Sri Lanka's Crisis: Default by Mismanagement

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Introduction

With usable foreign currency reserves of the Central Bank at near-zero levels[1] and further external debt repayments looming, including $78 million[2] in coupon payments of the 2023 and 2025 International Sovereign Bonds (ISBs) on 18 April, the Sri Lankan authorities announced a unilateral suspension of external debt repayments on 12 April 2022[3]. When the 30-day grace period on the suspended ISB coupon payments ended on 18 May, Fitch and S&P moved Sri Lanka's sovereign credit rating to Restricted/Selective Default. It is the first time that Sri Lanka is facing a sovereign default since independence.

The Consequences of Mismanagement

While the default on external financial obligations was only announced in April 2022, in the preceding months the Sri Lankan sovereign was gradually defaulting on some segments of the economy and society. Foreign payments were increasingly difficult from the second half of 2021 and importers were finding it challenging to clear letters of credit (LCs) through the banking system given the depleting foreign currency liquidity. By late 2021, multi-hour electricity cuts were the norm and by March 2022 there were long queues for fuel and cooking gas.

Despite these troubling developments, till February 2022 the former Central Bank Governor Ajith Nivard Cabraal was insisting on the importance of servicing external debt[4] and assuring of arrangements for financing after using depleted reserves to pay a $500 million ISB that matured in January. But the only lifeline came from India, which granted a $400 million currency swap and a $512 million deferment in Asian Clearing Union (ACU) trade liabilities in January followed by $1500 million in credit facilities for imports in March.

While pressure from India played a part in forcing a change in tone towards IMF, debt restructuring and reforms in March, it was the protest on the streets that really forced the government to act. On 31 March, peaceful protests turned violent near President Gotabhaya's private residence in a Colombo suburb. The cabinet of ministers and other major decision makers resigned, leading to a wholesale change in the economic decisionmakers, including the return of a former Central Banker in retirement in Australia as Governor of the Central Bank. What followed was a frantic April, with policy interest rates hiked 750 basis points, debt payments suspended, initial talks with the IMF in Washington D.C.[5] and expenditure rationalization[6].

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[1] "As of now, the usable liquid reserves are at negligible levels" - Former Minister of Finance Ali Sabry - 04 May 2022 - The Hindu

[2] Author calculation based on Central Bank of Sri Lanka data

[3] Multilateral debt service payments continue. Source: Ministry of Finance. 2022. Interim Policy Regarding the Servicing of Sri Lanka's External Public Debt. Colombo.

[4] Sri Lanka has foreign lenders' interests 'at heart': central bank - 21 Feb 2022 - Nikkei Asia

[5] Recent Visit of the Sri Lankan Delegation to Washington DC to attend IMF/World Bank Spring Meetings

[6] Ministry of Finance. 2022. Fiscal Sector: Present Situation and Way Forward. Colombo

However, political instability continues to impede the pace of policy action. April's new Cabinet of Ministers resigned on 09 May following violent protests in response to thugs associated with the governing Rajapaksa-led political party attacking peaceful protestors in front of the Presidential Secretariat. While Ranil Wickremasinghe, an MP from an opposition party with a single seat in Parliament, was appointed a few days later as Prime Minister for a sixth time, the political crisis delayed the appointment of the financial and legal advisors for debt restructuring and finalizing of further financing facilities. Meanwhile people are suffering; fuel queues continue, the currency has depreciated over 75% since 07 March (when it was floated), inflation touched 39.5% year-on-year in May and interest rates are over 20%.

Long-term Mismanagement

Economic mismanagement is not a new phenomenon to Sri Lanka. It has been a perpetual twin deficit economy, with persistent deficits on both the external current account and fiscal balance. Government revenue was over 20% of GDP until 1996, but it has gradually declined to a low of 8.3%[7] in 2021. Government expenditure has reduced as a share of GDP during this period, but fiscal deficits have been above 5% of GDP since 1990. Sri Lanka also has a long-standing tendency to provide open-ended subsidies, with the most prominent in recent years being below cost pricing for fuel and electricity sold by state-owned enterprises.

With persistent deficits to finance, this is also not the first period in which government debt surpassed the 100% of GDP level; it has done so previously in the late-1980s and early 2000s as well. What is different this time around is the composition of external debt. Following the 1997 upgrade to lower-middle income country (LMIC) status, Sri Lanka gradually lost access to most concessional financing. Therefore, the domestic infrastructure and consumption driven growth strategy of the first Rajapaksa government (2005-2014) was financed by a rapid increase in commercial borrowings from external creditors. Prominent amongst the new commercial borrowings were ISBs, and loans from EXIM Bank of China. The prioritization, investment case and modality for several infrastructure projects have been questionable especially those built in Hambantota, the home district of the Rajapaksa family (which led the government from 2005 to 2014 and again since November 2019).

Export growth was well outpaced by overall economic growth with this growth strategy. As a share of GDP, exports of goods and services dropped from 37.2% in 2000 to 16.8% in 2021. While growth in remittances provided some cushioning, this trend on exports meant that Sri Lanka's growth has been highly dependent on continued access to foreign capital inflows. Given the persistently low FDI levels Sri Lanka has managed to attract, this has meant dependence on debt inflows with the largest foreign borrower being the government accounting for $32.3 billion of the $55.8 billion in outstanding external debt at end-2021[8]. By 2021, commercial borrowings were 44.7% of government external borrowings, rising from just 4.4% in 2006[9]. The result has been rising government external debt service obligations which were forecast to be $4-5 billion a year in the 2021-2025 period[10], with ISB maturities every year.

