The Basic of

International Monetary Fund [IMF]

The International Monetary Fund (IMF) is an multilateral international organization established to promote global economic stability and cooperation.

The IMF plays a vital role in the global economy by offering financial assistance, policy advice, and technical support to its member countries. Its main objectives focus on maintaining global monetary stability, fostering economic growth, and reducing poverty, especially in low-income countries. Through its various facilities, the IMF provides crucial support to countries facing economic difficulties, helping them stabilize and recover.

IMF Overview

- Founded: 1944, at the Bretton Woods Conference, New Hampshire, USA.
- Headquarters: Washington, D.C., USA.
- Membership: 190 countries (as of 2024).

- Purpose:
  Ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries to transact with each other.

Main Objectives of the IMF:

1. **Promote International Monetary Cooperation:**
   Facilitate cooperation among member countries on monetary and financial issues.

2. **Ensure Exchange Rate Stability:**
   Support the establishment of a multilateral system of payments for current transactions between members and maintain orderly exchange arrangements among members.

3. **Facilitate Balanced Growth of International Trade:**
   Help member countries achieve high levels of employment and income, thereby fostering economic growth and reducing poverty.

4. **Provide Resources to Member Countries in Need:**
   Offer financial resources to member countries facing balance of payments problems to help them stabilize their economies.

5. **Reduce Poverty:**
   Especially in low-income countries, through financial support and policy advice aimed at promoting sustainable economic growth.

Main Functions of the IMF

1. **Surveillance:**
   The IMF monitors the global economy as well as the economies of individual member countries. It provides advice on economic policies, identifies risks to stability, and offers recommendations for policy adjustments.

2. **Technical Assistance and Capacity Development:**
   The IMF provides technical assistance and training to help member countries strengthen their capacity to design and implement effective policies in areas like fiscal policy, monetary policy, and exchange rate policy.

3. **Financial Assistance:**
   he IMF provides financial support to member countries facing balance of payments problems. This support helps stabilize the economy, allowing countries to implement necessary reforms.

4. **Research and Analysis:**
   The IMF conducts research on global economic trends and issues, publishing reports that inform both policymakers and the public. The World Economic Outlook and Global Financial Stability Report are among its key publications.

The Types of Facilities Offered by the IMF

The IMF offers several financial assistance programs to its member countries, tailored to the nature of the economic difficulties and challenges faced by each member country:

1. **Stand-By Arrangements (SBA):**
   - Purpose: Short-term assistance to countries facing short-term balance of payments problems.
   - Duration: Typically 12 to 24 months.
   - Key Features: Conditional on the implementation of policies aimed at addressing the causes of the financial difficulties.

2. **Extended Fund Facility (EFF):**
   - Purpose: Medium- to long-term assistance to countries with structural economic problems that require time to resolve.
   - Duration: Typically 3 to 4 years.
   - Key Features: Focuses on structural reforms to address deep-rooted issues.

3. **Poverty Reduction and Growth Trust (PRGT):**
   - Purpose: Concessional financial assistance to low-income countries aimed at reducing poverty and fostering sustainable economic growth.
   - Facilities under PRGT: Includes the Extended Credit Facility (ECF), Standby Credit Facility (SCF), and Rapid Credit Facility (RCF).

4. Flexible Credit Line (FCL):

- Purpose: Available to countries with very strong policy frameworks and track records of economic performance, providing them with flexible access to IMF resources.
- Key Features: No ex post conditionality, meaning countries do not have to meet performance criteria after the funds are disbursed.

5. Precautionary and Liquidity Line (PLL):

- Purpose: Designed for countries with sound economic fundamentals but facing potential balance of payments needs.
- Key Features: Combines features of traditional programs and preventive measures.

6. Rapid Financing Instrument (RFI):

- Purpose: Provides rapid financial assistance to countries facing urgent balance of payments needs without the need for a full-fledged program.
- Key Features: No ex post conditionality, suitable for emergencies such as natural disasters or economic shocks.

7. Special Drawing Rights (SDR):

Special Note: **Special Drawing Rights (SDR)**

SDR is an international reserve asset created by the International Monetary Fund (IMF) to supplement the official reserves of its member countries.

Purpose of Creatiion

- Established: 1969 by the IMF.
- **Purpose:**
  Providing liquidity to the global economy by supplementing member countries' foreign exchange reserves, reducing reliance on national currencies like the US dollar.

