Perspectives on Sri Lanka's Debt Burden & Policy Options

Prof. Lalith Samarakoon
lpsamarakoon@stthomas.edu

Professor and Chair of Finance, University of St. Thomas
Financial Economist & Former Secretary-General & Chief Economist of the National Economic Council of Sri Lanka

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Outline

1. How is debt created?

2. Debt Burden: How did we get here?

3. Solutions: What policy options do we have?

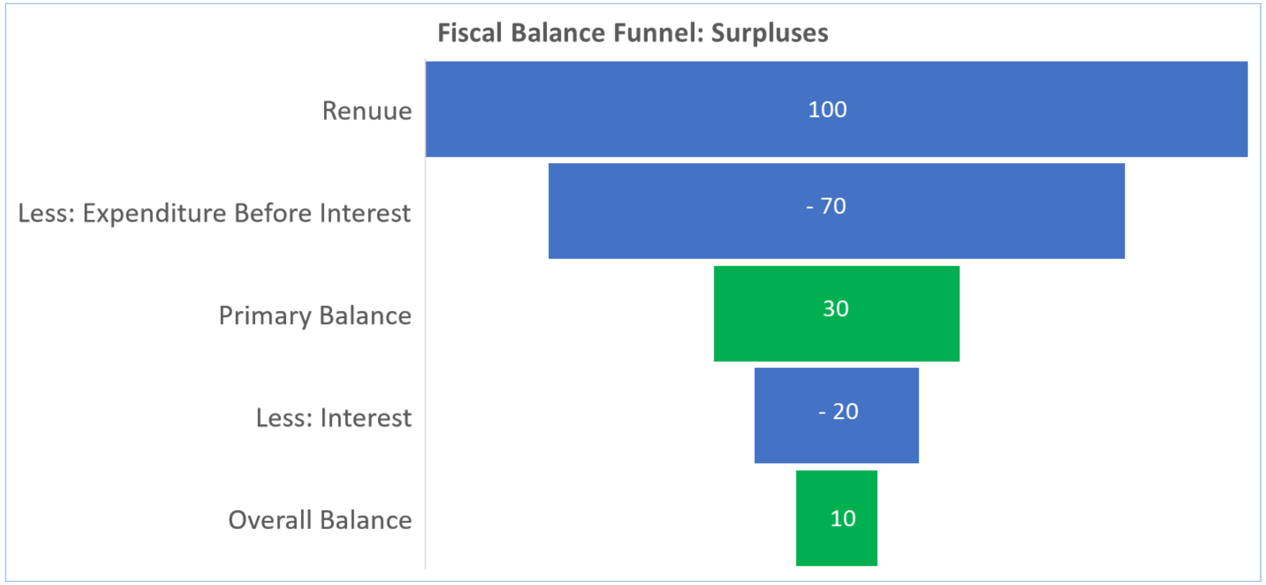
4. Plan: What are the necessary components of a Rescue, Recovery and Growth Plan.

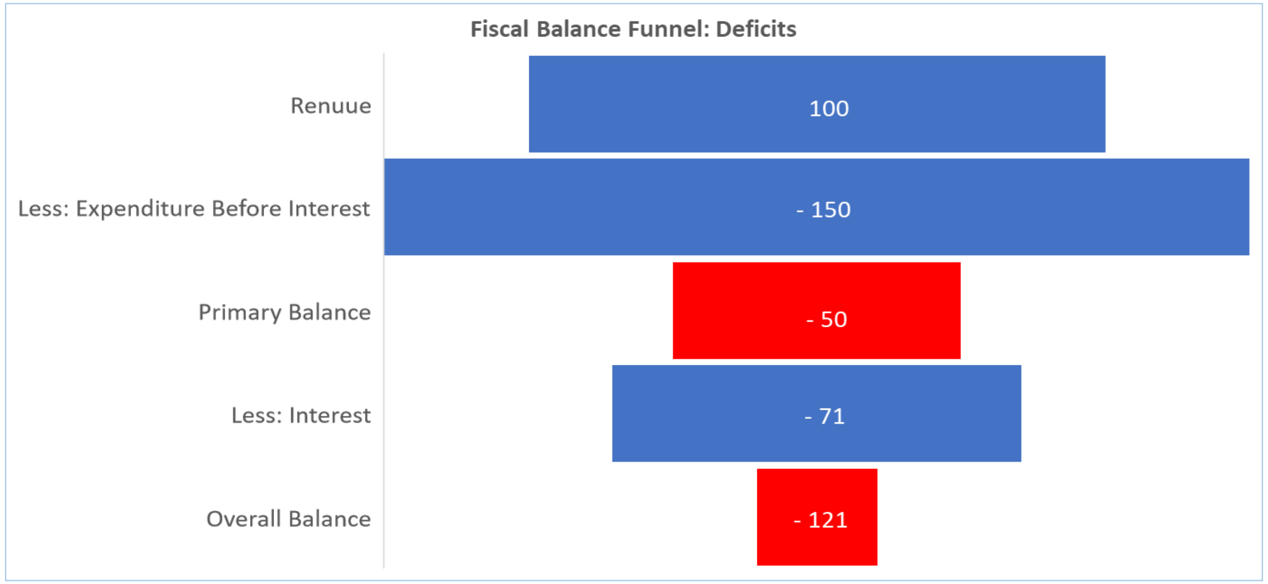
1. How is debt created?

