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Global Trade Tensions, Geopolitical Shocks, and their Impact on Sri Lanka's Economy

Key Takeaways

- **Sri Lanka's economic fragility was amplified by the impact of global shocks** such as the Russia-Ukraine war, Middle East tensions, and U.S. trade protectionism—translating swiftly into inflation, currency depreciation, and surging import costs due to high dependency on external energy, food, and remittance flows.
- **U.S. tariffs and geopolitical risks threaten Sri Lanka's export competitiveness**, especially in apparel and tea, with potential loss of market share in the U.S. to regional peers like Bangladesh due to modeled 44% reciprocal tariffs.
- **Sri Lanka's banking sector faced twin shocks**: rising non-performing loans (NPLs) from inflation and interest rate hikes, and mark-to-market losses from sovereign debt exposure, which tested financial stability despite regulatory buffers and IMF-supported recovery.
- **Comparative resilience in South Asia shows varied outcomes**: India weathered shocks via diversified imports and large reserves, Bangladesh took pre-emptive IMF support to avoid crisis, while Sri Lanka and Pakistan fell into economic emergencies exacerbated by limited buffers.
- **Policy response must prioritize economic diversification, external buffer-building, and safety nets**—including flexible exchange rates, commodity hedging, debt sustainability, and regional cooperation to withstand future global shocks.

Introduction

In the past few years, Sri Lanka's economy has been buffeted by a series of external shocks unprecedented in their simultaneity and scale. From rising trade protectionism by the United States to geopolitical conflicts in Eastern Europe and the Middle East, these global events have roiled commodity markets and disrupted trade flows worldwide. Sri Lanka – a small, import-dependent economy that was already grappling with a domestic debt crisis – has been highly exposed to these shocks. This report provides a brief analysis of how U.S. tariff impositions, Middle East uncertainties (involving Iran, Israel, and the U.S.), and the Russia-Ukraine war may have impacted the Sri Lankan economy. We examine the short-term effects of these developments (particularly through surging commodity prices like oil), assess why they are highly relevant to Sri Lanka's external trade (imports and exports), and analyze the transmission to domestic financial stability – including interest rate and exchange rate pass-through, inflation, and bank non-performing loans (NPLs). The experiences of neighboring economies (India, Pakistan, and Bangladesh) are also considered for regional context. Finally, we discuss policy implications and strategies for Sri Lanka to navigate these global headwinds.

Short-Term Global Shocks and Commodity Price Surges

The immediate aftermath of recent global shocks has been characterized by heightened volatility in commodity prices and financial markets. In February 2022, the Russian invasion of Ukraine sent shockwaves through international commodity markets. Prices of energy and food staples spiked to multidecade highs as supply chains were disrupted. Brent crude oil, for example, shot well above $100 per barrel in early 2022, and global food prices (wheat, maize, vegetable oils, etc.) skyrocketed. This war-induced supply shock hit just as the world was emerging from the COVID-19 pandemic, creating a *"new terrain of uncertainty"* for the global economy. Major economies imposed sanctions on Russia (a leading oil and gas producer), amplifying the surge in fuel prices and adding a financial dimension to the shock (e.g. exclusion of Russian banks from SWIFT). The result was a rapid rise in worldwide inflation and a scramble by central banks to tighten monetary policy. The U.S. Federal Reserve and others began aggressive interest rate hikes in 2022 to rein in inflation, further influencing global capital flows and currencies. In short, the Russia-Ukraine war created an acute short-term shock, with global energy and food supply disruptions that drove up prices across the board.

Fast forward to late 2023 and 2024, new geopolitical tremors emerged in the Middle East. For instance, an escalation of hostilities involving Iran and Israel in mid-2025 caused oil markets to gyrate. Following a military confrontation in June 2025, Brent crude futures jumped by 13% in a single day – from about $70.5 to $78.5 per barrel – before settling back as a ceasefire was announced. This illustrates how Middle East tensions can translate almost immediately into oil price volatility. The narrow Strait of Hormuz, through which ~20% of global oil passes, became a focal point of concern. Analysts warned that a severe disruption (e.g. closure of Hormuz) could *"catapult"* oil prices to $120–130 per barrel, a scenario that would imperil global growth. Even short of that worst case, the risk premium from conflict pushed energy prices up in the short term and injected uncertainty into markets. Fortunately, in the 2025 episode, a fragile ceasefire curtailed the price spike and oil quickly retreated below pre-crisis levels. Indeed, by late 2024, some institutions noted that an emerging oil supply glut (from higher production and slower demand) could mute the price effects of Middle East conflicts, limiting any spikes to be short-lived. Nevertheless, the initial shock underscores how sensitive commodity prices remain to geopolitical flashpoints.

Concurrent with these conflicts has been a shift in U.S. trade policy toward protectionism. The United States – a chief architect of the post-war free trade order – has in recent years imposed higher tariffs on various countries in the name of "fairness" and reciprocity. In a notable development, the U.S. announced in 2025 a set of "reciprocal tariffs" targeting countries with which it has trade deficits and higher import barriers. These tariffs, ranging dramatically up to 44–50% for some nations, signaled a new phase of trade tension. The immediate market reaction was significant: Sri Lanka's Colombo Stock Exchange plunged following the U.S. tariff announcement in April 2025, as investors feared the impact on export-reliant firms. Globally, businesses braced for a potential trade war between major economies. As analysts noted, if broad-based U.S. tariff hikes were fully implemented, it could lead to retaliatory measures and *"unprecedented effects on the global economy,"* possibly reducing world growth by about 1%. In the short term, the threat of a tariff war created immediate uncertainty, causing firms to delay investments and prompting volatility in currency and stock markets. In summary, whether through commodity price spikes or financial market jitters, these global events have delivered powerful short-term shocks. Sri Lanka, with its heavy reliance on commodity imports and export earnings, has felt these effects almost instantaneously at home.

