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South-South Integration and the SDGs: Enhancing Structural Transformation in Key Partner Countries of the Belt and Road Initiative

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Dhamikka Nanayakkara

Assistant Governor,
Central Bank
Sri Lanka

Debt Management and Debt Sustainability
The Sri Lankan Experience

Abstract

Between 2008 and 2018, the debt stock of Sri Lanka's central government rose rapidly, given the need to finance persistent budget deficits and public investments in infrastructure. Apart from explaining the reasons for debt increase, this paper presents the change in the composition of borrowing during the analysed period. Moreover, it sheds light on the debt sustainability of Sri Lanka, which has been impacted by the depreciation of the rupee, the diminished ability to secure low-cost concessionary foreign financing and the country's increasing dependence on foreign commercial debts. Finally, the paper examines the road towards fiscal consolidation in Sri Lanka, as well as how to re-establish debt sustainability.

Key words: debt sustainability, Sri Lanka, fiscal trade-offs

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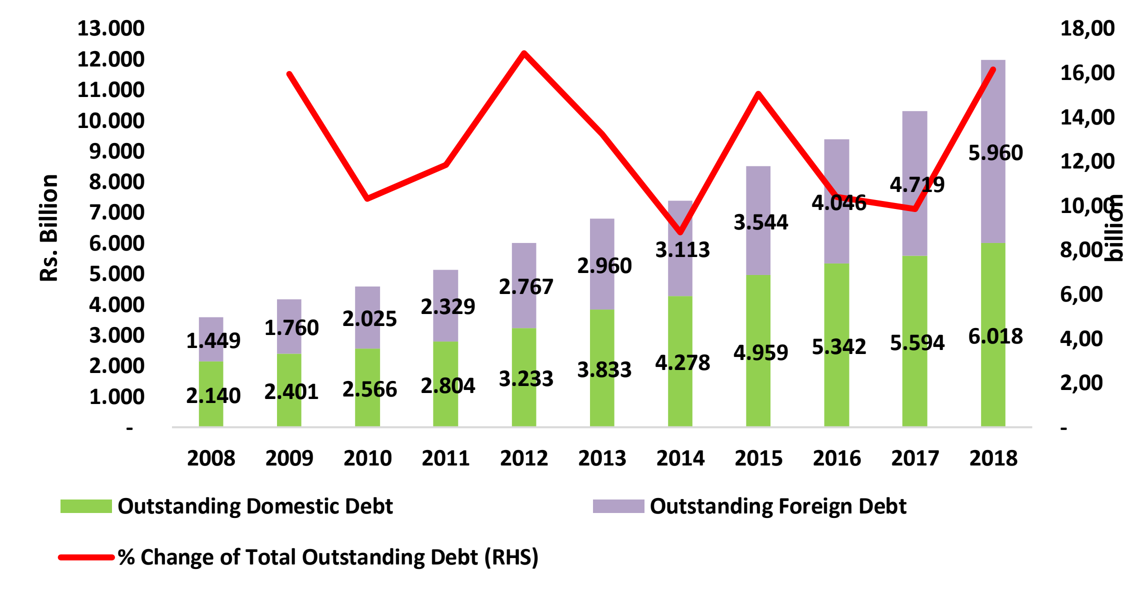
1. Overview of the Sri Lankan public debt portfolio

This paper explores the rise in the indebtedness of the central government in Sri Lanka over the period from end 2008 to end 2018, discussing the change in composition of borrowing, challenges faced and the road towards fiscal consolidation and debt sustainability ahead.

At the end of 2008, the total debt stock of the government was Rs. 3,589 billion which as a share of GDP, was 81.4 per cent. Of this debt stock, Rs. 2,140 billion (59.6 per cent) was domestic debt (by source) and the balance of Rs. 1,449 billion (40.4 per cent) was foreign debt (by source). Domestic debt stock had an overall duration of less than two years and was consisted of Treasury bills (19 per cent) with an average maturity of less than six months, Treasury bonds (60 per cent) with an average maturity of less than two years, and Sri Lanka Development bonds (7 per cent), Rupee Loans (6 per cent) and other loans (8 per cent). Similarly, the foreign loan stock at end 2008 had Rs. 1,227.2 billion taken on concessionary terms (84.7 per cent), including less than 1.0 per cent interest cost and up to 40-year repayment period with 2 – 16-year grace period. About 37 per cent of the total foreign debt stock at end 2008 was in Special Drawing Rights (SDR) while the share of Japanese Yen (JPY) and United States dollar (USD) denominated debt stood at 31 per cent and 18 per cent, respectively.

