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The Role of IMF in Restoring the Financial Stability of Developing Countries in the Post-Pandemic Era: Case Study of Sri Lanka

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Abstract: The International Monetary Fund (IMF) is helping developing countries that the Covid-19 pandemic has inconvenienced. As a result, The International Monetary Fund (IMF) has approved a 48-month Extended Fund Facility (EFF) of about 3 billion USD to support Sri Lanka's Covid-19 post-pandemic era. This IMF's support impacts Sri Lanka's economy, both directly and indirectly. Therefore, this research critically evaluates the role of the IMF in restoring the financial stability of Sri Lanka in the post-pandemic era. It has been examined here how the Covid-19 pandemic affects developing countries like Sri Lanka and why these countries need IMF support. Therefore, this research aimed to find the positive and negative effects of IMF support on Sri Lanka's economy in the post-pandemic era. As the significance of the research, it provides a lot of important information regarding the policy formulation of the governments and the way of conducting transactions with the IMF. Because IMF support is needed to help Sri Lanka address its economic crisis in the post-pandemic era. Looking at the methodology, this research is a mixed method of mixing qualitative and quantitative data and content analysis carried out using secondary data. Regarding the main findings, the study found the impact of the structural changes made by the IMF on this country. Due to structural change, political stability has been lost, and economic stability has been created in Sri Lanka. The reason was that Sri Lanka got rid of the consumption economy and turned into a capital economy. There are several other solutions that Sri Lanka could consider for restoring its financial stability instead of an IMF loan. These include debt restructuring, asset sales, diaspora bonds, tourism promotion, export promotion, domestic revenue mobilization, public expenditure reforms, etc. It is important to note that these solutions have their challenges and risks. Debt restructuring can be complex and time-consuming, and asset sales can be controversial. Diaspora bonds may not be enough to raise the money Sri Lanka needs, and tourism promotion and export promotion may take time to produce results. Domestic revenue mobilization and public expenditure reforms can be challenging to implement, especially in an economic crisis. It is also important to note that Sri Lanka is unlikely to be able to fully recover from its economic crisis without the support of the international community. Some argue that the IMF's conditions are too harsh and will only worsen the situation for the poor and vulnerable, that there are better ways to solve Sri Lanka's problems than the IMF, and that the government should focus on domestic reforms. Despite the criticism, the study concludes that IMF support is a necessary step to restoring the financial stability of Sri Lanka in the post-pandemic era.

Index Terms: Developing Countries, Financial Stability, IMF, Sri Lanka

1. Introduction

1.1 Background

The COVID-19 pandemic had thus set in motion an economic crisis of global proportions, leaving no economy immune from its negative effects. The impact of the virus was felt particularly hard in developing economies. Countries whose mainstays were sectors like tourism, exports, and remittances have faced steep falls in revenues, enlarged fiscal deficits, and reduced foreign reserves. As a middle-income developing country, Sri Lanka could not escape the acute financial instability that came tagged along with the pandemic, apart from the vulnerabilities inherent in its economy, such as unsustainable levels of debt and a meager stock of foreign currency. Before the pandemic struck, political instability, shrinking revenues, and poor fiscal management had already hit the Sri Lankan economy. (Iskyan, 2023)

These were further compounded by the pandemic, which collapsed international tourism-a key source of foreign exchange for Sri Lanka while increasing expenditures on health care and social support. This combination generated a severe balance-of-payments crisis along with inflationary pressures and mounting debt burdens. In this regard, options for post-pandemic recovery did appear dim for Sri Lanka without sizable external support, thus placing in stark vision the role of such international financial institutions as the IMF. (Reuter, 2023)

1.2 Problem Statement

The economic effects of the pandemic placed Sri Lanka on the verge of complete financial collapse and seriously damaged the country's financial stability. A sharp contraction in GDP, sky-rocketing inflation rates, and a depreciating currency furthered the economic crisis. Besides this, inability on the part of servicing foreign debt obligations triggered a loss of investor confidence, weakening the economic standing of the nation even more. It was at this time that Sri Lanka felt an immediate need for financial intervention to bring stability into its economy. The IMF was, therefore, the most important player that could offer economic reforms and recovery efforts through a 48-month Extended Fund Facility of approximately USD 3 billion in support. Though it looks sensitive, many other challenges are involved in dependence upon the facilitation of the IMF, especially regarding strict conditions which could promote socio-economic inequalities. (IMF Communications Department, 2023)

Therefore, the study has sought to identify the need for IMF intervention in Sri Lanka, while also critically appraising implications of such for financial recovery. It thus provides the ground for wider discussions on other approaches toward the resolution of such crises.

