Debt Crisis and Sustainability of Public Finance in Sri Lanka

Keynote Address

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Outline

- A brief overview of Sri Lanka's debt crisis
- Policies and measures required to achieve long-term sustainability in public finance in Sri Lanka

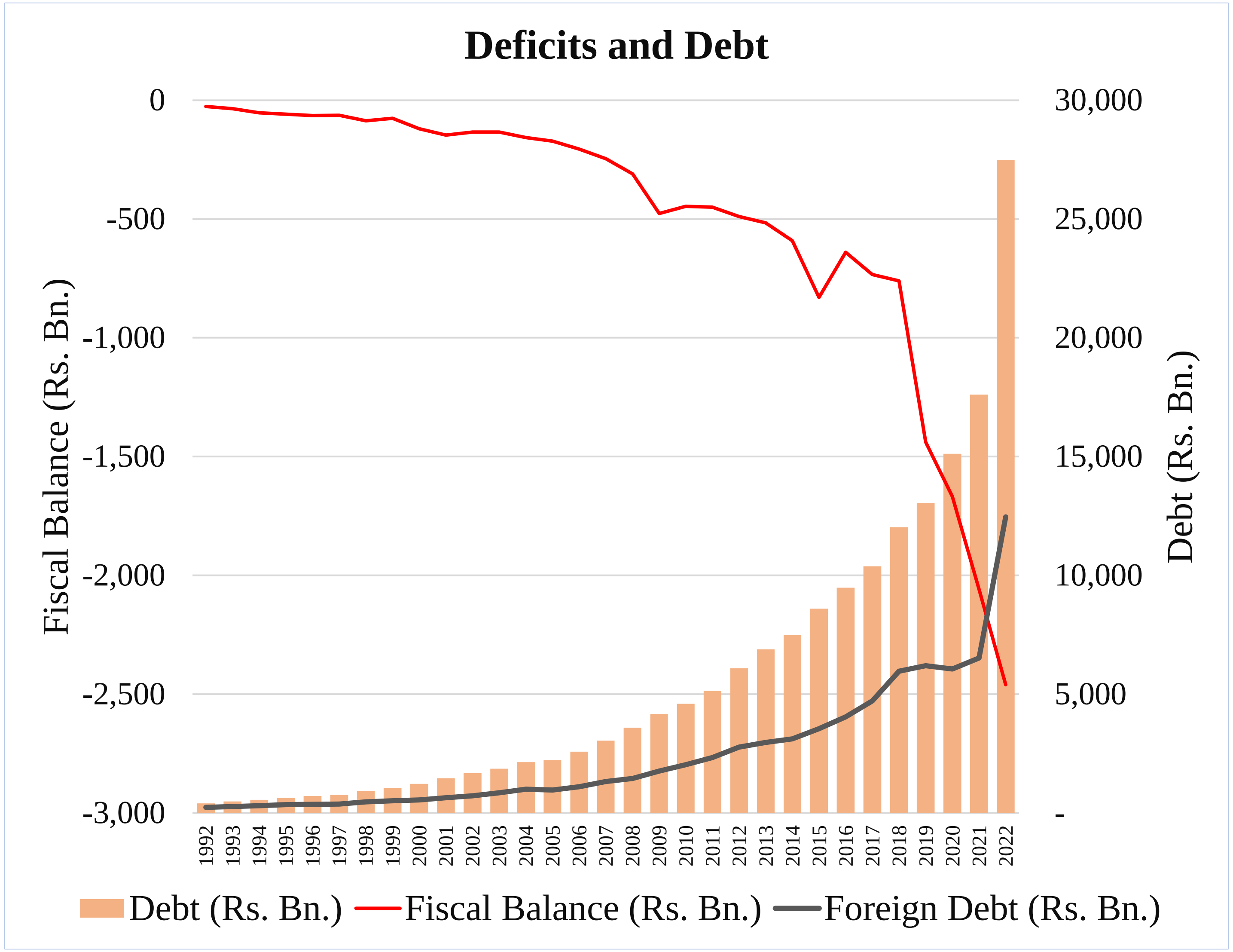
Debt Crisis

- Sri Lanka defaulted on payments on its foreign debt obligations by unilaterally suspending debt service payments on April 12, 2022.*

- This triggered an unprecedented economic (fiscal, debt, currency, BoP and inflation) and political crisis.