The rapid increase in the government debt stock during the period under consideration is depicted in the Chart – 1 and the Appendix 1. Total government debt stock increased by Rs. 8,389 billion (233.7 per cent) from Rs. 3,589 billion at end 2008 to Rs. 11,978 billion at end 2018. This rapid increase was due to new borrowings to finance the government's aggressive infrastructure development drive since 2008 that resulted in persistent budget deficits. The public-sector investments, mainly in such infrastructure as roads, telecommunication, electricity, ports and airports, and water etc. was increased to around 6.5 to 7.0 per cent of GDP during the period under review compared to about less than 3 per cent of such investments before. Sri Lanka experienced a 30-year internal conflict, ended in May 2009, and there was little or no visible investment made in country's infrastructure during this period. More importantly, soon after the ending of the conflict, the government had to make a substantial investment in infrastructure and social programmes in the conflict affected areas that represents about one-third of the land area of the country. In addition to the new borrowing, factors such as discount effect - issuances of Treasury bills and Treasury bonds at discounts- depreciation in local currency resulting a substantial increase in local currency value of foreign currency denominated debt issued to domestic sources, also caused the rapid increase in the central government debt in Sri Lanka.

Chart 1 Outstanding Government Debt - 2009 - 2018



Source: The Central Bank of Sri Lanka Annual Reports. Public Debt Bulletins of the Central Bank of Sri Lanka.

The share of domestic debt in the total public debt portfolio increased by Rs. 3,878 billion (181.2 per cent) from Rs. 2,140 billion at end 2008 to Rs. 6,018 billion at end 2018. Of this increase, Rs. 3,372 billion was due to new borrowings while the balance was due to the combination of discount effect, and depreciation of the local currency. Similarly, the local currency value of foreign debt share in the total debt too recorded an increase of Rs. 4,511 billion (311.3 per cent) from Rs. 1,449 billion at end 2008 to Rs. 5,960 billion at end 2018. Of this increase, Rs. 2,666 billion was due to new borrowings from foreign sources while the balance was mainly due to the depreciation of the local currency against major foreign currencies. As per end of the month exchange rates published by the Central Bank of Sri Lanka, the Sri Lankan rupee depreciated against the United States dollar by more than 60 per cent during the ten-year period end of 2018. For the ten years shown, the outstanding debt grew at over 10 per cent points every year, exceeding 15 per cent in 2018, due to the higher amount of new borrowings (Rs. 761 billion) together with combined effect of the depreciation of the rupee against major foreign currencies (Rs. 1,063 billion) and the discount factor (Rs. 81.2 billion). The debt to GDP ratio, a key debt sustainability indicator, which continued to improve until 2012 recorded a gradual deterioration since then from 68.7 per cent (2012) to 82.9 per cent by end 2018.

2. Debt Sustainability Challenges posed by Debt Composition and Debt Service Payments

Sri Lanka has been a classic twin deficits economy since 1970s. Prevalence of twin deficits implies fundamental economic imbalances, signaling that the country's national expenditure exceeds its national income, and that its production of tradable goods and services is inadequate (Weerakoon 2017).

Sri Lankan governments continued to experience a budget deficit around 5 per cent of the GDP while national savings was less than national investment during the period under review. The country has maintained an average national investment of about 33 per cent of GDP against an average national savings rate of around 29 per cent. As the private sector institutions had their own limitations to tap the international capital markets, the Sri Lankan government continued to borrow from abroad to bridge the savings and investment gap. In the past, as a developing country, Sri Lankan government had been able to source low cost concessionary financing to bridge its budget deficit from multilateral agencies, bi-lateral arrangements, and various donor countries as shown in the Table -1 below. For example, nearly 85 per cent of the total foreign debt stock of the government at end 2008 consisted of concessional loans obtained at very favorable terms. However, the foreign financing so sourced had been invested in general infrastructure such as building of free roads, hospitals, water projects, irrigation to supply water to farmers etc., and such investments, though have helped the country to achieve better human development indicators relative to other countries at similar levels of per capita income, did not generate the required return to pay back the debt obligations, as and when they fell due.

