

# **LOCAL CURRENCY DEBT DEFAULT IN SRI LANKA**



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## **Introduction**

Until 1978, Sri Lanka was predominantly an agriculture-based economy. During the 1970s, industrialization started picking up due to government-led investment and bilateral investments. Despite government investments, the Sri Lankan economy was plagued by high inflation and product scarcity, stemming from the supply-side shock caused by the oil embargo imposed by OPEC countries. In the early 1970s, Sri Lanka was not indebted to foreign countries due to strict trade and capital controls, along with policies geared towards a production-based economy.

Similarly, an increase in domestic money supply (money printing) wasn't possible without depreciating the domestic currency since the rupee was pegged to the dollar under the Bretton Woods System. However, in 1978, the victorious President of the United National Party embraced free-market ideology, opening the economy overnight. The Sri Lankan rupee was depreciated by 100% within 24 hours, marking a new chapter in Sri Lankan history. Around the same time, the world witnessed the termination of the Bretton Woods System unilaterally by the United States of America.

The liberalization of trade policies led to rapid deindustrialization in an economy that was still in its infancy. Subsequent liberalization of the capital account and domestic financial markets fueled consumerism, asset price inflation, and a balance of payment deficit. The liberalization of the capital account allowed the private sector to borrow in foreign currency, with banks and state-owned enterprises (SOEs) attracting significant inflows of foreign currency since 1978.

Even though the foreign inflows were a significant boost to the economy from the outset, the productive capacity of the economy gradually declined to below 30% of the GDP. It is true that GDP growth was accompanied by an even more rapid growth of imports, so the balance of payment current account deficit was rapidly rising. According to the Auditor General, these banks and SOE borrowings do not get recorded in the state accounts, suggesting that the total foreign debt could be larger than accounted for by the government, significantly reducing the degree of monetary sovereignty in Sri Lanka.

The Easter Attack, the so-called terrorist attack in 2019, significantly increased foreign capital outflow, triggering a balance of payment crisis by 2022. As a result, the rupee lost half of its former value, inflation skyrocketed, and finally, Sri Lanka defaulted on its foreign debt. Subsequently, IMF-led foreign creditors enforced Sri Lankan government default on domestic debt in order to start the negotiation for a foreign debt restructuring process.

## **The Events Leading to the Domestic (Local Currency) Debt Default**

As a country, our balance of payment account has been in deficit since 1978. Persistent current account deficits, along with borrowings for unsuccessful infrastructure projects, have resulted in a massive foreign debt pile larger than Sri Lanka's GDP. In 2019, when the country was in this dire economic situation, the Easter attack, a so-called 'terrorist attack,' occurred, killing more than 300 people and injuring thousands. To date, there is no evidence for the existence of such a terrorist group. According to the common view of citizens, this was a politically motivated attack to regain power.

The aftermath of the attack saw our foreign currency-denominated bond prices collapse in the international market in late 2019. This incident triggered an unexpected foreign capital outflow from the country. Similarly, creditors declined to advance any new foreign loans, and there was no demand for potential new foreign bond offerings since late 2019. A combination of these events began to take its toll on foreign reserves, which started declining steadily around the same time. This decline was further accelerated by the lack of tourism due to the Easter attack.

Unfortunately, the economic misfortunes related to the Easter attack were followed by government-enforced lockdowns due to the Covid-19 pandemic, plunging the economy into a prolonged crisis. Exports declined, while essential imports accelerated to feed and medicate the locked-down nation, further increasing the current account deficit. The weakening of foreign reserves depleted the value of the rupee by half, pushing the rupee exchange rate from LKR 180 per USD to 360 per USD by mid-2022.

Ironically, up to mid-2022, Sri Lanka made no attempts to renegotiate the terms of settlement with foreign creditors. During this period, foreign currency outflow accelerated due to the liberalization of capital controls, shrinking usable foreign reserves to USD 50M and forcing Sri Lanka to default debt in mid-2022. Since then, IMF-led negotiations with foreign creditors have been ongoing.

Foreign creditors are now enforcing the Sri Lankan government to restructure domestic debt first, before starting the foreign debt restructuring process. Additionally, during this period, there has been a significant drop in tax revenue and an increase in government expenditure in response to policy measures taken to combat the impact of the Covid-19 pandemic on the economy. These measures have significantly increased the government deficit, or in other words, the government has increased the money supply (printed money). Sri Lanka's government deficits have historically resulted from transfer payments, government salaries, and interest payments.

Historically, deficits were never the government's own initiatives to develop the productive capacity of the country or address any other important socio-economic matters; they were merely the results.

