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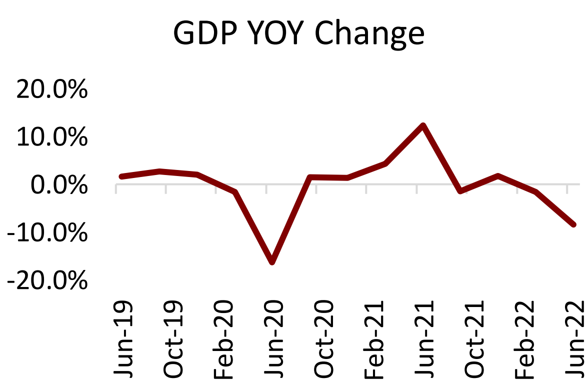
Sri Lanka Economic Crisis

Economic Profile	
Country	Sri Lanka
Currency	Sri Lankan Rupee
Population	21.9 Million
Economy	Developing
GDP	$84.52 Billion
GDP Per Capita	$4,156.97
Largest Trading Partner	China

Market Outlook	
Point in Business Cycle	Left-of-Trough
Market Outlook	Bearish



GDP Percent Change (Source: Thomson Reuters)

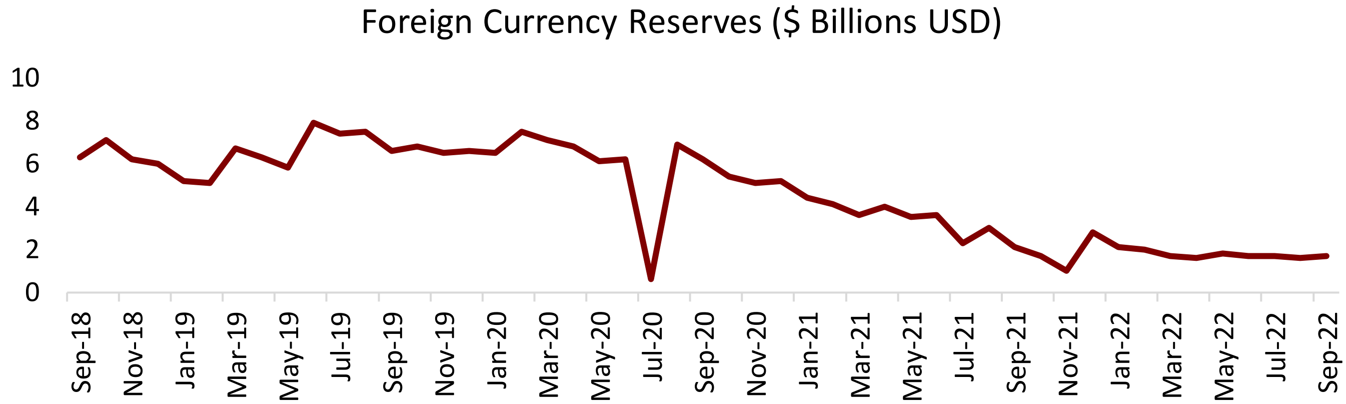
Macroeconomic Thesis:

Due to recent economic trends in Sri Lanka, the country is headed towards rock bottom. In the near-term, political instability and geopolitical tensions threaten the country's recovery. In the medium-run, the extent of these headwinds will be pivotal in determining if Sri Lanka can successfully bounce back.