Determination of Value

- Value: SDRs are not a currency but a potential claim on the freely usable currencies of IMF member countries. The value of the SDR is based on a basket of major international currencies.
- Current Basket (as of 2022):
  - US Dollar (USD)
  - Euro (EUR)
  - Chinese Renminbi or Yuan (CNY)
  - Japanese Yen (JPY)
  - British Pound Sterling (GBP)

The value of the SDR is calculated daily based on the weighted average of these currencies.

Allocation and Common Uses:

- Allocation: SDRs are allocated by the IMF to its member countries in proportion to their IMF quotas (which roughly reflects their share in the global economy).
- In response to global financial crises, the IMF has made substantial SDR allocations. For example, in August 2021, the IMF allocated about $650 billion worth of SDRs to help member countries combat the economic impact of the COVID-19 pandemic.
- **Use**:
  SDRs can be exchanged between member countries for freely usable currencies. They can also be used in transactions between countries and the IMF, such as paying charges or increasing reserve holdings.

Importance in Global Finance:

- Reserve Asset: SDRs help stabilize global financial markets by providing a reserve asset that countries can use to bolster their own currency reserves.
- Liquidity Support: In times of economic crisis, SDRs can be used by countries to meet balance of payments needs without having to use other foreign exchange reserves.

Principal Limitations:

- Not a Currency: SDRs are not used for everyday transactions or by the general public. They are a reserve asset intended for use by governments and the IMF.
- Limited Exchange: While SDRs can be exchanged for freely usable currencies, the process is managed by the IMF, and not all countries can immediately convert SDRs into other currencies.

Government of Sri Lanka's (GoSL's)

Extended Fund Facility (EFF) with IMF – 2022

Sri Lanka's current Extended Fund Facility (EFF) agreement with the International Monetary Fund (IMF) is a critical financial arrangement aimed at stabilizing the country's economy amidst severe economic challenges.

Loan Amount and Duration:

- The IMF approved a 48-month EFF arrangement for Sri Lanka, amounting to approximately $2.9 billion (2.286 billion SDR).
- 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
- The program aims to support Sri Lanka in restoring macroeconomic stability and debt sustainability.

Expected Developments under the IMF-EFF Arrangement

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) 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.

Gross Finaincing Needs (GFN):

Is the amount of borrowed funds required to cover all expenditure and amortization not covered by revenue (Source: IMF Institute).

Which can be estimated as:

GFNs = Govenemnt Total Revenue and Grants – Total Government Expenditure + Amortization Payments

Alternatively: GFNs = Amortization Expenditure – Overall Budget (or Fiscal) Balance

Importance of GFN:

- Debt Sustainability: High Gross Financing Needs can signal financial stress, as the government may face difficulties in securing funding, especially if market confidence is low.
- Debt Management: Governments must manage GFN carefully to ensure that they can meet their obligations without defaulting or excessively increasing their debt burden.

Further Info:

Economic Reforms:

- Fiscal Consolidation: The agreement emphasizes fiscal consolidation through increased revenue mobilization, rationalization of government expenditures, and reforms in tax policy and administration.
- Monetary Policy Reforms: The central bank is expected to adopt a flexible inflation-targeting framework, with a focus on maintaining price stability.
- Exchange Rate Flexibility: The agreement supports a flexible exchange rate policy to help rebuild foreign reserves and maintain external competitiveness.

Debt Restructuring:

- The EFF arrangement includes provisions for debt restructuring, aiming to bring Sri Lanka’s debt to a sustainable level. This involves negotiations with bilateral and private creditors.
- Creditor Participation: The program’s success hinges on adequate and timely creditor participation to ensure the country's debt sustainability.

Social Safety Nets:

- The program stresses the importance of protecting vulnerable populations during the adjustment process. It includes measures to strengthen social safety nets, such as targeted cash transfers and food assistance programs.

Structural Reforms:

- State-Owned Enterprises (SOEs) Reform: The agreement calls for reforms in SOEs to reduce fiscal risks, including the introduction of a new governance framework and improved financial transparency.
- Anti-Corruption Measures: Strengthening the anti-corruption framework is a key part of the EFF, aimed at improving governance and the investment climate.

Economic Growth:

- The program aims to restore economic growth by improving the business environment, attracting foreign investment, and boosting productivity through structural reforms.

Monitoring and Reviews:

- The IMF will conduct periodic reviews to assess the implementation of the program and make adjustments if necessary. These reviews are critical for the disbursement of funds in tranches.

External Support:

- The EFF program is expected to catalyze additional external financial support from other international financial institutions and bilateral donors.

Inflation Control:

- The program includes measures to control inflation, which has been a significant issue for Sri Lanka, with high inflation rates contributing to economic instability.

Restructuring Domestic Financial Sector:

- The program also addresses the need to strengthen the domestic financial sector, particularly the banking system, to enhance financial stability.