1.3 Research Objectives

The research objectives of this study are as follows.

I. Establish the level of disruption the pandemic has caused to the economy of Sri Lanka, especially in the sectors of tourism, remittances, and domestic revenue generation.
II. Determine the contribution of the IMF to restoring financial stability by reviewing measures put in place under the EFF program.
III. Assess the positive and negative impacts of IMF conditions and consequences on socio-political and economic contexts.

1.4 Research Questions

The research questions of this study are as follows.

I. What are the significant shocks that Sri Lanka's financial system faced in the post-pandemic period?
II. How much has the IMF contributed towards the stability of the Sri Lanka economy?
III. What is the positive and negative impact that IMF interventions have made in the Sri Lankan economy?

Is there some better alternative to this IMF support, and at what challenge may it juxtapose?

2. Literature Review

2.1 IMF's Role in Developing Economies

The International Monetary Fund was established in the year 1944, and with time has contributed significantly to solving many financial crises of developing nations across the globe. The programs pertaining to the stabilization of economies and restoring confidence have been laid down for sustainable growth. These normally have a set of conditions usually referred to as austerity measures, including fiscal discipline, tax reforms, monetary tightening, and structural adjustment. The work the IMF does in developing economies has seen it hailed and cursed; its interventions are critical in times of crisis but contentious due to their impact on socio-economic environments.

These include the Extended Fund Facility, Stand-By Arrangements, and Poverty Reduction and Growth Trust, among others, tailored for countries in need. For instance, the EFF provides medium-term financial assistance to countries experiencing protracted balance-of-payments difficulty. In the period 2000-2020, over 80 developing countries received such facilities with mixed results. Although some of the countries, like Mexico and South Korea, were successfully recovered from the crises, some of them, such as Greece and Argentina, have faced long socio-economic adversities, which again shows the complexity in IMF interventions. (Wigglesworth, 2024)

2.2 Economic Impact of COVID-19 on Developing Countries

The COVID-19 pandemic had triggered unparalleled economic disruptions across developing economies, largely through decreases in tourism, exports, and remittances. For example, global tourism receipts contracted 64% in 2020, and because developing countries rely very strongly on international tourism, this hits them particularly hard. In the same way, revenues from remittances declined on average by 7% in low-income countries, increasing their financial burdens. (World Bank, 2021)

Table 1: The key sectors in developing countries and their economic implications

Sector	Impact	Source
Tourism	64% decline in global receipts	World Bank, 2021
Exports	Average 20% decline in goods exports	WTO, 2021
Remittances	7% decline in low-income countries	IMF, 2021
Fiscal Deficit	Average fiscal deficits widened by 4.5% of GDP	IMF, 2022

The debt burdens also increased for developing countries, with global public debt climbing to 97% in 2021 from the 83% level in 2019 (IMF, 2022). These trends underline a deep-seated and multi-dimensional impact of the pandemic, which of course calls for stringent financial interventions such as those given by the IMF. (Kpodar et al., 2021)

2.3 Economic Crisis in Sri Lanka: Facts

While COVID-19 has accentuated this situation, the roots of economic challenges in Sri Lanka indeed go back to deeper structural vulnerabilities. Before the onset of COVID-19, Sri Lanka showed a rise in external debt, an increased trade deficit, and shrinking foreign reserves. The economic indicators, as observed from Table 2, have deteriorated vastly since the pandemic began.

This has led, for instance, to a situation where Sri Lanka, facing reduced tourism and remittances during the pandemic and reduced export earnings, is unable to service its debt obligations-a default in 2022. Intervention by the IMF through a USD 3 billion EFF was urgently needed. However, attached conditions for tax reforms and expenditure cuts, along with adjusting the exchange rate, have seen domestic unrest and political tumult. (IMF Communications Department, 2023)

Table 2: The key indicator status of Sri Lanka between pre- and post-pandemic time

Indicator	Pre-Pandemic (2019)	Post-Pandemic (2021)	Source
External Debt (% of GDP)	86%	101%	Central Bank of Sri Lanka (2022)
Tourism Revenue (USD)	3.6 billion	0.8 billion	Sri Lanka Tourism Board (2022)
Foreign Reserves (USD)	7.6 billion	2.3 billion	IMF (2022)

2.4 Criticism of IMF Programs

IMF support has been seen as crucial to the stabilization process of crisis economies, but equally criticized since its conditionality is harsh, and its socio-political consequences are dire. There are critics who say the fiscal austerity measures prescribed by the IMF fall disproportionately on poor people through the reduction in public expenditure on essential services, such as health and education (Stiglitz, 2016). For instance, in Sri Lanka, cuts to fuel and electricity subsidies called for by the IMF have provoked mass protests in 2022 and further destabilized the country.

