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Sri Lanka and IMF Renegotiations

The Case for Sustainable Debt Restructuring

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Charith Gunawardena and Amali Wedagedara

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GLOSSARY OF TERMS

International Monetary Fund (IMF)
An international financial institution set up in the aftermath of the World War in 1944, with the shift towards political independence of the colonised is funded by 190 member countries, with headquarters in Washington, D.C. It is the financial agency of the United Nations and regarded as the global lender of last resort to national governments, and a leading supporter of exchange-rate stability.

Debt Sustainability Analysis (DSA)
A formal framework for conducting an analysis of a country's capacity to finance its policy objectives and service the ensuing debt as tool to better detect, prevent, and resolve potential crises. The Fund's approach to debt sustainability analysis differentiates between market access countries (MACs) that typically have significant access to international capital markets, and low-income countries (LICs), which meet their external financing needs mostly through concessional financing.

International Sovereign Bonds (ISBs)
Foreign currency-denominated sovereign bonds are issued by a government to foreign investors and typically listed in a major bond trading centre like New York, London and Singapore. ISBs are issued under foreign law, usually British or New York law.

Official Creditor Committee (OCC)
The Official Creditor Committee for Sri Lanka consists of 17 countries. It is co- chaired by India, Japan and France. The committee includes India and Hungary, in addition to the Paris Club creditors.

Government of Sri Lanka (GoSL)
Sri Lanka is a free, independent, sovereign nation with a population of 22 million. Legislative power is exercised by a Parliament, elected by universal franchise on a proportional representation basis. A President is also elected by the people and exercises executive power including over defence. Sri Lanka enjoys a multi-party system, with people voting to elect a new government every six years.

KEY TAKEAWAYS

- A newly elected government in **Sri Lanka should renegotiate the 17th IMF agreement** to align with the terms with the country's long-term economic stability and development. This renegotiation should aim to establish a fair and effective framework that addresses Sri Lanka's financial challenges while also tackling systemic issues related to the global trade of labour intensive production and structural poverty. Given the existing agreements with the Paris Club, India, and China Exim Bank, as well as the nearly finalised deal with bondholders, it would be challenging to restart the restructuring process. Amendments to key programme parameters of the IMF agreement in the context of debt restructuring is also complicated but necessary.

- **There should be a change of orientation in dealings with the IMF and Sri Lanka's creditors.** The aim must be to protect the living standards of the people and to promote the growth of the economy to support living wages, expand income, create good-quality jobs (decent work), and improve the trade balance. The debt restructuring process must be based on ensuring that the debt stock does not increase with interest payments.

- The **haircut on commercial debt needs to be significant**. The haircut needs to be more than 30% keeping with historical evidence from other countries. Multilateral and bilateral agencies should also accept a reduction of their contribution to the debt stock.[1]

- The unjust nature of the global financial architecture has profound effects on the people and environment of Sri Lanka. By implementing protective policies and pursuing alternative financial strategies, they can **better shield the country from the adverse impacts** while striving to secure a more equitable and sustainable future.

- **Significant issues exist** with the IMF's Debt Sustainability Analysis (DSA).[2] The issues include unrealistic economic projections, calling for domestic debt restructuring for an external debt crisis, the push to return to global money markets, the compulsion to repay odious debts, ignoring Sri Lanka's capacity to repay, and the underestimation of social impacts as well as the lack of environmental and climate considerations. These flaws risk compromising the long-term viability of the economic recovery plan, **potentially exacerbating existing vulnerabilities and undermining efforts to achieve sustainable and inclusive development**.

1. Government Debt Landscape

The Sri Lankan government finances a portion of its day-to-day expenditures and capital investments through borrowing, drawing on both domestic and foreign sources. Borrowing in Sri Lankan rupees creates local debt, while its external debt is incurred in foreign currencies, primarily US dollars. This foreign currency debt is crucial for meeting international obligations, paying for critical imports and funding essential infrastructure projects that are vital for the country's development.

Rupee Borrowing

The government's sources for rupee borrowing include the Sri Lanka Central Bank, local commercial banks, and pension funds. As a sovereign entity with the authority to issue its own currency through the central bank, the country can fulfil all debt obligations denominated in Sri Lankan rupees. However, this ability is tempered by the potential risk of inflation, which can arise if the money supply grows excessively compared to the economy's productive capacity. Managing this balance is crucial to maintaining economic stability while meeting financial commitments.