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

Deficits Led to Debt Accumulation



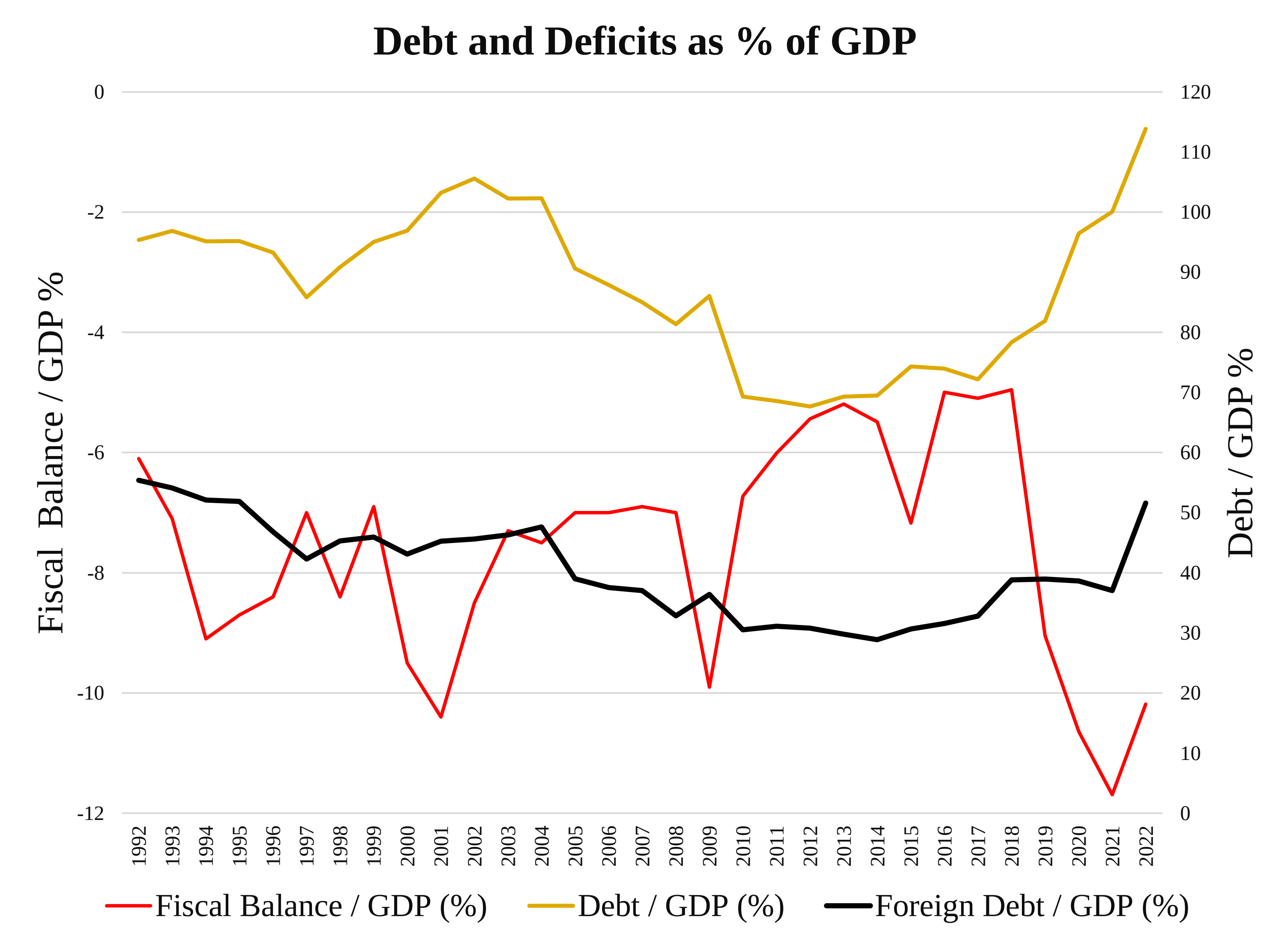
- Basic debt equation:
  Debt(t) = Debt(t-1) + Deficit(t)

- Budget deficits led to debt build-up. 2022 deficits and debt:
  - Deficit: Rs. 2,460 bn ($6.8 bn)
  - Debt: Rs. 27,492 bn ($76 bn)
  - Foreign Debt: Rs. 12,458 bn ($34 bn, 45% of TD)

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

- Correlation between the amount of debt and deficit is 97%

Deficits & Debt Disproportionate to the Economy



- As a % GDP in 2022:
  - Deficit: 10.2%
  - Debt: 114%
- Deficit averaged 7.6% in the past 30 years.
- Debt ratio averaged 88% in the past 30 years.
- Foreign debt ratio: 52% (EMDEs average 29%)

Large and unsustainable fiscal deficits and debt, compounded by the Covid-19 pandemic, set off a predictable chain of outcomes.

