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The need to avoid debt-traps

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The Need To Avoid Debt Traps

Dhanusha Gihan Pathirana
Economist, Institute of Political Economy

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Editorial Support: Kanchana N Ruwanpura, Charith Gunawardena
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GLOSSARY OF TERMS

Government of Sri Lanka (GoSL)
Sri Lanka, is a free, independent and sovereign nation with a population of 22 million. Legislative power is exercised by a Parliament, elected by universal franchise on proportional representation basis. A President, who is also elected by the people, exercises executive power including defence. Sri Lanka enjoys a multi party system, and the people vote to elect a new government every six years.

International Monetary Fund (IMF)
A major financial agency of the United Nations, and an international financial institution funded by 190 member countries, with headquarters in Washington, D.C. It is regarded as the global lender of last resort to national governments, and a leading supporter of exchange-rate stability.

International Sovereign Bonds (ISBs)
Foreign currency denominated sovereign bonds issued by a government to foreign investors and typically listed in a major bond trading centre like New York, London and Singapore. ISBs are issued under foreign law, usually English or New York law.

Debt Sustainability Analysis (DSA)
A formal framework for conducting an analysis of a country's capacity to finance its policy objectives and service the ensuing debt as tool to better detect, prevent, and resolve potential crises.

Agreement-in-Principle (AIP)
Sri Lanka previous administration and an ad-hoc group of international sovereign bondholders made a debt restructuring agreement, on 19 Sept 2024, that had yet to be formally accepted by the new government.

KEY TAKEAWAYS

- The revised bondholder agreement may cause balance of payments **instability even in the short term**. The ISB repayments will reach approximately US$ 1.85 billion in 2025 including interest on bilateral debt of US$ 420 million. Coupled with outflows of circa US$ 1.5 billion due to lifting the import ban on personal vehicles, an additional US$ 3.4 billion is required in 2025. Given the country's current usable foreign reserves of US$ 5 billion, this **excessively increases vulnerability to external shocks**.

- The extended maturity period masks **significant increases in total interest payments**. From 2028,, the weighted coupon rate of interest can climb to 6.8% and following 2032, the rates surge up to 9.75% for the next six years.

- By relying on the Net Present Value analysis method, analysts and policymakers risk **underestimating the true cost of debt restructuring**.

- The IMF DSA target of 95% debt-to-GDP ratio assigned for Sri Lanka excludes the present value of interest payments, **erroneously indicating that Sri Lanka's capacity to repay is greater** than the strongest economies as per IMF standards. Unbearable debt repayments will weaken the currency in the long run.
- Under the bondholder agreement-in-principle, Sri Lanka has effectively **waived the legal right to secure a higher debt cancellation**, creditors hold the right to alter the current governing law of Sri Lanka's outstanding ISBs. There is no evidence that the external financial advisors of the government, who have a close commercial relationship with creditors, are working in the best interests of the people of Sri Lanka.

- Lender awareness that Sri Lanka debt exceeded government revenue by a factor of ten, is a **clear indication of predatory lending practices**. Established norms in lending were blatantly violated by creditors.

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1. Background

The announcement on September 19, 2024, by former President Ranil Wickremasinghe and Sri Lanka's International Sovereign Bond (ISB) holders on an "agreement in principle" (AIP) appears to violate Sri Lanka's election laws, given it was reached two days before the election. This bargain raises significant concerns about political transparency and economic sovereignty. It is a policy consideration the new National People's Power (NPP) government and elected President Anura Kumara Dissanayake needs to be attentive towards.

Prior to the hasty AIP announcement, President Dissanayake had signalled his intent to renegotiate this ISB agreement. This reflects the views of many economic commentators that the AIP is economically precarious and likely to be detrimental to Sri Lanka's long-term financial stability (Setser 2024; Chandrasekhar 2024). By endorsing this AIP in the final hours of his presidency, Wickremasinghe compromised the democratic mandate and legitimacy of the new administration. The agreement may seem to offer short-term economic stabilisation, yet it risks ensnaring the nation in a prolonged cycle of debt and dependence.

Furthermore, the active interference of creditors in Sri Lanka's electoral process casts a troubling shadow on the legitimacy of this deal. Such foreign creditor involvement appears to exert undue pressure on an elected government, forcing it to honour terms that may serve international financial interests at the expense of Sri Lanka's economic independence and the well-being of its people.

