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Government of Sri Lanka

Reform Implementation Key to Ensure Lasting Fiscal, External Improvement from IMF Program

On 3 June 2016, the International Monetary Fund (IMF) board approved a $1.5 billion three-year Extended Fund Facility (EFF) for Sri Lanka (B1 negative). We expect the program to support Sri Lanka's external liquidity position and the initiation of fiscal reforms, both of which would be credit positive. However, we also see implementation risks to the program's ambitious fiscal targets, which contributed to our recent decision to change the outlook on the sovereign rating to negative from stable. [1]

Our view on implementation risks is informed by our analysis of previous IMF programs: Sri Lanka between 2009 and 2012, and the program experiences of five other countries — Ghana (B3 negative), Jordan (B1 stable), Mongolia (B2 negative), Pakistan (B3 stable) and Romania (Baa3 positive) — that faced similar credit challenges to Sri Lanka now. This report discusses our findings.

» **Fiscal strengthening following IMF programs often limited and short-lived** Generally, an initial narrowing of deficits diminished or reversed after a few years and the government's debt burden continued to rise. Although in the absence of an IMF program, there may have been no improvement or even further deterioration, the trends suggest that for most sovereigns, structural weaknesses in fiscal frameworks tend to reappear. Romania stands out for reform implementation that endured through several governments, and led to a materially stronger fiscal position.

» **Foreign reserves generally stabilized, but external vulnerability persisted** Where severe liquidity pressures exist, the ability to stabilize foreign reserves is a core credit-positive aspect of IMF programs. However, in several cases, reserves increased by less than the amount of IMF loans, suggesting that the countries' competitiveness or attractiveness to foreign investors did not improve significantly.

» **IMF programs tended not to bolster institutional strength scores** Although the programs included reforms that could enhance government effectiveness, tackling institutional weakness goes beyond the duration, focus and means of IMF assistance.

» **Whether IMF program supports Sri Lanka's credit profile will depend on reforms** Disbursements by the IMF and other international lenders will probably stabilize Sri Lanka's foreign exchange reserves. However, whether the government is able to implement the ambitious reforms agreed with the IMF will be key in determining whether the government's credit profile gets a temporary or more enduring boost.

Overview: Fiscal consolidation a key focus of Sri Lanka's IMF program

The $1.5 billion in funds that the EFF will provide aim to address Sri Lanka's immediate balance of payment pressures. The country's foreign currency reserves have fallen to low levels, below the amount of short-term external debt.

The program envisages reforms to bolster Sri Lanka's weak fiscal structures, one of the causes of the current financial tensions. In particular, three of the six reform "pillars" relate to budgetary measures including fiscal consolidation, revenue mobilization and public financial management reform. State enterprise reform, the fourth pillar, is also meant to diminish the vulnerability of the government's balance sheet to the worsening financial health of some state-owned enterprises (SOEs).

Pillars 5 and 6 relate to robust and stable medium-term growth, with a shift towards inflation targeting and a flexible exchange rate, and reform of trade and investment policies.

Fiscal, balance of payments pressures similar to Sri Lanka's tend to prompt IMF programs

Other countries have obtained IMF funding to bridge financing needs, while tackling similar fiscal and balance of payments weaknesses as Sri Lanka's today.

The main IMF facilities designed to meet such macroeconomic stabilization needs are Stand-By Arrangements (SBA) and EFFs. SBAs typically last for 12 to 18 months, and primarily aim to address short-term liquidity and external imbalances. EFFs provide financing over three years in general, with an emphasis on longer-term structural reforms.

Over the last few years, SBA countries include Pakistan in 2008, Romania and Mongolia in 2009, as well as Jordan in 2012. Many of these programs were followed by subsequent programs. [2] In our analysis, we also include Ghana, whose poverty reduction and growth program (PRGF) that started in 2009 was somewhat different in its goals, but also related to fiscal and balance of payments pressures.[3] By the time the countries approached the IMF, most of these countries' balance of payments were under significant stress and foreign exchange reserves had fallen to low levels.

