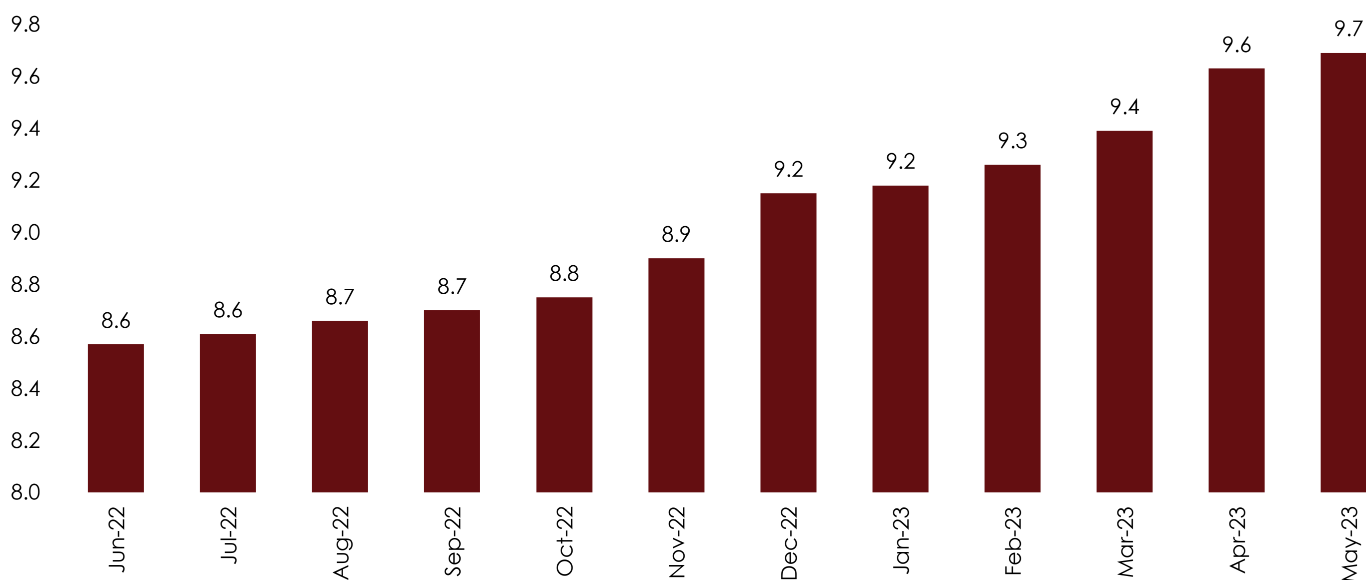
Debt Distress: Lessons from Greece, Ghana, and Sri Lanka

28 September 2023

This study looks at Kenya's public debt situation in light of the looming Eurobond 2024 maturity in June next year. We look into similar situations in Ghana, Greece, and Sri Lanka and examine the resultant implications for those economies. We try to draw parallels to these scenarios to paint a picture of any possible ramifications for Kenya.

The Kenyan Story So Far

Kenya's public debt has been a growing concern in recent years, with the total public debt reaching a staggering KES 9.6 trillion as of May 2023. This substantial debt burden has raised alarms both domestically and internationally, as it has the potential to impact the country's economic stability and future development. A key metric used to assess a country's debt sustainability is the debt-to-GDP ratio and as of December 2022, Kenya's debt-to-GDP ratio stood at 67.3 percent which is well above the International Monetary Fund's (IMF) recommended upper limit of 50 percent.

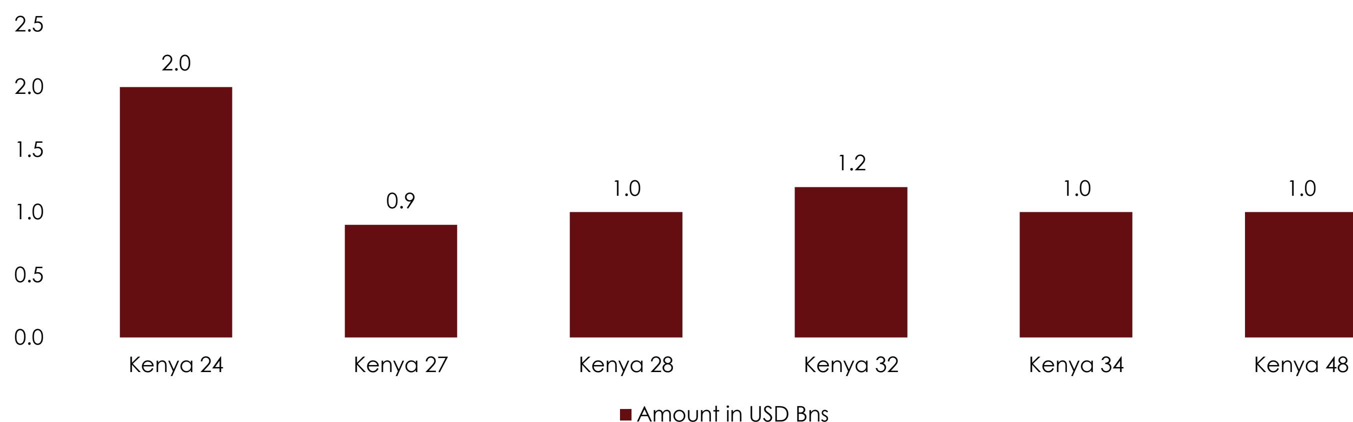


Source: Trading Economics and Central Bank of Kenya Data

In particular, external borrowing grew briskly from 2013 to 2020, as the Government ventured into the Eurobond market, drawn by competitive financing terms—with coupon rates in the 6.5 – 8.5 percent range.

	Issue Date	Maturity Date	Coupon	Amount in USD Bns
Kenya 24	Jun-14	Jun-24	6.875%	2.0
Kenya 27	May-19	May-27	7.000%	0.9
Kenya 28	Feb-18	Feb-28	7.250%	1.0
Kenya 32	May-19	May-32	8.000%	1.2
Kenya 34	Jun-21	Jan-34	6.300%	1.0
Kenya 48	Feb-18	Feb-48	8.250%	1.0
Total Amount				7.1

Source: National Treasury of Kenya Data



Source: National Treasury of Kenya Data

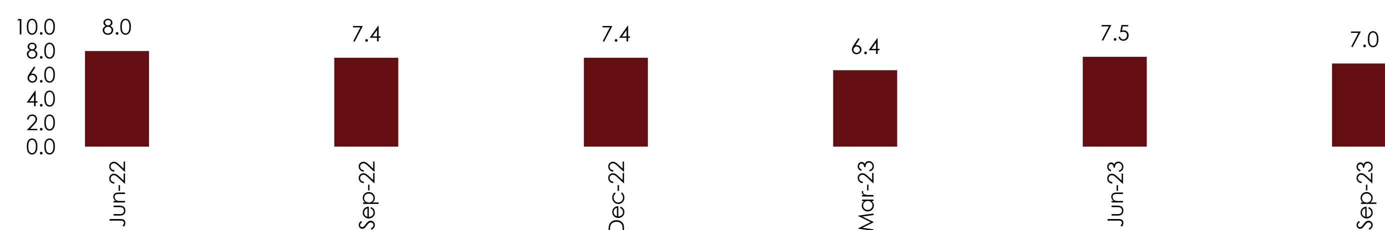
As such, total external debt jumped from USD 10.2 billion in 2013 to USD 34.8 billion in 2020, according to the Central Bank of Kenya (CBK), including a tenfold jump in commercial borrowing to USD 10.4 billion and a nearly fourfold rise in bilateral loans to USD 10.6 billion, led by China. This sharp rise in external debt, especially from non-concessional sources, has been accompanied by a steep increase in debt servicing outlays.

From 2020 to 2022, borrowing dynamics shifted as Kenya turned to concessional multilateral borrowing from the IMF, the World Bank, and the African Development Bank (AfDB), to help deal with the impact of the Covid-19 pandemic. It is also during this period that Kenya embarked on a 38-month IMF program in April 2021, running to mid-2024, supported by a USD 2.34 billion funding envelope, which is geared towards strengthening fiscal and debt management.

As the overall debt stock went up, Kenya planned a sale of USD 982 million Eurobond in January 2022 for the 2021/2022 financial year to partly plug a 7.5 percent budget deficit. However, this plan was scrapped in June 2022 due to rising yields on existing Eurobonds and this made the new issue financially unviable.

The resultant effect of the canceled Eurobond was the steady erosion of Kenya's foreign exchange reserves, from USD 8.3 billion in January 2022 (5.1 months of import cover) to USD 7.0 billion in November (4.0 months of import cover), before a temporary uptick in December to USD 7.4 billion (4.2 months of import cover). The improvement in December is from the disbursement of a fifth IMF program tranche of about USD 447 million, including a supplementary amount of USD 216 million to help relieve current financing constraints.