Table 1. Sri Lanka – Composition of Foreign Debt - 2010-2018

Category	2010		2016		2017		2018 (a)	
	Total Equivalent Amount in Rupees billion	**per cent**	**Total Equivalent Amount in Rupees billion**	**per cent**	**Total Equivalent Amount in Rupees Billion**	**per cent**	**Total Equivalent Amount in Rupees Billion**	**per cent**
Concessional	**1,266.9**	**62.6**	**1,897.7**	**46.9**	**2,130.5**	**45.2**	**2,705.8**	**45.4**
Bilateral	637.9	31.5	627.4	15.5	675.5	14.3	953.3	16.0
Multilateral	601.7	29.7	856.0	21.2	954.7	20.2	1,392.9	23.4
Other	27.3	1.4	414.2	10.2	500.3	10.6	359.7	6.0
Commercial	**757.7**	**37.4**	**2,148.1**	**53.1**	**2,588.1**	**54.8**	**3,253.7**	**54.6**
Sovereign Bonds	221.9	11.0	1,220.9	30.2	1,475.0	31.3	2,220.4	37.3
Bilateral	535.8	26.5	318.3	7.9	316.6	6.7	210.0	3.5
Multilateral	--	--	220.6	5.5	243.6	5.2	58.6	1.0
Foreign Holdings in T-Bills and T-Bonds	--	--	260.0	6.4	322.6	6.8	158.8	2.7
Other	--	--	128.3	3.2	230.3	4.9	605.9	10.2
Total	**2,024.6**	**100.0**	**4,045.8**	**100.0**	**4,718.6**	**100.0**	**5,959.5**	**100.0**

(a) Provisional

Source: Central Bank of Sri Lanka Ministry of Finance.

Sri Lanka was graduated to middle-income status from the list of Poverty Reduction and Growth Trust (PRGT) eligible countries in January 2010. With its graduation to a lower-middle-income status, government's ability to secure low cost concessionary foreign financing from foreign sources to bridge its annual budget deficit was diminished. Thus, the government has been compelled to depend on international commercial capital markets for its foreign currency financing needs, including the servicing of debt obligations relating to the concessional debt portfolio. As clearly reflected in Table -1 above, this has resulted the share of foreign commercial debt in total foreign debt stock of the government to increase to 54.6 per cent at end 2018 from about 15.3 per cent in 2008 and to rely on USD denominated commercial issuances compared to other major foreign currencies as indicated in the Table – 2 below.

Table 2. Currency Composition of Foreign Debts (As at end of Year)

Per cent

Currency	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018 (a)**
US Dollar	18.79	23.54	29.15	30.85	33.85	41.50	48.92	54.56	56.17	63.45
Special Drawing Rights	32.24	28.27	25.83	24.68	24.05	21.84	20.73	18.68	17.58	16.02
Japanese Yen	25.72	25.13	24.05	20.79	16.39	13.80	13.26	12.28	10.94	10.45
Sri Lankan Rupee (b)	10.54	11.90	11.57	14.37	16.13	14.69	8.57	6.43	6.84	2.67
Euro	8.15	7.03	6.30	6.31	6.27	5.23	5.11	4.54	4.41	3.79
Other	4.56	4.13	3.11	3.00	3.31	2.94	3.41	3.52	4.06	3.62
Total	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**	**100.0 0**

(a) Provisional

(b) Non-residents' investments in Treasury Bills and Treasury Bonds.

