

VERITÉ RESEARCH DEBT UPDATE

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

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KEY DEVELOPMENTS AND INSIGHTS

- The Official Creditor Committee for Sri Lanka issued a letter of assurance on 29 November 2023. It enables Sri Lanka to meet some of the criteria set for receiving the second tranche of financing under its current IMF programme. The tranche was originally expected in September but is now anticipated in December. However, the communication does not constitute a substantive agreement on debt restructuring terms.
- In contrast to the highly unstable macroeconomic conditions of 2022, characterised by soaring inflation and currency depreciation of approximately 60%, 2023 has seen significant stabilisation, particularly in the monetary sector. Inflation and currency depreciation are projected to remain below 3% for the year.
- Sri Lanka has proposed a budget for 2024, that is broadly in line with its IMF programme targets. It requires the treasury to increase revenue by 45% from the 2023 level. There is very heavy dependence on an increased value-added tax (VAT) – from 15% to 18% – with reduced exemptions, to achieve that target (see Exhibit 3). However, Sri Lanka has never met a budgeted revenue target in the last 23 years (see Exhibit 2).
- The timeline goal posts have shifted in Sri Lanka's external debt restructuring. Expectations have now been pushed to the first quarter of 2024, from the original expectation of mid-2023 (see Exhibit 5).
- There has been an extraordinary delay in the disbursement of the second tranche of IMF funding to Sri Lanka. It signals significant weaknesses in Sri Lanka's ability to deliver on the commitments, and meet the expected timelines, in the current IMF programme (see Exhibit 6).

- The IMF's governance diagnostic for Sri Lanka, a first for an Asian nation, highlights "systematic and severe governance weaknesses and corruption vulnerabilities across state functions." These issues, unless addressed effectively and swiftly, could hinder Sri Lanka's progress towards sustainable economic recovery.
- Sri Lanka completed a novel domestic debt restructuring (DDR) in September 2023, in which local currency debt restructuring exclusively targeted the retirement provident funds of formal sector workers. This approach excluded the banking and financial sectors, private creditors, and most public sector workers who have a separate government pension scheme. This has set a new global precedent in the targeting of local currency debt restructuring.¹
- To achieve a path of debt sustainability Sri Lanka still needs to focus on reducing its interest cost burden, which remain significantly higher than what is anticipated within the current IMF programme. (See Exhibit 8).

AGREEMENT IN PRINCIPLE BETWEEN THE OFFICIAL CREDITOR COMMITTEE AND SRI LANKA

On 29 November, the 17-nation Official Creditor Committee (OCC) published an "in principle" agreement to restructure debt in line with the parameters set by the IMF.²

Previously In October 2023 China also announced an "in principle" agreement with Sri Lanka in similar vein.

The primary aim of this agreement announced by OCC appears to be to enable Sri Lanka to fulfil one of the prerequisites for the disbursement of the second tranche of IMF funding.

The agreement obliges Sri Lanka to ensure:

1. That China, which is not a member of the OCC, consents "to sharing, in a transparent manner, the information necessary for the OCC to evaluate comparability of treatment".
2. That Sri Lanka reaches an agreement with private creditors (a) without undue delay, and (b) on terms no less favourable than those agreed with the OCC.

The agreement does not present a substantive accord that would expedite the resolution of terms for debt restructuring.

1 Verité Research, "Exceptionalism of Domestic Debt Restructuring in Sri Lanka", available at: <https://publicfinance.lk/en/topics/exceptionalism-of-domestic-debt-restructuring-in-sri-lanka-1691519159> [last accessed 30th November 2023]

2 Club de Paris, "AGREEMENT IN PRINCIPLE BETWEEN THE OFFICIAL CREDITOR COMMITTEE AND SRI LANKA", available at: <https://clubdeparis.org/en/communications/press-release/agreement-in-principle-between-the-official-creditor-committee-and-sri> [last accessed 30 November 2023]