Other studies show the impact of IMF programs on inequality in the long run. For example, Ortiz and Cummins (2020) reported that 78 percent of the countries studied had to increase income inequality due to fiscal consolidations imposed by the IMF. The most common criticisms of IMF programs and what each one implies are put together in Table 3.

Table 3: The most common criticisms of IMF programs

Criticism	Implication	Source
Austerity measures	Reduced access to essential services	Stiglitz (2016)
Focus on debt repayment	Limited investment in long-term economic growth	Ortiz & Cummins (2020)
Political instability	Public unrest due to unpopular reforms	IMF Independent Review (2022)
Inequality	Widening income disparities	Ortiz & Cummins (2020)

Political instability public unrest because of unpopular reforms (IMF Independent Review, 2022) Inequality Widening income disparities (Ortiz & Cummins, 2020) Despite these criticisms, proponents of IMF interventions argue that it provides a framework for the stabilization of economies and access to international capital markets. But taking the example of Sri Lanka, such interventions will work only when fiscal discipline is matched by socio-economic equity.

3. Methodology

3.1 Research Design

The research design shall assume a mixed-method approach to understand the effect of intervention by the IMF in the economic crisis in Sri Lanka by blending qualitative and quantitative research methods. The proposed mixed-method approach can enable this study to capitalize on the strengths of both data types and ensure holistic analysis of complex socio-economic phenomena. Qualitative data shall therefore focus on the contextual and interpretive aspects, as represented in the policy documents and reforms that go on to make up the IMF measures. Qualitative data shall then be set against quantitative data, which represents the economic outcomes comprising changes in GDP growth, external debt, and foreign reserves before and after the IMF's intervention. The design allows for the triangulation of data whereby the qualitative insights supplement or corroborate the quantitative findings. Further, the research is reliable and deep in nature.

3.2 Sources of Data

Research is based on secondary information sourced from renowned and authoritative organizations. Major sources of data include reports emanating from the IMF regarding the financial engagements, structural reforms, as well as progress of Sri Lanka under the Extended Fund Facility. The governmental publication will be very valuable to extract data on the fiscal and monetary position of Sri Lanka, especially on reports of annual budgets, Central Bank statistics, economic policy documents, etc. Full-text peer-reviewed academic articles and case studies will provide theoretical frameworks and comparative analyses of IMF programs in other developing economies. These are supplemented by news reports and think-tank analyses to capture contemporary perspectives and public sentiments about IMF interventions. In using varied secondary data, the study captures relevant aspects comprehensively.

3.3 Methods of Data Analysis

The data analysis consists of two major parts: content analysis and the assessment of economic indicators. The IMF measures are traced systematically through content analysis in order to understand the recurrence of themes and implications for the socio-economic environment in Sri Lanka. Quantitative analysis of trends in GDP growth, external debt, inflation, and foreign reserves was done before and after the intervention of the IMF in the economic indicator evaluation. In addition, comparative analyses will be provided for similar economies. Together, these approaches can potentially give a critical review of the role played by the IMF and greater implications for the recovery trajectory in Sri Lanka.

4. Data Analysis and Findings

4.1 Impact of COVID -19 on Sri Lankan Financial Stability

COVID-19 pandemic cast ominous shadows on the financial stability of Sri Lanka. As has already been discussed, in the previous year 2019, tourism accounted for a share of 12.6 percent of the GDP and was therefore critical in terms of foreign exchange supply. The slump in the industry by over 90% saw tourist arrivals fall massively and reduced government income from foreign visitors. This further worsened forex scarcity by 2021. This weakened the already strained foreign reserves since outward remittances started falling 23% between 2020 and 2021. Besides, an unsustainably high level of indebtedness was part of this pre-existing set of vulnerabilities. Accordingly, in the year 2022, more than 120% of the total debt-to-GDP ratio was reached, while foreign reserves stood at just US$1.6 billion, enough to pay for only one month of its imports. This critical fiscal pressure underlined the need for external intervention.

4.2 Role of IMF in Restoring Financial Stability

In 2023, the International Monetary Fund stepped in with a 48-month Extended Fund Facility worth $3 billion. The EFF was aimed at addressing the dual crises of debt sustainability and fiscal instability that Sri Lanka was facing. The IMF's intervention focused on the following key measures:

Reduction of Budget Deficit: Stringent fiscal consolidation measures were brought in to bring the budget deficit from 13% of GDP in 2020 to a target of 6% by 2025. In this regard, tax reforms like increasing indirect taxes such as VAT from 8% to 15%, besides efforts to broaden the base, were taken. Strengthening the Financial Sector: The IMF supported the reforms in the banking sector since risks associated with non-performing loans had risen to 11.3% by 2021.