Relevance for Sri Lanka's External Trade (Imports and Exports)

Although happening beyond its shores, the above global developments are *highly relevant* for Sri Lanka – primarily via the channels of import costs, export demand, and external income (like remittances and tourism). Sri Lanka's high dependence on imported essentials means that global price surges feed directly into its import bill. Chief among these is energy: Sri Lanka imports virtually all of its fuel needs. The Middle East supplies an estimated 80% of Sri Lanka's crude oil and petroleum gas, accounting for about 12% of Sri Lanka's total imports by value. Thus, a spike in oil prices acts like a massive tax on the Sri Lankan economy. For example, a 70% increase in oil prices (such as from ~$70 to $120 per barrel) would add over $2.5 billion to Sri Lanka's annual import bill. This is a huge burden given Sri Lanka's pre-crisis foreign reserves were under $2.5 billion. In 2022, this dynamic was on full display: the surge in world oil prices forced Sri Lanka to spend scarce FX on fuel, contributing to acute shortages (as the country literally ran out of dollars to pay for imports) and widening the trade deficit. Every extra dollar that Sri Lanka must spend on oil, gas, or coal imports puts downward pressure on the rupee and strains the country's balance of payments. Similarly, the war in Ukraine drove up prices of food and fertilizer, which Sri Lanka also relies on heavily. Global wheat prices jumped (Ukraine and Russia were key wheat exporters), and Sri Lanka, a net wheat importer, saw bread and flour costs climb. The country also faced a fertilizer crunch – not only had it controversially banned chemical fertilizer in 2021, but the war then made fertilizer globally scarce and expensive, hurting Sri Lankan agriculture further. In short, higher import costs for fuel, food, and farm inputs directly transmit global shocks into Sri Lanka's economy as inflation and foreign exchange stress.

On the export side, Sri Lanka is vulnerable to any downturn in its key markets or disruptions in trade logistics. The United States is Sri Lanka's single largest export destination, making U.S. trade policy extremely pertinent. In 2022, Sri Lanka exported about US$2.8 billion worth of goods to the U.S., mainly consisting of garments (apparel), rubber products, tea, and other agricultural goods. Roughly one-quarter of Sri Lanka's total exports (and over a quarter of its crucial apparel exports) go to the U.S.. This heavy reliance means that any U.S. tariff increase on Sri Lankan goods can significantly erode Sri Lanka's export competitiveness and earnings. The recently proposed U.S. *reciprocal tariff* of 44% on Sri Lankan imports is a case in point. A tariff of that magnitude would make Sri Lankan apparel and other products much more expensive in the U.S. market, likely causing American importers to switch to alternative sourcing countries. Sri Lankan garments would suddenly face a 44% duty, whereas some competitors like Bangladesh and Vietnam would face lower (though still high) tariffs of 37% and 46% respectively. Such a gap could be decisive – *"the 44% reciprocal tariff could make Sri Lankan garments less competitive, especially compared to countries like Bangladesh (37% tariff)"*. In effect, Sri Lanka could lose U.S. market share to those competitors. In anticipation of this risk, there were already signs of stress in Sri Lanka's apparel industry: reports in 2025 noted the closure of a major apparel factory and cancellation of worker bonuses, moves seen as *"a response to growing concerns over the impending impact of the*

US' tariffs.". Beyond apparel, other export sectors like rubber products and food/agriculture would also be hurt, since Sri Lanka generally has higher import tariffs (and thus would face high reciprocal tariffs) in almost all product categories. All told, losing preferential or low-tariff access to the U.S. could cost Sri Lanka a sizable chunk of its $3 billion in annual exports to that market and strain its foreign exchange reserves further. This illustrates why U.S. trade policy is directly relevant to Sri Lanka's export outlook.

Sri Lanka's export exposure is not only to Western markets. The country also trades with and earns income from Russia, Ukraine, the Middle East, and other regions impacted by recent conflicts. Prior to 2022, Russia was the third-largest buyer of Sri Lankan tea, and in January 2022 it had moved up to the second spot. When the war erupted and the Russian ruble collapsed under sanctions, Russian buyers of Ceylon tea suddenly faced *"affordability issues"* and some asked Sri Lankan exporters to halt shipments. Payments became difficult due to sanctions on Russian banks. This directly hit one of Sri Lanka's staple export industries (tea) at a critical time. Similarly, Ukraine – and even Poland/Belarus – had become important sources of tourists for Sri Lanka. As post-pandemic tourism recovery began, roughly 25–30% of Sri Lanka's tourist arrivals in early 2022 came from Russia, Ukraine, and nearby countries. The outbreak of war effectively *"turned off that tap"* of tourism dollars. Flights were canceled and Russian and Ukrainian travelers (who had been taking advantage of Sri Lanka's open resorts) disappeared overnight. Tourism and tea together earned Sri Lanka over $260 million in the first months of 2022 – inflows which suddenly were at risk when war began. Every dollar counts for Sri Lanka's reserves (which were only $2.3 billion in January 2022). Thus, losing hundreds of millions in tea and tourism revenues due to the conflict brought Sri Lanka *"closer toward default"* by worsening its balance of payments. Indeed, Sri Lanka defaulted on its external debt in April 2022, and officials acknowledged that *"Ukraine tensions have already badly affected the Sri Lankan economy"*. The government was even forced to consider raising local fuel prices (previously subsidized) because it could no longer afford the import costs amid the crisis.