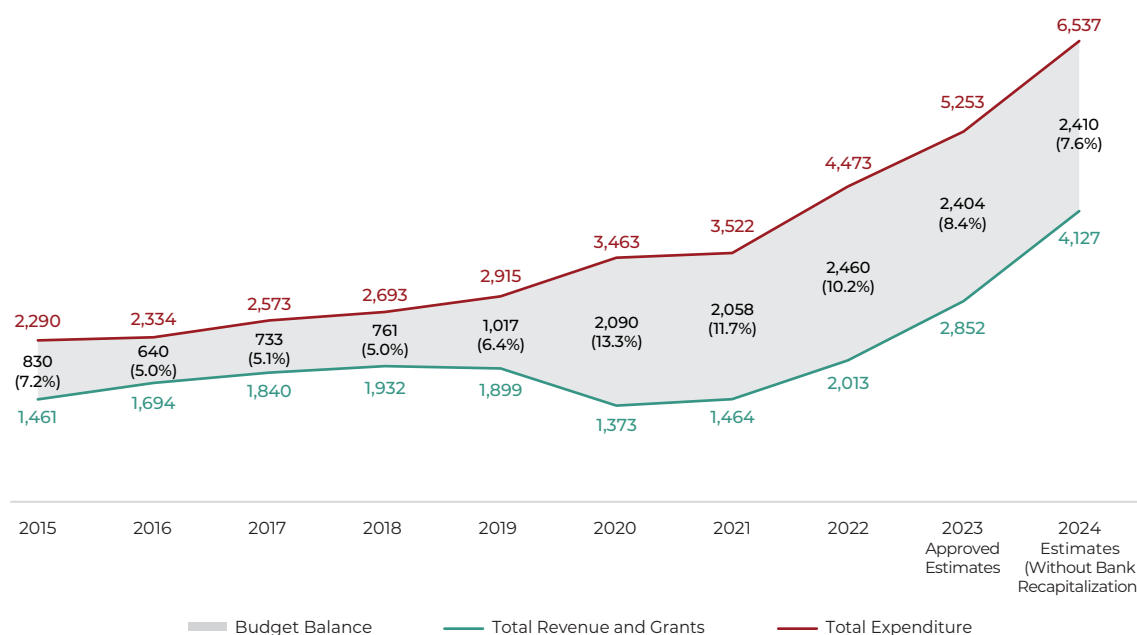
THE 2024 BUDGET

Deficit: The 2024 budget presented on 13 November 2023, anticipates a 45% increase in total revenue, with total expenditure growing by 24% – thereby reducing the budget deficit to 7.6% of GDP from the 8.4% of GDP expected for 2023 (see Exhibit 1). These expenditure and deficit numbers *exclude* the financing of 1.5% of GDP set aside for bank recapitalisation, which can potentially be recovered from the sale of assets owned by the state.

Revenue: Sri Lankan budgets have consistently overestimated the capacity to raise revenue (see Exhibit 2). Therefore, it is prudent to examine from where the 45% increase in revenue is expected. Exhibit 3 shows that more than half the increase (56%) is expected from increasing the VAT rate and reducing exemptions on it. In short, the country expects to make more organisations pay a higher rate of VAT for a larger set of goods and services.

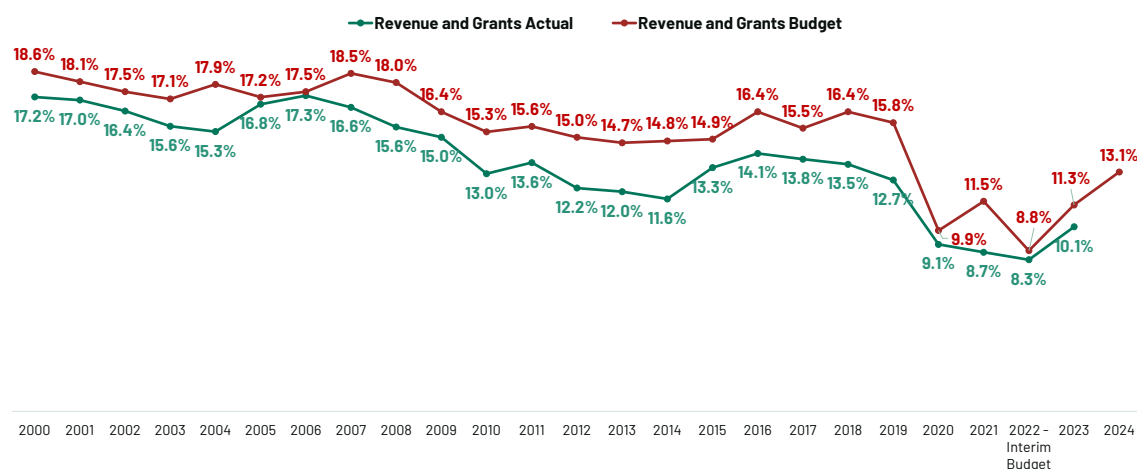
Tax net: The budget also outlines important administrative measures to expand the tax base in terms of personal income tax. One of them is to require the submission of a Tax Identification Number (TIN) for several activities such as opening a bank account, registering a motor vehicle, and transferring land.

