Sri Lanka Gone Broke: Sovereign Debt Restructuring and Challenges Ahead

By:

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Once nicknamed the pearl of the Indian Ocean, Sri Lanka is today suffering from political, economic, and social crises, becoming the teardrop of the Indian Ocean.

1. Introduction

Sri Lanka is facing the worst economic crisis in its history. Indeed, the crisis is an upshot of several interconnected factors revolving around economic maladministration, ultimately leaving the country with a substantial debt burden and a shortage of foreign reserves. As a result, on April 12, 2022, the Sri Lankan government declared a unilateral debt standstill, halting its foreign debt servicing except for payments to Multilateral Development Banks (MDBs). Accordingly, Sri Lanka defaulted on US$51 billion external debt, explaining that it is the "last resort" that prevents further worsening of the country's financial position. Defaulting on debt was further described as a measure to ensure “fair and equitable treatment of all creditors” ahead of securing a bailout package from the International Monetary Fund (IMF). Sri Lankan authorities recently reached a staff-level agreement with the IMF to obtain a $2.9 billion Extended Fund Facility (EFF). However, this EFF arrangement should be approved by IMF management and the Executive Board, and it is contingent on “receiving financing assurances from Sri Lanka’s official creditors and making a good faith effort to reach a collaborative agreement with private creditors”. Accordingly, the crisis-hit island nation has no option but to restructure its debt which is inherently painful and involves multifaceted challenges. Against this backdrop, I argue that Sri Lanka’s debt restructuring efforts will be more challenging due to factors unique to the country’s contemporary political landscape and its foreign debt profile. I elaborate on these factors under three subheadings: the lack of political stability, the China factor and the intricacy of the bond restructuring, which will be explained in turn. In doing so, this post provides an overview of diverse and complex challenges involved in Sri Lanka’s debt restructuring, which are worthy of serious attention.

2. The Lack of Political Stability

Political stability is crucial to economic growth. The significance of political stability is particularly underscored when a given polity is undergoing an economic crisis. This is because a stable government is a precondition to undertaking reforms, reestablishing its macroeconomic stability and debt sustainability. Indeed, the notion of political stability has been analysed through different approaches, which range from the non-existence of domestic civil conflict and violent behaviour to the systemic stability of a given polity. One of those approaches to political stability perceives it as legitimacy - “the extent to which the political system and the system’s outputs are accepted as right and proper by the population.” Accordingly, stability is not the “absence of negative phenomena” but the “presence of positive support and acceptance.” At the same time, widespread public confidence in the government is considered a precondition for political stability. Thus, the absence of public confidence has been identified as the possible root cause of dissidence or organised anti-government protests, threatening political stability. When analysing Sri Lanka’s recent political developments in the legitimacy-stability thesis, they seriously throw into doubt the country’s political stability.

Recent developments pose questions about the legitimacy of the new regime as they appear to be unacceptable to much of the population. There is a notable disconnect between what mass anti-government protests sought to achieve and what they eventually brought about. For context, an eschewed politician Ranil Wickremesinghe whose party was defeated in the 2020 parliamentary election, became Sri Lanka's president with the support of the political party which campaigned against him in that same election. They did so by capitalising on then-prime minister Wickremesinghe's alleged misconduct, such as the famous Central Bank Government Bond Scam of 2015-2016. For some, Wickremesinghe represents and protects the interests of the Rajapaksa political family while merely continuing the Rajapaksa administration, which is accused of ruining Sri Lanka's economy. Accordingly, Wickramasinghe's " constitutionally valid but unconventional path to the presidency" has called Sri Lanka's political system into question, losing public confidence in the system and causing public concern about political morality. Indeed, Wickramasinghe lacks positive support and acceptance of much of the population, particularly amongst anti-government protestors who demand political reforms or systemic change to hold those who mishandled the country's economy accountable.

Even though there has been a crackdown on dissidents and emergency laws have been utilised to return to so-called political normalcy, continuous anti-government protests demand Wickremesinghe's resignation and the dissolution of Parliament. Many allege that the current administration does not reflect the people's valid will, insisting that a fresh general election is the only way out of the current political crisis. Meanwhile, Wickremesinghe has had no success securing the full support for the all-party national government he proposed, inviting political parties to join him and work within a common policy framework. According to some, an all-party national government is vital in fixing Wickremesinghe's impugned mandate and enabling him to establish a stable government. However, although Wickremesinghe would secure the support of majority political parties and certain individual politicians, the robustness of such a political coalition and its ability to form a stable government is yet to be seen. Therefore, in practice too, Sri Lanka's political stability is at stake despite the country's dire need for a stable and predictable political landscape at this critical juncture where political stability particularly matters. Indeed, the EFF arrangement with the IMF has already compelled Sri

Lanka to embark on a comprehensive economic reform program, which would spark political unrest shortly.

