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SOMMAIRE

SRI LANKA, PAKISTAN AND BANGLADESH: WEAKENED ECONOMIES HIGHLY VULNERABLE TO SHOCKS

Johanna Melka

Apart from being located in South Asia, Sri Lanka, Pakistan and Bangladesh have the common weakness of being very vulnerable to exogenous shocks, particularly those related to the commodity cycle and climate change.

The Covid-19 epidemic and the very sharp rise in commodity prices in 2021 and 2022 have therefore exacerbated the macroeconomic imbalances of these countries, whose public finances and external accounts were already fragile. Consequently, Sri Lanka defaulted on its external debt in 2022. This is not yet the case in Pakistan, although the risk is very high. As for Bangladesh, it has been much more resilient to shocks than its two neighbours and should escape a default.

SRI LANKA, PAKISTAN AND BANGLADESH: WEAKENED ECONOMIES HIGHLY VULNERABLE TO SHOCKS

Apart from being located in South Asia, Sri Lanka, Pakistan and Bangladesh have the common weakness of being very vulnerable to exogenous shocks, particularly those related to the commodity cycle and climate change. The Covid-19 epidemic and the very sharp rise in commodity prices in 2021 and 2022 have therefore exacerbated the macroeconomic imbalances of these countries, whose public finances and external accounts were already fragile. Consequently, Sri Lanka defaulted on its external debt in 2022. This is not yet the case in Pakistan, although the risk is very high. As for Bangladesh, it has been much more resilient to shocks than its two neighbours and should escape a default.

THE CAUSES OF THE CRISIS: STRUCTURAL WEAKNESSES ACCENTUATED BY EXTERNAL SHOCKS

Public finances and external accounts are structurally fragile in Sri Lanka and Pakistan, and to a lesser extent in Bangladesh. All three receive international financial support.

From an accelerated deterioration in public finances...

The public finances of South Asian countries are fragile, especially those of Sri Lanka and Pakistan. The fiscal position in Bangladesh is much more comfortable, although it has deteriorated since 2018 due to higher capital expenditure.

Over the past five years, the average fiscal deficit has reached 9.3% of GDP in Sri Lanka, 7.7% of GDP in Pakistan and 4.5% of GDP in Bangladesh. Bangladesh's government debt remains moderate (33.1% of GDP). However, it is high in Pakistan (71.4% of GDP) and even higher in Sri Lanka (113.8% of GDP). In addition, guarantees state owned companies reach 11% of GDP in Sri Lanka compared with 5% of GDP in Bangladesh and 2.6% in Pakistan.

Structurally, the governments of these three countries have very limited fiscal leeway to deal with domestic and external shocks. Their fiscal base is low: fiscal revenue is between 8.4% of GDP (in Bangladesh) and 12% of GDP (in Pakistan), and the share of rigid expenditure is high (all incompressible expenditure accounts for at least 58.2% of total expenditure in Bangladesh and up to 86.7% of total expenditure in Pakistan), mainly due to very high interest burden on government debt.

Pakistan's debt is particularly vulnerable to an interest rate shock as 64% of domestic debt is made up of floating-rate securities (27% in the case of Sri Lanka and less than 10% in the case of Bangladesh's debt).

Furthermore, Sri Lanka and Pakistan's debt are particularly vulnerable to an exchange rate shock, as the proportion of their debt denominated in foreign currencies stands at 45% and 37% compared with less than 20% in Bangladesh. Prior to the start of the strong political tensions in 2022, Pakistan benefited from an advantage over its neighbours: its financial market was sufficiently developed to finance its fiscal deficit. Since 2022, the sharp rise in risk premiums on sovereign bonds and political instability have made debt issuance on the domestic market more difficult and costly.

Structurally fragile, public finances in Bangladesh and Sri Lanka weakened before the Covid-19 crisis.

Expansionary fiscal policies driving the deteriorating in public finances

In Sri Lanka, the deterioration began in 2019. Indeed, the fiscal deficit increased by 4 points of GDP, going from 5% of GDP in 2018 to 9% of GDP in 2019 due, on the one hand, to the drop in revenues caused by the contraction in economic activity following the attacks in April and, on the other hand, to the rise in government investments. In addition, the fiscal policy adopted by the elected government at the end of 2019 (lowering the VAT rate and reducing taxation on household income and corporate profits) generated a very significant reduction in fiscal revenues in 2020 already weakened by the Covid-19 epidemic (-3.5 points of GDP). The subsequent downgrading of the sovereign rating and the depreciation of the rupee increased the cost of debt servicing and accentuated the State's difficulties in financing itself. From 2020, the Sri Lankan government could no longer issue debt on international markets. At the end of 2022, the fiscal deficit reached 10.2% of GDP.