In a previous analysis,[4] we focused on the default rates of countries with and without IMF programs. We concluded that (i) the vast majority of IMF program countries avoided default, and (ii) a higher default rate among program countries than non-program countries highlighted the existence of an IMF program as a signal of credit stress.

In this report, we expand our assessment of the potential credit implications of IMF programs by looking at developments in fiscal and external metrics under and after the programs.

Other factors than the IMF program and related policies have influenced credit metrics of the sovereigns that we focus on in this report. In particular, the global financial crisis, which formed a backdrop to many of the recent IMF programs, weighed on GDP growth, government revenues and export receipts. More recently, the sharp drop in commodity prices helped to lower the import bills of a number of program countries, reduce current account deficits and ease balance of payment pressures.

Similarly for Sri Lanka, developments in fiscal and external metrics will result from a combination of domestic policy measures and external environmental factors.

Fiscal strengthening following IMF programs often limited and short-lived

Sri Lanka's EFF focuses on fiscal consolidation. A key objective is to reduce the budget deficit to 3.5% of GDP by 2020, from 7.4% in 2015.

All the countries in our sample were running sizeable deficits of more than 5% of GDP at the start of their IMF programs. Deficits generally narrowed in the first year of the programs (see Exhibit 1), consistent with disbursement of loans being conditional on meeting certain targets, including fiscal goals. However, the initial narrowing tended to peter out. In our sample, only Romania, and so far, Jordan, recorded a marked and sustained improvement in its budget balance.

Governments achieved initially narrower deficits through a range of measures including broadening of the tax base, sales of stakes in public sector enterprises, curtailment of subsidies and other expenditure cuts.

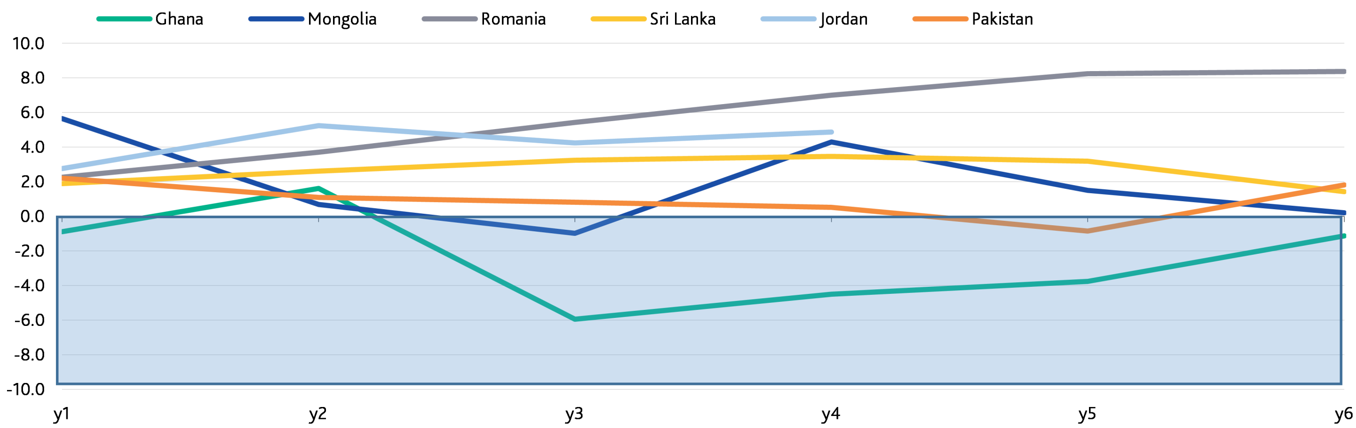
In Sri Lanka, reductions in expenditure contributed to narrower deficits in 2009-2012. However, since the end of that IMF program, revenues have fallen more markedly as a percentage of GDP and budget deficits have widened again.

In Pakistan, weak support for tax reforms and current spending overrun resulted in a renewed widening of deficits after an initial consolidation. In the country's 2013 EFF program, the budget deficit has narrowed: the finance minister announced a target deficit of 3.8% of GDP for the fiscal year ending June 2017 (fiscal 2017), from a peak of 8.2% of GDP in fiscal 2013.