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[7] Share of GDP figures for years after 2010 have been calculated by the author based on the latest GDP series with 2015 as base year introduced in June 2022. Source: Department of Census and Statistics, Sri Lanka

[8] Central Bank of Sri Lanka - External Sector statistics

[9] In 2019, the share of commercial debt peaked at 50.3%. Source: Central Bank of Sri Lanka. 2022. Annual Report 2021. Colombo.

[10] Ministry of Finance. 2021. Annual Report 2020. Colombo.

The risks created by this situation were understood in the period from 2016 to 2019 when Sri Lanka was within an IMF Extended Fund Facility (EFF) program. Several policy measures were taken including tax reforms and fuel pricing formula, which allowed the fiscal situation to improve with primary balance surplus of 0.6% of GDP with government revenue at 12.6% in 2018. But most of these measures were reversed or ignored following the change to a new Rajapakse-led government in November 2019.

Mismanagement since November 2019

The latest rebased GDP series shows the GDP contracted 0.2% in 2019, so it makes sense that Sri Lankan authorities engaged in monetary easing since May 2019, after the Easter Sunday terrorist attacks in April 2019, and introduced large tax cuts in November 2019 hoping to support economic recovery. Sri Lanka could have reversed course during the early stages of the pandemic had it re-engaged with the IMF for emergency financing via a Rapid Financing Instrument (RFI). But the government was unwilling to reverse its tax cuts nor do a preemptive external debt restructuring despite a further 3.5% GDP contraction in 2020. Thus, the easing measures were sustained throughout the COVID-19 pandemic, with the government hoping a recovery in growth will strengthen fiscal balances over time.

But Sri Lanka's existing macroeconomic fragility meant that monetary and fiscal easing over a prolonged period was highly imprudent. In downgrading Sri Lanka's sovereign credit rating in 2020 and 2021, credit rating agencies highlighted these concerns. The loss of access to international capital markets to refinance maturing ISBs meant that Sri Lanka kept running down its foreign currency reserves, from $7.6 billion at end-2019 to $3.1 billion at end-2021. Adding on to the reserve depletion was the decision to keep the Sri Lankan Rupee pretty much pegged around the 200/$ level from April 2021 to Feb 2022, with the central bank selling down its dwindling forex reserves to maintain the Rupee value against the US Dollar.

With the massive loss in tax revenues from December 2019 onwards, the government revenue ratio fell to 8.3% of GDP and the fiscal deficit rose to 11.6% of GDP by end-2021. This rising deficit had to be fully financed from domestic borrowings. But the domestic financial system was unable to significantly increase its share of lending to the government and the low interest rate regime was largely maintained. So, the central bank directly financed the fiscal deficit by purchasing government securities at primary auctions. The central bank's holdings of government securities, a proxy for direct financing, has increased exponentially from LKR 75 billion at end-2019 to LKR 1971 billion at end-May 2022. Thus, a dangerously inflationary form of fiscal financing was utilized while neither taxes nor interest rates were raised until recently.

Amidst all this mismanagement, the government also embarked on a disastrous organic fertilizer policy by banning the import of all chemical fertilizer and weedicides/insecticides in May 2021. Agriculture output, including the staple cereal rice, has dropped causing food prices to increase. While this ban has since been gradually relaxed, the country is currently unable to finance fresh fertilizer imports and has to finance food imports amidst rising global prices. By the time the Rajapaksa government realized it had to reverse course on economic policies in March 2022 it was much too late; two years of bad policy and mismanagement had done permanent damage to the economy and its prospects.

When the rupee was allowed to float on 07 March it was done without any credible central bank backstop nor sequencing of policy; there were neither sharp rate hikes nor IMF talks preceding the move. Thus, the exchange rate depreciated rapidly from around 200/$ to be around 360/$ in May. The impact of this massive depreciation has combined with the global price escalation and shortages locally -

due to difficulty in importing and reduced agricultural output - have caused inflation to reach 39.5% in May. It is expected to rise further in the coming months, with electricity tariffs yet to be revised upwards to match costs since 2014.

The Way Forward

Sri Lanka is in talks with the IMF for a new Extended Fund Facility program and has appointed legal and financial advisors for debt restructuring[11]. But both processes will take many months to be completed. The immediate priority is working with bilateral and multilateral partners for emergency financing to import essential goods including fuel, cooking gas, medicines, fertilizer and food. India has been a gracious neighbor and multilaterals, including the World Bank[12], are repurposing already committed project financing for importing essentials and cash transfers to the vulnerable. The government has also rolled out expenditure cutbacks, focused on reducing capital expenditure, and announced tax hikes[13] which largely returns Sri Lanka to the policies prevalent prior to the November 2019 tax cuts.

Yet, all of the above are measures vital to merely keep Sri Lanka's people and economy in survival mode. Neither an IMF program nor a comprehensive debt restructuring will put Sri Lanka on a sustainable path of economic recovery and prosperity. Both are simply measures required to regain access to the global financial system and to at least settle import LCs without issue.

The crisis has brought people from diverse backgrounds together to protest the mismanagement, creating another opportunity for deep reforms to the political system, public sector, economic structure and the overall business environment. Sri Lanka has a history of failing to make use of such opportunities in the past. Another failure over the coming few months and years risks keeping Sri Lanka in a cycle of debt distress with continued rounds of IMF programs and debt restructuring.

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[11] Appointment of International Financial and Legal Advisors for Restructuring of External Public Debt Restructuring of the Government Democratic Socialist Republic of Sri Lanka

[12] World Bank Statement on Sri Lanka - 24 May 2022

[13] Sri Lanka hikes tax rates to maximise government revenues - 31 May 2022 - The Hindu