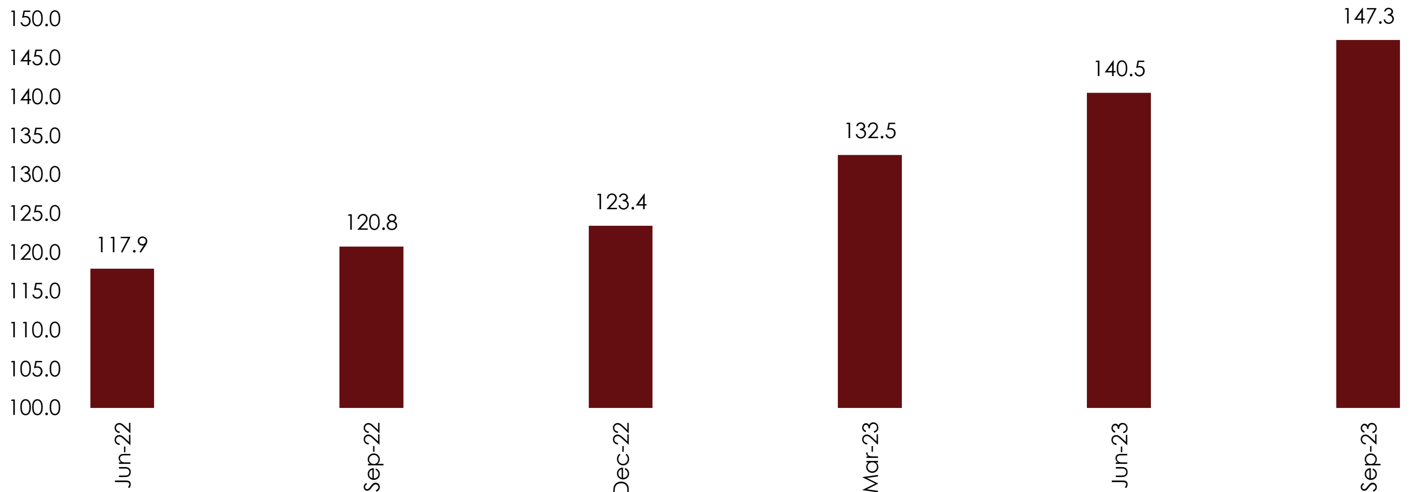
This rise was only temporary as foreign exchange reserves resumed their retreat in 2023, partly because of a USD 400 million SGR loan repayment to China in January, to reach about USD 6.4 billion at the end of February, cutting import cover to 3.9 months, a multi-year low. As of 22 September 2023, the foreign exchange reserves are at USD 7.0 billion which represents 3.8 months of import cover.



Source: Central Bank of Kenya Data

At current levels, the foreign exchange reserves have fallen below the statutory reserve threshold of 4.0 months of import cover and this growing mismatch between the demand and the supply of US dollars is disrupting business and fueling steady shilling depreciation, which has accelerated in 2023.

The exchange rate slumped to KES 147.8 against the dollar on 27 September 2023 which is a 22.0 percent depreciation year-on-year. This continued weakening of the shilling has added to inflationary pressures in line with Kenya's heavy import dependence and has increased Kenya's already-high debt-servicing costs. It can be argued that the current crunch in foreign reserves is a forewarning of what could happen in 2024 when the debt maturities fall due.



Source: Central Bank of Kenya Data

Amid the dollar scarcity, Kenya started experiencing fuel shortages as oil importers struggled to source the greenback to bring in supplies. To ease dollar pressure and improve the availability of fuel, the government entered into an oil importation deal that enabled the state to import petroleum products under a six-month credit hoping to postpone USD 500 million worth of dollar demand monthly. Under the government-to-government (G-to-G) deal, Saudi Aramco, the world's biggest oil company, advances diesel and Dual-Purpose Kerosene (DPK) twice a month with the payment falling due six months after the deliveries.

However, this deal did not have the desired effect. The shilling has weakened by over 11.2 percent since the deal was signed and in August 2023, the government stepped back from the deal entirely. Since then fuel prices have risen to over KES 211 for a liter of super petrol as the effect of rising global crude prices coupled with a depreciating shilling continues to be felt.

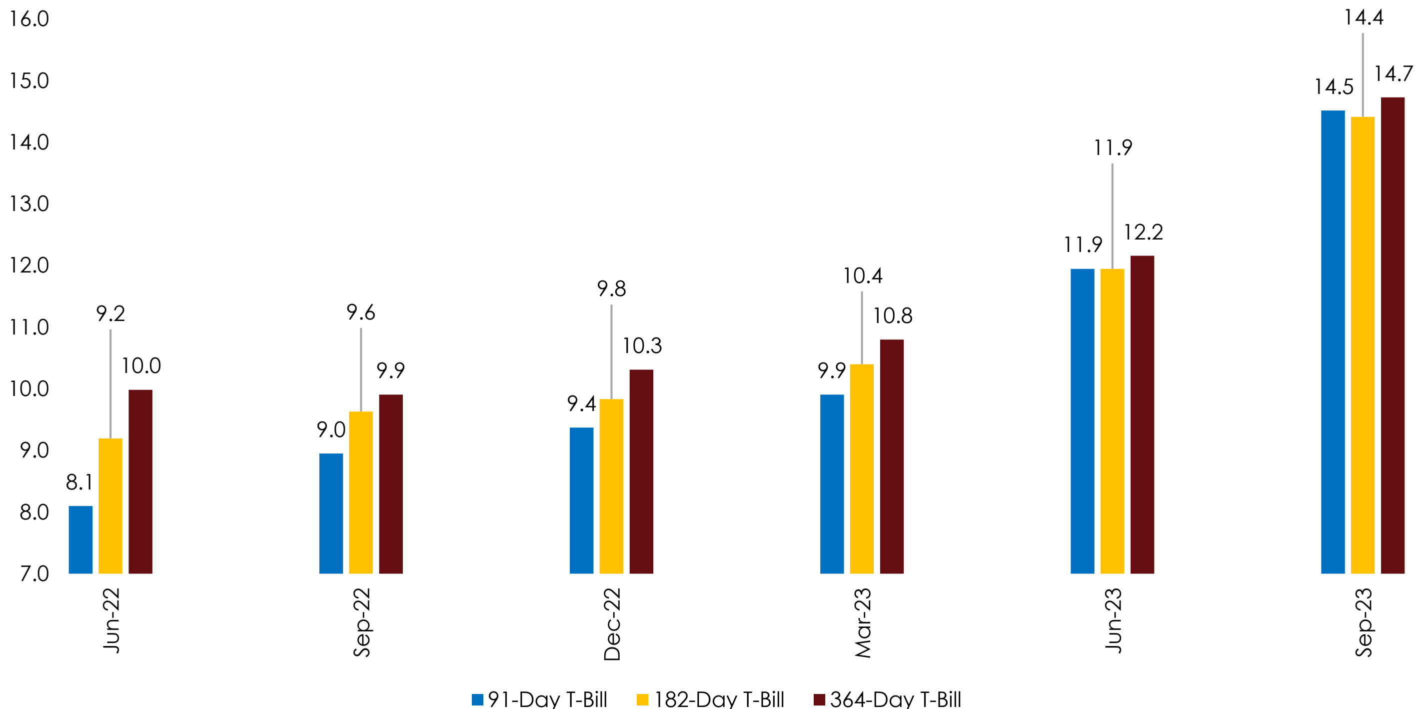
On the bright side, Kenya is set to receive additional inflows from the IMF program with disbursements expected at end-2023 and in mid-2024. Already in July 2023, the IMF allowed for an immediate disbursement equivalent of about USD 415.4 million. This included a USD 110.3 million augmentation of access. The Executive Board also approved a 20-month arrangement under the Resilience and Sustainability Facility (RSF) for about USD 551.4 million to support Kenya's efforts to build resilience to climate change and catalyze further private climate financing.

These arrangements however come with certain concessions. Key policy priorities of the program include reducing debt vulnerabilities through multi-year fiscal consolidation efforts by raising tax revenues and rationalizing spending while protecting priority social and developmental spending.

To this end, the government has already introduced a host of new fiscal policies the most famous of which is the Finance Act 2023 which affected the imposition of income tax, value-added tax, excise tax, and various fees and penalties, as well as general tax compliance requirements. Another key plank in the government's fiscal consolidation scheme is the importance that has been placed on domestic borrowing in budget financing for the next three years in a bid to reduce the share of external debt.

This has led to the cost of domestic debt heading higher, however, as Kenyan interest rates rise in response to inflation and global monetary tightening. The Central Bank of Kenya hiked the Central Bank Rate (CBR) to 10.5 percent in June 2023 which has had a knock-on effect on commercial bank lending rates which reached an average of 13.5 percent.

The domestic securities market has rising interest rates on government debt papers as the government has had to accept higher rates to meet financing requirements and investors are also demanding higher rates in auctions.



Source: Central Bank of Kenya Data

Against the backdrop of these macroeconomic concerns, the Eurobond 2024 maturity casts a shadowy figure. To alleviate pressure, in June the President announced at the New Global Financing Pact in Paris that the government planned to buy back at least 50 percent of the Eurobond before the end of 2023. However, the National Treasury says it's not keen on buying back part of the Eurobond citing strong confidence in the government's fiscal policy stance.

Moreover, in August, Moody's Investors Services said it may treat a planned buyback of some of Kenya's debt as a default. Moody's vice president and senior credit officer David Rogovic said that redeeming the bonds at a price below the par value would constitute an economic loss to investors. With yields on existing Eurobonds still high (at 18.7 percent on 27 September 2023) and no end in sight to the current US monetary-tightening cycle, the prospects of issuing another Eurobond remain low.

In the absence of a new Eurobond, foreign exchange reserves will come under fresh pressure in 2024 and the impending maturity comes with a chance of a debt and liquidity crisis in 2024. However, should Kenya manage to jump this hurdle and settle the Eurobond, external debt pressures could ease because of increased concessional borrowing and after that a 3-year pause until the next cycle of Eurobond maturities in 2027 and 2028.