## Sri Lankan Economic Indicators

### Sri Lankan GDP

Aftermath of the debt default, economy is contracting because of two main reasons, lack of demand due to lack of disposal income (excessive taxing, high-cost living, etc..) and lack of funding flows to generate investments (rapid decline in foreign funding, local private credit growth in negative territory).

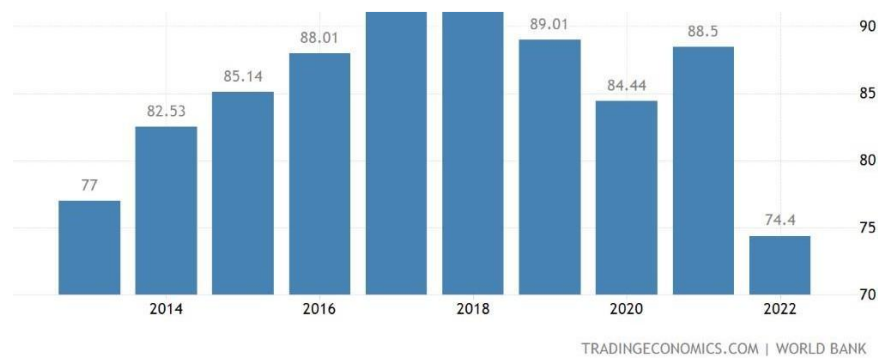


Figure 1: (Trading Economics, n.d)

### GDP Growth (Annual %) – Sri Lanka

There is a clear trend of contraction in GDP since 2019. The slight recovery in GDP in 2021 is predominantly due to the tax cuts and welfare spending by the government to minimize the socioeconomic impact caused by the COVID -19 pandemic. It was short lived, the economy contracted by 7.8 percent in 2022.

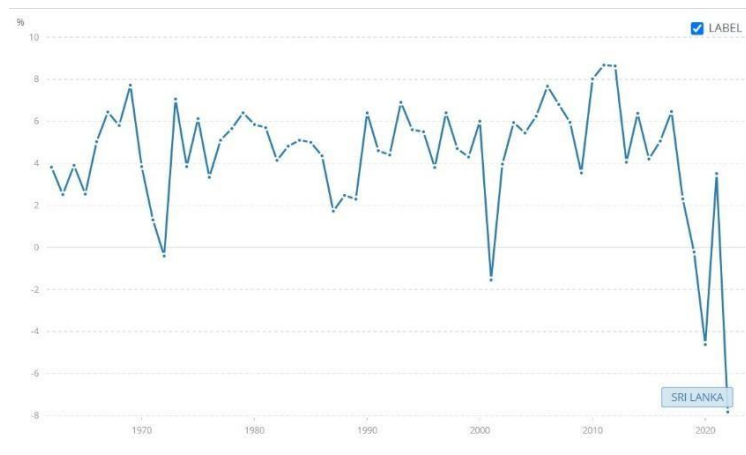


Figure 2: (World Bank, n.d)

## Agriculture, Forestry, and Fishing: Value Added (% of GDP) – Sri Lanka

Agriculture and industry combined have declined to 28% of GDP from the peak of 56% in 1970's. Agriculture, forestry and fishing have declined to 8.7% of GDP. This chart clearly indicates the declining trend in basic food production in Sri Lanka. Similarly, this means imports must rise to fill the gap in production.

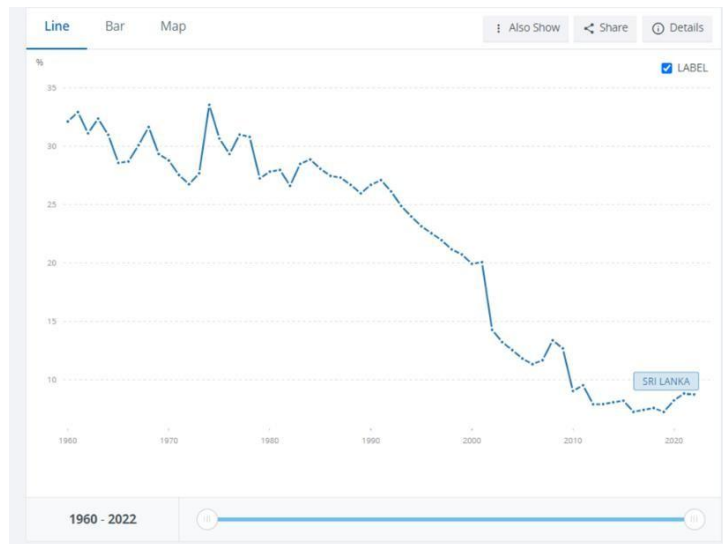


Figure 3 - Figure 03: (Agriculture, forestry and fishing value added- Sri Lanka. Source: The World Bank (2022))

## Income Inequality, Sri Lanka, 1980 – 2021

The red line indicates the share of income in the top 1% and the blue line indicates the share of income in the bottom 50%. These two lines are almost mirror images of one another since 1995. The pattern goes on to indicate the long-term trend in income inequality and income flow from the bottom 50% to the top 1%. There is no slowing down the extraction of income by the top 1% from the bottom 50%.



