NUS National University of Singapore
ISAS Institute of South Asian Studies
ISAS Brief
No. 726 – 23 November 2019

Sri Lanka's Presidential Election 2019: Managing External Debt a Top Priority

Amitendu Palit

The new government of Gotabaya Rajapaksa in Sri Lanka must address serious macroeconomic problems. These include high external debt, mounting debt service obligations, low gross domestic product growth and falling savings. Increasing foreign direct investment, discouraging easy corporate access to external borrowing and enhancing exports should be the immediate priorities.

The conclusion of the Presidential election in Sri Lanka and the entry of a new President, Gotabaya Rajapaksa, in office draw attention to the economic challenges the new government would have to handle. Foremost among these are macroeconomic difficulties.

Sri Lanka has often been cited as an example of an economy whose progress in social and human development has not been accompanied by sustained macroeconomic stability. The current economic conditions reflect the dichotomy. Sri Lanka has had 'twin deficits' for several years. These include deficits arising from an excess of domestic expenditure over revenue, which, in turn, forced borrowings, primarily from external sources, leading to excess of external liabilities over earnings from abroad. For Sri Lanka, both deficits have acquired serious proportions requiring immediate attention.

The External Debt Hole

Government debt, as a proportion of the gross domestic product (GDP), had declined from 86 per cent in 2009 to a record low of 69 per cent in 2012. The trend, however, could not be maintained. The ratio increased to 77 per cent in 2015 and further to 83 per cent in 2018.The rapid rise in overall government debt has been accompanied by a sharp increase in external debt. Unlike several other countries, where government debt is primarily internal, in Sri Lanka, external debt is prominent in total debt. As a proportion of the GDP, external debt is currently 66.2 per cent. From a share of 52 per cent of GDP in 2011, the external debt has steadily increased. The rate of rise was particularly high in 2018, during which there was a year-on-year increase of almost eight per cent.

Why has the external debt increased so much? Several quarters hold the view that it is a result of the large debt-financed infrastructure funds that Sri Lanka has received from China through the Hambantota port and other projects. The real reason is different. China held nine per cent of Sri Lanka's total external debt at the end of 2017. A much larger, 33 per cent of external debt, were loans raised through external sovereign bonds and foreign currency term financing facilities.

Much of Sri Lanka's high external indebtedness is due to the liberal policy of allowing corporates and state-owned enterprises (SOEs) to raise resources directly from external markets. Loans raised by the SOEs were also backed by government guarantees, leading to a sharp increase in external borrowings.

The ostensible reason behind such encouragement, since 2015, was to reduce the dependence of the SOEs on fiscal support from the Central government. The unfortunate outcome has been a rapid accumulation of external debt, leading to a concomitant rise in debt-service obligations. The borrowing profligacy has also resulted in rising share of non-concessional loans in total debt entailing greater interest repayment burden and stress on government finances, going forward.

Unavoidable Actions

The task of the new government is cut out with the immediate priorities being managing external debt and restoring fiscal discipline. On the first, the government has limited room for policy intervention. Debt-service obligations, which are likely to be high for the next couple of years, are fixed and cannot be renegotiated. The only possible policy intervention could be protecting the exchange rate. Further depreciation of the Sri Lankan currency will increase the nominal debt service burden.

Ideally, the government would be hoping for a steady increase in non-debt creating capital flows, such as foreign direct investment (FDI) and foreign portfolio investment, over the next couple of years. These flows would increase the stock of capital in the economy, reduce reliance on external borrowings and steadily appreciate the local currency. However, the prospects of receiving such flows are uncertain. It might require the government announcing big-ticket private greenfield investment projects, as well as the sale of government equity in some SOEs.

The other priority for the government is reviving GDP growth, along with increase in domestic savings. A quick uptick in GDP growth, facilitated by government investments in some key sectors, is the best way to revive investor sentiments to attract long-term FDI.

Equally important is curtailing domestic expenditure. Encouraging SOEs to directly access external borrowing sources has inflicted serious downsides on the economy. The policy needs to be reversed with the eventual goal of taking hard decisions like shutting down some perpetually loss-making SOEs.

Finally, for a more robust balance of payments and healthier macroeconomic conditions, Sri Lanka must go back to strongly encouraging exports. Under current circumstances, there appears to be little option of doing so other than a proactive policy of engaging in bilateral free trade agreements (FTAs) to get deep market access. Capitalising on the opportunities from the FTA with Singapore and finalising the comprehensive trade agreements with China and India are necessary steps.

. . . . .

Dr Amitendu Palit is a Senior Research Fellow and Research Lead (Trade and Economic Policy) at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). He can be contacted at isasap@nus.edu.sg. The author bears full responsibility for the facts cited and opinions expressed in this paper.