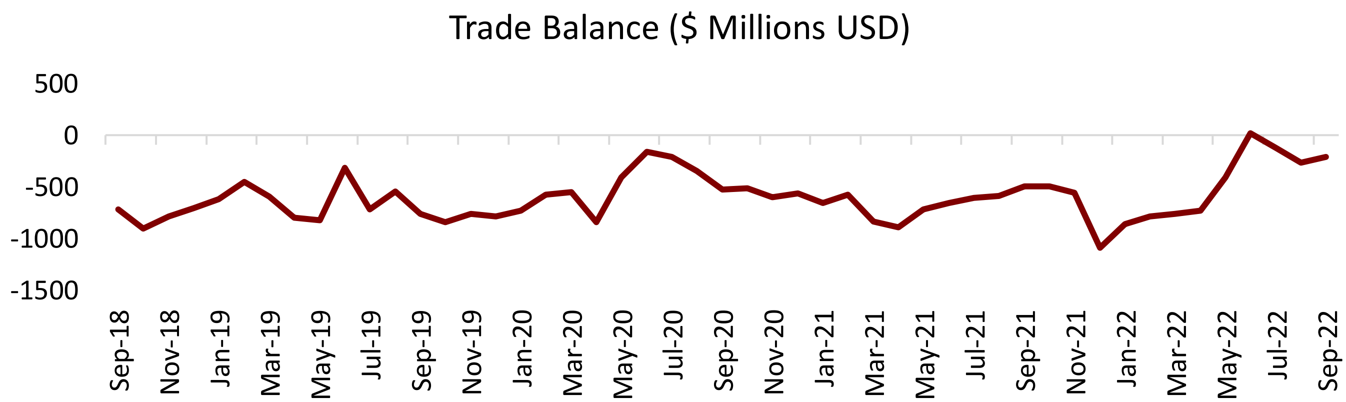
Defaulting on its debt for the first time in May, Sri Lanka's current crisis is in many ways comparable to the country's independence movement over 70 years ago. Tired of corruption, fund misappropriation, and worsening economic conditions, peaceful protests have turned violent. Due to mounting pressures, former President Gotabaya Rajapaksa and former PM Mahinda Rajapaksa resigned, and were replaced with Ranil Wickremesinghe and Dinesh Gunawardena, respectively.

As a small island country, Sri Lanka relies heavily on imports. Recently the pandemic and the Russia-Ukraine crisis have caused shortages of necessities, leading to more expensive imports. As China keeps its eyes on Taiwan, a Chinese invasion could exacerbate supply chain bottlenecks. Looking at the export side, Sri Lankan goods/services have taken a hit. One of country's main exports is tea, but President Rajapaksa's brief ban on synthetic fertilizers last year has resulted in unsuccessful crop yields. In addition, terrorist attacks, the pandemic, and current protests have hampered tourism, resulting in a decline of foreign income. As people lose trust in the government, less remittance money is going through the formal banking system, further inhibiting the country's efforts to increase foreign exchange reserves. As foreign reserves dry up and imports become more expensive, Sri Lankans experience daily power cuts, and are seen in line for days just to buy necessities. The shortages have put many out of work, and the daily power cuts ruin the ability for effective remote work. In response, over 200,000 people have fled the country this year. In a promise to bring economic prosperity, Gotabaya Rajapaksa cut the Value Added Tax from 15% to 8%, a stab to the government's revenue. Only after the current turmoil has the rate been hiked to 12%. Dousing the fire is Sri Lanka's high debt, which it owes a large share of to China, India, and companies such as Blackrock. Battling between importing necessities and paying creditors, the country decided to default on over $50B of debt. Currently, creditor countries and the IMF are working to coordinate a debt restructuring plan. With China and India as significant bilateral lenders, they have been competing for influence in Sri Lanka. The country's current economic crisis provides a cautionary tale for emerging nations in a similar position.

Economic Indicators



Foreign Reserves (Source: Thomson Reuters)



