First Capital
A Janashakthi Group Company

SRI LANKA'S ECONOMIC REBOUND

MARCH 27, 2023

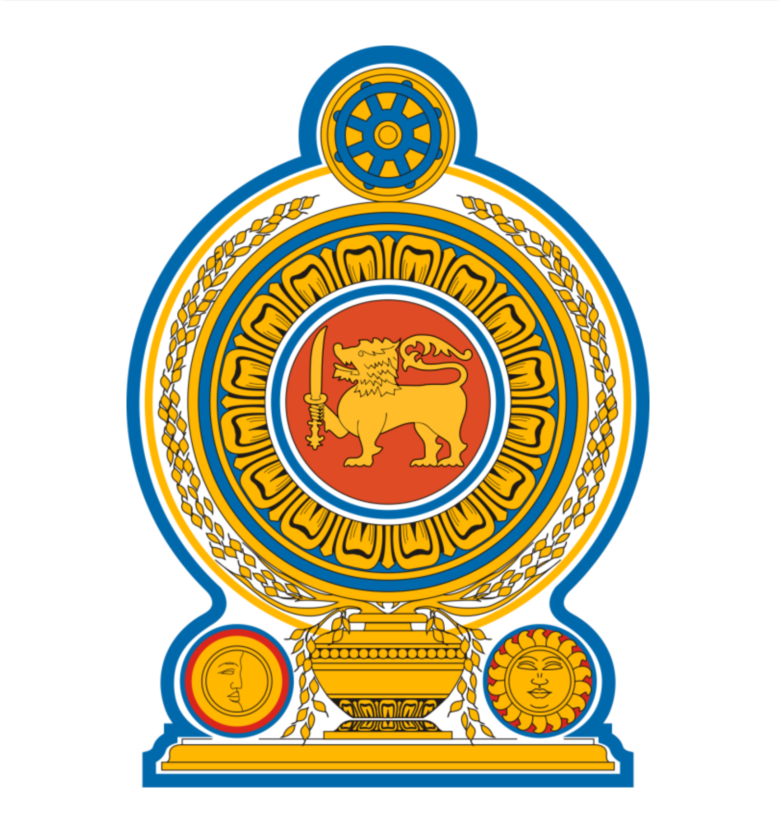
Root cause of Sri Lanka’s Economic Crisis

The country's vulnerabilities were worsened by the 2017 drought, 2018 political turmoil, and the 2019 terrorist attacks

After coming to power in late 2019, former President Rajapaksa's administration enforced unsustainable measures such as significant tax reductions and delayed anticipated reforms, which resulted in an anticipated revenue loss surpassing 2% of GDP

Due to limited reserves and high debt levels, the country was already struggling to repay external bonds when the pandemic hit. As a consequence, usable gross international reserves dropped from USD 7.6Bn in 2019 to USD 1.6Bn in 2021, insufficient for covering even a month's worth of imports. Consequently, the country suspended external debt service in Apr 2022 and defaulted on international sovereign bonds in May 2022, leading to a nearly 40% depreciation of the rupee in just three months. This caused a significant economic contraction and a surge in inflation

Measures taken by Sri Lanka to tackle the economic crisis



Tightened import restrictions and other balance of payment measures to address FX shortages and depreciation pressure. Implemented a digital fuel rationing system to manage fuel access and increased financial assistance to support vulnerable groups

Downsized monetary financing, raised policy rates, introduced tax measures, introduced energy price mechanisms, raised electricity prices, and introduced structural reforms

THE DAY OF SIGNIFICANCE: MARCH 20TH, 2023

IMF approved a 48-month extended arrangement under the Extended Fund Facility (EFF) of SDR 2.3Bn (395% of quota or USD 2.9Bn) for Sri Lanka which unlocks up to USD 7.0Bn in financing from the IMF, International Financial Institutions (IFIs), and multilateral agencies. Following the Executive Board's decision, the IMF announced an immediate disbursement of SDR 254.0Mn (USD 333.0Mn)

This is expected to bring several benefits to Sri Lanka, including improved reserves, faster economic recovery, positive capital inflows to government securities, possible easing of interest rates, technical assistance from the IMF, and restored investor confidence

