Sri Lankan Crisis:
Lessons for Developing Countries

Keynote Address

Lalith P. Samarakoon

University of St. Thomas, Minnesota, USA

lpsamarakoon@stthomas.edu

Webinar
Bureau of Business Research
Faculty of Business Administration
University of Chittagong, Bangladesh
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The Event: Debt Default

- Sri Lanka suspended payments on its foreign debt obligations on April 12, 2022.*

- This triggered an unprecedented economic and political crisis.

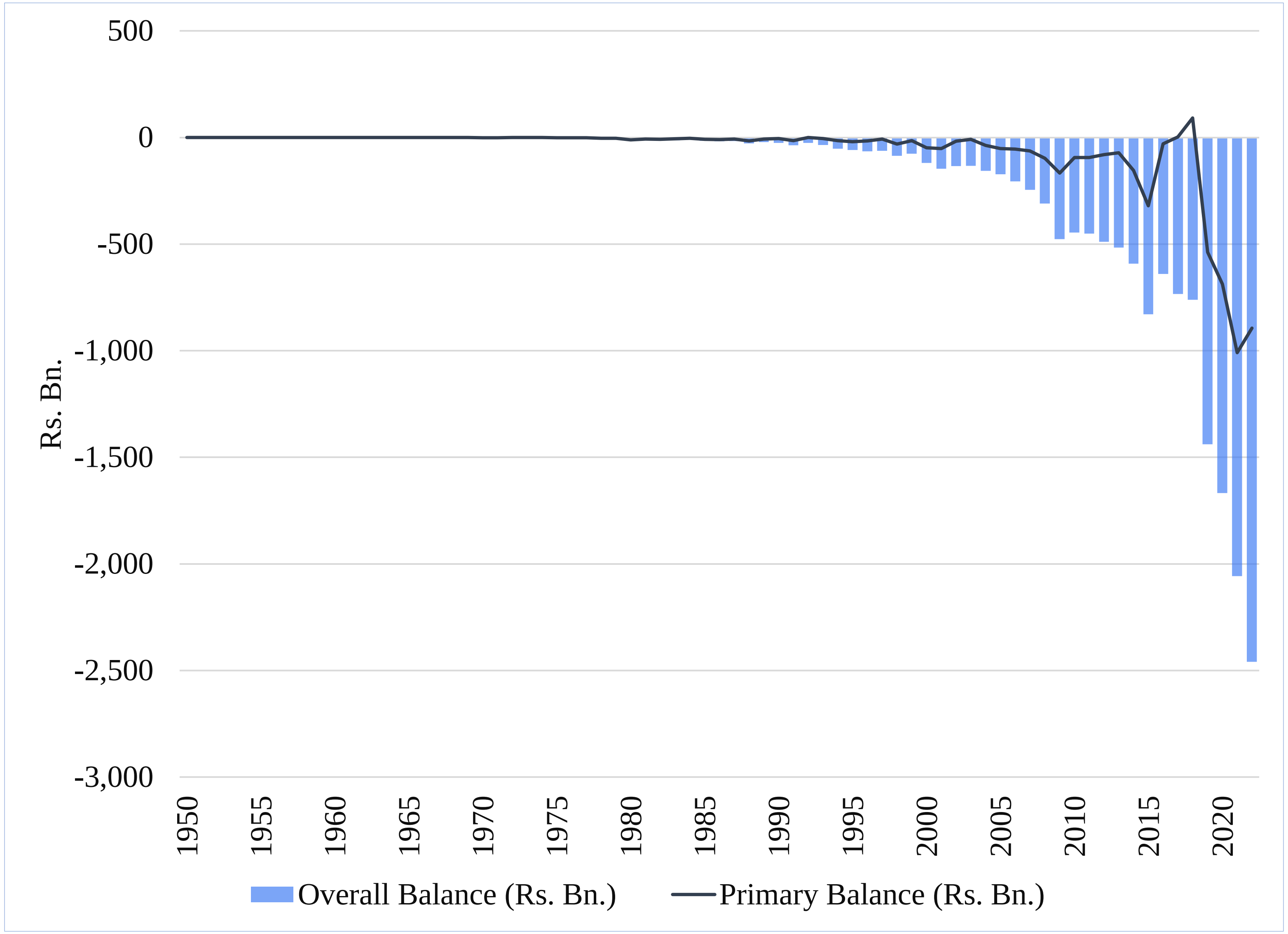
* $78.2 Mn interest payments on international sovereign bonds due on April 18, 2022.

Outline

- What are the root causes of Sri Lanka’s economic crisis?

- What are the key lessons for developing countries?

Budget Deficits – A Perennial Issue for Sri Lanka

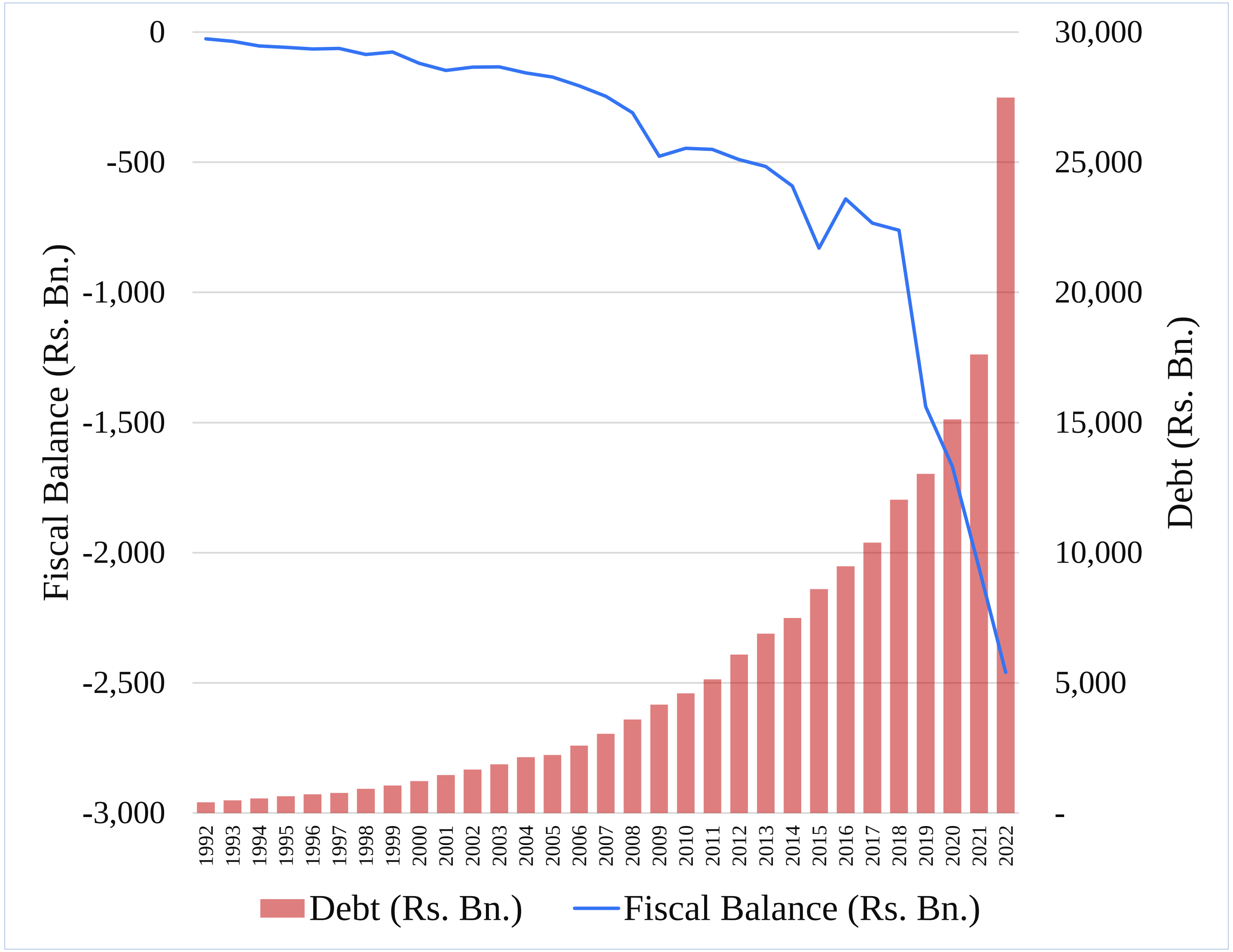


- History of persistent and increasing budget deficits.