Figure 4: (Sri Lanka - wid - world inequality database (2021))

## Private Credit Growth

Declining private sector credit growth indicates the continues lack of demand in Sri Lankan economy. The fact that credit demand has gone to negative territory in 2023 indicates the severity in the crisis. There is no proper statistics to capture the level of indebtedness of the private sector. However, in recent past private debt has grown disproportionately to private income levels due to the prolong economic crisis.

Figure 10: Credit growth  
(Percent, y-o-y)

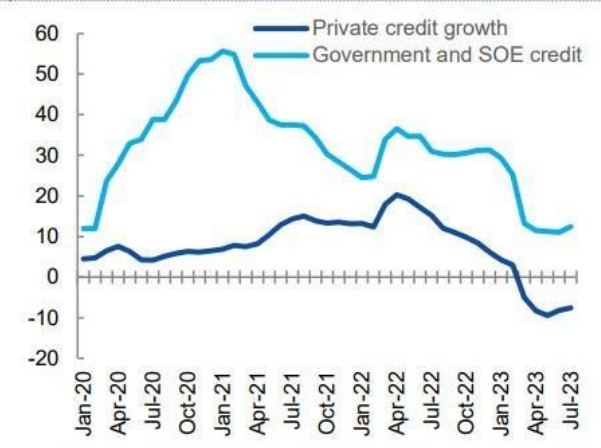


Figure 5: (World Bank, 2023)

## Unemployment, Total (% of Total Labor Force, Modeled ILO Estimate) – Sri Lanka

Sri Lankan unemployment rate for 2022 is 6.71%. Unemployment seems to be in a rising trajectory. However, underemployment is not recorded in this statistic. In reality unemployment situation is much worse considering the high number of headcounts in underemployment as well.

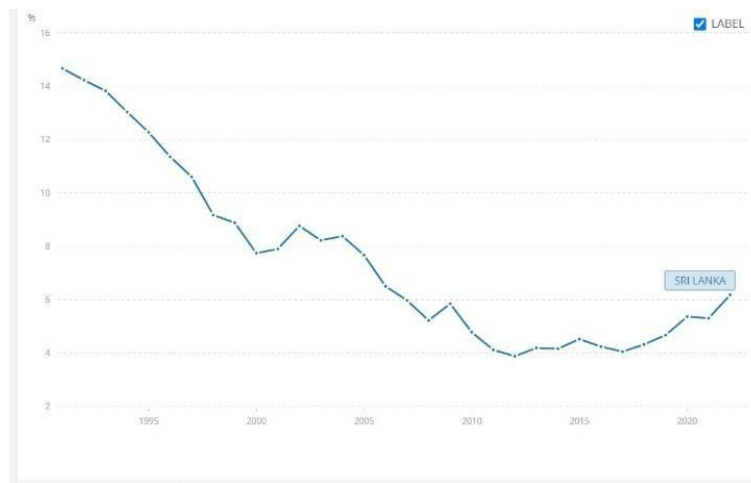


Figure 06: (Unemployment rates. Source: The World Bank, n.d)

## Inflation and Consumer Prices (Annual %) – Sri Lanka

Inflation is on the rise in Sri Lanka. This latest spike is due to the debt default. Essential products were scarce due to the balance of payment crisis and the rupee devalued significantly around this time. Situation has eased down a bit due to the dollar inflow through bilateral and IMF creditors. But, the long-term trend of the inflation seems to be on the rise due to the collapse of essential productive capacity including agriculture and the abusive market power of the suppliers.

