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Sri Lanka financial crisis: Explained

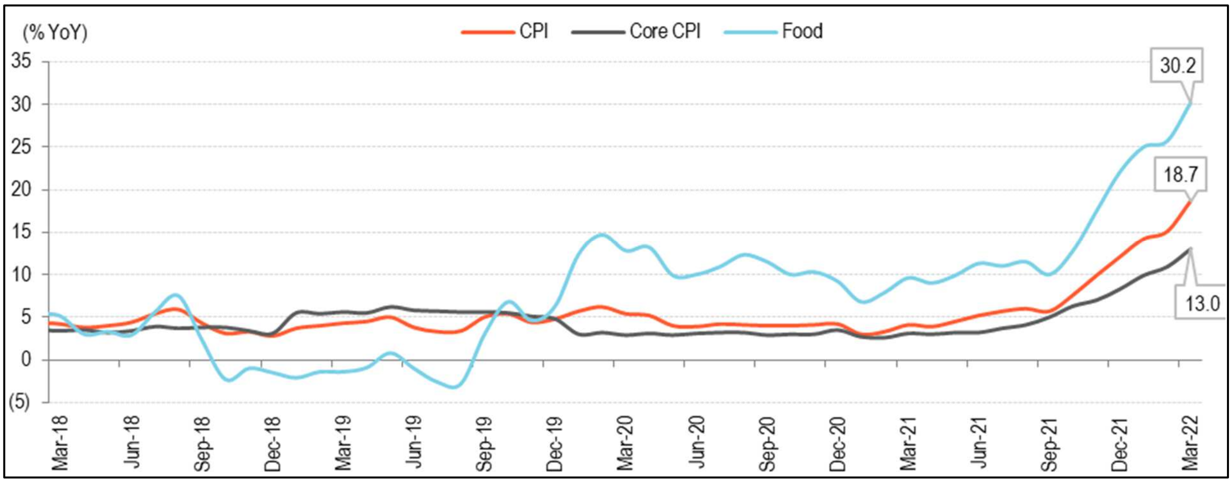
Background

Sri Lanka has been embroiled in an economic crisis amidst record-high inflation and mounting debt. Prices of essential items including food, fuel and medicines have skyrocketed and foreign exchange reserves have plunged amidst a shortage of dollars to finance imports. The ruling government has been scrambling to secure finance from major international agencies such as IMF and ADB as well as seeking support from other neighbouring countries. In this note, we attempt to briefly understand the roots of the crisis.

1. **Risks brewing:** Even before the Covid-19 pandemic hit, Sri Lanka was facing problems on several fronts. This included a constitutional crisis in 2018, resulting from dismissal of the Sri Lankan Prime Minister by the President. In 2019, Easter bombings in churches and luxury hotels killed hundreds of people. Further, government announced several tax cuts in 2019 which led to credit rating downgrade in 2020, thus impeding Sri Lanka access to international financial markets. This was followed by the Covid-19 pandemic in 2020.

2. **Surging inflation:** After remaining suppressed in 2020, due to a fall in demand during the Covid-19 pandemic as well as VAT cuts in 2019, inflationary pressures built up steadily since the mid of last year. This was due to a number of factors including, improved demand and higher global commodity prices. This coincided with a depreciating currency and supply shortages. Further, in 2021, government's banned chemical fertilisers in 2021, (the ban was later reversed) led to a significant decline in production of rice which is the staple diet of a majority of the population. From 4.1% in Mar'21, inflation has accelerated sharply to 18.7% in Mar'22 led by a steep increase in food inflation at 30.2%. It is likely to remain elevated in double-digits even in the coming quarters amidst both supply and demand side pressures. The Russia-Ukraine war and resulting surge in commodity prices is further fuelling inflation.