Debt and Deficits – Debt is created by deficits

- Two types of fiscal balances
  - Primary balance: Fiscal balance before subtracting interest on debt.
    - Primary balance = Revenue – (Expenditure – Interest)
    - This is what is available to pay interest.

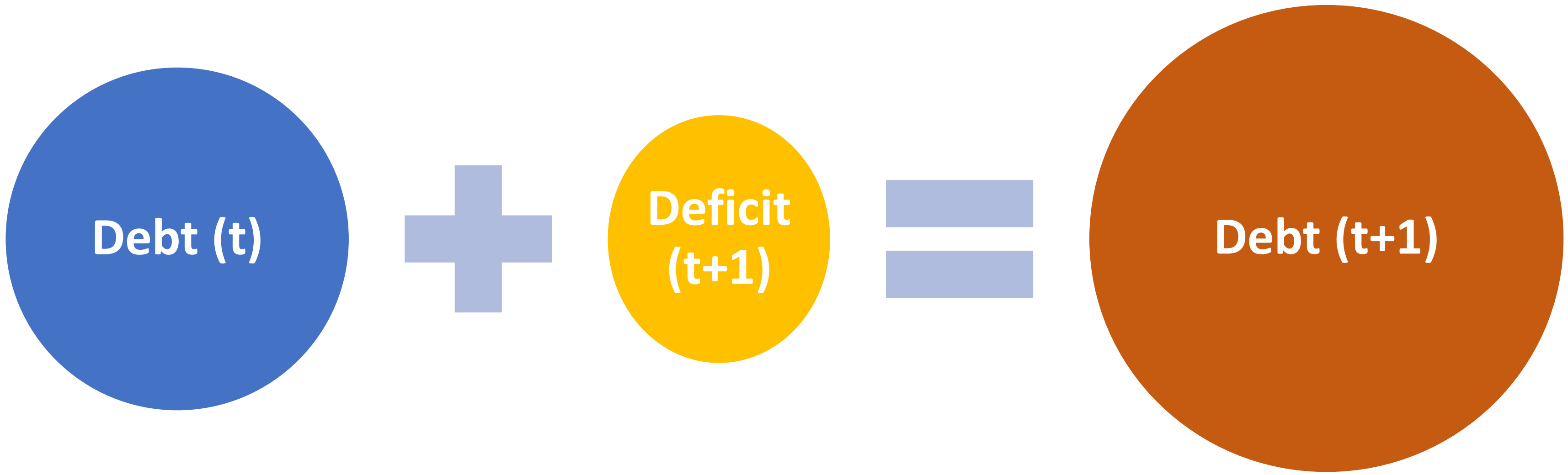
  - Overall balance: Fiscal balance after subtracting all expenditures.
    - Overall balance = Revenue – Expenditure