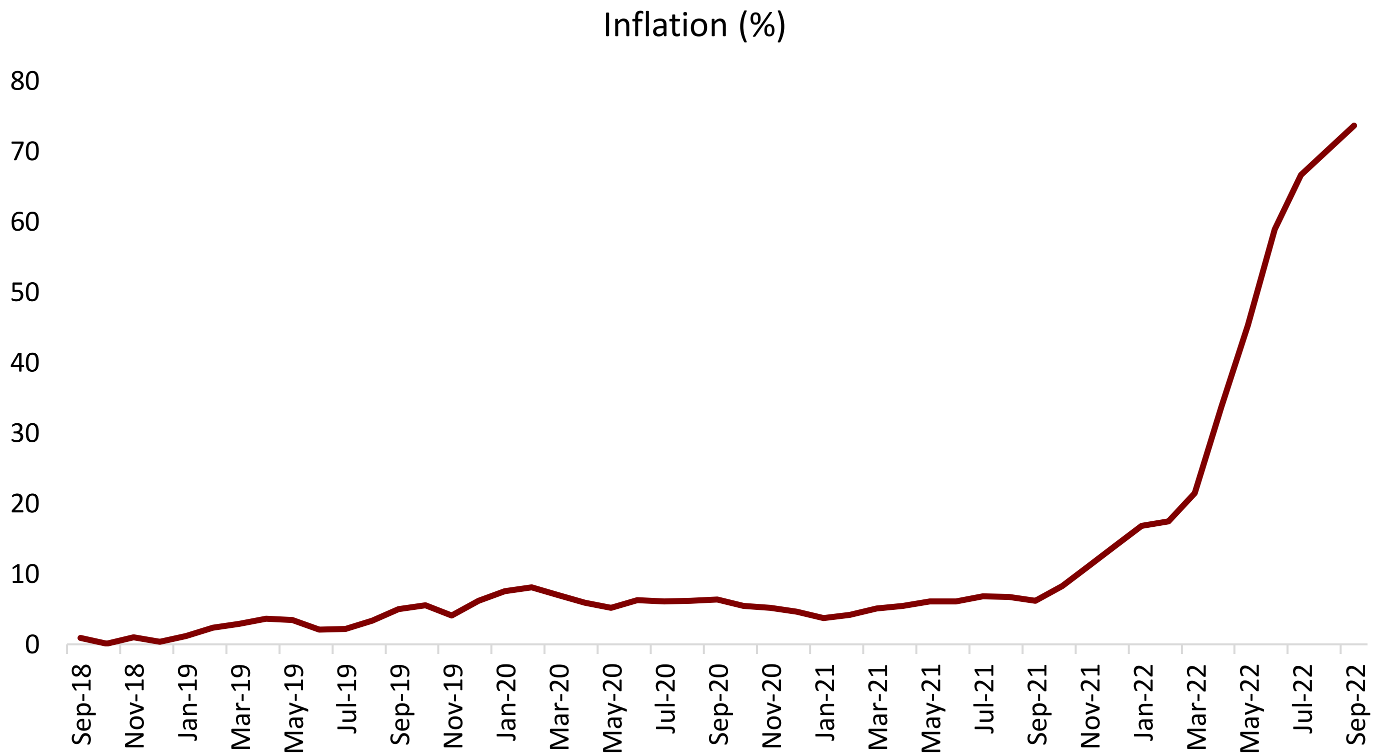
Balance of Trade (Source: Thomson Reuters)

Foreign Reserves and Trade Balance:

The steep decline in foreign currency reserves is one of the main drivers of the ongoing crisis. Sri Lanka relies heavily on imports and must have sufficient foreign reserves to purchase them. While demand for foreign reserves remains high, the inflow of foreign currency has declined for a variety of reasons. Following a decades-long civil war that ended in 2009, the end of this turbulent era marked an increase in foreign income from tourism. From 2009 to 2018, tourism earnings jumped from $350M to $4.4B. Recently however, a combination of the 2019 Easter Bombings, COVID-19, and civil unrest have hindered tourism earnings. Formal remittances, which refers to money sent from migrant workers through the banking system, helps increase a country's foreign exchange reserves. Unfortunately, formal remittances fell to a 10-year low of $5.49M in 2021, largely due to the unofficial peg of the Sri Lankan Rupee to the U.S. Dollar at the range of 200-203 rupees per dollar. This encouraged foreign workers to seek informal channels in which their dollars would fetch more rupees for their recipients in Sri Lanka. While informal channels can provide a better exchange rate, it results in a decline of foreign reserves since the money does not have to go through the formal banking system. In March, the central bank unpegged the rupee to the dollar, allowing for their currency to devalue. While $1 now fetches over 350 rupees, the recent lack of trust in the government will continue to bolster the demand for informal remittance channels.

Diving deeper into the country's trade balance, Sri Lanka relies heavily on other nations for necessities such as food, fuel, and medicine. With over 15% of its imports from fuels, the Russia-Ukraine crisis has made fuel very expensive to import, resulting in fuel shortages. Furthermore, in April 2021, President Gotabaya Rajapaksa placed a ban on synthetic fertilizers in an attempt to become reliant on organic farming. Although the ban was reversed that November, the damage was already done, leading to a significant drop in crop yields. One of the country's largest exports, tea, took a blow, and the rice yield dropped, leading to food shortages. As a result, Sri Lanka depleted foreign reserves by $450M to import rice. As the Russia-Ukraine conflict continues and China-Taiwan tensions simmer, it is unlikely that the cost of imports will decline in the short-run.