Dollar Borrowing

The Sri Lankan government secures its US dollar borrowings from multilateral institutions, bilateral agreements, and commercial markets. Like other low-to-middle-income countries, Sri Lanka depends on access to concessionary loans in US dollars to sustainably finance the purchase of essential goods and services that cannot be produced domestically. Since Sri Lanka cannot issue dollars, it also obtains foreign currency through other channels, such as exports of goods and services, grants, foreign direct investment, remittances, and the sale of assets, among others.

Domestic Debt

BORROWING RUPEES

- **Central Bank**
- **Commercial Banks**
- **Pension Funds**

External Debt

BORROWING DOLLARS

- **Multilateral** ($11.5 bn): IMF, World Bank, Asia Development Bank
- **Bilateral** ($12.6 bn): Paris Club (US/ Europe/ Japan), India, Russia, Hungary, China
- **Commercial** ($11.2 bn): ISB Bondholders, China Development Bank

2. Global Financial Architecture

The US dollar serves as the primary global reserve currency, accounting for over 60% of global reserves. This dominance stems from historical factors, including the 80-year-old Bretton Woods Agreement, which established the dollar as the reserve currency of the global financial system after World War II.[3] Today, the dollar remains the preferred currency for international trade, investment, and reserve holdings.

Concessionary Loans

Multilateral institutions such as the International Monetary Fund (IMF), World Bank, and regional development banks play a crucial role in providing financial assistance to countries in the Global South such as Sri Lanka. However, the funds available for concessionary loans - loans provided at below-market interest rates to support development and poverty reduction—are often inadequate.[4] This inadequacy reflects both limited capital within these institutions and the prioritisation of their resources towards wealthier countries or politically strategic regions.

However, these concessionary loans often fail to support countries in achieving industrialisation. Instead, their frameworks are structured to maintain an unequal exchange of goods and perpetuate the inequitable global division of labour.

Global Reserve Currency

As the sole issuer of US dollars, the United States wields significant influence over the allocation and usage of the global reserve currency. Despite the large-scale creation of new US dollars in recent years— with US debt now exceeding $34 trillion— the amount of money available to multilateral institutions remains limited.[2] Instead, a substantial portion of these dollars is concentrated within private banks, hedge funds, and investors predominantly located in the Global North. These entities often act as lenders to countries in the Global South, perpetuating a financial system where access to critical funding is controlled by a small, wealthy segment of the global economy.

Call for Reforms

There are growing calls across the Global South for the evolution of global governance and financial architecture into a less hierarchical and more networked democratic system. Advocates envision a framework where decision-making is decentralised, allowing for greater participation from diverse stakeholders and realisation of development aspirations of developing countries. This would enable the collective efforts of a wide array of actors to be harnessed toward shared global goals, fostering an inclusive and equitable international order that better reflects the needs and aspirations of developing nations.[5]

Impact on Sri Lanka

The unjust nature of the global financial architecture has profound effects on the people and environment of Sri Lanka. This inequitable system often places disproportionate burdens on developing nations, exacerbating economic vulnerabilities and environmental degradation - where Sri Lanka is not an exception. Consequently, decision-makers must adopt strategic measures to mitigate these risks when navigating and engaging with this flawed system.

- ***Lack of Affordable Financing:*** The lack of concessionary loans from multilateral institutions forces countries to rely on more expensive commercial borrowing, such as International Sovereign Bonds (ISBs), which come with high interest rates and shorter repayment periods and less leeway for restructuring in a situation of a crisis. This reliance on costly financing for loans has contributed to Sri Lanka's current debt crisis.

- ***Social and Economic Inequality:*** The need to allocate substantial resources to debt repayments limits the government's fiscal space and leads to austerity. This reduction in available resources can hinder investments in crucial areas such as healthcare, education, and infrastructure, further affecting socio-economic development. The economic strain caused by debt servicing and inflation disproportionately affects lower-income households, exacerbating social inequalities.