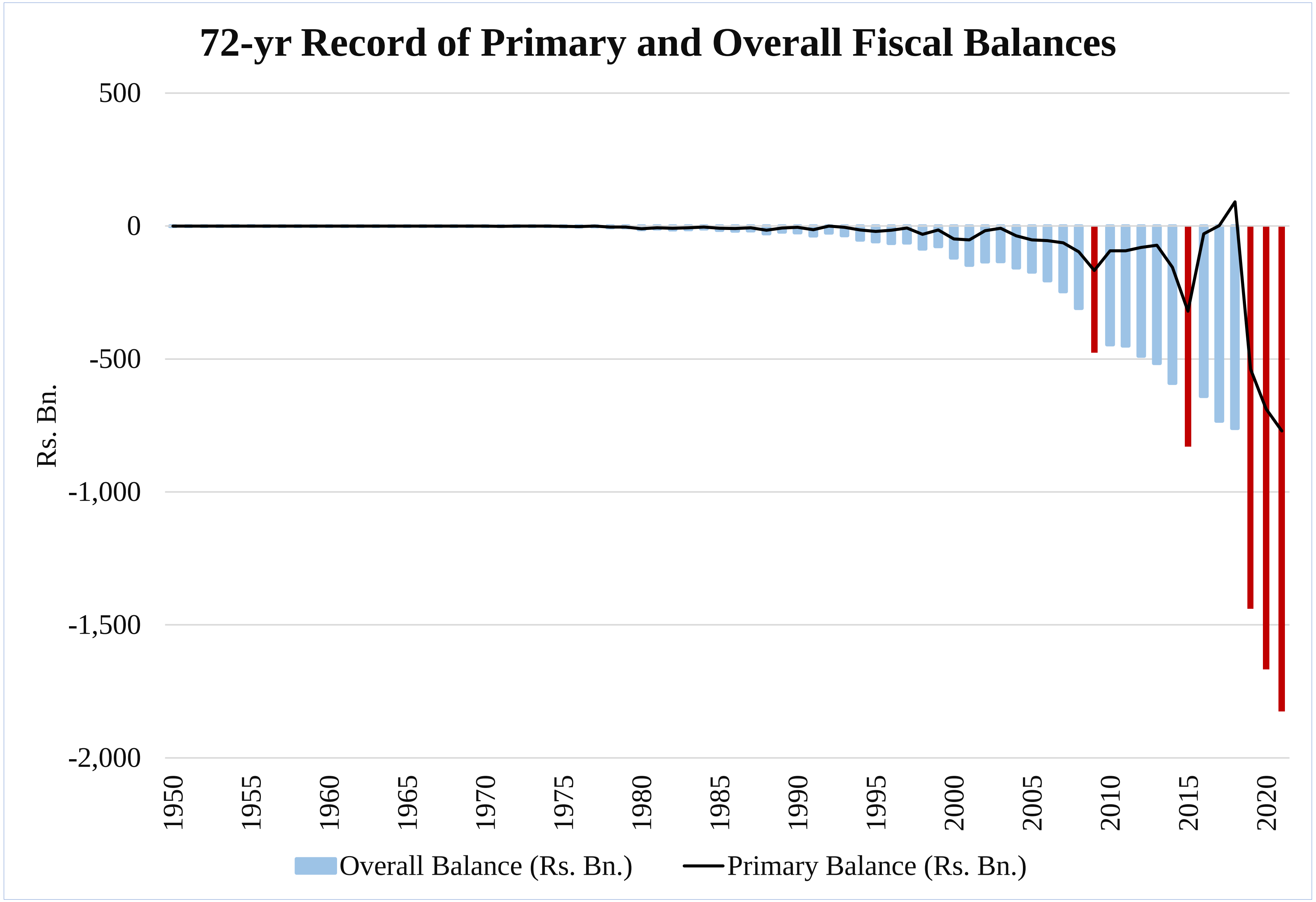
Deficits add to Debt

- Basic debt equation:
  - Deficit is financed through borrowings.
  - Debt(t) = Debt(t-1) + Overall Deficit(t)
  - Change in Debt(t) = Deficit(t)



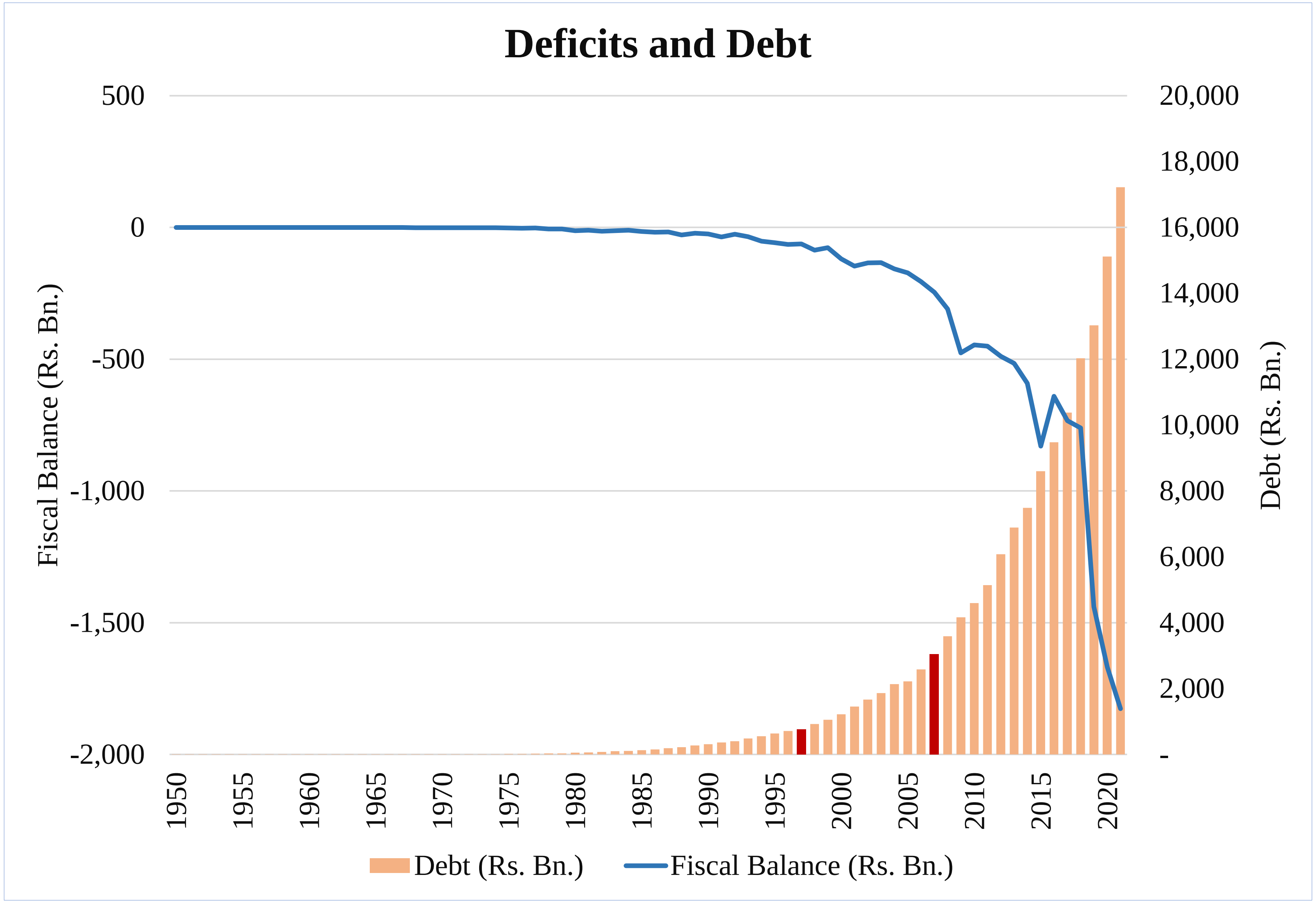
2. Debt burden: How did we get here?

