What Broke the Pearl of the Indian Ocean? Causes of the Sri Lankan Economic Crisis and Policy Implications

Lalith P. Samarakoon

Annual Research Forum
Opus College of Business, University of St. Thomas
March 17, 2023

The Event: Debt Default

- Sri Lanka defaulted on payments on its $32 Bn foreign debt obligations on April 12, 2022.*

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

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

Objectives of the Paper

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

- What are the main policy implications arising from the crisis?

Overview of the Crisis

Slower & declining growth

- GDP growth of 1.7% in the five years before crisis (2017-21)
- Expect -9% in 2022

High deficits and debt

- 21 Fiscal balance -$10 bn (-11.6% of GDP: MIE -5.3%)
- 21 Public debt $88 bn (100% of GDP: MIE 64%)

Balance of Payments & Liquidity Crisis

- 21 Current account balance: -$3.3 Bn (-4% of GDP: MIE 0.8%)
- FX reserves $3.1 Bn or 1.8 months of imports (3 months is benchmark)

Currency Crash

- Rupee plunged by 45% in 2022

  (25% or higher is a crisis)

Inflation Crisis

- Annual inflation rose to 70% in Sep 2022, 57% in 2022. (40% or higher is a crisis)

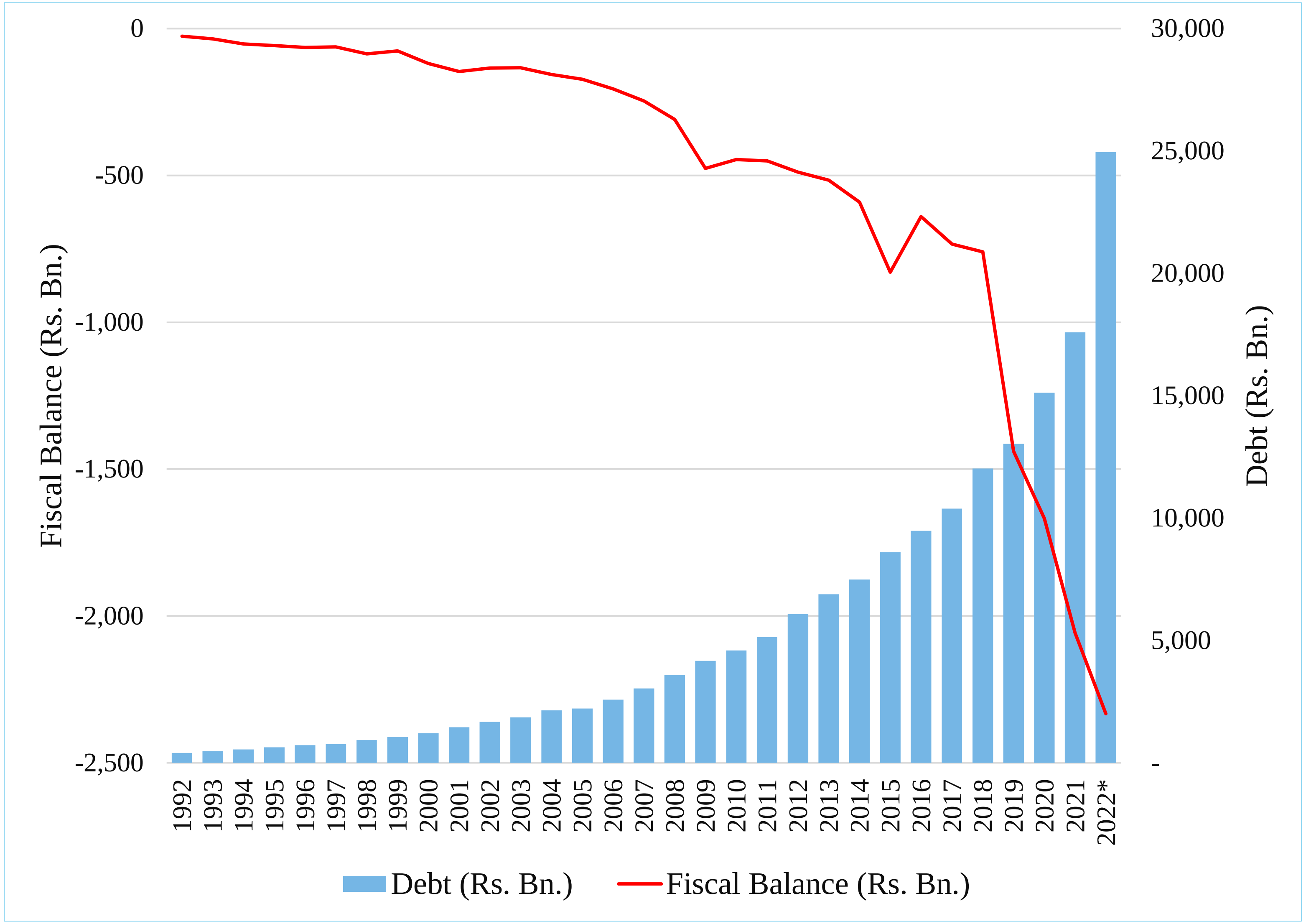
Loss of International Market Access

- Credit downgraded to default
- ST Sovereign bond yield peaked at 159% in Nov 2022. 140% in Dec 22.

IMF Assistance

- Sought IMF loan in March 2022.
- Staff-level agreement for $2.9 Bn, 4-yr loan in Sep 2022.

Deficits Led to Debt Accumulation



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

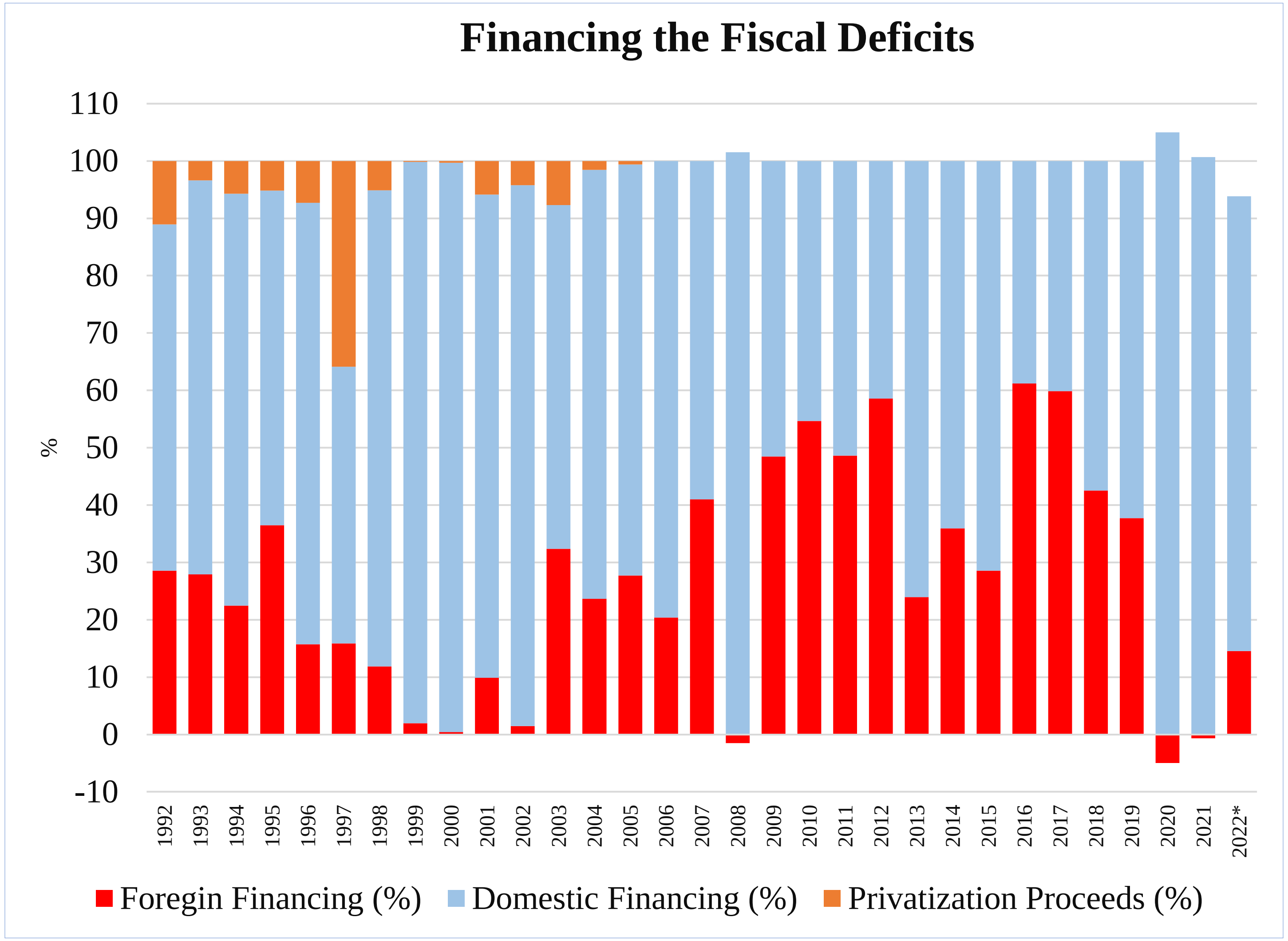
- Budget deficits led to debt build-up. 2021 deficits and debt:
  - Deficit: $10 bn (11.6%)
  - Debt: $88 bn (100%)

