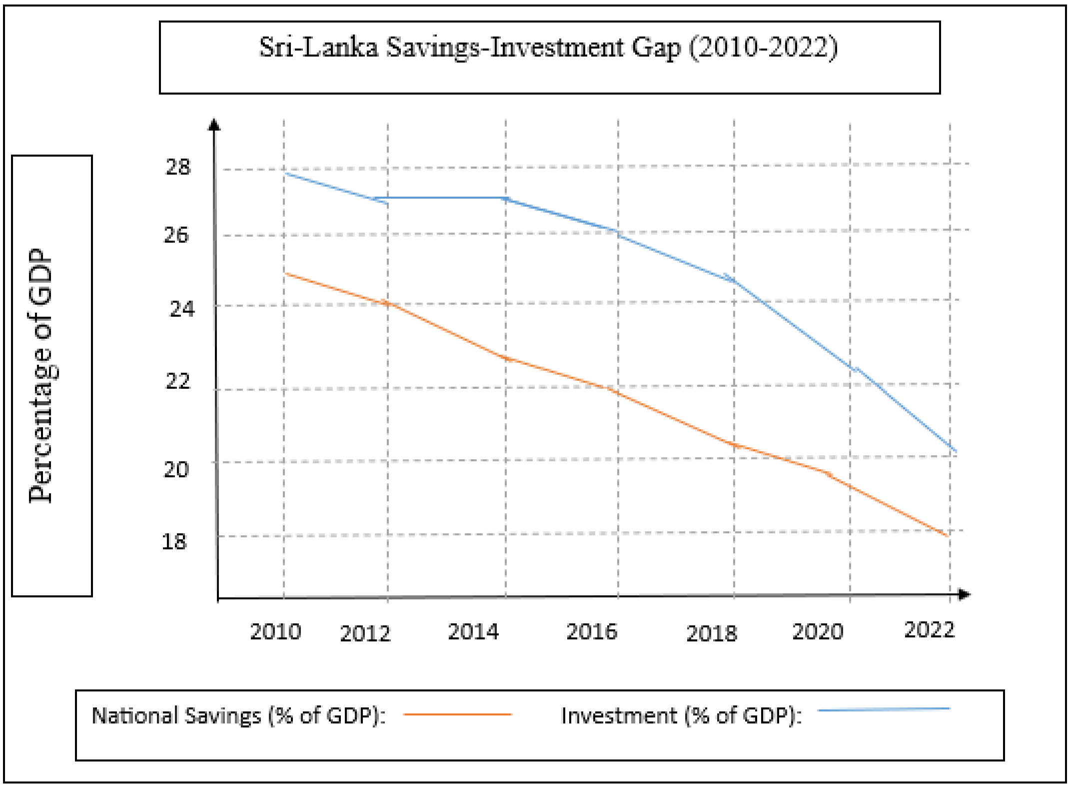

Figure 4.3.1: Savings–Investment Gap Model

(Source: Self-developed)

4.4 The Effects of COVID-19

The economy of nation had been hugely affected by the COVID-19, which had struck several sectors and aggravated inherent fragilities in the system. The sector which was widely affected was tourism, which is among the largest foreign exchange earners. With the travel restrictions enforced, lockdowns and global reluctance on movement of people, (they are considered as cost-effective methods to reduce human movement) arrivals had declined by over 60% for the year 2020-21 impacting significant foreign exchange earnings (Sri Lanka Government, 2022). Further, remittances inflows declined by 22.7% for Sri Lanka in 2021 worsening the country's balance of payments (United States Department of State, 2023). The service providing sector, which makes up roughly 60% of GDP, was disrupted broadly.

Airlines, hotels, and other related transportation and tourism industries operated at the same level as pre-COVID conditions, where the loss for Sri Lankan Airlines was RS 372 million, followed by the transport industry was working only at 14% (Adaderana, 2025). The disruptions had immediate effects on jobs, and labour demand by businesses was clear as day, leading to rising unemployment and a surge in poverty.

Manufacturing and agriculture sectors were also faced with disruptions in supply chains and labour shortages. Agriculture was negatively impacted by government misuse, for instance, the fertiliser bans, which indicated lower output, and urgency for increasing imports, leading to worse financial conditions. In the short term, GDP growth fell sharply, by 3.6% in 2020, inflation rose because of supply problems, and the government had a lot of trouble collecting taxes (Jayasinghe et al., 2022). The ability of the government to stabilise the economy was limited when foreign reserves ran out. Meanwhile, the long-term effects of the Covid-19 crisis include a slower recovery in employment, ongoing problems in the tourism and service sectors, and more external debt because the government relies heavily on borrowing money from outside sources to cover its budget deficits.