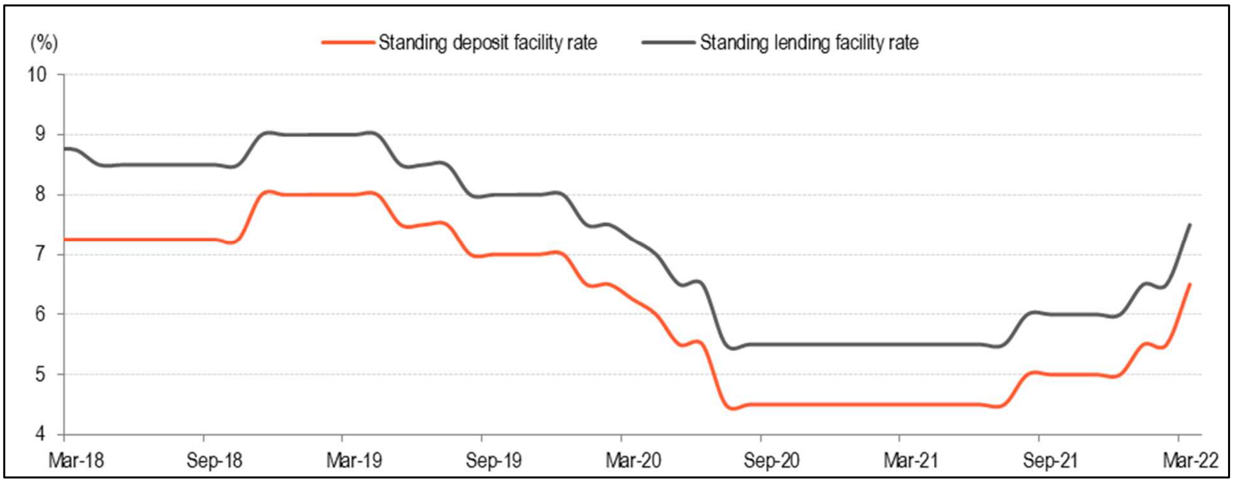
Fig: 1: Inflation in Sri Lanka has surged sharply



Source: Department of Census and Statistics Sri Lanka, Bank of Baroda Research

3. **Monetary policy response:** During the Covid-19 pandemic, Central Bank of Sri Lanka (CBSL) had cuts its key policy rates (standard lending and deposit rate) by a cumulative 200bps between, Mar'20 to Jul'21, before raising it by 50bps in Aug'21. However, in response to the surging inflation, it has raised policy rates by 150bps each this year. It must be noted that inflation has continuously remained above CBSL's target range of 4-6% since Oct'21. More recently, after delaying its recent policy meet, CBSL will announce its monetary policy statement later today. Market participants are expecting a 100bps increase in both the standard deposit and lending rates. Further rate hikes can also be not ruled out as inflation continues to run in double-digits.

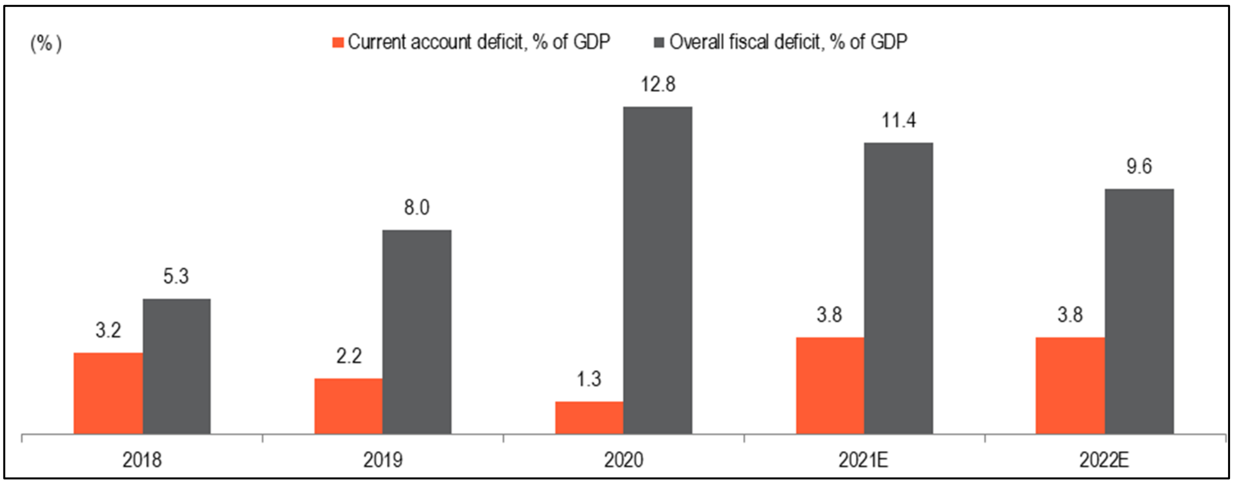
Fig: 2: Monetary policy response by CBSL