EFF-Program Objectives

Revenue-Based Fiscal Consolidation	Restoring Public Debt Sustainability	Restoring Price Stability and Rebuilding External Buffers
Ensuring Financial Stability	Reducing Corruption Vulnerabilities	Raising Potential Growth

1.0 REVENUE-BASED FISCAL CONSOLIDATION

Achieve fiscal consolidation	• Improve primary balance to a surplus of 0.8% of GDP in 2024 and 2.3% of GDP in 2025 • Achieve Tax to GDP ratio of at least 14% by 2025, revamp VAT system before 2024, remove product specific VAT exemptions, expedite valid VAT refunds, abolish Simplified VAT system, introduce property, gift, and inheritance taxes by 2025 • Strengthen the capacity of large taxpayer unit & IT-based tax administration • Avoid excessive cuts to capital spending & limit fiscal space for capital spending
Strengthen Social Safety Nets (SSN) to protect the poor and vulnerable	• Set a floor on SSN spending of LKR 187Bn in 2023 (0.6% of GDP) and maintain it to at least at 0.6-0.7% of GDP beyond 2023 • Parliamentary approval of the welfare benefit payment scheme & application of the new eligibility criteria by May 2023
Strengthen core Public Financial Management (PFM) functions	• Enact a new PFM law; develop a medium-term fiscal framework; roll out Integrated Treasury Management Information System by Sep 2023; strengthen the Macro-Fiscal Unit in the MOF; improve public investment efficiency; and update fiscal reporting to the GFSM 2014 standard
Depoliticize energy pricing	• Set retail fuel prices to cost-recovery levels with monthly formula-based adjustments • Set end-user electricity tariff schedule to cost-recovery level with semi-annual formula-based adjustments • Improve the Bulk Supply Transaction Account by Dec 2023 to determine the cost-recovery based electricity tariff and government transfer requirement
Strengthen governance & address debt levels of SOEs	• Cabinet Approval to conduct balance sheet restructuring of CEB, CPC, SriLankan Airlines, and the Road Development Authority by Jun 2023; publish audited financial statements for all 52 major SOEs by Jun 2023; prohibit new FX borrowing by non-financial SOEs with less than 20% FX revenues

2.0 RESTORING PUBLIC DEBT SUSTAINABILITY

Requirements for debt restructuring	• Reduce public debt levels below 95% of GDP by 2032 • Reduce gross financing needs (GFNs) below 13% of GDP in 2027–32 • Maintain FX debt service of government below 4.5% of GDP in each year over 2027-32 • Ensure that fiscal and external financing gaps are closed (government to announce plans on external and domestic debt operations by Apr 2023) • External financing gaps can be closed through debt service reduction during 2023-27. This would entail a total reduction of USD 17Bn, including arrears accumulated in 2022
Improve public debt management & debt transparency	• Establish a public debt management agency by Dec 2023 & complete the establishment of the agency by Dec 2024 • New PFM law should clarify the definition of central government debt, strengthen the guidelines for issuing treasury guarantees, prohibit the provision of guarantees to SOEs with negative equity and for SOE liabilities in foreign currency

3.0 RESTORING PRICE STABILITY

Restore price stability	• Reduce CBSL’s T-Bill holdings, discontinue monetary & bring YoY headline CCPI inflation within 4-6% by early 2025. This will be monitored via a monetary policy clause • A ceiling on CBSL's net credit to the government will be implemented • CBSL should refrain from direct financing of the budget deficit and unwinding its treasury securities • Monetary financing should be used only if there is a lack of budget support from IFIs during the first 6 months of the program
Restore a market-determined exchange rate & rebuild international reserves	• Achieve the program targets on Net Official International Reserves (NIR) by purchasing a net amount of USD 1.4Bn in foreign currency in 2023 • Use foreign exchange interventions only during disorderly market conditions, disclosed to guide market expectations, and capped at an amount consistent with meeting the NIR targets
Lift FX control measures	• Prepare a plan by Jun 2023 to remove FX control measures such as import restrictions, exchange restrictions, multiple currency practice (MCPs), and capital flow management during the program period • Refrain from implementing or intensifying exchange restrictions/MCPs/import restrictions or entering into bilateral payment agreements that conflict with Article VIII during the program period
Strengthen institutional framework	• Enact a new Central Bank Act (Parliamentary approval expected by Apr 2023) to strengthen central bank autonomy

