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Managing the Public Debt

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The stock of public debt is the total sum outstanding in respect of liabilities incurred by the government over successive years to finance its budgetary operations when government expenditure typically exceeds its total revenue. The Central Bank of Sri Lanka, in its capacity as the agent of the government, is vested with the responsibility of the management of the public debt, in terms of Section 113 of the Monetary Law Act (MLA). For this purpose, the Public Debt Department (PDD) was set up in 1950 when the Central Bank commenced its operations.

The key objectives of public debt management are to (i) manage the public debt to ensure that the government's financial needs are met at the lowest possible cost, consistent with a prudent degree of risk; (ii) service government debt on time with 100 per cent accuracy preserving the default free nature of government debt; and (iii) broaden and deepen the government securities market. Within the context of these three objectives, operations of public debt management cover the issuance of government securities including international sovereign bonds, making maturity and interest payments, recording of ownership of securities, maintenance of the debt databases, assessment and management of the risks associated with the debt portfolio, appointing and supervision of primary dealers, development of the domestic government securities market and activities related to obtaining the sovereign rating of the country.

In managing the public debt, the PDD maintains a close coordination with the activities of the Ministry of Finance, particularly with the Treasury Operations, External Resources and Fiscal Policy Departments, in a strong institutional framework where the Ministry is responsible for mobilisation and management of external concessionary funds, coordination with donors, maintenance of external debt database, treasury cashflow management, provision of funds for debt service and providing advice on borrowings and borrowing limits.

All borrowings for the government are made under the authority granted under section 2(1) (b) of the Appropriation Act in respect of the financial year and such borrowings should not exceed the amount specified in that section. As a part of public debt management, an annual borrowing programme is formulated at the beginning of each year, taking into account a number of considerations such as the maturity structure, currency distribution, domestic and foreign debt composition of the existing portfolio and estimated resource availability of the economy for that year. This annual programme is operationalised through monthly borrowing programmes formulated by the Domestic Debt Management Committee (DDMC), which is represented by Superintendent of Public Debt, Directors of Economic Research, Statistics, and Domestic Operations of the Central Bank and Director General of Treasury Operations of the Ministry of Finance, at its monthly meetings.

During the past 60 years, Sri Lanka's total public debt stock has shown a steep increase with debt to GDP ratio recording an increase from 17 per cent in 1950 to 82 per cent in 2010. Public debt can be divided into two components, domestic debt and foreign debt. After 1977, the government's dependence on borrowings from foreign sources increased rapidly, driving the foreign debt to GDP ratio to remain above 30 per cent, compared to the average foreign debt to GDP ratio of 10 per cent during the period, 1950-1976. However, this foreign debt was largely received as development assistance in the form of project and commodity aid from bilateral and multilateral sources on highly concessional terms. During the past 60 years, the Central Bank has taken several initiatives to improve the management of public debt, both domestic and foreign.

Domestic Debt

The government raises funds from domestic sources mainly by issuing Treasury bills and Treasury bonds. In addition, Rupee securities/loans have been issued to the domestic market to raise medium and long term funds since 1937, from time to time. All those debt instruments are Sri Lanka Rupee (LKR) denominated securities with fixed interest rates. At the initial stage, funds required for the government were raised through issuing Treasury bills for which an active market did not exist and almost the entire stock was absorbed by the Central Bank.

Treasury Bills

Treasury bills have been the main instrument for raising short term funds for meeting budgetary expenditure. The Treasury bills are issued under the provisions of the Local Treasury Bills Ordinance and the maximum limit on the issue of Treasury bills is fixed by the Parliament, under the authority of resolutions of Parliament passed under Section 2(1) of the Ordinance. This ceiling, which was Rs. 25 million in 1948, has been raised from time to time to adequately meet funding requirements of the government, and at present it stands at Rs. 850,000 million, reflecting the enhanced need for short term funds in absolute terms.

The Central Bank was first authorised to issue Treasury bills in 1953. However, there was no active primary or secondary market for Treasury bills in the 1950s to 1970s and about 98 per cent of the bill issuance was held by the Central Bank. Central Bank is authorised by Section 112 of MLA to subscribe to any unsubscribed amount of Treasury bills issues. With the introduction of measures to liberalise the economy, together with the liberalisation of interest rates allowing them to be determined through market forces, Central Bank initiated measures to develop the Treasury bills market in 1980, both to improve debt management and monetary management of the country.