Exhibit 1: Fiscal balances for 2015–2024 (figures in LKR Bn and Budget Balances as a % of GDP)

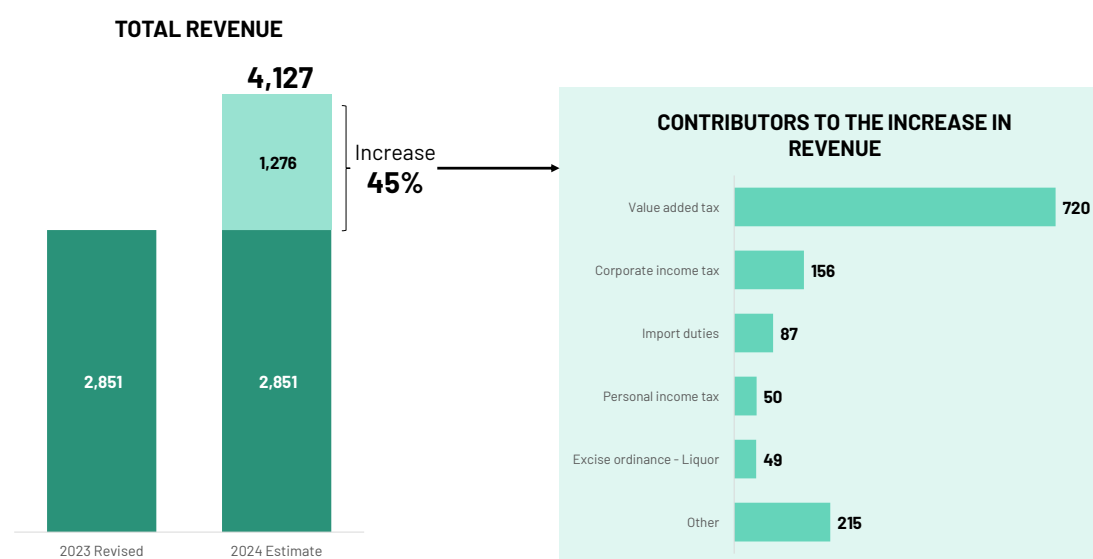


Source : CBSL Annual Reports | Budget Estimates | Appropriation Bill 2024

Note : *2019 and 2020 data differs from what is reported in the CBSL Annual report as the government has incorrectly portrayed expenditure for 2020 under 2019

Exhibit 2: Budgeted and actual revenue and grants as a % of GDP

Source : CBSL Annual Reports/Budget Estimates

Exhibit 3: Breakdown of the increase in revenue for 2024 (in LKR Bn)

Source : CBSL Annual Reports/Budget Estimates

Timeline of Sri Lanka's Path to Economic Recovery

Exhibit 4: Timeline of key economic milestones

GOALPOSTS ON DEBT RESTRUCTURING HAVE SHIFTED

Exhibit 5: Timeline of expectations of debt restructuring completion

			Expectation of Completing Debt Restructuring
2022	23 September	Ministry of Finance: Investor presentation ³	June 2023
	24 January	Ceylon chamber of commerce "Economic outlook 2023", Governor's statement ⁴	
2023	20 March	IMF Board level agreement ⁵	
	30 March	Ministry of Finance Investor Presentation ⁶	September 2023
	21 May	President's opening statement for the Asupini Ella water scheme ⁷	
	20 June	International democratic union (IDU4), Presidents' statement ⁸	
	03 August	State minister of Finance statement at the establishment of the new liaison office of CPA ⁹	
	24 August	CBSL Governor's statement at the Monetary Policy Review ¹⁰	October / November 2023
	05 October	CBSL Governor's statement at the Monetary Policy Review ¹¹	

Currently debt restructuring is not expected until the first quarter (Q1) of 2024.