- Higher budget deficits
- Larger public debt
- Increasing reliance on foreign debt
- Covid-19 pandemic and economic downturn
- Cost of external borrowing increased
- Loss of international market access
- Low FX reserves – liquidity problem
- BoP crisis, currency collapse, rising inflation
- Eventually external debt default

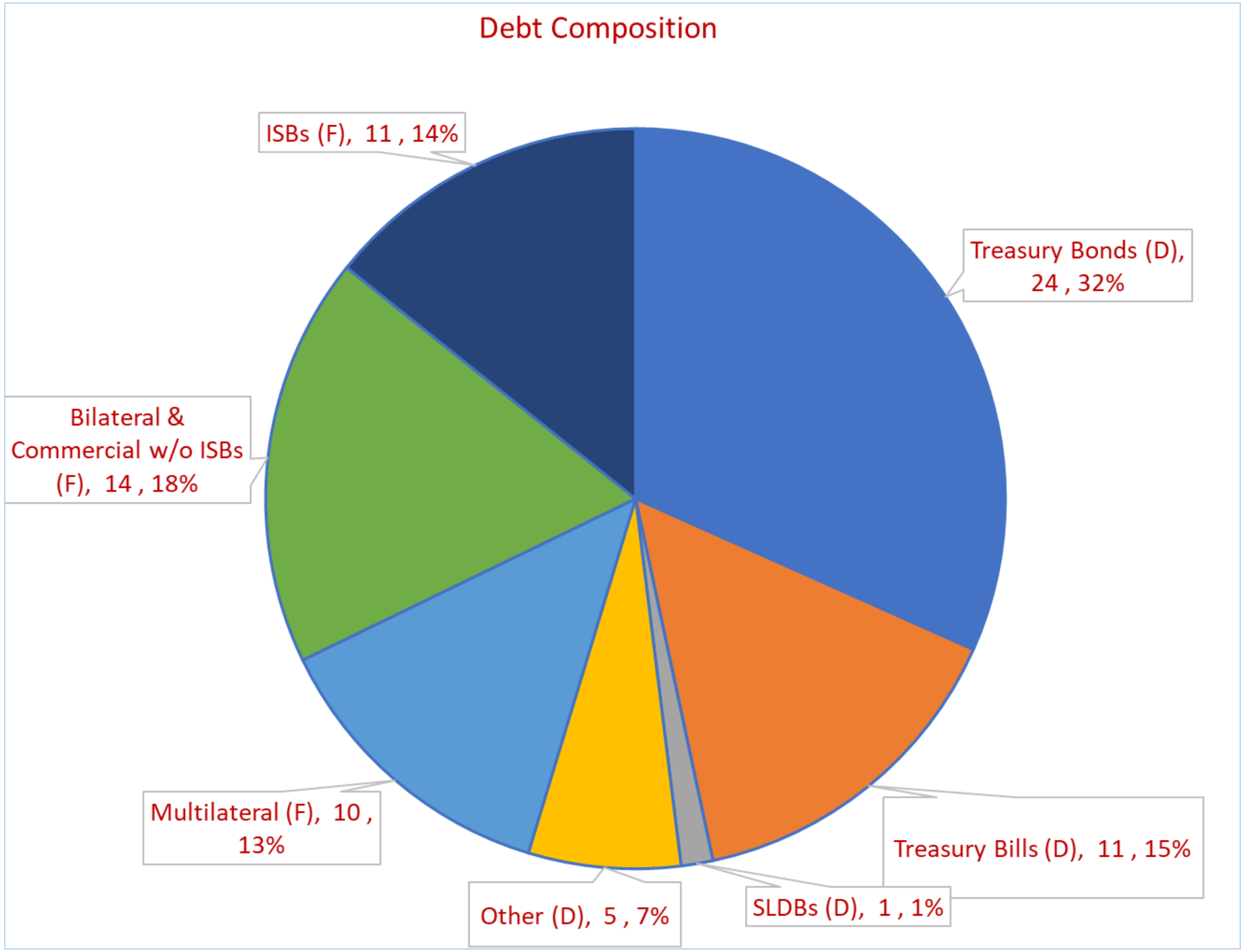
Policies and Measures Required to Address the Crisis

- Debt sustainability: Public debt is considered sustainable if the government can meet its debt payment obligations without restructuring and/or exceptional financial assistance.
  - Sri Lanka’s debt ratio in 2022 = 114%
  - Average debt ratio of Emerging Markets and Developing Economics in 2022 = 66%
- Fiscal sustainability: Fiscal policy is sustainable if the government can service debt obligations without changes in the fiscal policy.
  - Sri Lanka’s budget deficit in 2022 = 10.2%
  - Average budget deficit of Emerging Markets and Developing Economics in 2022 = 5.2%

Fiscal Policy

- Fiscal policy - Reduce the budget deficit
  - Revenue
    - Increase revenue (2022 R/GDP ratio: Sri Lanka 8.3% vs 26.5% EMMIEs) through a combination of broadening the tax base and increasing tax rates.
    - Improve tax collection efficiency: strengthening tax collection and enforcement mechanisms given the high incidence of tax evasion in the country. Mandatory tax filing requirement and digitization of tax administration.
  - Expenditure
    - Reduce and reprioritize expenditure (2022 E/GDP ratio: Sri Lanka 18.5% vs 31.8% EMMIEs)
    - Reduce unnecessary and duplicative government institutions, political and administrative structures, and non-priority areas.
    - Restructure/divestment of SOEs
    - Reduce excessive public sector employment
    - Reform ill-targeted social welfare and create welfare exit mechanisms