Another critical external income stream is worker remittances, which have a strong linkage to Middle Eastern stability. The Gulf region hosts a very large number of Sri Lankan migrant workers (housemaids, laborers, professionals). Over one million Sri Lankans work in the Middle East, and they remitted about $3 billion in 2024, which accounted for 46% of Sri Lanka's total remittance inflows. Any conflict that engulfs the Middle East could jeopardize this lifeline. For example, Israel alone employs around 20,000 Sri Lankan workers, contributing about 2% of remittances. During the Israel-Hamas war fears in 2023–2024 and a hypothetical Iran-Israel clash, there were concerns that new deployments of Sri Lankan workers might stall if air travel routes were disrupted or if host countries halted recruitment. Even a temporary suspension can significantly hurt household incomes in Sri Lanka (many families depend on relatives' remittances) and worsen the external account. In addition, a large share of Sri Lanka's *tea exports* (approximately 45%) goes to the broader Middle East region – countries like Iraq, Syria, UAE, Iran, etc. A widening conflict in that region could reduce demand or make shipping routes more difficult, directly denting the ~$600 million Sri Lanka earns by selling tea to the Middle East. There is also the aviation link: Gulf states (Dubai, Doha, Abu Dhabi) are major air travel hubs connecting Sri Lanka with Europe. As of 2024, about half of Sri Lanka's tourists come from Europe, many of whom transit through Gulf hub airports. If a conflict were to close Middle Eastern airspace, it would *"reduce seat capacity, lengthen journey times, increase travel costs, and weaken European visitor flows"* to Sri Lanka. In sum, through trade, remittances, and tourism, Sri Lanka's economic fortunes are tightly intertwined with global events. A distant war or policy change can reverberate through Sri Lanka's imports or exports within weeks, proving that these issues are not abstract or isolated for Sri Lanka. As one commentator concluded, Sri Lanka may have small direct trade with countries like Israel or Iran, but its *"economic interests are still highly exposed to Middle Eastern stability through three critical channels: energy imports, migrant-worker remittances, and aviation links"*. The same holds for its exposure to U.S. trade policy and the Russia-Ukraine region.

Macroeconomic Transmission to Sri Lanka

Inflation, Exchange Rates, and Interest Rates

The external shocks described above have transmitted to Sri Lanka's macroeconomy chiefly in the form of surging inflation, currency depreciation, and a sharp tightening of monetary conditions. When global commodity prices spiked in 2021–2022, Sri Lanka experienced one of the most extreme bursts of inflation in its history. Headline inflation, which was in single digits in early 2021, accelerated rapidly and peaked at 69.8% year-on-year in September 2022. This was among the highest inflation rates in the world at that time. While there were homegrown factors (such as monetary financing of deficits) contributing to inflation, the role of global price pass-through was significant. As a net importer of fuel, Sri Lanka saw fuel prices (and transport costs) soar domestically when crude oil doubled in price. The government eventually floated the retail prices (removing subsidies), causing petrol, diesel, and cooking gas costs to jump for consumers. Likewise, global food inflation hit Sri Lanka hard – essentials like wheat flour, sugar, and dhal became more expensive. Compounding this, the ban on fertilizer (a domestic policy mistake) and subsequent global fertilizer shortage due to the war led to poor harvests, driving food prices even higher. The result was widespread hardship: over one quarter of Sri Lankan households became food insecure by 2023, consuming inadequate diets. In economic terms, the exchange-rate pass-through was a key mechanism: as the Sri Lankan rupee lost value against the dollar (more on that below), the local currency cost of imported goods skyrocketed, further fueling inflation.

The exchange rate itself was under severe pressure from these external shocks. Sri Lanka historically managed a de facto peg, but in early 2022, facing dwindling reserves, the Central Bank had to let the rupee float (devalue). In the span of weeks, the rupee went from about LKR 200 per USD to over LKR 350 per USD – a depreciation of around 80% in 2022. This dramatic drop was partly inevitable given the BOP crisis, but it was accelerated by the external shocks: war-driven oil and food import bills were sucking dollars out, while key export and tourism inflows were drying up, creating a *"perfect storm"* for the currency. A Cabinet spokesman admitted in late February 2022 that foreign reserves were plunging and if Sri Lanka didn't devalue the rupee or secure new funding, it *"could miss [debt] repayments"*. Indeed, the currency had been held artificially strong until March 2022, at which point the inevitable collapse occurred. A weaker currency does help correct trade imbalances over time (by curbing imports and boosting export competitiveness), but in the short run for Sri Lanka it mainly translated to higher local prices (since so many goods are imported) – a classic exchange rate pass-through to inflation. It also ballooned the local-currency value of Sri Lanka's foreign debt, contributing to the government's default decision.

In response to the runaway inflation and currency depreciation, Sri Lanka's monetary policy underwent a U-turn from accommodation to drastic tightening. The Central Bank of Sri Lanka (CBSL) raised policy interest rates by a cumulative 950 basis points (9.5 percentage points) during 2022, one of the steepest hiking cycles in its history. By mid-2022 the Standing Deposit Facility Rate had reached 15.5% and some market rates (like Treasury bill yields and lending rates) exceeded 20–30%. This was an urgent attempt to tame inflation expectations and stabilize the rupee. High interest rates were also aimed at discouraging credit and imports (to reduce outflow of foreign exchange). The interest rate pass-through was felt economy-wide: commercial bank lending rates soared, with prime lending rates in 2022 peaking around 25-30%, and rates for riskier borrowers even higher. This made the cost of working capital and consumer loans extremely expensive. Private consumption and investment, already hit by inflation, were further dampened as borrowing became unaffordable for many. Sri Lankan businesses, especially small and medium enterprises, struggled with both skyrocketing input costs and suddenly prohibitive financing costs. The combination led to a deep recession – Sri Lanka's GDP contracted by 7.3% in 2022.