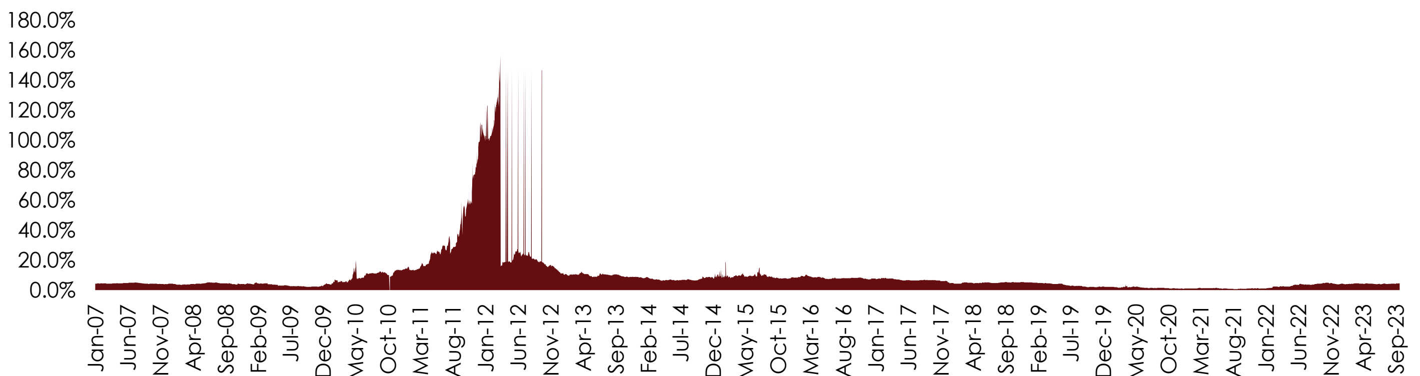
Having looked at the Kenyan situation, we now cast a light on some economies that experienced debt and liquidity crises of their own, sourcing timelines, drawing insights, and looking for lessons that can be learned from their circumstances.

The Greek Debt Crisis

A Bit of Background
Greece faced a sovereign debt crisis (the Crisis) in the aftermath of the financial crisis of 2007–2008. This period was characterized by a series of sudden reforms and austerity measures that led to impoverishment and loss of income and property, as well as a small-scale humanitarian crisis. During this period the Greek economy suffered the longest recession of any advanced mixed economy to date.

Starting in late 2009, the Crisis started as an aftershock of the Global Financial Crisis coupled with structural flaws in the Greek economy and a lack of monetary policy flexibility. The Crisis was highlighted by revelations that data on government debt levels and deficits had been understated by as much as 11 percent. In particular, government debt figures for 2009 were restated from USD 269.3 billion to 299.7 billion.

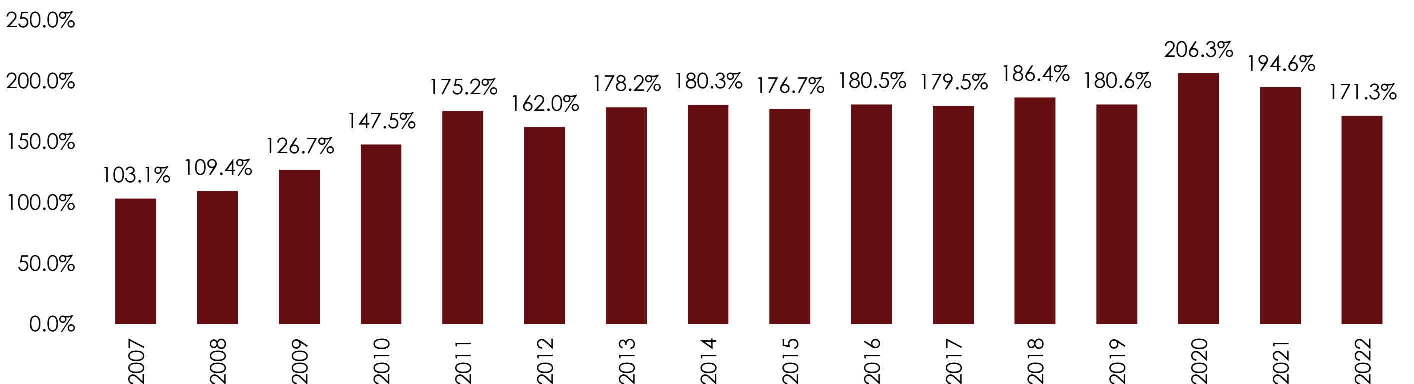
As the Crisis unfolded, there was a sustained lack of confidence in the Greek economy, underlined by widening spreads on sovereign bond yields and the rising cost of risk on credit. In the aftermath, the government adjusted its fiscal policy adopting rounds of tax hikes, spending cuts, and other reforms. The response from the public was calamitous as citizens engaged in riots and nationwide protests.



Source: Investing.com Historical Data

Next came the bailouts as the government negotiated bailout terms with the European Central Bank (ECB), Eurogroup, and the IMF. In 2015, a referendum was held that rejected any further austerity measures required for further bailouts. This was significant as it led to the closure of banks for several weeks and the subsequent failure of Greece to make a loan repayment on time – the first developed country to do so.

Since then, Greek government debt has risen as well as the debt-to-GDP ratio as a result of the significant GDP drop in subsequent years as a result of the Crisis.



Source: Trading Economics and Bloomberg Data

Causes of the Crisis

The Great Recession

During the Great Recession of 2007 to 2009, several nations faced rising budget deficits. In particular, Greece's budget deficit as a percentage of GDP reached 10.2 percent in 2008 and jumped further to 15.1 percent in 2009 according to data from Eurostat. This coupled with the high debt-to-GDP ratio exerted further pressure on debt sustainability.

The controversy about statistics on budget deficits and debt levels and their authenticity also worked against Greece. There was doubt cast on the credit-worthiness of the country and Greece was subsequently "punished" by markets which increased borrowing rates making it difficult for the country to service its debt.

Stunted GDP Growth

Post the Global Financial Crisis, Greece's GDP growth was lower than expected. In particular, the Global Financial Crisis had a large negative impact on two of the country's largest revenue earners - tourism and shipping – which fell by about 15 percent in 2009.

Fiscal Imbalances Resulting in Growing Debt

From 2004 to 2009, the Greek government experienced growing budget deficits. Eurostat estimates that expenditures increased by around 87 percent while revenues were only growing by 31 percent. This coupled with reduced GDP growth and higher debt-servicing costs drove the Greek government to acquire more debt to plug any deficits.

Imprudent Government Spending Leading to Current Account Deficits

Around 1974, the Greek government at the time wanted to shift its stance to be more left-leaning and subsequently include left-leaning citizens in the economy. This led to the government running high deficits to finance the military, jobs, pensions, and other benefits.

According to Frank Slijper's Guns, Debt, and Corruption 2013 report, Greece was the largest importer of conventional weapons in Europe and its military spending was the highest in the European Union relative to the country's GDP, reaching twice the European average. This spending widened the current account deficit and to support it, the government issued Eurobonds at low interest rates. However, when the Crisis started and borrowing became more difficult, the foreign inflows reduced and the deficits ballooned.

Tax Evasion and Corruption

According to Transparency International's Corruption Perception Index 2018, Greece ranked almost at the bottom of EU countries and 57th in the world, and during the Crisis, it fell to become the worst performer. Moreover, the country was finding it difficult to optimize tax receipts. The ability to service debt greatly depends on a government's ability to collect revenue and this situation added pressure to debt financing.

Timeline of the Crisis	
2010	▪ Yields on government securities interest rates started rising. ▪ GDP data started showing a recession. ▪ Credit rating agencies downgraded Greek bonds to junk status. ▪ ECB and IMF launched a EUR 110 billion bailout plan conditional on the implementation of austerity measures, structural reforms, and government assets. ▪ Revelations of fraudulent government statistics started and government debt was restated by about 10 percent.
2011	▪ The recession worsened. ▪ The government failed to achieve the conditions of the first bailout resulting in a second bailout worth EUR 130 billion including a bank recapitalization package worth EUR 48 billion. ▪ Private bondholders were required to accept extended maturities, lower interest rates, and a 53.5 percent reduction in bond face value.