FISCAL RECEIPTS

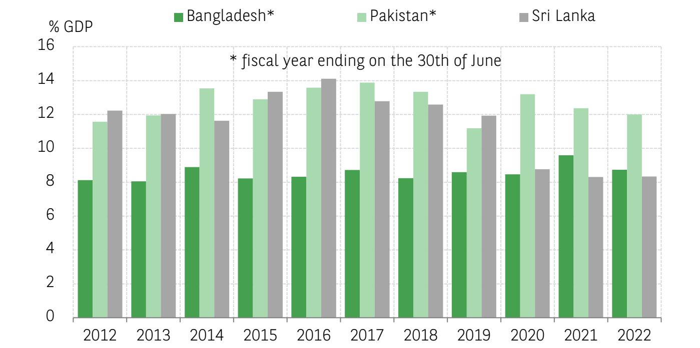

CHART 1 SOURCE: MOF, IMF, BNP PARIBAS

FISCAL EXPENDITURES

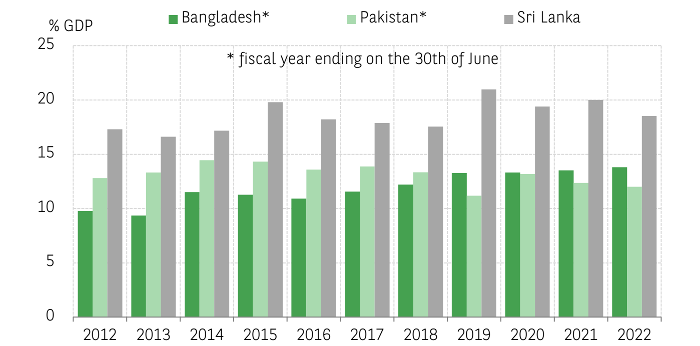

CHART 2 SOURCE: MOF, IMF, BNP PARIBAS

FISCAL BUDGET BALANCE

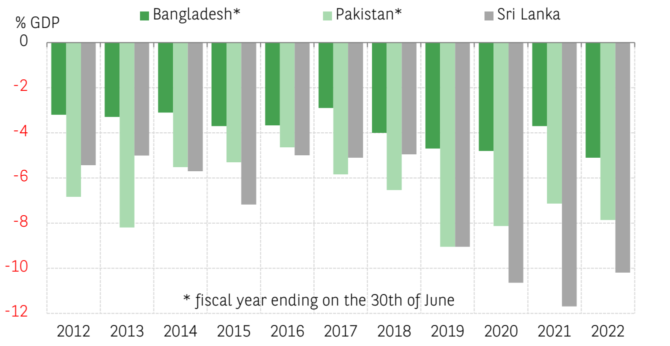

CHART 3 SOURCE: MOF, IMF, BNP PARIBAS

INTEREST PAYMENTS ON DEBT

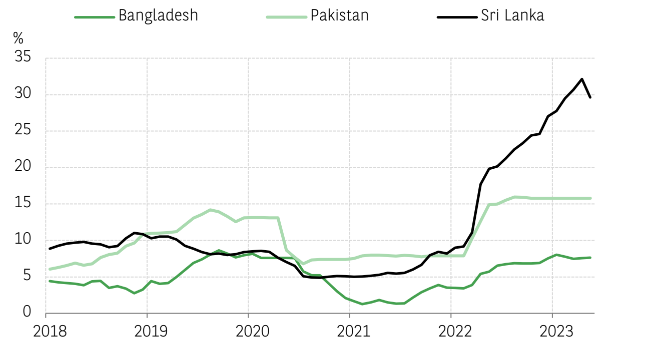

CHART 5 SOURCE: MOF, IMF, BNP PARIBAS

GOVERNMENT DEBT

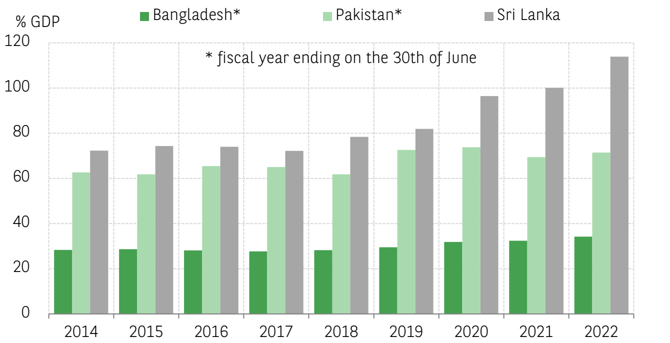

CHART 4 SOURCE: MOF, IMF, BNP PARIBAS

GOVERNMENT BONDS YIELDS (1 YEAR)

