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ECONOMIC CRISIS AND ITS IMPACT ON ECONOMIC DEVELOPMENT (SPECIAL REFERENCE TO SRI LANKA)

Shibly, FHA

Department of Arabic Language, South Eastern University of Sri Lanka
Corresponding author: shiblymis@gmail.com

ABSTRACT

Aim: The aim of the study is to find out the reason of economic crisis in Sri Lanka and the recovery methods for reducing the impact of economic crisis on Sri Lanka's developments. **Methodology**: Since it is a qualitative research, data were collected from articles, books and online resources. **Result**: There is no universal recipe for all types of crisis, not only for Sri Lanka, But also all countries in case of a specific crisis. The best strategy to cope with such events is to use the optimal undesirable effects on the combination of policy ingredients that will minimize the economy .Sri Lanka must be concentrated and responded on Prevent increasing and possibly unsustainable deficits; Contrary to the policy in developed economies affected by the crisis, interest rates should be slightly increased in order to maintain inflation at low levels; Precautionary investment policy, especially with respect to large (and somehow risky) projects in manufacturing, when such projects are financed by the state budget; Better and careful monitoring over the internal financial system, even if the system seems healthy and not affected by contagion. Prevention, rather than curing, is the right policy in these times. Among the experts in the field, there is a clear consensus that in case of such a financial crisis, with possible implications on real economy, the first thing to be done by decision makers is to avoid populist policies. **Conclusion**: The economic crisis severely affects on Unemployment, Inflation, Ecconomic growth, Export and Import .but, Sri Lanka tries to prevent from such hazards. Therefore what is desirable is to formulate a new/alternate economic model (based on socially-oriented market economy) where the benefits of economic development are not concentrated in a few but shared by all. Coming back to the Russian summit, BRIC refers to four fast-growing developing economies, namely Brazil, Russia, India and China. Now that Sri Lanka has been granted delegate status at the Shanghai Cooperation Organization, we would be eligible to get enrolled into "BRIC block" if Sri Lanka could truly demonstrate its capabilities as an emerging economy by working out and adopting this new economic model which is in line with "Mahinda Chintana" policies.

INTRODUCTION:

The term economic crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults. Many economists have offered theories about how financial crises develop and how they could be prevented. There is little consensus, however, and financial crises are still a regular occurrence around the world.

Economic Crisis – Overview: The global financial crisis, brewing for a while, really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems. On the one hand many people are concerned that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelihoods of almost everyone in an increasingly inter-connected world. The problem could have been avoided, if ideologues supporting the current economics models weren't so vocal, influential and inconsiderate of others' viewpoints and concerns. The term economic crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults. Many economists have offered theories about how financial crises develop and how they could be prevented. There is little consensus, however, and financial crises are still a regular occurrence around the world (John, 1997).

Economic Crisis in Sri Lanka: In the initial decade of the 21st century, the world has come to grip with the frightening scene of an economic crisis which - according to some - has no known precedent in history. The collapse of the banking system on which the countries depend for their economic activity has resulted in a multiplicity of problems, such as causing joblessness, bringing development to a standstill, shutting down of industrial and business organisations, and lowering the living standards of populations and the downward spiral of global trade. The first sign of the global economic crisis became visible in the U.S. housing market sector in 2008. Since then it has been spreading to almost every country in the world – developed as well as developing. At first, we were hopeful that we would not be affected by the ill-effects of the depression, but now there are signs indicating that we too would be caught up in the vortex. Ours is an export-import oriented economy. We export tea, rubber, coconut, spices, ready-made garments and jewellery etc. to earn the necessary foreign exchange to pay for the country's import needs. The countries which buy these things from us have been badly affected and demand for them is ever on the decrease. There are warnings that the plantation sector has begun to feel the clutches of the crisis. Several local industries have already laid off their work staff as a result of having no demand for their produce in the international market. The nationals who have migrated for employment abroad is another principal sector sending valuable foreign currency to their motherland, which is much needed for her economic development activity. They too have faced the threat of losing their employment in view of the looming economic crisis in the respective countries where they work. As a result of this situation, Sri Lanka's economy too has become exposed to the worsening global disaster. Set against this background where we are subject to the evil consequences of the global economic crisis, we have to evolve our own strategies to tide over this period of stress. There are numerous examples in history that demonstrate that, if you have the necessary confidence and courage, it is possible to overcome any obstruction. If Japan and Germany, which were reduced to debris by the Second World War, could rise, in a short time, as giant economic powers, we can reduce the impact of the crisis provided the government adopts proper fiscal measures and the nation is geared with determination to overcome the hurdle. Similarly, business establishments in the private sector should not decide at once to wind up just because the demand for their products, in the international market, has decreased. In the unfolding scenario it is inevitable there is the need to reduce staff. Yet they should not think of a complete shutdown. Instead, ways and means should be found to reduce overhead charges and day to day running expenses by evolving other strategies so that when conditions are improved they will be able to restart their enterprises. Alternatively they should change over to produce goods marketable locally (Annual Report, 2008).