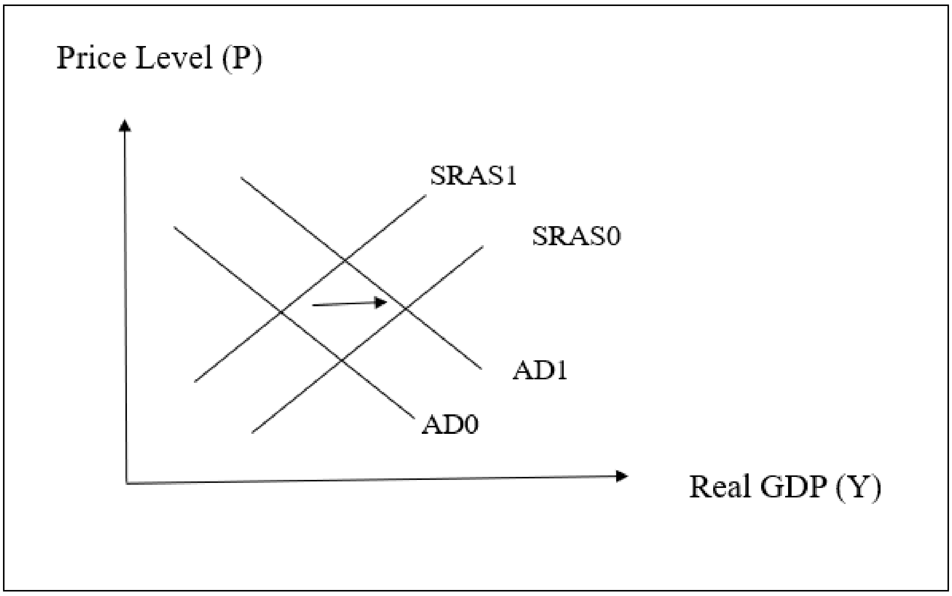

Figure 4.4.1: AD-AS Model

(Source: Self-developed)

- The AD curve moves downward ($AD_0 \rightarrow AD_1$), which means that tourism, remittances, and household spending lowers significantly.
- For a supply side shock in agriculture and manufacturing, the SRAS curve could be moved a little to the left.
- Result: The output is lower than the natural rate (Y) and there is stagflation in the price matrix (P).

During COVID-19, tourism, remittances, and household spending all fell at record rates, which shifted the overall demand to the left. The pull SRAS to the left is weak, which means that farming and manufacturing do not have an effect on supply. They cut back on production, which caused prices to rise quickly, like stagflation. In this regard, the AS-AD model has been optimised to look at how the pandemic has affected both the output and pricing of the Sri Lankan economy.

5. Policy Evaluation and Global Influences

5.1 Policy Evaluation

The recent macroeconomic condition of Sri Lanka indicates the inconsistency and poorly taken policy decisions. There are majorly three key policy episodes that are the 2019 tax cuts, the 2021 fertiliser ban, and the 2022–2023 IMF-led reforms. The 2019 tax cuts implemented to boost domestic consumption of the products and invested massively for fiscal revenue (Bdo.global, 2020). It was an effort to put money in the pockets of civilians to increase the demand and it was a grate initiative from the macroeconomics perspective. This fiscal expansion without productive backup creates an inflationary pressure and foreign reserve depletion. This also violated the basic Keynesian principle that stimulation must be countercyclical and fiscally achievable. The 2021 fertiliser ban was an example of supply-side policy disaster. It ignored the rule of derived demand and productivity connection. The ban decreased the agricultural production especially rice and tea (Drechsel et al., 2025). A massive shortage in supply chain ensued with the price of food increases. This policy failure reflects how interventions disregard the dynamics of the market and generate a social-costs. The 2022-2023 IMF reforms targeted to restore fiscal discipline and macroeconomic stability through monetary tightening. These kinds of reforms increased the credibility in global finance markets and open the door of external financing.