***Sources**:* Central Bank of Sri Lanka, Ministry of Finance.

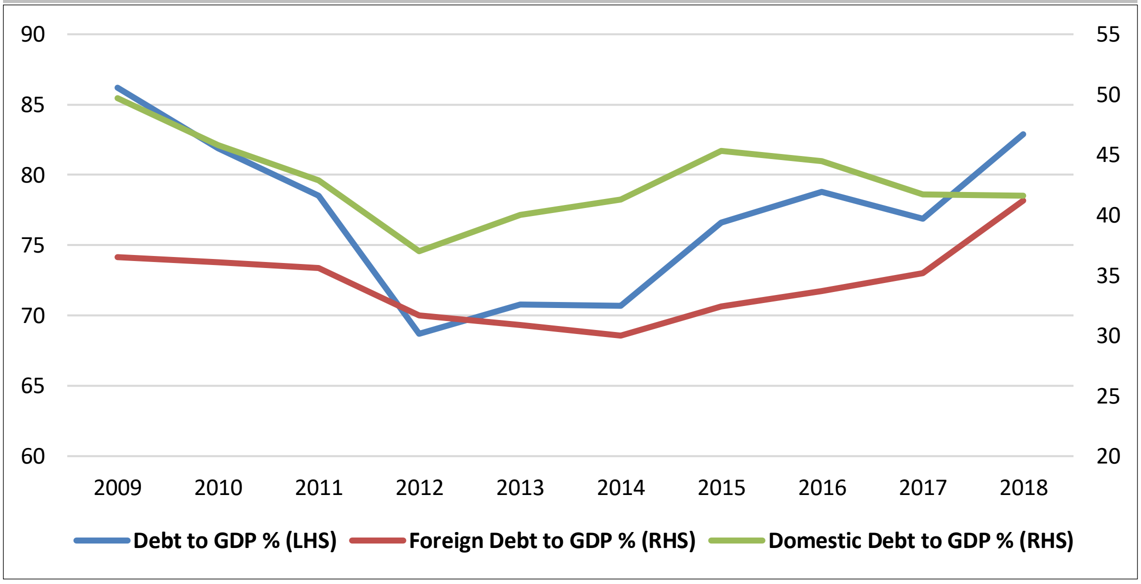
Although the Government of Sri Lanka (GOSL) has been an active borrower in the international commercial debt capital market since 2007, in view of its below investment grade rating, the country has been compelled to pay relatively higher risk premium over the risk-free benchmark rates. In view of its belief that the macroeconomic path and resultant positive outcomes would elevate the country's international sovereign rating to investment grade, GOSL continued to demonstrate its reluctance to lock-in at high interest rates of commercial borrowings for longer tenures. Therefore, the loan term of most of such commercial borrowings from the international market range from two to ten years.

This led to a situation of concerns about debt sustainability, associated with the government's external financing conditions due to the large and increasing share of foreign commercial debts already amidst its lower credit rating and increasing debt levels, Sri Lanka was faced with two key challenges as follows:

(a) an increasing dependence on external commercial debt which is highly sensitive to external shocks, and
(b) the gradual increase in total external debt service payments.

As indicated in Chart -2, with more than 40 per cent of total public debt obtained from foreign sources and with high concentration on USD, any adverse development, including adverse exchange rate movements and shifts in global credit conditions, is likely to have negative implications on the government's ability to access further foreign commercial financing. Further, as per the currency composition of the foreign debt stock of the government, it has a substantial concentration on USD denominated debt obligations which is increasing. The share of USD denominated foreign debt obligations of the government in its total foreign debt stock has increased sharply to 63.5 per cent at end 2018 from about 17.7 per cent in 2008.

Chart 2. Debt to GDP, Foreign Debt to GDP and Domestic Debt to GDP Ratios 2009-2018



Source: The Central Bank of Sri Lanka Annual Report. Public Debt Bulletins of the Central Bank of Sri Lanka

Table 3. Annual Debt Service Payment 2016-2020 (by currency)

Year	Total Debt Service Payments on domestic Currency denominated debts (Rs. Billion)	Total Debt service payments on Foreign Currency denominated debt (Rs. Billion)
2016	1,057	296
2017	1,213	390
2018	1,561	527
2019	1,039	966
2020	834	1,149

Source: The Ministry of Finance, Public Debt Bulletins of the Central Bank of Sri Lanka

There has been gradual increase in the annual foreign debt service payment, principal and interest element as indicated in Table – 3. This was mainly due to the need for refinancing majority of the foreign debt service obligations on concessionary foreign loans taken in the past, annual interest payments on commercial loans and the maturity of sovereign bonds issued since 2007, from commercial sources at relatively higher cost.

3. Measures introduced to address debt sustainability challenges

Given the lower level of per capita of around USD 4,000, Sri Lanka needs to tap external savings for bridging the persistent resource gap the country is facing in its endeavor to improve the living status of its people. Given the diminishing access to concessional funding from donors and international development agencies, the government must depend on international commercial capital markets for such funding requirements. To attract commercial financing at competitive rates, Sri Lanka must demonstrate its ability and willingness to manage its public debt profile in a sustainable manner, while its repayment capacity is maintained. International rating agencies and international institutional investors would continue their due diligence on Sri Lanka as to the country's debt sustainability, and any downward migration in country's debt dynamics would make it very costly for the country to tap international capital markets. Therefore, Sri Lanka has taken several policy initiatives, as discussed below, to preserve the country's debt sustainability.

