VERITÉ RESEARCH
DEBT UPDATE
24 February 2023

The Verité Research Debt Update provides a regular update for investors, policy makers and analysts, on the latest developments in this space together with commentary and analysis on Sri Lanka's path to resolving its economic crisis since suspending debt repayment in April 2022.

VERITÉ RESEARCH
Strategic Analysis for Asia

Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, politics, and media.

Nishan de Mel
Executive Director,
Verité Research

Udara Peiris
Associate Professor,
Oberlin College
Global Academic Fellow,
Verité Research

Contributing team:
Inoshini Perera
Raj Rajakulendran
Malinda Meegoda

For additional information contact:
debtupdate@veriteresearch.org

KEY DEVELOPMENTS

- The International Monetary Fund ("IMF") and Sri Lanka have received varying assurances from India, China, Private Bondholders, and the Paris Club on their commitment to support Sri Lanka's debt restructuring efforts.
- The communications are adequate for Sri Lanka to meet the technical criteria for IMF Board approval for the External Fund Facility ("EFF") of $ 2.9 billion, which achieved a staff-level agreement in September 2022.
- The Paris Club statement requested that any restructuring agreement treats all bilateral creditors equally, and on terms at least as favorable as all commercial creditors.
- The statement and letter respectively, from Paris Club and India supported the paths and targets agreed upon with the IMF, but did not express any commitment to specific short-term measures.
- The letter from China committed to specific short-term debt relief measures, but it did not express confidence that Sri Lanka will achieve the projected long-term path of debt or the macro-fiscal targets for debt sustainability agreed upon with the IMF.
- China and Bondholders (the "Bondholder Group") expressed concerns regarding the IMF's targets and projections and requested greater involvement and transparency in the analyses and formulation of those targets.
- The Bondholder letter introduced new negotiating positions that pressed for constraints beyond those agreed upon with the IMF (see further analysis section for more details).

CREDITOR ASSURANCE UPDATES

Sri Lanka's main creditors express support for debt restructuring

16th January 2023: India's letter of support

The Indian Government addressed a letter to the Managing Director of IMF Ms. Kristalina Georgina, with the Export-Import Bank of India representing India as the creditor institution. The letter outlined the Indian government's commitments: (1) support Sri Lanka's prospective External Fund Facility (EFF) programme under the IMF programme (2) provide financing support via the Export-Import Bank of India to meet the debt sustainability path outlined in the EFF, through reducing interest rates and extending maturity dates. It also underscores some of the conditions that Sri Lanka was expected to meet within the IMF programme: (1) reduce the ratio of public debt to GDP to below 95% by 2032, (2) the central government's annual gross financing needs below 13% of GDP on average in 2027-32, (3) central government's annual foreign currency debt service below 4.5% of GDP in every year in 2027-32 and (4) closing Sri Lanka's external financing gap. India also stressed the need for Sri Lanka to seek matching debt relief measures from all commercial and other official bilateral creditors, as well as adequate financial contributions from the multilateral development banks.

Comment: The letter had no explicit mention of a time frame or a repayment holiday on the credit support. The emphasis on IMF targets for debt sustainability indicates that the debt relief India is willing to provide will depend on Sri Lanka achieving targets prescribed by the IMF, citing targets that extend up to 2032. The letter also underscores the expectation of equitable treatment of debt, implying that this is a concern.

19th January 2023: China's letter of support

The Export-Import Bank of China, China's official bilateral creditor agency, addressed a letter to the Ministry of Finance of Sri Lanka on 19th January 2023. Although the letter has not been made public, a spokesperson from the Chinese Ministry of Foreign Affairs, Mao Ning outlined the contents of the letter in a press conference on 3rd February 2023. It was communicated that China has agreed to provide a moratorium on Sri Lanka's interest and principal payments due for 2022 and 2023. China seeks friendly consultation with Sri Lanka regarding medium and long-term debt treatment in this window period and also noted that it will support Sri Lanka in its loan application to the IMF. China further called on commercial creditors (including the International Sovereign Bondholders) to provide debt treatment in an equally comparable manner, and encouraged multilateral creditors to do their utmost to make corresponding contributions.