The Ceylon Chamber of Commerce (CCC), acting in its interest, as its members own approximately US$ 1.8 billion in Sri Lanka's outstanding ISBs (CBSL 2024). By purchasing bonds at significant discounts, reaching 40% to 50% of face value during the COVID-19 outbreak, CCC appears to have issued an ultimatum to the newly elected President. The CCC demanded immediate implementation of the AIP disclosed on September 19th (CCC 2024). The CCC is acting in its interest and that of the elite. If the AIP is pursued as it currently stands, this is likely to result in detrimental outcomes to the economy and its people.

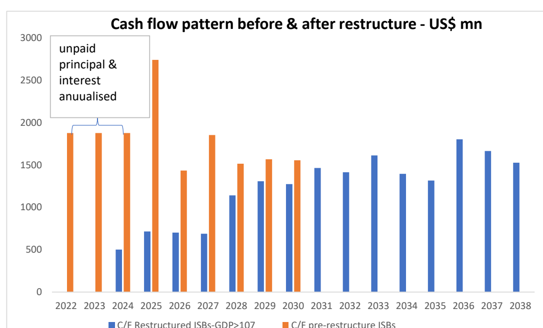
The terms of the AIP favour creditors globally compromising national interests (see also Chandrasekhar 2024; Chandrasekhar et al. 2024; Setser 2024). To pursue the AIP will inevitably lead to increased hardship for the masses, economic instability and worsening terms of trade in the long run. This brief aims to outline the consequences and how groups supporting it stand to gain at the expense of public well-being.

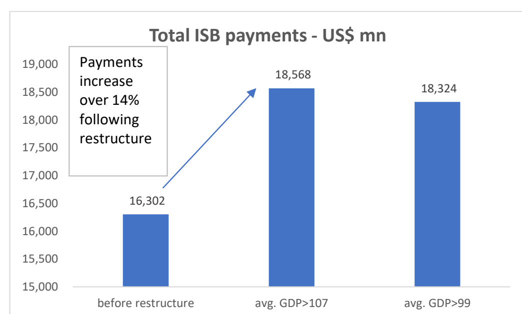
2. September 19th 2024: AIP in a nutshell

The proposed restructuring programme extends the maturity period of ISBs from 2030 to 2038 under different scenarios expected for Sri Lanka's nominal Gross Domestic Product (GDP). The extended maturity period masks significant increases in total interest payments.

First scenario: If the average nominal GDP between 2025 and 2027 exceeds US$ 107 billion, total nominal ISB payments will surge by over 14% to US$ 18.56 billion from US$16.3 billion before restructuring. This amounts to an additional US$ 2.3 billion in debt repayments over eight years. Under this arrangement, the weighted coupon rate of interest will be 6.8% from 2028 onwards, while the average coupon rate will climb to 9.65% from 2032 onwards from 6.95% before restructuring. However, under this arrangement, 14.9% haircut is offered on total principal payments.

Source: CBSL & London Stock Exchange

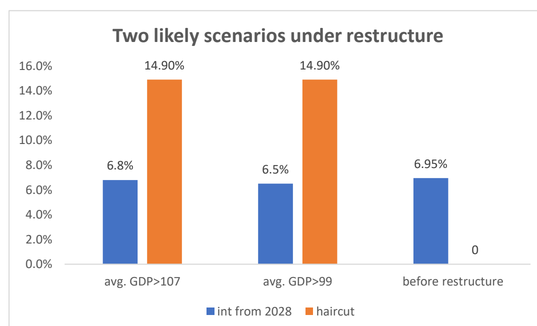


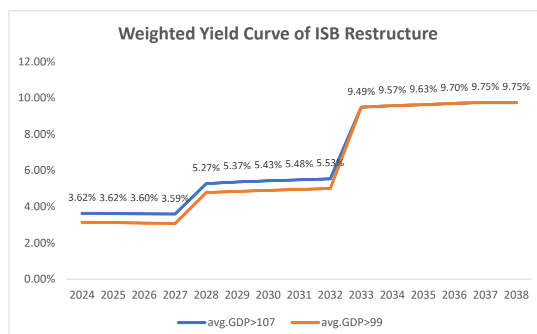


It should be evident that due to higher interest rates following 2028, the haircut becomes ineffective after a little over two years of interest payments. This is indicated by total payments exceeding the initial payments by over 14% following the restructuring. Despite a nominal haircut, the higher interest rates will effectively erase any relief, leading to a net increase in debt servicing costs.