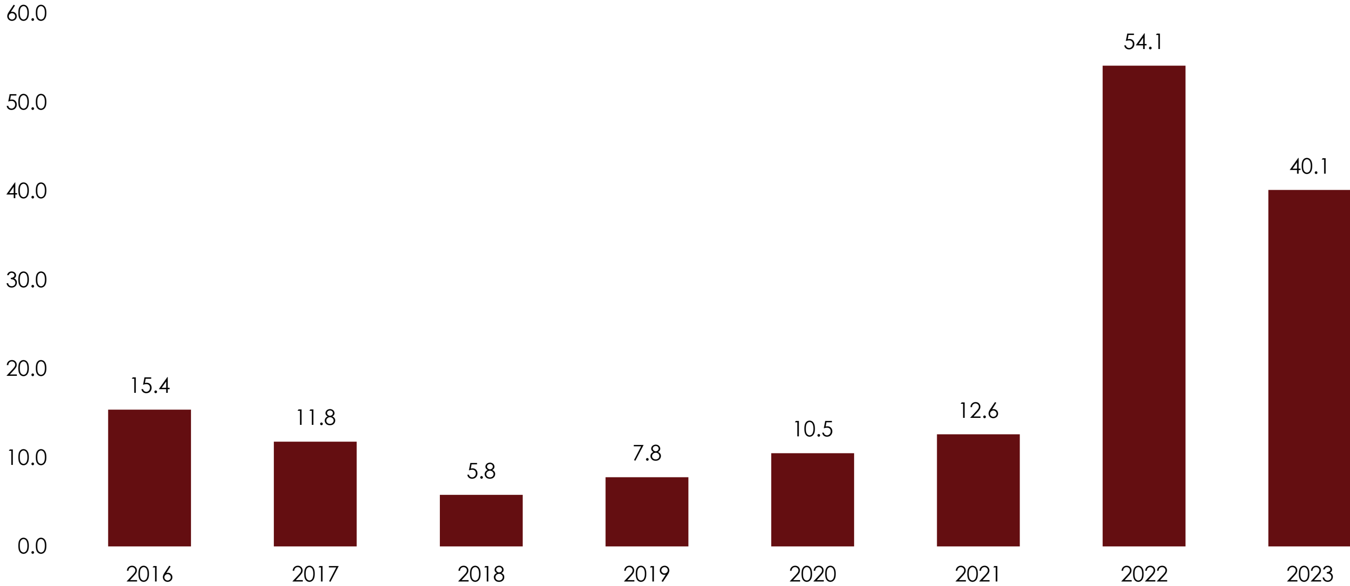
	▪ The government agreed to sell off state-owned assets to raise to EUR 50 billion. Receipts were ultimately lower than expected and were strongly opposed by political groups.
2012	▪ The second bailout was ratified. A total was to be transferred in regular tranches through 2014. ▪ The recession worsened. ▪ The IMF extended an extra EUR 8.2 billion to be transferred from January 2015 to March 2016.
2014	▪ A fourth recession started in Q4 2014. ▪ A new regime rejected the existing bailout terms. The EC, ECB, and IMF suspended the remaining aid causing a liquidity crisis and a subsequent plummet at the Athens Stock Exchange.
2015	▪ Facing default, the government tried to make new proposals under the bailout programs - both were rejected. ▪ The Greek stock market closed on June 27th. ▪ A referendum to reject bailout terms was approved. ▪ The ECB decided to stop liquidity assistance to Greek banks. This caused a bank run as citizens feared capital controls would be invoked. ▪ On June 30th, Greece missed the IMF loan repayment date.
2017	▪ By mid-2017, bond yields started reaching pre-2010 levels signaling a potential recovery and return to normalcy. ▪ In July, the government signed commitments with the IMF to change labor laws, introduce caps on public sector contracts, recalculate pension payments, and reduce spending on social security.
2018	▪ Greek creditors agree to a 10-year extension on EUR 96.6 billion of loan maturities and a 10-year grace period on interest payments. ▪ Greece exited bailouts in August.
2019	▪ Greece sold 10-year bonds for the first time since the bailout programs
2021	▪ Greece sold a 30-year bond for the first time since before the Global Financial Crisis in 2008.

Effects of the Crisis	
Economic Effects	▪ In 2011, GDP growth was -6.9 percent. During this year, 110,000 companies went bankrupt and unemployment shit up. ▪ Greece fell into a recession for about five years and the GDP shrunk by almost a quarter from 2009 – 2014. ▪ By 2014, an estimated 36 percent of Greeks lived below the poverty line. ▪ Greece defaulted on a USD 1.7 billion IMF bailout in 2015. ▪ Greek governments raised tax rates rapidly, with indirect taxes almost doubling. The tax rates of Greece have been compared with those of Scandinavian countries but Greece lacks similar welfare infrastructures. ▪ The tax regime led to firms relocating abroad to avoid the higher tax regime.
Social Effects	▪ Tens of thousands of Greeks were made homeless and shops vacated their premises. ▪ By 2015, an estimated nearly 20 percent of Greeks lacked funds to meet daily food expenses. ▪ Due to this, many Greeks slid into unhealthy coping mechanisms like depression, addiction, and suicide.

	▪ As a result of the austerity measures under the bailout programs, the government was unable to commit resources to the homeless.
Political Effects	▪ The Crisis led to the rise of the anti-austerity Movement of the Indignant. ▪ This movement involved a series of demonstrations and general strikes that took place in 2012. ▪ The protests were initially peaceful before turning violent and devolving into full-scale riots involving up to 500,000 people. ▪ These movements led to a gradual decline in popularity for the socialist PASOK party and in 2019, the New Democracy Party formed the first one-party majority government since 2011.

The Ghanaian Debt Crisis of 2022: A Bit of Background

Ghana's history of debt defaults and restructuring dates back several decades, with notable instances in the past. However, the story of Ghana's Debt Crisis of 2022 can be traced back to 2017 when the current administration took power. When the new government came in, it worked to bring down inflation significantly, from 15.4 percent in 2016 to around 7.8 percent in 2019 just before the COVID-19 pandemic started.

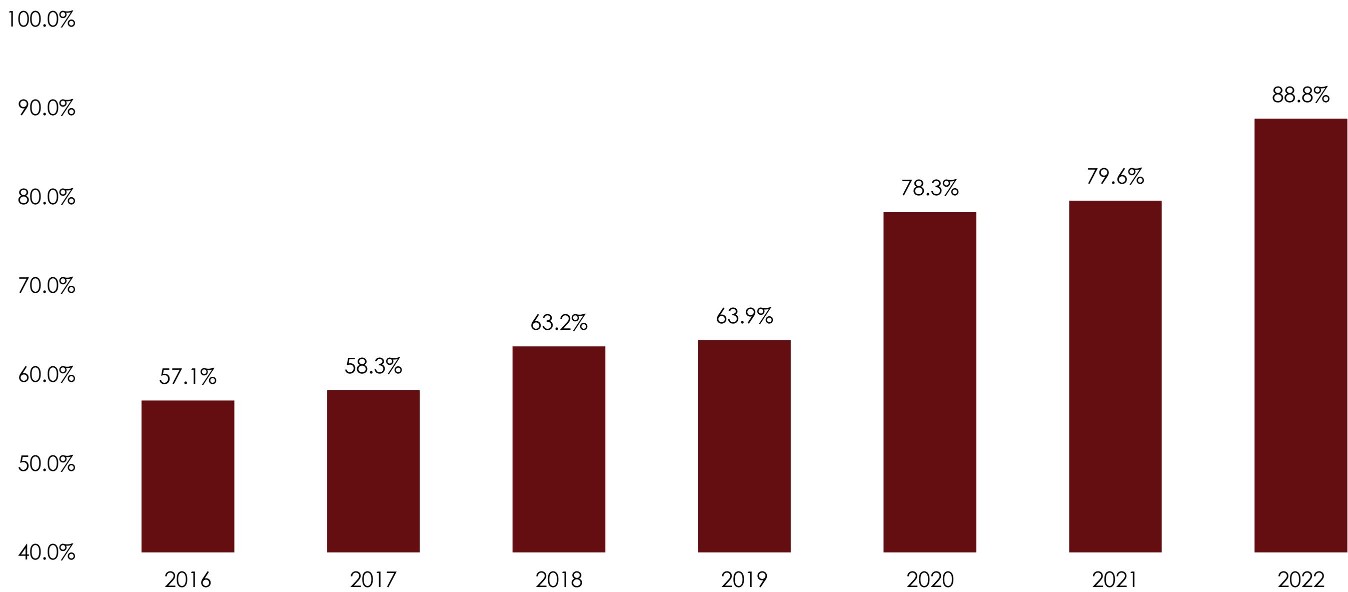


Source: Bloomberg Data

However, the new administration came with a raft of new changes introducing a free education program in public high schools. Also, in 2017, the governing New Patriotic Party scrapped what it called 15 "nuisance taxes". These included the 17.5 percent value-added tax on financial services, real estate, and selected imported medicines. They also reduced import duties on spare car parts and abolished the 1 percent special import levy and the 17.5 percent VAT on domestic airline tickets.

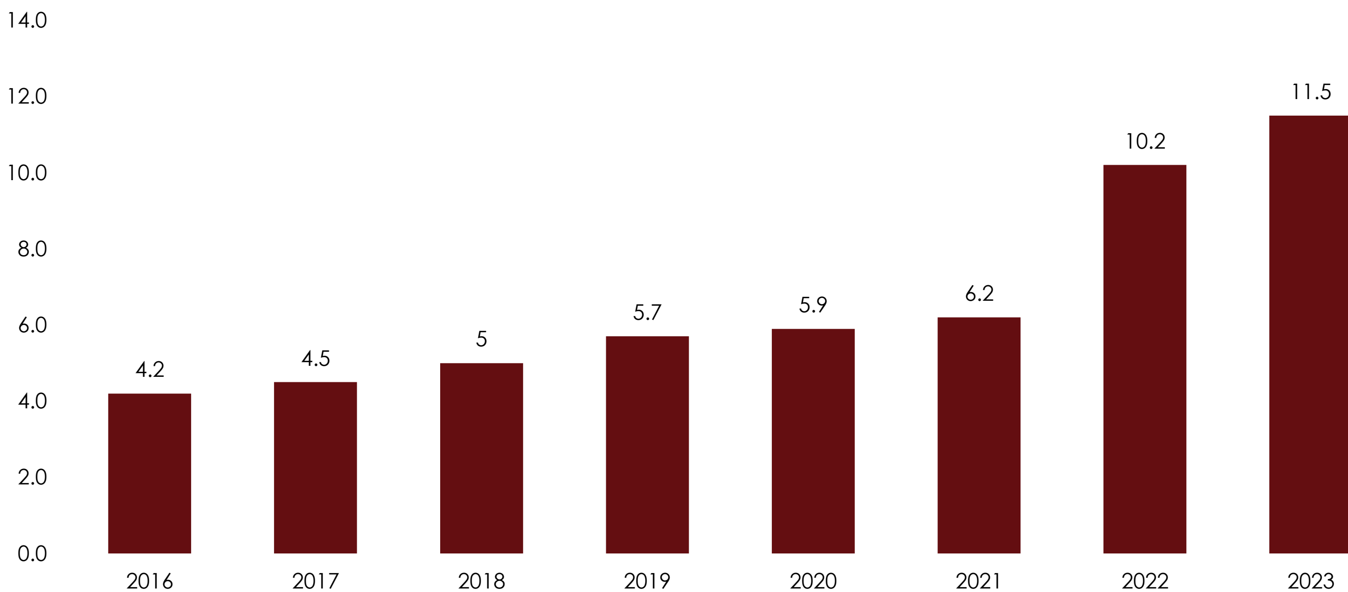
This led to revenue shortfalls and to make up for the revenue deficit, the government adopted borrowing. This increased Ghana's bond market activities domestically and externally and, as a result, led to a high debt-to-GDP exposure, leading eventually to debt unsustainability.