Budget Deficits – A Perennial Issue for Sri Lanka



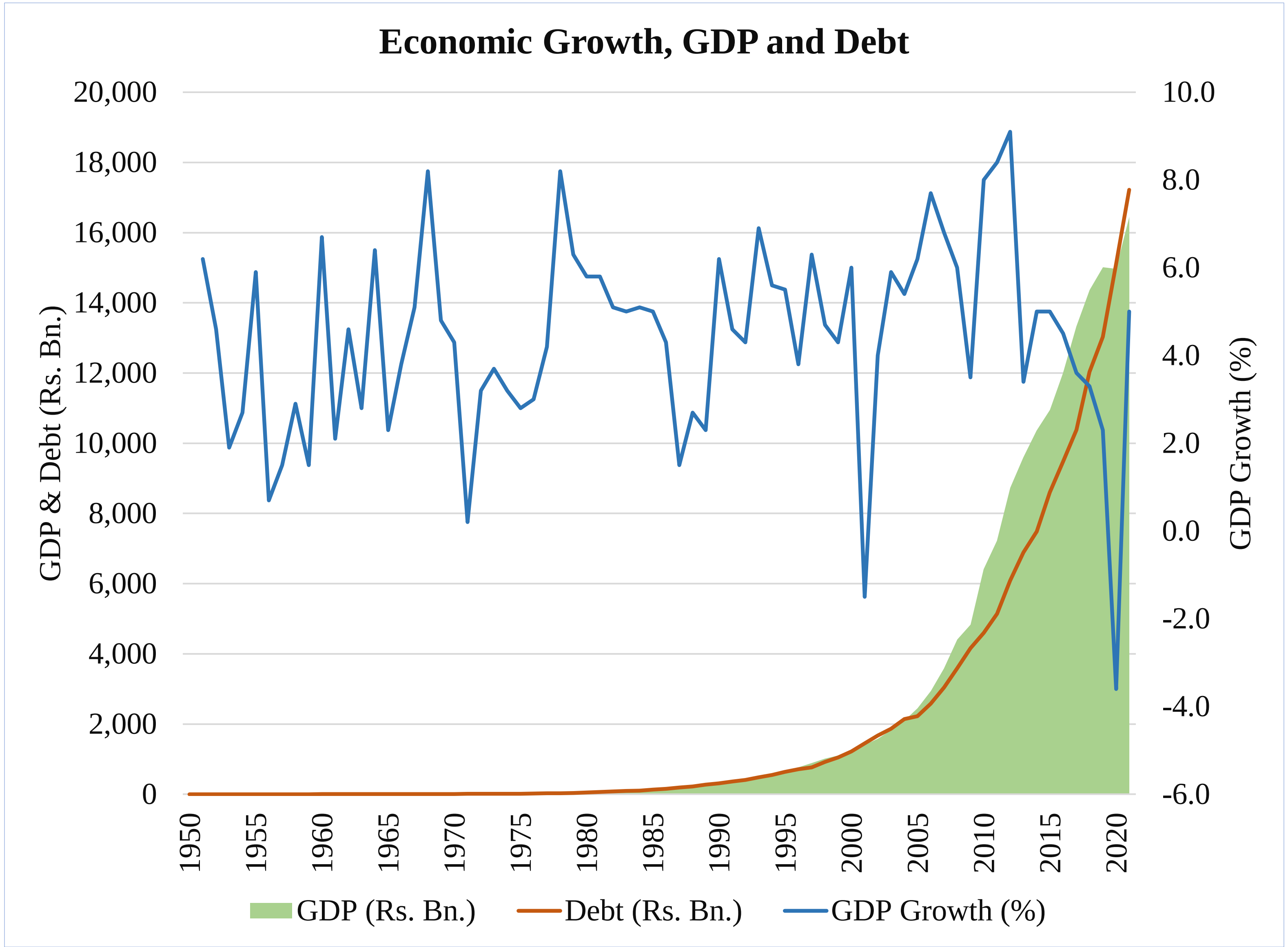
- History of persistent and increasing budget deficits.
- Primary deficits (except 1954, 1955 1992, 2017, 2018).
- Overall deficits (except 1954, 1955).
- Larger jumps in 2009, 2015, & 2019-2021 (exacerbated by the Covid-19 economic downturn)
- Overall deficit:
  - 2020: Rs. 1,668 Bn.
  - 2021: Rs. 1,826 Bn.*
- Interest expense (% of Rev):
  - 2020: Rs. 980 Bn. (71%)
  - 2021: Rs. 1,055 Bn. (68%)