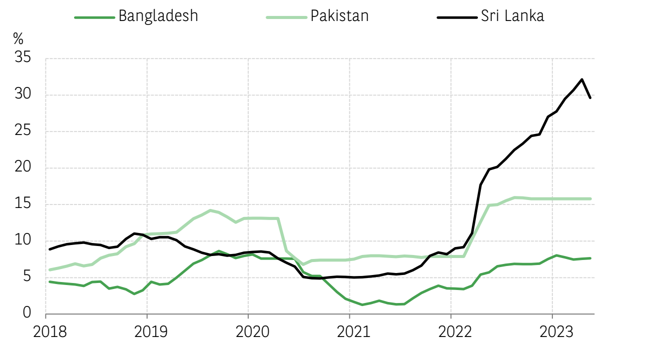

CHART 6 SOURCE: MOF, IMF, BNP PARIBAS

Bangladesh's public finances, although much stronger than Sri Lanka's, deteriorated from 2018 on account of the government's rising capital expenditure even though its revenues did not increase. In five years, the budget deficit thus increased by 2.2 points of GDP to reach 5.2% of GDP in 2022. In addition, to reduce the cost of interest payment on government debt, the government reduced the share of National Savings Certificates in favour of international loans denominated in foreign currency, which had lower interest rates. In doing so, its debt is now more vulnerable to an exchange rate shock. The share of foreign currency debt reached 36.5% of total debt at the end of 2022, i.e. 20 percentage points (pp) more than five years earlier.

Finally, in Pakistan, the deficit was already very high before the pandemic (7.9% of GDP).

Worsening budgetary imbalances due to the Covid-19 outbreak and rising commodity prices

The two shocks of the pandemic in 2020-2021 and the rise in commodity prices in 2021-2022 have further weakened the public finances of the three countries.

The Covid-19 outbreak has led to increased public spending in the form of, among other things, financial subsidies to the most disadvantaged households and subsidised loans (in addition to healthcare expenditure). These additional costs are estimated at 5% of GDP in Bangladesh and 2.1% of GDP in Sri Lanka (over 2020 and 2021). In Pakistan, on the other hand, the cost was limited, as the increase in the fiscal deficit was only 0.8 pp of GDP in the 2021/2022 financial year. Indeed, the government quickly suspended the measures to increase civil servants' salaries and the tax exemptions it had introduced in early 2022 in order to obtain the IMF's Extended Fund Facility.

In addition to the increase in expenditure to support activity and people's incomes, revenues fell due to the economic slowdown, the drop in excise duties revenues caused by the contraction in trade, and the collapse in tourism revenues. As such, Sri Lanka was particularly affected. Between 2019 and 2021, its fiscal deficit increased by 2.7 points of GDP even though the published data does not allow us to dissociate the impact induced by the expansionary budgetary policy, adopted by the government at the end of 2019, from the negative effect of the absence of tourists.

The sharp rise in commodity prices (+65% between the level recorded at the end of 2019 and that reached mid-2022), along with the global economic recovery in 2021, and accentuated by the conflict in Ukraine in February 2022, constituted the second exogenous shock. It led to i) a (temporary) increase in public spending, ii) an increase in the cost of interest burden on government debt (due to the subsequent monetary tightening) and iii) an increase in the value of external debt (induced by the depreciation of currencies).

Indeed, in an attempt to limit the impact of the rise in international commodity prices on household purchasing power, which was already weakened by the Covid-19 epidemic, the three governments sought to control rises in energy and food prices. This policy, which was too expensive for their public finances, could not be maintained for a very long time; it was abandoned in April, May and August 2022, in Sri Lanka, Pakistan and Bangladesh respectively. The subsequent increases in food and energy prices were passed on to all domestic prices. These reached unprecedented levels, particularly in Sri Lanka, where the very sharp depreciation of the rupee significantly amplified imported inflation (in 2022, the rise in consumer prices reached 7.7% in Bangladesh, 19.7% in Pakistan and 49.9% in Sri Lanka).

In order to contain inflationary pressures, central banks tightened their monetary policy, de facto leading to a sharp rise in interest payments on debt. In Pakistan (more exposed to a rate shock given the structure of its domestic debt), the interest charge increased by more than 15 pp between July and December 2022 to account for more than 50% of fiscal revenue. In Sri Lanka, this burden, which was already very high before the pandemic, reached the unsustainable level of 77.8% of government receipts. By comparison, interest payments accounted for only 20.4% of revenue in Bangladesh.

In addition, rising commodity prices, exacerbating external imbalances and downward pressures on exchange rates, have significantly increased foreign currency debt. This is particularly the case for the Sri Lankan government's external debt, whose rupee value increased by more than 91% due to the currency effect alone. Since the end of 2019, Sri Lanka's debt has increased by 31.9 points of GDP and Bangladesh's by 7.5 points of GDP, while Pakistan's debt (relative to GDP) has remained relatively stable over the same period.

... to the erosion of external liquidity

The external accounts of these three countries are structurally fragile, although those of Bangladesh are stronger.

In Pakistan and Sri Lanka, short term external financing needs (sum of current account deficit and external debt amortisation) far exceed foreign exchange reserves. The latter do not even guarantee the payment of debt servicing alone, including for Pakistan, whose debt is relatively modest (at the end of 2022 it stood at 33.5% of GDP compared to almost 64% of GDP in Sri Lanka). In addition, foreign direct investment (FDI) flows are structurally lower than the current account deficit. Covering all their short-term external financing needs therefore remains conditional on private external loans (public loans being by their nature less volatile) and/or portfolio investments, which are much more volatile than FDI flows.