Moreover, the administration restored allowances for trainee nurses and teachers that had been earlier suspended. These put a huge strain on government revenues, half of which at that point went to paying wages. As the pandemic rolled around, there was a significant drop in revenue in 2020 coupled with a rise in government expenditures. These were mainly Covi-related as the government adopted a populist approach, providing free water and electricity to citizens and feeding 470,000 households during a three-week lockdown.



Source: Bloomberg Data

In August 2021, the President began what later was admitted as "an overly ambitious" construction project of 111 hospitals with an estimated price tag of more than USD 1 billion. The pressure kept mounting on the government to fulfill a plethora of other electoral promises, such as the construction of roads, schools, and markets, forcing the government to keep borrowing and leaving an economy dogged by high public debt. The Russia - Ukraine war derailed post-pandemic recovery and the cedi depreciated by more than 50 percent against the dollar between January and October 2022, causing Ghana's debt burden to rise even further.



Source: Bloomberg Data

Investors began to lose confidence in the economy as the government grappled with liquidity challenges. They started moving their money out of Ghana. In May 2022, Ghana introduced an unpopular e-levy, which placed a 1.5 percent tax on all electronic and merchant payments, bank transfers, and remittances as part of measures to increase revenue. It brought in a low 10 percent of its targeted amount in its first month. In the middle of this economic storm, credit rating firms such as Moody's downgraded Ghana bonds to junk status, pushing even more investors away.

At this point, Ghana was forced in July to turn to the International Monetary Fund (IMF) for relief. By November 2022, inflation had hit a record high of 50.3 percent in November 2022, the Bank of Ghana Monetary Policy Committee met on 28 November 2022 and hiked the MPC rate to 27.0 percent the highest rate recorded in the last 10 years. This was followed by a decision in December by the government to suspend payments on most of its external debt, effectively defaulting as the country struggles to plug its balance of payments deficit. The finance ministry announced that it will not service debts including its Eurobonds, commercial loans, and most bilateral loans after entering a USD 3 billion staff-level agreement with the IMF.

In May 2023, the IMF approved the USD 3 billion 36-month Extended Credit Facility (ECF) arrangement for Ghana. This decision enabled an immediate disbursement of about USD 600 million. The rest is expected to be disbursed in tranches every six months, following program reviews approved by the IMF Executive Board. Under this arrangement, Ghana had to commit to agreeing to reforms that would mobilize more domestic revenue and improve the efficiency of public spending through supporting the fiscal adjustment. Ambitious structural reforms will have to be implemented in the areas of tax policy, revenue administration, and public financial management.

The macroeconomic situation in Ghana is yet to improve as the cost of living remains high. On September 23rd, thousands of protesters gathered in the Ghanaian capital Accra for a third day of anti-government protests linked to economic hardship that have led to dozens of arrests. Protesters, some waving placards of the Ghanaian flag, decried the high cost of living and a lack of jobs as they marched under the watch of riot police. According to the IMF's Quarterly Finances for July 2023, Ghana is currently the African country most indebted to the institution and with economic growth forecast to slow to 1.5 percent this year from 3.1 percent in 2022, the situation remains bleak for the West African country.

Causes of the Crisis

High Debt Levels and Debt Service Burden
Ghana has been grappling with high levels of public debt for several years leading up to 2022. As of the end of 2022, Ghana's total public debt was approximately 88.8 percent of its GDP.

External Shocks
Ghana has been hit by several external shocks in recent years and these shocks have hurt the country's economy and have made it more difficult to repay its debt. As a result of the COVID-19 pandemic, Ghana's GDP growth slowed to 3.3 percent in 2020, down from 6.8 percent in 2019. The unemployment rate also rose from 4.7 percent in 2019 to 6.6 percent in 2020. As the Russia-Ukraine war progressed, Ghana's inflation rate rose to 54.1 percent in December 2022, the highest in over 20 years.

Fiscal Deficits
Fiscal deficits have also contributed to Ghana's growing debt burden. With the government suspending some taxes, revenue collection became subdued and this coupled with high levels of corruption, drove the deficits upwards. Ghana's fiscal deficit reached 5.6 percent of GDP in 2021, up from 3.4 percent of GDP in 2020. Due to the high fiscal deficits, the government had to increase borrowing to finance government operations and development projects.

Depreciating Currency
The Ghanaian cedi has depreciated significantly against the US dollar in recent years. This has made it more expensive for Ghana to service its foreign debt, as well as to import goods and services. In 2022, the cedi lost over 50 percent of its value against the US dollar.

Timeline of the 2022 Crisis	
2016	▪ The new administration is elected with an ambitious post-election plan.
2017	▪ The Banking Crisis started. Several indigenous banks would be taken over by private countries. ▪ The government removed what they termed "nuisance taxes". This would severely hamper revenue collection, driving up fiscal deficits and later resulting in more borrowing.
2020	▪ The COVID-19 pandemic hit and the government undertook programs to cushion citizens against adverse living effects. This put extra pressure on finances.
2021	▪ The government embarked on ambitious white-elephant projects and under pressure to deliver on lofty

	campaign promises, was driven to more debt to finance the projects.
2022	▪ The impact of the Russia-Ukraine war started getting felt. Disruption in supply chains led to sky-rocketing inflation and the currency started depreciating rapidly. ▪ With revenues and foreign exchange reserves dwindling, the government resorted to introducing new taxes and levies to improve finances. This had little effect. ▪ Credit ratings start sounding alarms about the Ghana situation and subsequently downgrade Ghana bonds and Ghana's creditworthiness. ▪ In November, inflation peaked and the MPC hiked the CBR to 27.0 percent. ▪ In December, the government suspended payments on most of its external debt, effectively defaulting as the country struggled to plug its balance of payments deficit. The finance ministry announced that it will not service debts including its Eurobonds, commercial loans, and most bilateral loans after entering a USD 3 billion staff-level agreement with the IMF.
2023	▪ In May, the IMF approved the USD 3 billion 36-month Extended Credit Facility (ECF) arrangement for Ghana. This enabled an immediate disbursement of about USD 600 million. ▪ In September, with inflation and the cost of living still high, Ghanaian citizens took to the streets to protest.

The Sri Lankan Crisis

A Bit of Background

The Sri Lankan Debt and Economic Crisis is an ongoing crisis that started in 2019 and is currently ongoing. The crisis is the country's worst economic crisis and has led to unprecedented levels of inflation, near-depletion of foreign exchange reserves, shortages of fuel, and an increase in prices of basic commodities.

The crisis is believed to have originated from a confluence of various factors, including tax reductions, monetary expansion, a nationwide transition to organic or biological farming, and the repercussions of the COVID-19 pandemic in Sri Lanka.

Sri Lanka had long been on the brink of a sovereign default, primarily because its remaining foreign exchange reserves, standing at USD 1.9 billion as of March 2022, would not suffice to cover the country's foreign debt obligations for 2022, which amounted to USD 4 billion in repayments. Particularly, the government had a looming International Sovereign Bond repayment of USD 1 billion due in July 2022.

According to Bloomberg, Sri Lanka was facing a total of USD 8.6 billion in repayments in 2022, encompassing both domestic and foreign debt. In April 2022, the Sri Lankan government officially declared its default, marking the first default in the nation's history since gaining independence in 1948 and making Sri Lanka the first state in the Asia-Pacific region to experience sovereign default in the 21st century.

On 9 May 2022, then Sri Lankan Prime Minister Mahinda Rajapaksa resigned from his position after protests on the country's economic crisis turned violent. A new government came into power and revealed that the government had no usable dollar reserves and that government revenue was not enough to cover. Inflation continued to rise, daily power outages were experienced by up to 15 hours a day, medicine shortages became severe and fuel shortages gripped the country.