In this connection, it has to be pointed out that the potential of the internet is of immense help to shore up the wobbling ventures. The modern trend is that most of the work done in offices is outsourced. There are several advantages in this method of getting work done. There is no necessity to maintain big offices and spend money on infrastructure. Work could be got done several times cheaper engaging those who work from home. Strikes do not disrupt the continuous flow of work and the management is not called upon to pay EPF, ETF and other fringe benefits in case of outsourcing. In this setup, offices are required to maintain only a minimum skeleton staff. Why don't our local entrepreneurs think about this positively in order to tide over the stress instead of shutting down their ventures for good?. Time has come for us to think of our priorities. What is our first priority? It is to live as a nation. Then, it is inevitable to draw a dividing line between what is essential and inessential. Saving every cent of foreign exchange is a must in this critical period to harness it for imports essential for national survival. Take a look around you, and you will see what and what inessential items of goods have flooded the market. For example, even small boys and girls attending school are armed with mobile phones. Are these things essential for their education? Open market policy needs reconsideration at this juncture if we are to save foreign exchange to survive this calamity. Example should flow from our leadership who, it is a pity, only preaches but rarely practises what they want other people to do. First, they should tighten their belts and then ask the common man and woman to follow suit. If they abandon their joy rides abroad what a colossal amount of foreign exchange the country can save at this time of scarcity! This crisis has driven us to make a timely evaluation between nationalism versus internationalism. Some people exhort that there is no place for nationalism in these days when the world has shrunk to a global village due to the fast developing information technology. There is no intention to challenge this assertion. What is meant here is that we should not allow internationalism to subjugate our national identity and make us unnecessarily dependent on the international community. In other words it means that we should endeavour to be self-sufficient wherever we can. If we act in this manner, the nation can tide over this calamity, and the whole country will be with the government if it is convinced that the motives of the leadership are directed towards the general well-being of the masses. In the below example (Figure 1), you can see the effect of the economic crisis in South Asia. Especially Srilanka lost their GDP by10.2% which is higher than India (*www.imexport.gov.lk)*.