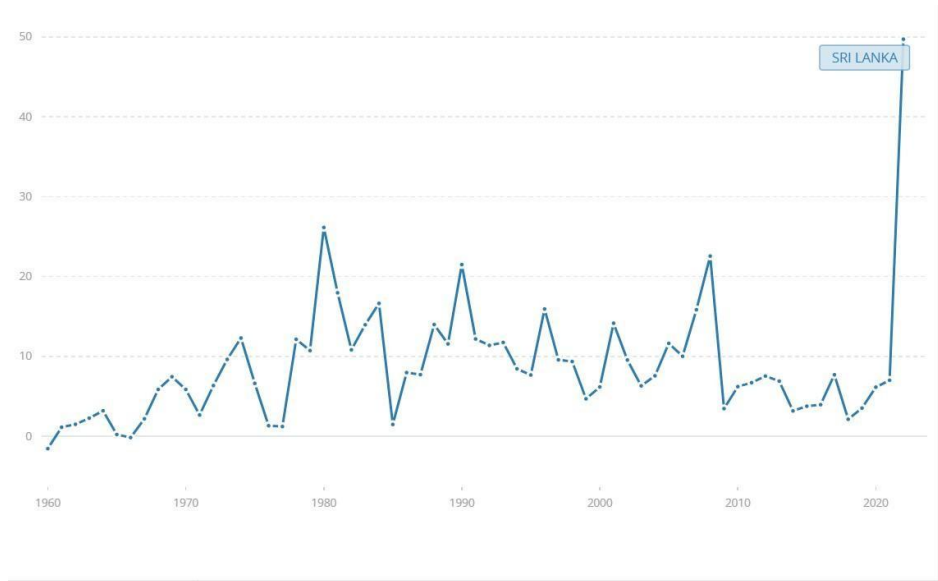
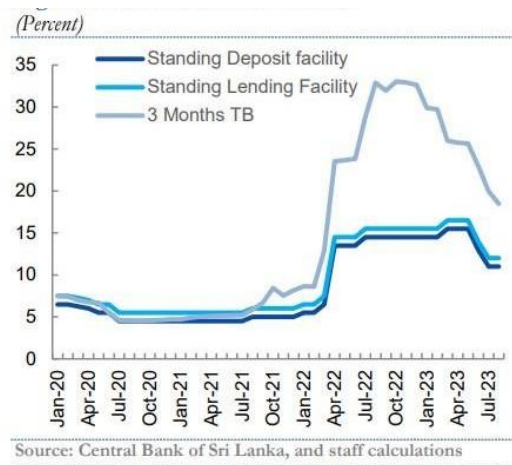


Figure 07: (Inflation, consumer prices- Sri Lanka. Source: The World Bank, n.d)

## Interest Rate Movements

Usual unsuccessful monetary policy implementation by the central bank of Sri Lanka is visible in below charts. Increasing interest rates to tame the inflation caused by a massive essential product scarcity and a collapse in the value of rupee against the USD. Only succeeded in collapsing the demand and sending the GDP through a downward spiral.



Source: Central Bank of Sri Lanka, and staff calculations

Figure 8: (World Bank, 2023)

## Official Exchange Rate (LCU per US\$, Period Average) – Sri Lanka

Central Bank of Sri Lanka claims that they follow an exchange rate regime called soft peg. An exchange rate corridor that allows flexibility by providing a pre-announced margin within which the bank can gradually adjust the exchange rate daily basis. During the period leading up to debt default in mid-2022 USD exchange rate depreciated to 360 rupees due to the lack of foreign reserves which is not visible in this chart. Subsequently, rupee has appreciated to 320 against US dollar due to the dollar inflow from IMF, bilateral creditors and improving workers remittances. Current exchange rate stability is mostly due to the dollar denominated debt default and trade, capital controls. But this will not last long.

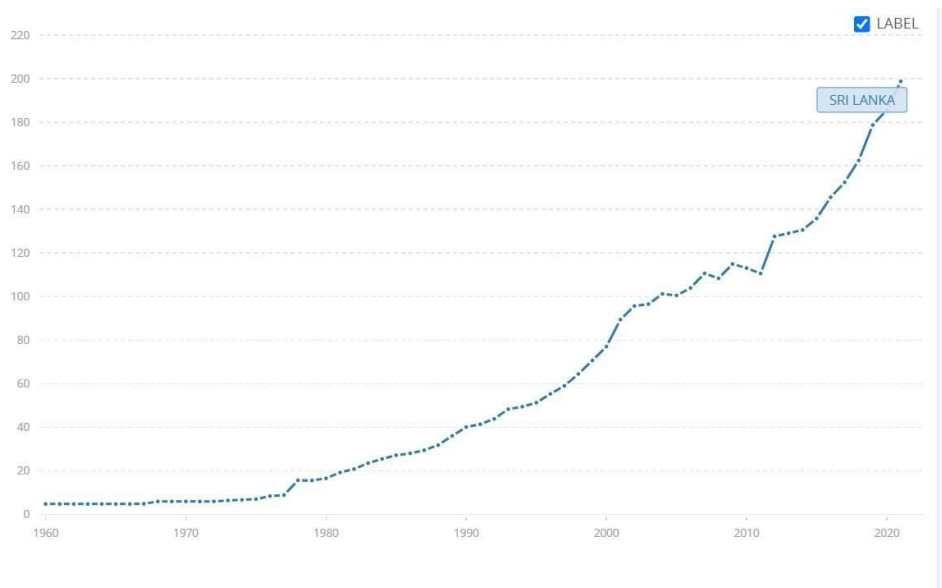


Figure 9: (Official Exchange Rate- Sri Lanka. Source: The World Bank, n.d)

## Balance of Payment Current Account

There has been a persistent trade deficit in Sri Lankan economy over four decades since the liberalization of trade in 1978. Upward spike in the graph (balance of payment current account) in 2022 is because of the recent trade controls imposed by the government due to lack of foreign reserves.