- ***Vulnerability to External Shocks:*** Sri Lanka's economic stability is highly sensitive to fluctuations in global financial markets and exchange rates in an environment of global deregulation. External shocks, such as global interest rate hikes or geopolitical tensions, can exacerbate debt servicing challenges and lead to economic instability.

- ***Impact of Geopolitics:*** Insufficient multilateral funds often with strings attached, pushes countries like Sri Lanka to seek financial support from individual nations, particularly those with geopolitical interests in the region. This can lead to a dependency on powers like China, India or the United States, which may leverage their assistance for political or economic influence.

- ***Environmental Degradation:*** The global economic order's focus on economic growth often comes at the expense of the environment. In Sri Lanka, this has led to deforestation, loss of biodiversity, and pollution, as the country pursues large scale infrastructure development (megapolis initiative for example), encroaching on protected forest cover and unplanned tourism projects. Often projects are politically driven and unregulated with no or limited attention to climate or ecological damage. Moreover, climate change, driven by the unsustainable practices of industrialised nations exploiting vulnerabilities in the Global South also pose a significant threat to Sri Lanka's environment.

3. 17th IMF Agreement

On April 12, 2022, Sri Lanka suspended debt servicing payments on most of its foreign debt as the country faced a severe debt crisis. To address this situation, Sri Lanka required a comprehensive sustainable debt restructuring program with its external creditors. In pursuit of this objective, the Sri Lankan authorities reached a staff-level agreement with the International Monetary Fund (IMF) and agreed to an Extended Fund Facility (EFF) in September 2022. This agreement led to the publication, in March 2023, of the IMF's Market Access DSA - for lower-middle income countries and above, also known as MAC DSA) - aimed at restoring fiscal stability and long-term debt sustainability.[6]

IMF Debt Sustainability Targets

CONDITIONALITIES

- **Debt stock:** Public debt should decline below 95 percent of GDP by 2032.
- **Post-program gross financing needs:** Average annual gross financing needs of the central government in 2027-32 should remain below 13 percent of GDP.
- **Post-program foreign exchange debt service:** Annual foreign exchange debt service of the central government should remain below 4.5 percent of GDP in each year over 2027-32.
- **Program financing gaps:** Debt service reduction during 2023-27 should be sufficient to close external financing gaps. Under staff's baseline scenario, US$17 billion in debt service reduction is required, including the arrears accumulated in 2022.

Key IMF Conditionalities and Their Inadequacies

- **Unsustainable Debt-to-GDP Ratio Target**: The IMF agreement sets a target debt-to-GDP ratio of 95%. There are no targets for the external debt stock. This figure is not reasonable. It is far too high for a sustainable economic recovery in Sri Lanka. For emerging markets like Sri Lanka, a debt-to-GDP ratio of below 50% is considered more manageable.[7] Such a high target places undue stress on Sri Lanka's fiscal capacity, making it challenging to maintain economic stability and growth.[8]

- **Gross Financing Needs at 13% of GDP**: The inclusion of both Sri Lankan rupees (LKR) and US dollar-denominated debt in calculating gross financing needs is problematic. As GDP measures are typically expressed in dollars, fluctuations in foreign exchange rates can exacerbate the perceived financing requirements. Rupee-denominated debt should be treated separately, as it is fundamentally a domestic responsibility. The IMF's insistence on combining these debts increases Sri Lanka's vulnerability to external shocks and currency fluctuations.

- **Foreign Debt Servicing at 4.5% of GDP**: The current agreement requires Sri Lanka to allocate 4.5% of its GDP to foreign debt servicing, consuming nearly a 1/3rd of government revenue. This allocation diverts critical resources away from essential social programs, healthcare, and education. A more realistic target would allow Sri Lanka to manage its debt obligations without sacrificing the well-being of its citizens.

- **Primary Surplus Target of 2.3%**: The IMF's arbitrary primary surplus target of 2.3% of GDP, that is not best practice, forces Sri Lanka into austerity measures that can stifle economic growth and exacerbate poverty. A more balanced approach, with a primary surplus target between -0.5% to 1%, would enable Sri Lanka to maintain fiscal responsibility while fostering economic growth and development.