- Treasury bond issuance began in 1997 and opened to foreign investors in 2007.

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

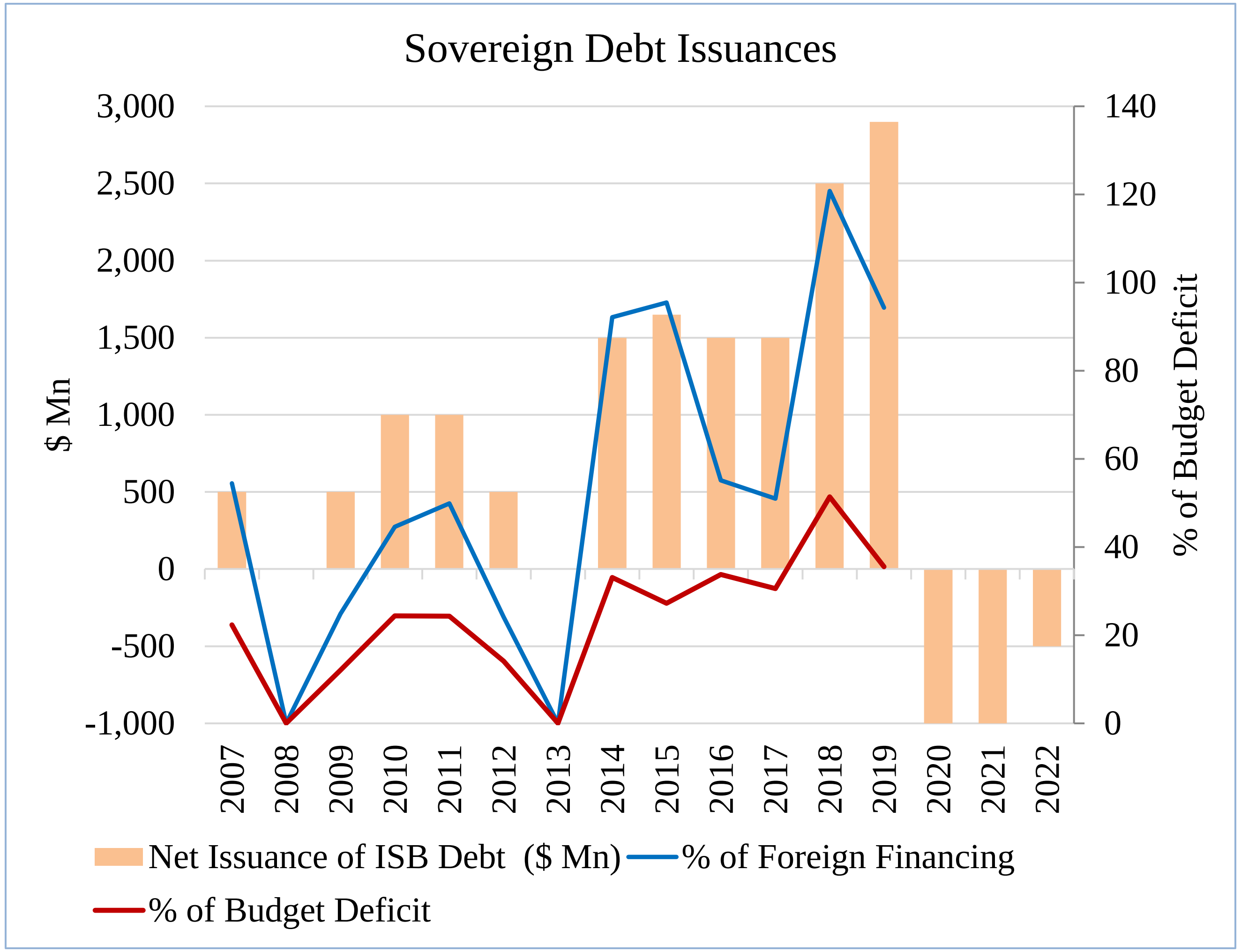
- Correlation between the amounts of debt and deficit is 97%