Bangladesh's external accounts are a priori structurally stronger than those of Pakistan and Sri Lanka because its foreign exchange reserves are sufficient to cover its external financing needs at less than one year. However, the country remains vulnerable to external shocks as FDI does not cover the current account deficit.

Furthermore, these three countries are highly dependent on worker remittances, which in the last five years have reached 5% of GDP in Bangladesh and 7.4% in Pakistan.

Finally, these countries have specific features that make them more vulnerable to external shocks: Sri Lanka is highly dependent on tourism revenue (4.6% of GDP in 2018) and Pakistan exports (like those in Bangladesh) are concentrated on textile products (cotton for Pakistan).

Worsening of external imbalances due to exogenous shocks

Sri Lanka's external accounts started to deteriorate after the terrorist attacks in April 2019 which caused a drop in tourism revenues. The closure of borders in 2020–2021 and the consequent collapse of tourism, the drop in exports (in 2020) and the sharp rise in commodity prices in 2021 (accentuated in the first half of 2022) increased external imbalances in these three countries.

In an attempt to contain the deterioration of their external accounts, the governments of Sri Lanka (in 2020), Pakistan and Bangladesh (in 2022) implemented capital controls and imports of non-essential goods and adopted measures restricting the activity of energy-intensive companies.

Despite these measures, the current account deficit reached 5.2% of GDP in Sri Lanka in the first quarter of 2022 (i.e. an increase of 3.2pp in a year) and 4.6% of GDP in Bangladesh and Pakistan at the end of the 2021/2022 financial year ending on 30 June 2022 (i.e. 3.6pp and 3pp more than a year earlier respectively). Furthermore, the flooding in Pakistan in autumn 2022 reduced exports of cotton and textile products.

To contain the risks of revaluation of their external debt, the central banks of these three countries chose to peg their exchange rate to the

CURRENT ACCOUNT BALANCE

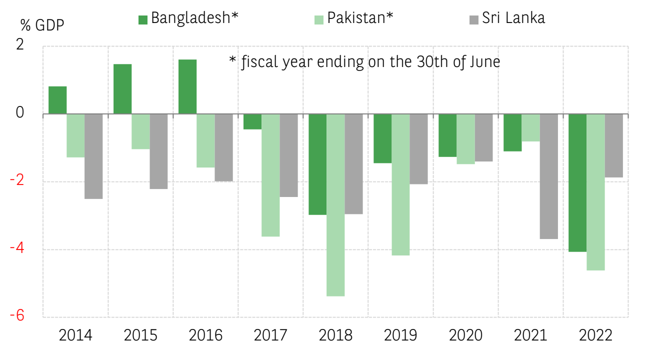

CHART 7 SOURCE: CENTRAL BANKS, IMF, BNP PARIBAS

EXCHANGE RATE PER USD

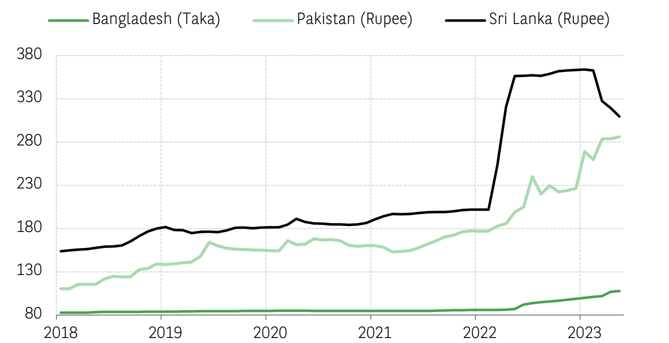

CHART 8 SOURCE: CENTRAL BANKS, BNP PARIBAS

US dollar (as from 2020 for Sri Lanka). The maintenance of fixed parity thus accelerated the drop in their foreign exchange reserves. Moreover, the adoption of this policy did not ultimately prevent the depreciation of the official exchange rate. Worse still, it favoured the emergence of parallel exchange rates, which discouraged the inflow of workers remittances.

Finally, monetary tightening in the United States and the eurozone, adopted in 2022 to cope with the sharp rise in inflationary pressures, led to a drop in global liquidity. Financial investment flows (FDI and portfolio investments) to emerging countries have thus been reduced, in particular for the most fragile countries, including the three countries under review.

In total, the increase in short term external financing needs led to an 84.5% fall in foreign exchange reserves in Pakistan (between August 2021 and February 2023), 78.5% in Sri Lanka (between February 2020 and October 2022) and 35.6% in Bangladesh (between August 2021 and today), which did not prevent the Sri Lankan and Pakistani rupees, and the Bangladeshi taka from depreciating by 44.4%, 21.6% and 13.2% respectively in 2022. Finally, Sri Lanka was forced to default on its external debt (announced in April and materialising in May 2022), Pakistan had to comply with the IMF's requirements to avoid defaulting on its debt and Bangladesh requested IMF assistance to consolidate its balance of payments to avoid a balance of payments crisis.