Deficits led debt accumulation



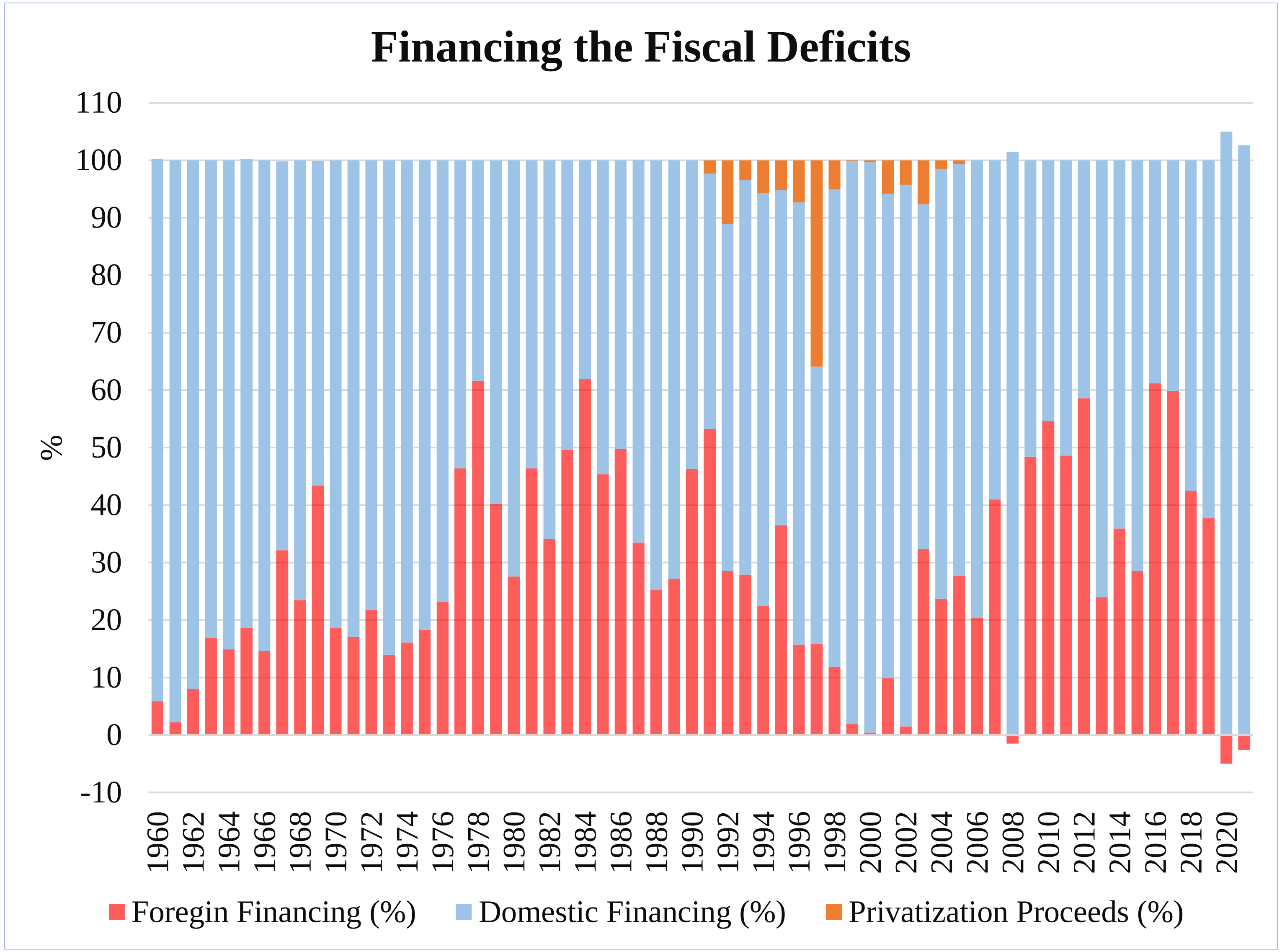
- Budget deficits have led to building-up of debt.
- Government began issuing Treasury bonds in 1997.
- Since opening-up of government securities market to foreign investors in 2007, debt stock has grown at an average rate of 14% per year.
- Debt is Rs. 17.2 Tn ($82 Bn) as of August 2021.
- Recent debt accumulation is alarming:
- Over the past 5 years (2016-2021): Rs. 7.7 tr or 82%.
- Over the past 10 years (2011-2021): Rs. 12.1 Tr. or 235%. This 70% of debt stock.