- Exacerbated by the Covid-19 economic downturn in 2020 & 21.
  - Primary deficits (except 1954, 1955, 1992, 2017, 2018).
  - Overall deficits (except 1954, 1955).
  - Larger jumps in 2009, 2015, & 2019-2022

- Overall deficit:
  - 2021: Rs. 2,058 Bn. ($10.3 Bn)
  - 2022: Rs. 2,460 Bn. ($6.8 Bn)

Deficits Led to Debt Accumulation



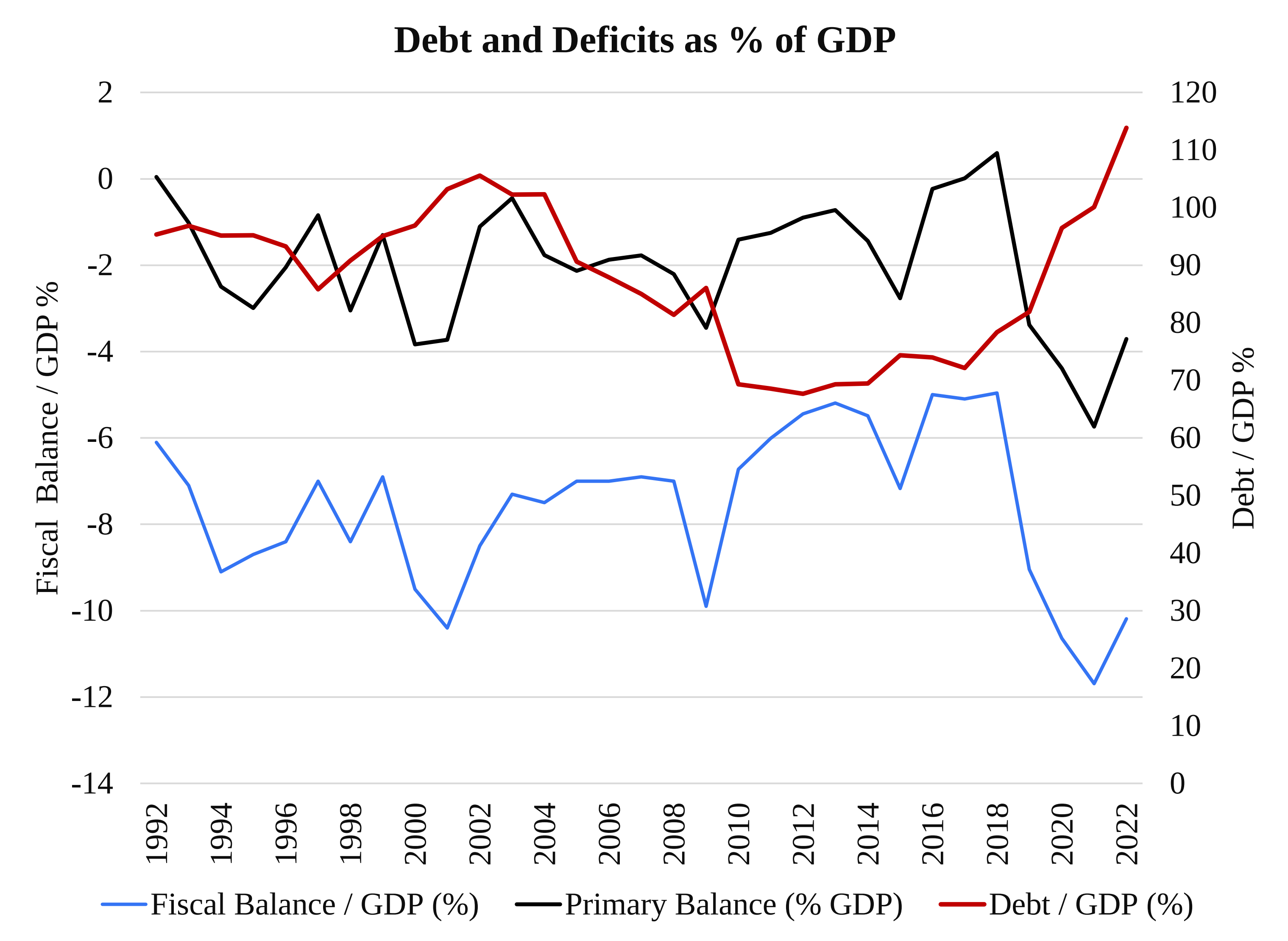
- Basic debt equation:
  Debt(t) = Debt(t-1) + Deficit(t)

- Public debt:
- 2021 (the year before the crisis): Rs. 17,674 bn ($88 bn)
- 2022 (year of crisis): Rs. 27,492 bn ($76 bn)

- Government began issuing Treasury bonds in 1997.
- Opened government securities market to foreign investors in 2007.
- Since then (2006-2021), debt stock has grown at an average rate of 14% per year.

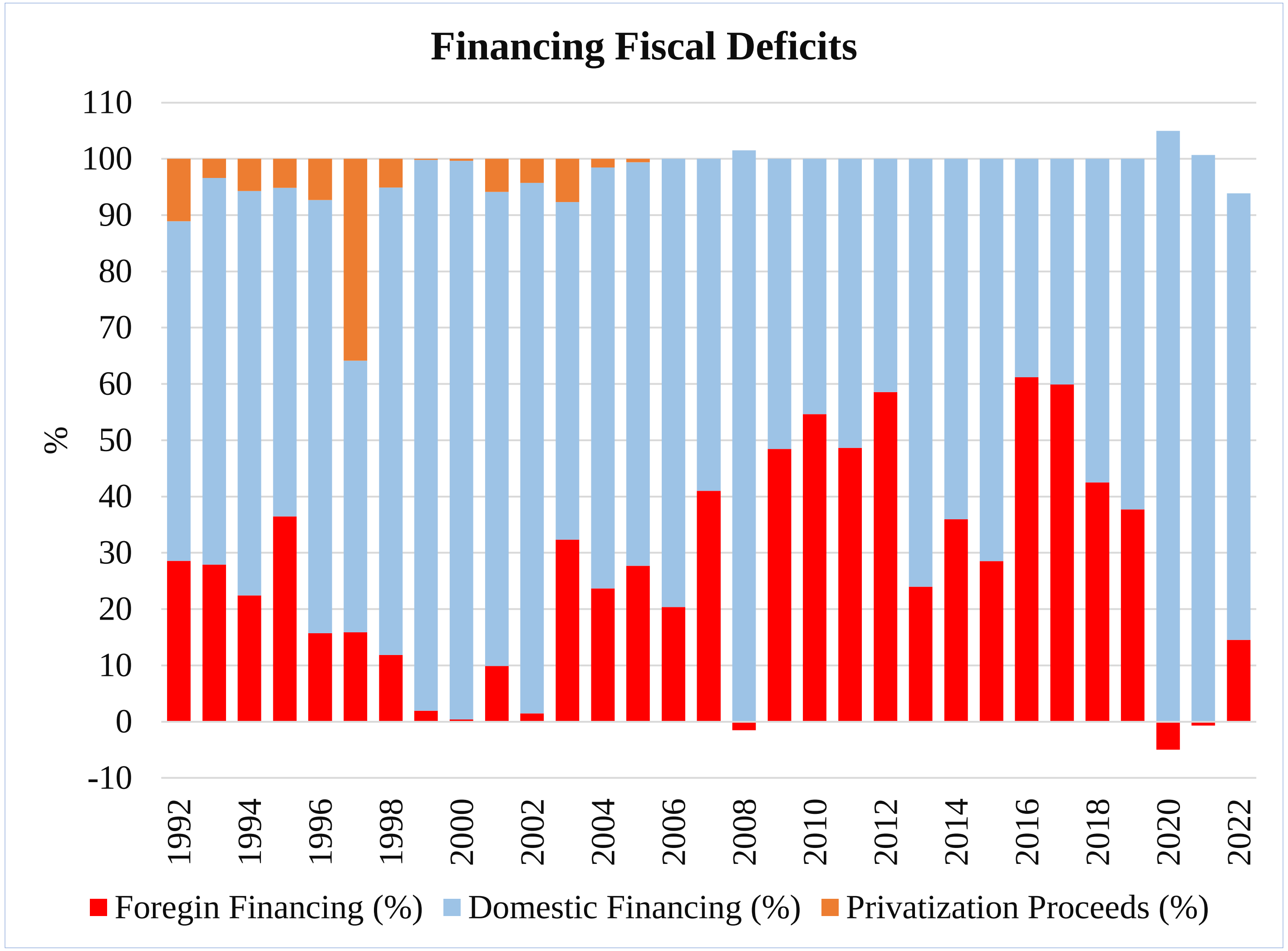
- High debt accumulation before the crisis: Over 5 years before default (2016-2021): Rs. 8.1 tr ($24 bn) or 86% increase.

