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PRESS RELEASE

Clarifications on Debt Restructuring and the Debt Sustainability Analysis

There have been recent reports in the media based on public commentary that have propagated false narratives that Sri Lanka has failed to produce its own Debt Sustainability Analysis (DSA) in engaging in debt restructuring negotiations. Such commentary is likely based on a lack of familiarity with standard operating mechanisms of debt restructuring negotiations. There has also been debate on the feasibility of renegotiating the debt restructuring framework. The following sets out an accurate representation of facts in this regard.

Sri Lanka has amended International Monetary Fund (IMF) agreements in the past, what is different in the present context?

In the past, Sri Lanka has adjusted IMF programme targets midway through programmes. For instance, in the 2016-2020 Extended Fund Facility (EFF) programme, following the Constitutional Crisis in October-December 2018, the government was able to negotiate an extension of the programme period and associated waivers[1], providing more time for the primary balance target to be met, creating required fiscal space to support recovery of the economy from the adverse impacts of the constitutional crisis. Sri Lanka's current economic reform programme supported by the International Monetary Fund (IMF) is the first time that debt restructuring comprises a major pillar of an IMF supported reform programme undertaken by Sri Lanka. Therefore, this programme is fundamentally different to Sri Lanka's past engagements with the IMF. In the context of debt restructuring, amendments to key programme parameters become far more complicated.

Why is Sri Lanka subject to the Market Access Debt restructuring framework?

The IMF's rules do not allow it to lend to countries that are deemed to have unsustainable debt. Therefore, Sri Lanka commenced the process of restructuring its debt in parallel to negotiating the macroeconomic reform programme with the IMF. Accordingly, Sri Lanka has committed to ensuring that all restructuring agreements that Sri Lanka enters into with

[1] https://www.imf.org/en/News/Articles/2019/05/13/pr19162-sri-lanka-exec-board-5th-rev-ext-arrange-under-eff-grants-waivers-approves-disburse

various creditors will enable public debt sustainability to be restored as assessed by the IMF. The IMF has two debt restructuring frameworks, one for low income countries and the other for middle income market access countries. Sri Lanka does not fall into the categorisation for IMF's Low Income Country Debt Sustainability Framework (LIC DSF) and therefore debt sustainability is assessed in the context of the IMF's Market Access Sovereign Risk and Debt Sustainability Framework (MAC SRDSF).

What is the MAC SRDSF Methodology?

The MAC SRDSF methodology[2] is publicly available. This framework is developed by the IMF and is applied to all middle income economies undergoing debt restructuring. Near term outcomes are determined by a multivariate logit model that takes into account the historic macroeconomic data of the country and applies stress and mitigating factors. Medium term outcomes are determined by a probabilistic fan chart considering debt and gross financing needs. Long term outcomes build in further specific vulnerabilities to increase granularity.

The above parameters all lead to mechanical, quantitative outcomes based on the model. A degree of judgment can be applied by the IMF staff based on the mechanical outcomes, such as additional stress tests or introduction of additional variables to ensure a more robust outcome. However, such judgment is subject to substantial review at IMF department level, IMF management, and finally requires the approval of the IMF Executive Board. In Sri Lanka's case, the mechanical signals (confirmed by IMF staff judgment) for medium term and long-term debt sustainability indicate high risk, due to vulnerabilities to shocks and structural issues such as an ageing population and climate risks[3].

Is the Debt Restructuring Framework Up to Date? Can it be Re-negotiated?

All of this goes to show that the parameters of the MAC SRDSF model are not open for negotiation. While the macroeconomic projections used in the model are informed by consultations with the Sri Lankan authorities, the outcomes are largely mechanical in nature. The projections of the model are updated regularly, particularly at the IMF programme reviews that happen every 6 months. For instance, in the latest review of June 2024, data from the full year 2023 is included into the historical data of the model resulting in the overall model projections being fully up to date.

The debt restructuring targets in particular, once designed, become stable parameters and cannot be changed unless there is evidence of a significant change in circumstances that make the targets unviable. The debt targets are based on deeper parameters of the country's

[2] https://www.imf.org/-/media/Files/Publications/PP/2021/English/PPEA2021003.ashx

[3] See Table 1 Page 58 - https://www.imf.org/-/media/Files/Publications/CR/2023/English/1LKAEA2023001.ashx

debt carrying capacity and do not change based on changes to the macroeconomic framework, including the fiscal stance.

Whilst the parameters of the MAC SRDSF model have little flexibility, the technical elements of the DSA have been abundantly discussed and negotiated between the Sri Lankan authorities, Sri Lanka's appointed debt advisors, and the IMF during programme design. This includes aspects such as the exact perimeter of public debt, the refinancing assumptions, the cost of recapitalizing the banking sector, and so on.

Did Sri Lanka Develop its Own Debt Sustainability Assessment?

Whilst recognising the role of the IMF's independent DSA in the sovereign debt restructuring architecture, a debtor country and creditors will also formulate their own DSAs. From the outset of Sri Lanka's debt restructuring process in June 2022, Sri Lanka prepared its own DSA modelling to inform its negotiating strategy. This was done with the assistance of the country's debt advisors and is regularly reconciled with the IMF staff team based on IMF programme reviews and other updates.

Sri Lanka uses its DSA modelling to design offers made to various creditors, and to assess proposals received from creditors, to ensure that the terms being discussed are compatible with IMF DSA constraints. Similarly, Sri Lanka's creditors in most cases also formulate their own DSA modelling to inform their negotiating positions. These DSA models remain confidential for obvious reasons in the context of ongoing negotiations.

Therefore, whilst Sri Lanka as the debtor country and its creditors have their own DSA modelling to inform their respective negotiating positions, the IMF's DSA has a different role in the sovereign debt restructuring architecture. Whenever Sri Lanka reaches agreement in principle on restructuring terms with a particular creditor or group of creditors, the IMF is called upon to confirm, as the independent actor, that the negotiated terms indeed provide the required debt relief in order to comply with the debt targets. In doing so, the IMF may use its own judgement, in addition to mechanical outcome, to render its assessment.

Conclusion

Any country can of course stand its ground and refuse to move forward based on the IMF's DSA if it disagrees with the outcomes of the model and the IMF's assessments. The IMF would simply not be able to proceed with a financing programme given its inability to lend to a country with debt deemed unsustainable. Such a stand-off would only serve to delay an agreement on a financing programme for several months if not years. Whilst such scenarios may be interesting to debate in academic circles, government authorities responsible for the well-being of citizens must act in a timely and pragmatic manner. This was particularly true of Sri Lanka's situation in mid-2022 with no foreign exchange reserves, galloping inflation, civil unrest, and a near breakdown of the socio-economic fabric of the country.