Accordingly, a secondary market for Treasury bills was introduced in 1981 by opening discount and rediscount windows for Treasury bills by the Central Bank and the Central Bank commenced selling Treasury bills in 1981 to divest its holdings. As rediscounting window was available to raise cash, if required, investors became quite willing to hold Treasury bills in their portfolios. As a result, the Central Bank holdings in total Treasury bills outstanding were gradually brought down to 16 per cent in 1996 from 93 per cent in 1985. The practice thereafter has been for the Central Bank to hold Treasury bills largely to the extent it is required for the Bank to conduct monetary policy.

In 1986, weekly primary auctions for the sale of Treasury bills commenced to reissue the maturing Treasury bills, taking into consideration the funding requirement of the government and to keep the market active by ensuring an undisrupted flow of Treasury bills to meet investor demand. Furthermore, in 1981 the Bank commenced issuing Treasury bills of relatively longer maturities of 182 days and 364 days to better manage funding requirements and suit investor appetite. This process improved the attractiveness of Treasury bills among all investor groups, including the non-bank private sector.

The weekly auctioning process of Treasury bills was automated in 1998, enabling primary dealers to submit their bids online. These developments made yield rates of Treasury bills benchmark market interest rates in the domestic financial market. The share of Treasury bill holdings in the total domestic debt portfolio was 20 per cent at end 2010, compared with 6 per cent in 1948.

Treasury Bonds

In 1997, Treasury bonds were introduced to the market under the provisions of the Registered Stock and Securities Ordinance (RSSO) as a market based instrument to raise funds to meet medium to long term financial needs of the government. The Treasury bonds issued to the market from 1997/1998 were of maturities of 2, 3 and 4 years. In the subsequent years, 5 and 6 year maturities were also issued to the market, providing investors with a range of instruments to manage their portfolios. However, until 2002 the Treasury bonds with longer term maturities did not have significant demand from investors. In 2003, the Central Bank issued Treasury bonds with maturities of 10, 13, 15 and 20 years, further extending the yield curve of government securities as a means of reducing the rollover risk, and to provide the market with a benchmark for pricing long-term debt securities. However, in the recent past only the Treasury bonds with maturities up to 6 years received a significant investor demand. As of end 2010, outstanding Treasury bonds totalled to 64 per cent of the domestic debt portfolio, primarily consisting of bonds with maturities up to 10 years, making Treasury bonds an important debt instrument in mobilising long term funds from domestic sources. The Treasury bond market is expected to remain the main domestic funding source for the government in future too.

In 2006, the Central Bank issued index-linked Treasury bonds of 3 and 4 year maturities with coupon rates for the years after the first year based on average annual inflation rate during the immediate previous six months plus a margin of one per cent.

Rupee Securities/ loans

Rupee securities/loans are the oldest instrument used to raise funds for the government. Being a medium and long term non-tradable debt instrument, ownership of Rupee securities/loans has been almost entirely with the public sector institutions and public statutory funds. With the introduction of more attractive other tradable debt instruments like Treasury bills and Treasury bonds, the share of Rupee securities/loans in the domestic debt portfolio decreased rapidly in the recent past to a level of less than 5 per cent, compared to a peak level of 96 per cent in 1949. Rupee securities/loans are now issued mainly to meet the requirement of long term institutional investors at a pre-determined rate. In contrast to the Treasury bills and Treasury bonds, Rupee securities/loans are still issued in scrip form.

Sri Lanka Development Bonds (SLDBs)

In view of the diminishing opportunities for obtaining funds from international donor agencies due to competition from other developing countries coupled with difficulties in raising additional funds from domestic Rupee markets without causing an excessive pressure on domestic interest rates, the government introduced Sri Lanka Development Bonds (SLDBs) in 2001 to raise funds in foreign currency terms, mainly aiming funds held in Non-Resident Foreign Currency (NRFC) accounts of commercial banks. Issued with the maturities of 2 and 3 years and the interest rate linked to the London Interbank Offered Rate (LIBOR), SLDBs has been attractive among investors in recent years. Investors of SLDBs have been primarily the domestic commercial banks and in the recent past some banks have marketed SLDBs among foreign investors. The current share of SLDBs in the domestic debt portfolio remains around 7 per cent.