Deficits Financed Increasingly by Foreign Borrowings



- International original sin (the denomination of external debt in foreign currency)
- % of foreign financing: 4 yrs (2016-2019): 50%
- Foreign debt reached 50% of debt by 2018.
- 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

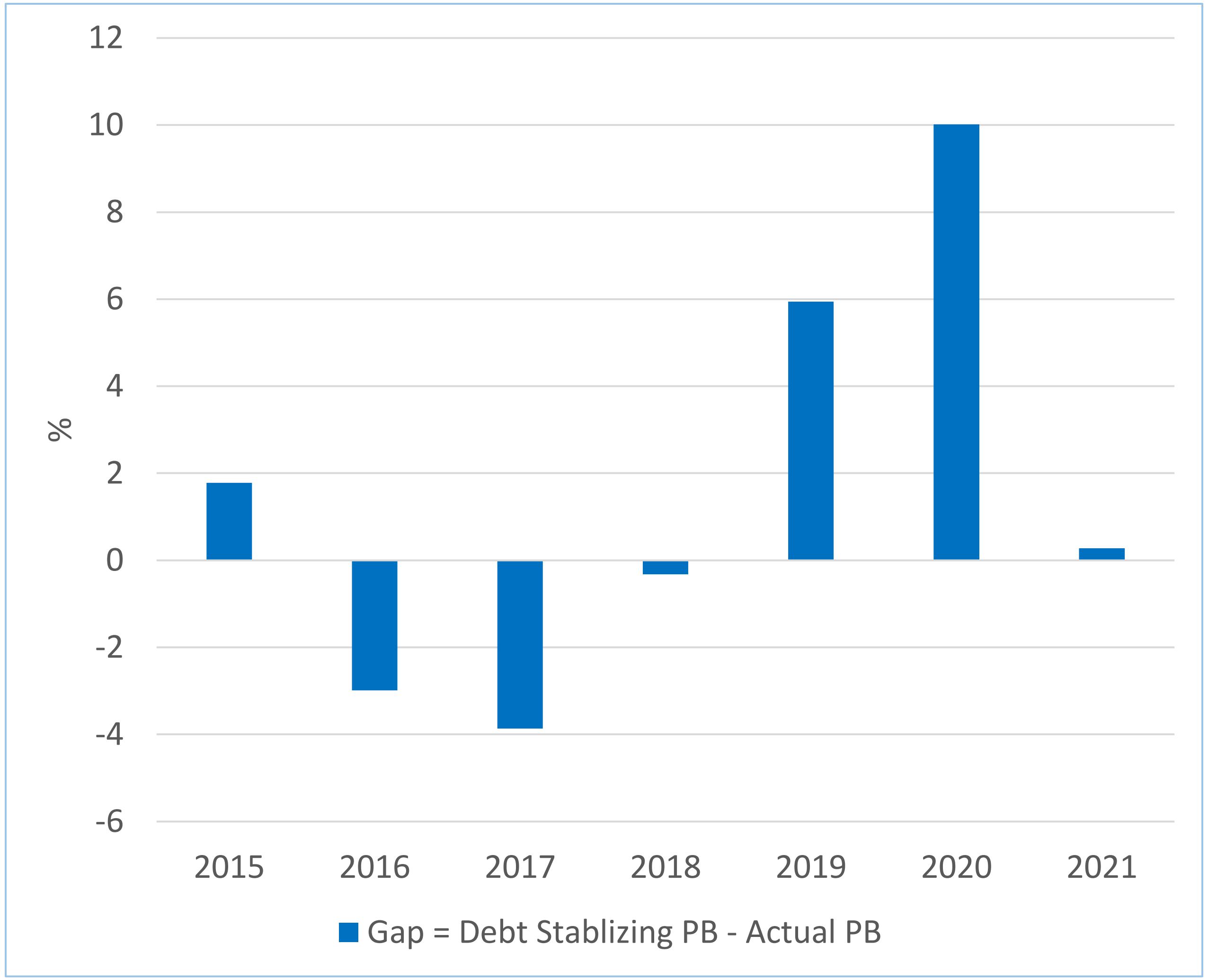


- Since 2007, SL issued ISBs worth $17.55.
  - $12.05 bn raised in the 5 years of 2015-2019.
  - $6.9 bn in the 2 years of 2018 & 2019!

- 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.

Debt Sustainability Analysis: Unsustainable Public Debt



- 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 5.7% and actual pb of -4.3%, gap of 10%

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 (%)
2015	7,304	7,653	4,772	3,580	95.4	4.6	153.1	38.6	387.9	133.7
2016	6,019	7,343	4,461	3,243	82.0	3.8	134.9	31.4	345.5	120.7
2017	7,959	7,833	4,566	3,167	101.6	4.6	174.3	37.9	344.7	145.3
2018	6,919	8,029	5,866	4,188	86.2	3.7	118.0	31.1	249.0	99.3
2019	7,642	8,250	5,757	4,096	92.6	4.6	132.7	38.3	414.7	128.7
2020	5,665	8,195	4,604	3,004	69.1	4.2	123.0	35.3	477.3	135.2
2021	3,138	8,417	4,498	3,111	37.3	1.8	69.8	15.2	94.6	48.8

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

Summary of Major Policy Implications

- Debt: debt restructuring (haircut and reprofiling)
