SRI LANKA

Medium-Term Debt Management Strategy (MTDS) 2019/2023

Ministry of Finance/ Central Bank of Sri Lanka

5 April 2019

Medium- Term Debt Management Strategy (2019/23)

This Medium- Term Debt Management Strategy (MTDS) was prepared by a combined working group representing officials of the Ministry of Finance and Central Bank of Sri Lanka is hereby approved.

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Table of Contents

List of Figures

List of Tables

Table of Acronyms

AASL	Airport Authority of Sri Lanka
ABP	Annual Borrowing Plan
AT	Analytical Tool
ATM	Average Time to Maturity
ATR	Average Time to Refixing
CBSL	Central Bank of Sri Lanka
CEB	Ceylon Electricty Board
CS-DRMS	Commonwealth Secretariat Debt Recording and Management System
DDMC	Domestic Debt Management Committee
DeM	Debt Management
DMO	Debt Management Office
DMS	Debt Management Strategy
DSA	Debt Sustainability Analysis
ERD	External Resource Department
EFF	Extended Fund Facility
EPF	Employees' Provident Fund
EMBI	Emerging Markets Bond Index
EUR	Euro
EURIBOR	Euro Libor
FX	Foreign Exchange
GDP	Gross Domestic Product
GSF	Government Finance Statistics
IDA	International Development Association
IMF	International Monetary Fund
ISB	International Sovereign Bond
ISIN	International Securities Identification Number
LKR	Sri Lankan Rupee
MoF	Ministry of Finance
MoNPEA	Ministry of National Policies and Economic Affairs
MTDS	Medium-Term Debt Management Strategy
MTFF	Medium-Term Fiscal Framework
PDD	Public Debt Department
Rs	Sri Lankan Rupee
SB	Structural Benchmark
SLDB	Sri Lanka Development Bond
SLFR	Standing Lending Facility Rate (of the CBSL)
SLPA	Sri Lanka Port Authority
SOE	State-Owned Enterprise
TA	Technical Assistance
T-bill	Treasury Bill: Rupee-denominated government discount security issued with a maximum of 360 Days original maturity
T-bond	Treasury Bond: Rs-denominated government security issued with at least two years original maturity
US$	United States Dollar
WB	The World Bank Group

Definitions

Average Time to Maturity (ATM)	An indicator used to assess refinancing risk based on the current average time to maturity of debt outstanding.
Average Time to Refixing (ATR)	An indicator used to assess refinancing risk based on the portion of debt exposed to a change in the interest rate, including debt issued at a variable interest rate and debt less than one year.
Present Value (PV)	The current worth of a future sum of money or stream of cash inflows to the MoF after the issuance of discounted instruments, which include T-bills and Zero-Coupon Bonds and give a specified rate of return.
Yield Curve	A line that plots the structure of interest rates, at a set point in time, of government securities with different maturities, ranging from 3-month T-bills to 10-year T-bonds. It enables investors at a quick glance to compare the yields offered by short, medium and long-term bonds.

Foreword

The Fiscal Management (Responsibility) Act, No. 3 of 2003 (FMRA) governs the fiscal operations of the Government of Sri Lanka by specifying targets for the fiscal deficit, the government debt, exposure for government guarantees. As a part of reporting requirements under the FMRA, the Government is required to publish a Fiscal Strategy Statement in Parliament alongside the National Budget. The Fiscal Strategy Statement is informed by the Medium-Term Fiscal Framework (MTFF), which includes projections for the major budget variables and the underlying macroeconomic inputs. Sri Lanka has witnessed a steady increase in the share of non-concessional debt sourced from external sources in recent years, as Sri Lanka's access to concessional funding became restricted with the rise country's per capita income. Following the cessation of the civil conflict, the funding necessary for infrastructure investment came largely from external sources due to Sri Lanka's under-developed capital markets. In addition, a structural decrease in government receipts over the past two decades or so added to the financing needs of the government.

The increase in the share of foreign debt of the total debt increases the country's vulnerability to external shocks, such as hikes in the international interest rates, volatility in cross-border capital flows, and potential exchange rate depreciation. The Government has therefore committed itself to stabilize and reduce the debt level through appropriate macroeconomic and fiscal policy measures, aided by an IMF program in effect through mid-2020. The Medium-Term Debt Management Strategy (MTDS) 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 FX-denominated debt, as well as lumpy debt servicing obligations. This MTDS was developed based on the MTFF which takes into account the structural reforms and fiscal consolidation measures that are to be implemented by 2023.

Debt management in Sri Lanka is carried out by the Central Bank of Sri Lanka in consultation with the Ministry of Finance, with the main objectives of ensuring the government's financing needs are met at the lowest possible cost consistent with a prudent degree of risk, while developing and strengthening the domestic government securities market. The MTDS emphasizes the cost-risk implications of the strategy that was developed for the purposes of the debt management. The risk characteristics of this strategy were evaluated under sets of shocks that were applied to the differently structured debt portfolios. The selected strategy aims to contain the exposure to foreign debt, while building FX reserves in the years 2019 and 2020 in line with IMF program. Rollover and interest rate risks are reduced though a shift from short-term to longer-term instruments. Given Sri Lanka's large FX debt servicing obligations over the medium-term, there exists only a remote possibility of immediately reducing the share of FX debt of the total debt from level observed at end 2018. However, it is noteworthy that even if the FX share in total debt stays at about the same levels over the next five years, the foreign debt as a share of GDP is expected to decline from 45.1 per cent at end 2018 to 38.5 per cent by end 2023 under the MTDS, a drop by 6.6 per cent.

Acknowledgements

This is the first attempt to formulate a Medium-Term Debt Management Strategy (MTDS) by the Government of Sri Lanka. The MTDS is expected to play a crucial role in making public debt more sustainable, while allowing the necessary fiscal space for much needed socio-economic infrastructure and social safety net programmes. The MTDS will assist the formulation of Medium-Term Fiscal Framework by the Government as per the requirement under the Fiscal Management Responsibility Act, and would guide debt management operations over the medium term.

