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BOX 2
Sri Lanka's Economic Adjustment Programme Supported by an Extended Fund Facility Arrangement of the International Monetary Fund

Introduction

The Sri Lankan economy has been experiencing frequent incidences of vulnerabilities and instability conditions instilled by structural macroeconomic problems coupled with global and domestic shocks. The conditions weakened drastically since 2020 with the onset of the pandemic, along with *ad-hoc* policy changes that exacerbated stresses in the economy. As a result, the country experienced severe Balance of Payments (BOP) distress and subsequently multiple crises in 2022. Several policy interventions were rolled out since early 2022 to guide the economy towards greater stability. Seeking financial assistance subject to macroeconomic stabilisation and related commencement of debt restructuring efforts to restore public debt sustainability are key steps that have been taken towards this journey. Before 2022, Sri Lanka had entered into numerous International Monetary Fund (IMF) programmes from time to time for various purposes including supporting the BOP and the Government's reform agenda. However, unlike on previous occasions, Sri Lanka initiated discussions with the IMF in early 2022 for an Extended Fund Facility (EFF) arrangement under the direst economic conditions. The success of policy interventions was constrained by debt overhang as well as persistently large fiscal and BOP financing needs. Amidst continuous downgrades in sovereign ratings, Sri Lanka was cut off from avenues for external financing, making new fundraising and servicing existing loans extremely challenging. Usable reserves depleted to near zero levels, the exchange rate depreciated at an unprecedented scale, access to fuel, electricity and other essential imported items by the public was limited, general price levels escalated to new heights with demand pressures and supply shortages, financial system stability was under threat, and social and political clashes were recurring in early 2022. Against this backdrop, the need for economic stabilisation with external assistance was required and the Sri Lankan authorities initiated discussions with the IMF. Continuous engagements over a year with the IMF staff team on the finalisation of the proposed economic and financial policies and successful completion of prescribed prior actions under the programme and the receipt of financial assurances from the official creditors enabled the approval of an EFF in late March 2023. Salient features of this economic adjustment programme, expected developments under the EFF arrangement, the country's commitment to the reforms in the ensuing period, and necessity of continuing this programme over four years are discussed briefly in the following sections.

Programme Objectives and Modalities of the IMF-EFF

The current IMF-EFF arrangement spans 48 months with the total disbursement amounting to SDR 2.286 billion (about US dollars 3 billion) to be utilised for budget support for the Government. However, the proceeds under the EFF would also help cushion the BOP by supplementing the Gross Official Reserves (GOR). The disbursement will be equally divided into nine tranches subject to semi-annual reviews and subsequent Executive Board approvals. The first tranche was received in March 2023 immediately following Board approval. The programme aims at restoring macroeconomic stability at large. This overall economic stability is designed to be achieved through building strong pillars on critical areas of restoring debt sustainability, advancing revenue based fiscal consolidation, restoring price stability and building external buffers, ensuring financial stability, reducing corruption vulnerabilities, and raising potential growth.

Prior Actions and Structural Benchmarks

Since the commencement of negotiations for the IMF-EFF arrangement in early 2022, Sri Lanka has completed nine prior actions by March 2023 and has formulated a mechanism for meeting the structural benchmarks. The completion of these prior actions was instrumental in paving the way for broader reforms to be implemented in the next four years under the EFF. The prior actions that have been already completed by Sri Lanka include, obtaining Cabinet approval for revenue measures to support fiscal consolidation during 2023 in line with programme parameters, obtaining Parliamentary approval for a revised 2022 budget, submission of the 2023 Appropriation Bill to the Parliament, obtaining Cabinet approval to automate monthly retail fuel price adjustment, to automate semi-annual cost-recovery based electricity price adjustment, Cabinet approval of the new Central Bank Act, Cabinet approval for the amendments to the Banking Act, strengthening key elements of the Central Bank's crisis management powers, hiring an independent firm to conduct banking sector diagnostic exercise, and increasing policy interest rates by 100 basis points to ensure forward looking real policy interest rates are on a firm upward path.

In addition to the above, three important upfront measures were also implemented which include Parliamentary approval of the 2023 budget that was in line with programme parameters, Parliamentary approval of necessary legislative revisions to implement the 2023 revenue measures, and updating the Emergency Liquidity Assistance framework for banks. Further, Sri Lanka is required to implement several structural benchmarks related to fiscal matters, State Owned Enterprises (SOEs), social safety net reforms, and monetary and exchange rate policies and reforms related to fiscal sector and governance in the period ahead, as detailed in Figure B 2.1.