3.1 Revenue based fiscal consolidation

Since 2018, the focus of the fiscal policy strategy has been to strengthen the revenue based fiscal consolidation supported by austerity. Accordingly, the fiscal measures, as summarized below, have aimed at enhancing revenue collection and rationalizing expenditure while reforming and restructuring state owned business entities (SOBEs) to contain the budget deficit and the outstanding government debt at targeted levels, as set out in Table 4. Accordingly, the budget deficit and government debt for coming years were targeted at gradually declining levels.

(a) The new Inland Revenue Act, No. 24 of 2017, which came into effect from 01 April 2018, supports the revenue mobilization effort of the government by simplifying and rationalizing the existing income tax structure, broadening the direct tax base and strengthening the administrative powers, while introducing international best practices to Sri Lanka's tax system.

(b) Amendments have been made to the VAT and Nation Building Tax (NBT) Acts in 2018 to grant tax exemptions to identified sectors with the aim of promoting activity in such sectors, while a VAT refund scheme was introduced for tourists to promote the tourism sector.

(c) Customs duty changes and the revisions to excise duty structure have been introduced to discourage non-essential imports.

(d) Measures to strengthen tax administration, including the Revenue Administration Management Information System (RAMIS) and National Single Window (NSW).

(e) On the expenditure front, several measures were introduced to improve the monitoring process of government expenditure and ensuring better management of public expenditure.

3.2 Introduction of a Medium-Term Debt Management Strategy

Having observed the risks emanating from the increasing share of foreign debt of the total debt and the country's vulnerability to external shocks, the Government has committed itself to stabilize and reduce the foreign debt level through appropriate macroeconomic and fiscal policy measures in effect through mid-2020, with much needed technical support from the IMF in areas of government cash flow management and formulation of a least cost and risk borrowing programme. The Medium-Term Debt Management Strategy (MTDS) introduced in mid-2019 is an important element in the Government's stabilization plan over the medium-term in that it addresses the high exposure to foreign debt, especially foreign currency denominated debt, as well as lumpy debt servicing obligations, as indicated in the Table 4 below.

Table 4. Key Debt Management Targets in the MTDS

Risk Indicator	**2018 *Current***	**Target 2023**
Foreign currency denominated debt (per cent of total debt)	54.0	Maintaining FX exposure at the current level
ATM External Portfolio (years)	6.6	Increasing from the current level
Debt maturing within 1 year (per cent of total debt)	16.4	Decreasing from the current level

Source: Ministry of Finance, The Central Bank of Sri Lanka

3.3 Active Liability Management

In view of the necessity for institutionalizing a legal framework for managing the country's public debt profile in a prudent manner that brings debt sustainability and macroeconomic stability amidst potential impact of exogenous and endogenous shocks, GOSL introduced the Active Liability Management Act (ALMA) in March 2018. The ALMA provides the legal framework for GOSL to raise loans in or outside Sri Lanka for management of public debt in terms of relevant laws.

The Active Liability Management framework is focused on acting in advance, to re-finance and/ or pre-finance debt repayable beyond a given financial year covered under the Annual Appropriation Act. The Liability Management Strategy of GOSL is planned to be implemented to ease the repayment of debt in the future and ensure that such repayments are done at the lowest possible cost in line with the Government's cash flow, prevailing and expected interest rates and the future maturities of public debt.

The Active Liability Management Framework provides much needed legal framework for GOSL to adopt debt management strategies depending on the market conditions such as, but not limited to:

(a) buy-back or early repayment of identified loans,
(b) issue of new loans at low interest rates in place of outstanding loans obtained at higher interest rates,
(c) lengthening of the maturity or repayment period of identified loans on new terms by way of switches and /or exchanges,
(d) consolidation or conversion of identified loans into new loans on new terms,
(e) raising of new loans outside the given financial year's borrowing limit approved by the Parliament under the Annual Appropriation Act to benefit from prevailing favorable market conditions and to use such proceeds for early repayment of existing loans obtained at unfavorable terms,
(f) maintenance of dedicated bank accounts, i.e. in rupee and foreign currency, to ringfence the money so raised under the resolution passed by the Parliament under section 3 of ALMA, and
(g) invest surplus funds in above mentioned bank accounts in appropriate liquid assets.

