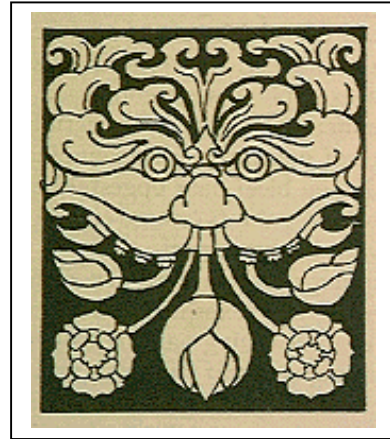


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An Overview of the External Debt Situation in Sri Lanka

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Abstract

Outstanding external debt of Sri Lanka has mounted to a staggering level of US\$ 10, 000 millions in 2003. Using data from the last five decades, this paper suggests that the capacity to service external debt is becoming a difficult task in the face of deteriorating terms of trade, mounting current account deficit, depreciating local currency value, heavy dependency on imports and tightening borrowing conditions. We find that Sri Lanka should not be too complacent about its external debt situation although it has received much needed foreign debt assistance in the form of debt write offs and debt moratoriums from its creditors after the disastrous Boxing Day tsunami.

Introduction

The 2004 Boxing Day tsunami has prompted several creditor countries to take measures to ease the amount of massive external debt owed by Sri Lanka. Creditor countries such as Japan, the United Kingdom and several other European countries have decided to write off some of the debt and granted interest free period to facilitate the recovery process. Sri Lanka has also been given a one year moratorium on repayment of its debt owed to the Paris Club members. Such a swift action by the creditor countries implies that Sri Lanka is in need of assistance in dealing with its huge external debt problem. In general, debt assistance packages such as debt write offs and rescheduling accompany tight conditions and restrictions on debtor countries which create more harm than benefit. However, the most recent offer made after the tsunami does not involve such detrimental preconditions on Sri Lanka.

The main objective of this paper is to discuss the current external debt problem in Sri Lanka and analyse how external debt is interrelated with selective macro economic variables. This will be beneficial for the researchers who are interested in analysing possible short run and long run economic impacts of this unprecedented debt assistance policy by the creditors. It would also be useful for any research project that investigates the external debt management problem in Sri Lanka. No econometric analysis is provided here because our only purpose is to provide background information regarding external debt data in Sri Lanka. Therefore, we think that econometric analysis should better be left to a separate research project.

This paper consists of several distinct sections. Section two provides an up to date description of the external debt situation in Sri Lanka beginning with its independence from the British in 1948. Section three makes an effort to identify potential reasons for the upward trend in the level of external debt. In this regard, we discuss how external debt is related to other macroeconomic variables such as exchange rate, exports, imports, and interest rates. We closely follow the current literature on determinants of external debt for selecting other macroeconomic variables for the discussion (see: Workie, 2004, Derado, 2002, Cohen, 1999). Section four offers a summary and conclusions.

The External Debt Situation in Sri Lanka

This paper uses data that spans five decades to analyse Sri Lanka's external debt situation after it gained independence from British. To illustrate, figure 1 provides a time path of the total external debt in terms of US dollars over the period 1948-2003. The figure clearly shows four different periods with different rates of increase in the outstanding external debt.

In 1948 when the country achieved its independence, the total external debt was only US\$ 37.8 millions. The amount of debt virtually remained unchanged until 1968. We consider that period as Stage 1. At the time of independence, external debt was represented only by sterling loans that were incurred during the pre-independence period. However, from 1950 onwards, the country started receiving project-based assistance from countries such as China, the USA and the former Soviet Union. Assistance was received in the form of loans and lines of credit. Most of the loans were intended for specified projects.

The second stage, which runs from 1968 to 1977, recorded a very slow growth rate of outstanding debt. There were several important changes to external debt policies during this period. For instance, for the first time, the country started receiving loans for commodity purchases during the latter half of the 1960s. Another development was the private sector involvement in external borrowings.

The third stage that extends from 1978 to 1995 recorded a rapid increase in the total external debt. The amount increased from US\$ 1136 millions in 1978 to 9405 millions in 1995. During the first two decades of the post liberalization period, the volume of government external debt increased from approximately 16% of GDP to 47% of GDP (Economic Progress of Independent Sri Lanka, 1998). We can identify several factors that contributed to the high accumulation of foreign debt.