Source: Bloomberg, Bank of Baroda Research

4. **Twin-deficit:** Sri Lanka has been running large current account and fiscal deficit in recent years.

Fig: 3: Sri Lanka's CAD and fiscal deficit remains elevated

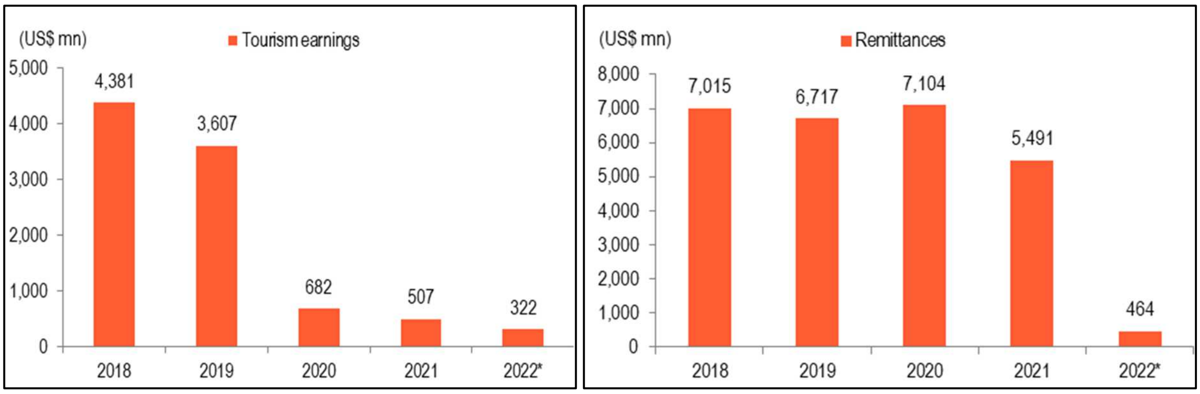


Source: IMF Staff Country Report (Mar'22), Bank of Baroda Research |*E: IMF Estimates

On the current account side, suppressed global commodity prices (including oil) in 2020, led to a dip in CAD to 1.3%. Higher remittances also supported the lower deficit. However, with a gradual recovery in global demand, commodity prices are now on an uptrend putting renewed pressure on trade deficit. Hence, CAD is estimated at 3.8% in 2021 and 2022. On the other hand, tourism receipts fell sharply in 2020 due to the Covid-19 pandemic and lockdown restrictions and continues to trail even till now. Apart from being an important source of foreign inflows, tourism sector is also an important contributor to Sri Lanka's GDP. As per estimates, *tourism sector has a share of 12% in Sri Lanka's GDP.*

On the other hand, even remittances lost momentum as the government pegged the exchange rate at 200/$ since Oct'21. This led to a severe dollar shortage to fund imports of essential commodities such as food and fuel. More recently, CBSL allowed the currency to depreciate to 230/$ in hopes of attracting investment and remittances.