FOREIGN EXCHANGE RESERVES

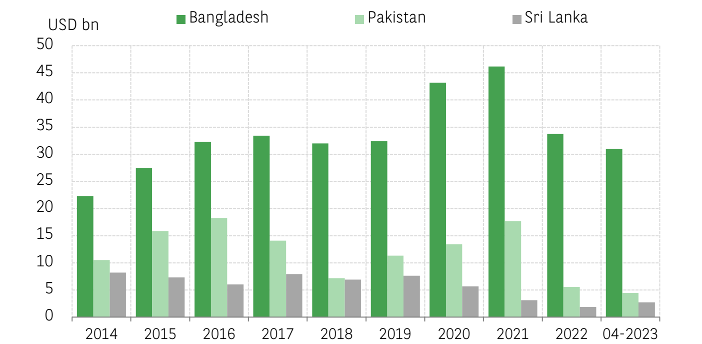

CHART 9 SOURCE: CENTRAL BANKS, IMF, BNP PARIBAS

EXTERNAL DEBT

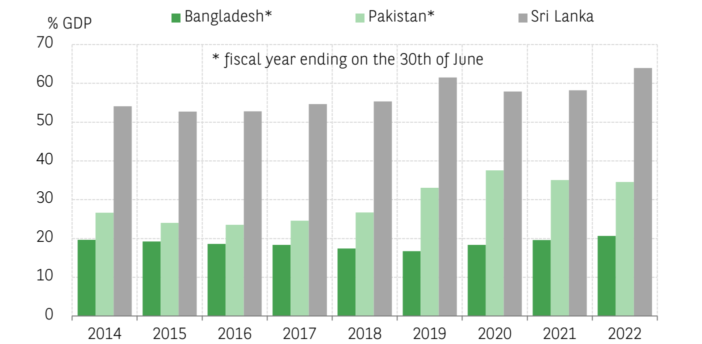

CHART 10 SOURCE: CENTRAL BANKS, BNP PARIBAS

COUNTRIES FAR FROM BEING OUT OF THE WOODS

Sri Lanka, Pakistan and Bangladesh are far from being out of the woods, although the former is currently negotiating a debt restructuring and all three are receiving financial support from the IMF.

The economic situation in Sri Lanka is particularly fragile. The country should record a further contraction in its economic activity in 2023 (-3% according to the IMF), its inflation rate remains very high (33.6% in April 2023) and the poverty rate (set below the threshold of USD 3.65 per day) should reach 27.5% in 2023, according to the World Bank, while it stood at 13% in 2021. In addition, negotiations on the restructuring of its external debt (started in May 2023) will be decisive.

Furthermore, the banking sectors of these three countries are heavily exposed to sovereign risk. Indeed, the value of the government debt has fallen significantly, reducing the value of their assets. Significant recapitalisation needs could emerge in the coming months, further weakening public finances while governments' fiscal leeway is extremely constrained.

External accounts are still very fragile

Since mid-2022, the external financing needs of these three countries have fallen. The constraints on imports of goods and services associated with the slowdown or even contraction of economic activity (-8.3% in Sri Lanka in 2022) enabled the current account deficit of these three economies to be significantly reduced; in spring 2023, Pakistan and Bangladesh even recorded a surplus.

At the same time, foreign exchange reserves in Pakistan and Sri Lanka have increased, reflecting rising tourism revenues, workers remittances, and loans received from international creditors (bilateral, multilateral, and private creditors, including Chinese).

Although slightly improving, the situation in Pakistan and Sri Lanka remains extremely fragile and vulnerable to any new external shocks. Their foreign exchange reserves, although slightly up since the beginning of 2023, remain at a particularly low level. In April 2023, they reached the equivalent of only 1 month of goods and services imports. It's hardly more than at the height of the balance of payments crisis, which hit both countries when their foreign exchange reserves had fallen to just two and a half weeks of imports of goods and services. Furthermore, the reserves are still very insufficient to meet the short-term external financing needs (unless the government of Sri Lanka were able to obtain very satisfactory arrangements regarding the restructuring of its external debt).

The situation in Bangladesh also remains worrying because, unlike the two neighbouring countries, it has been deteriorating continuously for a year, even though foreign exchange reserves remain a little more comfortable. They covered only 3.9 months of imports of goods and services in April 2023 compared to 8.4 months two years earlier.

Ongoing restructuring of Sri Lanka's debt

Since the end of 2022, pressures on Sri Lanka's external accounts have eased and the rupee has recovered against the US dollar. This consolidation can be explained by the suspension of payment to service the external debt since the declaration of default in 2022 but also by i) the significant drop in the current account deficit, ii) a first payment in March 2023 of USD 333 million from the IMF (under the USD 3 bn credit facility granted to the country for a 48-month period), iii) the start of discussions in May 2023 with international and domestic creditors for the restructuring of public external debt.