3.4 Issuance of non-USD Sovereign Bonds in Alternative Currencies/Alternative Markets

The outstanding debt stock of the country and its debt service payment requirement remain substantively above the threshold of many of Sri Lanka's peer countries. Therefore, the borrowing programme from external sources has been formulated considering the gradually increasing risk premiums compared to benchmark risk free rates of euro-dollar markets and the negative implications of undue concentration, in a volatile global environment of increasing interest rates.

The GOSL is exploring the possibility of diversifying the financing sources and instrument to manage cost and risk elements in meeting future debt service obligations by exploring opportunities in alternative bond markets including that of Renminbi (RMB) denominated Panda Bond market and Japanese Yen (JPY) denominated Samurai Bond market.

The proposed diversification of funding sources would be executed considering the overall cost of financing, including risk management and it is expected to contribute favorably to conventional Eurodollar Bond financing given possibility for GOSL to leverage between different markets and instruments. Proper diversification is also expected to balance the highly skewed currency composition of the external debt profile of the Government while providing a natural hedge against currency volatility related negative impact on the local currency value of the government debt portfolio. Rating agencies also identified such a move as credit rating positive.

4. Effects of measures to change debt profile over the medium term

4.1 Revenue based fiscal consolidation

In 2018, the government's total current expenditure was reduced to 14.5 per cent of the GDP as non-interest recurrent expenditure fell reflecting expenditure rationalization measures and as a result, the primary account surplus improved to 0.6 per cent of GDP from 0.02 per cent in 2017. Further, the government's overall budget deficit was declined to 5.3 per cent of GDP in 2018 from 5.5 per cent in 2017, indicating that the austerity measures used by government in 2018 have been effective.

4.2 Medium-Term Debt Management Strategy

Risk Indicator	**2018**	**End 2019(a)**
Foreign currency denominated debt (per cent of total debt)	54.0	53.0
ATM External Portfolio (years)	6.6	6.8
Debt maturing within 1 year (per cent of total debt)	16.4	16.0

(a) Provisional

Source: Ministry of Finance, The Central Bank of Sri Lanka.

4.3 Active Liability Management

As envisaged in the strategy, the specific liability management exercises initiated in 2019 helped GOSL pre-finance its foreign currency debt obligations of the first half of 2020 at lower rates. Regular issuances of long term Treasury bonds to pre-finance domestic market debt service payments and part of GOSL's financing requirements in 2020 helped increase the average time to maturity (ATM) of local Treasury bonds and Treasury bills portfolios to 8.13 years 0.65 year, respectively, as at 2019 from 7.83 years and 0.50 year, respectively, at end 2018, helping the ATM of domestic debt portfolio to increase to 6.0 years as of end 2019 from 5.8 years in 2018.

4.4 Issuance of non-USD Sovereign Bonds in Alternative Currencies/Alternative Markets

The GOSL has already initiated the necessary action within the Active Liability Management Strategy to diversify market based foreign funding sources to jurisdictions such as the Chinese Panda market, Japanese Samurai market and the very liquid Sukuk market. The GOSL is confident that the Liability Management Strategy being adopted would enable the authorities to change the country's public debt profile to address refinancing risk and rollover risk in coming years and to extend maturity duration of both domestic and foreign debt in a cost-effective manner.

5 Conclusion and way forward

Sri Lanka's government debt grew relatively fast over the recent years, reflecting the impact of sustained fiscal deficits, restricted access to concessional financing, persistent resource gap in domestic markets, and the depreciation of the exchange rate. Due to the limited availability of concessional funding, foreign currency financing tilted further towards commercial borrowings, resulting in significant increase of the share of foreign currency debt in the total outstanding debt. This has made the country is exposed to domestic and external shocks. The foreign exchange and rollover risks have been identified as the major risk that would affect the debt sustainability of the country. Against this backdrop, GOSL took several measures to minimize the country's vulnerability to any domestic and external risks and the envisaged benefits of such measures are yet to realize.

Given the country's high debt levels and debt service payments lined up for near future, its exposure to international capital markets and limited space to accommodate such obligations within the government budget, a committed effort is needed to further strengthen the effectiveness of many measures already introduced to improve debt management practices in line with technological advancement and required transparency considerations amidst challenges of both unique domestic conditions and external factors.

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