First, government has undertaken huge investment programs in the area of power and energy, irrigation and agriculture. Second, the Sri Lankan rupee has experienced a significant depreciation against the major currencies. For instance, the exchange rate depreciated from eight rupees per US dollar in 1977 to 96 rupees per dollar in 2003. Third, in addition to public borrowing, private enterprises also expanded their borrowing from external sources. By the mid 1990s, the private sector was responsible for around one-third of the total external debt. During the final stage, we can observe some fluctuations in outstanding external debt. For the first time outstanding external debt showed a downward trend during the early part of the fourth stage, but again started to increase after 2000. Total external debt has increased from US\$ 8.3 billion in 2001 to US\$ 10.6 billion in 2003; an increase of 27% for the three year period (UNESCAP, 2005). Another feature of this period is the increase in the relative importance of government and government-guaranteed debt. The percentage of government external debt to total external debt has increased from 76.3% in 1996 to 81.9% in 2003 (Central Bank Annual Reports). As far as long term debt is concerned, the government's responsibility has gone up to about 85% of the total debt.

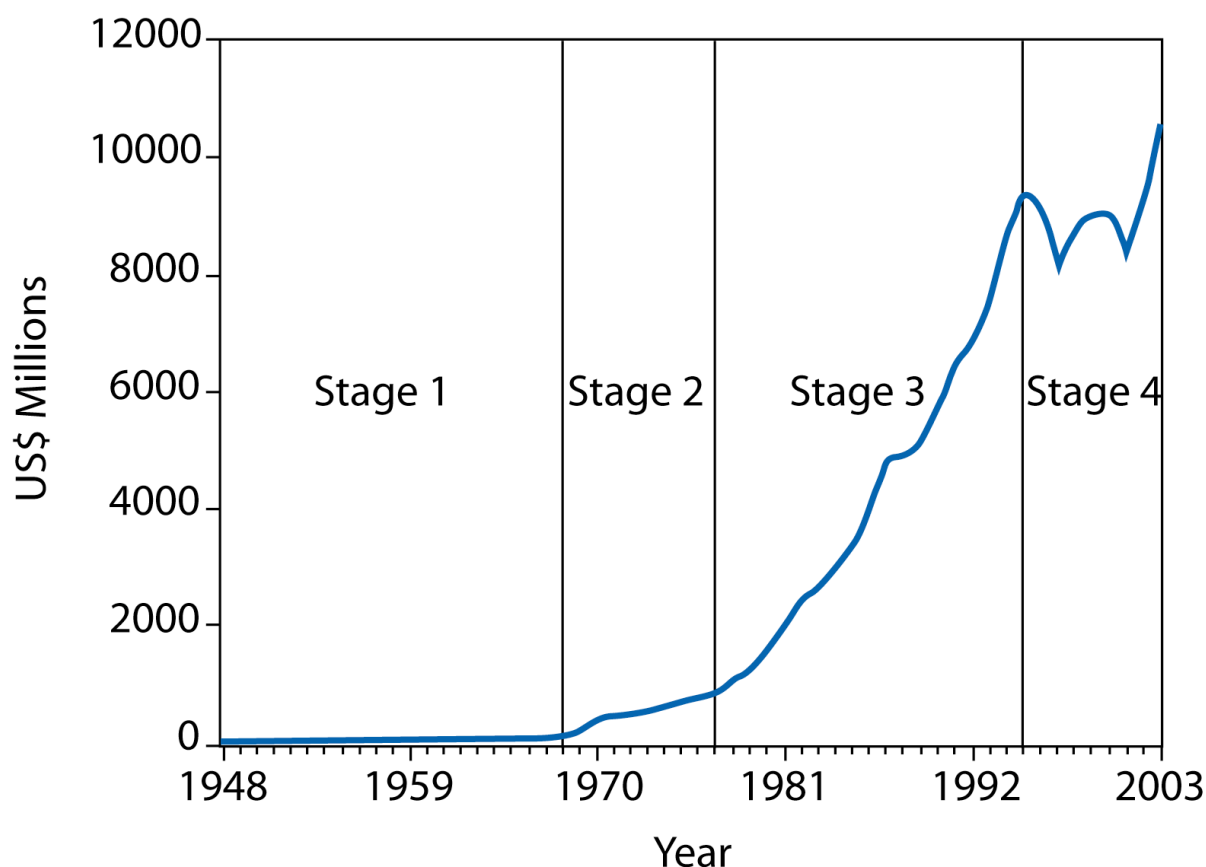


Figure 1. Time Path of Total External Debt.
Source: Central Bank Annual Reports (various issues)