Monitoring of Programme Progress

Performance of the EFF arrangement will be monitored in terms of a comprehensive mechanism that comprises Quantitative Performance Criteria (QPCs), Continuous Performance Criteria (CPC) related to external arrears and Article VIII obligations, Indicative Targets (ITs), and

Figure B 2.1
Structural Benchmarks under the IMF-EFF Arrangement

Fiscal, SOE, and Social Safety Net Reforms

- Continuous: **Set retail fuel prices to their cost-recovery levels with monthly formula-based adjustments**
- Continuous: **Adjust the end-user electricity tariff schedule to its cost-recovery level with semi-annual formula-based adjustments**
- End-May 2023: **Parliamentary approval of the welfare benefit payment scheme** and new eligibility criteria for beneficiary identification
- End-June 2023: **Cabinet approval of a comprehensive strategy to restructure the balance sheets of the CEB, CPC, SriLankan Airlines, and the Road Development Authority**
- End-July 2023: **Cabinet approval of revenue measures to support fiscal consolidation during 2024,** in line with programme parameters
- End-Sep. 2023: **Completion of the rollout of the ITMIS,** expanding its coverage to all 220 heads (national budget execution agencies)
- End-Oct. 2023: **Parliament submission for the first reading of the 2024 Appropriation,** in line with programme parameters
- End-Dec. 2023: **Parliamentary approval of the 2024 Appropriation Act and the spending allocations,** in line with programme parameters
- End-Dec. 2023: **Parliament submission of a new Public Financial Management (PFM) law,** in consultation with IMF staff
- End-Dec. 2023: **Improve the Bulk Supply Transaction Account (BSTA)** to accurately measure the electricity subsidy, and start using it to determine the cost-recovery based electricity tariff and government transfer requirement

Financial Sector

- End-Apr. 2023: **Completion of the asset quality review component of the bank diagnostic exercise** for the two largest state banks and the three largest private sector banks
- End-June 2023: **Cabinet approval of a full revision of the Banking Act** in consultation with IMF staff
- End-July 2023: **Development by the CBSL of a roadmap for addressing banking system capital and FX liquidity shortfalls and intervening in banks assessed to be non-viable**
- End-Oct. 2023: **Determination by the MOF of the size, timing, instruments, and terms and conditions for potential government recapitalisation of viable banks which are unable to close capital shortfalls from private sources**
- End-Dec. 2023: **Parliamentary approval of a full revision of the Banking Act** in consultation with IMF staff

Monetary and Exchange Rate Policies

- End-Apr. 2023: **Parliamentary approval of the new Central Bank Act** prepared in consultation with IMF staff

Governance

- End-June 2023: **Enact new anti-corruption legislation to harmonise it with the United Nations Convention Against Corruption,** pending comprehensive asset recovery provisions, in consultation with IMF staff
- End-Sep. 2023: **Publication of the report of an IMF-led governance diagnostic technical assistance mission** to assess Sri Lanka's anti-corruption framework

Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka.

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the monetary policy consultation clause. The QPCs that Sri Lanka is expected to achieve are the requirement to generate a primary surplus in the Government's budget, improve the gross official reserve levels by building net international reserves, and gradually phase out Net Credit to the Government by the Central Bank. A CPC applies to the non-accumulation of new external payments arrears on external debt which will be monitored continuously by the authorities and any non-observance will be immediately reported to the IMF. In addition, another QPC includes the prohibition of imposing or intensifying restrictions on the making of payments and transfers for current international transactions, introducing or modifying multiple currency practices, concluding bilateral payment agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement, and imposing or intensifying import restrictions for BOP purposes. A monetary policy consultation clause (MPCC) has also been included to monitor year-on-year inflation on specified target dates to ensure that Sri Lanka is moving on a steady disinflation path to reach the targeted level to restore price stability. Further, ITs have been specified mainly on central government tax revenue, social safety net spending, cost of non-commercial obligations for fuel and electricity as well as on treasury guarantees. More importantly, in order to ensure the achievement of objectives envisaged in attaining debt sustainability, the progress on the debt restructuring will be assessed at each programme review, with a view to completing debt restructuring within a reasonable time frame. The QPCs and ITs pertaining to the programme are detailed in Figure B 2.2.

External Financing Gap and Financing Sources

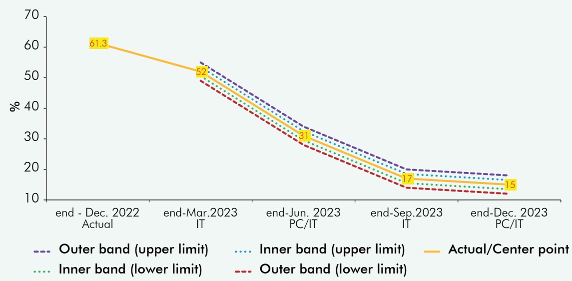
The programme is expected to trigger additional financing assistance with budget support from the World Bank and the Asian Development Bank of US dollars 3.75 billion, of which US dollars 900 million is expected in 2023. It is also expected that with the recovery in the economy and buildup of buffers, Sri Lanka would be able to access international markets to raise funds in terms of sovereign bond issues in 2027. These resources, together with external public debt service relief, will close the external financing gap and allow Sri Lanka to rebuild its gross international reserves.