Deficits & Debt Disproportionate to the Economy



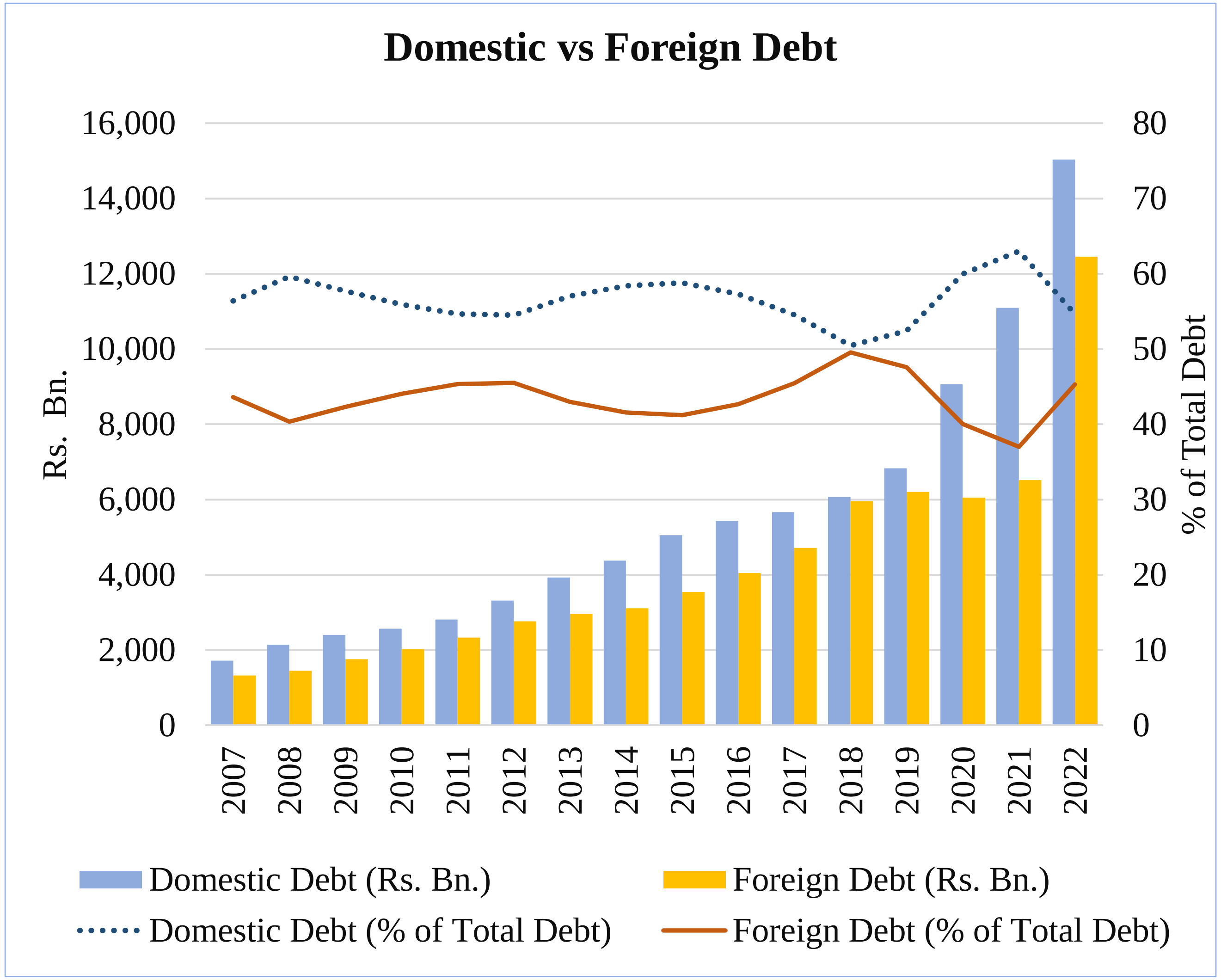
- Deficit/GDP:
  - 2021: 11.7%
  - 2022: 10.2%
- Debt/GDP:
  - 2021: 100%
  - 2022: 114%
- Interest Expenses/Rev:
  - 2021: 72%
  - 2022: 78%

Deficits Financed Increasingly by Foreign Borrowings



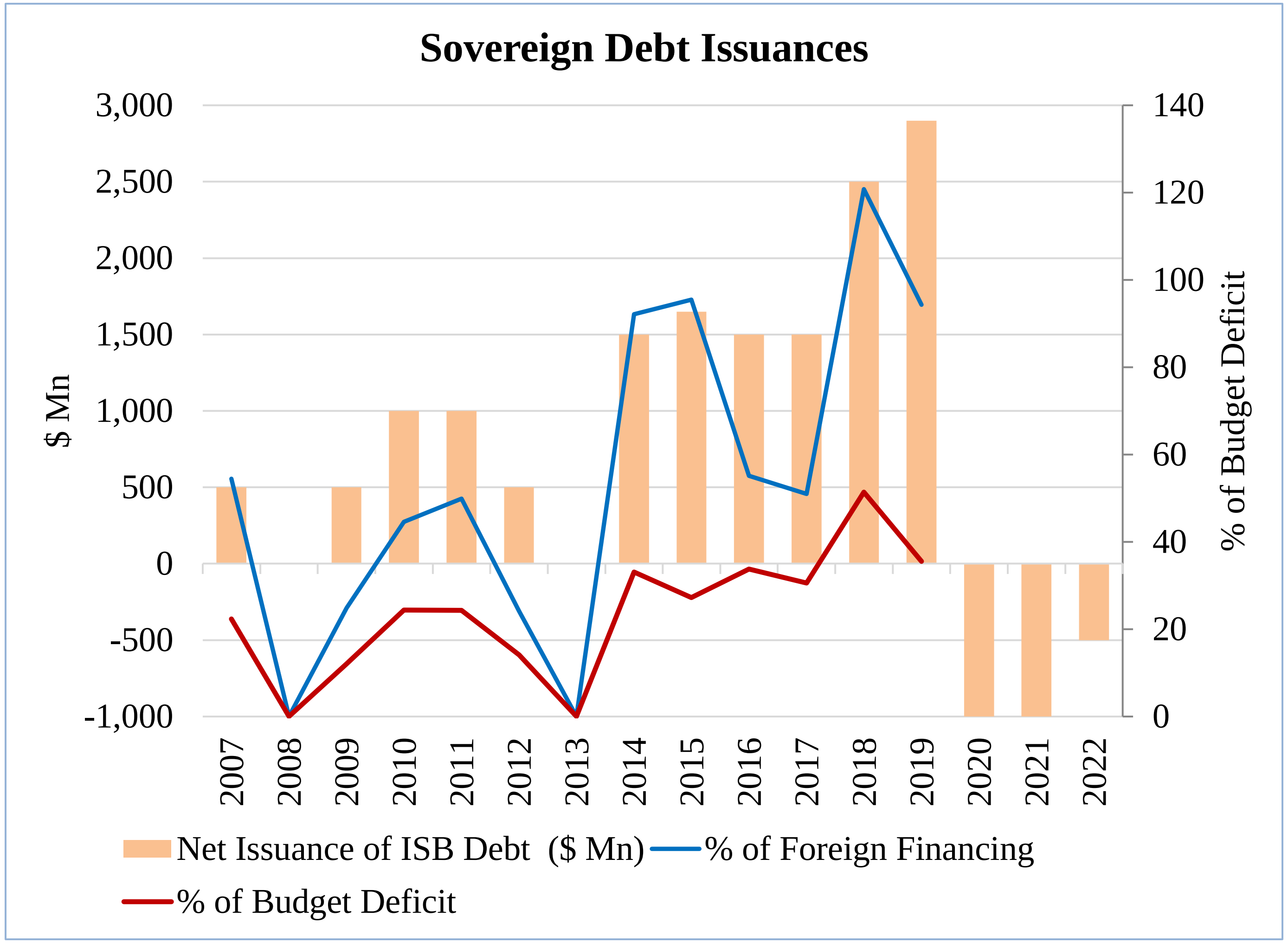
- % of foreign financing: During the 4 years (2016-2019): 50%