I wish to take this opportunity to acknowledge the contribution and dedication of the MTDS Working Group chaired by a Deputy Secretary to the Treasury, which comprised of officials from the General Treasury and the Central Bank of Sri Lanka whose unwavering commitment made this exercise a success. Further, the Working Group benefited from the guidance of the Coordinating Committee which also comprised officials from the General Treasury and the Central Bank of Sri Lanka.

The formulation of the MTDS also benefited from the team at the International Monetary Fund and the World Bank, which provided technical assistance on the use of the MTDS Tool and subsequent support throughout the process.

In addition, I gratefully appreciate the guidance received from the Hon. Minister of Finance, Hon. State Minister of Finance, the support from the Senior Management of the Ministry of Finance and the Central Bank of Sri Lanka including the Governor himself, and various officials of the Ministry of Finance and Central Bank for comments and suggestions in formulating the MTDS.

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Executive Summary

Sri Lanka's government debt grew relatively fast over the recent years, reflecting the impact of sustained fiscal deficits, restricted access to concessional financing, and the depreciation of the exchange rate. Due to the limited availability of concessional funding, foreign currency financing tilted further towards commercial borrowings by means of International Sovereign Bonds, syndicated loans, and short-term borrowings from the foreign currency banking units of domestic banks, resulting in significant increase of the share of foreign currency debt in the total outstanding debt.

Against this backdrop, the Government took measures to develop a Medium-Term Debt Management Strategy (MTDS) with the assistance of the International Monetary Fund and World Bank in 2018, in order to minimize the country's vulnerability to any domestic and external risks. Foreign exchange and rollover risk were identified as the key debt portfolio risks for Sri Lanka. Therefore, the MTDS is focused on containing the foreign currency debt as a share of total debt, improving the average time to maturity (ATM) of the foreign currency debt portfolio, and limiting the debt maturing in 1 year by end-2023.

Accordingly, the quantitative targets for the such objectives were set as 54 per cent of FX debt as a percent of total, i.e., continuing with the same share as at end 2018 due to large forex debt maturing over the medium-term, containing the ATM at 6.6 years, and reducing the debt maturing in 1 year to 15.7 per cent by 2023 from 16.4 per cent in 2018. The MTDS aims to improve the quality of foreign financing with switching instruments from short term to medium and long term. It is noteworthy that even if the foreign currency share in total debt would stay around 54 per cent by 2023, the foreign debt as a share of GDP is expected to decline from 45.1 per cent at end 2018 to 38.5 per cent by end 2023, a reduction of 6.6 percentage points.

The MTDS will be implemented by an interdepartmental working group consisting of staff from the Central Bank of Sri Lanka (CBSL), the Ministry of Finance (MoF) and other relevant agencies. The working group will implement, monitor, evaluate, and revise the MTDS on an annual basis.

1. INTRODUCTION

Against a background of significant fiscal deficits, tightening global financial market conditions, and the notable depreciation of the exchange rate, Sri Lanka's government debt as a share of GDP increased in the recent years. For instance, the central government debt as a percentage of GDP increased to 82.9 per cent at end 2018 from 76.9 per cent at end 2017, and from 68.8 per cent at end 2012. Meanwhile, the share of foreign debt in the total outstanding debt increased to 54 per cent at end 2018 from 43 per cent in at end 2005.

This Medium-Term Debt Management Strategy (MTDS), developed with the assistance of the International Monetary Fund and World Bank, is providing a plan towards satisfying the financing needs of the Government of Sri Lanka, while reducing the debt level to more sustainable levels over time. The challenges and constraints the Government faces require a disciplined approach geared at minimizing the cost of financing at an acceptable level of risk. The MTDS will facilitate the Government to diversify the investor base and reduce refinancing risks.

The MTDS will be supported by the recently enacted Active Liability Management Act (ALMA).[1] The ALMA, enables the government to manage the public debt more proactively by addressing part of the refinancing requirements ahead of time (reducing rollover peaks) and extending the maturity duration and smoothening repayments structure of International Sovereign Bonds (ISBs) and other debt securities. These liability management efforts will facilitate the Government to diversify the investor base, provide opportunities to streamline cost of borrowing based on market conditions, reduce refinancing risk in the near term and create a favorable price tension for any new issuances.

2. ECONOMIC AND FISCAL BACKGROUND

2.1 Economic Conditions

Real growth fell to 3.2 per cent in 2018 from 3.4 per cent in 2017. Economic growth in 2018 was mainly driven by the expansion in services activities together with the recovery in agriculture-related activities, while the industrial sector, expanded at a slower pace during the year. Both headline and core consumer price inflation remained contained in 2018 as a result of subdued demand pressures in the economy. The inflation outlook is expected to remain favourable within the target range of 4.0-6.0 per cent in 2019.

Central Bank of Sri Lanka (CBSL) followed a neutral monetary policy stance since April 2018. To ease a large and persistent liquidity deficit in the domestic money market in late 2018, the CBSL reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points effective from mid November 2018. At the same time, the CBSL increased the Standing Deposit Facility Rate (SDFR) by 75 basis points and the Standing Lending Facility Rate (SLFR) by 50 basis points to neutralisze the impact of the SRR

[1] The Active Liability Management Act, No. 8 of 2018.

reduction. In line with the changes in market liquidity conditions and the monetary policy stance of the CBSL, overnight interest rates showed mix movements during 2018.