Economic Indicators



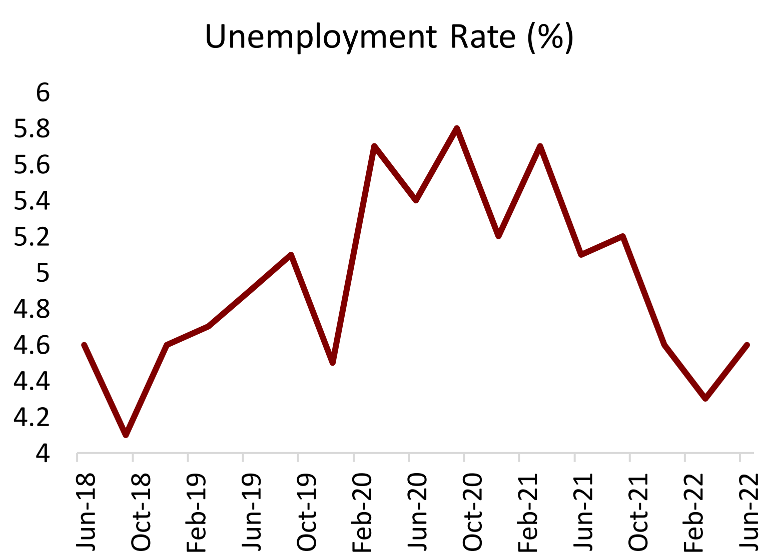
Inflation (Source: Thomson-Reuters)

Inflation:

Over the past year, prices have skyrocketed, with inflation hitting an all-time high of 73.7% in September. As Russia-Ukraine tensions strain supply chains and the country's reserves run low, Sri Lanka struggles to import enough of food staples such as wheat. Furthermore, the recent unsuccessful harvest seasons have exacerbated food shortages, resulting in 94.9% food inflation in September. The recent price pressure on oil has prevented Sri Lanka from importing enough fuel. As a result, citizens wait hours and even days in line for fuel, and experience daily power outages.

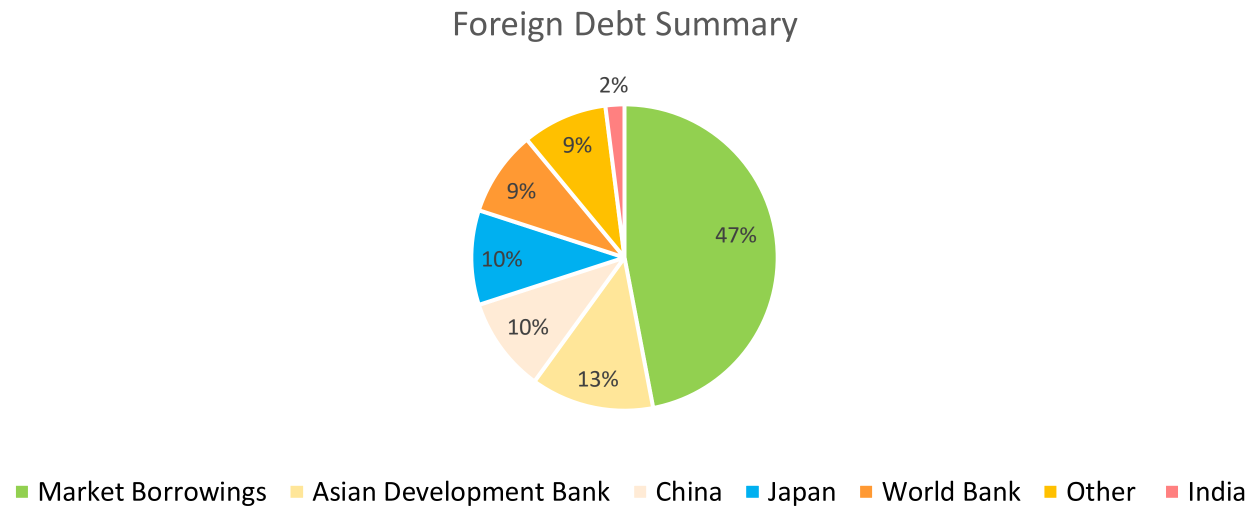
Unemployment Rate:

Like many other countries, the COVID-induced lockdowns in 2020 and 2021 caused unemployment to spike to all-time highs. While the decline in unemployment in the second-half of 2021 looked promising, the country's economic turmoil has led to unemployment rising again. Following the start of the Russia-Ukraine War in February, the price pressure on imports has led to a shortage of fuel and other necessities. With a shortage of fuel, businesses struggle to remain afloat, and schools are forced to shut down. The unreliable energy supply makes it difficult for Sri Lankans to easily switch to a work-from-home format. In response to the country's undesirable conditions, over 200,000 Sri Lankans have fled this year.