- 3 Ministry of finance (2022) "Investor presentation", available at: <https://www.treasury.gov.lk/api/file/20adcaf7-874b-48da-9bc2-69240015cd7c>
- 4 Ada Derana (2023) "Sri Lanka hopes to complete debt restructuring in six months, says CBSL governor", available at: <https://www.youtube.com/watch?v=kZ7Jk-YBLZ8&t=54s>
- 5 International Monetary Fund (IMF) (2023) "Sri Lanka: Request for an Extended Arrangement Under the Extended Fund Facility-Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka", available at <https://www.imf.org/en/Publications/CR/Issues/2023/03/20/Sri-Lanka-Request-for-an-Extended-Arrangement-Under-the-Extended-Fund-Facility-Press-531191>
- 6 Ministry of finance (2023) "Investor presentation", available at: <https://www.treasury.gov.lk/api/file/9f8870d3-4840-443d-b552-e5c0890e1613>
- 7 News First (2023) "Sri Lanka to complete domestic & external debt reworking by September – President", available at: <https://www.newsfirst.lk/2023/05/21/sri-lanka-to-complete-domestic-external-debt-reworking-by-september-president/>
- 8 News First (2023) "President sets ambitious timeline for Sri Lanka's debt restructuring", available at: <https://www.newsfirst.lk/2023/06/22/president-sets-ambitious-timeline-for-sri-lanka%E2%80%99s-debt-restructuring/>
- 9 News First (2023) "Sri Lanka to complete debt restructuring by Sept", available at: <https://www.newsfirst.lk/2023/08/03/sri-lanka-to-complete-debt-restructuring-by-sept/>
- 10 Central Bank of Sri Lanka (2023) "Monetary policy review No.08 of 2023", available at <https://www.youtube.com/watch?v=jhf-2WTTN0kE>
- 11 Economy Next (2023) "Sri Lanka still expects IMF review by Oct/Nov, staff level soon: CB Governor" <https://economynext.com/sri-lanka-still-expects-imf-review-by-oct-nov-staff-level-soon-cb-governor-133948/>

PROGRESS ON THE IMF PROGRAMME

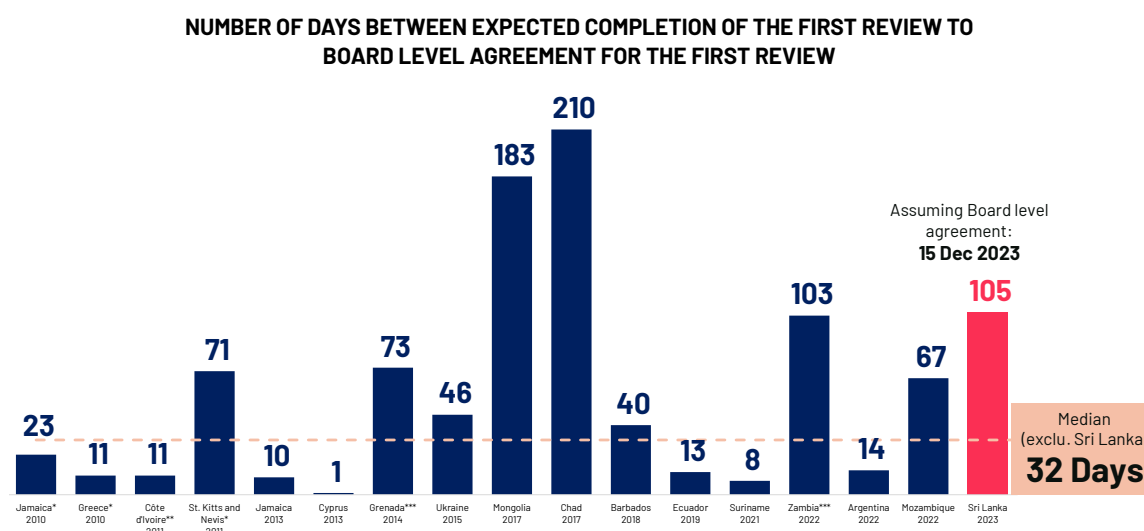
Sri Lanka has experienced unexpected delays in securing the second tranche of funding under the IMF programme initiated in March of this year. The IMF has cited two primary reasons for this delay. One, the shortfall in meeting the set revenue targets. Two, the inadequate progress in the debt restructuring negotiations.

