Sri Lanka's debt crisis

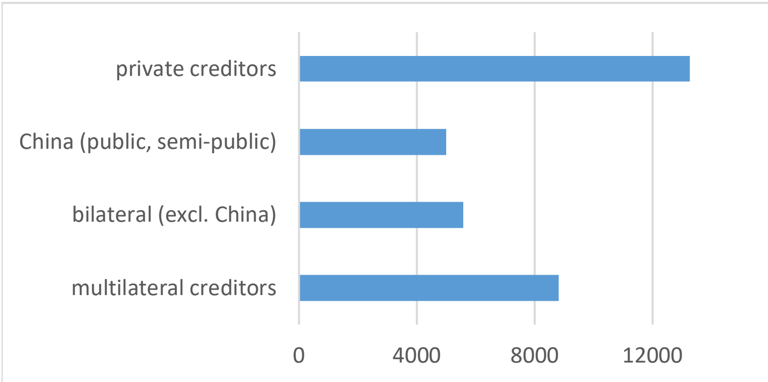
On 12 April 2022, the government of Sri Lanka announced that it had suspended all payments on government bonds, had asked for a comprehensive restructuring of these obligations, and had turned to the IMF, which had earlier qualified 'the country's debt situation as 'unsustainable'. Discussions between the government and the IMF are under way, but the country could soon face a severe humanitarian and political crisis. These developments may also be consequential for the strategic future orientation of both Sri Lanka and China.

The assessment by the IMF

Shortly before the government announcement of 12 April, the IMF had published the results of the (regular) 2021 Article IV consultation. The accompanying IMF 2022 staff country report was clear about the unsustainability of Sri Lanka's debt, but in its analysis also highlighted that these debt problems were aggravated by a balance-of-payments crisis. According to the report, at the end of 2020, government debt reached US$81.7 billion, representing 101 % of 2020 gross domestic product (GDP), with 53.1 % of GDP in domestic currency and 48.2 % of GDP in foreign currencies. Out of this 48.2 %, 11 percentage points (pp) were held by multilateral creditors and 6.9 pp. by bilateral creditors (excluding China); among these bilateral creditors, Japan held debt amounts representing 4.4 % of Sri Lankan GDP, India 1 %, Korea 0.5 % and Germany and France 0.3 % each. Sri Lanka's state debt held by China amounted to 6.9 % of Sri Lankan GDP and that held by private creditors to 16.5 % of GDP.

In its analysis of debt sustainability, the IMF confirms that the country's fiscal policies are not sustainable, as even in the baseline scenario public debt would rise considerably, not least because interest payments alone will remain higher than 70 % of tax revenues. According to the analysis, '**foreign exchange debt service needs of US$7 billion each year** will require access to very large amounts of external financing at concessional rates and long maturities, sustained over many years'. Furthermore, this assessment is subject to considerable additional risks in connection with potential liabilities of state-owned enterprises, pandemic and exchange rate shocks. The IMF therefore concludes that the necessary adjustment to bring debt levels down would be excessive in all likelihood.

Composition of external government debt (US$ million)



Source: EPRS, based on IMF staff report.

The problems have been aggravated by the fact that Sri Lanka's foreign exchange reserves fell to under US$2 billion already in March, forcing the country to significantly further reduce imports, including of food and fuels. As of mid-May, foreign exchange reserves had fallen to US$50 million, not enough to cover one day of imports according to *The Economist*.

The origins of the crisis

In its analysis of the (economic) origin of the crisis – a part of the Article IV report – the IMF looks at the economic and monetary policies pursued since 2019, on top of the 2017 drought, the 2018 political crisis and the 2019 terrorist attacks. The IMF mentions in particular the income and VAT cuts implemented in late 2019 resulting in revenue losses of more than 2 % of GDP. When the coronavirus pandemic struck Sri Lanka, the country was therefore not too well prepared. Due to the pandemic, revenues from tourism in particular dropped strongly while the necessary relief measures to cope with the impact of Covid-19 drove

Author: Ulrich Jochheim, Members' Research Service
PE 729.441 – May 2022

expenditures up. The general government deficit rose to more than 10 % of GDP both in 2020 and in 2021, bringing the debt level to 119 % of GDP at the end of 2021.

