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SRI LANKA IN DEFAULT: CAUSES AND CONSEQUENCES

Reserves and fiscal discipline as essential factors for economic sustainability

This April, the Ministry of Finance of the Democratic Socialist Republic of Sri Lanka announced that it had suspended payments on foreign debt. This was the country's first default since it became an independent state in 1948.

There were several reasons for the default, which gradually overlapped and weakened Sri Lanka's economy. In ACRA's opinion, the key reasons were the government's instable macroeconomic policy, the COVID-19 pandemic, the increase of the US Fed's interest rate, and higher prices for energy and food. As a result, Sri Lanka's budget and external position weakened considerably (*Table 1*).

Table 1. Sri Lanka's debt metrics reached critical levels by late 2021

PUBLIC DEBT	PUBLIC DEBT	PUBLIC DEBT INTEREST PAYMENTS	TOTAL FOREIGN DEBT	RESERVES	SERVICING OF EXTERNAL DEBT (2020)
% of GDP	% of budget revenues	% of budget revenues	% of GDP	% of GDP	% of exports
107.2	1,204.5	71.5	60.2	4.0	39.3

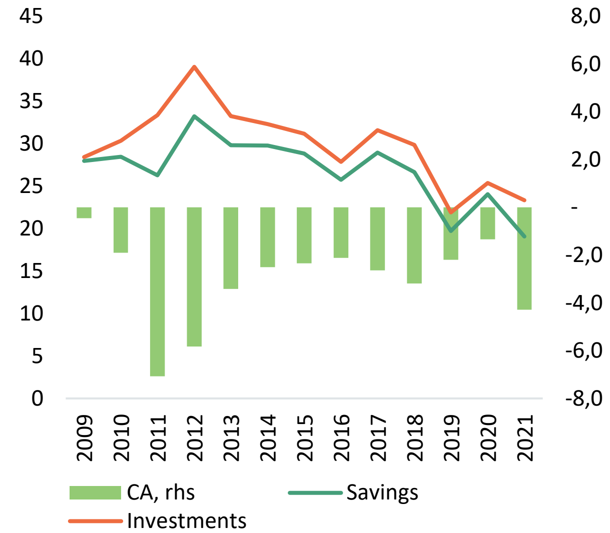
Sources: IMF, World Bank

After the 26-year-old Sri Lankan Civil War drew to a close in 2009, the country's economy, with a population of 20 mln, began to recover rapidly. Over the 10 years prior to the start of the coronavirus pandemic, the country's GDP in USD doubled to USD 80 bln, recording average annual growth of 5.2%, while GDP per capita reached USD 3,800 in 2019.

Sri Lanka's main exports traditionally include textiles, clothing, tea, and spices. Needs for energy and food, in turn, are covered by imports. Important contributors of foreign currency revenues include tourism and transportation (the Port of Colombo is the largest port in the Indian Ocean). In addition, remittances from citizens working abroad also provide the country with foreign currency.

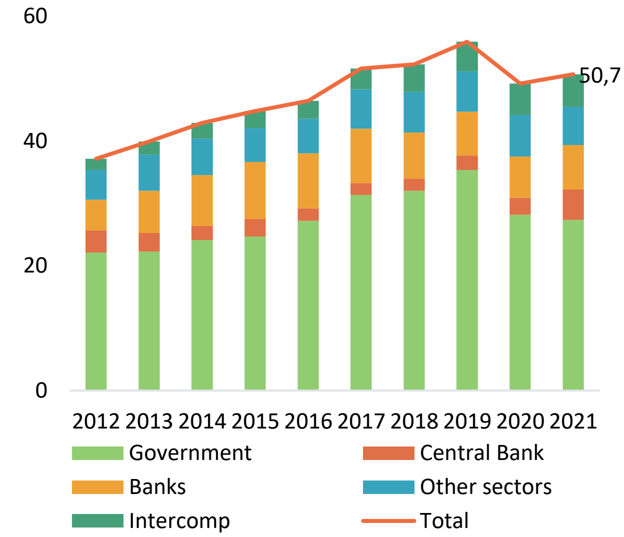
Foreign investments boomed at the start of the 2010s, and the lack of savings to support aggregate investments was covered by external borrowing (*Fig. 1*). This resulted in Sri Lanka's total foreign debt increasing from USD 37.1 bln in 2012 to USD 50.7 bln (or 60.2% of GDP) in 2021 (*Fig. 2*).