Exchange Rate Stabilization: Introduction of flexible exchange rate mechanisms was aimed at combating persistent foreign exchange shortages and making the country's exports more competitive internationally.

These measures stabilized some macroeconomic indicators. By mid-2024, foreign reserves increased to US$3.5 billion and inflation-which had reached 69.8% in September 2022-declined to 10.2%. However, fast fiscal adjustment triggered popular protest, highlighting the socio-economic ills of the IMF's prescription.

4.3 Structural Reforms and Outcomes

The other important precondition made by the IMF was structural reform, to be in a position to rework the consumption-driven economy into a capital-driven economy. These indeed helped bring better fiscal discipline but came along with colossal short-term economic pain. Of all these reforms, one major policy-austerity measure included privatization of state-owned enterprises. Such reforms attracted foreign investment and set up a fear of job losses amidst rising inequality.

Positive Outcomes:

I. Stable Exchange Rate: After devaluation the currency the exports of Sri Lanka became comparatively competitive.

II. Improved Fiscal Disciplines: Budgetary reforms reduced borrowings from the government unduly.

Negative Outcomes:

I. Political Stability: Widespread demonstration against fiscal stinginess of raising more taxes, subsidy cuts, which is therefore volatile for Governance to persist.

II. Grievance of Common People: Withdrawals of energy and Food subsidy hit poorer households harder that widened the socio-economic divide;

4.4 Challenges Facing the IMF in Sri Lanka.

The IMF had to make a series of painful choices between economic stabilization and its socio-political consequences. Austerity measures imposed on a sensitive socio-political situation naturally brought about political and civil society resistance. Meanwhile, the reform schedule also overlapped with inflationary trends worldwide, increasing the level of expensive living. A delicate balance had to be sought incessantly between securing debt repayment and social welfare.

4.5 Alternative Solutions for Financial Stability

While the IMF played a pivotal role, other potential solutions could complement or replace IMF support.

Table 4: Consequences of other solutions

Solution	Advantages	Challenges
Debt Restructuring	Reduces immediate fiscal pressure.	Time-intensive; requires creditor cooperation.
Asset Sales	Generates short-term revenue.	Politically controversial; risk of undervaluation.
Diaspora Bonds	Taps into Sri Lankan expatriates' capital.	Limited scale; requires trust in governance.
Tourism Promotion	Boosts foreign exchange inflows.	Time-intensive recovery; reliant on global factors.
Export Promotion	Enhances long-term economic resilience.	Requires structural adjustments in industries.
Domestic Revenue Mobilization	Reduces reliance on external debt.	Politically sensitive; requires institutional reforms.
Public Expenditure Reforms	Improves efficiency in government spending.	Risk of social backlash from subsidy cuts.

While tourism and export promotions are long-term gains, it takes a while before these bear fruit. Debt restructuring and asset sale provide quick relief but entail technical and political impediments. Integrating such strategies into and with the IMF program would thereby enhance the sustainability of recovery in Sri Lanka.

4.6 Comparative Analysis

The comparative study of other developing countries, like Greece in 2010 and Argentina in 2018, where the intervention of the IMF was realized, indicates long-term difficulties of stability. While IMF-guided austerity measures restored fiscal balance for Greece, they deepened the economic contraction. In another case, despite support from the IMF, Argentina struggled with recurrent inflation. Sri Lanka runs the same risks, hence the need for socio-economic contextualism of interventions.

Long-term Implications:

I. IMF support provides fiscal relief but risks entrenching dependency on external aid.

II. Sustainable alternative solutions require robust governance and institutional capacity.

5. Conclusion and Recommendations

5.1 Summary of Findings

The study has brought out the dual nature of impacts created by the IMF programs on the recovery of Sri Lanka. Though structural reforms under the EFF restored macroeconomic stability, they also provoked socio-political challenges. Alternative solutions, though feasible, require careful consideration regarding their feasibility and implementation challenges.

5.2 Policy Implications

I. For the Sri Lankan Government: Balance fiscal reforms with social safety nets to mitigate public backlash. Develop long-term strategies for export diversification and revenue mobilization.

II. For the IMF: Tailor program conditions to minimize socio-political disruptions. Incorporate flexibility to address unique national contexts.

5.3 Future Research Directions

Long-term, far-reaching socio-economic effects of IMF reforms in future studies may target the comparison of the recovery trajectory of Sri Lanka to that of other developing countries. Similarly, innovative financing mechanisms like climate-linked bonds are worth studying for compatible options for recovery with sustainability.

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