Public Debt Susutanitiy & GoSL

A country's public debt is considered sustainable if the government can meet all its current and future payment obligations without exceptional financial assistance or going into default (Source: IMF)

In other words, public debt sustainability refers to a government's ability to maintain its current level of debt without requiring debt relief or falling into default. It implies that a country can meet its debt obligations—both interest payments and principal repayments—without compromising its fiscal and economic stability.

Sustainable public debt levels allow a government to finance its operations and development projects, respond to economic shocks, and maintain investor confidence.

Key Indicators of Public Debt Sustainability

1. Debt-to-GDP Ratio:
2. Debt Service Ratio:
3. Primary Balance:
4. Interest Rate-Growth Differential:
5. External Debt Sustainability:

Main Methods of Debt Restructuring [General]

Debt restructuring involves reorganizing the terms of a country's debt to restore debt sustainability and avoid default.

1. Debt Rescheduling:

- Definition: Extending the maturity period of the debt, allowing the country more time to repay.
- Impact: Reduces immediate repayment pressures, improving cash flow in the short term.

2. Debt Reduction (Haircuts):

- Definition: Creditors agree to reduce the principal amount of debt owed (often called a "haircut").
- Impact: Directly lowers the debt burden, making it more manageable for the debtor country.

3. Interest Rate Reduction:

- Definition: Lowering the interest rates on existing debt.
- Impact: Reduces the cost of debt servicing, freeing up resources for other uses.

4. Debt-for-Equity Swaps:

- Definition: Converting debt into equity, where creditors take ownership stakes in the debtor country's assets or enterprises.
- Impact: Reduces the debt burden while potentially providing creditors with long-term returns.

5. Debt-for-Nature Swaps:

- Definition: A portion of the country's foreign debt is forgiven in exchange for local investment in environmental conservation projects.
- Impact: Links debt relief with environmental benefits, improving both fiscal and environmental sustainability.

6. Debt-for-Development Swaps:

- Definition: Similar to debt-for-nature swaps, but the debt relief is tied to investments in social or economic development projects.
- Impact: Promotes long-term economic development while reducing the debt burden.

7. Bond Exchange or Debt Conversion:

- Definition: Existing bonds are exchanged for new ones with different terms, such as longer maturities or lower interest rates.
- Impact: Helps realign the debt structure with the country's repayment capacity.

8. Reprofiling:

- Definition: Extending the maturity of short-term debt without reducing the principal or interest rates.
- Impact: Provides temporary relief while maintaining the original debt terms.

9. Preemptive Debt Restructuring:

- Definition: Voluntary renegotiation of debt terms before the country defaults.
- Impact: Can be less disruptive than post-default restructuring, maintaining market confidence.

10. Brady Bonds:

- Definition: defaulted commercial bank loans were exchanged for bonds
- Impact: Provided a market-based solution for sovereign debt crises, creating a secondary market for distressed debt.

Sri Lanka's Debt Restructuring Experiemce:

Sri Lanka's recent debt restructuring process is a critical part of the country's efforts to address its severe economic crisis, which has been marked by high levels of public debt, dwindling foreign reserves, and economic instability.

Background

- **Economic Crisis:**
  Sri Lanka's economic crisis, which escalated in 2022, was driven by a combination of factors including unsustainable public debt, poor fiscal management, the impact of the COVID-19 pandemic, and a loss of access to international capital markets.

- **Default:**
  In April 2022, Sri Lanka defaulted on its foreign debt for the first time in its history, as it struggled to make payments on its obligations, prompting the need for comprehensive debt restructuring.

Parties Involved

1. **Sri Lankan Government:**
   - Leading the negotiations for restructuring its debt to restore economic stability and regain access to international financial markets.

2. **International Monetary Fund (IMF):**
   - Role: The IMF is playing a central role by providing financial assistance through a $2.9 billion Extended Fund Facility (EFF) and helping Sri Lanka design and implement a comprehensive economic reform program. The IMF's support is contingent upon successful debt restructuring.

3. **Bilateral Creditors:**
   - Key Players: Includes countries like China, India, and Japan, which are among Sri Lanka's largest bilateral lenders.
   - Role: These creditors are involved in negotiations to restructure Sri Lanka's bilateral debt, which is crucial for meeting IMF conditions.

4. **Private Creditors:**
   - Key Players: Includes holders of Sri Lankan government bonds and other commercial lenders.
   - Role: Negotiations are ongoing with these creditors to restructure commercial debt, including Eurobonds, to ensure debt sustainability.

