

Sri Lanka's IMF Staff-Level Deal a Key Step to Debt Restructuring

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The next 20 days are crucial for Sri Lankans. This is due to the second or policy level discussions with the International Monetary Fund (IMF) under its economic adjustment programme, scheduled to commence this week to find a solution to the existing severe solvency and external liquidity crisis.

Officials of the Central Bank of Sri Lanka (CBSL) and the Ministry of Finance (MoF) are scheduled to participate in these discussions along with officials of the IMF who are currently in Sri Lanka. Representatives from Lazard, the financial adviser and Clifford Chance, the legal adviser, appointed by the Government of Sri Lanka (GoSL) to cover the interests of Sri Lanka during the debt restructuring process, will also take part in the discussions.

The purpose of these discussions is to finalise a Staff Level Agreement with the IMF most probably by the end of the discussions scheduled to close on 30th June. The two sides will also reach final agreement on the preferred level of debt sustainability for Sri Lanka during these discussions. Once a staff-level agreement is reached (likely in early July), the next stage will be to develop a comprehensive debt restructuring plan for discussions with creditors.

The expected staff-level agreement on comprehensive economic policies could be supported by a 36-48-month Extended Fund Arrangement (EFF) with access requested for a minimum SDR 2,173.9 million (equivalent to circa US\$3 billion).

IMF Executive Board approval

IMF Executive Board approval of the EFF and access to the USD 3 billion in financing is, however, unlikely before significant progress towards an agreement with all external creditors is reached.

Accordingly, the main objective of this debt restructuring process, we are made to understand; will be to reduce this Debt-to-GDP ratio to at least 80 per cent over a period of time with the IMF observation.

According to a recently released Standard Chartered Bank research report, Imposing haircuts on multilateral/bilateral debt is unlikely, though maturity extensions should be possible. However they were assuming a comprehensive restructuring of International sovereign bonds (ISB), involving principal haircuts, coupon reductions and maturity extension.

International creditors, who hold the ISB of Sri Lanka it should be noted, include local entities with some US\$ 1.6 B in their hands and are said to be contemplating in going to court or plans to take remedial measures collectively via Sri Lanka Bankers' Association (SLBA). External creditors with some US\$ 10.9 B in their hands have also hired Rothschilds to advise them. Application for treatment under the G20 Common Framework (CF) is another moving part in these negotiations.

Thus, the restructuring of external public debt will need to result in sufficient creditor participation to restore debt sustainability and close any financing gaps. The combination of rupee depreciation, persistently large fiscal deficits, higher interest rates and weak growth is likely to push Sri Lanka's Debt-to-GDP rate to be around 130-140 per cent at the end of 2022 that will include both the existing and proposed new Indian and other credit lines which were agreed after 12th of April 2022 being the date Sri Lanka announced a pre-emptive default on all its foreign debt at the time totalling USD 51 billion. This premature default was the result of long-term fiscal trends and several years of external debt accumulation.

Obtaining China's consent a challenge

Financial adviser Lazard will use an IMF/World Bank Debt Sustainability Assessment (DSA) Model to assess the need for debt treatment. The key parameters of the treatment will be enshrined in a Memorandum of Understanding (MoU) between the Paris Club members with a minimum required level of consent and non-Paris Club members that comprise both India and China.

Paris Club

The Paris Club which comprises the major creditor countries whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries.

"Obtaining Chinese consent (which represent 10% of total external debt) to Sri Lanka's debt restructuring process might be the hardest challenge for Lazard as China is still negotiating with Sri Lankan authorities to keep its debt servicing activities lives via their refinance process," experts said. Sri Lanka has, however, decided to turn down Chinese refinancing offers while giving equal treatment to all creditors.

Agreement on an MoU with all debtors could clear the way for IMF Board approval of the EFF by the end of 2022.

The MoU will also provide the basis for negotiations with private creditors, as a Common Framework (CF) deal with bilateral creditors would require comparable treatment by external commercial creditors.

Eurobond or ISB holders hold approximately 23% of Sri Lanka's external debt, unlike other countries attempting a CF restructuring. If the investors are unwilling to accept the terms of the MoU, that too could delay the final outcome.

Favourable and Unfavourable Points

Sri Lanka has entered into agreements with the IMF 16 times in the past. Although disputed by some, Sri Lanka also maintains very good diplomatic and economic relations with China, India, UK and many countries in Europe as well as the US.

These connections and relations provide positive signals for a successful outcome from the proposed staff level agreement with the IMF and for the debt restructuring process.

However, many say that Sri Lanka technically should have restructured its debt and entered into an agreement with the IMF some two to three years ago when matters were less acute.

Critics say that Sri Lanka should have sought the assistance of the IMF as soon as the country's international credit rating fell, blocking access by Sri Lanka to the international capital markets.