On the external front, the trade deficit expanded significantly during 2018 as import expenditure, driven by a significant increase in the import of fuel, gold and vehicles, outpaced the growth in export earnings. This development along with the higher deficit in the primary income account led to the widening of the current account deficit. Improvements in earnings of services exports, mainly due to an increase in tourist expenditures, as well as remittance inflows helped partially off-set the widened current account deficit. Meanwhile, the financial account recorded notable net inflows, mainly due to the proceeds from International Sovereign Bonds (ISBs), the receipt of the fifth tranche of the IMF-Extended Fund Facility (IMF-EFF), the foreign currency term financing facility and FDI inflows including proceeds from the divestiture of the Hambantota Port. However, foreign investment outflows from the government securities market and the Colombo Stock Exchange (CSE) since the second quarter of 2018 exerted pressure on the external sector.

2.2 Recent Fiscal Developments

2018 fiscal performance was marked by lower than expected government revenues, a significant moderation in public investment and a substantial rise in government debt, despite an improvement in the primary surplus and the overall budget deficit. The introduction of revenue enhancement measures – including improvements in revenue administration and tax collections - and measures to improve the efficiency of government expenditures through commitment controls should bear fruit in the near future. Reforms of the State Owned Enterprises (SOEs) including the introduction of automated fuel pricing mechanism were implemented to improve their financial performance. The enactment of the Active Liability Management Act (ALMA) should lead to a smoother the government's debt management, while the formulation of a MTDS is addressing the refinancing risk of the government debt.

The 2018 budget deficit fell to 5.3 per cent of GDP from 5.5 percent in 2017. The surplus in the primary balance, increased to 0.6 per cent of estimated GDP (Rs. 91.4 billion) in 2018 from 0.02 per cent of GDP (Rs. 2.1 billion) in 2017. The government relied largely on domestic sources in financing the budget deficit, accounting for 57.5 per cent of total net financing in 2018. Outstanding central government debt, as a share of GDP, increased to 82.9 per cent at end-2018 from 76.9 per cent at end-2017. This increase was mainly due to the depreciation of Sri Lankan rupee against major foreign currencies, relatively low nominal GDP growth, and higher net borrowings.

Table 1: Summary of Government Fiscal Operations

Item	2017	2018
As a percentage of GDP (c)		
Total Revenue and Grants	**13.7**	**13.4**
Total Revenue	13.6	13.3
Tax Revenue	12.4	11.9
Non Tax Revenue	1.2	1.4
Grants	0.1	0.1
Expenditure and Lending Minus Repayments	**19.2**	**18.6**
Recurrent	14.4	14.5
Capital and Net Lending	4.8	4.2
o/w Public Investment	4.9	4.3
Current Account Balance	**-0.7**	**-1.2**
Primary Balance	**0.0**	**0.6**
Overall Fiscal Balance	**-5.5**	**-5.3**
Total Financing	**5.5**	**5.3**
Foreign Financing (a)	3.3	2.2
Domestic Financing	2.2	3.0
Market Borrowings	1.9	2.3
Non Bank	0.5	1.5
Bank	1.4	0.8
Monetary Authority	-1.4	1.7
Commercial Banks	2.8	-0.9
Non Market Sources (c)	0.3	0.7

(a) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors

(c) Includes divestiture proceeds

(c) Based on revised GDP estimates for 2017 made by the Department of Census and Statistics available on 19.03.2019

3. THE GOVERNMENT DEBT

3.1 Debt Issuance and Trading

Treasury bills (T-bills), Treasury bonds (T-bonds), and Sri Lanka Development Bonds (SLDBs) are the three main types of instruments that support a part of Government's financing requirements. Government securities are issued in the primary market via auctions, where participation is limited to Primary Dealers (PDs) and Designated Agents (DAs).[2] Trading between different investors

[2] Sri Lanka's largest pension fund, the Employee Provident Fund (EPF) is the only non-dealer bidder eligible to take part in issuances of Treasury bills and Treasury bonds.

takes place in the secondary market, usually supported by PDs and other market intermediaries. Regular and consistent issuance of government securities helps ensuring a liquid and active secondary market for government securities. Furthermore, liquidity enhancement measures, for instance through the issuance of benchmark bonds and LMOs involving T-bonds has been proposed and at times executed in recent years.

3.2 Primary Market Instruments and Issuance Processes

(a) Treasury bills

T-bills are short term government securities with 91-day, 182-day, and 364-day tenors. T-bills are issued weekly through competitive multiple price auctions with T+2 settlement date, where strict adherence to the amount offered in aggregate is strived without any room for over acceptance of bids deviating from the aggregate amount offered. PDs and non-dealer bidders, as approved by the Monetary Board are eligible to participate at this auction. T-bills are the most liquid type of government security.

(b) Treasury bonds

The issuance of T-bills began in 1997 to raise medium to long term funds in the domestic rupee-market, with maturities from 2 to 30 years issued via a three-phase auction system open for PDs and non-dealer bidders, introduced with effect from July 27, 2017, replacing the fully auction-based system that was used since early 2015. The new system was developed to improve both the efficiency of the issuance process. The publication of quarterly T-bond issuance calendars in advance on rolling basis is supplementing the new auction system.

(c) Sri Lanka Development Bonds (SLDBs)

SLDBs are domestic foreign currency securities as issued either on a floating or a fixed rate basis instruments. SLDBs are currently issued in scrip format in maturities ranging from 2 to 5 years. Auctions are typically taken place when maturing, with DAs marketing the instrument among eligible investors. SLDB auctions involve competitive bidding in terms of rates or spreads over the London Interbank Offered Rate (LIBOR) for fixed or floating-rate SLDBs, respectively. Auctions are generally open for five business days for DAs to submit their bids, with a T+3 settlement period.