Debt Structure



Debt Policy

- Debt policy: Foreign debt restructuring
  - Foreign debt remains large. In 2022,
    - $34.3 billion
    - 45% of total debt
    - 52% of the GDP
  - Large external debt service payments: $4 Bn in 2021
  - Low and inadequate FX reserves: $1.9 Bn in 2022, $2.8 bn April 2023
  - Two main options:
    - Haircut: Principal reduction of commercial debt including International Sovereign Bonds (ISBs)
    - Reprofiling: Extend maturity, lower interest rates and extend grace periods of all debt including multilateral and bilateral debt

Debt Policy

- Debt policy: Domestic debt restructuring
  - A large stock of domestic debt: In 2022,
    - Rs. 15 Tr ($41 Bn)
    - 55% of total debt
    - 62% of GDP
  - Large interest payments on domestic debt. In 2021,
    - Interest payments on the domestic debt Rs. 794 bn ($ 4 bn)
    - 76% of total interest payments
    - 54% of revenue
    - 23% of expenditure
  - A haircut and reprofiling of domestic debt would also be necessary to achieve debt sustainability.

Debt Sustainability Analysis

- Standard debt sustainability analysis using the government budget constraint to project future debt under assumptions about economic growth, interest rates, inflation, primary balance and exchange rate.
- Uses assumptions in IMF Article IV Report (March 2023) for growth, inflation and primary balance. Other assumptions are specified appropriately based on best available data.

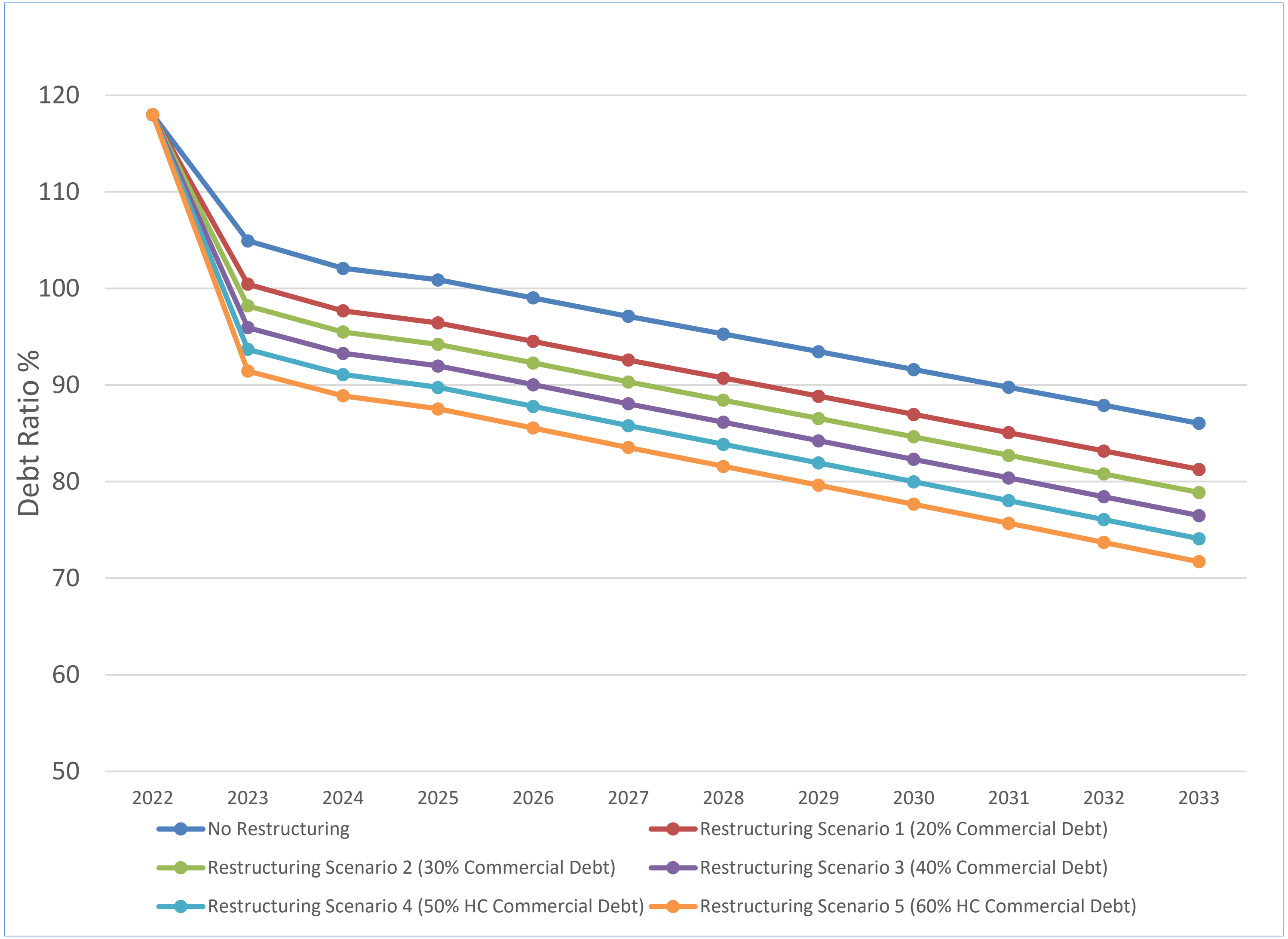
- Government budget constraint:

$$D_t = D_{t-1} + r_t D_{t-1} + PB_t$$

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

D_t = debt at time t
D_{t-1} = debt at t-1
PB_t = primary balance (-surplus/+deficit)
r_t = nominal interest rate on debt
g_t = nominal GDP growth rate

Haircut on Foreign Commercial Debt

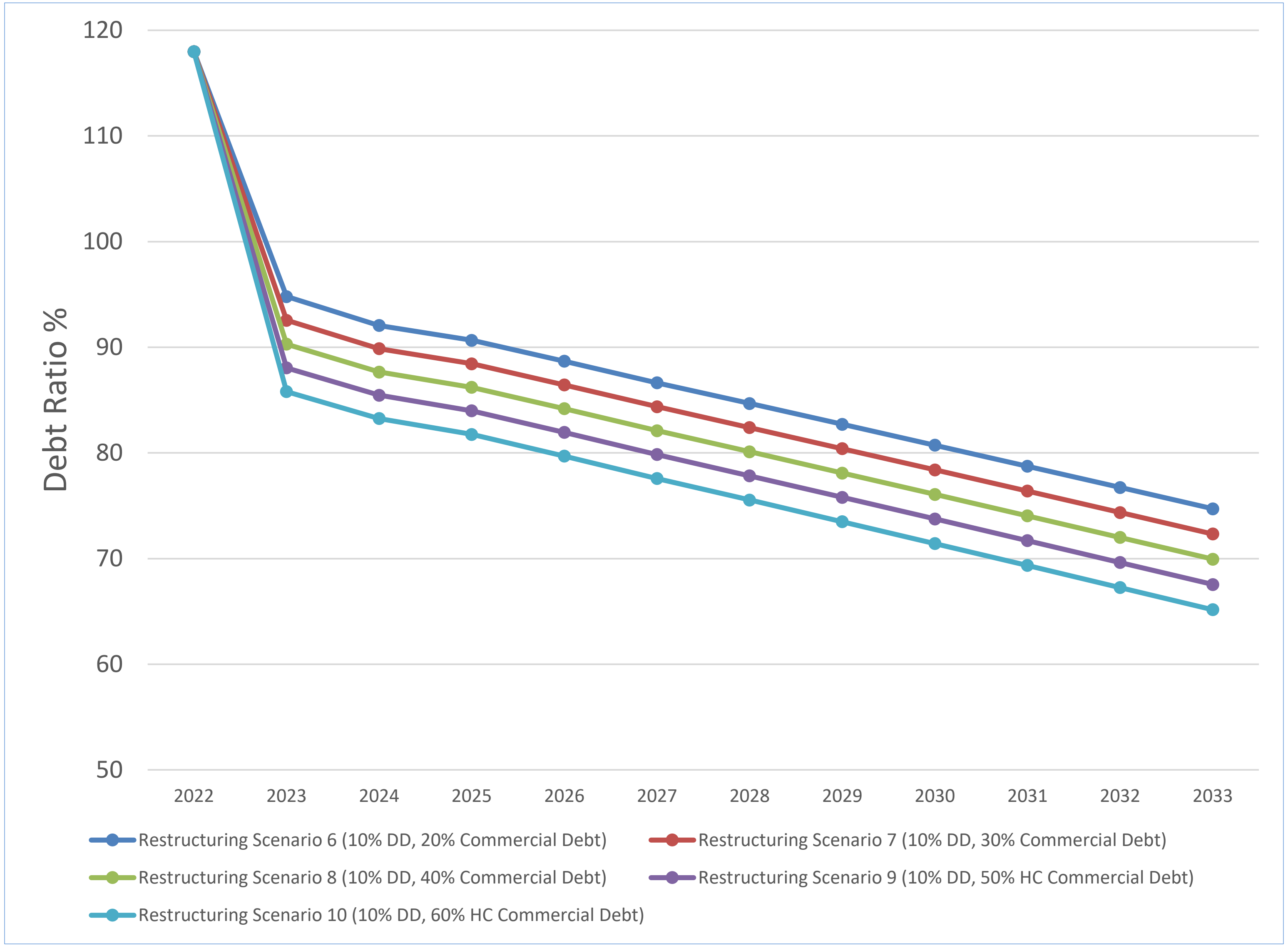


- No restructuring scenario: Continue default status, no payments on external debt except multilateral, interests accrue, no new external borrowings except multilateral. Proj. 2033 Debt Ratio 86%