Foreign Borrowings Increased Foreign Debt: International Original Sin



- International original sin (the denomination of external debt in foreign currency)
- Foreign debt reached 50% of debt by 2018.
- % of foreign debt (2015-19): 45%
- Debt composition in 2021 (before default):
  - Domestic $55.4 Bn (63%)
  - Foreign $32.4 bn (37%)
  - Total $87.8 bn

Largest Source of Foreign Financing: International Sovereign Bonds (ISBs) and Sudden Stop

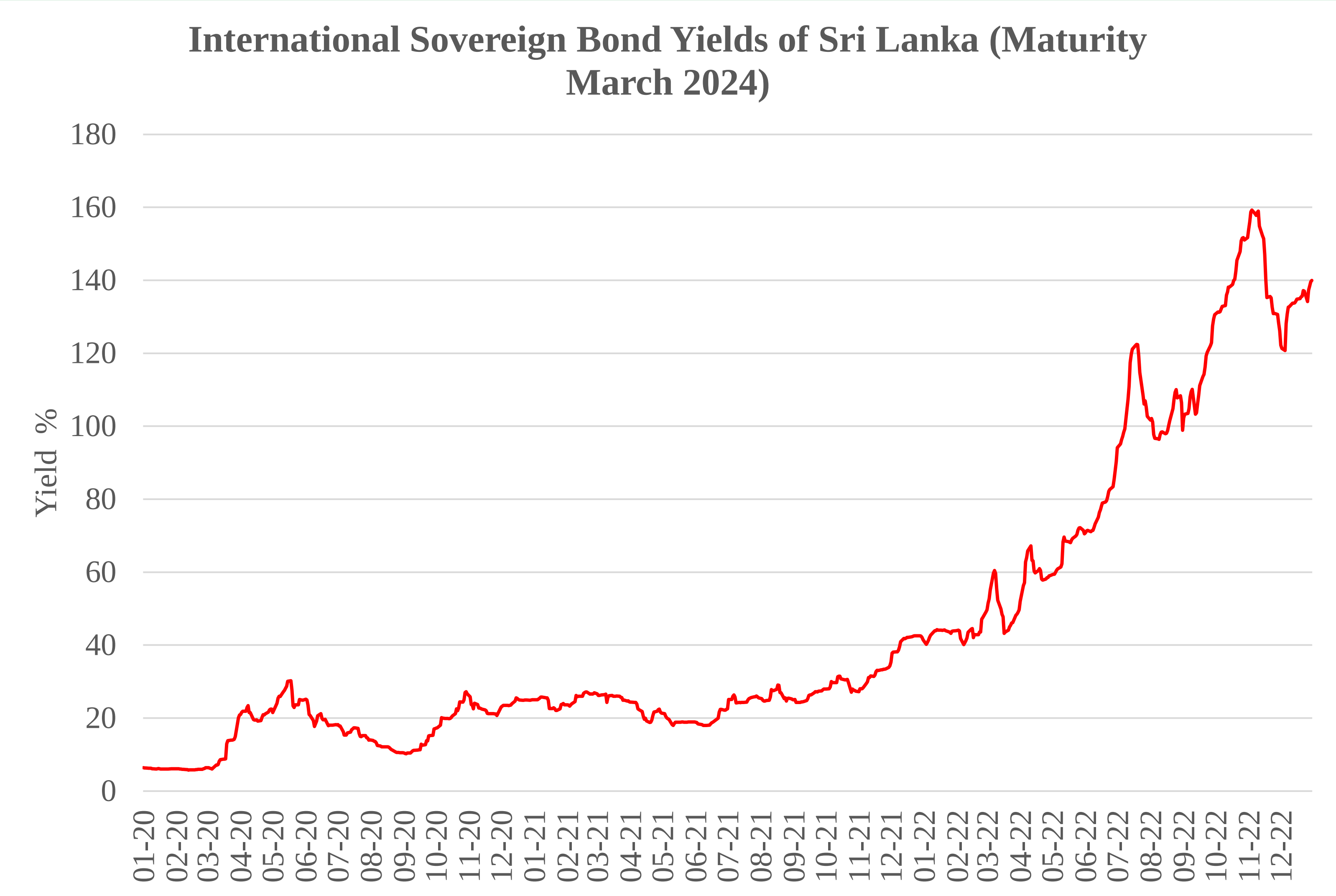


- Since 2007, SL issued ISBs worth $17.55.
  - $12.05 bn raised in the 5 years of 2015-2019.
  - $6.9 bn in the 2 years of 2018 & 2019!

- Sovereign bonds financed on average 85% of the foreign financing of the budget deficit during 2014-2019!

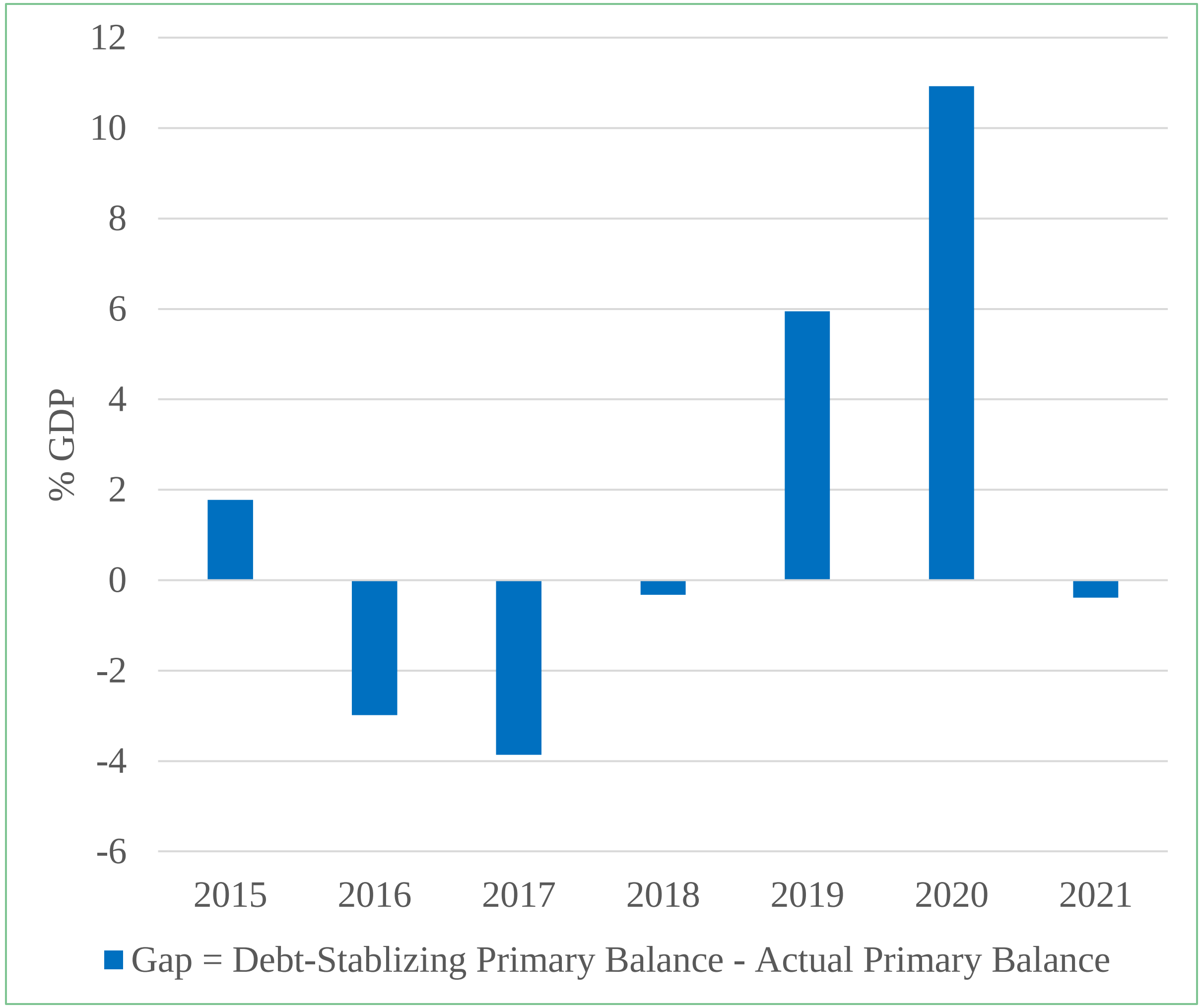
- Outstanding ISBs of $12.55 bn with maturities from 2022 to 2030.