3. The China Factor

Over the past two decades, there has been an increased Chinese presence in Sri Lanka's economy, giving rise to the contested narrative of the Chinese debt trap. Adding another dimension to this controversy, many argue that China is one of the major or perhaps the most critical players in Sri Lanka's economic crisis. This allegation is mainly based on the fact that China extended opaque loans for several ill-conceived infrastructure development projects in Sri Lanka that eventually became unprofitable, leading the country toward insolvency. China refuses this allegation, asserting that Chinese-funded infrastructure projects have "boosted Sri Lanka's economic development and brought tangible benefits to the Sri Lankan people." China further draws attention to Sri Lanka's debt profile, arguing that China-related debts account for far less share than other components of Sri Lanka's overall debt profile, notably the international capital market and MDBs. By the end of 2021, International Sovereign Bonds (ISBs) accounted for 36.5% of total foreign debt in Sri Lanka, whilst it has been frequently pointed out that as of April 2021, the Asian Development Bank and World Bank accounted for 13 % and 9% of Sri Lanka's foreign debt, respectively. Sri Lanka's main bilateral creditors, i.e., Japan and China, jointly accounted for 20 % of Sri Lanka's foreign debt profile, each forming approximately 10 %, while India's share was 2%. It has therefore been argued that China has never been Sri Lanka's leading lender, and as such, casting doubt on whether China should be blamed for Sri Lanka's economic crisis.

Although the answer to this question remains disputed, China's role in helping Sri Lanka to get out of this economic crisis is increasing underscored. In particular, the need to restructure Chinese debt has added a geopolitical tone to the issue. Therefore, China's stance on Sri Lanka's debt (its willingness to provide Sri Lanka with substantial debt relief and future funding assurances) is identified as critical in the debt restructuring process, pinpointing that Sri Lanka is not entitled to the G-20's Debt Service Suspension Initiative which expired at the end of 2021, or even the G20s Common Framework. Further, China is not a Paris Club Creditor. However, about 26% of Sri Lanka's foreign debt to be restructured is due to Chinese creditors, mainly EXIM Bank of China and China Development Bank. Consequently, restructuring Chinese debt has become inexorable because financing assurances from Sri Lanka's official creditors to restore the country's debt sustainability is essential in effectively implementing the EFF arrangement with IMF. IMF has already emphasised the urgency of Sri Lanka engaging with China on debt restructuring proactively, although its recent policy adjustment on official creditors allows the IMF Board to approve financing in a situation where there is no adequately representative Paris Club agreement, and the debtor has been unable to agree with one or more official bilateral creditors to clear its arrears, subject to specific criteria. These criteria notably include the necessity for "prompt IMF support" and the sovereign debtor's "good faith efforts to reach an agreement with the creditors."

This draws attention to China's stance on Sri Lanka's debt, which remains to be seen. Initially, China expressed concerns over Sri Lanka's decision to default on debt and seek IMF assistance, highlighting the impact of debt restructuring on future bilateral loans and rejecting Sri Lanka's request to reschedule Chinese loans, but suggesting extending another loan. It is unsurprising because of China's conventional inclination to refinance its loans or offer deferrals for large loans instead of write-down. Then, however, China's position witnessed a change as it agreed to "play a positive role" in negotiations with the IMF and offer Sri Lanka further loans providing the country with the hope of China's cooperation in a multilateral approach toward debt restructuring. Perhaps, China may adopt the same stance it adopted in restructuring Zambia's debt by agreeing to join the IMF-backed creditor committee, contrary to its conventional preference of discussing debt relief on a bilateral basis or through bespoke negotiations. China's corporation enabled Zambia to secure assurances from its official bilateral creditors to renegotiate their debt, paving the path to obtaining IMF's Executive Board approval for a new Extended Credit Facility (ECF) arrangement. However, it remains to be seen whether China will agree to commit itself to the same terms as other creditors, as opposed to China's general approach of seeking preferential treatment. Indeed, Sri Lanka has already emphasised "the need for all the creditors to sing from the same hymn sheet". Sri Lanka treating all its creditors in an evenhanded manner is essential in the smooth resolution of the crisis. Therefore, if China seeks preferential treatment, this will complicate and decelerate Sri Lanka's debt restructuring process by pushing other bilateral creditors (India and Japan) to play the geopolitical card already appearing in Japan’s attempt to coordinate with Sri Lanka creditors.