On a positive note, by late 2023 the policy measures and easing of external pressures started to restore some stability. Global commodity prices moderated from their peaks – for instance, oil fell back to $70-80 range and global food supply improved – which helped Sri Lanka's inflation fall sharply. From nearly 70% in September 2022, inflation moderated to single digits by mid-2023, and even fell below 1% by late 2024 amid a period of deflation in Sri Lanka. The Sri Lankan rupee, after overshooting to ~LKR 360 per USD, recovered some ground and appreciated about 10% in 2023 (assisted by strict import controls and improved foreign inflows from an IMF program). With inflation back under control and the currency relatively stable, the CBSL was able to reverse course and cut policy rates by a cumulative 725 bps between mid-2023 and mid-2024. By July 2024, lending rates had begun to fall again and credit to the private sector showed signs of picking up. This boom-bust policy cycle underscores how external shocks forced Sri Lanka into extreme adjustments: first a painful tightening to quell the crisis, then easing once some stability returned. The key implication is that external price shocks can rapidly transmit into domestic inflation and currency depreciation in Sri Lanka, given its vulnerabilities, necessitating aggressive monetary responses. Interest rate and exchange rate pass-through is very high: global shocks led to Asia's fastest inflation in Sri Lanka and one of its worst currency crashes. In the short term, these measures stabilized the macroeconomy at a high cost – inflation was crushed and the rupee anchored, but at the price of a severe output contraction and fiscal stress (as interest costs rose).

Financial Stability and Bank NPLs

The turmoil in the real economy inevitably fed into financial sector stresses, particularly in the banking system. Sri Lanka's banks entered 2022 in a relatively strong capital position, but the unprecedented economic crisis triggered by external and internal shocks led to a significant deterioration in asset quality. As businesses and households came under stress from soaring costs and falling incomes, loan delinquencies surged. By mid-2023, the banking sector's overall non-performing loan (NPL) ratio had risen to 13.3%, up from 7.6% at end-2021. In other words, the share of loans in default nearly doubled in the span of the crisis. This reflects how many borrowers – from large firms to individual consumers – struggled to service debt amid inflation nearing 70% and interest rates above 25%. Sectors like tourism, retail, and construction were especially hard-hit, leading to many SMEs failing or needing debt restructuring. The spike in NPLs was also aggravated by the sheer speed of interest rate hikes – loans that were affordable at single-digit rates became unpayable for some when rates climbed into the high teens or more. Research confirms this linkage: in Sri Lanka, interest rate increases tend to have a significant positive correlation with NPLs (as borrowing costs rise, defaults increase). Thus, the same policies needed to stabilize the economy contributed to credit risk materializing in banks' portfolios.

Another channel of stress was banks' exposure to the sovereign debt crisis. Sri Lankan banks traditionally hold a lot of government securities (treasury bonds, bills, and Sri Lanka Development Bonds) on their balance sheets. By 2022, facing insolvency, the government suspended debt servicing on foreign debt and later carried out a Domestic Debt Optimization (DDO) in mid-2023. Banks, being major holders of domestic treasuries, were directly impacted. The Central Bank took care to design the DDO in a way that *"minimise[d] the impact on the banking sector"* – for example, by excluding shorter-term bank-held bonds from restructuring and offering alternate instruments – precisely to preserve financial stability. Even so, banks had to take impairment charges (write-downs) on their holdings of defaulted International Sovereign Bonds (ISBs). By end-2023, many banks had provisioned roughly 50% of the value of their impaired foreign currency bonds. These losses dented capital and earnings, although most large banks were able to absorb them due to prior profit buffers.

Liquidity was another concern during the peak of the crisis. With foreign exchange so scarce, banks at one point struggled to open Letters of Credit for imports, and foreign banks curtailed credit lines. Domestic liquidity also tightened as people pulled cash for panic buying of essentials. The Central Bank had to provide rupee liquidity and impose import controls to manage the situation. Thanks to measures like swap lines from India and credit from multilateral institutions, a total financial meltdown was averted, but confidence in banks wavered at times. Notably, there were no widespread bank runs – a testament to some level of trust and also to Sri Lanka's deposit insurance and capital buffers. By early 2024, the banking system's capital adequacy ratios remained above regulatory minimums, aided by retained earnings and revaluation gains on the rupee's partial recovery.

However, financial stability risks remain elevated. The World Bank observed that, post-crisis, *"elevated non-performing loans and high exposure to the sovereign hinder financial sector stability."* This captures the two key vulnerabilities: credit risk (NPLs) and sovereign risk (government debt holdings). At mid-2023, an NPL ratio of 13.3% means banks had a significant chunk of assets not yielding income, forcing them to increase provisions and, in some cases, restructure loans. The good news is that by late 2024 there were signs NPLs had plateaued or even begun to ease slightly as the economy stabilized and interest rates came down. Larger banks have remained profitable, in part because the very high interest rates in 2022–23 led to wide net interest margins (banks charged more on loans than they paid on deposits). Some banks reported strong earnings for 2023 despite the turmoil. This profitability gave them capacity to absorb loan losses. Still, smaller financial institutions – such as finance companies and some state banks – have been under strain, and a few needed liquidity support or restructuring.