International Sovereign Bond (ISB) Yields



- Yields were in the 5% to 9.5% range before the COVID-19 pandemic.
- They jumped to the 19% to 40% range by mid-2020.
- Credit downgraded from B-/CCC- to CC in Dec. 2021.
- Yields went up further and prices declined to about 40 cents per dollar in early 2022.
- After the default, yields rose to the 30% to 1,067% range in 2022 with prices declining to about 35 cents.
- Credit downgraded to RD in May 2022.

Debt Sustainability Analysis



- Debt-stabilizing primary balance:

$$D_t = D_{t-1}(1 + r_t) + PB_t \quad (1)$$

$$d_t = \left(\frac{1+r_t}{1+g_t}\right) d_{t-1} - pb_t \quad (2)$$

$$pb_t = \left(\frac{r_t - g_t}{1+g_t}\right) d_{t-1} \quad (3)$$

$$pb_t = (r_t - g_t)\, d_{t-1} \quad (4)$$

- r > g, must maintain a primary surplus
- r < g, can afford to have a primary deficit

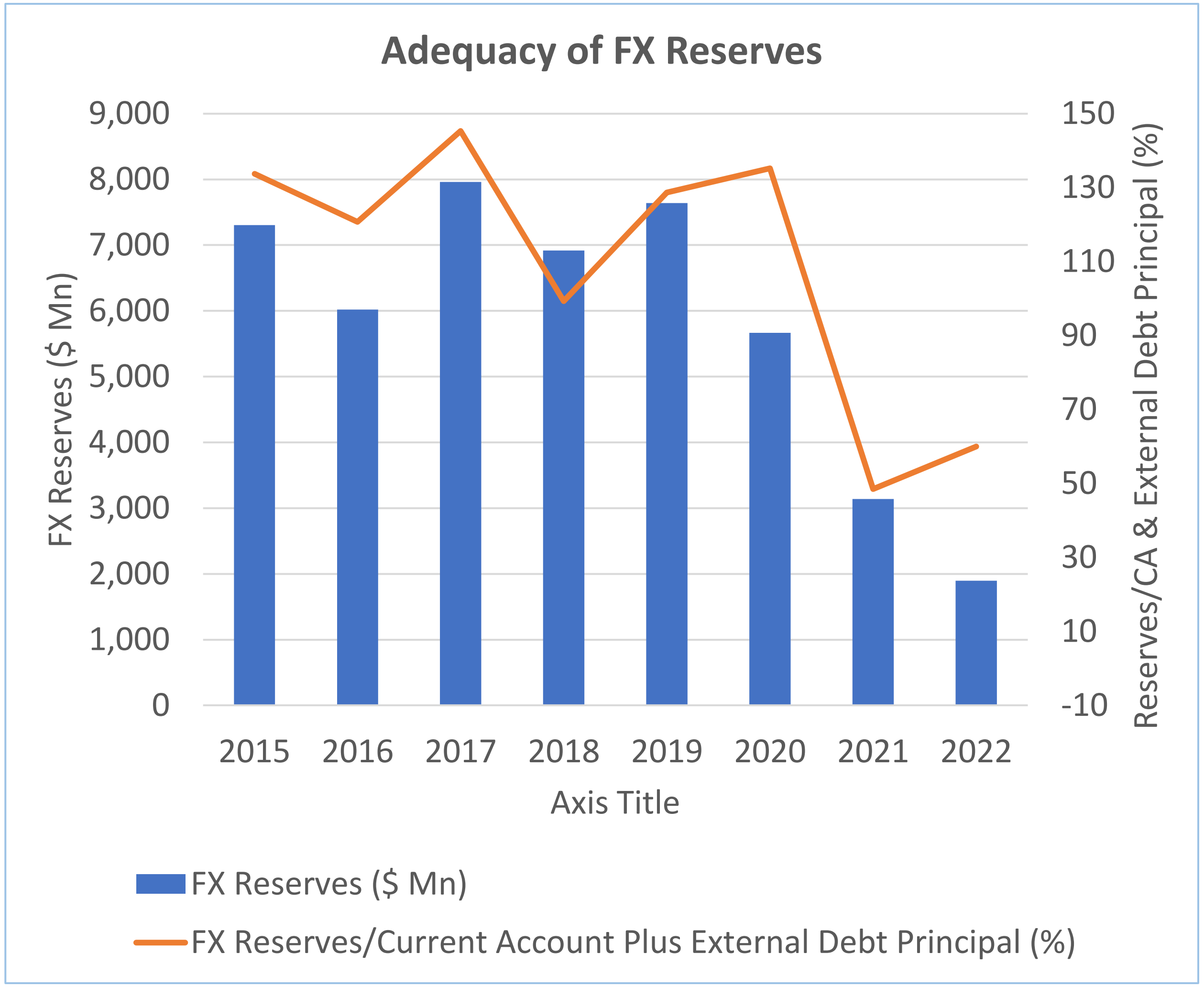
- Gap = Debt stabilizing PB – Actual PB
  Positive gap => PB Shortfall
  Negative gap => PB surplus

- The most damage to debt sustainability occurred in 2020, the first year of the Covid-19 pandemic. Debt-stabilizing pb of 6.5% and actual pb of -4.4%, gap of 10.9%

Liquidity Analysis: Reserve Adequacy Assessment

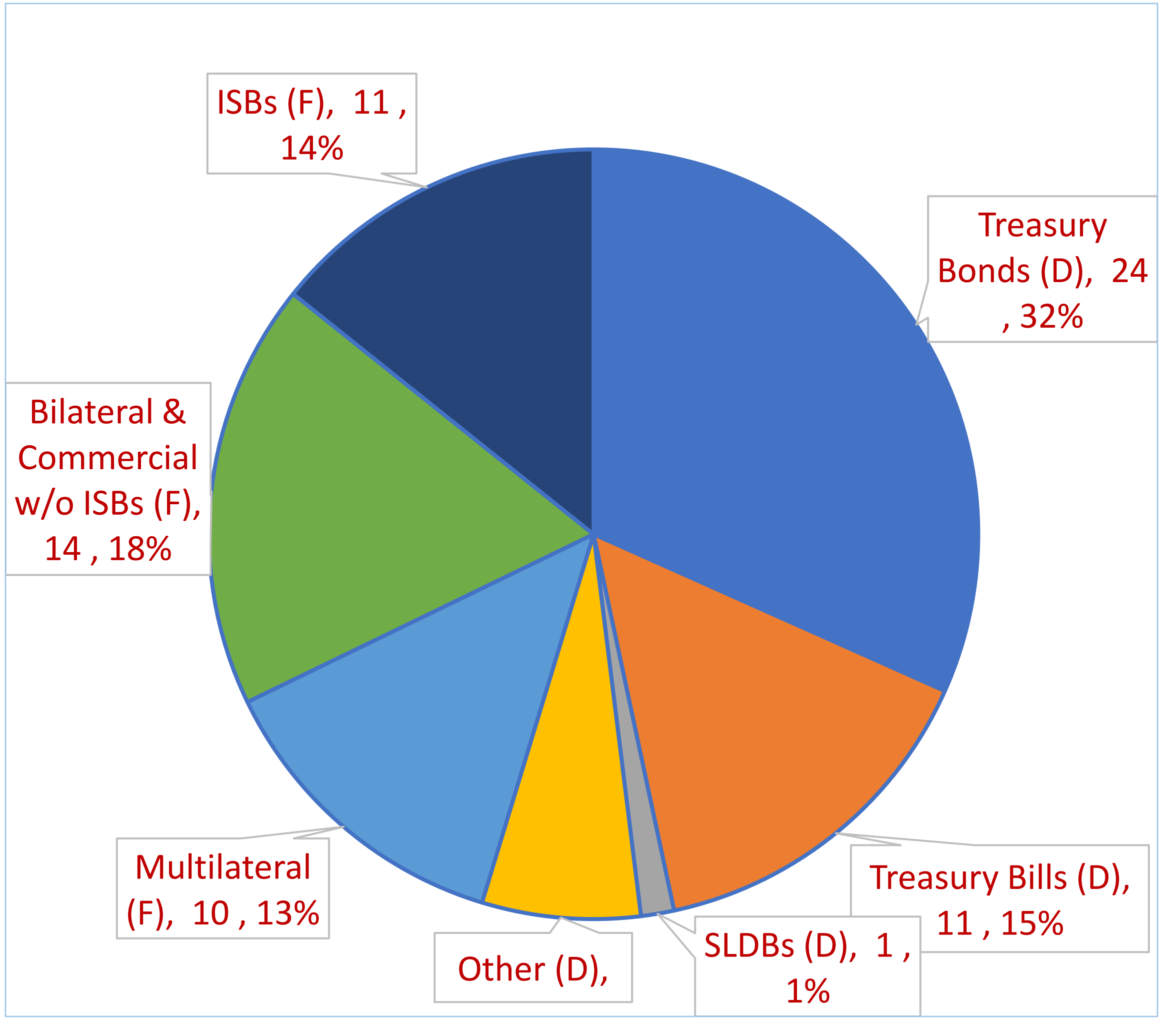
Year	Foreign Exchange Reserves (US$ Mn)	Short-Term External Debt (US$ Mn)	External Debt Service Payments (US$ Mn)	External Debt Service – Principal Payments (US$ Mn)	Reserves/ Short-term External Debt (%)	Import Cover (Months)	Reserves/ External Debt Service Payments (%)	Reserves/ Imports (%)	Reserves/ Current Account Deficit (%)	Reserves/ Current Account Deficit + Principal Payments (%)	Reserves/ ARA-EM Metric (%)
2015	7,304	7,653	4,772	3,580	95.4	4.6	153.1	38.6	387.9	133.7	53.7
2016	6,019	7,343	4,461	3,243	82.0	3.8	134.9	31.4	345.5	120.7	41.9
2017	7,959	7,833	4,566	3,167	101.6	4.6	174.3	37.9	344.7	145.3	49.8
2018	6,919	8,029	5,866	4,188	86.2	3.7	118	31.1	249	99.3	44.1
2019	7,642	8,250	5,757	4,096	92.6	4.6	132.7	38.3	414.7	128.7	46.1
2020	5,665	8,195	4,604	3,004	69.1	4.2	123	35.3	477.3	135.2	51.5
2021	3,139	8,421	4,597	3,187	37.3	1.8	68.3	15.2	95.6	48.5	27.9
2022	1,898	7,627	2,471	1,710	24.9	1.2	76.8	10.4	130.6	60.0	18.4

