BOX 2

International Monetary Fund's Extended Fund Facility (IMF-EFF) Programme – A Progress Update

Sri Lanka commenced discussions with the International Monetary Fund (IMF) on obtaining a funding arrangement linked to a macroeconomic adjustment programme to restore macroeconomic stability, debt sustainability and to rebuild the linkages with the world, following the historic socio-economic and political crisis in 2022. In September 2022, the IMF staff and the Sri Lankan authorities reached a staff level agreement for a 48-month arrangement under the EFF amounting to SDR 2.286 billion (about US dollars 3 billion). Subsequently, on 20 March 2023, the Executive Board of the IMF approved the EFF as budget support to assist Sri Lanka's economic policies and reforms denoting the commencement of the seventeenth IMF programme in Sri Lanka. Accordingly, the first and second tranches of the IMF-EFF totaling SDR 508 million (about US dollars 670 million) were disbursed in March and December 2023, respectively. The IMF and relevant authorities regularly monitor the progress under the EFF in terms of Quantitative Performance Criteria (QPCs), Continuous Performance Criteria (CPCs), Monetary Policy Consultative Clause (MPCC), Indicative Targets (ITs), and Structural Benchmarks (SBs) as set out in the EFF programme. Achievement of these targets on behalf of Sri Lanka is the responsibility of the Government and the Central Bank. In terms of performance, all QPCs and ITs for end December 2023 were met except for the IT on social spending, while most SBs falling due before end February 2024 were either met or implemented with delay. On 21 March 2024, a staff level agreement was reached on economic policies to conclude the second review of the IMF-EFF programme. Once the review is approved by the IMF Executive Board, Sri Lanka will have access to a further SDR 254 million (about US dollars 337 million) in financing.

To restore macroeconomic stability and public debt sustainability in Sri Lanka, the IMF-EFF programme was designed as a comprehensive economic reform programme that rests on several key pillars. These pillars include revenue based fiscal consolidation, a stronger social safety net to protect the most vulnerable, a sovereign debt restructuring strategy aimed at restoring public debt sustainability, a multi-pronged strategy to restore price stability and rebuild international reserves under greater exchange rate flexibility, policies to safeguard financial stability, focused reforms to address governance and corruption vulnerabilities, and growth enhancing broader structural reforms.

The key targets and elements of the current IMF-EFF programme, are discussed below.

Net International Reserves (NIR) Target

The NIR target is a QPC under EFF to gauge the reserve level maintained by the Central Bank excluding the reserve related liabilities. The reserves remained at depleted levels in 2022 and early 2023 as GOR declined notably, due to the continued moderation of inflows to the financial account, external debt service payments to the multilateral creditors, and net sales to the domestic foreign exchange market by the Central Bank primarily for importation of essential imports during the year. At the beginning of the programme, as at end March 2023, the reserve related liabilities were far higher than the reserve assets and thus NIR stood at largely negative levels. The primary aim of achieving the NIR target under EFF is to ensure that the gross official reserve assets increase surpassing the liabilities and thereby maintaining NIR at positive levels. Thus far in the EFF programme, the Central Bank has continued to build up reserves by purchasing foreign exchange from the domestic foreign exchange market on a net basis. As a result, the gross official reserve level also witnessed a notable increase from US dollars 1.9 billion as at end 2022 to around US dollars 4.4 billion by end 2023, and further to around US dollars 5.0 billion by end March 2024.

The Central Bank's Net Credit to the Government (NCG) Target

Historically, successive Governments have resorted to monetary financing from the Central Bank, which was one of the main causes for the elevation of inflation to significantly high levels in 2022. The Central Bank's NCG is measured as the difference between the Central Bank's claims against the central government and deposits made by the central government in rupees at the Central Bank. Prior to the IMF programme, the Central Bank was compelled to regularly engage in monetary financing of the budget deficit of the Government. One of the main purposes of the IMF programme is to prevent any avenues that would enable the Government to obtain monetary financing from the Central Bank, and this was achieved through the enactment of the Central Bank of Sri Lanka Act No. 16 of 2023 (CBA). With no new monetary financing and gradual offloading of existing holdings of the government securities of the Central Bank, end December 2023 NCG target set out by the IMF was also achieved.

Monetary Policy Consultation Clause (MPCC)

Sri Lanka's inflation escalated to historically high levels in 2022. The MPCC has been set to closely monitor the developments in inflation to ensure that Sri Lanka achieves the targeted level of inflation in line with its objective of maintaining domestic price stability. It monitors quarterly inflation on predetermined target dates. Accordingly, quarterly average year-on-year inflation calculated based on the Colombo Consumer Price Index (CCPI) (2021=100), as per the method specified in the Technical Memorandum of Understanding (TMU) of the IMF Staff Report was at 3.0 per cent by December 2023. Hence, realised inflation by December 2023 was within the lower outer band of MPCC of 2.0-3.5 per cent.