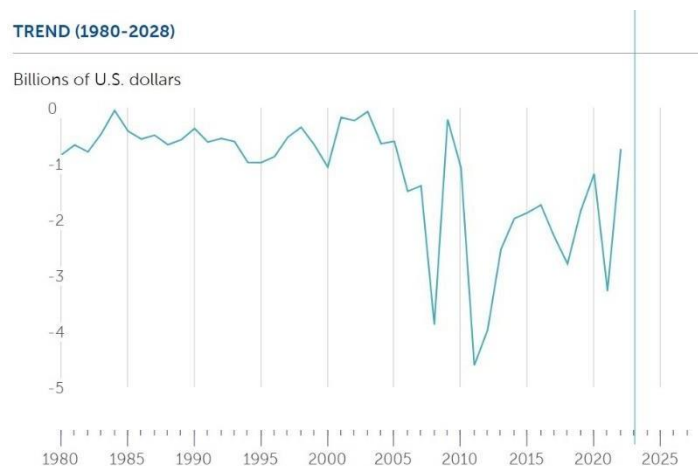


Figure10: (IMF, 2023)

## Sri Lanka – External Debt Stocks, Short-Term (DOD, Current US\$)

The growth in GDP during the past decade was basically built on foreign currency in flow which has disappeared by now leaving the liability in the balance sheet.

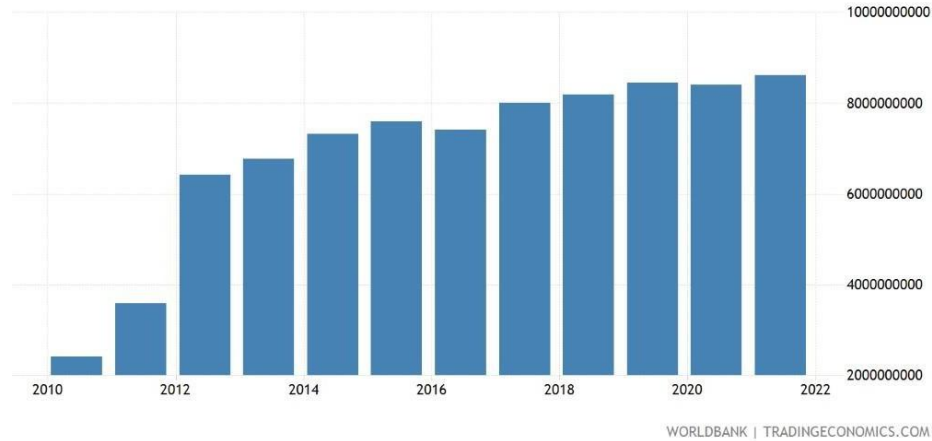
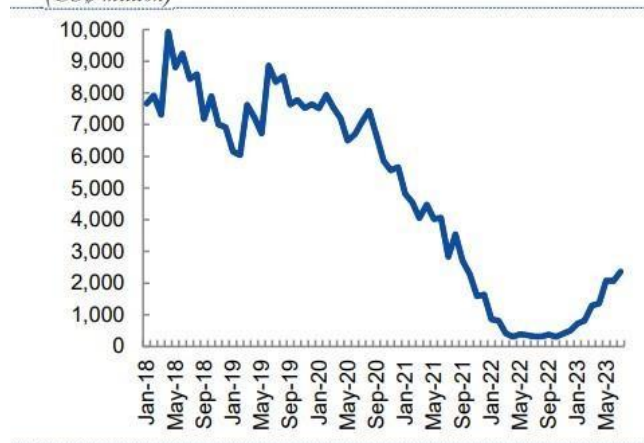


Figure 11: (Trading Economics, n.d)

## Usable Official Reserve

The declining trend in foreign reserves starts in the second half of the 2019 (aftermath of the Easter Attack). The above graph indicates a temporary recovery in the foreign reserves in the last quarter of the 2022 largely due to the non-payment to the foreign creditors. Sri Lanka officially declared the bankruptcy in mid-2022.

Figure 2: Usable official reserves  
(US\$ million)



Source: Central Bank of Sri Lanka, and staff calculations

Figure 12: (World Bank, 2023)

## Sri Lanka Government Budget

Since 1980's Sri Lankan budget has always been in deficit. It clearly demonstrates the ability of the government to deficit spend continuously over 40 years. But most economists believe money printing was the reason for debt default. They also assume money printing caused the inflation aftermath of the debt default.

