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Domestic Debt Optimization (DDO)

What's all this talk about DDO?

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Background

Sri Lanka lost access to international financial markets after the 2019 tax cuts caused a credit rating downgrade restricting our ability to roll over International Sovereign Bonds (ISBs)

Sri Lanka suspended repayments on all its foreign debt after the country's reserves equated to less than one month of imports

20 March
2023

2021

2020

12 April
2022

IMF assessed that Sri Lanka's public debt had risen to "unsustainable levels"

The IMF Board approved a 3.0 billion Extended Fund Facility (EFF) arrangement



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What are the objectives of Sri Lanka's EFF arrangement with the IMF?

1.

Restore
macroeconomic
stability and **debt
sustainability**

2.

Safeguard
financial stability

3.

Step up structural
reforms to unlock
Sri Lanka's
growth potential



Financial Stability

While protecting the most vulnerable
and improving governance



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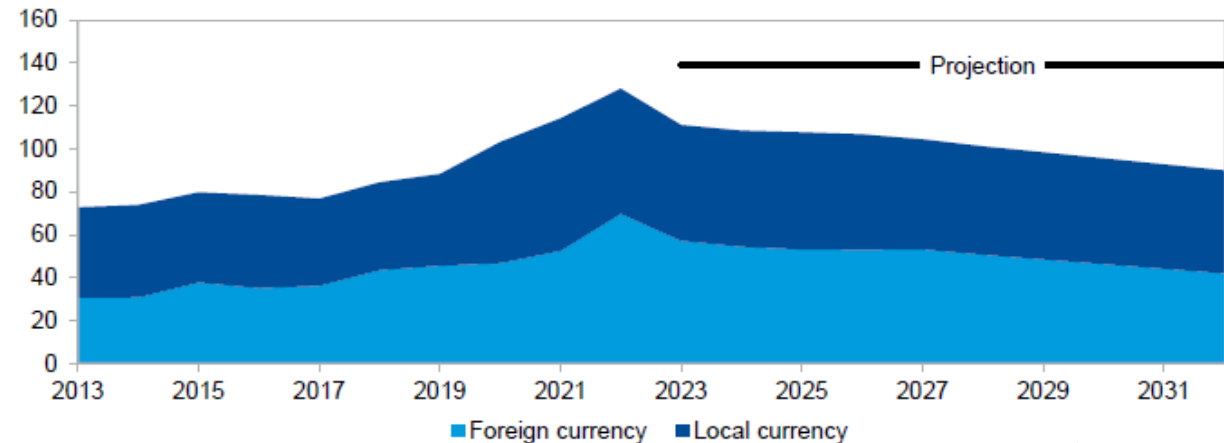


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Sri Lanka's debt-to-GDP ratio reached an all-time high of 128 % in 2022

What makes Sri Lanka's debt unsustainable?

Debt by currency (percent of GDP)



Note: The perimeter shown is central government.

Source: IMF

Between 2020 and 2022, public debt increased drastically due to:

1. Exchange rate depreciation

2. Large Fiscal Deficits

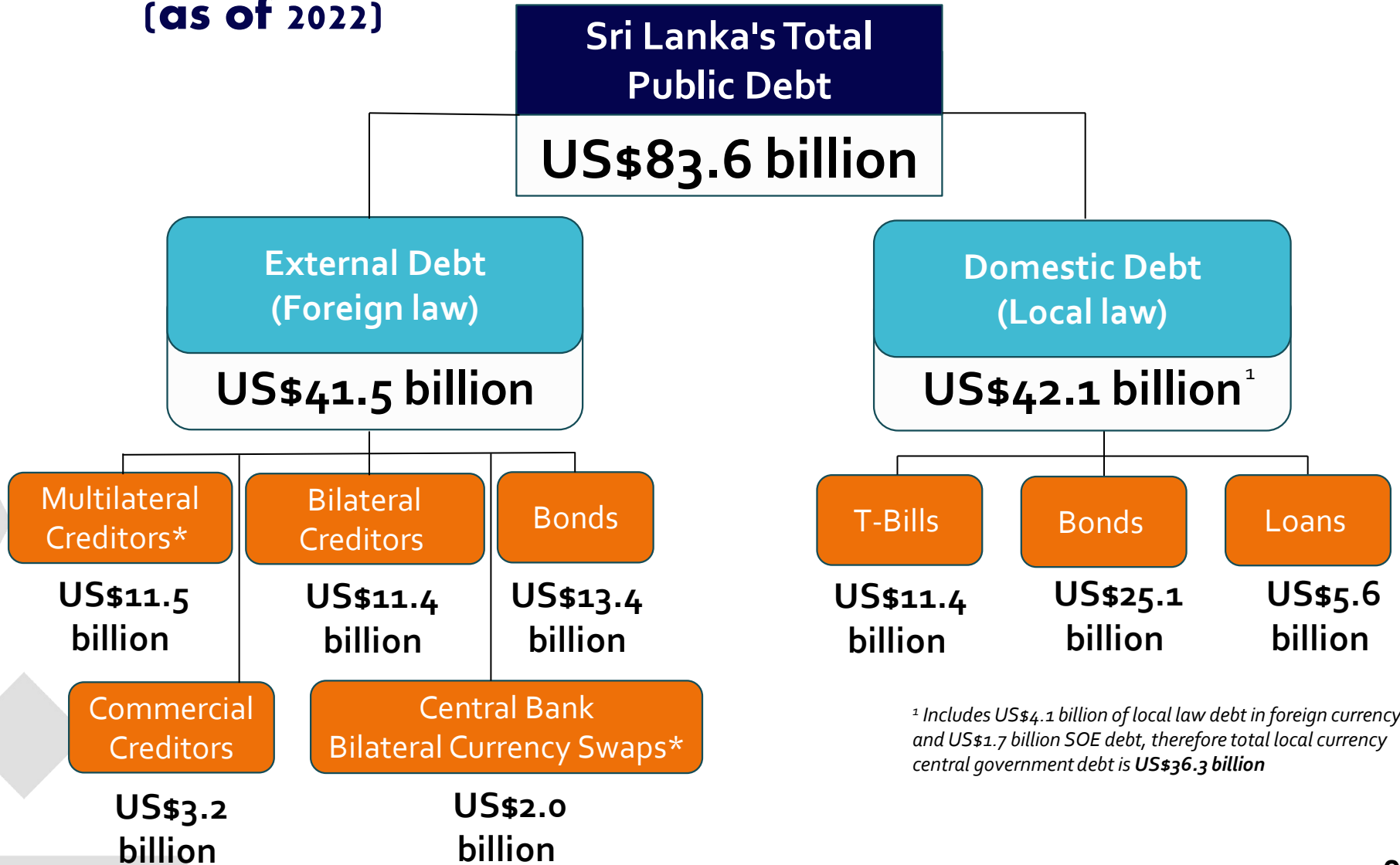
3. SOE borrowing

4. External borrowing by the central bank



Overview of Sri Lanka's Public Debt

(as of 2022)



¹ Includes US\$4.1 billion of local law debt in foreign currency and US\$1.7 billion SOE debt, therefore total local currency central government debt is US\$36.3 billion

The government will have to meet the following **debt sustainability targets** developed under IMF's guidance:

How can Sri Lanka restore debt sustainability?

No	Type of debt	Current level	Target	Timeframe
1	Total public debt	128 % of GDP as of 2022	Decline below 95 % of GDP	By 2032
2	Average annual Gross Financing Needs (GFN)	34.5 % of GDP as of 2022	Remain below 13 % of GDP	Between 2027 - 2032
3	Annual FX debt service	9.8 % of GDP for 2023	Remain below 4.5% of GDP	Each year between 2027 - 2032
4	Debt service reduction*	External financing gap - 23.6 billion as of 2022	Sufficient to close external financing gaps	Between 2027 - 2032

** Under the IMF staff's baseline scenario, US\$17 billion in debt service reduction is required, including the arrears accumulated in 2022*

In order to achieve these targets, the government must carry out comprehensive **debt restructuring** along with deep reforms



What is debt restructuring?

It is a process that allows companies, individuals, and countries facing cash flow problems and financial distress to **renegotiate the terms of their debt** in order to improve or restore liquidity.

Debt restructuring for countries:

Unlike companies and individuals, there is no bankruptcy court for countries, therefore **negotiations** between the **creditors** and the **sovereign nation** must take place. Thus, having IMF approval will help Sri Lanka during these complex negotiations.

Sri Lanka's Debt Restructuring

External Debt

Sri Lanka held its inaugural official creditors meeting on 9 May 2023. An official creditor committee co-chaired by India, Japan, and France was formally formed that consisted of seventeen countries altogether.

Domestic Debt

On 30 March 2023, the Central Bank of Sri Lanka announced its intention of exploring options for **Domestic Debt Optimization (DDO)***. The operation is aimed at liquidity relief while preserving financial stability.

**Also commonly referred to as Domestic Debt Restructuring (DDR)*



3 Ways Sri Lanka can restructure its domestic debt

1. Face Value Reduction (Haircut)



To reduce the total principal amount of debt

2. Coupon Adjustment



To reduce the interest rate or coupon payment that bondholders receive

3. Maturity Extension (Reprofiling)



Lengthening the repayment period of the debt

Example:

Treasury bond
Value
LKR 1 Mn
Coupon rate
25 %
Maturity
30 years

Reduce the face value from LKR 1 Mn to LKR 0.8 Mn

Reduce the coupon rate from 25% to 18 %

Extend the maturity from 30 years to 35 years

Or

A combination of the three

What is DDO?