Figure B 2.2
Sri Lanka: Proposed Quantitative Performance Criteria (QPCs), Continuous Performance Criteria (CPC), and Indicative Targets (ITs)
(Cumulative from the beginning of the year, unless otherwise noted)

		2022	2023			
Proposed quantitative performance criteria		end - Dec. Actual	end - Mar. IT	end - Jun. PC/IT	end - Sep. IT	end - Dec. PC/IT
Central government primary balance (floor)	Rs. bn	-895	-56	-113	-160	-209
Program net official international reserves (Program NIR, floor, end of period stock)	US$ mn	-3,540	-3,188	-2,830	-2,068	-1,592
Net credit to the government of the CBSL (ceiling, end of period stock)	Rs. bn	2,834	2,890	2,890	2,840	2,740
Stock of expenditure arrears of the central government (ceiling)	Rs. bn	60	30	0	0	0
Proposed continuous performance criteria (cumulative from beginning of the programme)						
New external payment arrears by the nonfinancial public sector and the CBSL (ceiling)	US$ mn	0	0	0	0	0
Proposed indicative targets						
Central government tax revenue (floor)	Rs. bn	1,751	650	1,300	2,100	2,940
Social spending by the central government (floor)	Rs. bn	142	35	70	120	187
Cost of non-commercial obligations (NCOs) for fuel and electricity (net of government transfers) (ceiling)	Rs. bn	-	0	0	0	0
Treasury guarantees (ceiling)	Rs. bn	1,159	1,700	1,700	1,700	1,700

Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka

Figure B 2.3
Proposed Monetary Policy Consultation Clause Year-on-Year Inflation Based on the CCPI



Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka.

Expected Developments under the IMF-EFF Arrangement

Some of the key expected outcomes of the IMF-EFF arrangement are as follows:

- **Achieving debt sustainability:** To achieve debt sustainability, Sri Lanka needs to achieve specific debt financing and debt servicing related targets. Further, the debt restructuring process will be guided by quantitative targets developed under the IMF Sovereign Risk and Debt Sustainability Framework (SRDSF) in order to ensure debt reduction, manage rollover risks, avoid a renewed buildup of external pressures from debt service needs, and ensure that financing gaps during the programme period are closed. Meeting these requirements would ensure Sri Lanka's public debt returning to sustainable levels in the eyes of creditors and the international community, thus easing difficulties and risk premia attached to Sri Lanka's future borrowings.

  The debt sustainability targets as per the Debt Sustainability Analysis (DSA) carried out by the IMF that needs to be achieved by Sri Lanka through the debt restructuring process are as follows:

  - Debt stock: Public debt to decline below 95 per cent of GDP by 2032.
  - Post-programme gross financing needs: Average annual gross financing needs of the central government in 2027-2032 to remain below 13 per cent of GDP.
  - Post-programme forex debt service: Annual forex debt service of the central government to remain below 4.5 per cent of GDP in each year over 2027-2032.
  - Programme financing gaps: Debt service reduction during 2023-2027 to be sufficient to close external financing gaps.

- **Improved fiscal performance and discipline:** With the emphasis given in the programme on the fiscal front and the relevant structural benchmarks, it is expected that the Government will persist with its fiscal consolidation efforts to meet the fiscal targets through revenue enhancement measures and rationalisation of expenditure further. With constrained access to monetisation of deficits going forward, the Government is expected to make required adjustments during the available

Figure B 2.4
External Financing Gap and Programme Financing (2022-2027)

US Dollars million

	2022	2023	2024	2025	2026	2027	Total 2022-27
Financing Gap (A)	-2,834	-4,939	-4,843	-5,018	-3,608	-3,911	-25,153
Programme Financing (B)	2,834	4,939	4,843	5,018	3,608	3,911	25,153
IMF EFF	0	663	665	663	662	329	2,982
IFI budget support	0	900	850	700	700	600	3,750
World Bank		250	400	400	400	300	1,750
ADB		650	450	300	300	300	2,000
Other		0	0	0	0	0	0
Debt moratorium: External arrears accumulation	2,834						2,834
Debt relief		3,376	3,328	3,655	2,246	1,482	14,087
Sovereign bond (market access)		0	0	0	0	1,500	1,500
Shortfall (A+B)	0	0	0	0	0	0	
Gross International Reserves	1,898	4,431	6,128	8,520	10,888	14,208	
Project loans	1,473	1,400	1,542	1,585	1,633	1,682	

Source: IMF. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release, Staff Report, and Statement by the Executive Director for Sri Lanka.

transitory period to ensure that such requirements would not arise. In the meantime, unwarranted leakages from the fiscal revenue are addressed through the envisaged broad-based programme for SOEs.