3.3 Outstanding Public Debt

The outstanding public debt,[3] which includes central government debt, T-bonds issued for restructuring of SOEs, foreign project loans received by SOEs, public guaranteed debt and international bonds issued by SOEs, increased substantially to 91.9 per cent of GDP by end 2018 from 84.9 per cent of GDP in 2017. Accordingly, the total outstanding public debt increased to Rs. 13,182.1 billion at end 2018 from Rs. 11,303.5 billion at end 2017 in nominal terms. The outstanding central government debt which is the largest component of the total public debt

[3] This, however, excludes state owned banking institutions.

increased by 16.1 per cent to Rs. 11,977.5 billion at end 2018, accounting for a relative share of 90.9 per cent of the total public debt. Meanwhile, government guaranteed debt enlarged by 33.0 per cent to Rs. 749.8 billion at end 2018 from Rs. 563.7 billion at end 2017. This accounted for 5.7 per cent of the total outstanding public debt. On the other hand, foreign project loans received by SOEs and outstanding international bonds issued by SOEs increased to Rs. 366.1 billion and Rs. 32.0 billion, respectively at end 2018 from Rs. 330.2 billion and 26.8 billion, respectively. Nevertheless, outstanding T-bonds issued for restructuring of SOEs declined to Rs. 56.7 billion at end 2018 from Rs. 69.8 billion at end 2017 as a result of the retirement of T-bonds in August 2018, which were issued to capitalise Sri Lankan Airlines.

4. DEBT MANAGEMENT

4.1 Objectives and Legal Foundation

In terms of Section 113 of the Monetary Law Act, CBSL is responsible for the management of the public debt as the agent of the government. Accordingly, Public Debt Department of the CBSL on behalf of the government issues debt instruments and handles all matters relating to servicing the domestic and foreign debt of the government. The MoF handles the matters relating to obtaining loans from the foreign sources, mainly bilateral and multilateral and recently on syndicated finance, under the Foreign Loans Act. Further, foreign loans obtained by the Government are reviewed by the CBSL for potential monetary implications. Also, on behalf of the Government CBSL facilitate the issuances of International Sovereign Bonds.

The objective of debt management is to manage public debt to ensure the financing needs and payment obligations of the Government are met at the lowest possible cost over the medium to long term consistent with a prudent degree of risk. Debt management would also look into developing and strengthening the government securities market, while enhancing efficiency and maintaining stability. Although the objectives pursued by government debt management have not been made explicit by any law in Sri Lanka, debt management in Sri Lanka is carried according to the following principles:

(a) Minimize the direct and indirect cost of public debt on a long-term perspective
(b) Avoid volatility in debt service cost and guarantee a balanced maturity distribution
(c) Prevent an excessive concentration of redemption payments
(d) Minimize any type of rollover risk / refinancing risk
(e) Promote the efficient functioning of the government securities market
(f) Service government debt on time with 100 per cent accuracy

Three statutes govern the issuances of government securities:
(a) The Local Treasury Bills Ordinance;
(b) The Registered Stocks and Securities Ordinance; and
(c) The Foreign Loans Act, No. 29 of 1957

Laws and regulations governing the payment and settlement function of government securities transaction include,

(a) Monetary Law Act, (MLA) No.. 58 of 1949
(b) Payment and Settlement Systems Act, No. 28 of 2005
(c) Foreign Loans Act, No. 29 of 1957

Other Laws and regulations governing the prudent management of public debt in Sri Lanka;
(a) The Active Liability Management Act, No. 8 of 2018

4.2 Operations

Sri Lanka's Parliament is responsible for setting annual borrowing limit as part of annual Appropriation Act. The General Treasury under the MoF manages the consolidated fund and attend to external concessionary funds and provides funds for debt servicing through the External Resources Department (ERD)[4] and the Treasury Operations Department (TOD). The ERD is responsible for the mobilization and the management of external concessionary funds, coordinating with donors and maintenance of external debt database while the TOD is responsible for Treasury cash flow management and provision of funds for debt servicing.

PDD of CBSL is responsible for the following operations:

(a) Mobilization of funds from domestic and external commercial sources for government budget and liability management purposes;
(b) Facilitation of the Servicing of public debt
(c) Issuance of government securities through auctions and direct means of distribution
(d) Maintenance of a database for domestic debt instruments
(e) Maintenance of the Central Depository System (CDS)
(f) Development of the domestic government securities market
(g) Dissemination of information on debt management
(h) Facilitation of the debt management strategy and the liability management framework

PDs as the main market intermediaries are supervised by the CBSL. The Bank Supervision Department supervises the bank-owned PD firms, while the Department of Supervision of Non-Bank Financial Institutions supervises the independent PDs that are not owned by banks. Minimum capital and capital adequacy requirements primary dealers have been stipulated by the CBSL. The minimum infrastructure requirements, managerial and technical skills, and regulatory compliance that have to be satisfied by all primary dealers as stipulated in regulations, directions and guidelines issued by the CBSL. PDs also have to comply with a Code of Conduct issued by the CBSL.

The main investors in the government debt market are the banks, insurance companies, and the two pension funds EPF and ETF. PDs and LCBs act as Dealer Direct Participants (DDPs)[5] in the

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[4] ERD is currently under the MoF.

[5] Dealer Direct Participant is a Licensed Commercial Bank or a Primary Dealer who shall maintain Securities Accounts to hold Scripless Securities (Government Securities) on behalf of such Institution as well as its customers, and appointed by CBSL in terms of the Registered Stock and Securities Ordinance and the Local Treasury Bills Ordinance.

secondary market of the government securities i.e., enter in to transactions on their own behalf and on behalf of other investors. Thus, among 26 LCBs there are 19 commercial banks who act only as DDPs, but not PDs.

The operational details within the approved budgetary plan for a particular financial year is coordinated by the Domestic Debt Management Committee (DDMC). The DDMC consists of senior officials from the MoF and the CBSL, and meets monthly–or more frequently if needed–and decides on an issuance strategy for the next four weeks, taking into consideration market conditions, investor appetite, monetary developments, inflation, government cash flow needs and the debt's maturity profile. The borrowing plans that are prepared based on this strategy are implemented by the PDD.