One specific issue was the temporary suspension of *parate executions* (foreclosures) by banks on collateral – a measure taken by authorities to prevent mass asset seizures during the crisis. While this provided relief to defaulting borrowers, it could delay the resolution of bad loans, potentially "further slow down the recovery of NPLs.". Thus, banks might face a longer workout period for bad debts. The banking sector also had to navigate the rapid shifts in policy rates; for a time, deposit rates lagged behind, causing a sharp rise in banks' funding costs as they eventually repriced deposits at higher rates. This squeezed some banks' interest margins in late 2022.

Despite these challenges, by 2024 the banking sector showed resilience. According to an ACCA analysis, *"the banking sector has delivered a solid financial performance for the year ending December 2023"* even if not as stellar as pre-crisis. Banks like NTB and DFCC saw profits surge in 2023 thanks to one-off gains and effective cost management. And with inflation and rates coming down in 2024, the outlook for banks improved as impairment charges on government bonds were largely accounted for and credit demand was expected to recover. The Sri Lankan rupee's appreciation in 2023–24 also had a mixed effect: it made imports cheaper (good for borrowers) but also meant banks' foreign assets and export earnings reduced in value; overall it was considered a net positive sign of stabilization.

In summary, Sri Lanka's financial stability was heavily tested by the external shocks and ensuing crisis. Short term, the system bent but did not break: there were no bank failures, thanks in part to regulatory interventions and the subsequent IMF-backed reforms. However, the cost was visible in the surge of NPLs from 7.6% to 13.3% and in the need for careful debt restructuring to shield banks. Going forward, the banking sector's health is intricately linked to macroeconomic recovery. A key risk is that if another global commodity shock or recession hits before Sri Lanka rebuilds buffers, it could reignite stress on banks (through a fresh wave of defaults or mark-to-market losses). This is why strengthening bank resilience – higher capital, better risk management – and maintaining prudent macro policies are vital lessons coming out of this period.

Regional Impact on India, Pakistan, and Bangladesh

The shocks we are examining – U.S. tariffs, Middle Eastern turmoil, and the Russia-Ukraine war – have been global in nature, affecting many emerging economies. Comparing Sri Lanka's experience with its South Asian neighbors (India, Pakistan, and Bangladesh) highlights both common impacts and differing degrees of resilience.

- **Pakistan:** Sri Lanka's northern neighbor Pakistan faced a parallel economic crisis between 2022 and 2023, and global commodity shocks significantly aggravated its woes. Pakistan, like Sri Lanka, is a net importer of oil and was hit hard by the surge in energy prices after the Ukraine war. Domestic fuel prices in Pakistan rose sharply as subsidies became untenable. Inflation in Pakistan accelerated to multidecade highs – over 21% by June 2022, the highest since 2008, and kept climbing; by May 2023

Pakistan's inflation exceeded 38% (at that point the highest in Asia, even surpassing Sri Lanka's). This inflation was driven by costly imports (oil, wheat, edible oils) and a steep currency depreciation. The Pakistani rupee, under pressure from a balance-of-payments crisis, lost about 50% of its value from early 2022 to mid-2023. The Ukraine war is explicitly cited as one cause of Pakistan's predicament – it *"contributed to a major spike in international commodity prices,"* worsening Pakistan's fiscal and external balances. Pakistan also had to deal with climate disasters (2022 floods) and political instability, but the external inflation shock was the immediate trigger for its emergency. The State Bank of Pakistan jacked up interest rates to 21% by 2023 to combat inflation and stabilize the currency. This mirrors Sri Lanka's tightening, though Pakistan tried to adjust earlier under an IMF program. By 2023, Pakistan was on the brink of default, with critically low reserves (enough for only weeks of imports). Only last-minute IMF approval and bilateral loans averted a hard default. Notably, Pakistan's economic planners explicitly mentioned the Ukraine crisis as pushing the country closer to default, similar to Sri Lankan officials. The banking sector in Pakistan endured stress as well: NPLs in Pakistan were already elevated due to COVID, and likely worsened with high interest rates (though Pakistan's banks are somewhat cushioned by a large Islamic banking segment and state-owned banks). Pakistan's experience underscores a shared vulnerability: heavy dependence on imported fuel and lack of external buffers made it acutely sensitive to the war's commodity shock, just as Sri Lanka was. Both countries illustrate how external shocks can compound existing debt problems and force painful adjustments.

- **Bangladesh:** Bangladesh initially appeared more shielded from global turmoil, owing to its stronger foreign exchange reserves and export earnings. However, as 2022 unfolded, Bangladesh too "felt the pinch" of the Russia-Ukraine war and commodity inflation. Bangladesh's inflation climbed from around 5.5% in early 2022 to about 8.9% by October 2022, a significant jump outside its comfort zone. The government had long subsidized fuel; facing high global oil prices, it finally hiked domestic fuel prices by over 50% in August 2022, which immediately fed into transport and food costs. The taka (Bangladeshi currency) came under depreciation pressure. From an average of 85–90 per USD pre-war, it slid to around 105–110 per USD by late 2022, and further towards 115–120 by 2023. A rapid depletion of reserves occurred as Bangladesh's import bill (for fuel, fertilizer, wheat – much of which it imported from