Primary Balance Target, Revenue, and Overall Budget Balance

Sri Lanka's central government revenue collection is identified to be one of the lowest in the world and has led to significant primary balance deficits historically. The IMF-EFF programme requires Sri Lanka to implement revenue based fiscal consolidation measures and introduce reforms to social safety nets, fiscal institutions, and State Owned Enterprises (SOEs) that are aimed at enhancing the efficiency and reducing the burden on government coffers. Supported by stringent fiscal consolidation efforts, the Government achieved a primary surplus in 2023, which is well over the primary deficit target set under the IMF-EFF for 2023. Meanwhile, the overall budget deficit for 2023 improved as a result of the significant increase in revenue despite an increase in government expenditure.

In addition, the central government tax revenue is specified as an indicative target under the IMF-EFF programme. During the recently concluded programme review mission of the IMF, the notable improvement in tax revenue collection was commended.

Continuous Performance Criteria (CPCs) and Indicative Targets (ITs)

The IMF-EFF programme has specified two CPCs. These include (i) non-accumulation of new external payments arrears by the nonfinancial public sector and the Central Bank and (ii) no new Central Bank purchases of government securities in the primary market. These CPCs have been met by the Sri Lankan authorities so far. In addition, the programme has specified ITs related to central government tax revenue, social spending by the central government, cost of non-commercial obligations (NCOs) for fuel and electricity, and Treasury guarantees. All ITs except for social spending by the central government have been met under the programme as of December 2023.

Progress on Debt Restructuring

The Government has been engaging with the external creditors to negotiate relief on external debt with the intention of bringing down the debt trajectory towards a sustainable path as envisaged by the IMF-EFF arrangement. There is significant progress in the external debt restructuring process. In November 2023, an agreement in principle was reached between the authorities and the Official Creditors Committee (OCC) and a preliminary agreement with the China EXIM Bank and Sri Lanka was also reached to restructure its claims on Sri Lanka. Currently, Sri Lanka is engaging closely with OCC and China EXIM Bank to reach debt agreements consistent with the programme parameters and in a comparable manner. Sri Lanka is also engaging closely with external commercial creditors in good faith through continuous dialogues and information sharing, aiming to reach a consensus on the debt treatment at the earliest.

Additionally, the Government launched its Domestic Debt Optimisation (DDO) programme in July 2023 and its key aspects were concluded in September 2023. The debt exchanges that were initiated were geared towards providing significant liquidity relief to the Government, while contributing to reducing future annual gross financing needs of the Government to sustainable levels.

Key Structural Benchmarks (SBs)

The ongoing IMF-EFF programme includes SBs in areas such as fiscal, SOEs, and social safety net reforms, financial sector and governance. Significant progress has been made thus far with respect to achieving these SBs. Major SBs applicable to the Central Bank that have been met include the enactment of the CBA, completion of the asset quality review component of the bank diagnostic exercise for the two largest state owned banks and the three largest private sector banks, the development of a roadmap for addressing banking system capital and forex liquidity shortfalls and recapitalisation plan. Further, Parliamentary approval for the amendments to the Banking Act was obtained although with a delay. With respect to SOE reforms, setting cost-reflective fuel pricing and electricity tariff schedules with formula based adjustments among others are important SBs that were met. These efforts have already shown successful outcomes with improved profitability of chronically loss making entities such as the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC). Parliamentary approval of the 2024 Appropriation Act, obtaining Cabinet approval of a reduction in the limit on government guarantees to 7.5 per cent of GDP, obtaining Cabinet approval on a strategy to build a Value Added Tax (VAT) refund system and to achieve a full repeal of Simplified Value Added Tax (SVAT) and introducing key performance indicators for tax compliance are some of the fiscal sector related SBs that have been met so far.

Governance

Addressing corruption vulnerability is critical to ensure sustainable and inclusive economic recovery in Sri Lanka. Sri Lanka remains committed to advancing governance and anti-corruption reforms as a main central pillar of the programme. In this regard, Sri Lanka published the Governance Diagnostic Report in September 2023 making Sri Lanka the first country in Asia to undergo the IMF Governance Diagnostic exercise. Further, Sri Lanka recently published the Action Plan to implement the key recommendations of the Governance Diagnostic Report, and this was commended by the IMF at the recent review. The IMF has emphasised the need for sustained efforts to implement these reforms to address corruption risks, rebuild economic confidence, and make growth more robust and inclusive.