In Ghana and Mongolia, the budget balance is typically very volatile, being highly sensitive to changes in commodity prices and one-off spending. No clear direction emerges in the years after the start of their IMF programs. Under the current ECF, Ghana's fiscal consolidation has advanced more markedly.

Exhibit 1

Initial Improvement in Fiscal Balances Tends to Peter Out
(Cumulated change in budget balances, percentage points of GDP, from y0, start of the IMF program)



For Jordan, the program started in 2012; y4 corresponds to Moody's 2016 forecasts
Sources: National authorities, Moody's Investors Service

Subdued economic growth, which generally accompanied the increase in fiscal and external pressures that triggered and persisted during the programs, weighed on budgetary performance.

Monetary easing often accompanied fiscal tightening, with central banks in Ghana, Jordan, Romania and Sri Lanka cutting interest rates during their IMF programs. However, marked currency depreciations that stoked inflation in some cases constrained monetary policy.

For Sri Lanka, a credible move towards inflation targeting as part of the current IMF program would help to mitigate inflationary pressure and create monetary policy space in the medium term.

Sustained revenue increases are not usual

The IMF programs generally envisaged an increase in revenues to GDP, which is a major focus of Sri Lanka's new EFF.

In Sri Lanka's 2009 experience and in Pakistan, the revenue-to-GDP ratio remained lower than at the start of the program (see Exhibit 2). In Jordan and Mongolia, the ratio increased initially and subsequently pared its gains.

This reflects difficulties in implementing efficient tax reforms. In particular, the removal of tax exemptions or increases in some tax rates can be fleeting, especially when a weak economic environment puts pressure on governments to reverse such changes.

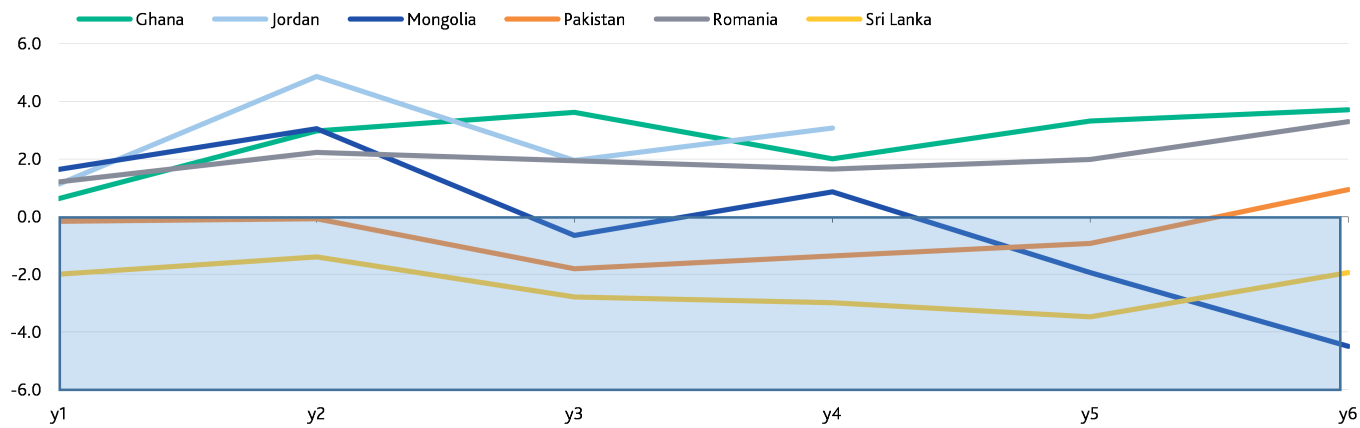
For instance, Sri Lanka introduced new tax exemptions in its 2013 budget, which dampened revenues and lowered the effectiveness of earlier tax reforms from the 2009 IMF program. Revenues have continued to fall as a share of GDP ever since.

Moreover, in some cases, revenue-raising has been based on one-off measures, such as foreign grants obtained by Jordan from some Gulf nations, the US and Europe.