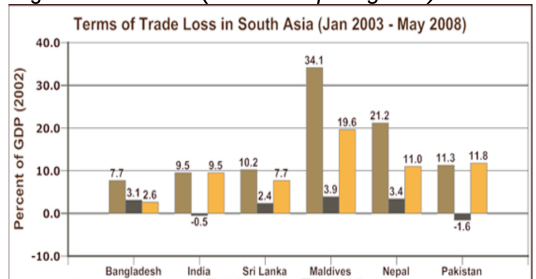

Fig: 1. Source:- Central Bank of Sri lanka

Root Causes for Economic Crisis: Certain pessimistic opinions consider that the current financial crisis may well be the biggest since the 1930s one, which ended up with the virtual collapse of market activity for several years, a very sharp fall in output and huge increase in unemployment, which required a decade for the economies around the world to recover. However, the current crisis is different from past similar events because the inter-linkages among financial institutions are much stronger now. It started as a (relatively isolated) crisis in low-quality mortgage loans in US, but it then spiraled out of control because the institutions that were making those mortgage loans were dependent on other institutions for the money they were using to lend. And those institutions were depending on other institutions. So very quickly, this spiraled into a crisis affecting financial institutions everywhere, triggered by the fact that the global financial system was already contaminated by increasing risk-taking in search of higher yield, and the use of sophisticated mechanisms such as asset-backed securities and structured credit products; neither the markets, nor the regulators were fully aware of the potential danger of these practices for the financial stability of the system. Initially, the phenomenon was not considered very seriously by decisional factors, but the fact that economic and financial globalization has been faster in the last decade that the speed of policy and regulatory adjustment led quickly to banking crisis affecting most of developed countries. In fact, the crisis got a world dimension because a regulatory framework for financial institutions exists only at national level. Or, in our days these institutions operate at global level, but no international regulatory framework exists; to a large extent, the spread over of the crisis at international level is not the result of a bad regulatory framework, but the consequence of the fact that a global framework does not exist at all. This deficiency may lead to a systemic crisis, which will force the decisional factors to react accordingly and design international regulations, while reshaping the national ones (Ajith Nivard, 2008).

Causes and Consequences of Financial Crises: Strategic complementarities in financial markets. It is often observed that successful investment requires each investor in a financial market to guess what other investors will do. It has been argued that if people or firms have a sufficiently strong incentive to do the same thing they expect others to do, then *self-fulfilling prophecies* may occur. For example, if investors expect the value of the yen to rise, this may cause its value to rise; if depositors expect a bank to fail this may cause it to fail. Therefore, financial crises are sometimes viewed as a vicious circle in which investors shun some institution or asset because they expect others to do so.

***Leverage*:** *Leverage*, which means borrowing to finance investments, is frequently cited as a contributor to financial crises. When a financial institution (or an individual) only invests its own money, it can, in the very worst case, lose its own money. But when it borrows in order to invest more, it can potentially earn more from its investment, but it can also lose more than all it has. Therefore leverage magnifies the potential returns from investment, but also creates a risk of bankruptcy. Since bankruptcy means that a firm fails to honor all its promised payments to other firms, it may spread financial troubles from one firm to another

Asset-liability mismatch: In an international context, many emerging market governments are unable to sell bonds denominated in their own currencies, and therefore sell bonds denominated in US dollars instead. This generates a mismatch between the currency denomination of their liabilities (their bonds) and their assets (their local tax revenues), so that they run a risk of sovereign default due to fluctuations in exchange rate.

Uncertainty and herd behavior: Unfamiliarity with recent technical and financial innovations may help explain how investors sometimes grossly overestimate asset values. Also, if the first investors in a new class of assets (for example, stock in "dot com" companies) profit from rising asset values as other investors learn about the innovation (in our example, as others learn about the potential of the Internet), then still more others may follow their example, driving the price even higher as they rush to buy in hopes of similar profits. If such "herd behavior" causes prices to spiral up far above the true value of the assets, a crash may become inevitable. If for any reason the price briefly falls, so that investors realize that further gains are not assured, then the spiral may go into reverse, with price decreases causing a rush of sales, reinforcing the decrease in prices.

Impact on Macro Economic Variable in Sri Lanka: Economic crisis has done so many damages into the variables of economics in several ways. According to the Sri Lanka's situation, I can explain this concept by using plenty of statistics and papers. particularly, this crisis attacked variables mainly, Unemployment, Inflation, Ecconomic growth, Export, Import and I am explaining these variables below.

Unemployment: The state of being unemployed or not having a job; "unemployment is a serious social evil"; "the rate of unemployment is an indicator of the e health of an economy. In Srilanka's situation, we can see the below chart to understand the unemployment up and down clearly. Following graph shows the unemployment rate for Sri Lanka for the last 6 years with an estimation value for year 2008. Actual figures for 2008 are yet to be published. With the current economic crisis, what would be the rate for 2009? Prediction is, it will for sure go above 7.2% which is the current rate for US.