Available data facilitates a comparison between Sri Lanka's delay/duration against that of 18 other countries that have restructured debt since 2010. Typically, there is a certain time period between the anticipated completion of the first review and the board-level agreement to release the second tranche of funding. The median duration for this period is 32 days. Should Sri Lanka receive the IMF board-level agreement on 15 December, it will have taken 105 days, making it the third longest period among these 18 countries (see exhibit 6).

Sri Lanka's staff-level agreement on the disbursement of the second tranche was also an outlier for having contingency clauses included. The release of funds has been made contingent upon (a) the implementation by the Sri Lankan authorities of all prior actions, and (b) confirmation of whether adequate progress has been made in debt restructuring, in conjunction with the completion of financing assurances reviews.

The IMF Tracker maintained by Verité Research shows that Sri Lanka verifiably met 46 of the 73 commitments that were due by end-November and failed to meet 12. Information was not available to assess progress on the balance 15, which are therefore classified as "unknown"¹².

Exhibit 6: Time taken between expected completion of the first review and board level agreement for the first review (figures in number of days)



Source : IMF Press Releases

Note: For the purposes of this analysis Sri Lanka is expected to get board level agreement on its first review by the 15th of December 2023

Note: Lebanon and Ghana have been excluded as they have not yet received a board-level agreement.

Note: The selection of countries was based on those that underwent debt restructuring since 2009, and for which there is publicly available information regarding the dates of agreement. Unless stated otherwise all countries entered an Extended Fund Facility Programme (EFF)

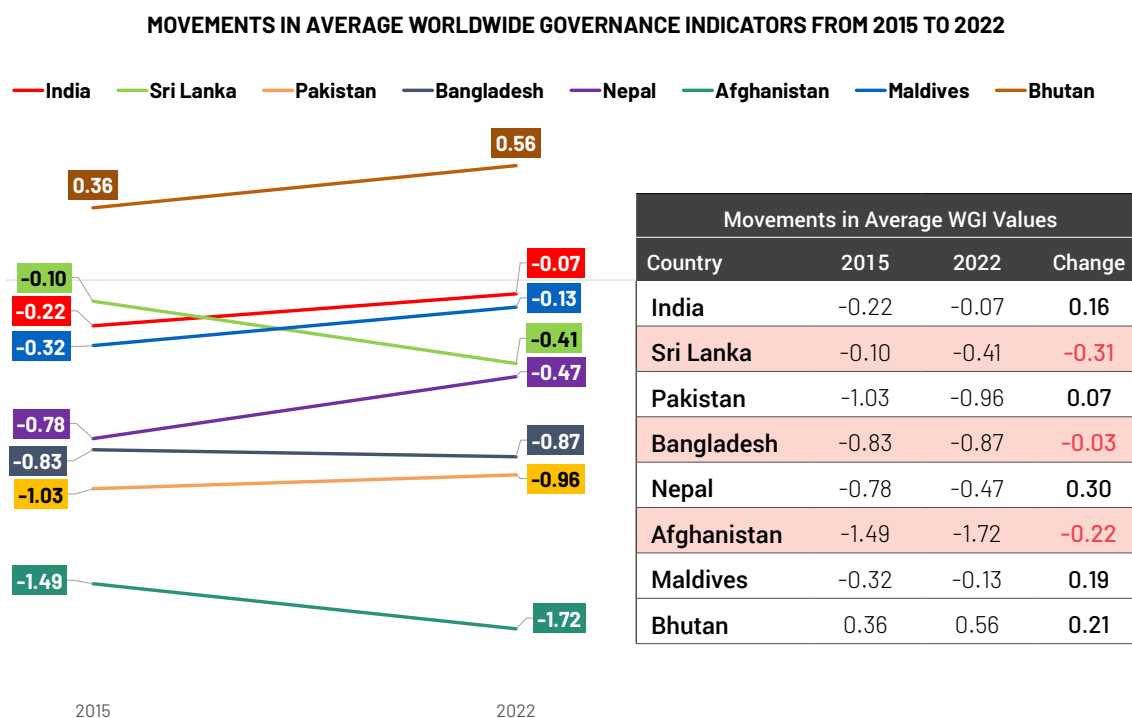
* Standby Agreement | ** Rapid Credit Facility *** Extended Credit Facility