5. **Paris Club:**
   - Role: An informal group of official creditors who coordinate solutions for debtor countries. The Paris Club has been involved in discussions to support Sri Lanka's debt restructuring efforts.

6. **Advisors and Legal Counsel:**
    - Role: Sri Lanka has appointed financial and legal advisors to assist in negotiations with creditors and to ensure that the restructuring process complies with international norms and standards.

Overall Progress:

- IMF Agreement: In March 2023, the IMF approved a $2.9 billion Extended Fund Facility (EFF) for Sri Lanka, contingent upon successful debt restructuring.

- **Bilateral Negotiations:**
    - China:
      Sri Lanka has been negotiating with China, its largest bilateral creditor, to restructure its loans. China has expressed willingness to support Sri Lanka but the terms of restructuring are still under negotiation.

    - India and Japan:
      These countries have also expressed support for Sri Lanka's debt restructuring efforts, with India offering a line of credit and financial assistance.

- **Private Debt Restructuring:**
    - Bondholders: Negotiations with bondholders have been challenging, given the complexity and diversity of these creditors. However, efforts are ongoing to reach an agreement that balances debt relief with the interests of creditors.

- **Paris Club Engagement:**
  The Paris Club has provided a framework for Sri Lanka to engage with its official creditors, although the process has been complicated by the need to include non-Paris Club members like China.

- **Creditor Coordination:**
  Coordination among various creditors has been one of the significant challenges. The involvement of different types of creditors (bilateral, multilateral, and private) with varying interests has made the process complex.

Challenges and Outlook:

- Coordination among Creditors: One of the main challenges has been coordinating among the various creditors, especially between China and the Paris Club members, given differing approaches to debt restructuring.

- Timely Restructuring: The success of the IMF program and Sri Lanka's economic recovery depends on the timely conclusion of the debt restructuring process.

- Sustained Reforms: Beyond restructuring, Sri Lanka needs to implement sustained economic reforms to restore fiscal discipline, improve governance, and ensure long-term debt sustainability.

Main External Debt Hoders (Lenders) of the GoSL:

The Government of Sri Lanka has relied heavily on external lenders to meet its financing needs, especially due to its high debt levels and fiscal deficits.

1. Multilateral Institutions

These are international organizations that provide loans and financial assistance to countries for development projects, infrastructure, and economic stabilization.

- **International Monetary Fund (IMF)**: The IMF provides financial assistance to countries facing balance of payments crises or severe financial instability. Sri Lanka has received several IMF programs aimed at stabilizing its economy, managing its debt, and supporting fiscal reforms.
- **World Bank**: The World Bank provides loans for development projects in sectors like education, health, infrastructure, and poverty reduction. It supports long-term economic development and reduces poverty through low-interest loans and grants.
- **Asian Development Bank (ADB)**: The ADB is a regional development bank that provides loans and grants for development projects and poverty alleviation in Asia. Sri Lanka has received funding from ADB for infrastructure, energy, and social development projects.

2. Bilateral Lenders

These are individual countries or government agencies that provide financial assistance through loans, grants, or credit lines.

- **China**: China has been one of the largest bilateral lenders to Sri Lanka, primarily funding infrastructure projects like ports, roads, and energy. Much of this lending is part of China's Belt and Road Initiative (BRI). Major projects like the Hambantota Port and Colombo Port City have been financed by Chinese loans.
- **India**: India has provided credit lines and loans for infrastructure projects, trade, and economic cooperation. India also extended financial support in times of crisis, such as fuel supply loans and emergency financial assistance during economic instability.
- **Japan**: Japan has been a long-standing partner and lender to Sri Lanka, providing concessional loans, particularly for infrastructure projects like highways, water supply systems, and urban development.
- **Other Bilateral Partners**: Countries like the United States, the United Kingdom, and other members of the European Union have provided financial assistance, often tied to development aid and specific projects.

3. Commercial Lenders (International Capital Markets)

Sri Lanka has also raised financing through international capital markets by issuing bonds.

- **International Sovereign Bonds (ISBs)**: Sri Lanka has issued sovereign bonds on global markets to raise funds. These are typically high-interest, commercial loans from private investors and financial institutions, making them an important but expensive source of external financing. Due to the high debt burden, repayment of ISBs has been a significant challenge for Sri Lanka.

- **Private Banks and Financial Institutions**: Sri Lanka has borrowed from foreign private banks and institutions through syndicated loans, which are usually provided at market rates. These loans tend to have shorter maturities and higher interest rates compared to concessional loans from multilateral or bilateral sources.

4. Export Credit Agencies (ECAs)

ECAs provide financial backing for international trade, particularly when governments or companies in the lending country export goods or services.