- Restructuring scenarios:

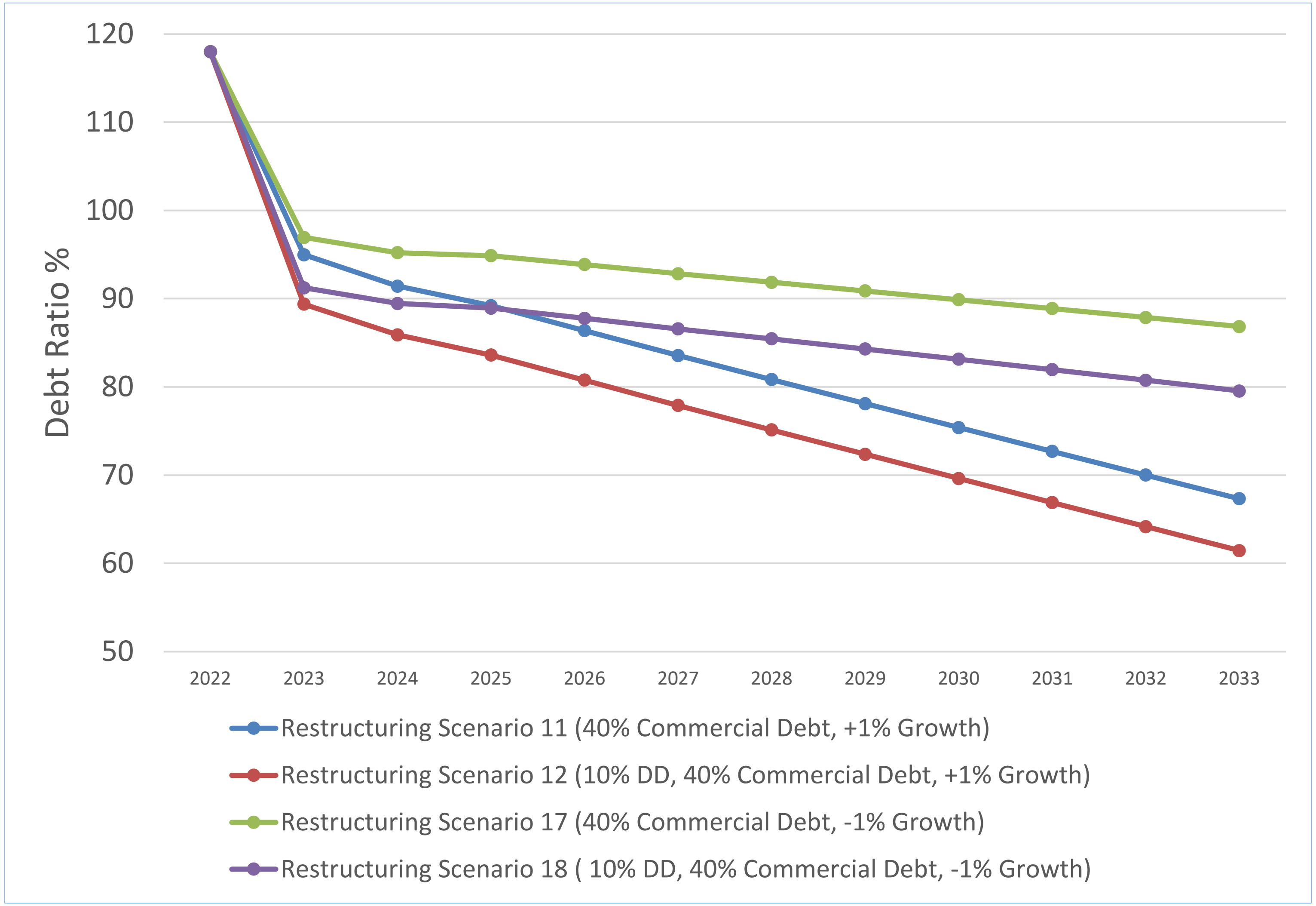
HC %	Reduction $ Bn	% FD	% TD	Proj. 2033 Debt Ratio
20	4.6	10.2	4.8	81
30	6.8	15.3	7.2	79
40	9.1	20.4	9.6	76
50	11.4	25.4	12.0	74
60	13.7	30.5	14.4	72

