

The ABCs of the Debt Crisis in Sri Lanka - FAQ's

- 1) **What is a debt crisis?** A government can have domestic debt held in its currency and/or external debts held in the currencies of other nations. It has a debt crisis when it is unable to meet the debt obligations of either of those loan categories.
- 2) **What is meant by debt restructuring?** When a government is unable to service its debts, it engages in sovereign debt restructuring. This is where the government engages in negotiations with its creditors to reduce debt repayments in line with its current capacity to repay.
- 3) **What does debt restructuring usually entail?** Usually, debt restructuring can consist of either: a) extending the maturity period of the loan; b) reducing interest rates; and/or c) a haircut, meaning reducing the principal loan.
- 4) **What is external debt restructuring?** This usually involves negotiations with creditors based outside of the country and takes place when debt is held in foreign currency.
- 5) **What is Domestic Debt Optimisation (DDO) or Domestic Debt Restructuring (DDR)?** DDR or DDO involves negotiations with creditors, which is relevant only when a domestic debt needs to be repaid in local currency.
- 6) **Is DDR (Domestic Debt Restructuring) always necessary?** No, since domestic debt is denominated in LKR (Sri Lankan Rupees) and can be repaid by the government. DDR can destabilize the country's financial system if people start pulling out their life savings and investments.
- 7) **Who are the internal debt holders?** Domestic debt holders are typically the central bank, commercial banks, pension funds and other financial institutions and individuals (local or foreign).
- 8) **Who are the external debt holders?** External debt holders are typically multilateral creditors (such as IMF and World Bank), bilateral creditors (other governments) and commercial creditors (commercial financial institutions and bondholders, which may be individuals, institutional investors, or other countries).
- 9) **Why did a debt crisis take place in Sri Lanka in 2022?** In April 2022, Sri Lanka went into an 'orderly' default on its external debt as it was unable to service its debt obligations because of a shortage of foreign currency reserves.
- 10) **Is Sri Lanka's debt crisis unique?** Sri Lanka's debt crisis needs to be located within a global debt crisis, where the UNDP (2022) identified at least 53 countries worldwide as going into default.
- 11) **Why is there a global debt crisis?** The structural conditions of finance capitalism and the role of reckless lending by private financiers must be accounted for in the global debt crisis. In these situations, human rights and ecological threats are displaced.
- 12) **What is the role of the IMF (International Monetary Fund) in debt restructuring?** The IMF becomes the arbiter of debt resolution, provides analysis on financing the gap and oversees reforms. Some private creditors make an IMF programme obligatory to restructure debt – meaning to reduce debt stock through a reduction or a cancellation of external

- debt. IMF reforms, however, are focused on the country becoming eligible to borrow from external creditors.
- 13) **What is IMF's External Fund Facility (EFF) about?** The EFF provides financial assistance to countries facing serious medium-term balance of payments problems because of structural weaknesses that require time to address. EFF has two main conditions: attaining debt sustainability and ensuring primary budget surplus, which is when government revenue exceeds expenditure.
 - 14) **What does the IMF demand of Sri Lanka?** The IMF has not publicly called for DDR, although the Sri Lankan government and the Central Bank of Sri Lanka (CBSL) are pursuing DDR to achieve this. The IMF has not considered the differences between external and domestic debt and instead has simply demanded to reduce Gross Financing Needs (GFN) to under 13% of GDP.
 - 15) **Are external bondholders pushing for DDR (Domestic Debt Restructuring)?** Commercial borrowings make up about 41% of Sri Lanka's external debt. These private lenders are demanding comparable treatment between external and domestic debt. This strategising may lead to less of a reduction in external debt compared to domestic debt.
 - 16) **Can domestic debt and external debt be compared?** No, domestic debt and external debt cannot be compared because: a) the government can always meet its local currency debt obligation in its currency by raising taxes or printing money, and therefore cannot default; b) for external debt, the government must either earn foreign currency to repay debt, seek debt restructuring, or call for odious debt – which is based on negotiations with external creditors.
 - 17) **What is the EPF (Employee Provident Fund)?** The Employee Provident Fund (EPF) was set up in 1958 and is currently the largest and most widespread social security scheme in Sri Lanka for private sector and semi-government sector employees (i.e. Private Sector firms, State Sponsored Corporations, Statutory Boards and Private Businesses). According to the EPF Act, it is mandatory that employees contribute a minimum of 8% and employers contribute a minimum of 12% of the total earnings of an employee's monthly salary. It is recorded that 90% of retirement funds of the EPF are invested in Treasury Bonds, usually considered a low risk saving/investment.
 - 18) **Who are the custodians of the EPF?** The administrative aspects of the EPF are controlled by the Department of Labour, whilst the management of the funds is entrusted to the Monetary Board through the Employees' Provident Fund Department of the Central Bank of Sri Lanka.
 - 19) **Why does DDR/DDO affect EPF (Employee Provident Fund)?** CBSL plans on reducing the interest rates on Treasury Bonds held by EPF retirement funds, where the EPF has invested about 90% of its funds. EPF members are projected to lose a third of their fund value through the proposed DDO. Domestic debt has already gone through a 35-40% haircut due to inflation. The additional losses to the EPF, because of the reduction of coupon rate for government bonds proposed in the DDO from 13.5% to 9.1%, could be between 38-41% over the period up to 2038.
 - 20) **What other alternatives are available for Sri Lanka to deal with its debt crisis?** There are global calls for debt cancellation, tracing illicit financial flows

and odious debt – where in 1898, “the United States argued neither it nor Cuba should be held responsible for debt the colonial rulers had incurred without the consent of the Cuban people and not used for their benefit” (IMF 2002). This conceptualisation of odious debt resonates with the Sri Lankan debt crisis

as well, since an authoritarian and corrupt regime was recklessly borrowing without any tangible benefits to the people. These are areas that Sri Lanka’s policymakers have shied away from exploring with the seriousness they deserve if it is to uphold the sovereignty of the people.

Authors:

Githmi Rabel, Kanchana N Ruwanpura

References:

- Aboneaaj, Rakan, Jocilyn Estes and Clemence Landers (2023) “The ABC of Sovereign Debt Relief” *Centre for Global Development* <https://www.cgdev.org/publication/abcs-sovereign-debt-relief>
- Debt Justice (undated) “Countries in Crisis” <https://debtjustice.org.uk/countries-in-crisis>
- EPF (2023) “What is EPF?” https://epf.lk/?page_id=2
- IMF (2002) “Odious Debt” by Michael Kremer and Seema Jayachandran *Finance and Development* 39(2) <https://www.imf.org/external/pubs/ft/fandd/2002/06/kremer.htm>
- Kadirgamar, Ahilan, Madhulika Gunawardena, Shafiya Raifathu, and Sinthuja Srirathan (2023) “Frequently asked questions on domestic debt restructuring” *Daily Financial Times* September 12th 2023 <https://www.ft.lk/opinion/Frequently-asked-questions-on-domestic-debt-restructuring/14-752873>