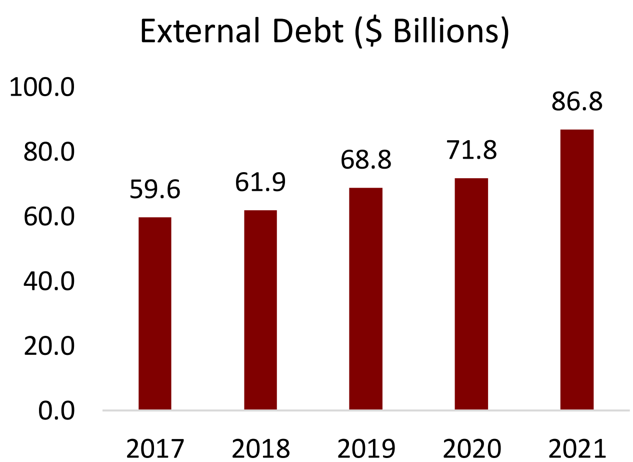


Unemployment Rate (Source: Thomson-Reuters)

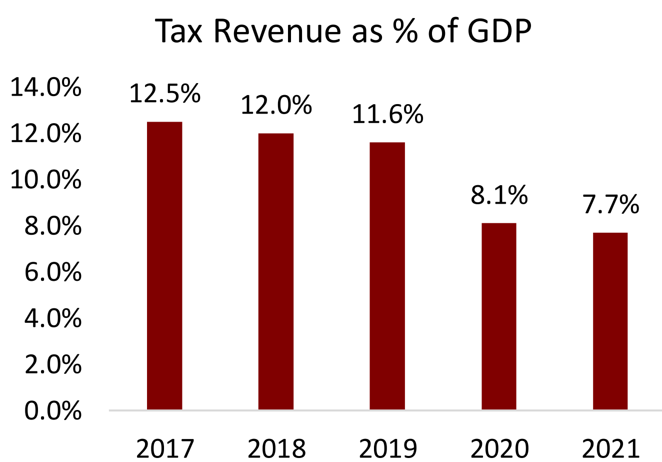
Economic Indicators



Foreign Debt Summary as of April 2021 (Source: Visual Capitalist)



External Debt (Source: The Global Economy)



Tax Revenue to GDP (Source: World Bank and Asia Times)

Default of High Debt:

Over the years, Sri Lanka has racked up immense external debt, especially from China, the Asian Development Bank, and private-sector bondholders such as Blackrock. With low foreign reserves and high debt, the country had to choose between importing necessities or paying creditors. In May, the country defaulted on over $50B of debt. To get out of this rut, Sri Lanka needs to reach a debt restructuring agreement with its creditors and the IMF. While Sri Lanka is currently in talks with creditor nations and the IMF, they are yet to reach an official agreement.

Tax Cuts:

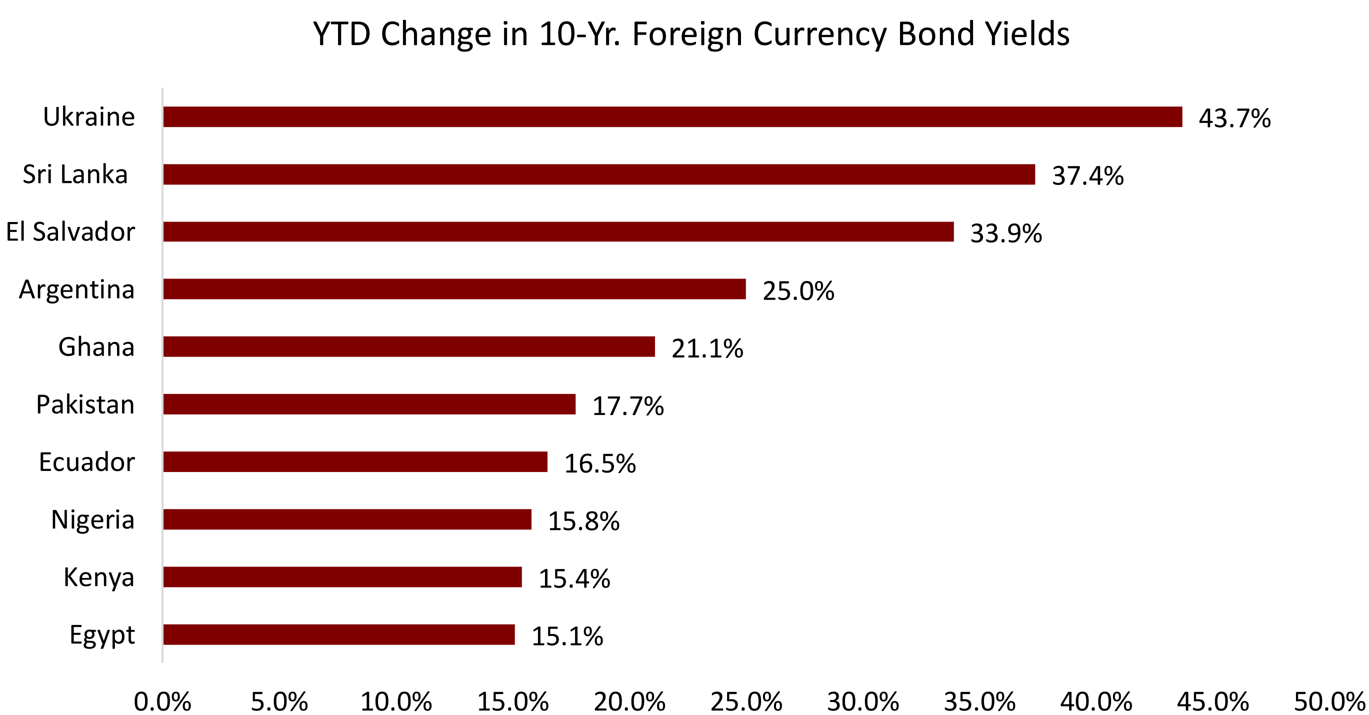
When Gotabaya Rajapaksa ran for president in 2019, he promised economic prosperity, and once elected, he did this through significant tax cuts just months before the COVID-19 pandemic. Most notably, he cut the Value Added Tax (VAT) from 15% down to 8%. Furthermore, he abolished taxes such as the Economic Service Charge and the Credit Service Tax. Because of Rajapaksa's tax policies, the decrease in tax revenue coupled with the rising expenditures to fight the pandemic worsened the budget deficit. Moreover, creditors became more wary about lending to Sri Lanka, which resulted in creditors increasing the cost of borrowing. Despite expensive borrowing costs, Sri Lanka continued to borrow billions. When Wickremesinghe took office in May, he began by increasing the VAT from 8% to 12% and made numerous other tax revisions. As the country continues to evaluate its tax laws, reducing the deficit is crucial for getting the country back on its feet.

Geopolitical Factors

Relations with India and China:

As an island country on the Indian Ocean, Sri Lanka is in the middle of a key sea key route connecting the East and West. For many years, China and India have competed for influence over the country. Since 2005 after Mahinda Rajapaksa became president, Sri Lanka strengthened ties with China. For instance, China supplied the Sri Lankan government with weapons, which helped them end the civil war that lasted over 25 years. As one of Sri Lanka's largest bilateral lenders, China's lending was used to support large infrastructure projects such as the Hambantota Port and the Colombo Lotus Tower. When Gotabaya first stepped in as president, the government continued to make decisions that supported China's best interests. One notable example is the passing of the Port City Economic Commission Bill, which gave a Chinese construction company the right to use 153 acres of land on a 99-year lease from the Sri Lankan government. The bill was passed with 149 votes in favor, and 58 against, with critics arguing that passing this bill would threaten Sri Lanka's sovereignty.

During the pandemic, China and India supplied Sri Lanka with aid. With a current dispute at the Himalayan Ladakh border and growing fears of Chinese influence in neighboring countries, India is using Sri Lanka's crisis as an opportunity to regain significant influence in the region. Since the beginning of this year, India has provided nearly $4B of assistance, which exceeds China. Shortly after protesting Sri Lanka's partnership with a Chinese company for a solar plant project, India secured a deal with Sri Lanka to jointly develop the Trincomalee Oil Tank Farm, which will allow India to store oil reserves in over 60 large tanks. As major bilateral lenders to the island nation, India and China will be pivotal in the restructuring of Sri Lanka's debt.



YTD Change in 10-Yr. Foreign Currency Bond Yields (Source: Financial Times)

Implications of Crisis on Other Emerging Markets:

Following Sri Lanka's debt default, this raises fears that other developing nations with similar circumstances are headed the same direction. Due to rising interest rates, the strengthening dollar, and geopolitical tensions, investors have withdrawn over $70B in emerging market bond funds this year. In a time of rate hikes and a strengthening dollar, this hurts these countries' ability to service dollar-denominated debt in a time they need capital the most. China and other world powers have loaned billions to emerging economies, so how they react to Sri Lanka's requests will set precedent for what these nations can expect going forward.

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