Figure 1. Investments and savings, % of GDP



Source: IMF

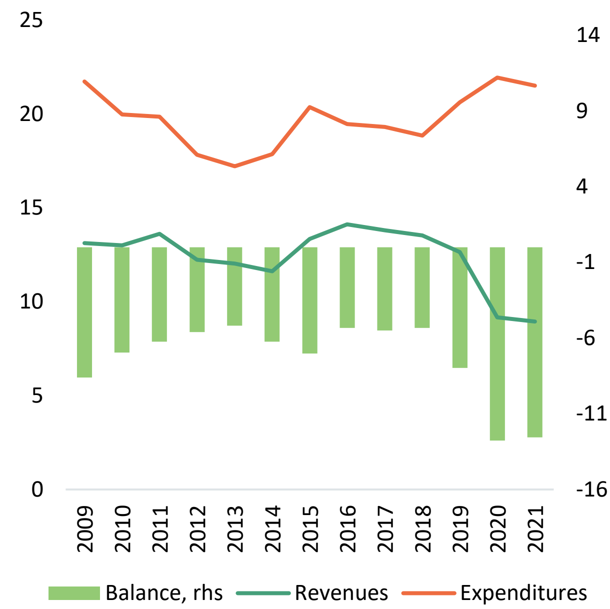
Figure 2. Foreign debt, USD bln



Source: IMF

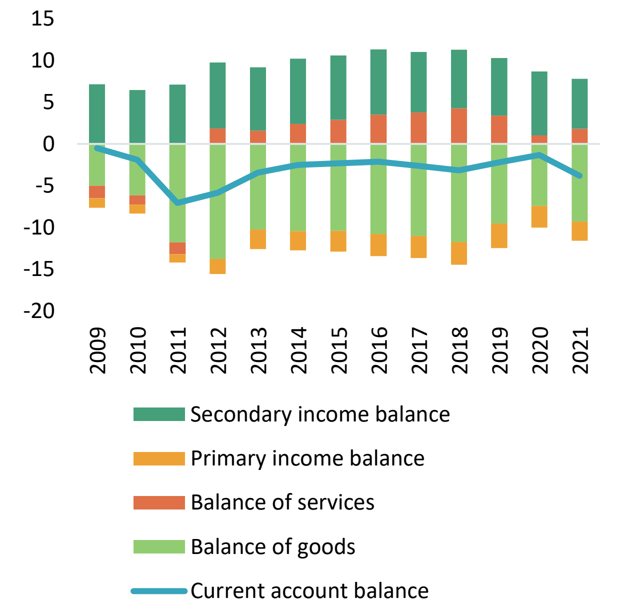
Growth of government spending and imports led to two persistent deficits (*Charts 3–4*): a fiscal deficit (about 5% of GDP annually) and a current account deficit (about 7–8% of GDP annually).