Second probable scenario: Sri Lanka's average GDP between 2025 and 2027 equals or exceeds US$ 99 billion, and the terms of debt repayment essentially remain the same as before, except for an insignificant reduction of the weighted coupon interest rate from 6.8% to 6.5%. This will result in total payments reaching US$ 18.32 billion. The upshot is a negligible reduction of nearly US$ 240 million over eight years for a reduction of nominal GDP by US$ eight billion compared to the US$ 107 billion parameter of scenario one. This indicates that reduction in ability to repay, reflected by the lower nominal GDP in scenario two, is disproportionately greater than reduced repayments. Consequently, the total payments will exceed initial ISB payments by over US$ two billion under scenario 2.

Source: CBSL & London Stock Exchange





Under the current AIP, the weighted interest rate after the rearrangement is set to significantly exceed the expected real GDP growth rate. This is deeply troubling for a restructuring programme aimed at stabilising a country. Given that a quarter of the population has been living in poverty since the onset of the debt crisis, the potential negative ramifications on working-class communities, low-income groups and poverty is likely to be dire (World Bank, 2024; UNDP, 2023).

Moreover, the AIP is also potentially violating the 'Golden Rule' in economics derived initially from Von Neumann's paper on multi-sector equilibrium (1932/37) which Roy Weintraub (1983) called 'the single most important article in mathematical economics' (see also Philip Mirowsky (2012)) and recently resurrected by Thomas Piketty in his Capital in the 21st Century (2013). According to them, this is where a real growth rate falls below the real interest rate, exponentially increasing the degree of maldistribution of income in favour of capital. Growing divergence of rates will increasingly compromise economic stability as the gap between the two rates widens.

This is evident as illustrated in the proposed AIP on the ISB. Under the terms of the AIP, if Sri Lanka's real GDP growth exceeds 2.7% from 2024 to 2027 or cumulative real growth exceeds 11.5% during the period, the weighted coupon rate of interest climbs to 6.8%. After 2032, the rates surge up further reaching a maximum of 9.75% for the next six years. This is more than twice the expected minimum real growth rate threshold stipulated in the AIP. If Sri Lanka accepts these terms, it risks locking itself into a perpetual cycle of debt and underdevelopment.

3. The illusion of debt relief: The flawed NPV analysis

The use of Net Present Value (NPV) analysis to assess the impact of foreign debt restructurings is inaccurate because it is unable to capture the complex dynamics of sovereign debt. NPV analysis has been used by the IMF and most think tanks based in Sri Lanka. Moreover, it is an ill-suited method for developing countries like Sri Lanka, as outlined below.

A core assumption of NPV analysis is that the value of the unit of account remains constant over time. However, this assumption is violated for developing countries, where currencies are prone to depreciation. As the Sri Lankan Rupee depreciates, the rupee cost of future debt payments, denominated in US dollars, increases significantly, which must be met with increased taxation. This means that the burden on the nation's economy, measured in local currency terms, grows exponentially.

NPV calculations rely on the assumption that the future payments are worth less than present ones when the value of the unit of account remains unchanged. However, this assumption is violated in the case of third-world nations. Depreciation of third-world currencies against creditor nations *increases* the value of future payments. Hence, the use of NPV method prevents a meaningful analysis of debt restructuring impacts on third-world nations.

Discounting cash flows in NPV analysis can hence incorrectly show a reduction in payments for the debtor nation due to restructuring (for example see NPV analysis of Sri Lanka's July agreement by Debt Justice UK (2024) and September agreement by Verite Research (2024) with private creditors). However, the rupee cost of the debt is rising exponentially with depreciation in tandem with the higher value of nominal payments in the US $ terms. This is shown to hold for Sri Lanka, as illustrated in the sections above. Hence, from the perspective of the debtor nation, it is detrimental to use the NPV method, as it is advantageous to the creditors at the expense of indebted countries.