Gradually and then Suddenly! Liquidity Crisis and Default



- Large current account deficit and external debt payments
- Cut-off from international market access for foreign borrowings
- FX reserves are used to meet imports, make external debt payments, and for market interventions
- Declining FX reserves
- FX liquidity and Balance of Payments crisis
- Inevitable default on external debt service

Sri Lanka's Debt Structure (Dec 2022)



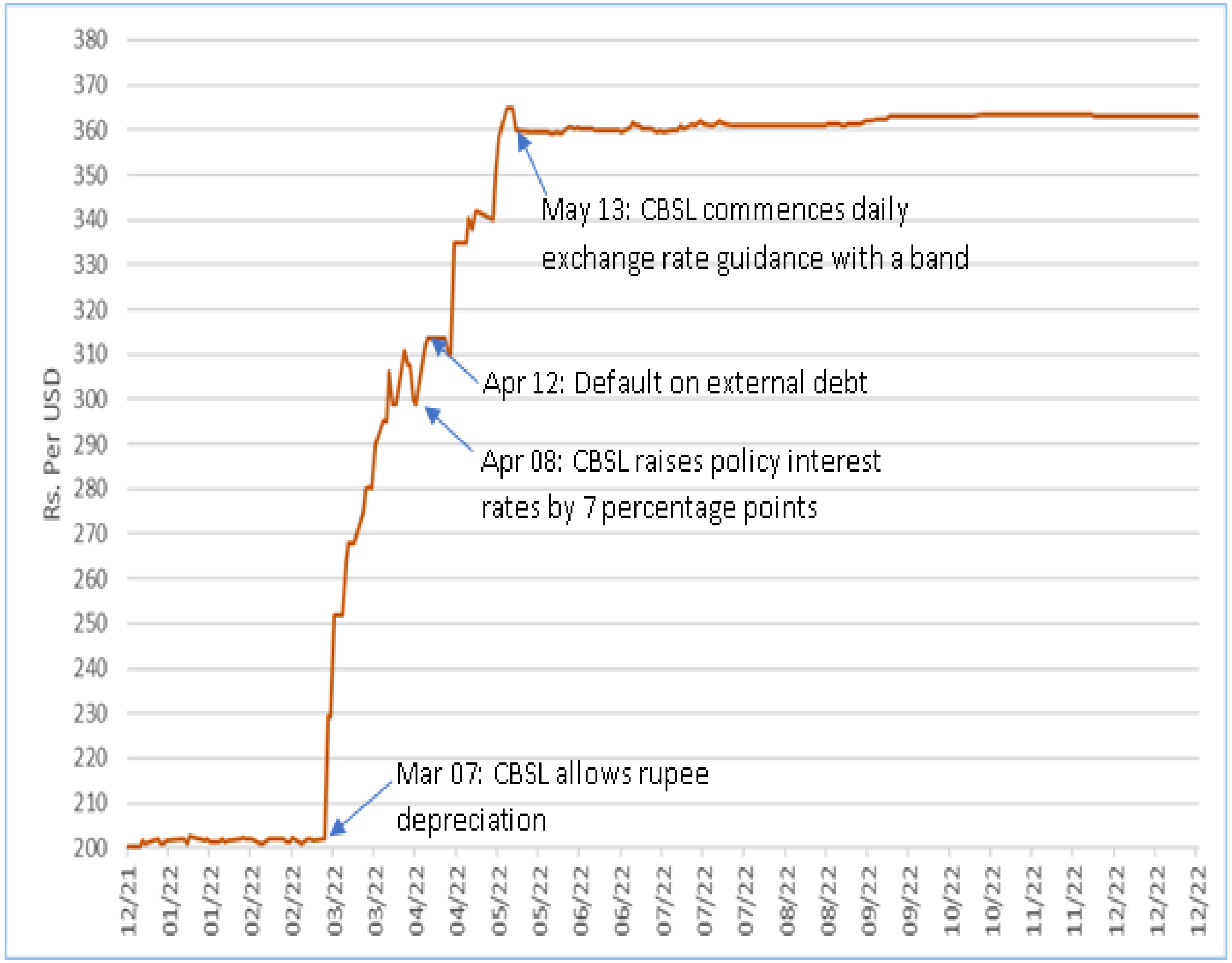
Domestic Debt 55%, $41.4 Bn
Foreign Debt 45%, $34.3 Bn
Total Debt $75.7 Bn

Major Sources of External Debt

Source	Amount $ Mn.	% Total Debt	% Foreign Debt
Bilateral			
China	6,902	9.1%	20.1%
Japan	2,692	3.6%	7.8%
India	1,721	2.3%	5.0%
Multilateral			
ADB	5,643	7.5%	16.4%
World Bank	3,839	5.1%	11.2%
Commercial			
ISBs	12,550	14.3%	31.5%
Total	33,347	41.7%	92.1%