- **Legislative changes for enhanced governance and accountability framework:** New pieces of legislation, such as the proposed Central Bank Act, Banking Act, and other revisions to existing legislations are expected to strengthen the institutional and regulatory framework relating to the economic management of the country. A new anti-corruption law is to be introduced harmonising the United Nations Convention against Corruption, the first such law in South Asia, providing for the creation of an independent Anti-Corruption Commission. A new Public Financial Management (PFM) law will be enacted to streamline the budget formulation process and to enhance accountability mechanism in public finance.
- **Reforming social safety nets:** Despite an increase in social safety nets related spending and beneficiaries in recent years, it has been identified that there is significant scope for improvement regarding the coverage and selection. Considering the issues prevailing in the existing social safety nets framework, the IMF-EFF arrangement has specified certain institutional reforms to improve efficiency, coverage, and targeting of social safety nets programmes.
- **Restoring price stability:** The Central Bank is expected to restore price stability by driving inflation in a steady disinflation path to bring it back to the targeted range under the Flexible Inflation Targeting (FIT) framework through appropriate monetary policy actions. As a part of this process, monetary financing to the Government is expected to be phased out. The price stability commitment also entails maintaining more flexibility in the exchange rate and rebuilding reserves to withstand future shocks.
- **Strengthening financial institutions and financial system stability:** The IMF is of the view that Sri Lanka's financial system is heavily exposed to the public sector, moderately capitalised, and could face material capital and forex shortfalls following a debt restructuring. Consequently, there is a possibility that banks could face significant capital and forex shortfalls as a result of a sovereign debt restructuring. Therefore, plans are under way for the capital restoration of systemic banks following asset quality reviews to strengthen the resilience of the state owned banks. Meanwhile, financial sector supervision and the crisis management framework will be strengthened to make Sri Lanka's financial system more robust.

In addition to these specific benefits, the IMF supported programme would bring several positive spillovers to the economy through improved investor confidence, possible sovereign rating upgrades, and reopening of access to markets, among others. Considering the challenging nature of the targets set out, the authorities will have to put in a lot of effort and show commitment to ensuring the successful completion of the programme throughout the programme period. Also, in view of the maintenance of political and social stability during the programme period, especially considering the possible initial unpopularity of the reform measures and consequent public dissent, public awareness of how initial sacrifices would lead to long term economic benefits needs to be created.

Reforms Agenda Beyond the IMF-EFF Arrangement

The success of the IMF-EFF arrangement will largely rest on the extent to which the long neglected structural reforms are implemented. The structural reforms are anticipated to boost the competitiveness of the economy, provide a foundation for productivity enhancement, increase the efficiency in resource utilisation, and thereby enhance the growth potential. The severity of the current economic crisis faced by Sri Lanka highlights the importance of addressing the longstanding structural issues in a sustainable manner beyond the reforms agenda in the IMF programme through national policies which are formulated in consultation with stakeholders and free from political influences with vested interests. In this regard, the reforms agenda should focus on improving the productivity and output of the economy through technological innovations and increased economic connectivity to the world over trade and investment, by enhancing diversity in merchandise exports and potential services export sectors including tourism, IT/BPO sectors, and attracting FDI. It is also necessary to strengthen legal frameworks to ensure public accountability of state institutions, exercising available legal powers in policy formulation and implementation by relevant authorities to ensure lasting economic welfare in the country. These would complement the reforms agenda in the IMF-EFF arrangement to ensure that Sri Lanka attains and sustains macroeconomic stability in the earliest possible timeframe.

Conclusion

Despite being part of sixteen programmes since the first in 1965, only a few IMF programmes in Sri Lanka have been successfully implemented by authorities. This has been mainly due to the lack of commitment to meeting the conditionalities attached to such programmes, especially those related to structural reforms, which required painful macroeconomic adjustments and unpopular policies that were aimed at long term welfare enhancements. Therefore, it is imperative that Sri Lanka internalises these reforms in its policy formulation and implements the major areas of reforms in the current IMF programme as well as reforms beyond the programme to help the economy transform into greater stability and a higher growth path at the earliest while circumventing the need for repeated access to IMF bailouts and several rounds of debt restructuring in the future.

Reference

1. International Monetary Fund. (2023). Sri Lanka: Request for an Extended Arrangement Under the EFF - Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka. 116. International Monetary Fund, Washington D.C.