Economic Growth decelerated and Debt surpassed the GDP



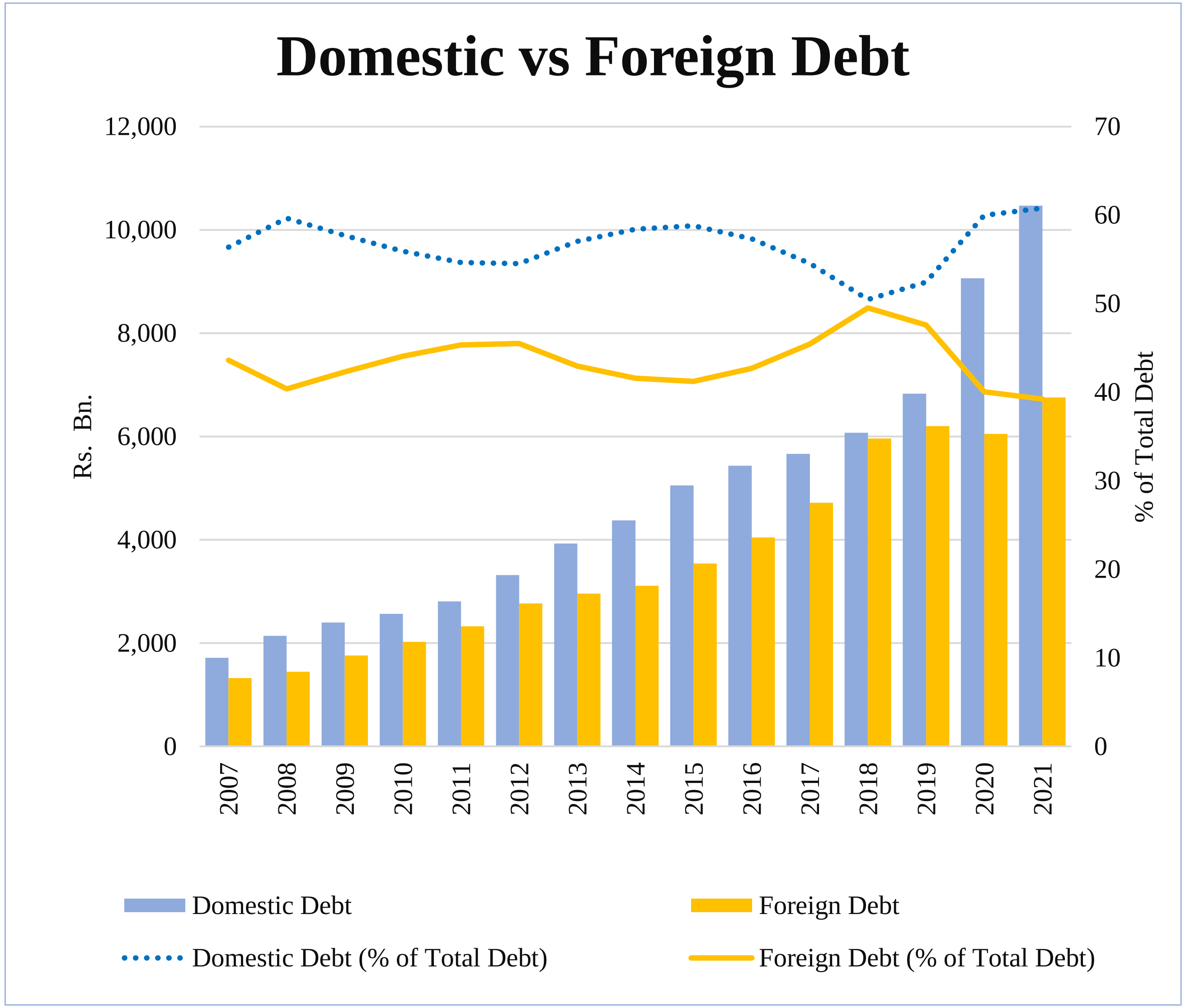
- Economic growth has been moderate and volatile, and decelerating.
- GDP growth averaged 3.7% in the 5 years before the Covid-19 pandemic (2015-19).
- Covid-19 pandemic caused the economy to contract by 3.6% in 2020.
- However, the growth has been on a downtrend since reaching 5% in 2015.
- Debt grew at a higher rate and surpassed the GDP in 2020.
- Now GDP Rs. Tr. 16.5 and Debt Rs. Tr. 17.2