Key Problems with the IMF's Debt Sustainability Analysis & Extended Fund Facility

- ***Unrealistic Economic Projections:*** The IMF's MAC DSA relied on arbitrary assumptions about future economic growth, which does not align with the ground realities in Sri Lanka. To treat a diverse range countries with one broad brush is problematic. Even though economic crises regresses socio-economic status of people, including their income, the creditors, including the World Bank has not considered adjusting Sri Lanka's regressed economic status to accommodate them in cheaper and concessional credit or treat them as a low-income country when preparing DSA. The DSA predicts a rebound in growth based on structural reforms, increased exports, and improved investor confidence. However, these projections have been unrealistic given the country's socio-political instability, ongoing economic challenges, and global economic uncertainties.

- ***Calling for a domestic debt restructuring for external debt crisis:*** The IMF EFF (Extended Fund Facility) agreement stipulates that the Sri Lanka Central Bank (CBSL) can no longer finance the Government to repay its rupee debts. The IMF expects the Government to raise funding from money markets by imposing certain

limitations on the domestic debt expansion of the country.[9] Under the agreement, the Government is required to convert its primary balance (total income minus expenditure, excluding interest payments) in to a surplus by 2024. This includes meeting the maturity payments of both domestic and external debts. Sri Lanka is required to cut down its gross expenditure (austerity) despite the impact on the well-being of people. Because of the agreement, the risk-free bonds of the Sri Lanka Government will now have a risk premium attached to them.

- ***Returning to global money markets:*** The IMF has decided to make all public debt—external and domestic—the source of the crisis. The problem is defined as unsustainable gross financing needs in the coming years. Sri Lanka had to undergo a Domestic Debt Optimisation (DDO) program. It is the fundamental issue.[10] Any sustainable solution required an immediate reduction in the volume of external debt owed, involving debt cancellation, substantial reduction or haircuts for foreign creditors.[11] IMF is supporting demands of international bondholders, who would like to see a lower debt stock reduction, higher share of Government revenue to be repaid as debt servicing and reduce the risks associated with repaying their debt. Despite large profits made by ISB holders through predatory interest rates, the haircut required of foreign private creditors is insufficient. The imperfections in the global economic order (US dollar supremacy, profiteering from odious debts, sovereign debt governance favouring private creditors, undemocratic multilateral institutions, the persistence of neo-colonial pathways in the financial system) have not stopped Sri Lanka Government wanting to borrow from global money markets once again by floating International Sovereign Bonds, starting in 2028.

- ***Underestimation of Social Impacts:*** The DSA focused on macroeconomic indicators like debt-to-GDP ratios, underestimating the social impacts of austerity measures that accompany IMF programs. In Sri Lanka, austerity has already led to significant reductions in public spending on health, education, and social protection, exacerbating poverty and inequality. According to the World Bank, 7.2 million people are currently living below the poverty level in Sri Lanka. The Domestic Debt Optimisation (DDO) proposal places the financial burden squarely on those who can least bear it by exclusively squeezing the retirement income funds of the poorest workers while creating windfall profits for private bondholders and equity holders of the banks. The Government's DDO proposal targets its main two creditors, the Central Bank of Sri Lanka and the Superannuation fund (where the Rs. 3 trillion Employee Provident Fund, the EPF, is the largest stakeholder). 85% of EPF members are the poorest workers who have a balance of less than Rs. 100,000. Yet all 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.[12]

- ***Lack of Environmental and Climate Considerations:*** The IMF's analysis did not adequately consider the impacts of climate change on Sri Lanka's economy. Given the country's vulnerability to climate risks, these factors should be integral to any long-term debt sustainability assessment. Ignoring ecological risks could lead to

unrealistic projections of economic stability and debt servicing capacity.

- ***Unsustainable debt levels even after austerity:*** The IMF debt sustainability assessment clearly states, that "even after a successful program and debt restructuring, debt risks will remain high for many years".[6] With the calculated debt restructuring scenario, Sri Lanka's debt will not return to safe levels. Still, the IMF requests a heavy level of austerity that the Sri Lankan government diligently follows. This means that even with sacrifices made by Sri Lankan people, currently there is no guarantee that sustainable debt levels would be reached.