5.2 Global Influences

The macroeconomic crises in Sri Lanka are not completely explainable in isolation without taking into account the international economic environment. Among the major external threats, the drastic increase in oil prices across the globe and the Russo-Ukrainian war (Shah et al., 2022). Sri Lanka experienced the rising costs of energy and this raised production and transportation costs to the various sectors. At the same time, the disruption of supply chains in the world markets resulted in supply chain disruptions and reduce the domestic productivity. These also assist to raise the consumer price of goods. These supply-side threats were converted to inflationary pressures, declining real incomes, and worsening social pressures. The financial situation around the world also was crucially taken into consideration. Central banks responded to the continued inflation in the advanced economies by raising interest rates creating tightening of global liquidity. The emerging markets such as Sri Lanka, it entailed less inflow of capital, higher cost of borrowing and having fewer accessibility to rollover external debt. This led to an increased rate of foreign reserve depletion to such an extent that the government would no longer be able to stabilize the currency and finance the necessary imports. Relying on foreign lenders such as China and

IMF made them more susceptible to geopolitical and economic changes (Debtjustice.org.uk, 2024). Because the terms of the loans and provision of the funds was usually conditional on policy changes. The business decision making was severely affected. The import companies of manufacturing and energy sectors were left for the liquidity crises and it creates the production plans down. The export companies also faced limitations with for the sourcing of inputs because of currency inadequacy and disruption of supplies globally. This reduces both the production as well as profit margins. These firms gained in the short run with LKR devaluation as their products became more competitive in the world markets.

6. Limitations

The study had limitations that impacted on the richness and transferability of findings. The sources of data in the study are largely secondary from departmental reports, case studies and institutions. These sources also provide economic information that does not necessarily show a changing economy in some cases. In quantitative validation, publicly available in number are few and unusable with accuracy. The analysis is at the macro-policy rather than micro policy level, considering national fiscal and current account performance. Such analysis is much often not covering lower level of detail of economic data such as firm level, household behaviour or informal sector input that will provide more accuracy to understand this economic interaction. Results are country specific and may not be applicable to developing countries with different fiscal structures or external sector characteristics in general. Some simplifying assumptions were made, such as conditional export demand elasticity to import competition, exchange rate and export reactions, and linear fiscal and external imbalance determinants. The assumptions were assumed for simplification in this work, though empirically did not apply. All these issues would be dealt with in later work.

7. Conclusion and Recommendations

Conclusion

This observation implies that Sri Lanka's economy is weakening due to issues that are inherent, such as high public debt and chronic twin deficits. These fiscal imbalances created excessive spending and low taxation, which resulted in the increasing current account deficit. Nevertheless, the weakening currency ensured that the country's foreign exchange reserves levels remained very low. The spread out of COVID-19 pandemic was a catalyst that revealed these shocks including collapsing tourism revenues, disrupted supply chains and fiscal strain. This crisis should not be attributed solely to external shocks. This is largely a reflection of domestic policy failures including poor fiscal discipline, populist decision-making for short-term gains and weak institutional governance. Sustainable recovery will necessitate addressing internal structural inefficiencies through coherent policy reform and long-term planning.

Recommendations

For rebuilding a stronger and more sustainable economy, more immediate stabilisation together with longer-term structural adjustment approaches are necessary. In this regard, an integrated approach is recommended consistent with fiscal, monetary and trade policy priorities as follows:

Short-Term Priorities

- **Fiscal Discipline:** Seek greater commitment to spending discipline, rationalising subsidies and broadening the tax base to reduce the fiscal deficit and reorient budget.
- **Financial Stabilisation:** Stabilisation in macroeconomic could be achieved via coordination of fiscal stance with monetary credibility (inflation targeting) and stabilising the exchange rate to regain investors' confidence and also maintaining prices stability.

- **Targeted Welfare and Safety Nets:** Establish effective social protection systems to protect low-income families vulnerable during the fiscal adjustment period, thereby maintaining social stability while strengthening public finances.
- **Debt Restructuring and International Coordination:** Strengthen collaboration with regional partners, the IMF and World Bank to facilitate debt restructuring and financing requirements while bolstering orderly macro adjustments.

Medium to Long-Term Priorities

- **Strengthening Financial Sector:** Deeper financial sector to lead to higher real deposit rates, improved access to credit and increase domestic savings through pension or insurance reforms that support long-term capital formation.
- **Diversification:** Create investment in renewables (particularly solar and wind) to reduce the external oil import bill, enhance the current account and sustainably develop industry.
- **Diversifying exports and value addition:** Encouraging high-value exporting-industries, including technology transfer intensive manufacturing industries, information turning services through ICT application, agro-modernisation and so on to promote-export-oriented visible exports in place of traditional sector like tea tourism.

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