¹² Verité Research, IMF Tracker, available at: https://manthri.lk/en/imf_tracker [last accessed 1st December 2023]

ALL EYES ON GOVERNANCE REFORM FOR ECONOMIC RECOVERY

According to the World Bank's Worldwide Governance Indicators (WGI)¹³, which are composite governance indicators that report on six broad dimensions of governance,¹⁴ Sri Lanka experienced the most substantial decline in governance among regional peers in South Asia between 2015 and 2022 (Exhibit 7).¹⁵

Exhibit 7: Movements in the worldwide governance indicators (figures in value of the index)



Source : World Bank Worldwide Governance Indicators

Note: The average Worldwide Governance Indicators is calculated by taking a simple average on the 6 sub - components

The focus of Sri Lanka's economic recovery might now need to pivot towards improving governance. The need to do this has been underscored by two governance diagnostics that have been published for Sri Lanka, and a wide consensus that Sri Lanka's economic problem is rooted in severe problems with regard to its governance.

The IMF's Governance Diagnostic Assessment (IMF-GDA) for Sri Lanka was published on the 30 September 2023. It was the first IMF governance diagnostic for an Asian country. It introduces its findings as follows:

"The GDA revealed **systematic and severe governance weaknesses and corruption vulnerabilities across state functions**, with particular macroeconomic impact in: budget credibility; expenditure control; public investment management and control of spending); public procurement; management

13 The WGI broadly defines governance as the set of traditions and institutions by which authority in a country is exercised. This includes (1) the process by which governments are selected, monitored and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.

14 Voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law and control of corruption

15 Each of the six dimensions is given a score ranging from -2.5 to 2.5, with higher scores indicating better governance. The scores across the six dimensions were averaged to determine an overall governance score for a country.

and oversight of State-Owned Enterprises (SOEs); transparency of revenue policy and the integrity of revenue administration; the governance and legal frameworks of the Central Bank; the application of financial sector regulations; and clarity and security of land ownership and the integrity of the judicial sector.” [emphasis added] (IMF-GDA, p. 11)

The above evaluation of “systematic and severe”, and the long list of state functions listed as a subset of areas with “particular impact”, makes for a rather strong judgement of Sri Lanka’s state of governance.

A Civil Society Initiative on Anti-Corruption Reform for Economic Recovery in Sri Lanka published its own Governance Diagnostic Report (CS-GDR) in mid-September 2023, a few weeks prior to the IMF-GDA. It offered at least 34 specific recommendations for reducing corruption and improving governance. This, too, was unprecedented — the first time Civil Society Organisations in a country have rallied together in a debt crisis to produce a governance diagnostic for economic recovery. Its findings seem rather convergent with the IMF-GDR, and introduces its diagnosis in the following words:

“the economic crisis in Sri Lanka is first a crisis of governance. This view has wide resonance with the Sri Lankan people. If the foundational governance issues in Sri Lanka are not addressed by concrete actions, then the policies and plans for debt sustainability and economic recovery are likely to be on shaky ground” (CS-GDR, p.3)

The recommendations provided in both diagnostics reflect a common understanding that addressing governance weaknesses is critical to restoring and sustaining economic stability in Sri Lanka — an understanding that resonates widely among the public, civil society organisations, the business community, international organisations engaged with Sri Lanka, as well as external stakeholders.

THE PATH OF YIELDS ON GOVERNMENT SECURITIES

The path of the yields on government securities has been a matter of serious concern for Sri Lanka's economic recovery and debt sustainability. Exhibit 8 maps out the fluctuations in those yields over the Central Bank of Sri Lanka policy rate and Exhibit 9 shows the resulting movements across the yields as well.