Financing the Deficit – Increased Reliance on Foreign Financing



- The major source of the debt burden is foreign debt. They must be paid in foreign currency.
- Since 2007, the governments increased the reliance on foreign sources for financing the deficit.
- % of foreign financing:
  - 5 yrs (2015-2019): 46%
  - 2007-2019: 42%
  - 30-yrs prior (1978-2006): 30%

Foreign Debt Increased

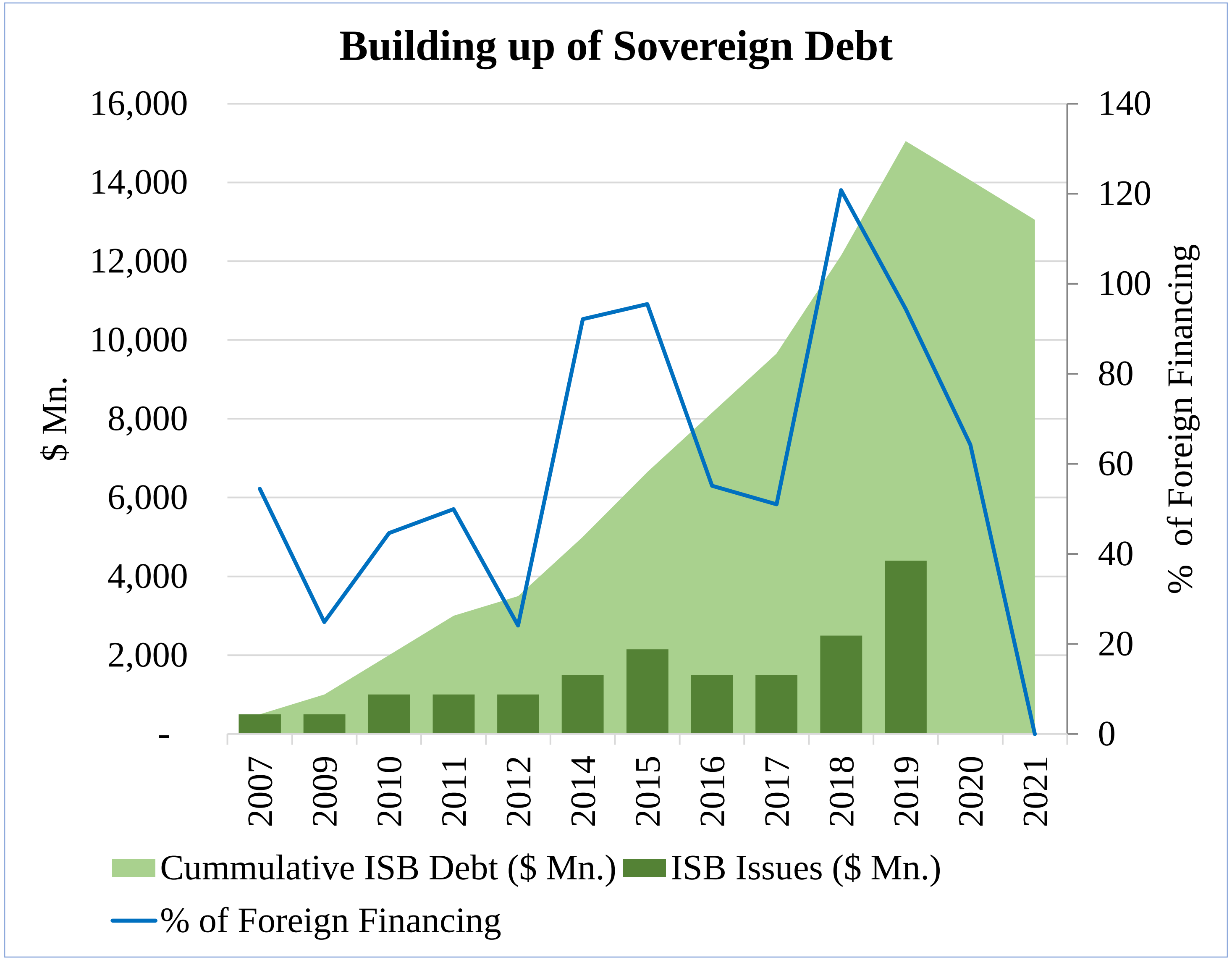


Most Recent		Rs. Bn. ($ Bn.)	% of Total Debt
202/08	Domestic	10,467 (50)	61%
	Foreign	6,754 (32)	39%
	Total	17,220 (82)	100%

- As a result of the increase in foreign debt, in 2018, foreign debt almost equaled domestic debt (approx. Rs. 6 Tr. each).

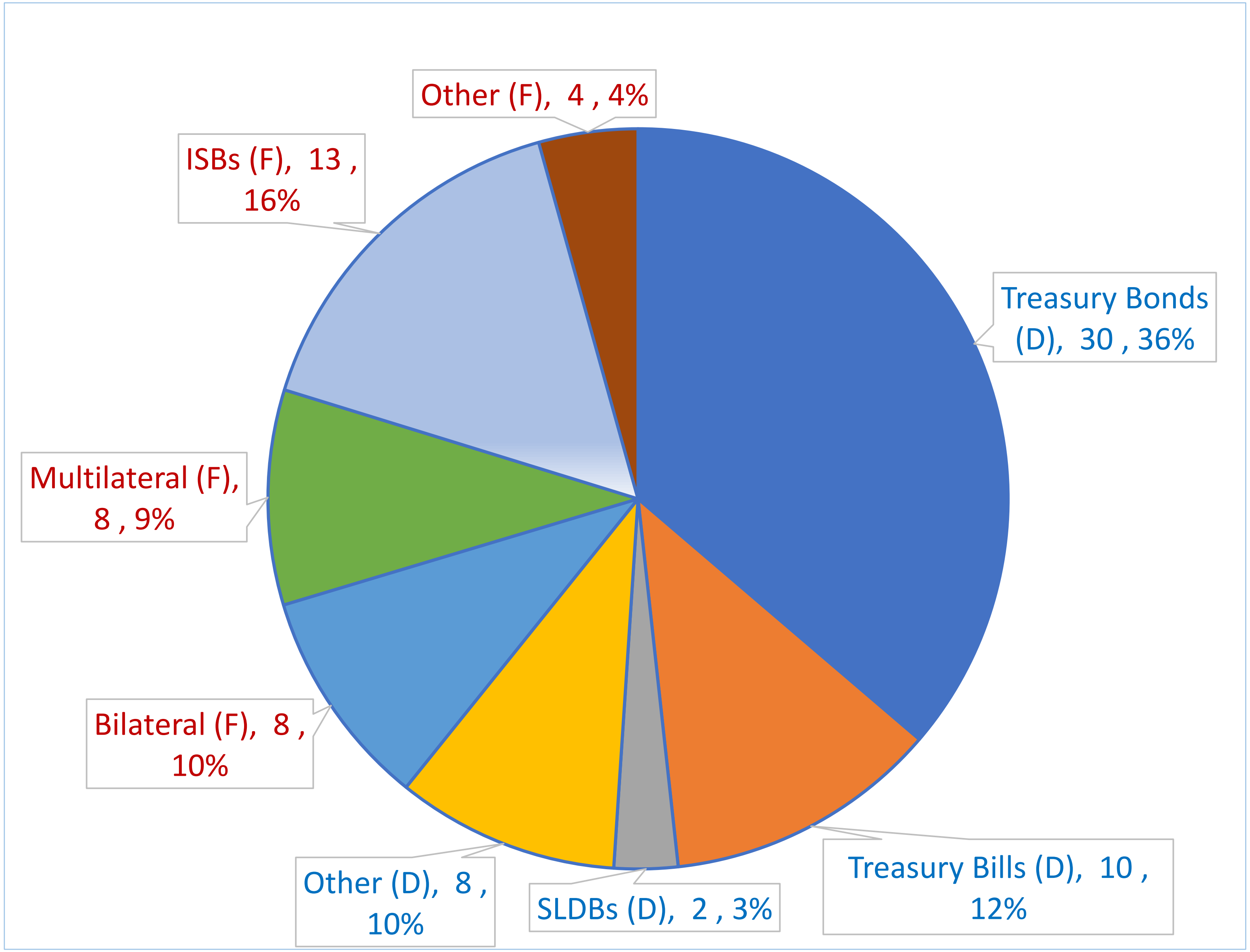
- Increase in debt since 2006:
  - Foreign debt (5.7 tn or $22 Bn, +612%)
  - Domestic debt (9.0 tn or $36 Bn, +708%)

Biggest source of Foreign Financing: International Sovereign Bonds



- 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 64% of the foreign financing of the budget deficit during 2007-2019!
- Outstanding ISBs of $13.05 bn with maturities from 2022 to 2030.