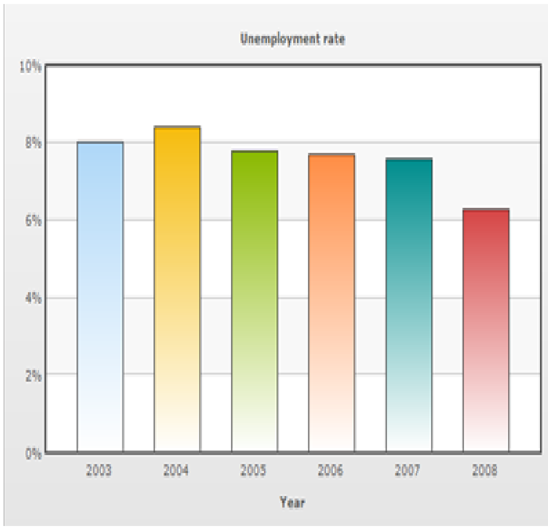

Fig: 2. Sources: - *www.infosl.com*

In the above example, There are some declining trend is available in the unemployment rate by comparing 2007 and 2008 indicators. So, I can write that there are very few changes happened due to the economic crisis. I found some reasons to this unchanged situation. Such as, Outsourcing., Small Medium Businesses, Self employments, Migrations and Emerging industries.

Inflation in 2008 – during the economic crisis's initial period: Sri Lanka's central bank has warned that inflation may remain high around 16 to 20 percent in the first half of 2008 and blamed "low supply" of domestic foods for the sudden price jump of 3.0 percent in January. Eighty percent of the price increases was due to food, the monetary authority said, while an increase fuel and cooking gas brought in 16 percent, pushing inflation measured by the new Colombo Consumer Price Index to 20.8 percent from 18.8 percent in December. "The pass through of international price increases, though it leads to a one time increase in prices, will have a favorable impact on containing future inflation by eliminating the need for subsidizing same, through expansionary borrowings of the government," the Central Bank said. This one time increase will be gradually dissipated over the next few months. Hence, until it is fully dissipated, inflation is likely to remain around 16 to 20 per cent during the first half of 2008." The central bank also claimed that the upward trend in prices in 2007 was largely due to the removal of a fuel subsidy and increases in prices of imported food products.

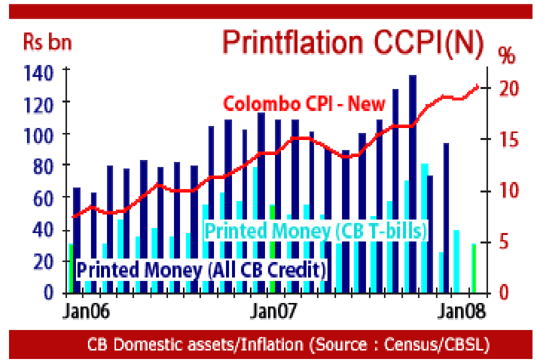

Fig: 3. Sources: - CBSL
Colombo Consumers' Price Index (CCPI)
Consumers' Price Index (CPI)

Sri Lanka inflation rate lowest ever in June 2009: June 30, Colombo: Sri Lanka Central Bank today said the country's annual inflation grew only 0.9 percent in June falling from a year-on-year rate of 3.3 percent for the month of May. The decline is continuing for the twelve months from a high of 28.2 recorded in June 2008.
Sri Lanka's Annual Average inflation dropped to the lowest level since April 2007, 12.5% in June from a 14.7% in May while the Colombo Consumers' Price Index (CCPI) increased slightly to 207.8 from 205.1 in May 2009. The Central Bank attributed the decline to the tight monetary policies of the Bank that targets the reserve money to keep the inflation checked.