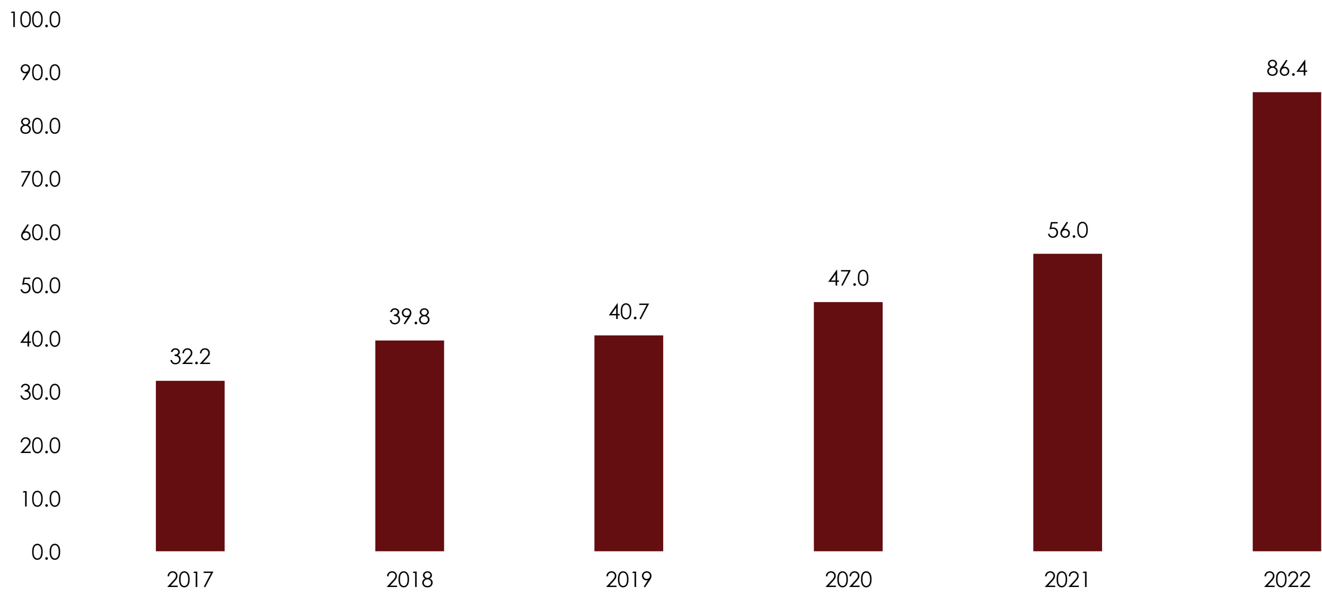
Ultimately in March 2023, the IMF Board approved a 48-month extended arrangement under the Extended Fund Facility (EFF) of about USD 3 billion to support Sri Lanka's economic policies and reforms with an immediate disbursement equivalent to about USD 333 million.

Causes of the Crisis

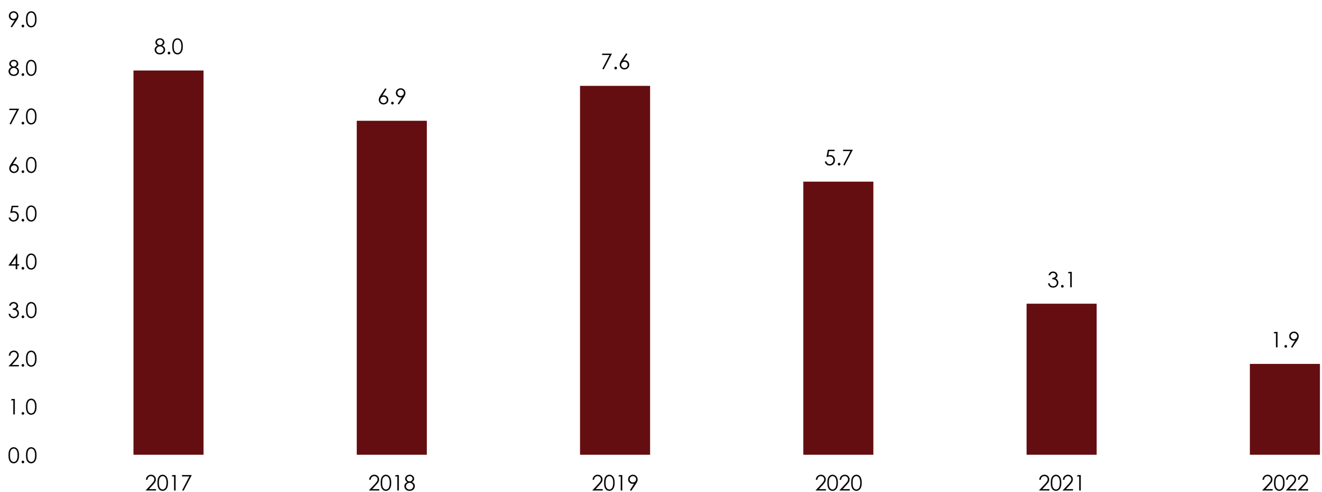
Rise in External Debt Coupled with Dwindling Foreign Exchange Reserves

According to World Bank Data, Sri Lanka's foreign debt increased substantially, going from USD 32.2 billion in 2017 to USD 86.6 billion in 2022. This coincided with a rise in debt-to-GDP ratio from 72.2 percent in 2017 to 113.8 percent in 2022. Sri Lanka also experienced a reduction in foreign exchange reserves and by February 2022, the country had only USD 2.3 billion left in its reserves, yet faced debt repayments of around USD 4 billion in 2022, which also included a USD 1 billion international sovereign bond maturing in July 2022.

In September 2021, the government announced an economic emergency, as the situation was further aggravated by the falling national currency exchange rate, inflation rising as a result of high food prices, and pandemic restrictions in tourism which further decreased the country's income. In January 2022, the foreign exchange reserves took another hit as the government repaid USD 500 million worth of International Sovereign Bonds, and ultimately in April 2022, Sri Lanka announced that it would be defaulting on its external debt of over USD 51 billion.



Source: Bloomberg Data



Source: Bloomberg Data

Tax Cuts Leading to Revenue Shortfalls and Printing of Money
The Sri Lankan government implemented significant tax reductions that had a substantial impact on government revenue and fiscal policies, leading to a surge in budget deficits. These tax adjustments encompassed an expansion of tax-free thresholds, causing a notable 33.5 percent decrease in the number of registered taxpayers, a reduction in the Value Added Tax (VAT) rate to 8 percent, a decrease in corporate tax from 28 percent to 24 percent, the elimination of the Pay as You Earn (PAYE) tax, and the removal of the 2 percent "nation-building tax" that funded infrastructure development.

The substantial reduction in tax income prompted credit rating agencies to downgrade the sovereign credit rating, making it more challenging to acquire additional debt.

To finance government expenditures, the Central Bank embarked on an unprecedented money-printing spree, disregarding counsel from the International Monetary Fund (IMF) to cease this practice and instead consider raising interest rates and taxes while cutting spending.

On April 6th, 2022, the Central Bank of Sri Lanka reportedly printed 119.08 billion rupees, marking the highest recorded amount printed on a single day by the Central Bank in 2022. The total injection of money into financial markets for the year 2022 surged to Rs. 432.76 billion.

Currency Problems and the Rise of a Black Market
The Central Bank of Sri Lanka pursued a policy of attempting to maintain the fixed exchange rate of the Sri Lankan rupee while concurrently engaging in extensive money printing and enforcing stringent exchange controls. This approach led to a devaluation of the rupee's market value. By February 2022, despite the government's efforts to peg the currency at Rs. 200 to the US dollar officially, the unofficial market value of the rupee had risen to over 248 to the dollar.

Consequently, Sri Lanka's credibility with international lenders eroded, intensifying the difficulty in accessing global financial markets for borrowing purposes. As a result, foreign workers resorted to informal remittance channels, depleting Sri Lankan banks of foreign currency reserves and causing a 61 percent drop in official remittances in January 2022.

The Effects of the Pandemic and the Russo-Ukraine War
According to the World Bank, Sri Lanka's tourism industry constitutes more than ten percent of the country's Gross Domestic Product (GDP). However, this sector faced significant setbacks during the COVID-19 pandemic and hindered subsequent recovery. In 2018, tourism contributed USD 4.4 billion to Sri Lanka's economy, making up 5.6 percent of the GDP. Unfortunately, by 2020, this contribution had dwindled to a mere 0.8 percent.

The aftermath of the 2022 Russian invasion of Ukraine also deepened the pre-existing economic challenges in Sri Lanka. This invasion notably worsened the economic crisis in the country, primarily because Russia ranks as the second-largest market for Sri Lanka's tea exports, and Sri Lanka's tourism industry heavily depends on both Russia and Ukraine, given that a significant portion of tourist arrivals originate from these two nations.

Corruption and Lack of Integrity from Sri Lankan Officials
In the 2021 Corruption Perception Index, Sri Lanka ranked 102 worldwide. This meant tax revenues were significantly reduced through tax evasion, diminished compliance, inefficient resource allocation, and the deterrence of investment and economic growth.

A UN report in September 2022 also highlighted that the impunity of Sri Lankan officials for human rights violations and economic crimes in the country are reasons for its economic crisis.

Timeline of the Crisis	
2022	▪ The IMF released a statement following a review of the 2021 Article IV reports saying publicly for the first time that the lender had found Sri Lanka's debt to be unsustainable. ▪ The Sri Lankan rupee plunged to a record low to become the worst-performing currency in the world with USD 1 trading at Rs. 355. ▪ Sri Lanka's cabinet ministers resign as protests start and intensify. ▪ On 8th April, policy rates were hiked by a record 700 basis points to 14.5 percent from 7.50 percent.