Domestic Debt Optimization (DDO) is the name given by the government for restructuring sovereign debt in **domestic currency (LKR)** – debt owed by the government to any individual or institution, such as local T-Bills and T-Bonds.

Central government local currency debt accounts for US\$36.3 billion¹

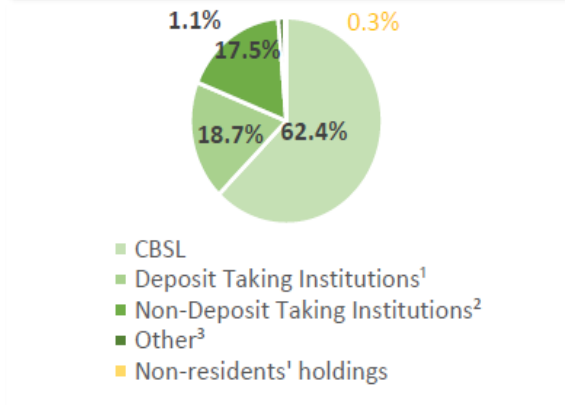
T-Bills account for 31 % of central government local currency debt

T-Bonds account for 66% of central government local currency debt

Overview of Central Government Local Currency Debt : LKR 13,189bn (USD 36.3bn)⁴

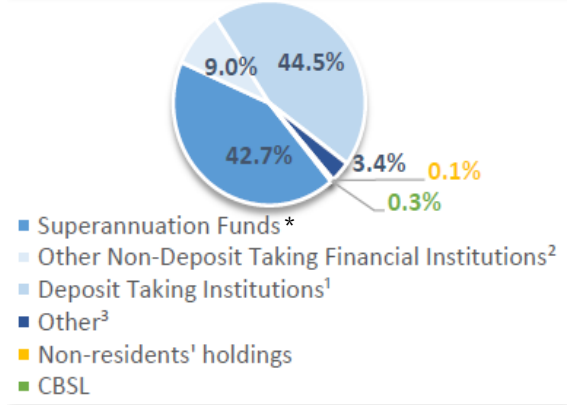
Debt category	Amount
T-Bills	LKR 4,126bn (USD 11.4bn)
T-Bonds	LKR 8,722bn (USD 24.0bn)
Other Loans⁵	LKR 104bn (USD 0.3bn)
CBSL advances⁶	LKR 236bn (USD 0.6bn)

Overview of T-Bills holders



Only T-Bills held by the CBSL will be considered for treatment to create some fiscal space

Overview of T-Bonds holders



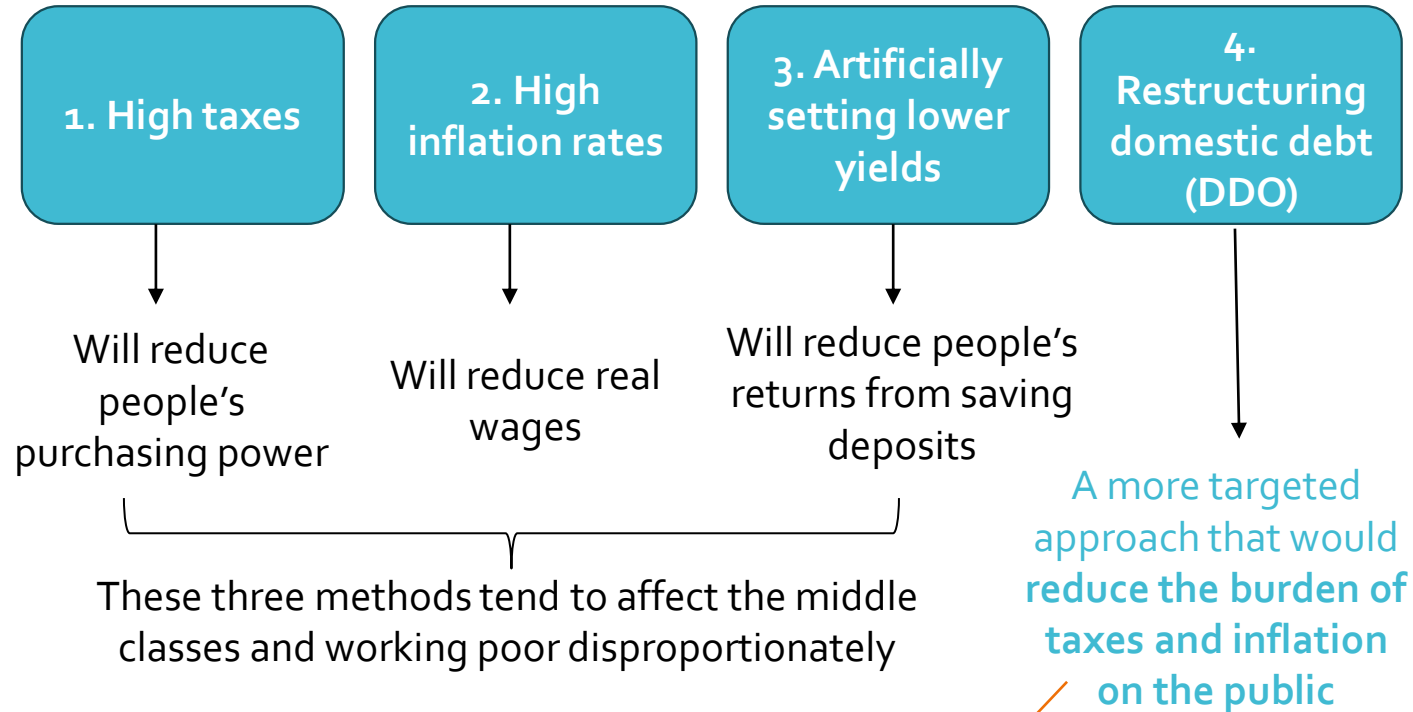
A voluntary domestic debt optimization operation without coercion is envisaged
Sri Lankan government and its advisors will initiate consultations with major T-Bonds holders to gauge options and constraints

