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PRESS RELESE

Sri Lanka Reaches Final Debt Treatment Agreements with the Official Creditor Committee and Exim Bank of China

What is the significance of the final debt treatment agreements reached on the 26th of June 2024?

On the 26th of June 2024, Sri Lanka reached final agreement on its debt treatment with the members of the Official Creditor Committee (OCC) of Sri Lanka's major bilateral lenders, and also Bilateral Debt Treatment Agreements in relation to the loans owed by Sri Lanka to Exim Bank of China. Accordingly, through these two sets of agreements reached on the 26th of June, 2024, Sri Lanka has successfully concluded the treatment of its debt with its major official bilateral creditors, including China, and the OCC members; Japan, India, France, Australia, Austria, Belgium, Canada, Denmark, Germany, Hungary, Korea, the Netherlands, Russia, Spain, Sweden, United Kingdom and the United States of America. This amounts to a total of USD 10 billion agreed to be treated by these lenders.

Why did Sri Lanka have to restructure its debt?

During the recent economic crisis, Sri Lanka ran out of foreign exchange reserves. By April 2022, the country had completely run out of usable reserves and on the 12th of April 2022 had to announce a temporary moratorium on the repayment of selected external debt. As Sri Lanka was unable to service its debt, it prevented creditor nations, multilaterals and commercial lenders from extending fresh financing to the country. This significantly hindered the progress of economic development as there was no concessional financing available for critical infrastructure investment. Fiscal cashflow management was also adversely affected as borrowings were entirely raised from the domestic market with significant impacts on inflation as monetary financing was used to fund deficits and subsequently on interest rates as monetary financing was phased out.

In order to recover from the crisis, Sri Lanka required support from the International Monetary Fund (IMF). However, the IMF's lending rules prohibit it from lending to countries that have debt that is deemed to be unsustainable. Therefore, in order to obtain an IMF programme, it was necessary for Sri Lanka to simultaneously commence the process of restructuring its public debt with a view to restoring the sustainability of its debt.

How does debt restructuring take place?

As a first step, the IMF produces a Debt Sustainability Analysis (DSA) which provides the IMF's assessment of the level of debt relief that is required for a specific country's debt to be ascertained as sustainable. This level of debt relief and debt-carrying capacity varies significantly between countries.

For example, Sri Lanka, being a middle-income country, has a different DSA model (MAC SRDSF) to, by way of comparison, Ghana, a low income country (LIC DSF). According to Sri Lanka's DSA, public debt needed to be reduced to less than 95% of GDP by 2032. Whereas for Ghana, for example, the present value of its public debt had to be reduced to under 55% of GDP by 2028.

Therefore, the IMF's DSA determines the level of debt relief required through the debt restructuring process at the outset. The respective creditors and debtor then negotiate to restructure debt such that the required debt relief to reach the IMF DSA target is met. Depending on the DSA targets, the required debt relief will differ from country to country.

How is debt relief provided?

Different creditors provide debt relief through different methods. In the case of official creditors, such as the OCC and Exim Bank of China, debt relief is typically provided not through a haircut on the principal value of the debt but through an extension of the payment period (maturity extension) and reduction of interest rates. This reduces the payment burden for the debtor country in the near term until the economy has recovered and its payment capacity has improved in the future. To quantify this, the OCC and Exim Bank of China restructuring agreements provide debt relief of up to 92% of their respective debt service falling due during the IMF programme period.

This cash flow relief frees up financial resources for the debtor country to spend on priority public services and essential development needs instead of spending it on debt service in the near term. By discounting the value of the cash flow relief provided through the restructuring period, the net present value effort (NPV effort) incurred by the creditor can be ascertained. In the case of official creditors, this NPV effort is incurred by the taxpayers of their respective countries on behalf of Sri Lanka’s economic recovery.

Is debt relief comparable amongst different creditors?

In addition to ensuring that the debt relief is in line with the IMF DSA targets, it is also necessary to ensure that different creditors do not receive better treatment than one another in the restructuring process. For instance, the OCC will assess whether the forthcoming debt restructuring agreed between Sri Lanka and bondholders is comparable to the restructuring agreed with the OCC. Sri Lanka and the bondholders would necessarily have to ensure that their restructuring agreement is indeed comparable to that provided by the OCC and Exim Bank of China.