Sri Lanka Economic Growth: Sri Lanka's economic growth is forecast to slow sharply to 2.5 percent this year, from six percent last year and then recover to five percent in 2010, the central bank said. The Sri Lankan economy is projected to grow at a lower rate in 2009 and then recover its growth momentum in 2010 with expected recovery in the global economy," the bank said in its annual report for 2008. Central Bank governor Nivard Cabraal said new conditions such as the liberation of the north from Tamil Tiger separatist rebels will provide tremendous opportunities for the country. "The end of the war will be looked at positively by foreign investors," he told a news conference where he presented the annual report. "We are at a cross roads, notwithstanding global developments." Government forces have cornered the rebels on a small strip of coast in the north-east and say they are about to crush the guerrillas. Cabraal said economic growth may be between 4.5 to 5.0 percent in 2009 if conditions are favourable. "On a more pessimistic assessment it can be between 2.5 to 3.5 percent," he said. "But new conditions of liberating the entire country from terrorists will have an impetus on growth." The bank's annual report said the economy has been growing over six percent continuously for four consecutive years since 2005. This strengthened the prospects of the economy achieving the medium-term growth targets of eight per cent enunciated in the government's medium-term macroeconomic policy framework, the bank said. Growth is likely to slowdown in 2009 primarily due to the impact of the global financial crisis and subsequent global recession on Sri Lanka, the bank said. The overall budget deficit for 2009 is projected at seven percent, down from a provisional 7.7 percent in 2008. The central bank said, inflation, which decelerated to a single digit in February 2009, is projected to remain at a single digit level throughout 2009 and stabilise at a low level in the medium-term. "The high inflation experienced over a long period of time remains one of the weaknesses in the Sri Lankan economy," the report said. This has been fuelled largely by the excessive monetary expansion arising from the increased financing of widening fiscal deficits with bank resources." In order to contain the inflation and inflation expectations, the Central Bank adopted a quantity based stringent monetary policy strategy in 2007 and 2008 that has yielded desired results supported by declining international commodity prices, it said. With the expected global recovery, the international commodity prices might also revert to pre-crisis levels, the bank warned.

Export: Sri Lanka's exports, particularly to the United States, have been suffering even before the global meltdown due to excessive money printing since 2004 that drove the country's inflation to much higher levels than the rest of the world. Annual inflation above 20 percent in recent years had made the rupee progressively 'overvalued', but foreign borrowings and seesawing monetary policy has strengthened the currency. By November 2008, the Sri Lanka rupee was 28 percent overvalued on a real effective exchange rate index calculated by the country's central bank. The export incentives are a part of what the government calls a 'stimulus package' to make up for an overvalued currency, amidst calls from exporters to depreciate the currency. In 2008, Sri Lanka's industrial exports grew by only 3.2 percent with apparel, the island's main industrial export, growing 3.9 percent. International trade minister G L Pieris say a 3.0 percent incentive will be given if 90 percent revenues can be shown. Once a payment is approved, an exporter can also use the certificate to set of tax payments to the Treasury. But emerging trends seems to indicate that even a 90 percent target may be tough. Already in December 2008, revenues from apparel had fallen 6.3 percent while industrial exports as a whole plunged 18.4 percent.

Import: Sri Lanka will have to further relax import tariffs on goods like cement from April this year under its trade deal with India, with customs revenues taking a hit. Sri Lanka's bilateral trade agreements with both India and Pakistan allow for a phasing out of tariffs over a eight year period, for goods that are not on a sensitive list. Under the Indo-Lanka Free Trade Agreement, tariffs are to come down to not less than 70 percent of the general customs duty rate this year. That means, for imports of finished goods from India, tariffs will drop from 28 percent to 8.40 percent and from 2.5 percent to 0.75 percent for industrial raw materials and machinery. The rates will have to be made effective from April this year, though no dates of implementation have been announced yet, C W Jayatilake, Director General of Sri Lanka Customs, said on Thursday. "Barriers are going to be diminished as far as our taxes are concerned." The tariff phase on Indian imports covers over 2000 products. Tariffs under the Sri Lanka-Pakistan FTA will also have to be relaxed by 30 percent of customs duty rates from July this year. About 17 percent of Sri Lanka's total imports are from India to the tune of US$ 1.4 billion.India is also Sri Lanka's third largest export market, buying up US$ 560 million in goods last year. The trade agreements will whack revenues from customs duties, with Jayatilake expecting a three to four percent drop on the Rs42 billion in duty collections last year. "This is going to diminish taxes in areas where so much is being collected at the moment. Tariffs will be phased out on some of our highest revenue collecting items like cement." Commonly traded items from India includes petroleum products, motor cycles, motor vehicles, cement, paper products, lentils, onions, man-made fibres among others. Top items that Sri Lanka exports to India include copper and copper products, vegetable oil, spices like pepper, tea, rubber products, machinery parts, tiles, apparel and clothing.

