

## **Statement by academics on dealing with Sri Lankan debt, January 2023**

Sri Lanka, along with many other low- and middle-income countries, has experienced a series of financial shocks due to both external and internal factors. Global forces have caused food and energy import costs to soar and interest rates to rise, even as the currency has devalued significantly. These shocks, along with a history of policy mismanagement—and specifically the deregulation and openness that encouraged irresponsible borrowing, enabled illicit financial flows out of the country and assisted political corruption—have intensified external debt and balance of payments crises.

Over the last decade of liquidity expansion and low interest rates in the world economy, private lenders provided loans to low- and middle-income countries, at higher interest rates than for advanced countries. These higher rates were purportedly due to greater risk exposure that could make debt repayment more difficult in such countries. That risk has now materialised, firstly through a global pandemic, and then the price shocks and interest rate increases of 2022.

Private creditors own almost 40% of Sri Lanka's external debt stock, mostly in the form of International Sovereign Bonds (ISBs), but higher interest rates mean that they receive over 50% of external debt payments. Such lenders charged a premium to lend to Sri Lanka to cover their risks, which accrued them massive profits and contributed to Sri Lanka's first ever default in April 2022. Lenders who benefited from higher returns because of the "risk premium" must be willing to take the consequences of that risk. Indeed, ISBs are now trading at significantly lower prices in the secondary market. In this context, giving private bondholders an upper hand relative to sovereign debtors in the Paris Club and the IMF's required debt negotiations violates the basic principles of natural justice.

In addition, the lack of transparency of the debt negotiation process and accountability of the holders of ISBs underscores the concern that risky lending to corrupt politicians (leading to what is now recognised as "odious debt") was a significant element in generating the current debt crisis. Apart from revealing the identity of ISB holders, it is also important to disclose how ISBs were deployed, and the use of those funds.

Debt negotiations in Sri Lanka are now at a crucial stage. All lenders—bilateral, multilateral, and private—must share the burden of restructuring, with assurance of additional financing in the near term. However, Sri Lanka on its own cannot ensure this; it requires much greater international support. Instead of geopolitical manoeuvring, all of Sri Lanka's creditors must ensure debt cancellation sufficient to provide a way out of the current crisis.

The role of multilateral organisations, particularly the international financial institutions (IFIs), such as the IMF and the World Bank, is also significant. They were founded to assist sovereign nations, particularly in contexts in which financial markets would not deliver, to ensure financial stability and prevent or reduce the impact of financial crises, and to provide resources for crucial investments required to meet social and developmental needs.

The IFIs are not currently living up to these responsibilities, at a time when they are most urgently required. In Sri Lanka they encouraged the very policies of more open capital accounts and deregulation that have led to the current crisis. They have been slow to respond to the crisis, and are apparently requiring onerous policy and fiscal conditionalities, such as moving to a primary fiscal surplus in a very short time, even as the economy continues to plunge.

The implications are already evident in the recent Budget of the Sri Lankan government, which has unrealistic revenue assumptions that are unlikely to be met. Revenue shortfalls would then

necessitate further “austerity” and likely cuts in essential public spending. The Budget also proposes public asset stripping and privatization of strategic lands, marine resources, energy, transport and telecom infrastructure and public enterprises. These policies will harm the most vulnerable groups in Sri Lanka, exacerbate poverty and inequality, and lead to further economic decline. Instead the focus should be on legal and regulatory changes to stem the illicit outflow of capital through transfer pricing and trade mis-invoicing over the past 15 years, which is estimated to be far more than the aggregate foreign debt of Sri Lanka, and on taxation of wealth and consumption of the super-rich.

The Sri Lankan case will provide an important indicator of whether the world—and the international financial system in particular—is equipped to deal with the increasingly urgent questions of sovereign debt relief and sustainability; and to ensure a modicum of justice in international debt negotiations. It is therefore crucial not only for the people of Sri Lanka, but to restore any faith in a multilateral system that is already under fire for its lack of legitimacy and basic viability.

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