This is a complicated process since different creditors provide different types of debt restructuring. Commercial bondholders for instance typically include a principal haircut in addition to lower interest payments, but with shorter maturity periods than official creditors. However, the comparability of the restructuring effort is determined by the net present value of the total cash flow relief provided during the restructuring period collectively through these different methods (interest reduction, maturity extension, principal haircut). Therefore, the restructuring with each creditor must meet the IMF's DSA target and must be comparable with restructuring agreements reached with other creditors.

Will Sri Lanka’s nominal debt stock reduce as a result of this restructuring?

Since official creditors provide debt relief through maturity extensions and interest rate reductions, there is no immediate impact on the nominal debt stock through restructuring. However, through interest rate reductions, the impact on Sri Lanka’s future budget deficits will be reduced, thereby reducing additions to the debt stock as debt flow is reduced. Maturity extensions provide space for the economy to grow and improve debt service capacity, enabling debt to GDP to reduce in line with IMF DSA targets. The nominal debt stock is not a useful measure of debt sustainability which is why the IMF's DSA targets do not consider nominal debt stock but instead the debt to GDP ratio and other measures of debt flow such as Gross Financing Needs and Forex Debt Service as a share of GDP. The nominal debt stock in Rupee or Dollar terms will continue to increase as long as the country has a budget deficit, as in any other country.

Debt sustainability has to be managed by ensuring the country maintains a primary budget surplus through the recent fiscal reforms, along with debt restructuring to achieve the DSA targets to restore debt sustainability. More details on the appropriate measures of debt stock, fiscal responsibility, and debt sustainability are available here; https://www.treasury.gov.lk/api/file/f4890cb6-2bea-4763-a9f0-4034b62e420d

What are the next steps in Sri Lanka's debt restructuring process?

The final restructuring agreement with the OCC reflected in the OCC Memorandum of Understanding signed on 26th January 2024 will be translated into individual bilateral agreements with each member of the OCC. Similarly, domestic regulatory formalities will be concluded by Sri Lanka and Exim Bank of China to give effect to the Amendment Agreements. This will enable the official restructuring to be implemented. The successful implementation of the restructuring agreements with official creditors will provide an impetus to the negotiations with commercial creditors. Sri Lanka continues to engage with its bondholders and their advisers which is expected to yield a restructuring agreement that meets the DSA targets and is comparable to the agreements reached with the OCC and Exim Bank of China. As of now, the domestic debt restructuring has been completed, the official restructuring agreements have been concluded, leaving only the external commercial debt restructuring to be concluded for the overall debt restructuring process to be finalized.

What are the benefits that arise from the restructuring agreements on 26th June 2024?

Foreign Financing: The successful conclusion of the official debt restructuring will enable the resumption of bilateral lending between Sri Lanka and its major international partners in the OCC and with the Exim Bank of China.

This has important implications for supporting economic growth as foreign-funded capital expenditure can resume. This would have material implications for the construction sector in particular, along with the positive spill-over effects for the rest of the economy. In the medium term, this has important implications for infrastructure development in the country.

Fiscal Relief: The restructuring of debt provides significant fiscal relief to the government. One example of this is whilst in 2022, Sri Lanka's foreign currency debt service cost was 9.2% of GDP, post restructuring, this would reduce to less than 4.5% of GDP on average by 2027-2032.

The government's overall annual gross financing needs will be reduced from 34.6% of GDP in 2022 to under 13% of GDP between 2027-2032. The cashflow savings can be used for priority expenditure on essential public services. The restructuring of official debt makes a major contribution to both these targets.

The availability of external budgetary financing will also support fiscal cash-flow management with positive implications for domestic interest rates.

Credit Ratings: The conclusion of the official debt restructuring is another important step towards restoring the country's credit ratings. Once commercial debt restructuring, including International Sovereign Bond (ISB) debt and syndicated loans held by China Development Bank (CDB) is also concluded, this would mark the completion of the overall debt restructuring process which would be a key milestone in enabling Sri Lanka's credit ratings to be re-rated.

The timing of such a re-rating is not certain, however, the conclusion of the restructuring process is a key enabling condition, along with continued adherence to the macroeconomic reform process.

An upgrade of credit ratings would enable easier and lower-cost access to international financial markets, which has impacts across the board from trade finance to inter-bank financial transactions.