

Sri Lanka's Economic Crisis: Background and Sources

- **Government's New Fiscal Policies following Presidential Election Victory on 19th November 2019**
 - **Comprehensive Tax Cut and their implementation since early December 2019**
 - **Tax cut led to drastic revenue reduction (on the order of 4-5% GDP)**
 - **No alternative revenue proposals**
 - **Severe fiscal imbalances and macroeconomic instability**
 - **First Response: In December 2019, Sri Lanka was downgraded by international sovereign rating agencies**

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Item	2018	2019	2020	2021
Budget deficit (% of GDP)	-5.3	-9.6	-11.1	-12.2
Budget deficit (Rs/Bn)	-761	-1,439	-1,668	-2,058
Government revenue with grants (% of GDP)	13.5	12.7	9.1	8.7
Government revenue with grants (Rs/Bn)	1,933	1,899	1,373	1,464
Government expenditure (% of GDP)	18.8	22.3	20.2	21.0
Government Expenditure (Rs/Bn)	2,693	3,338	3,041	3,522

(Sources: CBSL Annual Report 2021)

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- **Lowest government revenue was reported for 2021 and 2022 for the post independent seven decades**
- **Highest budget deficit after 1988**
- **Budget deficit was financed entirely from domestic sources as Sri Lanka did not have access to international financial markets (rating agencies have downgrade Sri Lanka continuously over the last two had a half years.)**

Rating Agency/Date	Exiting Rating	Rating after Action	Outlook
Moody's			
Nov 20, 2018	B1	B2	stable
Sep 28, 2020	B2	Caa1	stable
Oct 28, 2021	Caa1	Caa2	stable
Apr 18, 2022	Caa2	Ca	stable
S&P			
Dec 04, 2018	B+	B	stable
Jan 14, 2020	B	B	negative
May 20, 2020	B	B-	stable
Dec 11, 2020	B-	CCC+	stable
Aug 27, 2021	CCC+	CCC+	negative
Jan 12, 2022	CCC+	CCC	negative
Apr 13, 2022	CCC	CC	negative
Fitch			
Dec 03, 2018	B+	B	stable
Dec 18, 2019	B	B	negative

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- As financing of the deficit had to be met from CBSL, and the deficit being huge, interest cost was also rising
- Accordingly, CBSL reduced its policy rates to one of the lowest in the recent times (on the 09 Jul 2020 SDFR and SLFR reduced by 100 basis points to 4.50% and 5.50%, respectively)
- CBSL move led to economy wide interest rate reduction for nearly 2 years.

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- CBSL financing of budget deficit had a direct bearing on the rising inflation with a time lag of about 6 months- The country is presently running inflation in the region of 40% and food inflation is coming closer to 60% Y-O-Y basis. This is reminiscent of hyper inflation experienced in the early 1980s.
- But on the 8th of April 2022, CBSL in a dramatic turn has raised its interest rate in a manner to have wide ranging effect on the economy (also curbing rising inflation). Accordingly, SDFR and SLFR increased by 700 basis points to 13.50% and 14.50%, respectively,

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- As the printing of money (CBSL financing of budget deficit) continued unabated, it has had other negative effects on the forex reserves and the exchange rate.**
- The CBSL has since April 2021 decided to hold exchange rate by pegging it at Rs.200/dollar until 7th of March 2022 nearly a year. As such central bank had to provide forex at that rate from the existing reserves.**
- Forex reserves were US \$ 7.9 Bn in February 2020 and thereafter it went down precipitously till present times**

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- Accordingly, some estimate indicates that as much as US\$ 5.0 Bn of forex reserves were provided (wasted) by CBSL to defend the exchange rate at Rs. 200/dollar for nearly a year.**
- As official forex reserves had depleted and having seen no other option, 7th of March 2022, the rupee was floated and thereafter Sri Lanka had seen the rapid depreciation of rupee on a continuous basis until the present time.**
- By this time, official forex reserves were at the lowest level in the recent times, and as there were no scope for going to international financial markets and the government reluctance to seek IMF support over the 30 months, CBSL Governor declared on the 12th of April 2022 that Sri Lanka is unable to service its foreign debt.**