It is clear from figure 1 that the country has not managed to overcome its external debt problem over this time. Public debt, which includes both external and internal debt, has now exceeded the country's GDP. It is noteworthy here that out of the total outstanding public debt approximately 43 percent was external debt in 2002. This is still an underestimation because we have not included the massive amount of soft loan foreign assistance, 4.5 billion U.S. dollars, agreed at the Tokyo summit in 2003. Once private borrowings and other pledged loan assistances are taken into consideration, this number would rise by a substantial amount.

External Debt and Other Macroeconomic Variables

The severe debt problem faced by Sri Lanka can also be understood by examining the debt-service ratio. Debt service payments include two components, i.e., principle or amortization payments and interest payments. The ratio of debt service payments to export earnings is called the debt service ratio. The time path of the external debt service ratio for the period 1951-2003 is given in Figure 2.

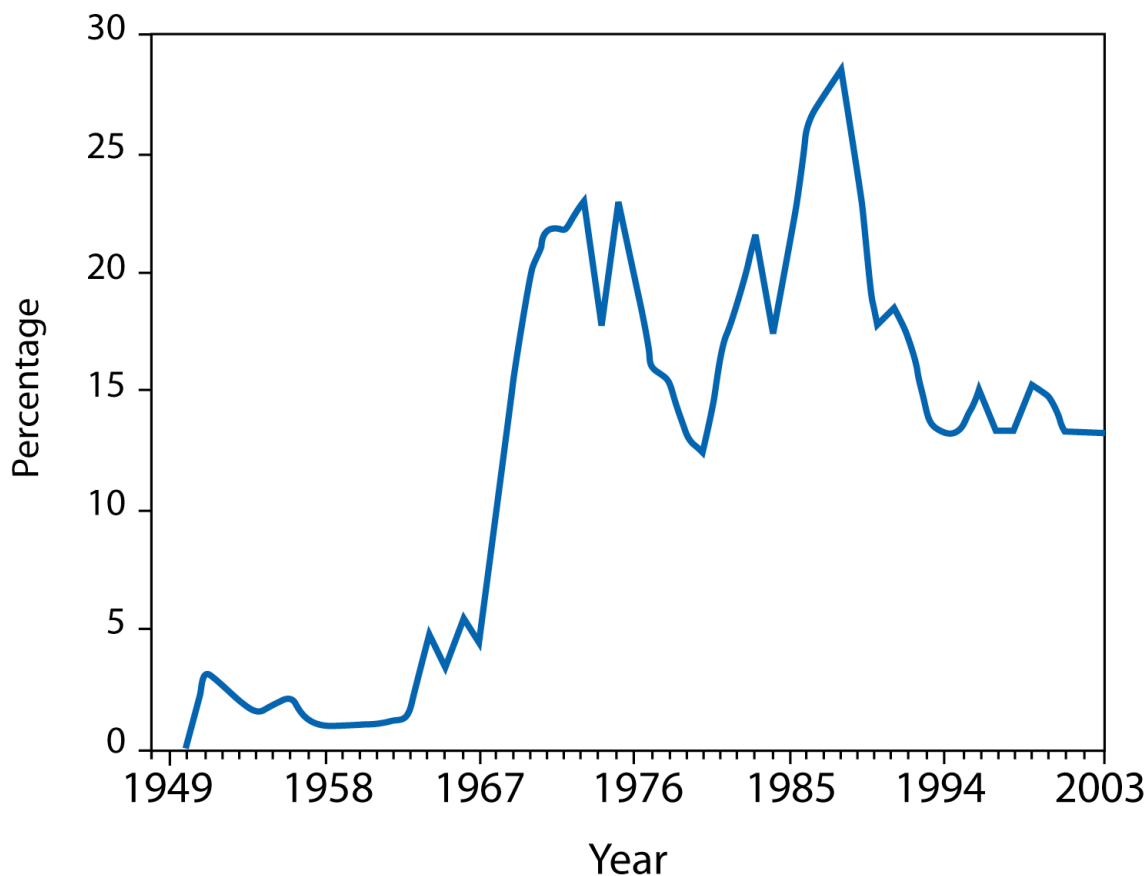


Figure 2. Time Path of Debt Service Ratio.
 Source: Central Bank Annual Reports (various issues)