Exhibit 2

No Sustained Increase in Revenues Following Programs

(Cumulated change in revenue-to-GDP ratios, percentage points, from y0, start of the IMF program)



For Jordan, the program started in 2012; y4 corresponds to Moody's 2016 forecasts

Sources: National authorities, Moody's Investors Service

Expenditure cuts often concentrate on investment spending

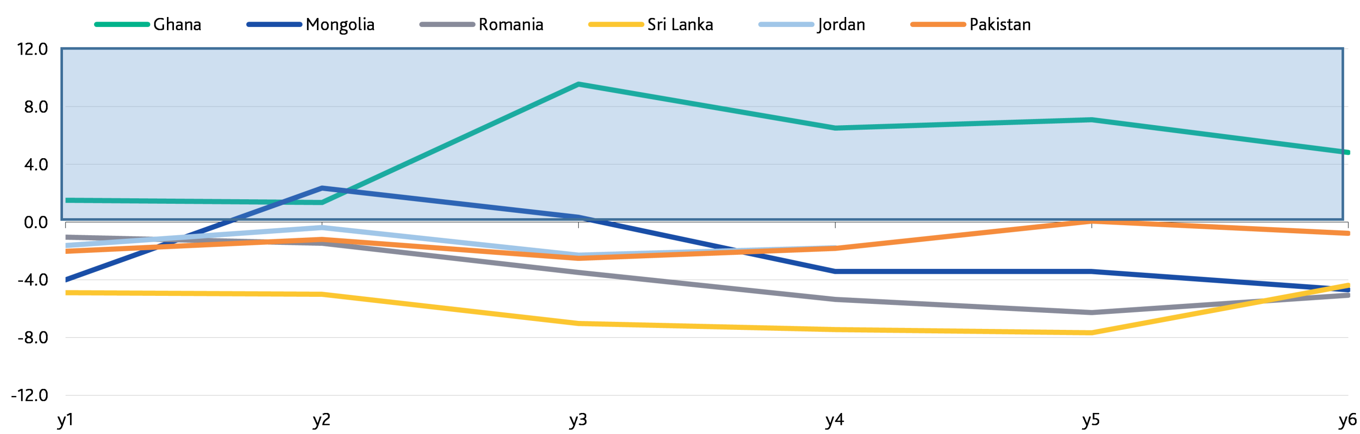
Expenditure control rather than outright cuts is a focus of Sri Lanka's current EFF.

In previous programs, expenditure cuts contributed to lowering deficits and have generally endured longer than revenue increases (see Exhibit 3). Governments often rely on cuts to capital spending, which are politically less difficult to implement than reductions in current expenditure. However, such cuts come at the cost of delays in infrastructure improvements in particular, and hurt medium-term growth.

Exhibit 3

Expenditure Cuts Are Generally More Sustainable

(Cumulated change in expenditure-to-GDP ratios, percentage points, from y0, start of the IMF program)



For Jordan, the program started in 2012; y4 corresponds to Moody's 2016 forecasts

Sources: National authorities, Moody's Investors Service

Romania has been a notable exception to this rule. There, the government cut public wages by 25% and social transfers by 15% in 2010. It also introduced a fiscal responsibility law, which formalized targets and stipulated corrective actions in case of deviations. Cuts in government expenditure were sizeable and endured through various governments, leading to a marked narrowing in the budget deficit. The last government eased fiscal policy which will lead to a renewed widening of the budget deficit. However, this will occur from much stronger levels than when the country entered the IMF program.

In the case of Sri Lanka, the government cut expenditure markedly during the previous program, partly through lower military spending following the 2009 end of the civil war.

Uneven progress on SOE reform

Sri Lanka's EFF emphasizes SOE reform to reduce sizeable contingent liability risks to the government.

Similarly, for several sovereigns, such as Jordan, Pakistan and Sri Lanka in 2009, SOEs posed significant contingent liability risks, some of which had already crystallized as material fiscal costs in the years leading up to the program. In these cases, the IMF recommended the restructuring and privatization of loss-making SOEs.

Progress on SOE reform in previous programs was uneven. For Sri Lanka, the IMF assessed in its first post-program review in 2013 that the large losses of the Ceylon Electricity Board (unrated) and the Ceylon Petroleum Corporation (unrated) were unsustainable, and recommended moving towards cost-recovery pricing. The Sri Lankan authorities have recently reasserted such goals. Moreover, the financial health of some other large SOEs has deteriorated in recent years, including that of SriLankan airlines (unrated). In May 2016, the cabinet announced its approval to take over the company's liabilities, at least temporarily, to the tune of around 4% of GDP.