Figure 3. Budget balance, % of GDP



Source: IMF

Figure 4. Current account balance, % of GDP



Source: IMF

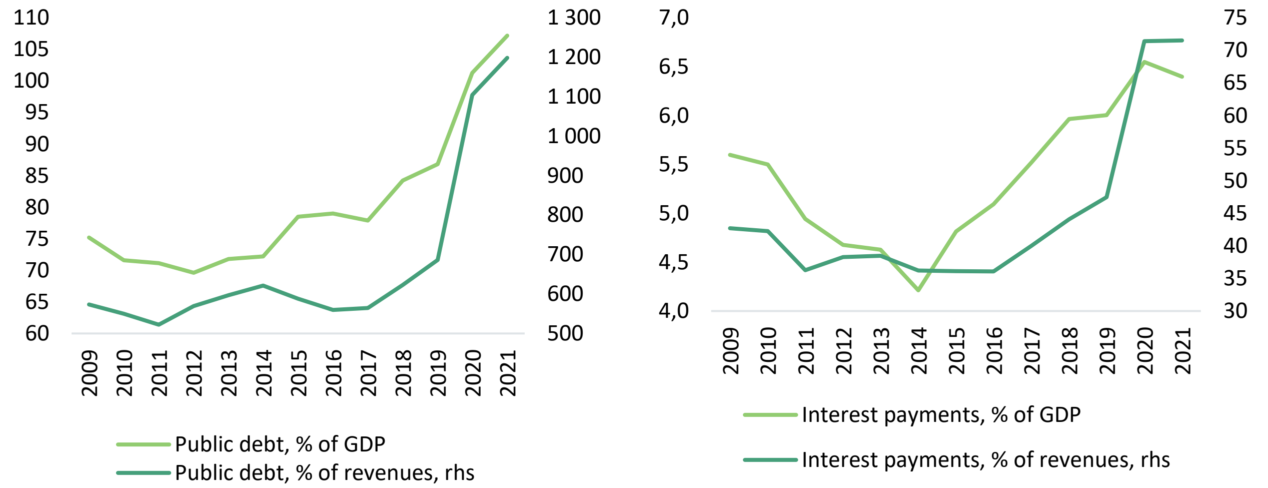
In 2019, the government of Sri Lanka carried out a number of measures to reduce taxes in order to deliver additional economic stimulus, and this led to general government revenues falling to 8.9% of GDP in 2021. As of the end of 2020, 40.6% of public debt was financed by non-residents. The share of private creditors (Eurobond holders) amounted to 16.5%, multilateral — 11.0%, unilateral — 13.1%, including China — 6.2%. The budget deficit exceeded 10% of GDP for the second year in a row in 2021. The Central Bank of Sri Lanka's (CBSL) funds totaling 6.7% of GDP were used to cover the deficit. In 2021, public debt hit record levels — 107.2% of GDP, or 1,204.5% of budget revenues (*Fig. 4*), while budget servicing expenses stood at 6.4% of GDP, or 71.5% of revenues.

In May 2021, the President of Sri Lanka announced a ban on using chemical fertilizers to increase the quality of agricultural sector products, which led to a substantial decline of the harvest and even greater dependence of the country on food imports. The ban was lifted in November of the same year, but the growth of the cost of fertilizers and farms going bust are aggravating the food crisis in the country.

The IMF classifies the currency regime in Sri Lanka as 'other managed', i.e. it is neither a fixed regime nor a fully market-based one. The CBSL, through interventions, maintained the relative overvaluation of the national currency, preventing its significant weakening and thereby creating additional advantages for importers. This policy resulted in reserves being maintained at around 10% of GDP for several years, and then falling to 4% of GDP in 2021.

The consequences of the COVID-19 pandemic significantly curtailed the inflow of foreign currency revenues generated by tourism and transportation services and resulted in the balance of services losing around 1.5% of GDP. In addition, shrinking remittances from abroad led to a further loss of 0.8% of GDP. The increase in the Fed's key rate that followed the pandemic led to an increase in the cost of external borrowing. Higher prices for food, in turn, considerably increased the volume of funds needed to finance the country's needs.

Figure 5. Public debt and interest expenses grew sharply over the past two years



Source: IMF

The virtual absence of reserves (in May 2022, the Sri Lankan Minister of Finance announced that liquid reserves were less than USD 50 mln), a decrease in foreign currency earnings from foreign economic activity, increased import financing costs, and the need to support budget spending led to the national currency weakening by 77.5% since the start of 2022 and inflation reaching 54.6% as of June this year. In these conditions the country was unable to service its external debt and is currently in talks with the IMF regarding the restructuring of this debt.

The example of Sri Lanka proves the fact that accumulating reserves that are sufficient to support economic stability, a market-based exchange rate regime, and fiscal discipline are some of the key factors necessary for long-term economic stability.

The negative impact of external factors — growth of the cost of borrowing and energy and food prices — may put pressure on other countries, especially those that are heavily dependent on external markets to cover their needs and do not possess sufficient reserves. For example, Pakistan, Egypt and Tunisia are already holding talks with the IMF on potential restructuring.

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