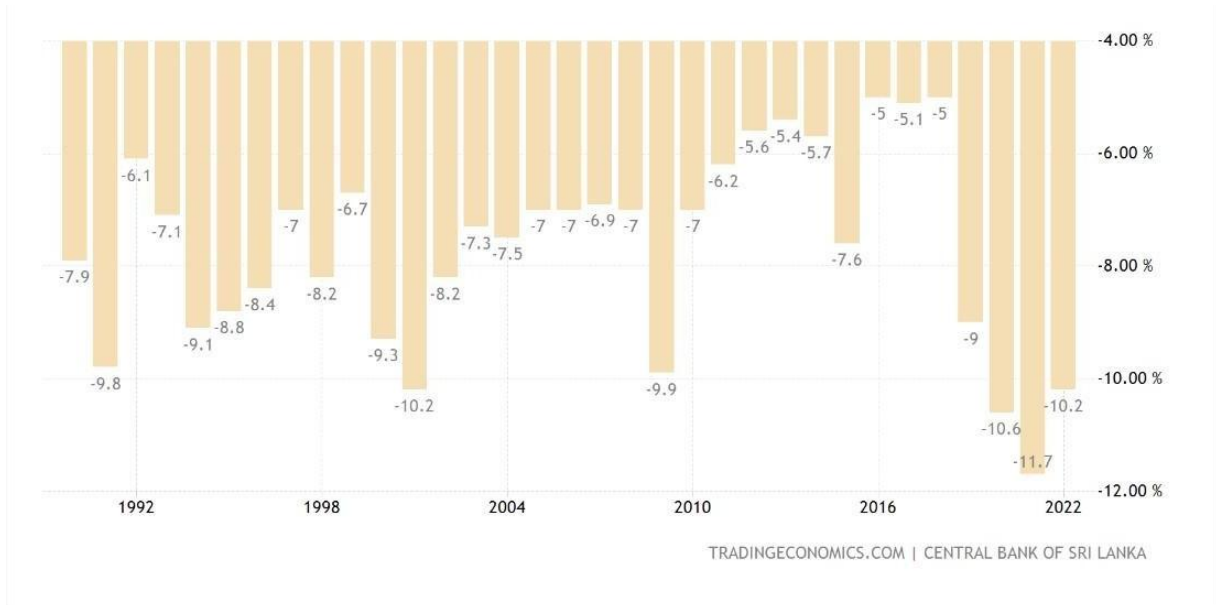


Figure 13: (Sri Lanka Government Budget. Source: Trading Economics, 2021)

## Summary of the Democratic Socialist Republic of Sri Lanka's Public Debt – As of End 2022

As at end 2022, Sri Lanka's total public debt was USD equiv. 83.6bn including arrears.

The end 2022 foreign and local currency stock (including arrears) of Central Government debt, guaranteed SOEs loans and CBSL debt, amounted to USD 76.8bn, USD 3.7bn and USD 3.1bn, respectively.

The table below provides a comprehensive summary of the total public debt of Sri Lanka as at end 2022. It includes Central Government, guaranteed state-owned enterprises debt and CBSL debt, denominated in both FX and LC.

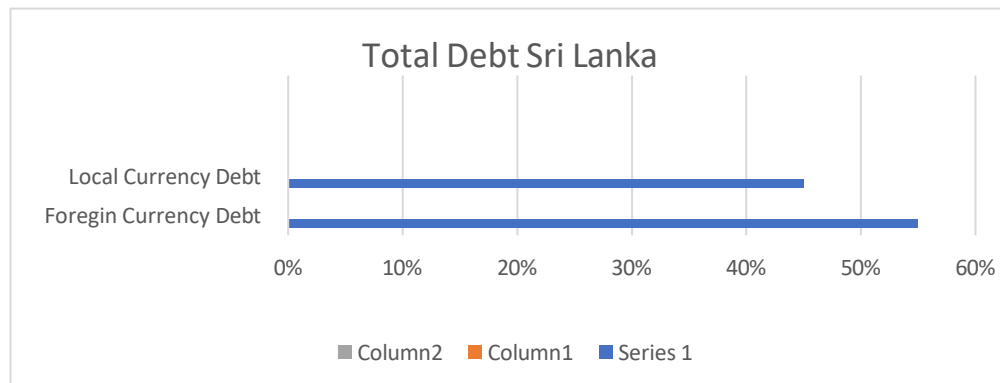
Memorandum Items	Unit	End 2022
Nominal GDP (2022)	LKRtm	23.7
FX rate, EoP (End 2022)	LKR per USD	363.1