How does Sri Lanka responded these issues?: There is no universal recipe for all types of crisis, not only for Sri Lanka, But also all countries in case of a specific crisis. The best strategy to cope with such events is to use the optimal undesirable effects on the combination of policy ingredients that will minimize the economy.Sri Lanka must be concentrated and responded on: i) Prevent increasing and possibly unsustainable deficits; ii) Contrary to the policy in developed economies affected bythe crisis, interest rates should be slightly increased in order to maintain inflation at low levels; iii) Precautionary investment policy, especially with respect to large (and somehow risky) projects in manufacturing, when such projects are financed by the state budget; iv) Better and careful monitoring over the internal financial system, even if the system seems healthy and not affected by contagion. Prevention, rather than curing, is the right policy in these times. Among the experts in the field, there is a clear consensus that in case of such a financial crisis, with possible implications on real economy, the first thing to be done by decision makers is to avoid populist policies. It is recommended that, depending on the avity of the crisis and its implications furor the, the actions should be taken at three different levels: 1. Policy measures for the financial sector: vulnerability indicators, proposed by IMF, will provide an overall picture of country's financial and banking sector. The use of inerrability indicators is recommended even if he rest of the would the sector is not very well developed or is relatively isolated from trld financial system. 2. Actions under the authority of the Central Bank_for managing the exchange rate and the inflation. Since the most likely influence on the economy will come through the deterioration of the terms of trade and decline in exports, the exchange rate stability is crucial for coping with this situation. Controlling inflation may also help in limiting the economic fallout, particularly in case of credit problems. 3. Vulnerability indicators_are proposed by IMF to monitor the government, financial, and household and corporate sectors. When economies are under stress, problems arising in one sector often spread to other sectors. Concerns about the fiscal deficit, for example, may lead to a run on the exchange rate, or undermine confidence in banks lding government debt, thereby triggering banking crisis.

CONCLUSION

The conclusion here is that the free market economic policies if not managed properly, are undesirable in terms of achieving true economic development and improve the quality of life of the people. It is interesting to note that United Nations, Food & Agricultural Organization (FAO) has last week reported that agricultural sector is more resilient to global financial crisis than any other sector of the economy. Our farmers have been working on this premise anyway. As I stated the carbon dioxide emissions per capita in metric tons, based on 2004 figures : Sri Lanka- 0.6(Low); India-1.2; Brazil- 1.8; China-3.9; we are even better than "BRIC" countries and US figure was as high as 20.6 per capita in metric tons (World Development Report 2009). Therefore what is desirable is to formulate a new/alternate economic model (based on socially- oriented market economy) where the benefits of economic development are not concentrated in a few but shared by all. Coming back to the Russian summit, BRIC refers to four fast-growing developing economies, namely Brazil, Russia, India and China. Now that Sri Lanka has been granted delegate status at the Shanghai Cooperation Organization, we would be eligible to get enrolled into "BRIC block" if Sri Lanka could truly demonstrate its capabilities as an emerging economy by working out and adopting this new economic model which is in line with "Mahinda Chintana" policies.

I sketched out *a solution to our financial crisis*, in three parts. (1) Stabilize the financial system – Being attempted, probably now it's too late. (2a) Stabilize the economy with monetary stimulus– Rates are coming down and money printed, but probably with relatively little effect. (2b Stabilize the economy with fiscal stimulus — Just now being considered; will work but slow to implement and slow to have effect. (3) Arrange long-term financing for steps #1 and #2 with our foreign creditors – Unacceptable to our leaders at this time.
(4) Can introduce Islamic banking system in Sri lanka.

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