The debt service ratio was highly vulnerable over the last five decades. The behaviour of the ratio depends on factors such as the amount of service payments and the amount of export earnings. Sri Lanka has managed to improve its export earnings to some extent over the last five decades particularly after the trade liberalization in 1977. However, external debt service payments have also increased steadily. Hence, rising export earnings virtually had no favourable impacts on the debt service ratio.

Figure 3 illustrates the time path of the logarithmic change in debt service payments and export earnings over the period 1950 to 2003. It suggests that the growth rate of debt service payments has consistently outperformed the growth rate of export earnings except in several years. For instance, debt service payments grew by approximately 35 % in 1981 while export earnings reported merely a 5% growth rate in the same year. The only relief is that in the 1990s the growth rate of outstanding debt remained at a low level and recorded a downward trend.

The servicing of existing external debt and debt management are the most crucial issues that debtor countries are facing today. For instance, some heavily indebted countries such as Cameroon, Chad and Congo Republic had recorded more than 200% debt-to-export ratios in 1998 (Mbanga, 2003). Although Sri Lanka has not been categorised as one of the heavily indebted countries, it has also been facing severe difficulties of financing its foreign debt. The interest payment, which is also known as the real cost of borrowing, shows that the average rate of borrowing is about 3% a year (Central Bank Annual

Reports, various issues). This rate is higher than the current interest rate paid to the non-resident-foreign-currency account holders by the local banks. Some literature provides evidence for the foreign debt overhang problem using interest rates as indicators of indebtedness (see, Afxentiou, 1993).