Furthermore, the NPV method is unsuitable for comparing debt portfolios with different maturity profiles. In the case of Sri Lanka's ISB restructuring, the maturity period has been extended, altering the timing of cash flows. To accurately assess the impact of such changes, more sophisticated techniques like the Replacement Chain Method or Equivalent Annual Annuity Method can be employed on expected future repayments denominated in debtor nations's currency as opposed to in US$.

By relying on the NPV method, analysts and policymakers risk underestimating the true cost of debt restructuring. This approach can lead to imprudent decisions that may exacerbate financial woes. Adopting a more rigorous and realistic framework for evaluating debt sustainability and the efficacy of restructuring efforts is likely to yield different and positive outcomes valuable for the people and the nation.

4. IMF, international norms and indebtedness

The basis for the AIP was laid by the IMF's debt sustainability analysis (DSA). The DSA, has weaponised and locked the nation into a cycle of indebtedness.

The IMF stated that Sri Lanka's debt-to-GDP ratio must decline to 95% by 2032 from nearly 113% in 2023 to reach sustainability. This envisaged debt ratio of 95% is almost twice that of the ratio declared by the World Bank in the 1990s, which classified low-income economies as highly indebted.

The United Nations reiterated this position in 2006/07, declaring that a developing economy with a nonconvertible currency is highly indebted if its total outstanding debt to gross national income exceeds 50% (Kappagoda, 2007). This indicates that the ratio assigned for Sri Lanka under the AIP is designed to sustain the indebtedness of the economy and its people as opposed to reaching debt sustainability. More importantly, this manipulation by the IMF cripples Sri Lanka's bargaining power with creditors.

The IMF-World Bank debt sustainability framework was initially launched in April 2005 and is periodically updated. It holds that if the threshold for debt sustainability shown by the present value of the total outstanding debt being greater than or equal to 70% of the GDP a country has a higher capacity for debt repayment (IMF, 2023). Hence, the present value of outstanding debt implies we consider the total discounted future interest payments of borrowings. This is in addition to the outstanding principal amount borrowed as a ratio of the GDP.

Therefore, the 95% debt-to-GDP ratio assigned for Sri Lanka excludes the present value of interest payments,

indicating that Sri Lanka's capacity to repay is greater than the strongest economies as per IMF standards. This is a distortion of accepted parameters to enrich creditors at the expense of an impoverished population, which is an approach adopted by the IMF previously too. This position by the IMF favouring creditors weakens the bargaining power of Sri Lanka to demand meaningful reductions on principal payments of foreign debt at negotiations with creditors. The potential upshot is that extracting surplus via debt repayments will weaken the Sri Lankan rupee currency in the long run. It will also potentially deny non-debt forms of capital required to transform the Sri Lankan economy from its current crisis predicament.[1]

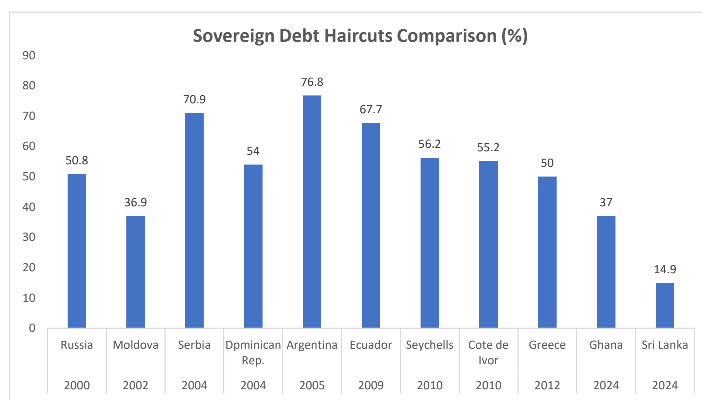
1. It facilitates the extraction of surplus labour at the lowest possible price in the form of exports. This underlying aim is further emphasised by the IMF, demanding labour market liberalisation as a binding condition to approve its ongoing programme, making working-class communities more vulnerable. To illustrate, the new labour law reforms proposed seek to abolish the eight-hour working day by changing the threshold to a 40-hour work week. If implemented, it will also abolish the need to pay overtime for work performed more than eight hours a day.