Haircuts on Foreign Commercial & Domestic Debt

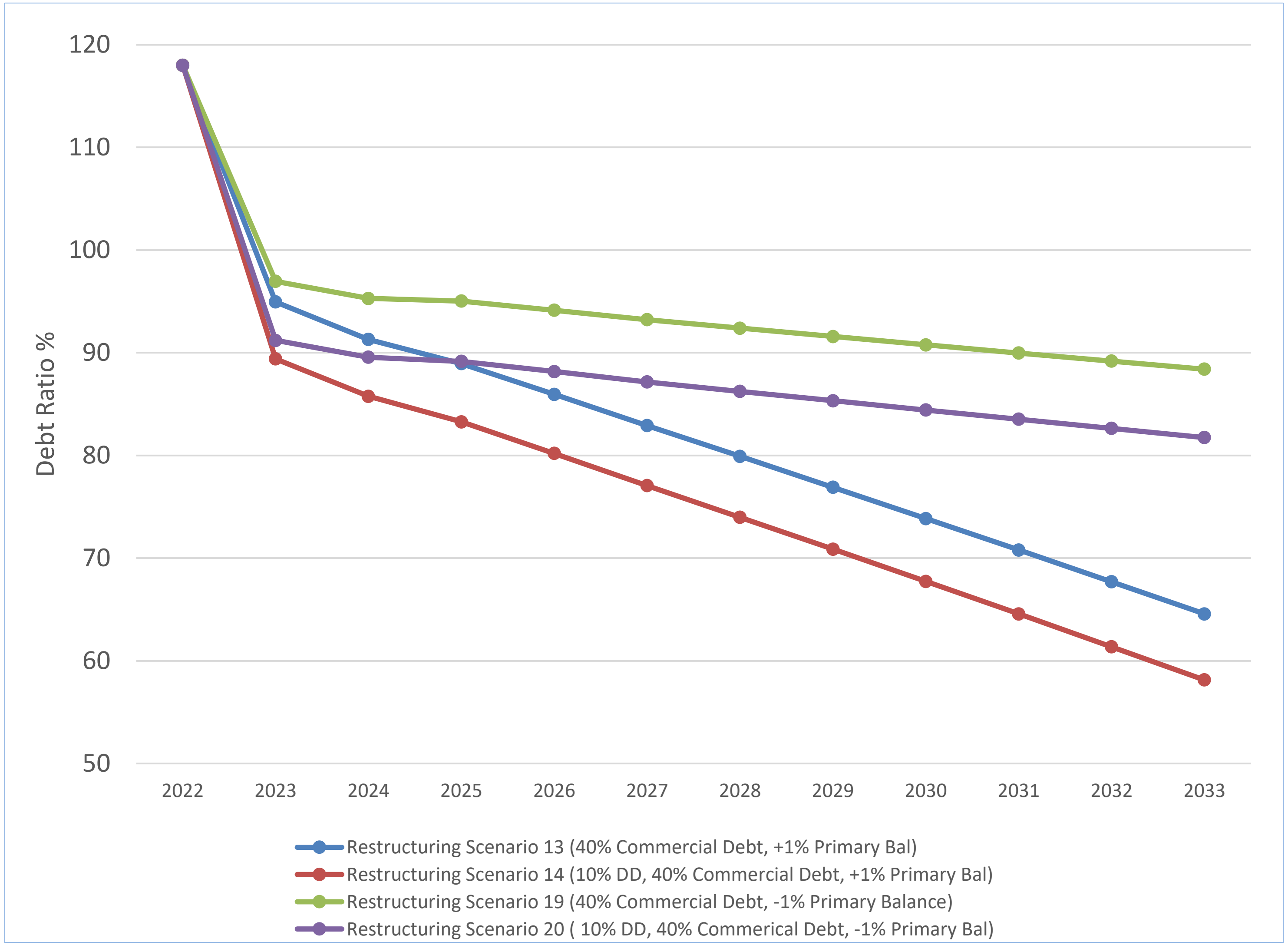


HC% FD, DD	Reduction $ Bn	% TD	Proj. 2033 Debt Ratio
20,10	10.3	10.8	75
30. 10	12.6	13.2	72
40, 10	14.9	15.7	70
50, 10	17.1	18.1	68
60, 10	19.4	20.5	65