However, the country's external accounts remain extremely fragile, as evidenced by the IMF's decision to allow the central bank to maintain control over capital movements and foreign exchange transactions (conversion of the rupee into foreign currency). This was even if the central bank abandoned pegging the rupee to the dollar.

According to IMF estimates, a reduction in external debt servicing of between USD 3.4 and USD 3.6 bn is essential to enable the country to cover its external financing needs over the next three years. Indeed, without restructuring its external debt, debt servicing alone is estimated at between USD 3.7 bn and USD 4.3 bn per year (2023–2025) while foreign exchange reserves stood at USD 2.7 bn at the end of April.

To reach the debt servicing relief range, the Sri Lankan government's objective is to achieve a restructuring of around USD 31 bn in debt stock (equivalent to 68% of total external debt). Bilateral debt and that of private creditors (international bonds and domestic bonds issued in foreign currency, "Sri Lanka Development bonds") are affected by these restructuring programmes. Domestic debt in local currency should also be restructured, including short and long-term securities held by the central bank and commercial banks. Given that around ¾ of the interest is on domestic debt, including domestic debt in the restructuring programme would accelerate the consolidation of public finances and avoid having the full weight of the restructuring borne by external creditors.

Pakistan: still waiting for the IMF funding line to be unblocked

Mid-June 2023, the government was still awaiting the findings of the ninth review of the IMF's Extended Fund Facility, which had been suspended since November 2022, as the government was failing to comply with the fund's budgetary consolidation requirements. At the beginning of 2023, the IMF asked the Government of Pakistan to provide evidence of the financial commitment of its official bilateral lenders (including China and Saudi Arabia) to enable it to cover all its external financing needs by the end of June. Even though, to date, the government seems to have fulfilled the IMF's requests, the unblocking of USD 1.2 bn of the USD 2.6 bn which the country could still claim by the end of the current programme (initially set at June 2023) has still not occurred. The presentation, at the beginning of June, of the budget for 2023/2024 also seems very far from the targets defined by the IMF and could constitute a further obstacle to any new IMF commitment. It is now likely that the IMF's programme will end on 30 June without an agreement on the 9th and 10th reviews, and therefore the government will not receive the expected funds. However, even without IMF financial support, Pakistan should be able to meet its financing needs until the end of June. On the other hand, the risk of default remains very high, especially if the government fails to convince the IMF. The rating agencies and the IMF estimate the need for external financing as close to USD 30 bn per year over the next three fiscal years (including USD 20-25 bn in debt servicing alone) while foreign exchange reserves stood at only USD 4 bn at the end of May 2023. Whether it can cover its short- and medium-term foreign currency financing needs will strongly depend on whether it can obtain further foreign loans. Indeed, the government is unable to issue on international financial markets given the political situation which remains extremely conflicted, the prospect of further elections in October 2023 and the very high level of interest rates. Three-year yields on government bonds reached 19.9% at the end of May 2023 (compared to 13.6% a year earlier).

Bangladesh: continued decline in foreign exchange reserves

Faced with the deterioration of its external accounts, the government of Bangladesh also called on the IMF in mid-2022. At the end of January 2023, the Executive Committee approved a 42-month ECF/EFF plan for a total of USD 3.3 bn and an RSF (Resilience and Sustainability Facility) plan of USD 1.4 bn (to finance the investments necessary to combat climate risk), giving rise to an instant payment of USD 476 million.

Since December 2022, the country's current account has recovered significantly (-74.6% between July 2022 and March 2023 compared to the same period last year), reflecting the economic slowdown and the very high constraints on imports. However, foreign exchange reserves continued to fall, despite funds received from the IMF. Indeed, the contraction in imports led, de facto, to a significant drop in commercial lending in foreign currencies. Furthermore, given the sharp rise in interest rates, the government has limited international borrowing as much as possible in the medium and long term. Over the first nine months of the current fiscal year (July 2022-March 2023), the financial account recorded a deficit while it posted a surplus at the same time last year. The deficit in overall the balance of payments (excluding FX reserves changes) was multiplied by 2.6 and foreign exchange reserves fell to USD 29.9 bn at the end of May 2023.

One of the conditions imposed by the IMF to continue to disburse funds under the extended credit facility is that the country's net foreign exchange reserves[1] must have increased by USD 1.5 bn between January and June 2023, to reach USD 24.4 bn at the end of June. However, the central bank of Bangladesh is not publishing such figures. Nevertheless, gross foreign exchange reserves fell by USD 2.3 bn between January and May 2023.

In addition, even if the government announced that it was able to negotiate to obtain new loans from multilateral lenders (World Bank, Asian Infrastructure Investment Bank, Japan International Cooperation Agency) for an amount of USD 1 bn, this may not be sufficient to achieve the target set by the IMF.