Similarly, SOE reform has been slow in Pakistan, with sales of some of the government's stakes delayed by parliamentary opposition and strikes.

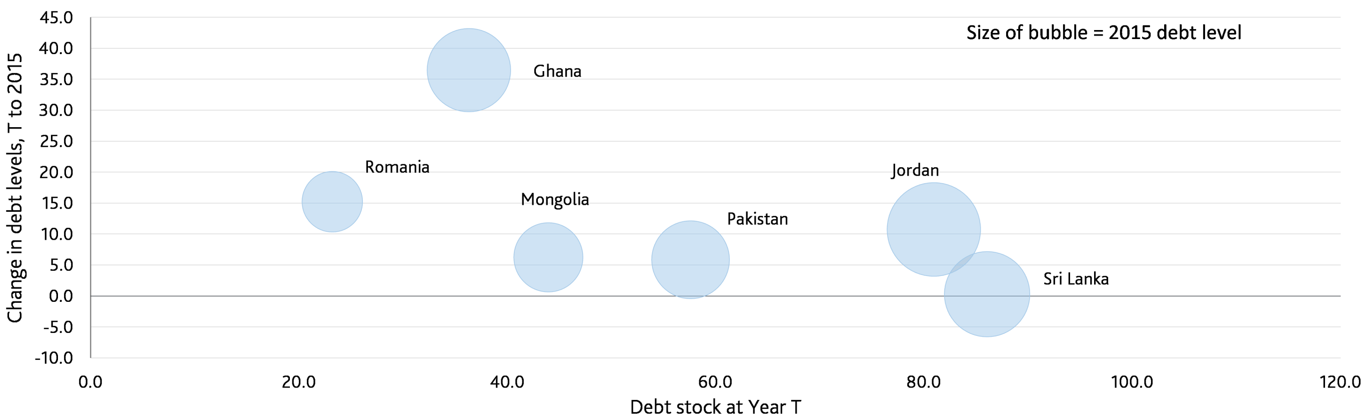
More positively, the Jordanian government's exposure to NEPCO (unrated), the state utility company, has diminished as the company has moved closer to operating balance. According to the staff-level agreement, achieving cost recovery for NEPCO and the Water Authority of Jordan is an objective of Jordan's new EFF.

Debt stocks tend to increase during and after IMF programs

Overall, with limited improvement in fiscal balances, in some cases crystallization of contingent liabilities, and mostly subdued nominal GDP growth, in none of the countries in our sample did the debt-to-GDP ratio fall on a sustained basis (see Exhibit 4). In general, debt continued to rise during the program and in the years after it.

Exhibit 4

Debt Stock Increased in all Countries
(Level of and change in government debt to GDP)



Note on Sri Lanka: Revisions to GDP levels from 2010 imply a jump down in the debt to GDP ratio calculated on the basis of published data. In this chart, we adjust the data to obtain consistent estimates of debt to GDP over time.
Sources: National authorities, Moody's Investors Service

In Ghana, debt was broadly stable during the 2009 PRGF program. Subsequently, deficits widened markedly and debt increased to 72.8% of GDP in 2015, from 47.8% in 2012 when the PRGF ended, prompting a new program of financial assistance from the IMF.

In Mongolia, debt was relatively moderate at the start of the program, at 44.0% of GDP in 2009. It decreased substantially in the first year, to 24.5%, as nominal GDP surged 48.5% on the back of a booming mining sector and increases in copper prices. However, debt increased again from 2012 and we forecast it to reach close to 58% of GDP this year.

In Sri Lanka, strong nominal GDP growth in 2010-2012 also helped to reduce the debt burden. However, with a slowdown in economic expansion, debt has increased rapidly again over the last three years.

These outcomes highlight the challenges in achieving sustained fiscal consolidation and the structural weaknesses in the countries' fiscal frameworks that led to IMF programs becoming necessary in the first place.