- **China Export-Import (Exim) Bank**: This is one of China's key financial institutions supporting infrastructure development in Sri Lanka. The Exim Bank has provided large-scale project financing, especially for infrastructure projects.

- **Japan International Cooperation Agency (JICA)**: JICA finances development projects in Sri Lanka, often in the form of concessional loans with low-interest rates and long repayment periods, focusing on sectors like transport and water supply.

5. Development Funds and Donors

These lenders provide grants, loans, and technical assistance aimed at fostering sustainable development.

- **United Nations Agencies (UNDP, UNICEF, etc.)**: UN agencies provide grants and technical support for social development projects, often in collaboration with Sri Lankan government agencies.

- **European Union (EU)**: The EU provides development aid and concessional loans for projects in areas like poverty reduction, governance, and social development.

Summary of Key External Lenders to Sri Lanka:

- **Multilateral Institutions**: IMF, World Bank, ADB
- **Bilateral Lenders**: China, India, Japan, other countries
- **Commercial Lenders**: International Sovereign Bonds (ISBs), private financial institutions
- **Export Credit Agencies**: China Exim Bank, JICA
- **Development Funds and Donors**: UN agencies, EU

The **World Bank** (World Bank Group)

The **World Bank** is an international financial institution that provides loans and grants to governments of low- and middle-income countries for development projects. Its primary aim is to reduce poverty and support sustainable development. The World Bank is part of the **World Bank Group**, which includes five institutions, with the most prominent being:

- **International Bank for Reconstruction and Development (IBRD)**: Focuses on middle-income and creditworthy low-income countries.

- **International Development Association (IDA)**: Provides concessional loans and grants to the world's poorest countries.

Main Objective

The **main objective** of the World Bank is to reduce poverty and foster sustainable economic development in its member countries. It does so by:

- Promoting economic growth.
- Encouraging shared prosperity by helping to reduce inequalities within countries.
- Supporting social development through projects in education, health, and infrastructure.

Functions of the World Bank

The World Bank's key functions include:

- **Financial Assistance**: Providing low-interest loans, interest-free credits, and grants for investments in areas like education, healthcare, public administration, infrastructure, and agriculture.

- **Technical Assistance and Policy Advice**: Offering expertise and advice to help countries implement sound economic policies, improve governance, and strengthen institutional capacity.

- **Research and Knowledge Sharing**: Conducting economic research and providing data and analysis to guide development policies and strategies. It is a key source of knowledge on global development challenges.

- **Capacity Building**: Helping countries improve their capacity to manage public finances, implement reforms, and develop human capital.

- **Private Sector Engagement**: Through its arm, the **International Finance Corporation (IFC)**, the World Bank promotes private sector development by investing in private enterprises and promoting job creation.

Sri Lanka's Engagement with the World Bank (as of 2022)

Sri Lanka has had a long-standing relationship with the World Bank, dating back to 1950 when it became a member. As of 2022, Sri Lanka has engaged with the World Bank in various ways, including:

- **Financial Assistance**: The World Bank has provided Sri Lanka with **loans and grants** for a range of development projects in sectors such as infrastructure, education, healthcare, and social welfare. The Bank has focused on poverty reduction, rural development, climate resilience, and disaster risk management.

- **COVID-19 Response**: In 2020 and 2021, the World Bank provided emergency funding to help Sri Lanka respond to the COVID-19 pandemic. This included support for strengthening healthcare systems, social protection programs, and economic recovery efforts.

- **Economic and Fiscal Reforms**:
  The World Bank has supported Sri Lanka in implementing **fiscal reforms** and improving public financial management. This includes advice on debt management, tax reforms, and improving governance.

- **Climate and Environmental Projects**: The World Bank has been involved in projects aimed at improving **climate resilience** and promoting sustainable development in Sri Lanka. This includes investments in agriculture, renewable energy, and natural resource management.

- **Challenges (Debt and Economic Crisis)**:

  As Sri Lanka faced a severe economic and debt crisis in 2022, the World Bank played an important role in **assessing the country's economic situation** and providing advice on recovery measures. However, due to the nature of the crisis, the World Bank limited direct financial assistance to emergency support while encouraging structural reforms.

Key Areas of Engagement:

- **Poverty reduction** and improving livelihoods, particularly in rural areas.
- **Education and health** sector reforms and infrastructure improvement.
- Support for **economic diversification**, focusing on sectors like tourism, agriculture, and small enterprises.
- **Climate resilience** projects, especially in disaster-prone areas.
- **Emergency financial assistance** in response to the COVID-19 pandemic and ongoing economic crises.