However, gross foreign exchange reserves are still largely sufficient to cover the external debt service of the country as a whole, estimated at less than USD 5 bn per year over the next three years (USD 3.2 bn for the public sector alone). On the other hand, the depreciation of the taka against the dollar is more worrying as it increases inflationary pressures and increases the exchange value of external debt in local currency. Between January 2023 and May 2023, the taka continued to depreciate by 8.2% against the dollar, bringing the increase in the exchange value to over 20% since January 2022.

Vulnerable banking sectors

The banking sectors of these three countries are structurally fragile. The institutional environment is weak and monetary policy is not very effective. In these three countries, the quality of banking assets is low, especially those of public banks.

In Sri Lanka, the ratio of non-performing loans increased by 6pp in two years to 10.9% of total credits at the end of 2022. Over the same period, it rose by only 0.5pp in Bangladesh (to 8.2%) and fell by almost 2pp in Pakistan to 7.3%. However, asset quality is even more fragile in public banks, where these ratios reached 13.2%, 20.3% and 14.7% respectively in Sri Lanka, Bangladesh and Pakistan at the end of the year. In Sri Lanka, the end of the moratorium on loan repayments at the end of

1 Net foreign exchange reserves exclude, in particular, bank deposits with the central bank and investments that are not considered investment grade.

NON-PERFORMING LOANS

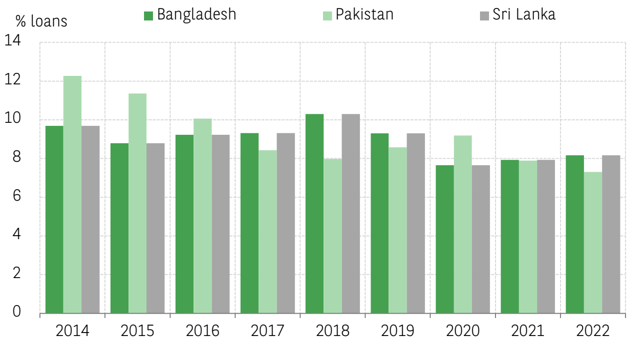

CHART 11 SOURCE: CENTRAL BANKS, BNP PARIBAS

CAPITAL ADEQUACY RATIOS

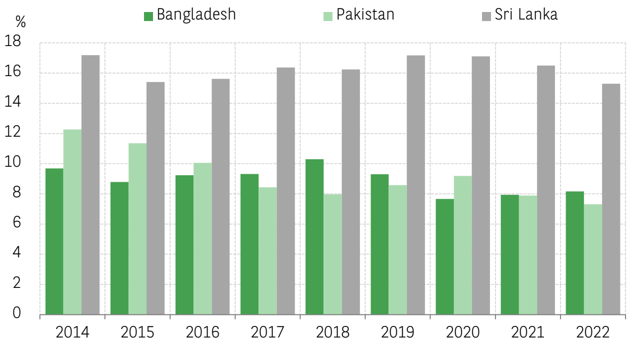

CHART 12 SOURCE: CENTRAL BANKS, IMF, BNP PARIBAS

2021, excluding the tourism and transport sectors, and six months later for tourism and the transport sector also partly explains this sharp deterioration in the quality of banking assets.

Officially, solvency ratios in Sri Lanka and Pakistan remained satisfactory at the end of 2022. Indeed, capital adequacy ratios (CAR) reached 15.3% and 17%, respectively, which was not the case in Bangladesh (the CAR ratio overall was 11.8% and only 6.8% in public banks, a level well below the regulatory threshold of 12.5%).

Furthermore, although Pakistani banks appear relatively stronger than those in Sri Lanka and Bangladesh, they are much more exposed to sovereign risk. At the end of 2022, claims on the government accounted for 65.8% of the banking sector's total domestic claims in Pakistan compared to 40.1% in Sri Lanka (State and public companies) and only 21.5% in Bangladesh. However, the financial losses of banks, caused by the drop in the value of the sovereign bonds they hold, have reduced the value of their assets, which should lead to a significant need for recapitalisation and have an impact on the distribution of credit in the short and medium term. The IMF estimates the recapitalisation needs of the banking sector in Sri Lanka to be 6% of GDP. More than two thirds of Sri Lanka's government banking sector exposure is debt denominated in domestic currency, which has not been provisioned. Similarly, non-bank financial companies are also very exposed to sovereign risk. Pension funds are the largest holders of debt in local currency. The Employees' Provident Fund (EPF) holds 29% of government bonds in local currency and invests 94% of its funds in these securities. Similarly, 43.5% of insurance company assets are made up of government debt. The restructuring of Sri Lanka's public debt (including domestic debt) could thus have serious consequences for the banking and non-banking financial sectors, and consequently its ability to finance the economy.

Pakistan's public banks may also have significant recapitalisation needs in the coming months, even though the government's ability to support them has significantly decreased. However, the fragility of public banks particularly affects the financing of the economy because the liquidity of the banking sector is concentrated within these public institutions. Already facing significant foreign currency liquidity problems, banks have been forced to limit their foreign currency credits, which penalises economic activity.