Comment: The debt payment extension provided is presented as a short-term measure to provide liquidity, during which time the Export-Import

Bank of China seeks dialogue on how to treat medium and long-term debt with a view on debt sustainability. This is emphasized as the maturity extension is seen as a short-term measure to provide liquidity to the country. China calls on other creditors and the IMF to provide liquidity relief as well. Overall, the communication from China flags a lack of confidence in the feasibility of the proposed medium and long-term debt sustainability path negotiated with the IMF, and the need to address that concern before further assurances are provided. The repeated calls for dialogue and nuances of both the letter and press conference suggest that China sees itself as an important and separate party from the IMF in evaluating a feasible path of debt sustainability for Sri Lanka, and may not believe it is being effectively engaged in the process.

3rd February 2023: Private Bondholders' letter of support

Ad Hoc Group of Sri Lanka Bondholders **(International Sovereign Bondholders)** identified as the 'Bondholder Group' issued a letter addressed to the Managing Director of the IMF. The Bondholder Group stands ready to engage quickly and effectively with the Sri Lankan authorities to design and implement restructuring terms that would help Sri Lanka restore debt sustainability, and allow the country to re-gain access to the International capital markets during the IMF Programme period. The letter indicated support for Sri Lanka consistent with the IMF programme targets indicated in the India Letter, but also added an additional point limiting domestic gross financing to 8.5% of GDP.

Comment: While the India letter restricts attention to achieving IMF targets, the Bondholders Group letter goes beyond that in two ways. Firstly, the letter adds a new limit on domestic gross financing, that further limits the pathway to debt sustainability and is not likely to be in Sri Lanka's current plan negotiated with the IMF. These requests, if accepted, will place significant new constraints on Sri Lanka, and are delineated separately in the analysis section of this update. Secondly, it states that the group would wish to participate in the discussion of the IMF targets and the assumptions behind them. This indicates that the bondholders also may have concerns about the likelihood that debt and macro-fiscal targets will be met by Sri Lanka (which was also a concern raised by China).

7th February 2023: Paris Club letter of support

Formed in 1956, The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by borrower countries. Sri Lanka's bilateral official creditors which are Paris Club members are Japan, France, Korea, Germany, the United States of America, Spain, the Netherlands, Russia, Sweden, Austria, Canada, United Kingdom, Denmark, Belgium and Australia.

The 7th February statement is an outcome of a meeting held on 25th January. This meeting was held with representatives from the Paris club together with Hungary, Saudi Arabia, the Kuwait Fund for Arab

Economic Development and India withthe IMF and the World Bank to provide financing assurances and support for an IMF board approved programme. Paris Club pledged to negotiate with Sri Lanka the terms of a restructuring of their eligible claims to restore debt sustainability, while considering the targets and overall macroeconomic goals set forth in the EFF in accordance with the principle of comparability of treatment among all bilateral creditors.

Comment: In this statement, the Paris Club expressed solidarity with the IMF EFF and targets. They explicitly request China to also align with the IMF EFF targets and parameters. Further they emphasized the need for equal debt treatment and state that debt should not be paid (but kept in arrears) until all debt facilities with all bi-lateral and commercial creditors are re-negotiated completely.

Additional Analysis

On the Private Bondholders' letter of support

The Bondholders Group letter stipulates new / modified targets and constraints on the organization of Sri Lanka's debt restructure. The Indian Letter suggests that Sri Lanka has set for itself the following targets in consultation with the IMF: (1) total Gross Financing Need (GFN) capped at 13% of GDP from 2027-2032. (2) foreign currency debt service to reach 4.5% of GDP in every year between 2027 and 2032.

Note: A lower GFN target can be achieved by either (a) increasing the extent of restructuring present debt or (b) having more concessional terms on future borrowing or (c) reducing the fiscal deficit in the future. Therefore, the lower the GFN target for the future, the deeper the debt restructure that is needed at present, all other things being equal.

The Bondholder Letter explores a negotiating position that can advance Bondholder interests in two ways.The pivotal request is that the domestic debt component of GFN be capped at 8.5% of GDP. (Note: there is no reciprocal request for a maximum limit on the foreign currency component of GFN). This is a new negotiating position, because the IMF targets stated in the Indian letter did not specify a cap on either the domestic nor foreign debt component of the GFN. The foreign currency debt service target does not translate to a limit on the foreign currency component of GFN because it only limits debt servicing payments, not new borrowing in foreign currency. For instance, the total GFN target could be achieved with domestic debt issuance of 10% of GDP and foreign debt issuance of 3% of GDP or vice versa. Requesting a maximum limit on the domestic debt component of GFN is equivalent also to placing a minimum limit of 4.5% of GDP on the foreign debt component of GFN, if total GFN goes up to the limit of 13%.