Foreign Debt

As a developing country, Sri Lanka had to seek the assistance of its development partners as domestic resources have not been sufficient to meet the public investment requirement. Borrowing from foreign sources first appeared in 1955 when the government borrowed from the International Bank for Reconstruction and Development (IBRD) for capital projects. Since then the contribution of project loans to finance the budget deficit continuously increased. This increasing trend has been rapid after 1977 with large inflows of foreign capital being received for economic and social infrastructure development projects.

The project based financial assistance was received from various countries and bilateral sources. Countries such as Japan, Germany and China and the multilateral organisations like the Asian Development Bank and International Development Association were the dominant contributors of the foreign project and programme loans in the recent past. Japan has become the largest development partner of the country, contributing 23.7 per cent of total outstanding government foreign debt as at end 2010. After 2007, China has also emerged as a major development partner to the country with its share of total government foreign debt at 5.1 per cent as at end 2010.

Sri Lanka's total foreign debt stock has shown a significant increase during the past 60 years, with foreign debt to GDP ratio recording an increase from 3 per cent in 1950 to 36 per cent in 2010. As at end 2010, there were 703 active foreign loans in the foreign debt portfolio with the total outstanding balance of Rs. 2,025 million or 44 per cent of the total government debt portfolio. However, 63 per cent of this total foreign debt portfolio is on concessional terms and 69 per cent is from bi-lateral and multi-lateral donors with grace periods of 2 to 20 years and long pay back periods of 5 to 50 years. This nature of the foreign debt portfolio together with the current average interest rate of about 1.9 per cent per annum have eased the burden of the foreign debt service payments of the country. In addition to the net borrowings from foreign sources, the depreciation of the LKR against major currencies also added a substantial amount to the expansion of the foreign debt stock in LKR terms.

Domestic Treasury bonds and bills market was opened to the foreign investors in 2006 and 2008, respectively. In 2009, these markets were opened to Sri Lankan diaspora and migrant workers abroad. However, those foreign investments were limited to a ceiling of 10 per cent of the total outstanding amount of Treasury bills and Treasury bonds. This initiative was not necessarily to raise foreign funds, but to make both Treasury bills and Treasury bonds market more competitive. The Bank has recognised the potential risk of a sudden withdrawal of foreign investors from Treasury bills and bonds markets as experienced in 2008 as an outcome of global financial crisis and hence holds a buffer stock of foreign reserves to meet such contingencies.

Tapping International Capital Markets

Sri Lanka issued its first Floating Rate Notes of US dollars 50 million in the international capital markets in 1997. During the period 1977-2008, the country raised funds several times through the international capital markets via various types of loan arrangements. In view of the declining access by Sri Lanka to concessional financing from the World Bank and ADB with its achievement of middle income status and the urgent need to implement several development partner-funded infrastructure projects in a timely manner, the government issued its debut international sovereign bond in 2007 to mobilise US dollars 500 million from international investors with a maturity of 5 years. With the improved investor confidence in the country after the end of the internal conflict and favourable growth prospects in the post-war period, the government successfully issued its second international sovereign bonds in 2009, amounting to US dollars 500 million with 5 year maturity. This bond offering attracted an orderbook that was over-subscribed by more than thirteen times, one of the highest level of over-subscription of any sovereign US dollar bond offering during 2009. The government issued its third international sovereign bond in 2010, amounting to US dollars 1,000 million with 10 year maturity at the coupon rate of 6.25 per cent, which was significantly lower than the cost of borrowing of 8.25 per cent and 7.40 per cent on the international bonds issued in 2007 and 2009, respectively.

The bond issues have established benchmark reference rates, which would enable the private sector to mobilise funds in the international market at competitive rates. Also these issues placed Sri Lanka ‘on the map’ as most of the portfolio investors who will become familiar with Sri Lanka’s credit record are likely look for other investment opportunities in the country. The proceeds of these sovereign bonds were used to part finance the capital expenditure programme of the government and restructuring of the debt portfolio to reduce the interest burden and improve debt profile. With Sri Lanka’s limited access to concessionary foreign financing in the future, international capital market funding is expected to remain a significant component of Sri Lanka’s borrowing programme.

Debt Service and Interest Cost

Sri Lanka has an unblemished record of debt service for the past 60 years as it has never defaulted, suspended, rescheduled any of its debt service obligations.[1] This has attracted the confidence of foreign investors on Sri Lanka government debt. In terms of Section 113 of the MLA, the Central Bank has taken the responsibility of servicing of all debt taken by the government with close coordination with the Ministry of Finance, which maintains the Commonwealth Secretariat-Debt Recording and Management System (CS-DRMS) debt database.