Fig: 4: Tourism and remittance receipts have slipped

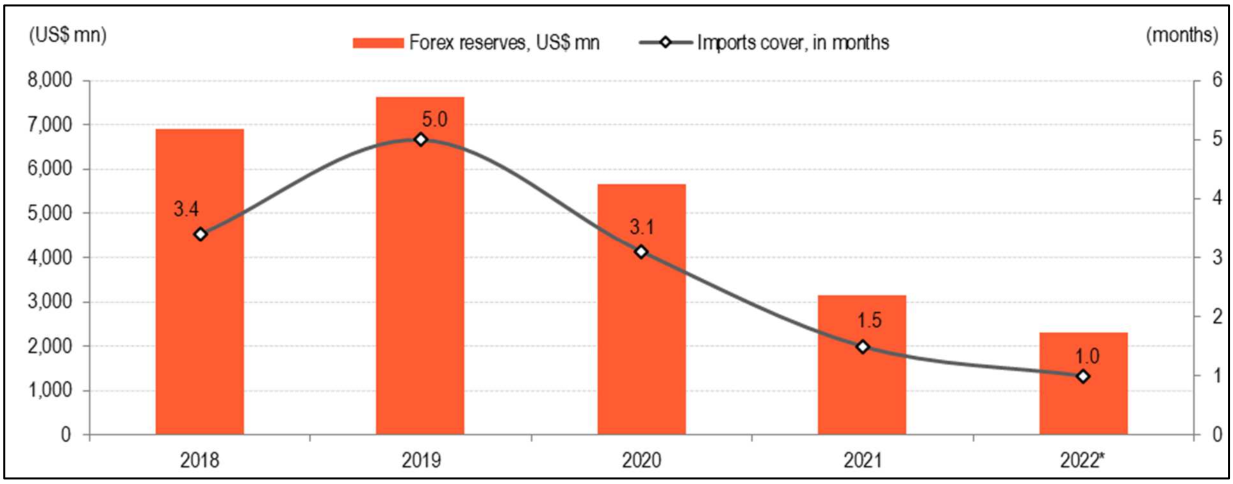


Source: Central Bank of Sri Lanka, Bank of Baroda Research | * Data as of Feb'22

On the fiscal side, the government had been running high deficits even before the Covid-19 pandemic. In fact, fiscal deficit rose to 8% of GDP in 2019 due to the large tax cuts announced by the government. In 2020, the Covid-19 pandemic pushed government revenues lower, while expenditure was expanded to support economic growth. This pushed fiscal deficit to 12.8% of GDP in 2020 and 11.4% in 2021. Concomitantly, public debt as a % of GDP has risen to 118.9% of GDP in 2021. The government was financing fiscal deficits through both domestic and foreign sources. With access to foreign sources being curtailed due to rating downgrade, the Sri Lankan government looked at domestic sources of funding. Apart from borrowing domestically by issuing bonds, it also took advances from CBSL.

5. **Dwindling foreign exchange reserves:** Sri Lanka used its foreign exchange reserves to fund its burgeoning deficits. As a result, foreign exchange reserves fell from US$ 6.9bn in 2018 to about US$ 2.3bn in 2022 (Feb'22). While Sri Lanka's forex reserves could cover 5.9 months of imports in 2019, it can only cover 1 month of imports at present levels. Sri Lanka is highly dependent on imports of essential commodities including fuel from abroad. This is further exacerbating the availability of fuel and other essential items. Further, the present level of reserves is inadequate to service its debt repayments of roughly US$ 4bn. This also includes a US$ 1bn international sovereign bond (ISB) maturing in Jul'22. ISBs form a major part of Sri Lanka's foreign debt at US$ 12.55bn apart from ADB, Japan and China.

Fig: 5: Foreign exchange reserves and import cover



Source: IMF Staff Country Report (Mar'22), Bank of Baroda Research

Response from International community:

India has already dispatched a diesel shipment under a US$ 500mn credit line signed in Feb'22. Sri Lanka and India have also signed a US$ 1bn credit line for importing essentials, including food and medicine. The ruling government has also requested another US$ 1bn support from India.

China has already provided a US$ 1.5bn swap to CBSL and US$ 1.3bn syndicated loan to the government. It is also planning on a US$ 1.5bn credit facility as well as another loan of US$ 1bn.

Further, the nation has been in talks with IMF for securing a bailout package. However, this would require a multi-pronged approach in addressing the crisis through prudential fiscal management, a flexible exchange rate regime as well as higher policy rates to combat surging inflation.

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