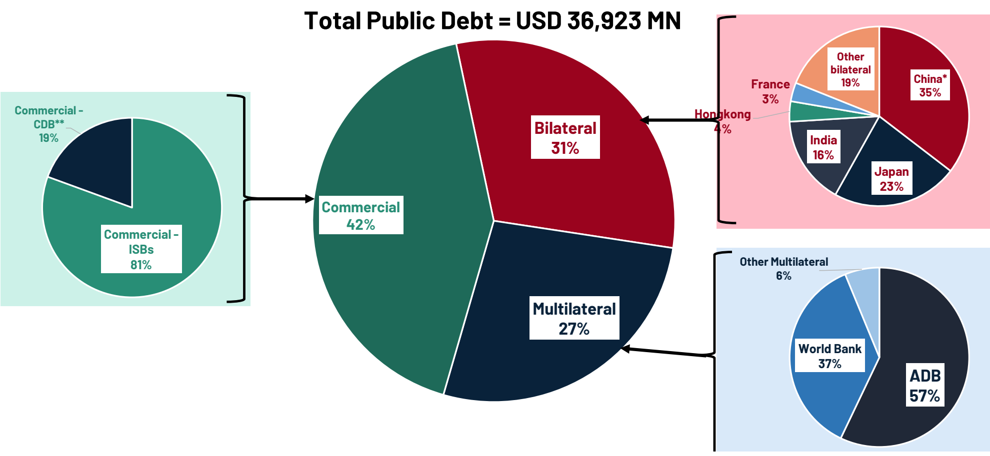
Not having a minimum limit on the foreign debt component of GFN would allow Sri Lanka to achieve the present targets with larger haircuts on foreign debt and/or reducing the dependence on foreign debt in the future. Therefore, the position could be understood as (a) one that is seeking to limit the scope of the foreign debt restructure (by setting criteria to increase the scope of domestic debt restructure), and (b) one that is keeping Sri Lanka open to taking more foreign debt in the future (by limiting the domestic debt component of the GFN).

It is important to note that the letter ask for the entire domestic debt component of GFN to be capped at 8.5% and not simply the domestic currency debt component. Sri Lanka issues foreign currency debt, known as Sri Lanka Development Bonds (SLDBs), which are bought mainly by Sri Lankans. SLDBs are issued under domestic law and classified as domestic debt. Therefore, this Bondholder posture seeks, in addition to the above, to (a) limit Sri Lanka's ability to shift the burden of foreign currency debt restructure away from SLDBs and (b) reduce the scope that Sri Lanka might have in the future to move away from issuing international sovereign bonds and issuing more SLDBs.

Bottom Line: The Bondholder letter has set out a new negotiating position, which favours Bondholder interest in two ways. Firstly, it seeks to limit the extent to which international sovereign bonds might be restructured under the current fiscal consolidation path agreed with the IMF. Secondly, it seeks to limit the extent to which Sri Lanka's future financing (in local and foreign currency) can be raised in the domestic financial market, instead of borrowing in the international financial markets.

Debt Indicators at a Glance

Sri Lanka's External Debt (as at Sept 2022)

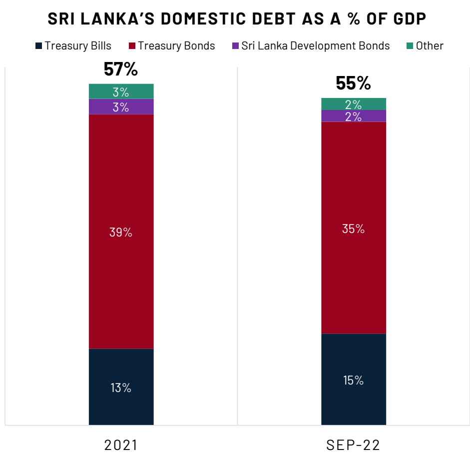


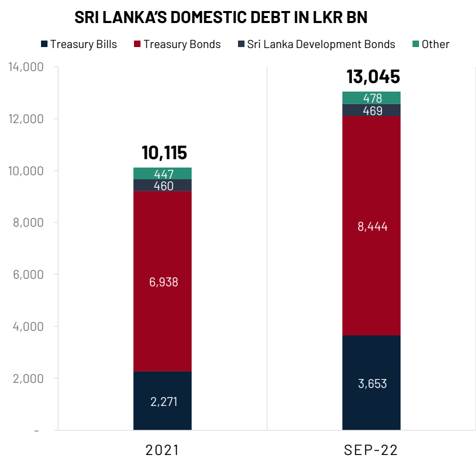
Source: Ministry of Finance Quarterly Debt Bulletin Sept 2022