Russia/Ukraine) jumped while export growth slowed. By mid-2022, Bangladesh's reserves had fallen from ~$45 billion to around $35 billion. In an unprecedented step, Bangladesh sought IMF assistance (a ~$4.7 billion program agreed in late 2022) as a precautionary measure to shore up confidence. Exports: As a major garment exporter, Bangladesh was indirectly exposed to U.S. and EU economic conditions. The war-driven inflation in the West and rising uncertainty could have dampened retail demand, although Bangladesh actually benefited slightly from some trade diversion (buyers looking beyond China due to U.S.-China tensions). Still, by 2023 Bangladesh's garment sector faced slimmer margins because input costs (cotton, dyes, energy) were up. Financial sector: Bangladesh's banks have long-standing issues with NPLs (officially around 8-9%, though true figures may be higher). The external shocks didn't trigger a banking crisis there, but the central bank had to tighten monetary policy modestly and manage the exchange rate by rationing dollars. Bangladesh also experienced some project implementation delays – notably the Russia-financed Rooppur Nuclear Power Plant, a $12bn project, faced potential delays and cost escalations due to sanctions and supply disruptions. This could increase Bangladesh's future debt burden. Overall, Bangladesh weathered the period without a full-blown crisis, thanks to its prior buffers, but it clearly faced headwinds: higher inflation, a stressed currency, and the need for policy support. Growth slowed from ~7% to ~5% in 2023. The lesson from Bangladesh is that even a well-managed economy can be knocked off course by global turbulence – and prudent measures like seeking IMF help early or curbing imports (Bangladesh imposed import restrictions on luxury goods and energy conservation measures) can prevent a crisis from escalating.

- **India:** India, as the largest South Asian economy, had more cushions and leverage in dealing with these shocks, yet it too felt notable effects. When oil prices spiked in 2022, India's import bill soared; energy comprises a significant share of India's imports. However, India undertook a diplomatic and strategic response – it began importing large volumes of deeply discounted Russian oil, taking advantage of Russia's need to find buyers post-sanctions. By mid-2023, Russia had become India's top oil supplier (from near-zero pre-war), which helped India secure oil at around $20–30 below global benchmark prices. This certainly mitigated the impact of high oil prices on India's trade deficit and inflation. Even so, India's inflation hovered around 6-7% for much of 2022, breaching the RBI's target range. The Reserve Bank of India responded by raising its repo rate from 4% to 6.5% over 2022-2023, a more modest rise compared to Sri Lanka or Pakistan, reflecting relatively lower (but still significant) inflation. The Indian rupee fell to all-time lows (~83 per USD), but depreciation was moderate (around 10-12% over 2022) and managed by the RBI which used its abundant reserves (over $600 billion at one point) to smooth volatility. India's growth slowed to about 6-7% (from a post-COVID rebound of 8%+), partly due to global factors, but remained positive – India did not face recession. Financially, Indian banks entered this period in a much stronger position after years of cleanup of bad loans. They largely withstood global shocks; in fact, rising interest rates improved banks' net interest margins and profitability in 2022-23. Credit growth in India picked up in 2022 as pandemic effects waned. Thus, India demonstrated resilience: its large domestic economy, diversified export basket (including benefiting from high commodity exports like refined petroleum, and services exports like IT), and policy buffers (reserves, stable banking) allowed it to absorb external shocks with comparatively less dislocation. That said, India's fiscal deficit remained high, and it had to spend more on food and fertilizer subsidies to shield its population from the worst of global inflation. India also saw political pressure to ban wheat exports and sugar exports at times to keep domestic food prices in check. These actions, while protecting India, further affected global markets (for instance, reducing supply to others).

In summary, across South Asia, the Russia-Ukraine war and commodity price spikes of 2022-2023 uniformly caused higher inflation, currency depreciation, and current account pressures. Each country's outcome depended on its initial buffers and policy responses. Sri Lanka and Pakistan, with weak fundamentals and limited reserves, suffered the most – both teetered into default territory, requiring emergency measures. Bangladesh felt intermediate effects: significant stress but managed to avoid crisis through timely intervention. India managed relatively well, leveraging its strengths and even finding opportunity (cheap Russian oil) amid crisis, though it too dealt with elevated inflation and had to tighten policy.

Another shared impact came from the U.S. and Western policy response to inflation – rapid interest rate hikes in advanced economies led to capital outflows from emerging markets, putting additional downward pressure on currencies like the Sri Lankan rupee, Pakistani rupee, etc. This “second order” effect meant that even countries not directly exposed to Russia/Ukraine found global financial conditions tightening. South Asian central banks (including Sri Lanka’s) had to raise rates in part to avoid destabilizing capital flight and support their currencies.

Regarding the U.S. tariff impositions (reciprocal tariffs) and trade slowdown: this is more of a forward-looking risk. If the U.S. and possibly Europe move towards more protectionism, all South Asian exporters could face tougher market access. Sri Lanka and Bangladesh, as apparel exporters, would particularly be exposed to higher tariffs in the U.S. (as discussed, Sri Lanka 44%, Bangladesh ~37% in a modeled scenario). That would alter competitive dynamics – Bangladesh, with slightly lower tariffs, might grab market share from Sri Lanka, but overall a U.S. slowdown or higher import costs could hurt both. India and Pakistan export less to the U.S. in apparel (India is more services/IT and specialty goods, Pakistan’s U.S. exports are smaller), but they could also face tariffs on other goods. Regionally, this might spur South Asian countries to seek new markets (e.g. more South-South trade, or focus on Middle Eastern and Asian markets) and to improve regional cooperation. For example, if Western markets become less accessible, intra-regional trade or trade with East Asia could be vital – Sri Lanka has already signaled interest in joining RCEP, and India is negotiating new trade deals.

