The role of external debt in economic growth in Sri Lanka

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Economists have observed in recent times that Sri Lanka's external sector has become very vulnerable to the Balance of Payment crises due to soaring external debt stock along with the rise of external debt servicing. Given such a backdrop, this paper investigates the impact of external debt on Sri Lanka's Gross Domestic Product. The study adopts the Autoregressive Distributed Lag (ARDL) econometric model to estimate the impact of Gross Domestic Capital Formation, Gross Domestic Savings and external debt on GDP. Estimates indicate that a 10% increase of Gross Domestic Capital Formation resulted in 3.6% increase of GDP, while a 10% increase of Gross Domestic Savings resulted in a 1.3% growth in GDP. However, as per the estimates, a 10% increase in external debt stock resulted in reducing GDP by 1.7%. The regression estimate results are supported by the literature. A number of studies conducted to identify the relationship between external debt and economic growth in developing countries suggest that an increase of external debt affects GDP adversely. This study attributes the negative relationship between external debt and GDP growth to the massive external debt servicing payments, resulting in foreign reserve outflows which causes a contracting of public investment. It is observed that raising money by issuing Sovereign Bonds (categorized as commercial borrowings) has a significant impact on increasing external debt servicing payments because interest in such commercial borrowings is high. Government finance figures show that, as the debt servicing cost rises, capital expenditure of the government has fallen, reducing investment in the economy.

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