The CBSL is also responsible for the:

(a) Central Security Depository (CDS) and ensure all government securities transactions are recorded in the CDS with 100 per cent accuracy.
(b) Development of the domestic government debt market through the issuance of benchmark securities to foster the development of a yield curve
(c) Advising the MoF on debt management and issuance, taking into account the prevailing economic and market conditions.
(d) Developing and maintaining the technological infrastructure underlying public debt management and issuance.

4.3 The Financing Environment in 2018

The overall budget deficit was financed largely through domestic sources in 2018. In financing the budget deficit through domestic sources, the government relied largely on domestic non-banking sector in 2018, while lowering the dependence on the domestic banking sector significantly. Funds mobilised through foreign sources declined in 2018 due to significant outflows in foreign holdings of rupee-denominated T-bonds and T-bills.

Table 2: Sources of Budget Financing

Rs. Bn

Item	2017	2018 (a)
Domestic Financing	**294.3**	**437.2**
By Instrument	**294.3**	**437.2**
Treasury Bonds (b)	109.1	374.5
Treasury Bills (c)	-81.7	52.9
Rupee Loans	-	-
Sri Lanka Development Bonds	53.3	-129.5
Central Bank Provisional Advances	116.5	-1.2
Other	97.0	140.4
By Source	**294.3**	**437.2**
Bank	187.7	109.5
Non Bank (d)	106.5	327.8
Foreign Financing	**439.2**	**323.5**
Foreign Project Loans	0.8	7.7
International Sovereign Bond	228.5	390.4
Treasury bills and bonds (e)	57.3	-141.1
Syndicated loans and other	152.7	66.6

Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) Provisional

(b) Excludes rupee denominated Treasury bonds issued to foreign investors and funds raised for restructuring of SOBEs in 2012, 2014 and 2015

(c) Excludes rupee denominated Treasury bills issued to foreign investors

(d) Includes divestiture proceeds in 2017 and 2018

(e) Includes rupee denominated Treasury bills and bonds issued to foreign investors

Domestic borrowings of the government by way of T-bills and T-bonds, in net terms, increased significantly in 2018, whereas non instrument borrowings declined. Foreign currency-denominated domestic borrowings recorded an overall net repayment during 2018. Repayments to commercial banks were largely on account of SLDBs and Treasury bonds owing to the retirement of T-bonds and SLDBs during the year, while borrowings through Treasury bills declined significantly. Borrowings through foreign project loans on a net basis increased during 2018.

4.4 Transparency and Communications

In 2017, the PDD started publishing a quarterly calendar for T-bonds issuances on rolling basis incorporating the auction date, settlement date, tenor and amount information. For T-bills the same information is published, but with the amounts omitted. This process has enhanced the predictability of the primary auction process, making this information available to investors well in advance of the auctions.

In line with publishing a quarterly calendar for Treasury bills and T-bonds issuances on rolling basis, PDD took measures to develop a benchmark yield curve. Accordingly, 2, 5, 8 and 10 year maturities have been identified as benchmark tenors and Treasury bonds with such maturities are being regularly issued. Coupon rates are determined based on input from the PDs, actual market transactions for similar maturities and bid yields quoted by PDs.

Prior to the upcoming Treasury bond auctions pre-bid meetings are held to share information between primary auction participants and the licensed commercial bank community. Market developments and the authorities' thinking behind the upcoming auctions are discussed in these meetings. In addition, investor awareness programmes and investor meetings continued to be held in 2017 inform [the public] of recent economic developments and the prospects of the Sri Lankan economy. These were augmented by two public investor awareness programmes for investors at the provincial level, on-site promotion activities and television programme over the course of the year to educate public on investments in government debt securities.

5. A MEDIUM-TERM DEBT MANAGEMENT STRATEGY FOR 2019-2023

The MTDS for 2019-2023 aims to achieve the public debt management objectives to ensure that the government's financing needs are met at the lowest possible cost consistent with a prudent degree of risk and developing and strengthening the government securities market, while enhancing efficiency and maintaining stability. The MTDS has been formulated with consideration such as potential variation in debt servicing costs and its budgetary impact, linkages with other key macroeconomic policy objectives/ targets, improvement in debt sustainability and the need for the development of the domestic debt markets. The MTDS for 2019-2023 is based on the Government Budget 2018 and the medium-term policy direction announced in the same.

5.1 Definition

The Medium-Term Debt Management Strategy (MTDS), which is a rolling plan, articulates the strategies and debt management framework that the MoF and CBSL plans to execute over the next five-year period with the aim of implementing a prudent borrowing program and achieving Government's debt management objectives. The MTDS is principally focused on building an appropriate composition of the debt instruments focusing on the projected path of macroeconomic framework and market environment.

5.2 Debt Management Targets

The MTDS is based on the government's MTFF. The government is committed to implementing revenue based fiscal consolidation resulting in a sustainable level of debt in future. Smooth policy coordination centered on the MTDS allows each agency to focus more clearly on its core objectives, in turn helping to achieve greater accountability in the management of the public debt.

The Government is of the view that Quantitative targets will facilitate a more sustainable and a predictable debt strategy independent of political or other exogenous impacts. Once targets for a set of risk indicators have been established, they help to more clearly to communicate objectives like "risk" and "cost," and the tradeoffs between them. Quantitative targets allow also for clear comparisons versus the realizations of the underlying indicators.

Due to the inherent uncertainty associated with debt management targets, and the potential need for quick reactions to changes in market conditions, debt management targets are usually accompanied by ranges, or have upper or lower limits associated with them. Both the targets and the ranges or limits should be achievable in line with market conditions.
The key debt portfolio risk for Sri Lanka are foreign exchange and rollover risks, especially for the FX denominated debt. The strategy objectives are therefore to reduce exposure to FX debt and reduce roll-over risks of the portfolio.