In conclusion, Sri Lanka’s experience is in many ways a microcosm of the challenges faced by developing economies amid global turmoil. Pakistan’s crisis echoed Sri Lanka’s in many aspects (high debt, commodity shock, political instability). Bangladesh’s struggles highlighted that even better-managed economies are not immune to global price shocks and must adjust policies. India’s trajectory showed the value of buffers and agility (e.g., recalibrating oil sourcing) in weathering storms. These comparisons emphasize that while external shocks hit everyone, outcomes differ based on domestic resilience. Sri Lanka unfortunately was at a point of extreme fragility – a “perfect storm” where global shocks met domestic mismanagement – leading to a collapse. Others fared better or worse on that spectrum.

Policy Responses and Implications

The confluence of U.S. tariff threats, Middle East conflicts, and the Russia-Ukraine war holds several important lessons for Sri Lanka and similarly positioned economies. These events underscore the necessity for strategic policy responses both in the short term (to manage crises) and long term (to build resilience). Here we outline key implications and possible policy measures:

- **Diversify Trade Partnerships and Export Markets:** A clear takeaway is that over-reliance on a few markets or products can be perilous. Sri Lanka's heavy dependence on the U.S. for exports and on a handful of countries for critical imports (fuel from the Gulf, wheat from Russia/Ukraine, etc.) made it extremely vulnerable. To mitigate this, Sri Lanka should pursue diversification of both export destinations and product mix. For example, Sri Lanka is seeking to join the Regional Comprehensive Economic Partnership (RCEP) and strengthen ties with ASEAN and other Asian markets. Such moves could open up new markets and reduce the reliance on U.S./EU apparel markets or on tea sales to the Middle East alone. Regionally, Sri Lanka is part of initiatives like the Bay of Bengal Initiative (BIMSTEC) and SASEC, which can be platforms to boost trade with India, Bangladesh, and Southeast Asia. On the import side, finding alternative suppliers or building strategic reserves is key. The war forced Sri Lanka into a tea-for-oil barter with Iran in 2022–23 to get fuel when others wouldn't supply. While creative, such measures are ad-hoc; a longer-term approach is to maintain buffer stocks of essentials and diversify procurement (e.g. import a mix of Middle Eastern, Russian, and hopefully someday domestic/refined oil if capacity allows). Reducing Sri Lanka's own tariff barriers is another important step. The U.S. "reciprocal tariffs" are high partly because Sri Lanka itself has high para-tariffs and import taxes. Phasing out these para-tariffs (as Sri Lanka has started doing in recent trade agreements) will lower the tariff differential and make Sri Lankan goods less likely to be targeted or more able to compete if they are. In short, integration into a broader range of markets and liberalizing trade on Sri Lanka's side can provide insurance against unilateral actions by any single partner.

- **Enhance Commodity Security and Price Stabilization Mechanisms:** The commodity price roller-coaster has been extremely damaging to Sri Lanka. Policies to buffer the domestic economy from commodity volatility are crucial. For energy, Sri Lanka could explore financial hedging (locking in oil prices via futures or options when prices are low) and negotiate long-term supply contracts with diverse partners (for instance, extended credit lines from countries like India for fuel, or entering LNG supply agreements when prices are favorable). Investment in alternative energy (solar, wind) and potentially oil storage capacity can also improve energy security over time. Some countries maintain stabilization funds – putting money aside when commodity prices are low, to use to cushion the impact when they spike. While Sri Lanka's fiscal situation is tight, seeking grants or support to build such reserves could help. On food, encouraging domestic production where possible (e.g. reversing the decline in local agriculture that happened due to the fertilizer saga) can reduce import dependence. Sri Lanka might also coordinate with South Asian neighbors to share food reserves or purchase collectively. For example, SAARC had considered a food bank mechanism. *Regionally pooled reserves* of essentials could be a buffer in times of shortage. The World Bank noted that in the current context, *"falling commodity prices and better supply conditions can provide a buffer against geopolitical shocks."* Sri Lanka should use periods of lower global prices (as projected for 2025–2026) to rebuild its buffers – replenish foreign reserves, stock up on critical imports, and lock-in advantageous import deals. This will increase resilience when the next shock comes. Additionally, pricing reforms are vital: Sri Lanka has moved to cost-reflective pricing for fuel and electricity as part of IMF reforms. Maintaining that (i.e. letting domestic prices adjust gradually to global prices) will prevent sudden fiscal blowouts. It's politically hard, but transparent adjustment formulas can depoliticize the process. The painful lesson of 2022 was that artificially suppressing prices (fuel, power) only leads to larger crises later.

- **Maintain Flexible Exchange Rate and Adequate Foreign Exchange Reserves:** If one lesson stands out, it is the peril of running down reserves to defend an overvalued currency. Sri Lanka delayed its currency adjustment and paid dearly. Going forward, exchange rate flexibility should be embraced to absorb external shocks. A market-determined rate (possibly with managed float to smooth extreme volatility) will help prevent abrupt one-time devaluations and discourage speculative attacks. Building reserves during good times is essential. For instance, Bangladesh and India entered the 2022 period with relatively high reserve levels, which gave them more space to handle import surges and defend their currencies moderately. Sri Lanka needs to target reserve accumulation in its recovery – through export promotion, import rationalization, attracting FDI, and securing concessional credit – such that it has at least 3-4 months of import cover as a buffer. This ties into maintaining prudent current account deficits and encouraging stable inflows (like remittances and tourism). On monetary policy, the CBSL must improve its credibility so that it can manage inflation expectations even when external shocks hit. The experience has also opened debate on whether Sri Lanka should have regional swap lines or safety nets – e.g., a swap arrangement with the Reserve Bank of India (as was briefly utilized) or participation in arrangements like the Chiang Mai Initiative (an Asian currency swap pool). Such facilities could provide emergency liquidity in foreign currency during external shocks, buying time to adjust.