At the same time, by helping forge a consensus behind fiscal consolidation and with concessional financing relieving governments' debt servicing burdens, the IMF programs likely helped prevent or mitigate a further deterioration in fiscal metrics.

Foreign reserves stabilized, but external vulnerability persisted

Besides fiscal pressures related to high debt burdens or government liquidity strains, IMF program countries often experience balance of payment pressures.

In past programs, wide current account deficits sometimes contributed to reserve depletion before the start of IMF assistance. For instance, Pakistan recorded a large current account deficit in 2008, at the start of its SBA. The trade deficit then narrowed and, combined with a rise in remittances, led to a balanced current account in 2011. Pakistan has recorded small deficits since.

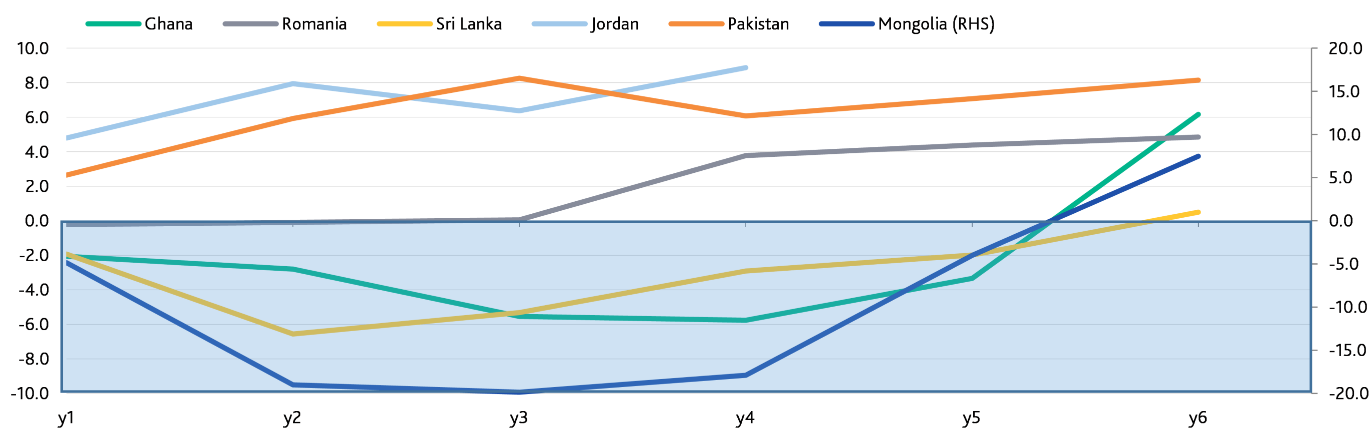
No consistent current account trend emerges from the countries in this report (see Exhibit 5). Various factors affected current account balances including commodity prices, the impact of evolving domestic demand on imports, and changes in export markets.

Structural reforms that focus on improving the business environment, for exporters in particular, may support export shipments, and hence current account balances, over the medium term, and beyond the lifetime of an IMF program.

Exhibit 5

Mixed Picture on Current Account Balances

(Change in current account balance, % of GDP, from y0, start of the IMF program)



For Jordan, the program started in 2012; y4 corresponds to Moody's 2016 forecasts
Sources: National authorities, Moody's Investors Service

IMF, multilateral financing flows boosted foreign exchange reserves

Notwithstanding the mixed outcomes on current account positions, foreign exchange reserves stabilized and generally increased during the IMF programs of the countries in our sample.