5. Colluding with creditors?

The AIP demands that the creditors hold the right to alter the current governing law of Sri Lanka's outstanding ISBs from New York to Delaware law. Currently, U.S. law allows countries to declare debt cancellations if it can establish that borrowed funds were not used in the best interest of the public and have enriched a few under previous governments or have been the means to suppress human rights, the knowledge of which cannot be denied by the creditors (Buchheit et al., 2007). The majority of Sri Lanka's external debt can also be categorised under this framing according to legal scholars (Sornarajah, 2022; Pathirana, 2023). Therefore, if the AIP is upheld, Sri Lanka has effectively waived the legal right to secure a higher debt cancellation.

The AIP entertaining the interests of the creditors at the expense of the general public is further revealed by comparing the Sri Lankan case with Ghana's debt restructuring. The government of Ghana rejected a disastrous proposal like that of Sri Lanka made by its international creditors. It reached an agreement with 90% of bondholders, meaningfully reducing both principal and interest payments. Ghana secured a 37% haircut on outstanding sovereign debt, while the maximum interest rate applicable for new bonds was capped at 6% as opposed to 9.75% for Sri Lanka. As a result, its nominal debt relief amounts to US$ 4.4 billion (The Africa Report, 2024) as opposed to increase in nominal payments of Sri Lanka by up to US$ 2.3 billion.

In contrast, Sri Lanka's proposal submitted through its advisors, Lazzard and Clifford & Chance, in April 2024, was comparable to that proposed by the creditors, where interest rates reach a maximum of 9.5% for a debt that was borrowed at 6.95%. Ironically, bilateral lenders and the IMF disagreed with the initial agreement, stating it violates comparability of treatment and does not meet IMF programme requirements.



Debt Restructurings 1950-2010; theafricanreport.com; calculations from London Stock Exchange data

Moreover, Lazzard was the financial advisor for both Ghana and Sri Lanka. Sri Lanka demanding a programme benefiting the creditors and both countries hiring the same financial advisor points to the conclusion that the previous GoSL was not necessarily working in the interest of its own people. Moreover, it also hints at how the deal may have been open to corruption.

The current government may be reluctantly compelled to adopt a revised version of the existing AIP. This revised AIP offers only a marginal reduction in the weighted coupon rate of the bonds, decreasing it from 8.1% to 6.8% or 6.5% beginning in 2028 and yielding a total payment reduction of just US $1 billion. This change, while touted as a concession, falls short of addressing the structural risks posed by the country's high debt burden.

The new government aims to break free from this unsustainable path and instead prioritise the welfare and interests of the people. Achieving this will require a firm stance against the undue influence of entrenched financial interests that prioritise profit over Sri Lanka's sovereignty and stability.

To secure a fair debt restructuring process, the government must prioritise transparency and accountability, distancing itself from both domestic and international financiers who may act against the nation's best interests. This means revisiting the pathway laid out in the AIP brokered by an unelected former head of state and, instead, crafting an approach to debt management that centres on the well-being and future prosperity of the Sri Lankan people.

6. Conclusions: Predatory lending

Sri Lanka's debt crisis is a stark example of the destructive power of predatory lending. Despite the nation surpassing the critical 50% debt-to-GDP threshold (Kappagoda, 2007), international lenders continued to pile on debt, disregarding basic financial prudence and contravening the equator principles laid out by the World Bank.

Commercial banks typically adhere to a 1:1 debt-to-income ratio, carefully assessing a borrower's creditworthiness to mitigate default risk. For instance, commercial banks assess whether the borrower has already piled up a mountain of debt that is un-payable before lending further. However, when lending to Sri Lanka and the global South, metropolitan lenders wilfully violated these accepted criteria, which are in place to mitigate risks of default.

Sri Lanka's lenders have continued to sink the economy in a bottomless ocean of debt. They persisted in extending credit even as government revenue hovered around a mere 10% of GDP and debt-to-GDP ratios approached 100%. This reckless behaviour, where debt exceeded government revenue by a factor of five, is a clear indication of predatory lending practices. Established norms in lending were blatantly violated by creditors. It is imperative to hold lenders accountable for their role in exacerbating the debt crisis globally. By ignoring sound financial principles and fuelling unsustainable debt burdens, they have contributed to the economic hardship faced by millions of poor across the global South.

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https://antipodeonline.org/a-right-to-the-dicipline

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