- **Strengthen Financial Sector Resilience and Crisis Management**: The banking sector's stability is a cornerstone of overall economic health. Policymakers should draw lessons from this crisis to fortify the financial system. This includes enhanced supervision and stress testing for banks against scenarios of severe commodity shocks, interest rate spikes, or currency crashes. Banks might be required to hold more capital against market risks and maintain higher liquidity ratios. Reducing the sovereign-bank nexus is tricky (since banks will inevitably hold government bonds), but steps can be taken to diversify banks' asset portfolios and develop alternative investors for government debt (to avoid over-concentration in banks). Establishing a clear financial crisis management protocol – such as emergency liquidity assistance frameworks, and legal provisions for bank resolution – will be useful. The fact that no bank failed in Sri Lanka is good, but it was also because the government guaranteed debt and restructured carefully; one cannot be complacent. NPL resolution will be a priority in the next couple of years. The government and CBSL may need to facilitate corporate debt restructuring through out-of-court mechanisms or asset management companies to deal with bad loans, so that banks can return to lending. Notably, First Capital Research in Sri Lanka expects an improvement in NPLs as the economy recovers, but also warns of risks if banks have to increase provisions further. Thus, it's a delicate balance: giving banks the tools to recover loans, while also possibly providing regulatory forbearance in the short term so they can lend again. Additionally, continuing to improve transparency and governance in financial institutions (to prevent hidden loan problems) will ensure the system is robust when the next shock comes.

- **Fiscally Preparing for Shocks & Social Safety Nets:** Fiscal policy in Sri Lanka (and neighbors) has a role in cushioning external shocks, but it can only do so if there is space. Sri Lanka had virtually no fiscal space in 2022 – in fact, it was insolvent. The implication is that fiscal prudence in normal times is rewarded during crisis times. Moving forward, Sri Lanka needs to stick to the path of debt sustainability – increasing revenue (through tax reforms) and rationalizing expenditure – to reduce its debt and deficits. A lower debt burden and healthier finances will enable the government next time to, say, temporarily cut fuel taxes or give targeted subsidies when oil prices surge, without risking bankruptcy. One positive example is how India's relatively stronger fiscal position (though deficit was high, its debt was largely domestic and manageable) allowed it to cut fuel taxes in 2022 and expand food subsidies to shield the poor from inflation. Sri Lanka had to do the opposite – raise taxes and prices in the middle of the crisis – which, while necessary, worsened short-term pain for citizens. This brings us to social safety nets: a huge lesson is that crises hurt the most vulnerable the worst. Sri Lanka's poverty nearly doubled to 25% by 2022/23, erasing years of gains. To avoid such regressive outcomes, countries need scalable safety net programs. This means having systems (like a cash transfer registry or food ration scheme) that can be quickly expanded to deliver assistance when food and fuel prices jump. Sri Lanka did implement some relief packages, but often reactively. Instituting something like an automatic stabilizer – e.g., if fuel prices go above a threshold, some cash support kicks in for low-income households – could be considered. International aid can help fund such programs during global shocks (as the World Food Programme did in Sri Lanka for food aid). The World Bank chief economist noted in late 2024 that despite falling global prices, food price inflation in developing countries remains about double that in rich countries, and over 725 million people were food insecure in 2024. This is a sobering statistic that underscores the need for stronger safety nets and disaster preparedness in countries like Sri Lanka.

- **Regional and Global Cooperation:** Finally, these crises highlight that unilateral approaches are often insufficient – international cooperation is vital. Sri Lanka's recovery was only possible with an IMF program that unlocked financing and debt relief discussions. Likewise, Pakistan, Bangladesh, and others engaged the IMF. These institutions should continue to refine tools for shock response, such as rapid financing instruments. Regionally, South Asia could improve cooperative mechanisms – perhaps a regional emergency fund or better trade integration to reduce costs. For instance, if SAARC had a functioning trade agreement, Sri Lanka could more easily source alternatives from neighbors when global supply is disrupted. There were moments of positive cooperation: India extended credit lines to Sri Lanka for fuel and essential imports in 2022, literally keeping the lights on in Colombo for a while. Such neighborly support can be systematized. The experience also shows the importance of geopolitical non-alignment for small countries – Sri Lanka will try to maintain good relations with all major powers to avoid being caught in sanction crossfires (as it nearly was with the Russian oil/tourist situation). It has to deftly manage ties with the U.S., China, India, and others, to secure economic partnerships but not be overly reliant on one.

In conclusion, the turbulence of recent years has stress-tested Sri Lanka's economy and banking sector like never before. The short-term impacts were severe: a foreign exchange crisis, inflation nearing 70%, a currency collapse, and a banking system laden with bad loans. External shocks – from war to trade barriers – greatly amplified Sri Lanka's internal vulnerabilities, tipping it into the worst crisis in its history. The fact that Sri Lanka is now stabilizing (with inflation back to single digits and growth resuming) is testament to painful adjustments and external support. Looking ahead, the implications for policy are clear: Sri Lanka must proactively adapt to an era where global markets are volatile and geopolitical risks run high. That means safeguarding financial stability, diversifying its economy, and protecting its people from the brunt of global storms. Countries like Bangladesh and India show the benefit of prudent buffers and agile policies, while Pakistan's parallel crisis shows the costs of delay. As global conditions evolve – whether U.S. tariffs or another commodity cycle – Sri Lanka's ability to weather future shocks will depend on implementing these lessons. By diversifying trade, building economic buffers, and pursuing cooperative solutions, Sri Lanka can aim to break the cycle of vulnerability and move toward a more resilient and stable economic future

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