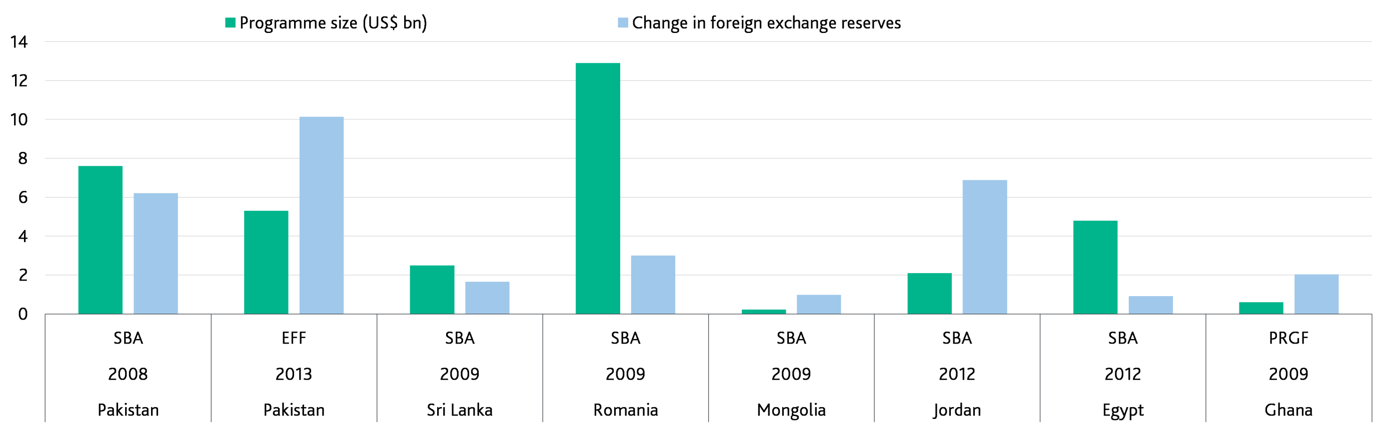
The programs often included quantitative and policy objectives aimed at preserving or restoring adequate levels of foreign exchange reserves. As is the case in Sri Lanka's current EFF, conditions for disbursements featured targets for reserve coverage of at least three to four months of imports or a dollar floor on net international reserves.

Moreover, recommendations to adopt flexible exchange rate policies were also part of a number of programs, including Sri Lanka's 2009 program and the objective to shift to flexible inflation targeting under the current program. A more flexible exchange rate can help reduce central bank foreign exchange interventions and preserve foreign exchange reserves.

However, we find no consistent evidence that foreign exchange reserves increased beyond the amounts of loan disbursements during the IMF programs (see Exhibit 6), despite other multilaterals often providing funding at the same time. Instead, in several cases, the rise in foreign exchange reserves was smaller than the total amount of IMF funding. This implies that external vulnerability persisted, potentially becoming more visible as repayments of IMF loans started.

Exhibit 6

Official Foreign Exchange Reserves



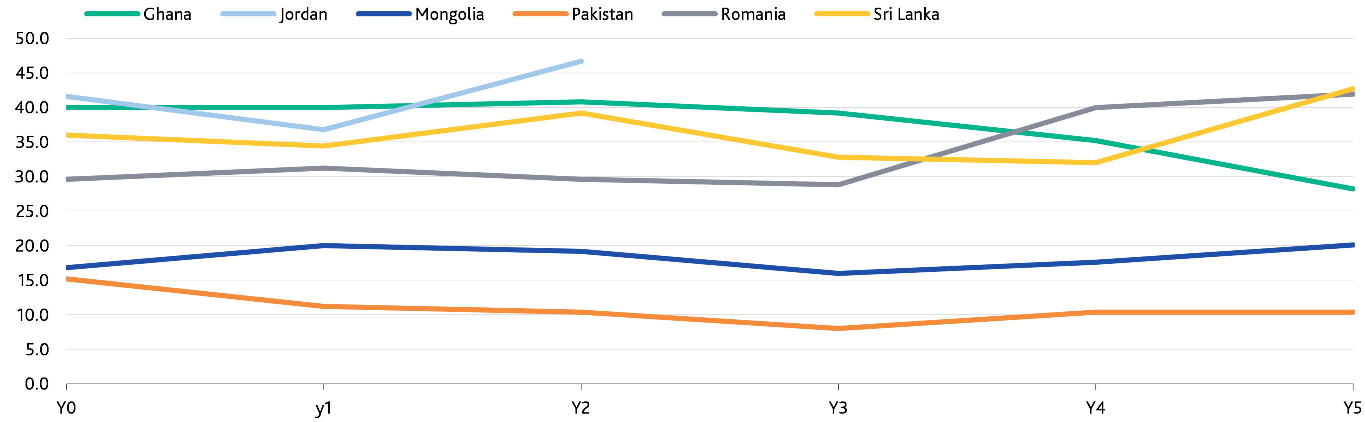
Note: Change in reserves over two or three years from the year of the start of the program, depending on its duration. Reserve levels are as of year end. For Pakistan's 2013 EFF, we compare Moody's 2016 forecasts of foreign exchange reserves to their 2013 levels.
Sources: National authorities, Moody's Investors Service