- ***Downplaying Corruption, Governance Deficiencies and Mismanagement:*** The IMF Governance Diagnostic Assessment highlighted the clear administrative shortcomings within the Government. Inadequate transparency on Sri Lanka's red-lines or clarity on who is directing Lazard and Clifford Chance (the paid consultants) in the restructuring negotiations. Bondholders, who knowingly lent to governments with a track record of poor governance and human right violations, should bear a commensurate share of the losses, considering they profited from a risk premium for the odious debt. There must be a decisive shift away from rewarding reckless lending practices and disregarding odious debt burdens particularly as there is inadequate transparency on whether local politicians or politically connected persons benefited from the ISB deals. Other countries have obtained inadequate but yet better deals. For instance, Argentina bondholders received over 60% haircut vs < 28% for SL; Greece bondholders haircut was nearly 50% of GDP; Zambia debt repayment as a percentage of GDP was 14% vs SL peak is 29%.[13]

IMF Renegotiation - Scope and Options

Continue Agreement	Adjust MAC-SRDSF	Sustainable Solution
Continue with IMF targets set via the mechanical process called Sovereign Risk Debt Sustainability framework for Market Access Countries (MAC - SRDSF) that would give Sri Lanka significant access to international capital markets (but risk moving further into a debt trap) IMF staff judgement confirms that for medium and long term, debt sustainability indicates high risk. This would also result in prolonged economic hardship, increased poverty, and long-term damage to the country's socio-economic fabric. Sri Lanka's categorisation into the MAC-SRDSF is an ideologically driven political choice by Multilateral organisations. The country would be better served under Low Income Country DSF (LIC).	Renegotiate MAC - SRDSF targets. Request the IMF to update their DSA and agree on the assumptions that are used in doing that.[14] Make key adjustments to some IMF conditionalities so that they better serve people of Sri Lanka rather than external creditors (debt-to-GDP target; primary surplus balance, debt-servicing target; gross financing needs; revenue targets). While this might provide short-term relief, it would not address the fundamental un-sustainability of Sri Lanka's debt situation, leaving the country vulnerable to future economic shocks.	Keep renegotiating in good faith. Request IMF for a LIC DSF and agree on the assumptions that are used in doing that. Aim to meet external financing needs mostly through concessional financing. Risk perpetual impasse. Mitigate risk of IMF intransigence • develop a value-added export strategy to generate $s for essential imports, • continue ban on non-essential imports, • promote import substitutions to strengthen local manufacturing • leverage local resources such as land, water, labor & rupee to foster economic resilience • build strategic partnerships with other Global South countries • strengthen bi-lateral relationships.

4. Sri Lanka's External Debt Restructuring

In the absence of a formal global debt restructuring framework, Sri Lanka has been conducting restructuring negotiations through an ad hoc process.[15] Sri Lanka reached a provisional agreement with bilateral creditors which was finalised in June 2024. An in-principle agreement with some bondholders was announced in July 2024.[16] The IMF has not yet said whether it is consistent with their targets for the restructuring, and bilateral creditors have not said whether they regard the bondholder deal as comparable.[17]

Debt Restructuring Status (Memorandum of Understanding)

	BILATERALS	BONDHOLDERS
Debt stock	No cancellation of principle	Cancels only 28% of principal owed, and 11% of defaulted interest.
Coupon rate	Reduced to 2%	Start at 3.5%-5.5%, rising to 8.75% to 9.75% from 2033 onwards
Payment extension	No repayment until 2028, then repaid up to 2042.	The remaining defaulted interest is repaid form 2024-2028, then the main principal repaid from 2029 to 2036.
GDP changes	No change in payments	Three tiers of increases depending on how much higher GDP is from $88.6bn to average of 2025-2027

IMF Prioritising Wellbeing of Creditors over People

The IMF plays a crucial role in restructuring debt for struggling nations. However, the real power lies with its Executive Board, dominated by rich nations due to their larger financial contributions. These wealthy countries not only influence IMF policies but also control bilateral and multilateral lending and the legal frameworks governing private creditors lending to the Global South. Consequently, the collective actions of these affluent nations significantly shape how debt restructuring occurs and the terms of loans.

Systemic Flaws in IMF Solutions: Sri Lanka's experience illustrates the complexity of debt restructuring. Despite multiple engagements with the IMF, Sri Lanka's economy grew significantly, with GDP per capita increasing five fold from 1990 to 2018. This economic boom occurred even as the country endured a prolonged and brutal civil war. However, the recurrence of countries returning to the IMF for restructuring suggests systemic flaws in the current arrangements.