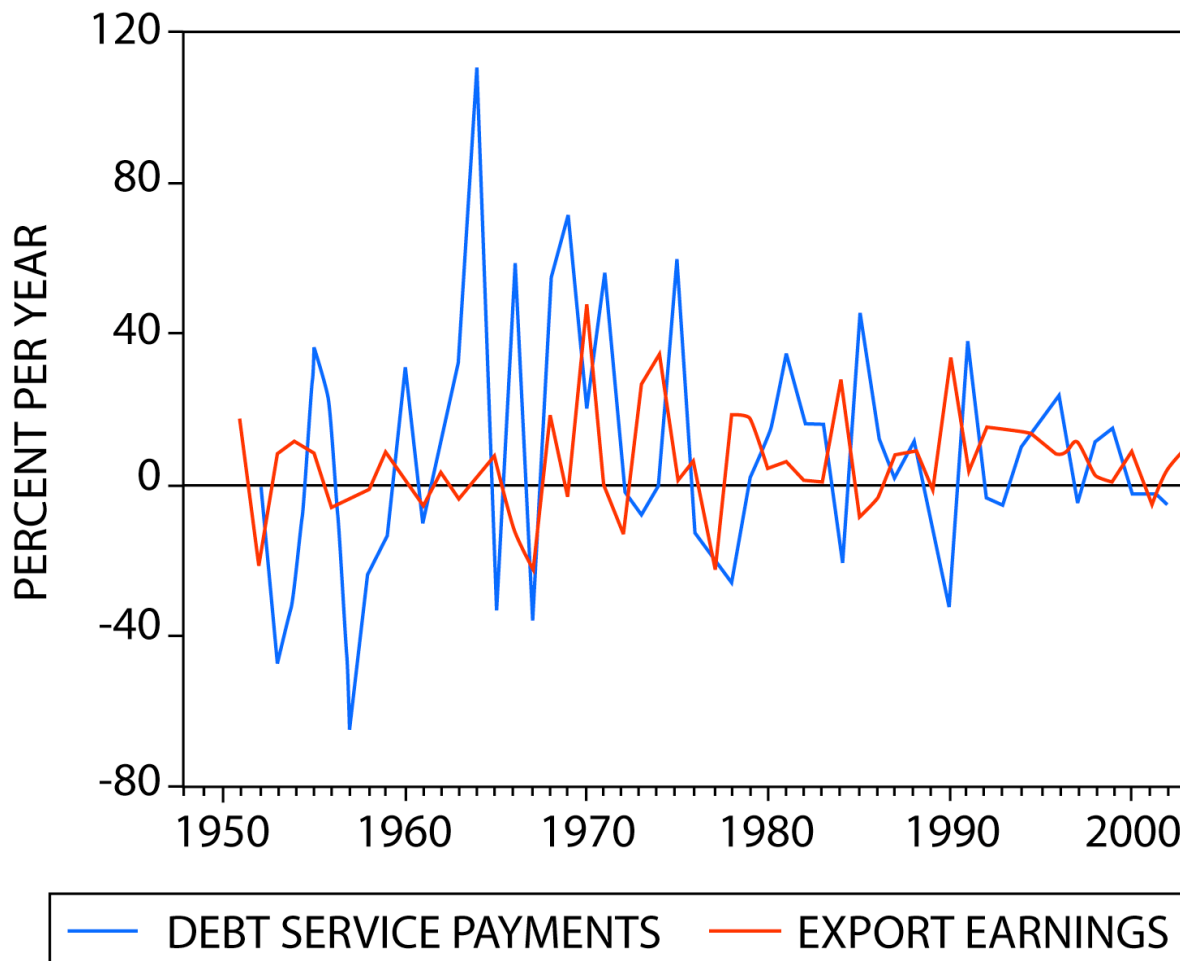


Figure 3. Growth Rates of Debt Service Payments and Export Earnings
 Source: Central Bank Annual Reports (various issues)

Several issues can be raised with regard to the interest payments for the external debt. If any country is to manage its own external debt, it should maintain a high rate of export earnings in terms of foreign exchange. If the growth rate of export earnings is less than the cost of borrowings, then the debt problem will continue to arise indefinitely. However, the experience of Sri Lanka shows that in some years the growth rate of exports earnings was negative and it is almost always lower than the cost of borrowing.

The pattern of external debt growth and growth of export earnings is highly dependant on the policies adopted by successive governments. As a country that has been successful in maintaining a vibrant democracy, governments have changed frequently in Sri Lanka after independence in 1948. Over the last five decades, economic policies also changed dramatically. For instance, in 1977, policies changed from import substitutions to export promotions as well as from inward-looking policies to outward-looking policies. The rapid increase in outstanding external debt is partially attributable to economic

reforms introduced in 1977. Sri Lanka was one of the first countries to implement structural reforms in the late 1970s. The continued balance of payments deficit, declining terms of trade, slow growth rate of export earnings, stagnation of the economy, heavy import dependency, and increasing inflation led the country to a crisis. As a result, Sri Lanka had no option other than accepting the economic reforms as a condition of getting 'structural loan facilities'. On the other hand, the government of Sri Lanka had initiated three major development projects funded by the donor countries and institutions in the 1980s. Figure 1 supports the view that trade liberalization in 1977 had a considerable impact on the level of outstanding external debt in Sri Lanka. It should be emphasized here that long term impacts of trade liberalization have been positive on both external debt and export earnings. This phenomenon could be examined using data given in Table 1.

Table 1: Growth Rates of Outstanding Debt and Export Earnings during Different Political Regimes

	Growth rate of debt	Growth rate of Exports
1960-65	0.108	-0.012
1965-70	0.349	-0.016
1970-77	0.109	0.150
1978 -94	0.145	0.099
1995-2001	0.059	0.035

Source: Central Bank Annual Reports (various issues)

The table summarizes the average annual growth rate of outstanding debt and the average annual growth rate of export earnings for different political regimes. It is clear from the table that the average annual rate of growth of export earnings was negative for two political regimes prior to 1970. After 1995, the rate of growth of exports as well as the rate of growth in outstanding debt went down reducing the gap between the two rates accordingly.

The above relations can also be explained using the earning capacity of foreign exchange. The very reason for such comparison is that the external debt will have to be paid back in foreign exchange. Table 2 shows the ratio of outstanding debt to export earnings or earning capacity of foreign exchange in Sri Lanka in recent years. It simply suggests that about one and one half years of export earnings is necessary to pay back the country's outstanding yearly debt.