Exhibit 8: Gap between policy rates and secondary market yields overtime (figures in basis points)

Period	Key Economic Milestones	3 M	1 Y	5 Y	10 Y
Period 1	Staff level agreement on IMF programme – 1 Sept 2022	1,274	1,284	912	981
Period 2	Board level agreement on IMF programme – 23 Mar 2023	908	731	937	740
Period 3	Announcement of DDR – 30 Jun 2023	793	381	816	543
Period 4	Completion of DDR – 14 Sep 2023	565	131	232	102
Period 5	Staff level agreement on the first review of the IMF programme – 19 Oct 2023	510	190	274	194

The fluctuation in the yield differential and the explanatory background might be summarised as follows:

Period 1:

The average yield curve differential spikes to around 1,113 basis points. There was a huge liquidity crunch after reserves were drained without access to multilateral financing, alongside severe economic turmoil and uncertainty.

Period 2:

The average yield curve differential stabilises at around 829 basis points. There was limited access to multilateral financing during this phase, coupled with ongoing uncertainty regarding economic recovery and domestic debt restructuring (DDR).

Period 3:

The average yield curve differential gradually decreases. There was increased access to multilateral financing and diminished uncertainty over economic recovery. However, there was increased uncertainty about DDR.

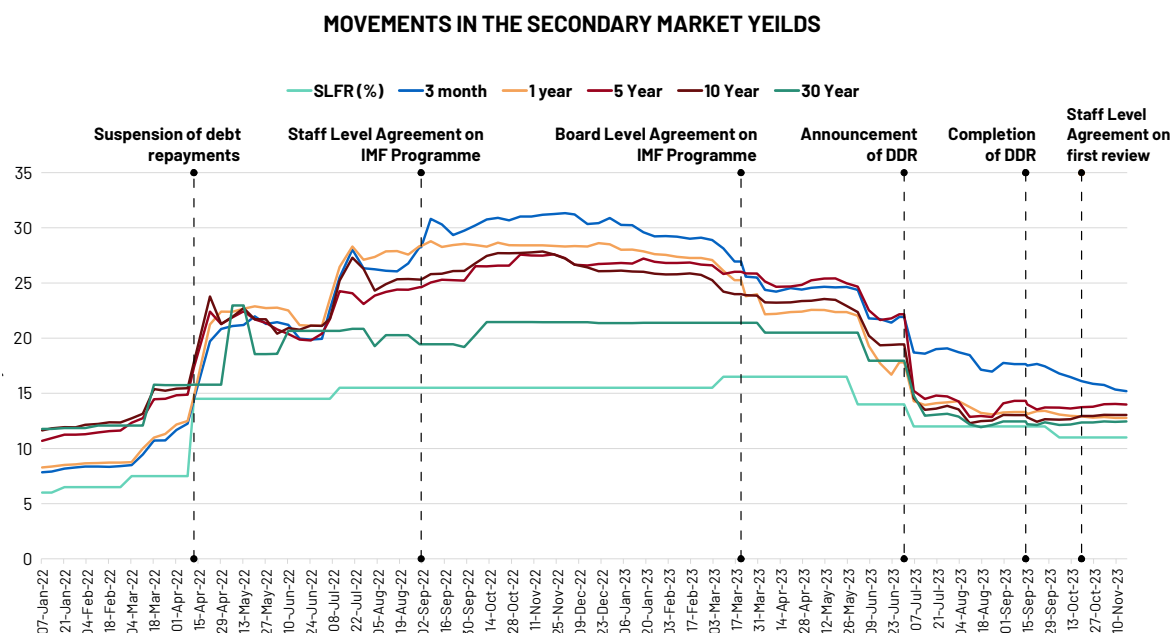
Period 4:

There is a dramatic reduction in the average yield curve differential, which falls to around 258 basis points. The uncertainty surrounding DDR was removed, which lowered bond yields. However, liquidity constraints and limitations on the monetary financing of government spending contribute to higher yields on the shorter tenure treasury bills.

Period 5:

The average yield curve differential experiences a slight increase of around 292 basis points. The government failed to meet milestones and expectations on the IMF programme, which heightened uncertainty. Meanwhile, the easing of liquidity constraints following DDR leads to a reduction in short-term yields.

Exhibit 9: Movements in secondary market yields



Source : Central Bank of Sri Lanka weekly indicators | IMF and Sri Lanka

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

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