	▪ On 12th April, the Government of Sri Lanka indicated that it had taken steps to temporarily default all of its external debts worth USD 51 billion to avoid a hard default. ▪ On 13th April, Standard and Poors downgraded Sri Lanka to CC and announced Sri Lanka was on track to be downgraded to SD (selective default) after the first payment was missed. ▪ On 14th April, Fitch Ratings downgraded Sri Lanka to C and announced Sri Lanka was on track to be downgraded to RD (restricted default) after the first payment was missed. ▪ On 18th April, Moody downgraded Sri Lanka to Ca. ▪ On 9th May, Sri Lankan Prime Minister Mahinda Rajapaksa resigned from his position after protests on the country's economic crisis turned violent. ▪ The newly appointed Premier revealed that the government has no usable dollar reserves and even finding a million dollars was a challenge. ▪ In June, a fuel shortage crisis hit as queues started forming and prices rose. Daily power outages hit and shortages for various commodities started.
2023	▪ In March 2023, IMF Executive Board approved USD 3 billion under a new Extended Fund Facility (EFF) arrangement for Sri Lanka. The first tranche of USD 330m was released soon after with an additional USD 3.8 billion expected to follow from the World Bank, the Asian Development Bank, and other lenders., ▪ The administration undertook many reforms to meet the IMF conditions for the bailout. These included major tax increases and debt restructuring.

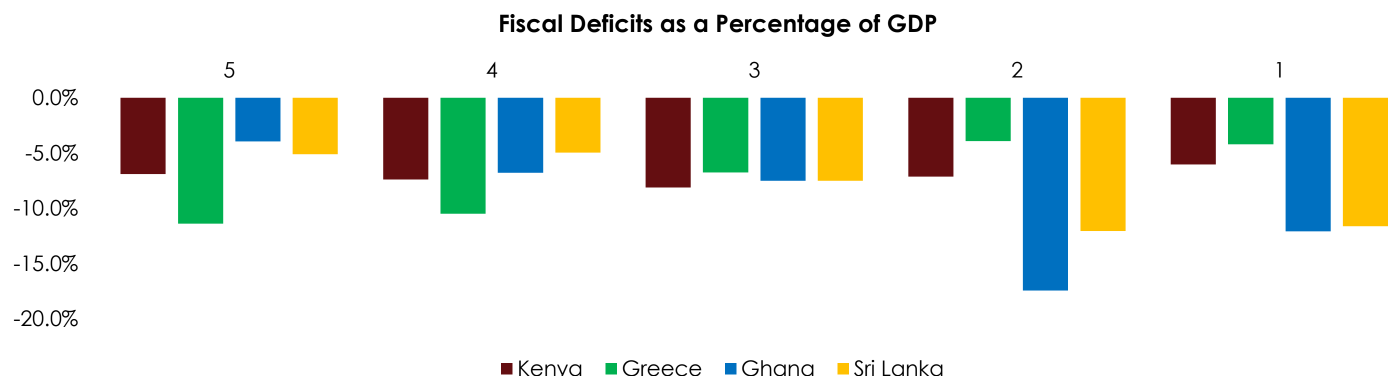
Similarities Between the Greek, Ghanaian, Sri Lankan, and Kenyan Situation

Having examined the debt crises in Greece, Ghana, and Sri Lanka, it is possible to draw parallels between these situations and the Kenyan situation. There are a couple of similarities that can be seen in the progression of the debt crises up until the eventual default. A trend can be seen and it can be mapped as follows:

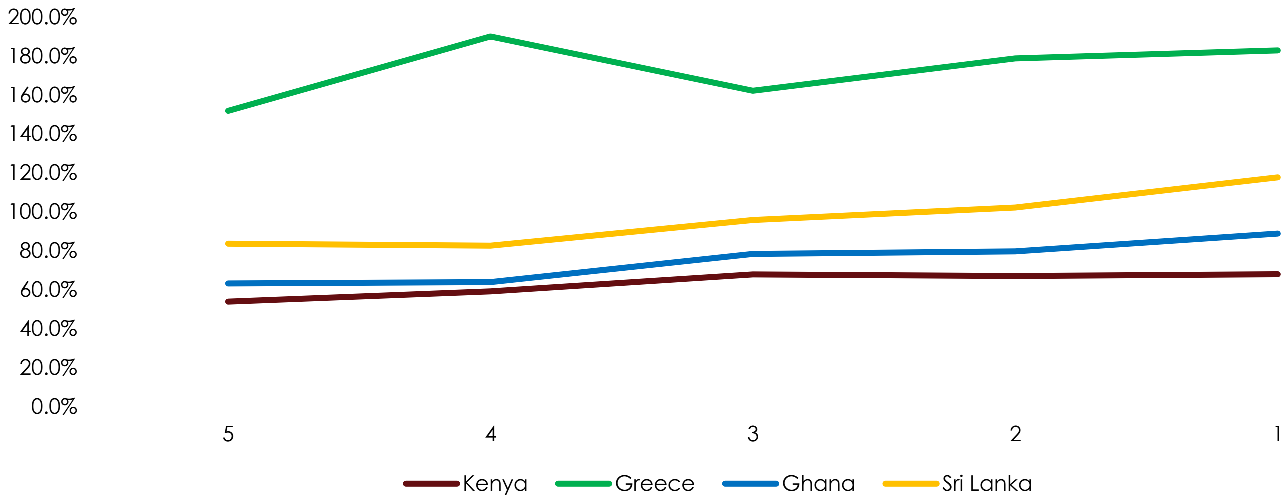
1. External Debt Starts Rising and With It, Debt-to-GDP Ratios

In all cases, these countries took on more and more external debt in each subsequent year and this can be attributed to several factors. For instance, most of these countries took on debt when it was easily accessible and at low interest rates which made the loans attractive for example the Kenya 24 Eurobond which was borrowed at a 6.88 percent coupon rate.

The prevailing administrations also take on debt to fund their respective ambitious campaign promises and, in most cases, end up investing in white elephant projects that rarely bring the envisioned return for the countries. However, the most glaring reason for taking up more and more debt is the need to plug fiscal deficits in the countries.



Source: Bloomberg and IMF Data



Source: Bloomberg and IMF Data

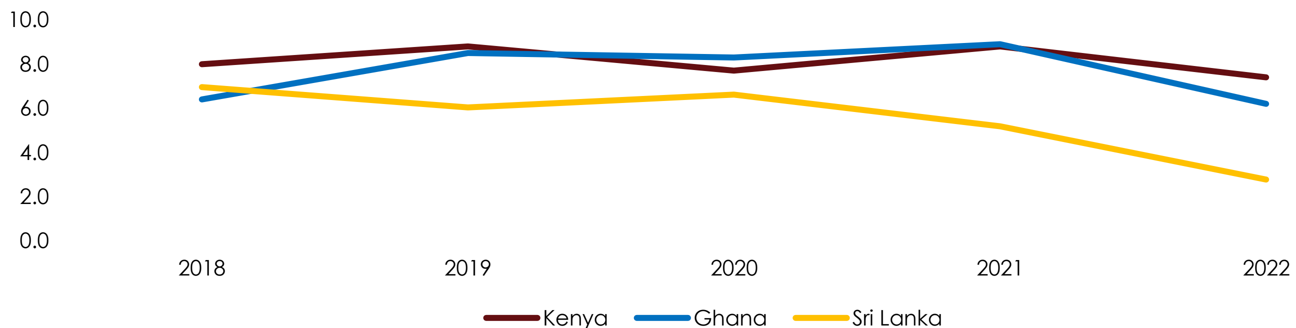
The graphs above highlight the fiscal deficits of each country as a percentage of GDP and the debt-to-GDP ratio for 5 years to a year before the peak of the crisis. Kenya is included comparatively, to see if the trend seen in Kenya matches that of these countries.

The growing fiscal deficits year-on-year can be attributed to the subdued tax revenue collection. In most of these countries, the administrations abolished some taxes that hurt revenue collection. In some instances, the governments adopted populist policies like increasing social benefits and increasing civil servant wages. This adds to government expenditure and puts pressure on revenues. With these countries suffering from high corruption rates and tax evasion problems, tax revenue collection becomes suboptimal and widens the deficits.

It is key to note that the impact of global shocks like the Global Financial Crisis and the COVID-19 pandemic exacerbate these problems. Most of these countries like Greece, Sri Lanka, and Kenya rely heavily on tourism for revenue. This revenue took a hit during these periods for example in Sri Lanka, tourism made up 5.6 percent of the GDP in 2018 and by the height of the pandemic, had dwindled to a mere 0.8 percent. Moreover, overall production is subdued leading to muted revenue and GDP growth. For instance, in 2020, Kenya's GDP grew by -0.20 percent. This leads to increased debt-to-GDP ratios and further amplifies debt unsustainability.