4.0 ENSURING FINANCIAL STABILITY

Recapitalize the banking system	• CBSL to conduct asset quality reviews for the 2 largest state-owned banks and 3 largest private banks by Apr 2023 • CBSL will develop a roadmap for financial sector restructuring and recapitalization by Jul 2023 • Government to decide on conditions for potential use of public funds by Oct 2023
Strengthen financial sector supervision, safety nets, and crisis management	• A proposed revision of the Banking Act is expected to be approved by the Cabinet and Parliament by Jun and Dec 2023, respectively
Strengthen regulatory & governance frameworks for state-owned banks	• Banking Act will enforce equivalent regulatory standards for state-owned as private banks • Appointment framework for directors and senior managers of state-owned licensed commercial banks & licensed specialized banks to be changed
Increase supervision of smaller non-bank deposit taker sector	• CBSL has already tightened non-performing loan classification and capital requirements and liquidated 5 leasing companies

5.0 REDUCING CORRUPTION VULNERABILTIES

Strengthen governance	• IMF will release a diagnostic report by Sep 2023 which will be used to determine and implement time-bound reforms under the program
Strengthen anti-corruption framework	• The draft anti-corruption legislation (to receive Parliamentary approval by Jun 2023) should establish a transparent and merit-based method for selecting independent commission members • Comprehensive asset recovery provisions in compliance with UN's Convention Against Corruption should be incorporated into a draft legislation by Mar 2024
Improve fiscal transparency	• Establish an online transparency platform to enhance transparency of debt, public procurement contracts, and tax exemptions
Strengthen risk-based AML/CFT supervision	• Revise laws on beneficial ownership of legal persons to align with FATF standards • Leverage financial intelligence extensively to detect corruption with better cooperation between law enforcement agencies

6.0 RAISING POTENTIAL GROWTH

Expand growth-enhancing reforms	• Formulate structural reforms at a later stage under the program with support from the World Bank, ADB, and other development partners
Improve trade & investment	• Develop a medium-term plan to rationalize para-tariffs • Implement a national single window, etc. to reform the investment regime
Increase employment for women & youth	• Improve access to transportation & financial services, provision of benefits & remuneration such as flexible work arrangements & affordable childcare, and expand technical & vocational education programs
Reduce SOEs' & government's role in the economy	• Implement reforms to strengthen SOE governance • Increase adoption of digital technology and digital platforms for SMEs • Improve private sector's access to land, upgrade labor skills, and enhance labor market flexibility
Reform the electricity sector	• Implement structural reforms in the electricity sector with technical support from development partners to reduce electricity costs and address large investment requirements in generation and transmission
Adapt to climate change	• Strengthen efforts to adapt to climate change by creating contingency budgets, implementing insurance policies for natural disasters, etc

IMF'S Illustrative Scenarios

PRE-STRUCTURING SCENARIO

- Assumption that external financing gap in 2022-27 will be closed through additional new external financing (unavailable currently)
- Debt stock and gross financing needs would remain above 95% of GDP and 13% of GDP, respectively
- Debt will not stabilize if additional downside risks were to materialize
- FX debt service would spike after the program period and exceed new financing, causing the reserves to decline rapidly

RESTRUCTURING SCENARIO

- CBSL's holdings of T-Bills will be exchanged for longer term bonds
- Domestic Debt: A select pool of the remaining domestic debt will be reprofiled to reduce gross financing need, while limiting the impact on financial sector
- External Private Debt: A large NPV cut with principal reduction and amortization beyond the program period
- Bilateral Debt: A large NPV cut with principal reduction through a long maturity extension with amortization payments starting in 2033

External Financing Gap & Program Financing

(in USD millions)	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
Program 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 bonds (market access)		0	0	0	0	1,500	1,500
Shortfall (A+B)	0	0	0	0	0	0	
Memorandum:							
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

DISCLAIMER

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Thank you!

"SUCCESSFUL INVESTMENTS IS ABOUT MANAGING RISKS"

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