¹ Refer to slide 4 for a breakdown of Sri Lanka's public debt

*Superannuation Funds: EPF, ETF **08**

Of the 4 methods of reducing our domestic debt burden, DDO is the most viable

Why is Sri Lanka exploring options for DDO?



What are the benefits of a DDO?



DDO and financial sector stability

“... when you restructure domestic debt, you have to make sure that you also safeguard financial stability. So, these are issues on which the government is currently working and we’ll flesh out a strategy on that, hopefully very soon. That’s the next step,”

- IMF Asia and Pacific Department Director
Krishna Srinivasan

05 May 2023



“We will ensure any kind of domestic debt optimization, we will ensure the safeguard of the banking system stability as well as the protection of the public deposits,”

- CBSL Governor Dr. Nandalal Weerasinghe

10 May 2023



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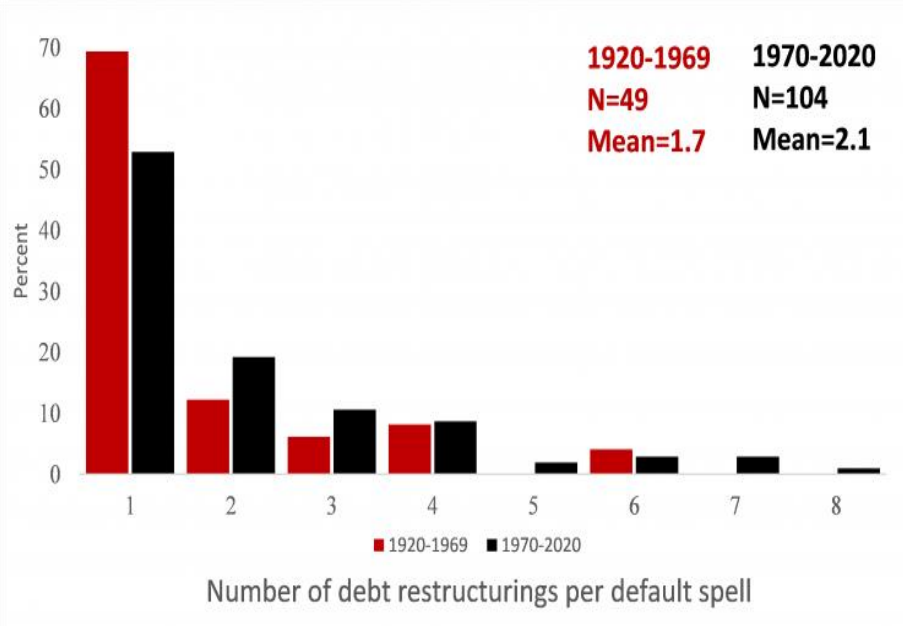
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Source: IMF, CBSL

Domestic Debt Restructuring: Do it right the first time

There are 2.1 restructuring episodes on average when a country enters default (1970 - 2020)

How can Sri Lanka ensure it is done right the first time?



1. Avoid shallow restructuring

2. DDO should be part of a broader policy package

3. Fiscal and monetary discipline

4. Create sufficient fiscal space (buffer)

More information and insights will be shared once the Domestic Debt Optimization (DDO) framework is announced

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