1 After the 2004 Tsunami disaster, Sri Lanka has been given a one to three year debt moratorium by the Paris Club creditors, India and Korea with a view to allowing Sri Lanka to allocate more resources to address humanitarian and reconstruction needs. In addition, outstanding debt to Italy was fully written off and that of China was partly written off. The government of UK agreed to refinance 10 per cent of debt service payments made to the World Bank.

Despite the initiatives of the Bank to develop the debt securities market and minimise interest cost, a sharp increase of the debt profile together with high interest rates owing to higher borrowing requirements and directions of monetary policy to maintain price stability, which will eventually stabilise interest rate, have made the interest cost a significant expenditure item in the current budget. In 2010, interest cost accounted for about 41 per cent of the total government revenue and 26 per cent of the total government expenditure. Compared to the levels of 0.6 per cent of GDP that prevailed at the time of independence, interest cost on public debt rose significantly to 6.1 per cent of GDP in 2010. In terms of total current government expenditure, interest cost increased to 36 per cent in 2010 from 4 per cent in 1948.

Total public debt service payments, which remained around 1 per cent of GDP during the first two decades after independence, remained around 11 per cent during the 1990s. This ratio has gradually increased to 14.6 per cent of GDP in 2010, mainly due to the expansion of the outstanding debt portfolio. The external debt service ratio which is defined as the percentage of total external debt service payments to exports of goods and non factor services including workers' remittances and compensation of employees, recorded 7.9 per cent in 2010.

Market Developments

Primary dealer system and supervision

With a view to developing an active and efficient secondary market, an accredited Primary Dealer (PD) system was established in 1992 restricting the participation at primary market auctions to PDs. This system was replaced by the dedicated PD system in 2000 and PDs were given specific privileges and responsibilities such as rights to deal with the Central Bank as a counterparty in the primary market and engage in any secondary market transactions relating to Treasury bills and Treasury bonds for the PDs own account and for the account of any customer. In 2009, the PDs were allowed to diversify their activities within certain parameters defined by the CBSL. The activities of PDs are supervised by the Public Debt Department through on-site examinations and continuous off-site surveillance.

Transparency, predictability and price discovery

Transparency and predictability were given much attention in the recent years in managing public debt as it helps domestic debt market developments, indirectly helping to lower the cost of raising funds from the market. Towards this target, the publication of the annual public debt management report, regular update of the Central Bank website, issuance of press releases and regular dialogue with CEOs of PDs have been carried out. Further, towards this objective, an efficient real time price discovery process in the secondary market for Treasury bills, Treasury bonds and SLDBs will be implemented in the near future. As a prerequisite, a benchmark yield curve of Treasury bills and Treasury bonds has already been established.

Ownership Recording

In order to improve the efficiency of the payment and settlement system, the Central Bank introduced a Scripless Securities Settlement System (SSSS) and Central Depository System (CDS) in 2004, enabling real time settlement of securities trading on Delivery Vs Payment (DvP) basis. Under the SSSS, settlement and recording of Treasury bills and Treasury bonds are carried out on an electronic system. The CDS (LankaSecure) maintains all information on trades and ownership of scripless government securities. Introduction of these systems significantly improved the efficiency of the government debt securities market by enhancing secondary market trading and eliminating risks associated with paper based securities. A record of ownership of external debt is maintained at CS-DRMS.

Risk Management of the Debt Portfolio

Management of risks associated with the public debt portfolio is a key aspect in relation to meeting the overall objective of debt management. Therefore, the Central Bank mitigates risks associated with its debt management activities by adhering to prudent risk management policies and targets. In the recent past, the Central Bank strengthened this aspect by establishing a sound risk management framework using a spreadsheet based risk scenario model, assessing a matrix of risk indicators in line with the best international practices and undertaking annual debt sustainability analysis. This risk model is heavily used in formulating the annual borrowing programme. Further, the Central Bank has identified a set of medium term targets for risk indicators to bring refinancing, interest rate and foreign exchange risks to prudent levels. Necessary measures to achieve these medium term targets have been taken through suitable actions such as extension of the maturity structure of the debt portfolio.