Composition of Debt



As at End Aug, 2021, Type, USD, %

Recap: Debt Heatmap

Year	GDP Growth	Budget Deficit %	Total Interest / Gov Rev %	Total Interest / Gov Exp %	Total Debt / GDP %	Foreign Debt /GDP %	Foreign Reserves ($ Mn)	Credit Rating	Sovereign Bond Yield %	Country Risk Premium %
2012	9.1	-5.6	38.3	26.2	69.7	31.7	7,106	BB-	4.90	3.10
2013	3.4	-5.4	38.5	26.6	71.8	30.9	7,495	BB-	6.78	3.80
2014	5.0	-5.7	36.2	24.3	72.3	30.0	8,208	BB-	5.58	3.38
2015	5.0	-7.6	34.9	22.3	78.5	32.4	7,304	BB-	7.79	5.45
2016	4.5	-5.3	36.1	26.2	79.0	33.7	6,019	B+	7.02	4.52
2017	3.6	-5.5	40.0	28.6	77.9	35.4	7,959	B+	5.41	3.00
2018	3.3	-5.3	44.1	31.6	83.7	41.5	6,919	B	8.1	5.44
2019	2.3	-6.8	47.5	27.0	86.8	41.3	7,642	B	7.62	5.78
2020	-3.6	-11.1	71.4	32.2	101.0	40.4	5,665	B-	16.6	12.59
2021	5.0	-11.1	67.6	31.1	104.7	41.1	1,587	CCC /C	20.41	19.00

Large external financing needs: $4-5 Bn. annually. $26 Bn between 2022-2026 (Fitch)!

3. Solutions: What policy options do we have?

Policy Options – Grow out of Debt

Options	Pros	Cons
Growing out of Debt: - Continue to service debt. - Implement fiscal reforms to lower fiscal deficit and debt. - Implement sound macro-economic policies and obstacles for growth via structural reforms.	• Take control of the destiny on our own. • Maintain the unblemished record of debt service. • Achieve sustainable levels of fiscal deficit and debt with a robust economic growth trajectory.	• Given the severity of the deficit and debt, need very aggressive fiscal reforms which potentially inhibit economic growth. • Aggressive fiscal reforms potentially increase economic hardships to people. • Difficult to continually finance large foreign debt service \$ 4 to 5 Bn of debt annually through piecemeal funding. • Predicated on reforms success which depends on political commitment and policy stability. • Continued weak investor confidence and risk appetite. • If unsuccessful, high deficits, debt distress and low growth will continue. • Very low probability of success.

Policy Options – Actions of Last Resort!

Options	Pros	Cons
Debt moratorium: Delay in payment of debt obligations	• Buys time to repay. • Releases fiscal resources for development and growth. • Possible for bilateral and some multilateral loans.	• Considered a technical default for market debt. • Adversely affects further financing. • Debt problem reappears after the moratorium. • Need to be a part of a broader debt reforms strategy.
Debt default: Non-payment of debt obligations	• Removes the urgency to have funds to service debt. • Provides fiscal space.	• Triggers a full-blown debt, currency and economic crisis with extremely adverse socio-economic ramifications. • Damages investment environment and shuts-off from market access. • Takes years of debt restructuring and economic reforms before the country could access market. • Not a viable option.

Policy Options – IMF Program

Options	Pros	Cons
IMF Program: - Seek the IMF financial assistance to mitigate balance of payment problems. - Agree to an IMF Reforms Program with macroeconomic and structural reforms. - Implement reforms to lower fiscal deficit and debt and enhance growth.	• Provides support to meet debt service payments. • Provides a credible anchor to international investors. • Provides a chance to implement macroeconomic (fiscal & monetary) and structural (public sector, labor, welfare, product & service market) reforms. • May lead to fiscal sustainability and robust economic growth path.	• The IMF does not lend if debt is unsustainable based on a debt sustainability analysis. • Given the very high levels of deficit and debt, the probability that Sri Lanka's debt is considered unsustainable is very high. <u>So, this is unlikely to be an option by itself.</u> • Even a program becomes possible, it takes strong fiscal adjustment and possibly a longer period (and multiple programs) to achieve goals. • Country might have to implement difficult and unpopular reforms • Predicated on reforms success which depends on political commitment and policy stability. • Might not be possible / low probability of success by itself.

Policy Options – Debt Restructuring

Options	Pros	Cons
Debt rescheduling (debt reprofiling): Domestic and foreign debt - Extending maturity - Lowering interest rate	• Spreads the debt service burden across a longer period reducing annual debt service burden. • Lowers the interest burden. • Provides fiscal space for necessary reforms and growth.	• Adversely affects further financing for some time period. • Need to factor in the effect on the financial stability. • Difficulties in getting creditors to agree to terms.
Debt reduction: Reducing face value of debt - Debt forgiveness - Haircuts - Debt buyback at a discount	• Lowers debt burden permanently. • Provides fiscal space for reforms and growth. • Preemptive debt reforms is a quick way to achieve fiscal sustainability and avoid a messy forced default.	• Triggers a potential currency and economic crisis. • Further loss of investor confidence. • Shut-off from market access for a considerable period. • But debt restructuring is needed for the long-term financial stability and growth. • Needs to be accompanied by an IMF program.

4. Plan. Here is what Sri Lanka could do preemptively to avoid a messy default and a socio-economic catastrophe.

Rescue, Recovery and Growth: Four-Point Plan

- Economic Policy Board (National Economic Council)
- Broader Economic Reforms Plan
- Debt Restructuring Program
- IMF Program