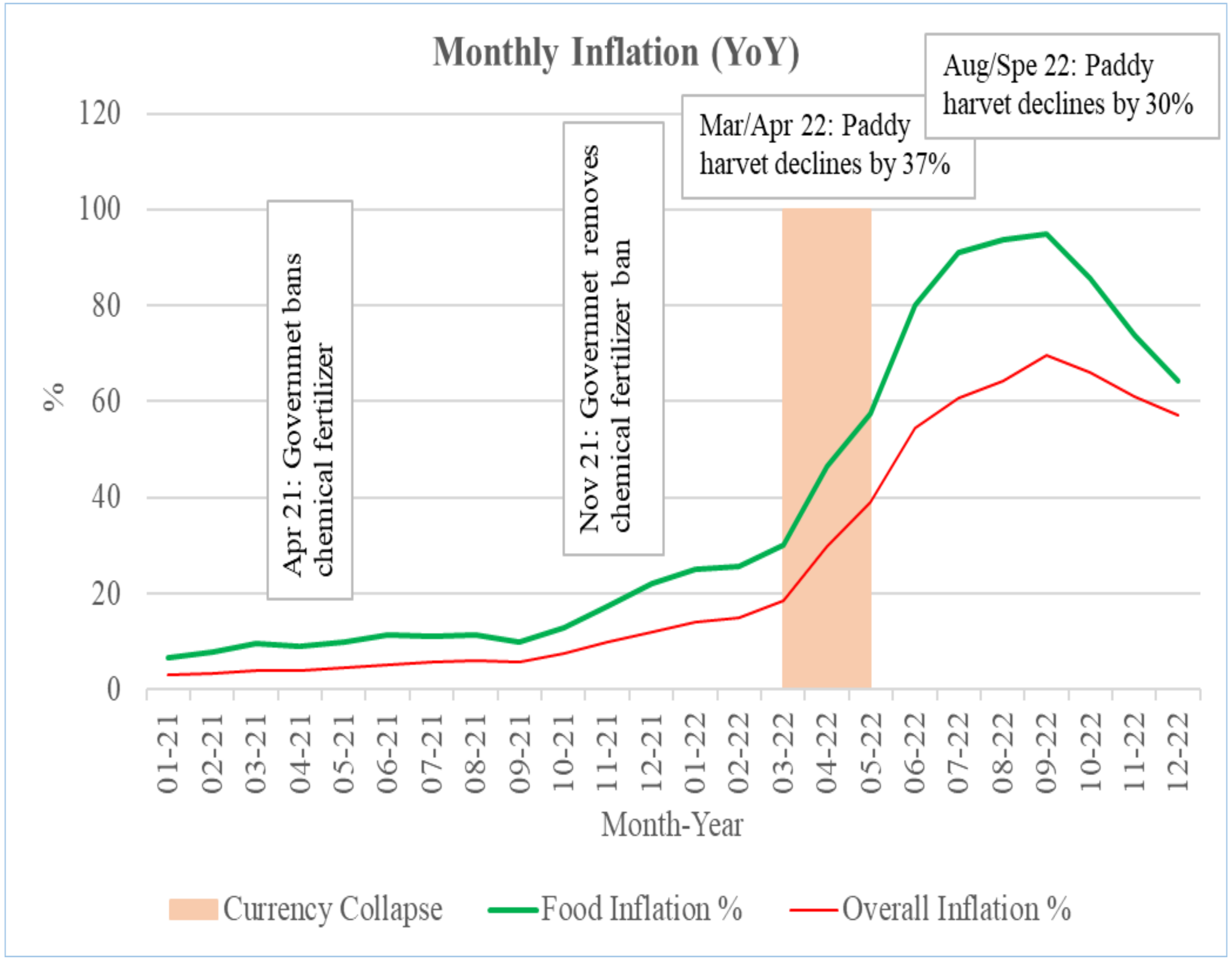
Currency Crisis

- CBSL allowed the rupee to depreciate from March to May 2022.
- Rupee depreciated from 200 to 364 Rs. Per USD within about 2 months.
- Depreciated by 45% in 2022, the largest in history.
- Announced various current account and capital controls due to the FX liquidity crisis.



Inflation Crises

- Overall inflation reached 70% in Sep 2022.
- Food inflation rose to 95% in Sep 2022.
- Contributing factors:
    - Following the ban on chemical fertilizer, and the subsequent currency shortages to import fertilizer after the lifting of the ban, paddy production declined by 34% in 2022.
    - Market speculation about supply shortages.
    - 45% currency depreciation in 2022



Major Conclusion

The root cause of the Sri Lankan economic crisis is fiscal.

Fiscal profligacy (large and unsustainable fiscal deficit and debt), compounded by the Covid-19 pandemic, set off a predictable chain of outcomes.

Higher budget deficits	Higher public debt	Higher foreign debt	Credit downgrades	Higher cost of external borrowing	Loss of international market access	Loss of FX reserves	BoP crisis	Currency collapse	Rising inflation	External debt default

Lessons for Developing Countries

- Fiscal Balance
  - Lage and persistent budget deficits are unsustainable and cause debt accumulation.

  - They cannot be financed through market borrowings without negative economic repercussions such as higher interest costs and crowing out of private investments, leading to loss of output.

  - Fiscal soundness requires sound revenue and expenditure management policies and systems.

Lessons for Developing Countries

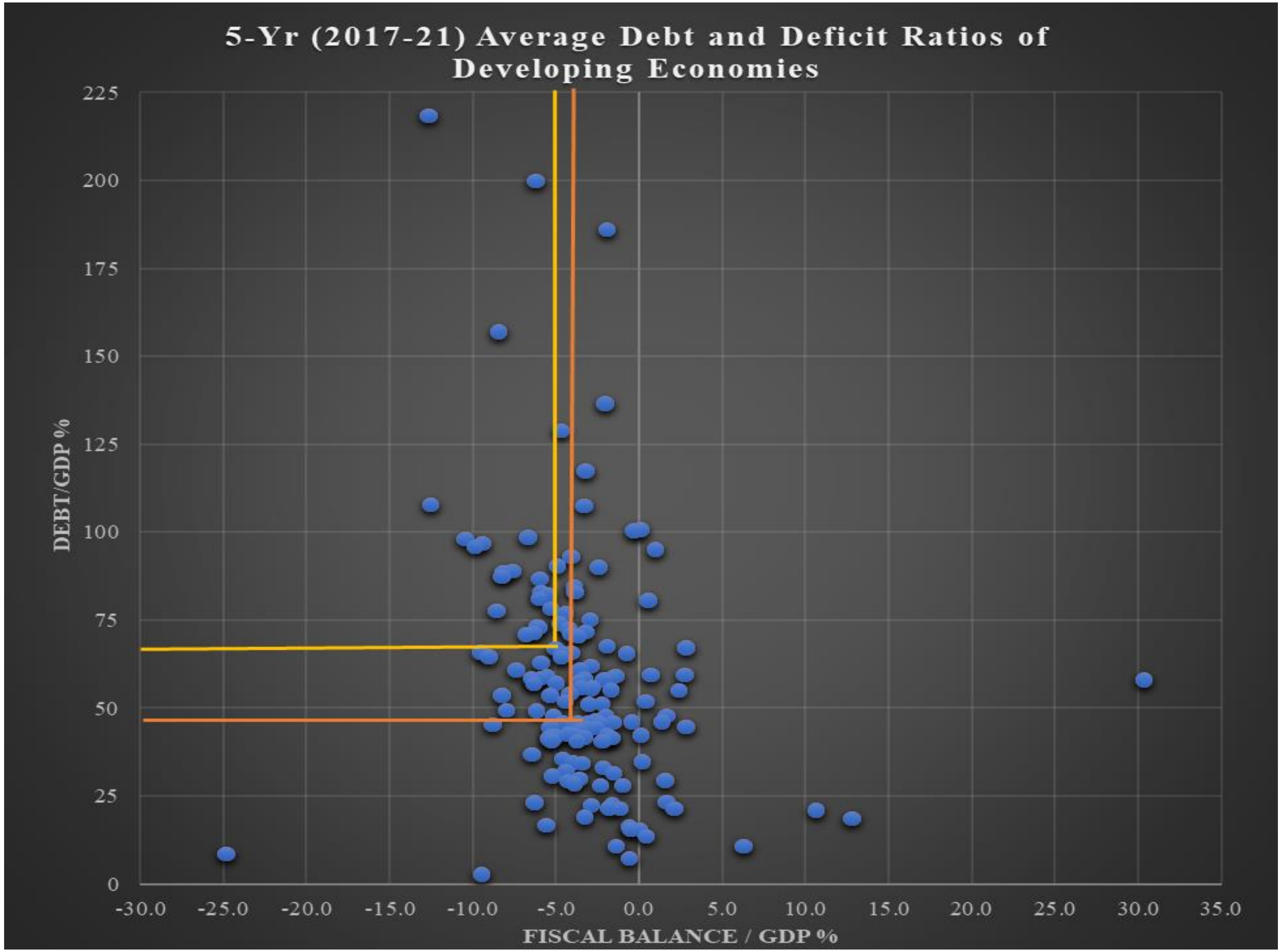
- Public Debt
  - Large debt levels relative to the economy are unsustainable.
  - Larger interest burden reduces the fiscal capacity for productive investments.
  - With continued deficits, governments are forced to refinance debt service payments, leading to more debt.
  - At some point, rolling over becomes prohibitively expensive, potentially leading to default if there is no liquidity.