In USDbn equiv.	Foreign Currency					Local Currency			Total		
	Foreign Law		Local Law		Total	Local Law		Total	in USDbn	% of public debt	% of GDP
	Debt stock <sup>1</sup>	o.w. arrears <sup>2</sup>	Debt stock <sup>1</sup>	o.w. arrears		Debt stock <sup>1</sup>	o.w. arrears				
<b>Central Government Debt</b>	<b>36,730</b>	<b>2,691</b>	<b>3,708</b>	<b>156</b>	<b>40,438</b>	<b>36,321</b>	<b>-</b>	<b>36,321</b>	<b>76,758</b>	<b>92%</b>	<b>117.7%</b>
<b>Multilateral</b>	<b>9,923</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>9,923</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>9,923</b>	<b>12%</b>	<b>15.2%</b>
<b>Bilateral</b>	<b>9,856</b>	<b>602</b>	<b>-</b>	<b>-</b>	<b>9,856</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>9,856</b>	<b>12%</b>	<b>15.1%</b>
<b>Private</b>	<b>16,951</b>	<b>2,089</b>	<b>3,708</b>	<b>156</b>	<b>20,659</b>	<b>35,672</b>	<b>-</b>	<b>35,672</b>	<b>56,330</b>	<b>67%</b>	<b>86.3%</b>
Bonded	13,183	1,633	1,103	156	14,286	35,384	-	35,384	49,671	59%	76.1%
Non-bonded	3,768	456	2,604	-	6,372	288	-	288	6,660	8%	10.2%
<b>ECA-Backed</b>	<b>937</b>	<b>126</b>	<b>-</b>	<b>-</b>	<b>937</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>937</b>	<b>1%</b>	<b>1.4%</b>
<b>Non ECA-Backed</b>	<b>2,831</b>	<b>331</b>	<b>2,604</b>	<b>-</b>	<b>5,435</b>	<b>288</b>	<b>-</b>	<b>288</b>	<b>5,723</b>	<b>7%</b>	<b>8.8%</b>
<b>CBSL Advances</b>						<b>649</b>	<b>-</b>	<b>649</b>	<b>649</b>	<b>1%</b>	<b>1.0%</b>
<b>Guaranteed SOEs Debt</b>	<b>1,647</b>	<b>311</b>	<b>361</b>	<b>74.3</b>	<b>2,008</b>	<b>1,731</b>	<b>-</b>	<b>1,731</b>	<b>3,739</b>	<b>4%</b>	<b>5.7%</b>
<b>Multilateral</b>	<b>510</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>510</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>510</b>	<b>1%</b>	<b>0.8%</b>
<b>Bilateral</b>	<b>288</b>	<b>19</b>	<b>-</b>	<b>-</b>	<b>288</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>288</b>	<b>0%</b>	<b>0.4%</b>
<b>Commercial</b>	<b>848</b>	<b>292</b>	<b>361</b>	<b>74</b>	<b>1,210</b>	<b>1,731</b>	<b>-</b>	<b>1,731</b>	<b>2,941</b>	<b>4%</b>	<b>4.5%</b>
ISBs	181	6	-	-	181	-	-	-	181	0%	0.3%
<b>ECA-Backed</b>	<b>339</b>	<b>28</b>	<b>-</b>	<b>-</b>	<b>339</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>339</b>	<b>0%</b>	<b>0.5%</b>
<b>Other private</b>	<b>329</b>	<b>259</b>	<b>361</b>	<b>74.3</b>	<b>690</b>	<b>1,731</b>	<b>-</b>	<b>1,731</b>	<b>2,421</b>	<b>3%</b>	<b>3.7%</b>
<b>Central Bank of Sri Lanka's Debt</b>	<b>3,098</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3,098</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3,098</b>	<b>4%</b>	<b>4.7%</b>
<b>Multilateral</b>	<b>1,062</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,062</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>1,062</b>	<b>1%</b>	<b>1.6%</b>
<b>Bilateral<sup>3</sup></b>	<b>2,036</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,036</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>2,036</b>	<b>2%</b>	<b>3.1%</b>
<b>TOTAL</b>	<b>41,474</b>	<b>3,002</b>	<b>4,069</b>	<b>230</b>	<b>45,543</b>	<b>38,052</b>	<b>-</b>	<b>38,052</b>	<b>83,595</b>	<b>100%</b>	<b>128.1%</b>

Notes: (1) Outstanding debt stock incl. arrears; (2) Including both principal and interest arrears;

