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PRESS RELEASE

Government Budget Deficits, Borrowings and Debt

Several commentators have highlighted the point that Sri Lanka's government debt has increased by USD 4 billion to USD 100 billion as at end March 2024 from end 2023. Many have attributed this increase in debt to fiscal mismanagement. In reality, the biggest driver of the increase in the USD value of the debt stock during this period is the appreciation of the rupee from Rs. 324/USD in end December 2023 to Rs. 301/USD in end March 2024. Naturally, this leads to the dollar value of the component of rupee denominated domestic debt increasing even in the case of the absolute rupee debt remaining unchanged. In reality, the rupee denominated domestic debt has increased only by about 1.5% during the first quarter of 2024. However, when these rupee figures are translated into USD, it increases far more, reflecting the appreciation of the LKR against the USD during the first quarter of 2024.

A country's debt increases in absolute terms when government expenditure exceeds government revenue - that is a budget deficit, and borrowings are made to finance such deficits. In Sri Lanka, successive governments have been running with budget deficits and as a result, the debt has accumulated over the years due to borrowings made to finance such deficits. The budget deficits have been very high in recent years in particular, with the country running deficits of 10.7% of Gross Domestic Product (GDP) in 2020, 11.7% of GDP in 2021 and 10.2% of GDP in 2022, which has reduced to 8.3% of GDP in 2023. These high budget deficits are largely due to the adverse impacts of the tax reductions towards end 2019 which brought government revenue down to a record low 8.3% of GDP in 2021. In each of these years, there has been a material increase in government debt in absolute terms since the budget deficits have to be financed with additional borrowings incurring new debt.

However, it is important to ascertain the composition of such deficits as well. The budget deficit includes a government's expenditure on interest that has accrued due to the borrowings of past governments as well. That is why the fiscal responsibility is measured by what is known as the primary balance. The primary balance excludes interest cost from the budget deficit. It is a reflection of the revenue and expenditure management of the government of the day, without including the cost of "past sins". Therefore, the primary balance is a better measure of a government's fiscal performance.

If we consider Sri Lanka's post-independence era, the country has run a primary balance surplus in only 6 years. That is 1954, 1955, 1992, 2017, 2018 and most recently in 2023. This rarity of primary surpluses is a major contributor to the buildup of debt and the resultant economic crisis. In 2020, the primary deficit was 4.4% of GDP and in 2021, it was 5.7% of GDP. The trend began to reverse in 2022 with the primary deficit reducing to 3.7% of GDP with the fiscal reforms introduced from the second half of the year amidst significant economic challenges. By 2023, the government was able to achieve a primary surplus of 0.6% of GDP. That means in 2023, the government revenue in excess of non-interest expenditure was able to contribute to the repayment of past debt service cost. This indicates the importance of running primary balance surpluses, which is why this is included as a target in the proposed Economic Transformation Bill as well.

Another important factor to keep in mind is that the way debt is measured over time and between countries is not in absolute terms as a certain number of rupees or dollars. This is because the size of the economy and capacity to pay varies between countries and over time. That is why the more appropriate measure is to consider debt as a percentage of GDP. When this measure is considered, Sri Lanka's central government debt reached 100% of GDP in 2021, which was increased to 114.2% of GDP in 2022. By 2023, this adverse trend has reversed and central government debt to GDP ratio declined to 103.9%. This is in spite of the central government absorbing some debts that had previously been parked on the balance sheets of state-owned enterprises.

Finally, it is also necessary to consider how this debt is being incurred or managed. Between 2020 and 2022, the government incurred large increases in debt as evident by the high annual budget deficits. This debt was largely financed directly by the Central Bank through monetary financing (loosely referred to as money printing). This is however a highly inflationary practice, as was evident with the record spike of inflation to around 70% in 2022. Since 2023, the government has eliminated monetary financing, and the required domestic borrowings are made entirely from the domestic market. This comes at a cost as interest rates increase due to higher demand for borrowing - and this spike in interest rates in 2023 contributed to the high interest cost incurred by the government. In fact, in 2023, interest cost accounted for about 80% of government revenue, and this is why the budget deficit remained at 8.3% of GDP in spite of the primary surplus of 0.6% of GDP. However, by now, interest rates have declined back to single digit levels (Treasury bill yields) in response to effective monetary and fiscal management by the government. The debt burden is expected to ease further as economy grows and real interest rates remain low.

The government is in the process of restructuring its debt, which will further ease the debt service burden, which is why it is essential that this process continues uninterrupted. The debt restructuring process will reduce the debt stock and the cost of debt as set out in the debt restructuring targets which are also included in the Economic Transformation Bill. The unpaid debt and interest during the debt standstill period will be phased out over time under the debt restructuring strategy, thereby easing the burden on fiscal operations. There are still limits to the extent of debt restructuring since a lot of the outstanding domestic debt is held by local institutions such as the state banks and superannuation funds, such as the EPF. The domestic debt optimization operation implemented in 2023 helped ease fiscal burden to a large extent. Any further restructuring of debt held by domestic entities could result in significant economic and social costs.

It should be evident that the government revenue, expenditure, budget deficits, deficit financing and debt are a complex and nuanced process with multiple factors to take into account. It is not helpful to use simplistic, flawed analysis of a single number to try to explain complex topics. Such simplistic analyses have been used in the past to misguide the public, and this is indeed one of the causes of the deep economic crisis Sri Lanka faced. It is important to avoid making the same mistakes again and to ensure that our judgment is guided by professional analysis and evidence.