Examining Sri Lanka's fiscal situation, the general government budget balance was -7.5% of GDP in 2019.[18] Globally, the primary fiscal balance best practices range between -2% and 0.5% of GDP, indicating that Sri Lanka managed its fiscal policies relatively well before 2020. The decline in general revenue from 19% of GDP in 2000 to 13% in 2019 was gradual, not sudden, and the primary balance remained within best practice, supported by private sector activities.

Poor Lending Practices and odious debt: The crisis in 2020, triggered by the government's loss of control over borrowing, raises questions about whether the fault lies with the borrower or the lender. The IMF blames the borrower, but poor lending practices by lenders only interested in profit also contribute to bad loans. A correct framing of the problem is essential to address the roots of the crisis effectively.

The people of Sri Lanka should not be burdened with the repayment of odious debts.

Primary Surplus Exceeds Best Practice: The IMF's current program for Sri Lanka targets a medium-term primary surplus of 2.3%, which exceeds best practice for countries with similar GDP levels. This target compromises Sri Lanka's sovereignty and prioritises creditors' interests over the well-being of the country's economy and its people. Such stringent surplus targets are growth-impairing and push countries into regions outside best practice, hindering economic development.

Unaligned Conditionalities: Global challenges posed by the IMF's policies call for a reevaluation. The IMF's arbitrary and non-transparent target-setting process allows it to impose harsh conditions that prioritise creditor interests over sustainable growth. This approach risks pushing countries into unsustainable debt positions, leading to repeated restructuring.

Sri Lanka risks following a path that can lead to severe economic distress with unaligned IMF conditionalities unless the IMF adjusts its policies to reflect best practices. The mis-specified conditionalities are not mere complaints but critical issues that require collective action from affected countries.

Prioritising Creditor Interests: Lenders, including the IMF, played a significant role in generating the 2020 crisis by providing

excessive loans beyond what was necessary for COVID-19 relief, as seen in Ghana. The high interest rates, influenced by global rates and surcharges, place an additional burden on borrowers. Choosing between subsidised lending rates and imposing realistic primary surplus targets, the latter is preferable if it aligns with growth and best practices.

IMF conditionalities often prioritise old creditors' interests over new investment opportunities, deterring potential creditors who perceive these conditions as growth-stifling. These dynamic underscores the need for Sri Lanka to retain control over its macroeconomic decisions, similar to the European Stability Mechanism established by the Eurozone to limit IMF intervention.

Bondholders are demanding to be repaid to 98 cents for every dollar lent if Sri Lanka's economy grows more than expected by the IMF. In contrast, bi-lateral creditors are set to receive 67 cents for every dollar lent, with no increase in payments if economic growth is higher than expectations.[19]

Enforcing primary balance targets: Addressing these issues requires a holistic approach to reform the global financial architecture. The lack of stringent capital ratios for lenders allows risky lending practices, as lenders are assured that the IMF will enforce primary balance targets to secure repayments. To mitigate these risks, countries can impose capital controls on inflows and push for higher capital ratios for lenders.

The broader debate on global economic justice often gets muddled with multiple agendas, making meaningful action challenging. However, three key reforms can make a significant impact:

- **Imposing High Capital Ratios on Lenders:** Ensure that advanced world lenders have significant stakes in the outcomes of their loans, promoting responsible lending.
- **Reforming the IMF:** The IMF should not enforce medium-term primary surplus targets outside best practice peer bands, removing incentives for low-quality lending.
- **Integrating Climate Finance with Debt Solutions:** Address the dual challenge of curbing emissions and managing debt, ensuring that countries like Sri Lanka are not overwhelmed by debt while addressing global warming.

Renegotiating the IMF agreement is imperative for Sri Lanka's economic recovery and future stability. The current conditionalities are not aligned with best practices and pose significant risks to the country's fiscal health and social well-being.[20] A restructured agreement that includes substantial debt reduction, realistic fiscal targets, and respect for Sri Lanka's sovereignty over its economic policies will provide a foundation for sustainable growth. By pursuing these changes, Sri Lanka can ensure a more equitable and prosperous future for its people and set a precedent for fairer global economic practices.[21]

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