Table 2: Comparison of Export Earnings and Outstanding Debt.

Year	Export Earnings US\$ millions	Outstanding Debt US\$ millions	Debt/Export Earnings
1998	5712	8749	1.53
1999	5578	9088	1.62
2000	6476	9031	1.39
2001	6172	8544	1.38
2002	5967	9291	1.55
2003	6509	10644	1.63

Source: Central Bank Annual Reports (various issues)

One of the traditional methods of analysing external debt is the comparison of debt as a ratio of GDP. The relationship between external debt and economic growth has been estimated using different econometric techniques (See, Cunningham, 1992, Karagol, 2002). Sri Lanka has maintained a healthy

economic growth rate over the last two decades. To illustrate, real GDP has grown approximately 4.5% on average over the said period. Even with this situation, the country has not been able to check the continuous growth of its external debt as a ratio of GDP.

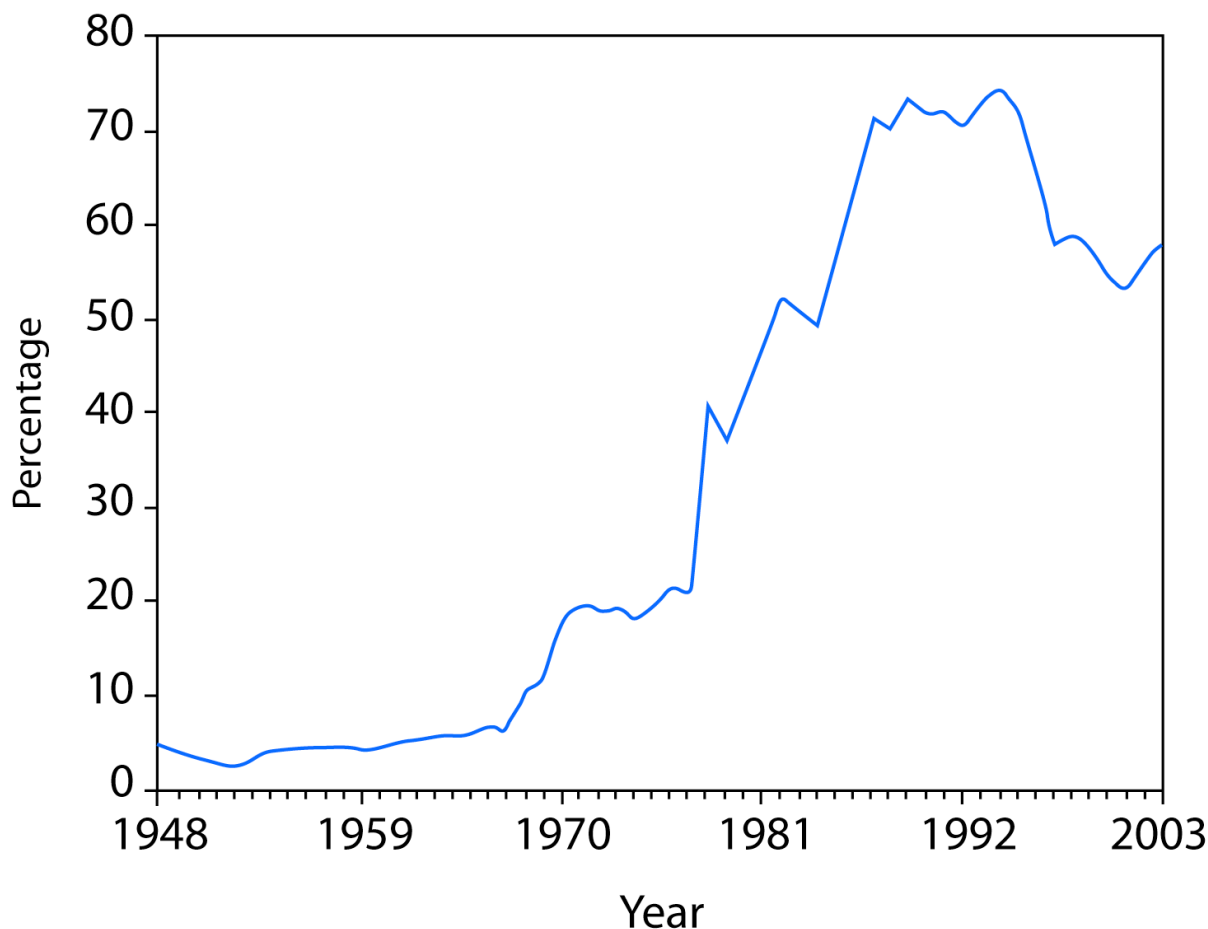


Figure 4. External Debt as a Percentage of GDP: 1948-2003.