2. Foreign Exchange Reserves Dwindle and Subsequent Currency Depreciation

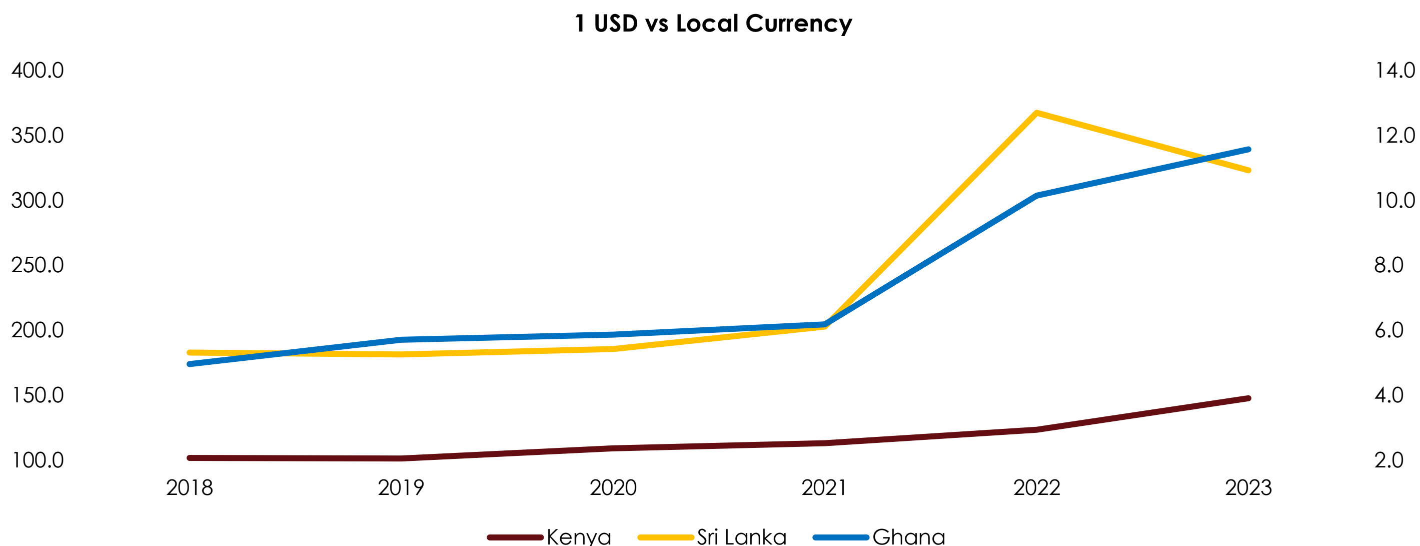
Another factor that compounds the debt unsustainability is the dwindling of foreign exchange reserves and their relationship with currency depreciation. It is important to note that global shocks have aggravated this situation. With the COVID-19 pandemic and the Russia-Ukraine war, most large global economies experienced high inflation. To deal with high inflation, these economies had to hike interest rates. In particular, the US Federal Reserve Bank hiked the Fed Rate to 5.50 percent. This restrains foreign outflows to frontier markets.



Source: Bloomberg and Respective Central Bank Data

As foreign inflows into the markets become subdued, the foreign exchange reserves may tumble. This leads to other problems as most of these countries are net importers. This leads to fuel shortage problems and coupled with other supply shocks causes rising inflation in the countries. For example, Ghana's inflation hit 54 percent in December 2022 on account of rising fuel costs.

As reserves dwindle, the currency depreciates in tandem. In Sri Lanka, the rupee has lost 98.1 percent in value while the Ghanaian cedi has depreciated by 73.1 percent since 2020. The problem of currency depreciation rolls over to debt and debt servicing costs. The interest payments balloon on account of weakening currency and so do the initial principal amounts. To shine a light on this, the Eurobond 24 was borrowed in 2014 when USD 1 was KES 87. As of 27 September, 1 USD is at KES 147. This represents a 69.0 percent increase in debt and debt servicing costs.



Source: Bloomberg Data
Direction: Kenya and Sri Lanka are plotted on the Left-Hand Side Axis while Ghana is plotted on the Right-Hand Side Axis

In some cases, the reduction of foreign reserves may not even be enough for principal debt repayment. Particularly in Sri Lanka, the remaining foreign exchange reserves, standing at USD 1.9 billion as of March 2022, were not enough to cover the country's foreign debt obligations for 2022, which amounted to USD 4 billion in repayments. Particularly, the government had a looming International Sovereign Bond repayment of USD 1 billion due in July 2022.

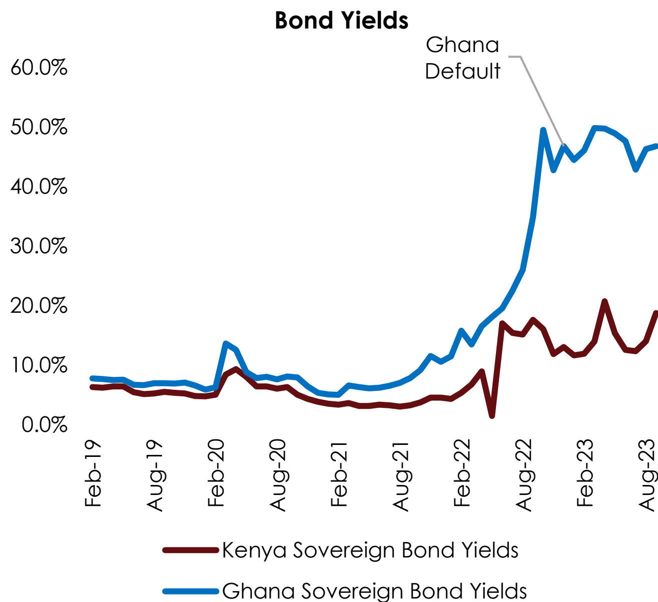
3. Markets Take Notice, Yields Spike

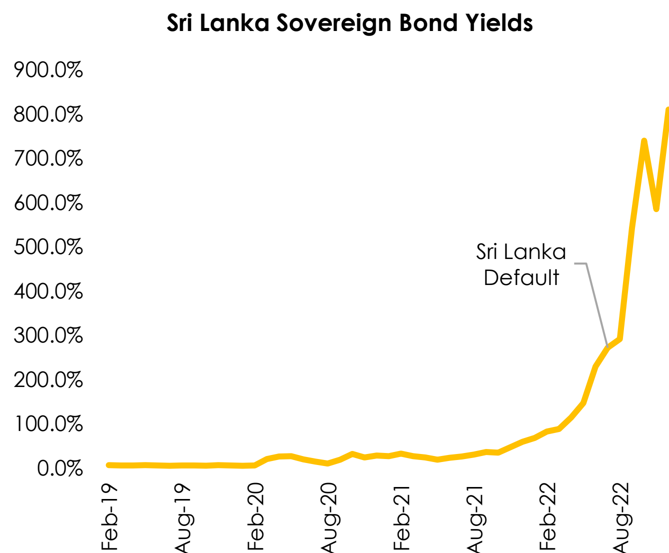
As these factors take effect on the markets and debt sustainability, markets start taking notice as well. International credit rating agencies adjust their credit ratings to reflect these developments.

Moody's, Fitch, and Bloomberg all downgraded Ghana's status to junk on account of concerns about Ghana's ability to repay its debts. In Sri Lanka, Fitch downgraded the credit rating five separate times since 2020 from CCC (currently vulnerable and dependent on favorable economic conditions to meet its commitments) to RD (Restricted Default) by default in April 2022. Years earlier in Greece, credit ratings also downgraded Greek bonds to junk status. In May 2023, Moody's downgraded Kenya's credit rating from B2 to B3, with the country being judged as being speculative and a high credit risk.

The effect of these ratings filters through to investors whose perceptions turn negative. In theory, the greater the credit risk on an investment, the higher the yield investors demand to compensate for it. What is witnessed is the rise in bond yields exponentially. The worst-case scenario is in Sri Lanka, whose sovereign bond yields rose by 1,938 percent from 5.6 percent in January 2020 to 114.3 percent in April 2020. Post default, yields rose further to peak at 4,702.6 percent in March 2023.

Yields on the Eurobond 24 have risen by 297.9 percent since January 2020, going from 5.9 percent to 18.7 percent as of 26 September 2023.





Source: Bloomberg Data

The knock-on effect of rising bond yields and downgrades in credit ratings is the subsequent difficulty in accessing financing from international markets. Most of these countries rely on taking on more debt to service existing debt and the inability to secure such financing makes it harder to settle debt obligations when they fall due.

4. With Nowhere Else to Turn, Enter the IMF

The common denominator with all these situations is the eventual entry into an IMF arrangement. In 2022 after defaulting on its loans, Sri Lanka sought the IMF for a bailout program. This was eventually approved in March 2023, when the IMF Board signed a 48-month extended arrangement under the Extended Fund Facility (EFF) of about USD 3 billion to support Sri Lanka's economic policies and reforms with an immediate disbursement equivalent to about USD 333 million.

The same case happened in Ghana and Greece, which were subject to different IMF programs after their defaults to help in consolidation and restoration efforts. In May 2023, the IMF approved the USD 3 billion 36-month Extended Credit Facility (ECF) arrangement for Ghana. This decision enabled an immediate disbursement of about USD 600 million. Kenya has been part of an IMF Extended Fund Facility and Extended Credit Facility arrangement since 2021. In July 2023, the IMF allowed for an immediate disbursement equivalent of about USD 415.4 million. These IMF injections are expected to help alleviate the debt unsustainability problem,

However, these programs do not come cheap and countries are expected to implement a structural reform agenda as prescribed by the IMF that is centered on fiscal policy, public financial management, improved governance and oversight, and an enhanced anti-corruption framework.

What Lies Ahead for Kenya

The progression of the debt crisis in Kenya is similar to that in Greece, Ghana, and Sri Lanka as the ailments that plagued these countries are present in Kenya and the lessons learned are profound. The settlement of Eurobond 2024 maturity in June 2024 almost becomes a date with destiny. At present, Kenya's currency depreciation is still sustained and foreign exchange reserves are still dwindling, standing at USD 7.0 billion as of 22 September 2023. Interest rates on T-Bills are still high and rising, and this adds to the debt maturity pressure in 2024. Moreover, despite increasing taxes, the government is still not meeting its revenue targets and no cuts in government expenditure have been witnessed so far. This leaves Kenya in a perilous position.

However, the government does have the IMF program as a crutch to assist with inflows and is actively consulting lead arrangers to find solutions and timelines for the upcoming maturity. With that being said, the practice of taking on debt to pay debt is unsustainable, and going forward, new strategies centered on debt sustainability should be put in place with Eurobond 2027 and 2028 maturities coming soon after this one.