Comparative Fiscal Data (% GDP in 2022)

Type of Economy	Revenue	Expenditure	Fiscal Balance	Debt
Advanced Economies	37.4	41.7	-4.3	113
Emerging Markets & Middle-Income Economies	26.5	31.8	-5.3	66
Low Income Economies	14.7	18.9	-4.2	48
Sri Lanka	8.3	18.5	-10.2	114

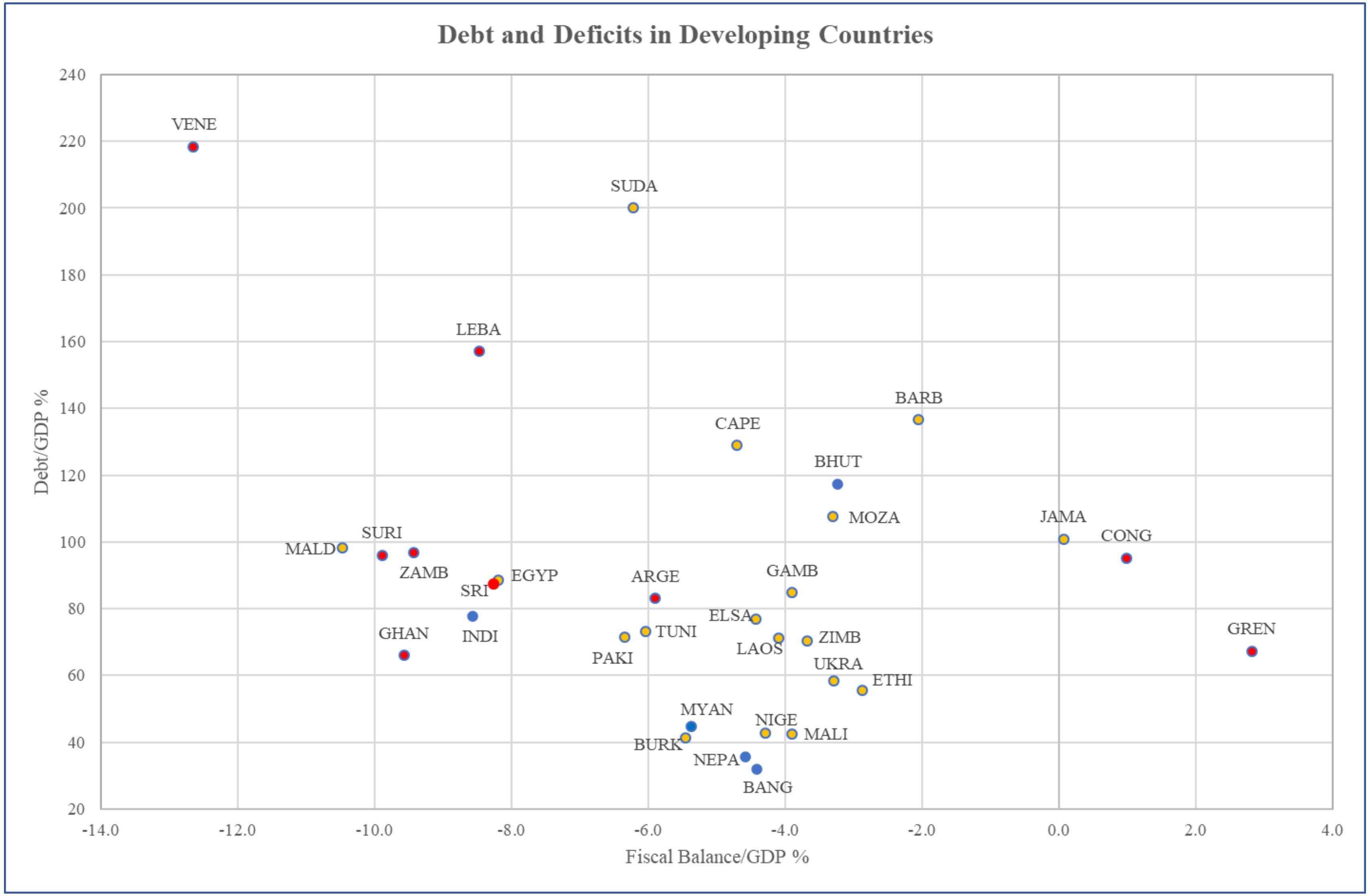
Sources: Fiscal Monitor, IMF, April 2023 & Ministry of Finance, Sri Lanka

Debt and Deficit of Developing Economies



- Gold line benchmarks: Emerging Market & Middle-Income Economies (-5%, 66%)
- Red line benchmarks: Low-Income Economies (-4%, 48%)

Debt and Deficit of Developing Economies



Defaulted. Rated SD, RD or D

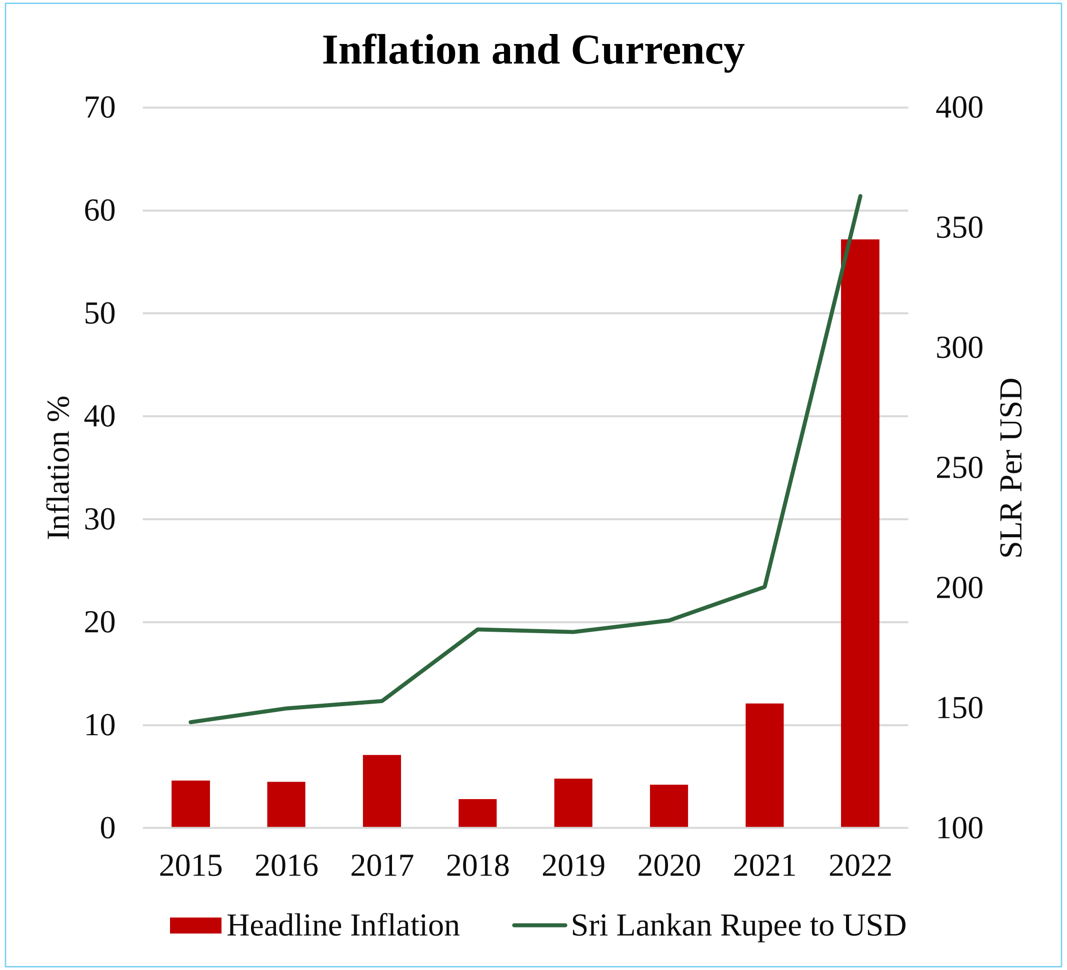
In distress / under IMF programs / rated CCC or CC category

Lessons for Developing Countries

- Foreign Debt
  - Foreign borrowings need to be tied to the country’s capacity to service foreign debt obligations.
  - Maintaining adequate FX reserves to cover principal payments on foreign debt in addition to the current account needs is critically important to avoid a liquidity crisis.
  - International investor sentiment, credit ratings, and bond yields reflect a country’s economic and financial conditions, no matter what the governments say about such conditions, potentially increasing country risk premium and borrowing costs, and losing access to international markets.
  - Foreign debt rollover cannot continue indefinitely, and, at some point, a country must be able to pay down its debt without refinancing.

Lessons for Developing Countries

- Currency
  - Fixing the currency without regard to economic fundamentals for extended periods leads to large subsequent disorderly devaluations/depreciations.
  - Gradual adjustments to reflect the market and economic fundamentals are less destabilizing to the economy and financial system.
  - Greater exchange rate flexibility through flexible inflation targeting.



Lessons for Developing Countries

- Development Policy/Economic Growth
  - Ultimately, a country would have to achieve steady economic growth.
  - Economic policies to increase investments and productivity of labor and capital are critically important to enhancing the potential output.
  - Structural reforms to enhance growth potential are important.
  - An integrated and long-term socio-economic development plan and a robust mechanism for coordinated national economic policy formulation and implementation are important to the economic strategy.