Source: Central Bank Annual Reports (various issues)

The ratio of the external debt to GDP is given in figure 4. This shows that until 1968 the debt/GDP ratio remained at an insignificant level of below 10 percent. From 1968 to 1972, there was a slow increase in the ratio and the average annual ratio was around 19 percent. In 1978, the ratio shot up to a high level of 40%. During the period of 1979 to 1989, the ratio of outstanding debt to GDP increased from 40% to 73.6%, the highest level ever. The debt/GDP ratio remained at a high level of around 73% until 1993 and declined to 56% in 2002.

If the resources generated by external borrowings are invested in infrastructure development projects or specific development projects rather than for consumption purposes, the GDP is expected to increase. In that case, even if the growth rate of export earnings is low the management of external debt will not be a serious problem. Many scholars have examined how external debt impacts on investments using both theoretical and empirical methods (see Eduardo, 1989, Hoffman and Reisen, 1991, Savvides, 1992). They find that wherever a country is in debt, a large amount of public spending and foreign exchange earnings are absorbed by debt servicing. Reduction in public investments widens the investment savings gap jeopardizing development attempts. Foreign debt has a negative impact on investment due to

two effects (Eduardo, 1989). One is the debt overhang problem and the other is the credit rationing problem.

Debt overhang occurs when debt payments are linked to the economic growth of the country. A part of the gains of economic growth is spent as debt repayments. This phenomenon is sometimes called a foreign tax on production. A significant part of the investment goes to creditors and not to the country itself. This may discourage governments from undertaking growth-oriented economic policies. However, if the economy is booming, debt overhang will not be a serious issue because the returns on investment are high (Lamon, 1995). As far as Sri Lanka is concerned, it has been able to achieve a healthy economic growth rate in spite of facing long running civil unrest in the island. As a result of this, the ratio of external debt to GDP has declined gradually over the decade until 2002, except in 2003. However this was not the general case until the early 1990s. During that period the GDP growth rate was highly variable and in many years the rate was lower than the rate of increase in outstanding external debt.

The credit rationing effect arises when debtors are unable to pay back their debts. In order to narrow the savings gap, fiscal authorities increase interest rates which in turn adversely affect investments. These two effects on investments will impact negatively on economic growth.

Much of the literature on the external debt issue has focused on the savings investment gap, or the domestic resource gap, which is a key factor that decides the level of dependency on external resources (Faini and DeMelo, 1990). Particularly, the developing countries that are struggling to achieve a high economic growth are seeking external resources in the form of credits or capital inflows. A larger share of external resources coming into these countries is in the form of public sector loans and/or grants. In Sri Lanka, before 1977, the difference between savings and investments was rather small, but the gap had widened considerably after 1977. The gap between the two ratios remained as high as around 10% of the GDP after 1978 (Central Bank Annual Reports).

One of the arguments is that if a country can make fruitful investments from borrowed resources, the problem of repayments will not emerge. Japan, Korea, and Malaysia can be good examples to strengthen this point. However, the experience in Sri Lanka does not show such a healthy situation. This is because of the poor absorption capacity of investments. The capital budgets allocated for most of the ministries and public sector institutions were not absorbed within the specified period. This is the reality of most of the public sector institutions in Sri Lanka. A question which naturally comes to one's mind is that if the economy cannot absorb its investments, is it reasonable to continue to borrow and how can it maintain the required rate of growth to repay the loans?

