The Nightmare Scenario: A Default on Sovereign Debt

A Pathfinder Perspective

The Pathfinder Foundation invited Prof. Shanta Devarajan who was the World Bank's Chief Economist in a number of regions to write this article as a sequel to the two previous ones titled " 1. Pulling back from the precipice: A Pathfinder perspective" & "2. Sri Lanka has no choice but to restructure external debt "

On December 17, 2021, Fitch downgraded Sri Lanka's rating to "CC", the lowest rating prior to default. With external reserves at around $1.6 billion and almost $1 billion in debt-service payments coming due in January 2022 (and $7 billion during the coming year), the country faces a very real possibility of a sovereign debt default. If this were to happen, what would be the consequences for the economy, the poor, and society?

We can get an idea by looking at the experience of other countries that defaulted recently. Last year (2020) saw an unusually large number of countries defaulting on their sovereign debt. One of them, Lebanon—a country with sharp divisions along religious lines, a history of civil war, and an economy dependent on tourism and remittances—provides telling lessons for what might happen should Sri Lanka default.

A country defaults when it fails to meet the service payment on its sovereign debt. In the case of Lebanon (and almost every other sovereign default), the immediate consequence was that the country could no longer borrow abroad. In particular, it could not finance its current account deficit, which (like Sri Lanka's) has always been high. A recent World Bank report documents how this resulted in a massive compression of imports (40 percent) that, in turn, triggered a sharp decline in economic activity. In one year, Lebanon's GDP declined by 20 percent—one of the steepest drops in history. The exchange rate depreciated 129 percent. The pass-through effects of the currency depreciation meant that inflation has been accelerating: the 12-month inflation rate, which was 10 percent in January 2020, reached 158 percent in March 2021.

The economic slowdown and spike in inflation disproportionately hurt the poor and vulnerable. With food inflation at 254 percent in 2020 and poorer households spending about a third of their consumption on food, people are suffering. They stand in long lines for food, fuel and pharmaceuticals. Phone surveys in late 2020 showed that some 40 percent of households reported difficulties in obtaining food and other basic needs. About one in five manufacturing firms have closed and the remaining ones are operating at an average of 35 percent capacity. The unemployment rate, already high in Lebanon, has risen to 40 percent.

Most troubling is that the harsh economic conditions have led to violence in the streets. Eerily reminiscent of the civil war, armed clashes have broken out among sectarian militias. Beirut is seeing the worst violence in decades. Soon after the default, the government fell and was unable to reconstitute a coalition for thirteen months.

To be sure, Sri Lanka is not Lebanon. And Lebanon's problems were confounded by the August 2020 explosion in the Port of Beirut that killed 218 people. Yet, the many similarities in both countries' circumstances before 2020 and Lebanon's horrifying experience post-default point to one conclusion: Sri Lanka should avoid a sovereign debt default at all cost.

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