FX debt as a percent of total, the average time to maturity of the FX debt portfolio, and the debt maturing in 1 year were therefore selected as the debt management targets to be achieved by end-2023. The targets for the three objectives are given below.

Table 3: Key Debt Management Targets

Risk Indicator	**2018** ***Current***	**Target 2023**
FX debt (percent 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 (percent of total)	16.4	Decreasing from the current level

Source:MOF, CBSL

5.3 Classification of Debt Instruments

For the purposes of the MTDS Sri Lanka's government debt is divided into FX-denominated and rupee-denominated debt. The FX-debt is then divided into variable-rate debt and fixed-rate debt:

Variable rate external debt can be mainly divided into three categories.

i. Multi concessional
ii. Semi-concessional
iii. Commercial
iv. SLDBs

Fixed rate external debt can be mainly divided into six categories.

i. Multi concessional
ii. Semi-concessional
iii. Commercial (syndicated loans)

iv. Commercial 5-year ISB
v. Commercial 10-year ISB
vi. SLDBs
vii. Short-Term loans from domestic banks (i.e., loans from Foreign Currency Banking Units -FCBUs)

Table 4: Classification of Debt Instruments

Instrument Number	Instrument Type / Name	Fixed / Variable / T-bills	Maturity (Years)	Grace (Years)	Currency
USD_1	Multi-concessional fixed FX (Project Loans)	Fix	40	10	USD
USD_2	Multi-concessional var FX (Project Loans)	Var	40	10	USD
USD_3	Semi-concessional fixed FX (Project Loans)	Fix	25	5	USD
USD_4	Semi-concessional var FX (Project Loans)	Var	25	5	USD
USD_5	Commercial 5-year ISB	Fix	5	4	USD
USD_6	Commercial 10-year ISB	Fix	10	9	USD
USD_7	Commercial var FX (Syndicated Loans)	Var	4	2	USD
USD_8	Commercial fixed FX (Syndicated Loans)	Fix	8	3	USD
USD_9	Short Term Commercial Fixed (FCBUs)	Fix	1	0	USD
LKR_10	Semi-concessional fixed LKR	Fix	3	2	LKR
LKR_11	Overdraft fixed LKR (OD)	Fix	1	0	LKR
LKR_12	Rupee loan fixed LKR	Fix	5	4	LKR
USD_13	SLDB var USD	Var	4	3	USD
USD_14	SLDB fix USD	Fix	4	3	USD
LKR_15	T bill LKR	T-bills	1	0	LKR
LKR_16	T bond 3 years LKR	Fix	3	2	LKR
LKR_17	T bonds 5 years LKR	Fix	5	4	LKR
LKR_18	T bond 10 years LKR	Fix	10	9	LKR
LKR_19	Commercial var LKR	Var	6	5	LKR
LKR_20	CBSL Advance	Fix	5	1	LKR

The rupee debt portfolio is also divided into fixed rate and variable rate debt. The fixed rate category is divided into four categories. They are T-bills, T-bonds, Over Draft Fixed (OD) and Legacy Debt Fixed (CBSL Advances). Under the variable rate category commercial (Domestic Project Loans). Overdrafts with fixed rates and Legacy Debt fixed are loans incurred from commercial banks and the CBSL to facilitate Government funding requirements. Secondary market traded debt instruments are broadly divided according to their maturity: T-bills that mature within a year and T-bonds that have longer original maturities.

5.4 Debt Management Strategy Development

5.4.1 Assumptions

The MTDS incorporates the government's medium-term macroeconomic projections along with its MTFF. Real GDP growth is projected to improve from 3.2 percent in 2018 to 5.0 percent over the medium term. Inflation was projected to be about 5 percent in 2019 and beyond with the adoption of flexible inflation targeting framework by the Central Bank. Supported by ongoing fiscal consolidation measures, fiscal deficits are projected to decrease from 5.3 percent of GDP in 2018 to 3.5 percent of GDP in 2020 and beyond, implying a steady improvement in the primary balance to 2.3 percent of GDP by 2023. Debt service payments on the outstanding debt are based on the payments to be made on the debt as of time of issue, while secondary markets rates prevailed at the beginning 2019 are used to project the interest rates on newly issued debt. Gross financing needs are determined by the primary deficit, interest costs, and principal payments/redemptions. A currency depreciation of about 3 percent is assumed beyond 2019.

The major sources of foreign currency financing are SLDBs, ISBs, and project loans. Maturities of SLDBs will be retained below a level of USD 1 billion annually and focused more on issuing fixed rate to reduce the volatility emanating from floating rate benchmark in the medium-term. Further, around 60 to 70 per cent of the ISBs will be locked in longer tenor to reduce rollover risk in medium term.

Local currency borrowing will be undertaken through issuance of T-bills and T-bonds. By converting part of the T-bills and 3 to 5-year T-bonds into long term maturities of T-bonds will smoothen the payment cycle and reduce the bunching of maturities in the medium term based on the resource availability.