3. The Intricacy of the Bond Restructuring

Bond restructuring has become inevitable for Sri Lanka as IMF’s EFF arrangement is contingent on “making a good faith effort to reach a collaborative agreement with private creditors.” As mentioned, commercial borrowing in the form of ISBs accounts for the most significant component of Sri Lanka’s diversified debt profile. It accounts for $11.5 million, predominantly owed to Western sovereign bondholders who largely include American and European institutional investors. In addition, Sri Lanka’s bondholders may consist of retail investors (or individual creditors). Compared to the former category, it would be challenging for Sri Lanka to recognise and organise such retail investors, leaving creditor coordination difficult. Although there are different types of bondholder representations aimed at ensuring “better results” for themselves, one possible way for Sri Lanka to overcome this creditor coordination problem is relying on collective action clauses (CACs), included in sovereign-bond contracts, albeit those clauses are not an ideal solution. CACs afford bondholders an “ex-post coordination mechanism,” allowing the majority of creditors to modify the monetary terms of bonds, such as maturity dates or interest rates. Therefore, CACs are significant in providing the issuing government with the flexibility to modify the original terms of sovereign-bond contracts, thereby easing the handling of an economic crisis. Moreover, CACs prevent minority holdout creditors from interfering with swift and orderly debt restructuring and shield sovereign debtors from creditor lawsuits for enforcing repayment through the courts.

Nevertheless, CACs will be no panacea for Sri Lanka. This is because some of its debt contracts provide for the classic single-series CACs; thus, they still carry the high risk of creditor holdouts. Indeed, bonds are legally enforceable debt instruments. Therefore, external bondholders can bring contractual claims under the applicable foreign laws (usually New York or English law) before foreign courts. Such lawsuits are hard to escape since the issuance of sovereign bonds and subsequent defaults are now widely considered by domestic courts as commercial activities for which certain defensive legal doctrines such as absolute sovereign immunity and act of state do not apply. The absence of an international sovereign bankruptcy regime and the fact that no domestic bankruptcy code applies to a sovereign debtor makes this threat more obvious. Sri Lanka has already faced this challenge as one of the bondholders filed holdout litigation against the country in the Federal Court of New York Southern District, seeking to enforce its claim in full; perhaps there would be many more down the road. Such lawsuits would eventually oblige Sri Lanka to enforce creditor claims, perhaps making its assets abroad (if any) vulnerable to being seized by creditors who obtained court judgments against the country. At the minimum, successful holdout litigations compel Sri Lanka to settle those creditor claims at favourable terms compared to creditors who participated in the restructuring, perhaps endangering the entire debt restructuring process. This is not to say that enforcement of sovereign debt contracts is associated with no disadvantages, such as the difficulty of actually attaching sovereign assets and getting foreign judgements enforced.

Against this backdrop, the recent past has seen an inclination to bring the sovereign debt crises into the purview of international investment law, giving rise to the notion of "holdout arbitration". Such arbitrations aim to make the sovereign debtor liable under its international investment obligations to pay " compensation amounting to full repayment of the bonds." For example, holders of Argentinian and Greek bonds brought investment arbitrations against these sovereign debtors, alleging defaulting and restructuring of concerned bonds as violations of Argentina-Italy BIT and Slovak-Greece and Cyprus-Greece BITs, as the case may be. Although those arbitrations have been settled or dismissed, they showed the possibility of exploiting treaty-based investment arbitration under the Washington Convention of 1965 by holdout bondholders. The same avenue could be deployed against Sri Lanka by the bondholders who do not wish to participate in the restructuring, which usually takes the form of bond exchange. Indeed, such arbitration will have an immense disruptive impact on Sri Lanka's restructuring process since it has been argued that "even where the bond includes CACs, and a supermajority agrees to participate in the restructuring…holdout creditors may still be able to resort to investment treaty arbitration". If that is the case, investment treaty arbitration provided for in almost all of Sri Lanka's vague and ill-defined BITs enables bondholders to surpass limitations imposed by CACs and challenge modifications to Sri Lanka's payment obligations under sovereign-bond contracts as violations of investment treaty protection. Although the success of such claims depends on a combination of several complicated factors that remain to be fully explored, it should not be overlooked the fact that Sri Lanka's BITs afford foreign investors the greatest possible protection while hardly providing sufficient regulatory space for the host State.

4. Conclusion

Sri Lanka's debt restructuring process is burdened with several challenges. They include typical political and legal challenges, as well as evident geopolitical tensions and possible disruptive investment arbitration based on Sri Lanka's BITs. Indeed, these atypical challenges will possibly make Sri Lanka's debt restructuring process more complex and perhaps prolonged, leaving the country more vulnerable. Besides these challenges, debt restructuring might have immediate repercussions on the economy, such as difficulties in attracting foreign investors and losing access to international financial markets. Furthermore, although sovereign debt restructuring could bring the country's distressed economy back to debt sustainability if appropriately managed, there is no guarantee that it will end the calamities of an insolvent nation grappling with several intertwined crises. Finally, Sri Lanka's more daunting debt restructuring process will test the existing global financial infrastructure, questioning its adequacy to accommodate the current global economy's challenges.

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