Import dependency, the ratio of essential imports to total imports, is another factor that decides the external resource gap of a country. In Sri Lanka, the ratio of capital and intermediary imports to the total imports has been consistently high over the last two decades. For instance, capital and intermediary imports contributed approximately 75% of total imports over the study period. These imports are highly correlated with the economic growth of the country. Since this ratio has been significantly high, Sri Lanka was not in a position to control its imports to overcome balance of payments difficulties. The heavy import dependency and the slow growth rate of export earnings expanded the trade deficit which in turn caused a huge deficit in the current account. It is interesting to note that Sri Lanka was enjoying a surplus in the current account at the time that it gained independence. Since 1978, the current account has continuously been in deficit. In 2000, the current account balance went to a record deficit of US\$ 1065 millions (Central Bank Annual Reports, various issues).

One of the possible reasons for the widening current account deficit may be the increasing military expenditure due to the long-running civil war in the country. Further worsening this problem, the donors were not responsive to aid-group meetings on several occasions citing human rights violations on

the part of the government. Some suggest that myopic nature of politicians can be attributed to this problem. Whatever the reasons, increasing current account deficit has compelled the government to borrow more from foreign sources to finance the balance of payments.

Another important issue arising in the analysis of external debt is that the country is moving towards short-term credits, which are often accompanied by hard terms. The percentage of short term external debt to total external debt has increased from 5.2 in 1999 to 6.4 in 2002. This implies that the pattern of borrowing is moving away from long term capital flows to short term flows.

Summary and Conclusions

The main objective of this study has been to provide background information about the existing external debt problem in Sri Lanka. After analysing various external debt indicators and the relationship between external debt and other macroeconomic variables, this paper has reached several conclusions.

First, Sri Lanka has been unable to maintain a satisfactory growth rate in export earnings to cope with the rising amount of external debt. While the growth rate of export earnings has been slow and even negative in some years, the growth rate of external debt has been positive and dominating. This situation has been worsened by a high import dependency rate. As we have seen, the average rate of import dependency remained as high as around 75% of the total imports throughout the last two decades. This not only made it difficult to service the debt, but also compelled successive governments to borrow more from foreign sources to finance the huge balance of payments deficit.

Second, annual interest payments to foreign creditors have been relatively high even though most of the borrowings consist of concessional loans. It was shown that the average annual interest rate for outstanding external debt remains approximately 3%. It is important to emphasize that this is not substantially different from the rate of interest in commercial lending. This cost of borrowings is rather high and is often higher than the interest rate paid to non-resident-foreign-currency accounts holders by the local banks. Interest payments as well as outstanding external debt have further increased by the continuous depreciation of the value of the rupee against to other major world currencies. The Sri Lanka rupee has depreciated from approximately eight rupees per US dollar in 1977 to 96 rupees per US dollar in 2003.

Third, the widening resource gap or the savings investment gap has created a limitation to development efforts of the country. Throughout its post-independence era, Sri Lanka has experienced a huge gap between its desired investment and actual national savings. Because national savings are not enough to accommodate the desired investment level, the county was compelled to look for some form of foreign savings such as foreign investments, donations and foreign loans. If foreign borrowings are going to be used efficiently for productivity-enhancing projects, external debt is not going to be a serious issue. However, Sri Lanka's experience was not so pleasant in this regard. It has been unable to allocate foreign borrowings exclusively for capital investments. It is even disturbing to observe that a substantial percentage of the allocated capital has returned unused due to the poor absorption capacity in the economy. In the face of the high cost of borrowings it is a critical issue, which will not only jeopardize the effort of external debt management, but also the current development attempts.

Fourth, the available data provide mixed findings about the overall debt management ability of Sri Lanka. Although external debt has reached an alarming level, almost all the external debt indicators show a favourable change since the mid 1990s. To illustrate, total external debt as a percentage of GDP has decreased from 72% in 1990 to 58.4% in 2003 and the debt service ratio decreased from 28% in 1988 to 13 % in 2003. However, once we include the massive amount of foreign loans, totalling US 4.5 billion dollars that were agreed upon at the Tokyo Summit in 2003, this favourable trend will revert back to the

previous trend. It is rather clear that as a small country, Sri Lanka has no other option than moving along the present path of globalization. However, within this framework, choices are to be made between potential investment projects, the cost of external debt, management of debt servicing and the prospects of maintaining credit worthiness. There is a dearth of literature on the debt management issue in Sri Lanka. Therefore, more research is needed to investigate these crucial macroeconomic aspects of external debt servicing and management.

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