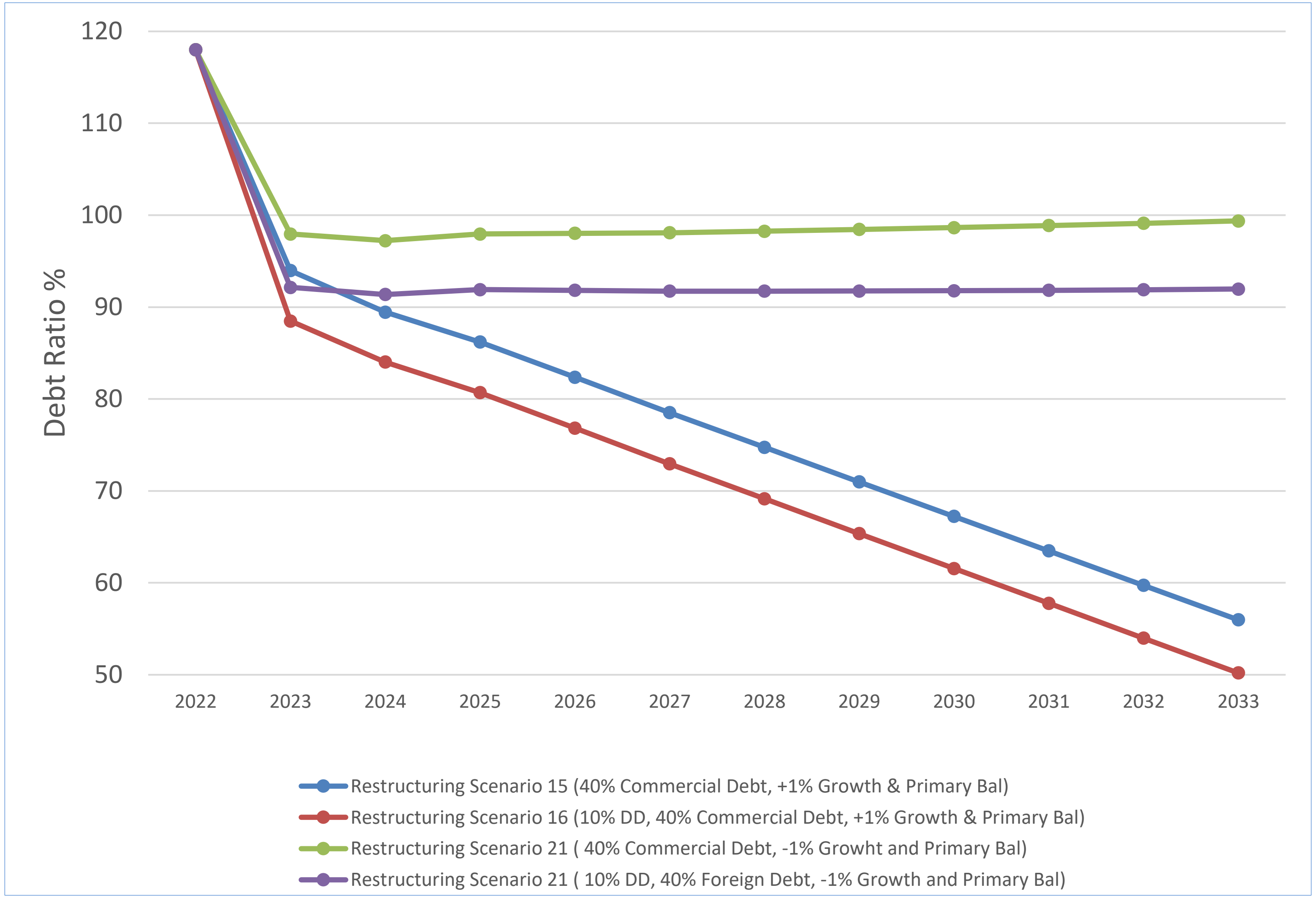
Haircuts on Foreign Commercial & Domestic Debt Plus 1% Growth Shock



Haircuts on Foreign Commercial & Domestic Debt & 1% Primary Deficit Shock



Haircuts on Foreign Commercial & Domestic Debt & 1% Growth and Primary Deficit Shocks



Structural Reforms

- Structural reforms: Tackle impediments to growth and improve productivity, investments, output and employment.
  - Trade reforms: Export diversification and promotion
  - Investment reforms: Attract foreign investments (FDI) and increase domestic investments
  - Infrastructure development-transportation, energy, communication
  - Industrial and SME development
  - Tourism development and promotion
  - Increase productivity of labor and capital
  - Technology and innovation: Adapting new technology and digitization
  - Education and training: reforms to develop human capital with relevant knowledge and skills
  - SOE reforms -restructuring and divestment- to make them efficient and financially viable.
  - Welfare reforms – better targeting and exit mechanisms
  - Financial market development
  - Pension reforms

Policy Making and Implementation

- Establish a credible and coordinated mechanism for economic policy formulation and implementation
  - Establish a long-term national economic plan
  - Establish an institutional mechanism for policy formulation and implementation

- IMF program is not going to solve the crisis. It could bring short-term stability and increase investor confidence.
- Reforms will need to be prudently selected and appropriate for the socio-economic conditions and the stage of development of Sri Lanka.
- Reforms must be implemented by Sri Lanka expeditiously.
- Must create conditions for Sri Lanka to break from the deficit-debt spiral and grow out of debt in the long term, which requires higher and sustained economic growth.

Thank You!