Table 5: Macroeconomic Assumptions

Rs. Bn

	2018	2019	2020	2021	2022	2023
Real GDP Growth (%)	3.20	4.00	4.50	5.00	5.00	5.00
CCPI Inflation (average %)	4.3	5.0	5.0	5.0	5.0	5.0
External Sector						
International reserves (USD million)	6,919	8,628	9,730	10,431	11,027	11,608
Central Governemnt Budget						
Budgeted Revenue and Grants	1,932	2,357	2,738	2,986	3,259	3,562
Budgeted Revenue and Grants (% of GDP)	*13.4*	*15.2*	*16.2*	*16.2*	*16.2*	*16.2*
Budgeted Primary Expenditure	1,851	2,126	2,328	2,555	2,789	3,049
Budgeted Primary Expenditure (% of GDP)	*12.8*	*13.7*	*13.8*	*13.9*	*13.9*	*13.9*
Total Expenditures including budgeted interest payments	2,693	3,066	3,329	3,623	3,970	4,336
Total Expenditures including budgeted interest payments (% of GDP)	18.6	19.8	19.7	19.7	19.8	19.8
Budgeted interest payments	852	938	1,003	1,066	1,164	1,267
Budgeted interest payments (% of GDP)	*5.9*	*6.0*	*5.9*	*5.8*	*5.8*	*5.8*
Primary Balance	91	231	410	431	470	513
Primary Balance (% of GDP)	***0.6***	***1.5***	***2.4***	***2.3***	***2.3***	***2.3***
Budget Balance	(761)	(709)	(591)	(637)	(711)	(774)
Budget Balance (% of GDP)	*(5.3)*	*(4.6)*	*(3.5)*	*(3.5)*	*(3.5)*	*(3.5)*
Nominal GDP	14,450	15,521	16,868	18,378	20,064	21,938

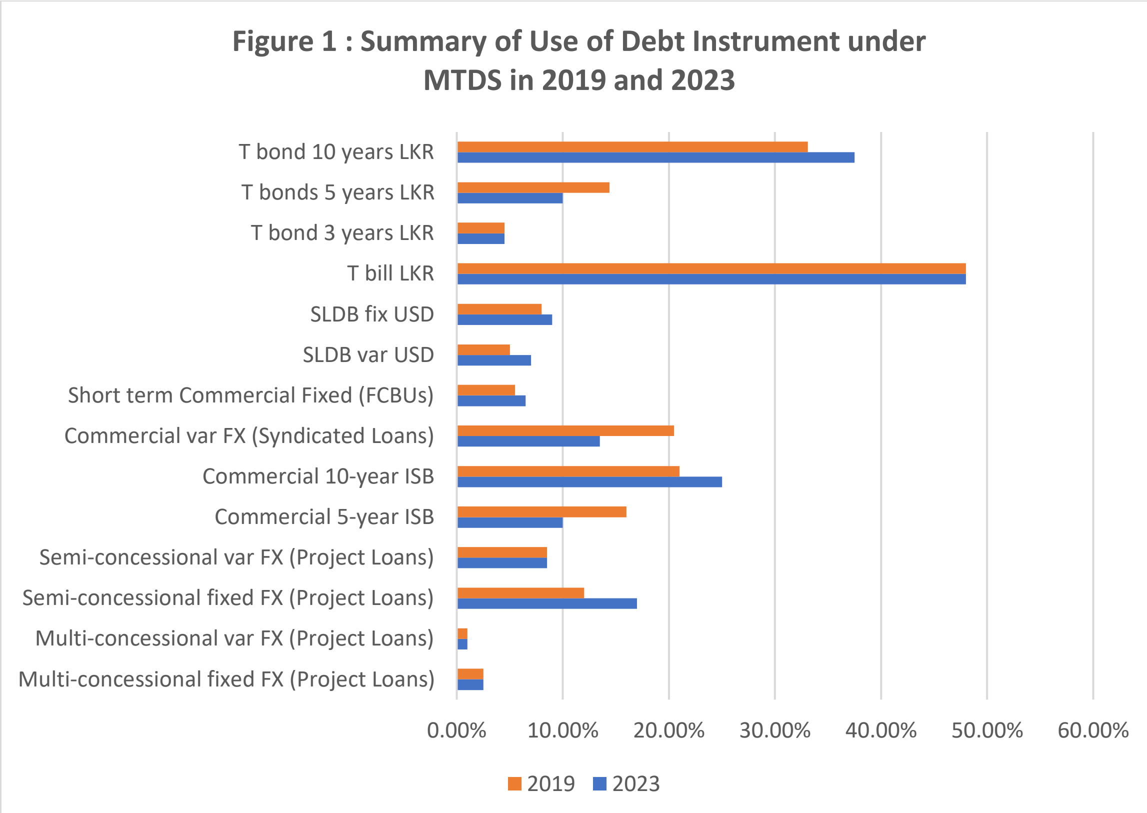
Note: The path of budget deficit for the purpose of MTDS has taken into account some deviations from the projections published along with the Budget 2019 making some allowance for unforeseen economic shocks, if any, over the medium-term.

5.5 Proposed Strategy to Address Portfolio Risks

Reduction in foreign financing while switching instruments from short term to medium/ long term

The proposed strategy will reduce foreign financing over the medium term while switching instruments from short term to medium/ long term, which will contain the FX exposure at the level which was observed in 2018 and reduce roll-over risks of the portfolio.

It has been developed in a way that the share of yearly gross external financing reduces from 48.8 per cent in 2019 to 35 per cent in 2023, after increasing in 2019 and 2020 to build up FX reserves in line with the EFF, to achieve sustainable FX-share of the public debt stock in the medium term, while reducing the debt maturing within a year and lengthening the average time to maturity. The ratio of debt instruments in this strategy is shown in the table below. Further, the issuances of 10-year T-bond has been increased and T-bills has been reduced to extend the maturity duration of the domestic debt stock and smoothen bunching of maturities in medium term horizon, and develop the domestic financial market.



It is noteworthy that in bringing down the share of gross external financing from 48.8 per cent in 2019 to 35 per cent in 2023, it was assumed that non-debt creating FX inflows are materialized and could be utilized by the Government over the medium-term. Under the recommended strategy, the Government would not roll-over all maturing FX debt with new FX debt, leaving a net FX cash requirement to be fulfilled in meeting FX debt servicing payments in full. Such net FX cash requirement is computed taking into account of all FX inflows from debt instruments net of FX debt servicing. With regard to FX inflows relating to project financing, it is assumed that about 35 per cent of total project loan disbursements will be made in cash form.