* Includes government of China and the EXIM bank of China

** Refers to China Development Bank

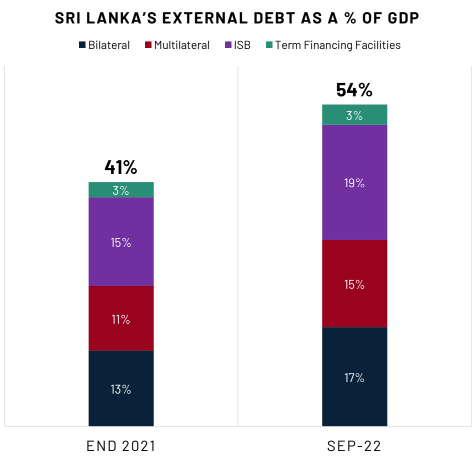
Sri Lanka's Domestic Debt fell to 55% of GDP, even with a nominal LKR increase of 29% (Dec 2021 - Sept 2022)

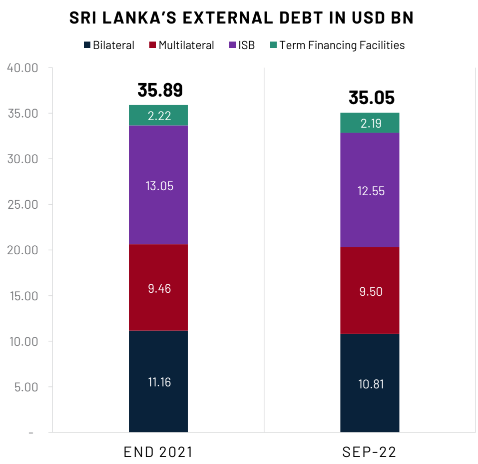




Source: CBSL Annual Report 2015-2021 | 2022 September Quarterly Debt Bulletin

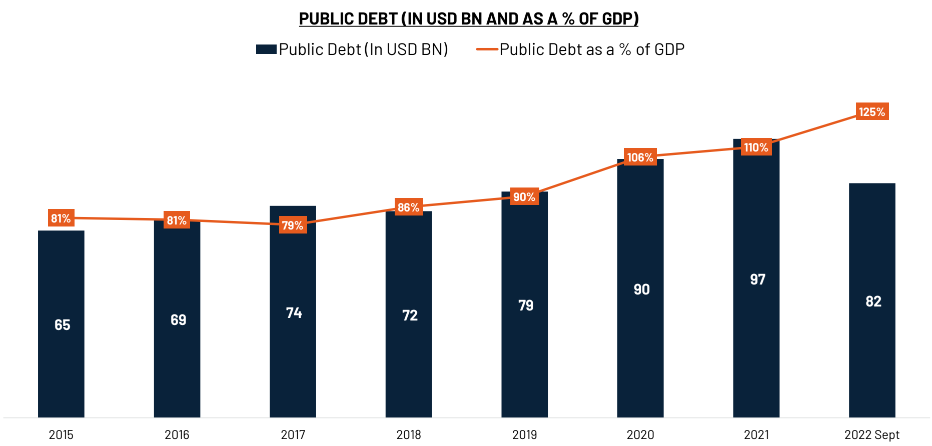
Sri Lanka's External Debt rose to 54% of GDP, even with a nominal USD decrease of 2.3% (Dec 2021 - Sept 2022)





Source: 2022 September Quarterly Debt Bulletin

Sri Lanka's Public Debt to GDP grew by 15 percentage points from 2021



Source: CBSL Annual Report 2015-2021 | 2022 September Quarterly Debt Bulletin

Note: Central Government Debt includes treasury guarantees, public debt includes central government debt and central bank debt

For additional research information refer: https://publicfinance.lk/en

VERITÉ RESEARCH
Strategic Analysis for Asia

Issue 1 | Verite Debt Update | February, 2023

Our mailing address is:
No 5A, Police Park Place, Colombo 5

To unsubscribe debtupdate@veriteresearch.org