- Fiscal: fiscal consolidation (austerity)
- Trade and investment promotion
- Exchange rate: flexible exchange rate
- Structural reforms: Grow out of debt

Details of Major Policy Implications (Reforms)

- Debt: debt restructuring (haircut and reprofiling)
  - 50-60% haircut on external commercial debt
  - Extend maturity and lower interest
  - Reduction of bilateral debt

- Fiscal: fiscal consolidation (austerity)
  - Increase revenue reforms (R/GDP ratio: Sri Lanka 8% vs 26% MIEs)
  - Reduce and reprioritize expenditure (E/GDP ratio: Sri Lanka 20% vs 31% MIEs)
  - Improve tax collection efficiency
  - SOE reforms
  - Social welfare reforms

Major Policy Implications

- Trade and investment: export and investment promotion
  - Export diversification
  - Tourism promotion
  - Import rationalization
  - Investment liberalization
  - Export-oriented FDIs

- Exchange rate: flexible exchange rate
  - Minimize disorderly currency volatility
  - Return to market-determined (managed float)
  - Gradually unwind currency controls

Major Policy Implications

- Structural reforms: Grow out of debt
  - Diversification of the economy
  - Increasing domestic production to reduce reliance on imports
  - Increase capital investments
  - Increase productivity of labor and capital
  - SOE reforms