5.5.1 Cost and Risk Analysis of the Strategy

The proposed strategy will achieve the MTDS targets which address the FX risk and the maturity risk of the debt portfolio over the period 2019-23. It reduces the share of yearly gross borrowings over time so that FX-share of the public debt stock reaches sustainable level, while maintaining acceptable level of average time to maturity and reducing the debt maturing in a year. It aims to contain FX risk by keeping the share of foreign currency borrowings at 2018 levels.

Table 6: Summary of the Cost and Risk Analysis

Risk Indicators		2018 Current	As at end 2023 Recommended Strategy
Nominal Debt as percent of GDP		83.5	71.2
Interest Payment as percent of GDP		5.7	4.4
Implied Interest Rate (percent)		6.8	6.1
Refinancing Risks	Debt maturing in 1yr (percent of total)	16.4	15.7
	Debt maturing in 1yr (% of GDP)	13.7	11.2
	ATM Foreign Currency Portfolio (years)	6.6	6.6
	ATM LKR Portfolio (years)	5.7	5.1
	ATM Total Portfolio (years)	6.2	6.0
Interest rate Risks	ATR (years)	5.5	5.2
	Debt refixing in 1yr (percent of total)	27.5	26.2
	Fixed rate debt incl T-bills (percent of total)	86.5	87.5
	T-bills (percent of total)	6.3	5.5
FX Risks	FX Debt as % of Total	54.0	54.0
	ST FX debt as % of reserves	62.8	38.0
	as % of GDP	45.1	38.5

The share of debt maturing in one year will be decreasing and the ATM of the FX debt slightly decreasing compared to the current (2018) levels. Re-directing the debt portfolio from FX to rupee debt needs to go hand in hand with further development of the rupee market as well as enhanced foreign inflows. This limits the ability to implement very large changes in financing framework in the medium term. The decrease in the share of debt maturing within one year is largely due to increase in issuances of long tenor instruments in the medium term. The 2023 outcomes of the target strategy would also achieve the targets set for the debt management strategy.

The proposed strategy is in line with the targets of the EFF-supported Fund program, while also allowing much needed space in Sri Lanka's sizable infrastructure financing needs over the medium term. It allows additional funding through FX-denominated concessional loans by about US$1.1 billion as net additions, across the identified concessional financing sources over 2019-2023.

It is noteworthy that even if the FX share in total debt would stay at 50 per cent at the initial years, the foreign debt as a share of GDP is expected to decline from 45.4 per cent to 38.5 per cent, a decline by 7 per cent by 2023. Under the strategy, the "Debt Maturing in 1 year (percent of total)" and the "ATM of the Foreign Currency Portfolio (years)" both decline versus their current levels.

5.6 Strategy Implementation

It is noted that although the proposed strategy achieves the set targets, implementation and achieving the said targets may be challenging, given the level of depreciation of the LKR with significant outflows in recent times from the debt and equity markets, resulting from both global and local issues coupled with a low growth trajectory. The impact on the Balance of Payments emanating from the lack of a robust growth in non-debt creating inflows such as exports, FDIs etc., with a lack of foreign currency net inflows may severely impact the exchange rate and the macro framework therein, creating significant pressures on the implementation of the proposed strategy.

The MTDS will be implemented by an interdepartmental working group consisting of staff from the CBSL, the MoF and any other relevant agencies. The working group will implement, monitor, evaluate, and revise the MTDS on annual basis.

To improve market transparency and the implementation of the strategy in a predictable and transparent manner, an Annual Borrowing Plan (ABP) will be developed based on the target strategy, and also published as relevant and appropriate. The ABP will provide the indicative volumes of the instruments to be issued for the following year, thus serving as the basis for the quarterly issuance calendars.

It will be important for the MoF and CBSL to communicate this strategy and its objectives to reduce exposure to FX debt and reduce roll-over risks of the portfolio consistently to domestic and international market investors, credit ratings agencies, multilateral and bilateral partners.

6 CONCLUSIONS

Building on the public debt management objectives, the MTDS for 2019-2023 is focused on interest costs and their budgetary impact, foreign debt exposure, debt sustainability, and objective of the development of the domestic debt markets. Towards this objective, the MTDS also aims to contain the refinancing risks of the government debt over the medium-term.

The key debt portfolio risks identified in the MTDS are foreign currency and rollover risks, the latter especially for the foreign currency denominated debt. Hence, foreign currency debt as a share of total government debt, the average time to maturity (ATM) of the foreign currency debt portfolio, and the debt maturing in 1 year were selected as the debt management targets to be achieved by end-2023.

By assessing alternative scenarios for better achievement of the intended objectives, a strategy was recommended to be adopted over the medium-term. The selected strategy aims to contain the exposure to foreign financing, while building FX reserves in the years 2019 and 2020 in line with EFF-supported IMF program. Rollover and interest rate risks are reduced though a shift from short-term to longer-term instruments. The selected strategy will also allow Sri Lanka sufficient space to fund the necessary infrastructure needs over the medium term. Against the backdrop of

Sri Lanka's large foreign currency debt servicing obligations over the medium-term, a quick reduction of the share of foreign currency debt of the total debt from end-2018 to end-2023 is not realistic. However, it should be noted that even if the foreign currency share in total debt were to stay at about the same levels between 2018 through 2023, the share of foreign debt in GDP terms would decline from 45.1 per cent at end 2018 to 38.5 per cent by end 2023, a drop by 6.6 percentage points.

Nevertheless, the implementation of the selected strategy requires a strong commitment from all stakeholders to ensure the envisaged outcomes for the fiscal variables, and the improvements in the investment environment and trade performance projected under government's new investment and trade strategy. Downside risks could materialize if a rapid depreciation of the Sri Lankan rupee occurs, for instance as witnessed in 2018. This could occur due to weaknesses in non-debt creating inflows such as exports, Foreign Direct Investment (FDI), and others that could adversely impact the Balance of Payments and the exchange rate.