They say the country had about USD 7 billion in foreign reserves at the time, allowing it to restructure its debt peacefully without any economic or political pressure.

But now the country's foreign reserves are in a negative state and the Government is compelled to borrow more to fulfil bridging finance needs until the IMF programme is finalised.

According to Standard Chartered Bank's recent analysis at least USD 200mn of current account funding is needed every month. This has had a far reaching impact on the economy, leading to severe shortages of fuel, electricity and essential commodities, spiralling inflation, a sharp rise in interest rates, and rapid rupee depreciation. This has resulted in a widening social and political crisis in the country.

This political instability and the related government policy uncertainties could have a negative effect on the IMF programme and debt restructuring process.

Many believe that the current Cabinet, led by Prime Minister Ranil Wickremasinghe, will remain unchanged until at least a general election is held in January-February of 2023.

Future of current CBSL Governor

Another moving part that is certain to impact the situation is the position of the current CBSL Governor. It is widely understood that due to some economic policy conflict (specially relating to the real sector of the economy) between the President and the Prime Minister regarding the current Governor of the CBSL, Dr. Nandalal Weerasinghe, his re-appointment is yet to be finalised. Thus, if he is not re-appointed to the post after his term ends on 30 June, Analysts say, the programme with the IMF could suffer a setback. At the time of his appointment, it was claimed that all sections of the political divide supported his appointment. IMF is likely to make up their own mind come the 30th of June which will be 10 days into their engagement in Sri Lanka.

Reforms

Meanwhile, we understand, the Government has taken steps to determine the fuel tariff on the basis of cost. Accordingly, electricity tariffs will also increase in the future. The Government is also taking steps to privatise the loss-making SriLankan Airlines. The CBSL has also established transparent-monetary-policy tightening and more market-based exchange rate determination systems to help restore confidence of stakeholders in the economy in the period ahead.

The Government expects a revenue-focused fiscal consolidation plan to be put in place by the IMF given Sri Lanka's very low revenue levels currently. Therefore, the IMF has indicated that the EFF will support a large upfront fiscal adjustment as well as efforts to shift spending from subsidies and inefficient public investment towards health, education, and the delivery of social benefits. IMF believes adjustments to Sri Lanka's food and energy subsidies will be an important element of any significant fiscal reform framework. However, such changes could be politically controversial, because reform could lead to higher food and fuel prices. Critics said that the weaknesses in public financial management are likely to remain despite signs of willingness to undertake fiscal reform.

Economic Indicators

Fiscal deficit of Sri Lanka in 2021 reach 12.2% of GDP, which took aggregate government debt to 119% of GDP. Most of global analysts expect the country to record a deficit of 15% of GDP in 2022, above the budget target of 8.8% for 2022, easing to 7.3% in 2023.

"Weaker economic activity is likely to reduce direct tax revenue, while a sharp slowdown in imports

due to the FX shortage may also reduce indirect tax revenue. We see total government revenue remaining at around 8% of GDP in 2022," according to Standard Chartered Bank stated in its research note.

Most of the analysts now forecast the GDP contracting 6% to 10% in 2022, and growth improving gradually over the medium term.

The CBSL Governor expects the Colombo Consumer Price Index (CCPI, 2013=100) based inflation to rise above 40% later this year as a result of sharp currency depreciation, supply shortages and higher commodity prices. However, assuming Sri Lanka secures an IMF programme by end-2022, inflation should gradually moderate towards high single digits by the end-2023.

The CBSL Governor has indicated that the current level of monetary tightening is appropriate and that current inflationary pressure is primarily driven by supply-side factors. The IMF, however, has maintained that further monetary tightening (most probably increase of further 200-500 basis points of policy rates) may be needed to contain inflationary pressure.

External debt sustainability

The country envisages enhancing gross official reserves to cover a minimum of four months of merchandise imports.

Tourism and enhanced remittances will provide support for Sri Lanka's external debt sustainability, which together with as the increased export income, FDI and non-strategic asset sales will lower the country's gross financing requirement and bolster international reserves.

However, these events may complicate debt restructuring negotiations if creditors view them as supporting the government's debt repayment capacity.

Credit rating agencies such as Fitch Ratings would only look to move Sri Lanka's Long-Term Foreign-Currency Issuer Default Rating out of 'RD' once a debt exchange is agreed and relations are normalised with international creditors.

The Government has so far excluded the domestic debt from the debt restructuring process, but 80 per cent of the country's total interest is spent on domestic debt. Therefore, some say local credit also needs to be restructured, but the impact on the local banking system and retirement funds is huge.

Thus, Sri Lanka enters a crucial period in its history this week with key negotiators and members of the team in place but not yet firmed. The negotiations have several moving parts each capable of derailing the final outcome. If another Lebanon is to be avoided all will have to move together.

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