Referring to the foreign exchange outlook, the analysis underlines that even if tourism slowly recovers, and 'even if **fresh, still-unidentified balance** of payments support of US[$]2-3 billion became available each year, gross reserves would stay critically low at around one month of imports over 2022–2026'. Given these very serious economic and financial imbalances, the IMF arrived at the conclusion that 'fiscal consolidation and macroeconomic policy adjustments alone cannot restore Sri Lanka's debt sustainability', making a restructuring of the country's debt unavoidable.

The political situation

Blackouts and acute shortages of food (rendered worse by the rise in food prices as a consequence of Russia's war against Ukraine), of fuel and pharmaceuticals have since mid-March 2022 triggered widespread protests clamouring for the government's resignation. These events have considerably increased pressure on the Rajapksa family, which has been dominating Sri Lanka's politics since 2005, when Mahinda Rajapaksa won the presidential election. Mahinda was re-elected in 2010 but lost power in 2015. Following the political crisis of 2018, Gotabaya Rajapaksa won the 2019 presidential election and made his brother Mahinda prime minister. Gotabaya's authority has since been weakened as a result of the fast deteriorating situation and allegations that mismanagement and corruption have contributed to the crisis. Against the background of the worsening political situation, on 8 April the Delegation of the EU together with some Member States and like-minded countries issued a statement, asking all parties to act with restraint and to explore democratic ways out of the crisis.

On 9 May, ongoing protests forced Mahinda to resign; on 12 May, Ranil Wickremesinghe – Mahinda's opponent since the time of the presidential elections of 2005 – accepted to become prime minister; the Sri Lanka Podujana Peramuna Party (SLPP) close to the Rajapksas, which has a clear majority in Parliament, announced that it would support the new PM.

The international context

According to Oxford Analytica, Sri Lanka's government is seeking a bailout of up to US$4 billion from the IMF, and Indian media report that talks for financial assistance with countries like China and Japan have also been going on. Given the huge financing needs Sri Lanka is facing, the media report posits that a bailout by the IMF alone appears insufficient to solve these needs.. The media report also points out that India has been using this crisis to gain more influence in Sri Lanka, in particular given the fact that Mahinda had been perceived as steering his country to a position closer to China, although the foreign policy approach actually pursued by the two Rajapksas is likely to have been less focused on China than frequently affirmed.

From the Indian point of view, the Chinese-promoted development of the port of Hambantota – supported by the Mahinda presidency – has been part of the 'String of Pearls' strategy developed by China 'to encircle India'. From this perspective, Sri Lanka is an extremely important hub to ensure China's oil supply via sea lanes, which also explains its significance for China's Belt and Road initiative. India is reportedly likely to provide around US$3 billion in (potential) economic support to Sri Lanka in 2022 alone (US$1 billion credit line for essentials; US$500 million credit line for purchase of petroleum products; US$400 million bilateral currency swap; and over US$1 billion under the Asian Clearing Union Framework).

Beijing has also extended Sri Lanka a US$1.3 billion syndicated loan and a US$1.5 billion yuan-denominated swap to boost its reserves; furthermore, the two countries are in talks for a US$1.5 billion credit line and a fresh syndicated loan of up to US$1 billion. According to the *Wall Street Journal*, China remains a viable alternative to India for Sri Lanka.

Outlook

Little is known about the current state of negotiations with the IMF. However, the political situation appears to be still very tense. Credible media expect the military to play a decisive role in how the Gotabaya presidency might end. An additional factor of complexity is the geostrategic importance of Sri Lanka in the Indo Pacific, with the Strait of Malacca connecting the Indian and the Pacific Oceans. While this could be an asset in the ongoing negotiations, the strategic antagonism and resulting disagreements among creditor countries could also delay the necessary fast solutions.