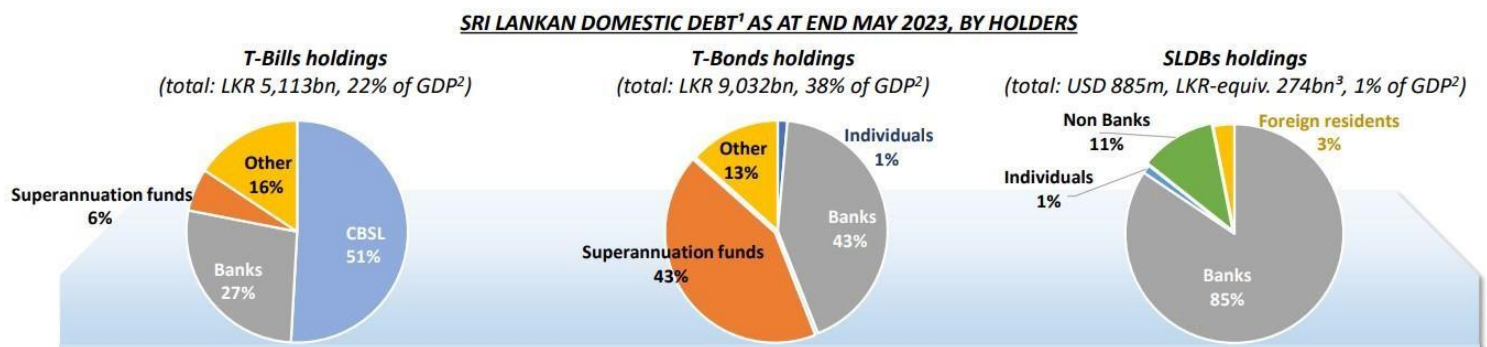
(3) Bilateral swap lines with the People's Bank of China (conditional), Bangladesh Bank, Reserve Bank of India. This figure excludes ACU liabilities amounting to USD 2.0bn as at end 2022

Source: Ministry of Finance, Economic Stabilization and National Policies and Central Bank of Sri Lanka



## Domestic Debt Default

Total local currency (LC) treasury bonds value as at end May 2023 is approximately LKR 9 trillion. The single largest treasury bond holder is the superannuation fund amounting to 43% of the bonds. The superannuation fund is directly under the authority of the Sri Lankan Central Bank. Hence, the government has enforced a reduction in the coupon rate for the treasury bonds held by the superannuation fund. The coupon rate of these bonds will be limited to 12% per annum until 2025 and further reduced to 9% per annum thereafter until maturity. Analysts claim that the potential loss for the superannuation fund will be approximately LKR 12 trillion over 15 years. The people's uprising against this was muted by the threat of imposing a 30 percent tax on superannuation, instead of the existing tax rate of 14 percent.



## Government is expecting to achieve following targets through domestic debt restructuring

- Debt stock target: 95% Of GDP by 2023, As at end 2022, it was at 122.5%
- Gross Finance Need Target: 13% Of GDP (2027-32), As at end 2022, it was at 26%

Most economists believe that successful completion of domestic debt restructuring process will trigger positive credit ratings, which in turn will reduce the risk premia of yields on sovereign securities and bring down the public debt trajectory towards sustainability path. These economists are blinded by sound finance principles and fear the repayment ability of domestic (LC) debt.

## Conclusion

In summary, there is no technical constraint in repaying rupee-denominated debt to the Sri Lankan government. This domestic debt default is purely an IMF-imposed constraint on the Sri Lankan government. Unfortunately, the superannuation fund has to bear the brunt of it, causing a loss of future income for its members. The rise of neoliberalism has left Sri Lanka indebted to foreigners, which has led to the destruction of its industries, agriculture, and local productive capacity. This dependency has made Sri Lanka reliant on foreign imports, resulting in a very low degree of monetary sovereignty due to rising foreign debts and import dependencies.

We can clearly see foreign bondholders already controlling Sri Lanka's bankrupt puppet government, dictating terms on national policymaking and enforcing austerity programs that restrict the government's spending on health, education, and infrastructure. As per their conditions, Sri Lanka will have to privatize its public assets, such as public infrastructure and utilities, to creditors. Further opening up the economy will only lead to a further outflow of dollars in the form of revenue repatriation. These IMF-led measures are being imposed on a population that has been economically suffering since the 2019 Easter attack. These measures will create a deficiency in effective demand due to a lack of disposable income, further shrinking the economy.

In conclusion, economies that are dependent on global trade inflows for their primary needs are extremely vulnerable to exchange rate fluctuations, which can lead to large changes in domestic prices. These trade flows are not possible without the financial flows to initiate them. Hence, financial flows dominate the trade flows, putting pressure on the exchange rate and devaluing the domestic currency. Financial flows determine the outcome of an economy, emphasizing the role played by the banking system led by the central bank in that country. This system has certainly influenced growth through foreign debt in the past in Sri Lanka, creating a few billionaires while bankrupting the rest of the country.

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