IMF programs tended not to bolster institutional strength scores

The IMF programs included a number of reform objectives which, if implemented, should have enhanced policy effectiveness. Conversely, the existence of weak institutions at the start of programs risks hindering the effectiveness of reforms.

According to the World Bank's Worldwide Governance Indicators, there was no significant change in government effectiveness during and after the programs, except in Romania from 2012, three years after the start of the first SBA (see Exhibit 7). In the last two years, survey results on Romania's government effectiveness have improved, suggesting that investors recognize the efficacy of the fiscal responsibility measures.

Exhibit 7
World Bank Governance Indicators - Government Effectiveness
(Percentile rank)



Source: World Bank

In Mongolia and Pakistan, the World Bank's indicators of government effectiveness remained very low throughout the programs. The underlying weakness of these countries' institutions hampered effective reform implementation. In Pakistan however, we have reflected the implementation of reforms over the last few years in our stronger assessment of Institutional Strength.

Sri Lanka's government effectiveness is higher than the other countries in this analysis, increasing the likelihood of tangible and sustained reforms.

Whether IMF program supports Sri Lanka's credit profile will depend on effective reforms

The main focus of Sri Lanka's IMF program is on fiscal and SOE reforms.

Notwithstanding bumps along the way, the IMF program should help to forge a consensus around fiscal consolidation. We expect Sri Lanka to reduce its fiscal deficits to slightly under 5% in 2020, larger than the program target of 3.5%, but narrower than the 7.4% that it recorded in 2015. Slowing growth and hurdles to effective improvement in tax collection and broadening of the tax base will likely prevent more rapid fiscal consolidation.

With nominal GDP growth slower than in the last decade, persistent sizeable deficits will raise the government's debt burden. We expect government debt to rise to just under 80% of GDP and subsequently fall to around 75% by the end of the decade, above the IMF's projection of 68.2% in 2020 and debt levels of similarly rated sovereigns.

Meanwhile, the IMF program and disbursements by other international lenders will play an important part in stabilizing Sri Lanka's foreign exchange reserves and help to offset capital outflows. The period of program engagement usually leads to a turn in investor confidence, which supports higher portfolio inflows in the short term. However, unless capital inflows increase markedly and stay at a higher level, foreign exchange reserves will remain low in relation to imports and external debt payment needs.

In sum, whether Sri Lanka's credit profile gets a temporary or more enduring boost from the IMF program will depend on the effective sustained implementation of its ambitious reform targets.

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Endnotes

1 See Government of Sri Lanka - Update Following Recent Change in Outlook to Negative from Stable

2 Pakistan then obtained a EFF in 2013, which is relatively recent and hence provides less of a track record on changes in credit metrics. Reform implementation has been stronger under this program, which was one of the drivers of the upgrade of Pakistan's rating to B3. Jordan also reach a staff-level agreement on a new EFF with the IMF in June 2016. A number of other countries have received EFFs in recent years, although their experiences are less relevant to Sri Lanka, as the issues that prompted the programs were different. These countries include Ireland (Baa1 positive) in 2010, Portugal (Ba1 stable) in 2011, Greece (Caa3 stable) in 2012, Cyprus (B1 stable) in 2013 and Ukraine (Caa3 stable) in 2015. Albania (B1 stable) 2014 and Bosnia's (B3 stable) 2016 EFFs are too recent to include in our observations. We also exclude the Seychelles' (unrated) 2009 program.

3 Ghana's PRGF was followed by a three-year Extended Credit Facility (ECF) signed in 2015.

4 See Sovereign Defaults Series: IMF Program Participation Underscores Medium-Term Sovereign Credit Challenges, August 2013

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