IMF loans conditional on ambitious targets

Sri Lanka and Bangladesh must meet the targets set by the IMF at the risk of seeing the aid granted under the extended credit facilities frozen. However, these targets are very ambitious both in terms of reducing the deficit of the primary fiscal balance (fiscal deficit excluding payment of interest on debt) and in terms of reducing external imbalances, which will have to be reflected in both Sri Lanka and Bangladesh by an increase in foreign exchange reserves (see table 3 below). As the IMF's current financial assistance programme for Pakistan will be completed at the end of June, it is not setting such targets.

CONCLUSION

Financially supported by international organisations, the economies of Sri Lanka, Pakistan and, to a lesser extent, Bangladesh, remain very fragile.

In Sri Lanka, restructuring of its debt is essential to avoid a new balance-of-payments crisis and further weakening a banking sector that is highly exposed to sovereign risk.

For its part, Pakistan remains at the mercy of its international creditors, whose financial flows are essential for it to cover its external financing needs and, in particular, debt repayments denominated in foreign currency. However, the political instability, which could extend beyond the elections scheduled for October 2023 at the latest, could jeopardise the adoption of a new IMF aid programme.

Finally, although Bangladesh's macroeconomic and financial situation is less fragile than that of its neighbours, the continued deterioration of its external accounts is worrying. In addition, the IMF's budgetary and external consolidation targets are very ambitious and could be difficult to achieve.

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STRUCTURE OF GOVERNMENT EXTERNAL DEBTS IN 2021 (% TOTAL EXTERNAL DEBT)

	Multilateral creditors	Official bilateral creditors	Bondholders	Foreign banks
Bangladesh	**53.4%**	**38%** of which: Japan: 40.3% China: 22.2% Russia: 18.8%	**8.6%**	**0%**
Pakistan	**37.2%**	**39.3%** of which: China: 67.3% Japan: 14.1%	**8.8%**	**14.7%**
Sri Lanka	**27.3%**	**30,5%** of which: China: 44.9% Japan: 25.4% India: 9.8%	**42.2%**	**0%**

TABLE 1

SOURCE: INTERNATIONAL DEBT SERVICE, WORLD BANK

QUANTITATIVE OBJECTIVES SET BY THE IMF UNDER THE EXTENDED CREDIT FACILITIES

	Financials	External accounts	Banking industry
Bangladesh	The primary deficit should not exceed 3.3% of GDP from FY2024 (compared to 3.8% expected for the current budget year, which will end on 30/06/2023).	Quantitative objectives for net foreign exchange reserves (USD 24.462 bn in June 2023, USD 25.316 bn in September 2023 and USD 6.811 bn in December 2023). Payment arrears must be nil.	
Sri Lanka	Drop in the primary deficit to 0.7% of GDP in 2023 (compared to 3.8% of GDP in 2022) and surplus of 0.8% of GDP in 2024 and 2.5% of GDP in 2025. Payment of all arrears on expenditure made by the end of June 2023. Government debt must be reduced to 95% of GDP by 2032 (compared to 128% of GDP in 2022 according to the IMF). Government financing needs to be reduced below the threshold of 13% of GDP from 2027 compared to 34.5% of GDP in 2022. Foreign currency debt servicing to be reduced to 4.5% of GDP from 2027.	The central bank's foreign exchange intervention will be extremely constrained (only to limit too high volatility). Targets for net foreign exchange reserves. The IMF estimates that they were loss-making at USD 3.54 bn at the end of 2022. This deficit in reserves should be reduced to USD 3.188 bn in March 2023, USD 2.8 billion in June 2023, USD 2.1 bn in Q3-23 and USD 1.6 bn in Q4-23.	Adoption of a limit on financing by the government's central bank. At the end of 2022, purchases by the central bank of government debt on the primary market had reached 14% of GDP.

TABLE 2

SOURCE : BNP PARIBAS

STRUCTURE OF PUBLIC DEBT IN SRI LANKA

	% of GDP	% total
Total public debt	**128.1**	**100**
External (foreign law)	63.6	49.6
Multilateral creditors	**17.6**	13.8
Bilateral creditors	**17.5**	13.7
Paris Club	7.3	5.7
o/w Japan	4.3	3.4
Non-Paris Club	**10.2**	**7.9**
o/w China	6.9	5.4
o/w India	2.8	2.2
Private creditors	**25.3**	**19.8**
Bonds	20.5	16.0
o/w China Development Bank	4.4	3.5
Central Bank bilateral currency swaps	**3.1**	**2.4**
Domestic debt (local law)	64.6	50.4
Debt in domestic currency	**58.3**	**45.5**
T-bills	17.4	37.4
o/w Central Bank of Sri Lanka	11	8.6
T-bonds	36.8	28.7
Loans	3	2.3
o/w contingent liabilities	2.7	2.1
Debt in foreign currency	**6.2**	**4.9**
o/w Sri Lanka Development Bonds (SLDB)	1.7	1.3
Loans	4.5	3.5

TABLE 3

SOURCE: BNP PARIBAS

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