

ASIAN DEVELOPMENT BANK
SOUTH ASIA DEPARTMENT

SRI LANKA: BORROWING CAPACITY ASSESSMENT

November 2003

CURRENCY EQUIVALENTS

(as of 14 November 2003)

Currency Unit	–	Sri Lanka rupee/s (SLRe/SLRs)
SLRe1.00	=	\$0.0104
\$1.00	=	SLRs96.13

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
CBSL	–	Central Bank of Sri Lanka
CEB	–	Ceylon Electricity Board
CPC	–	Ceylon Petroleum Corporation
CSP	–	country strategy and program
CWE	–	Cooperative Wholesale Establishment
GDP	–	gross domestic product
GNI	–	gross national income
HIPC	–	heavily indebted poor country
ICOR	–	incremental capital-output ratio
IMF	–	International Monetary Fund
JVP	–	Janatha Vimukthi Peramuna (People's Liberation Front)
LTTE	–	Liberation Tigers of Tamil Eelam
NPV	–	net present value
OCR	–	ordinary capital resources
RMSM-X	–	Revised Minimum Standard Model—Extended
SDR	–	special drawing right
SLFP	–	Sri Lanka Freedom Party
UNP	–	United National Party

NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

This report was prepared by the Economics Unit of the Sri Lanka Resident Mission, with the assistance of Mr. N. Siripala and Mr. S. Perera, staff consultants. The opinions expressed in this report are those of authors and do not necessarily reflect the views of the Asian Development Bank or the Government of Sri Lanka.

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EXECUTIVE SUMMARY

In its framework for development, *Regaining Sri Lanka: A Vision and Strategy for Accelerated Growth*, the Government recognizes the challenge and need to bring the public debt under control as Sri Lanka embarks on an ambitious growth path. The Government aims to increase gross domestic product (GDP) growth from 4% in 2002 to 7% in 2006, in part through an increase in public investment from 4.6% of GDP in 2004 to 7.3% of GDP in 2006. At the same time, a major thrust of the Government's medium-term economic framework is to reduce the fiscal deficit, and the domestic financing of the deficit, to achieve fiscal sustainability. The cease-fire agreement signed with the Liberation Tigers of Tamil Eelam and the subsequent peace talks have helped bring the stability needed to accelerate development. However, the country is now faced with the challenge of reconstructing the war-torn north and east of the country, which alone will require roughly \$3 billion over the next 6 years. As grant and concessional loan financing will likely be insufficient to cover the investment needs, this study will analyze Sri Lanka's capacity for borrowing nonconcessional resources in the medium term.

Sri Lanka's main weakness in terms of its debt sustainability is the level of public debt, which is an outgrowth of years of high fiscal deficits. The 57% of GDP foreign debt burden in 2002 is somewhat high, but manageable. As the bulk of the external debt is long-term loans on a concessional basis, foreign debt service currently at 13% of exports does not pose any problems from a liquidity perspective. However, the public debt situation is an area of concern. Total public debt reached 105% of GDP in 2002, which is clearly unsustainable. The high levels of government debt service may pose future liquidity problems if they are not well managed. The Government's recent moves to reduce its outstanding bank overdrafts and to issue treasury bonds with longer maturities are steps in the right direction, although public debt service rose to 109% of current revenue as a result of this transition. The Government needs to substitute longer-term, foreign financing for local borrowing, but it must do so in the context of tighter fiscal policy and enhanced revenue mobilization to bring the total public debt under control.

The study's baseline projections for key macroeconomic variables are based on the Government's medium-term forecasts, but are generally more conservative. Numerous sensitivity tests are carried out to verify the robustness of the results under the baseline scenario. The alternate scenarios include situations with (i) no concessional lending, (ii) export price shocks, (iii) an oil price shock, (iv) an exchange rate shock, and (v) no domestic reforms. The simulation results indicate Sri Lanka's debt situation is sustainable over the medium term, provided the environment for higher growth is established and control of the fiscal deficit is achieved. An increase in the share of nonconcessional loans does not adversely affect debt sustainability as long as fiscal discipline is maintained. Only under the situation of continued high fiscal deficits and low economic growth does the public debt situation get out of control.

The Asian Development Bank (ADB) can prudently commit \$150–200 million on average per year in new ordinary capital resources (OCR) loans during the implementation period of the new country strategy and program. The higher end of this range would be considered if concessional financing is not forthcoming, since ADB's OCR terms are softer than alternative financing from commercial loans or even many export credits. Higher levels of OCR commitments are contingent on continued progress on the peace front and the economic reform agenda. These two complimentary elements are necessary if the Government is to achieve and sustain the higher rates of growth it is projecting and reduce the fiscal deficit. ADB will regularly review the prevailing economic and political situation and make adjustments to OCR lending levels as necessary to ensure that the debt burden remains manageable.

I. INTRODUCTION

1. In recent years, the Government's debt stock has expanded significantly with public debt rising to more than 100% of Sri Lanka's gross domestic product (GDP). Moreover, the funds required to service this debt burden exceeded the total revenue collected by the Government last year.¹ In its framework for development, *Regaining Sri Lanka: A Vision and Strategy for Accelerated Growth*, the Government recognizes the challenge and need to bring the public debt under control as Sri Lanka embarks on an ambitious growth path. The Government aims to increase GDP growth from 4% in 2002 to 7% in 2006, in part through an increase in public investment from 4.6% of GDP in 2004 to 7.3% of GDP in 2006. At the same time, a major thrust of the Government's medium-term economic framework is to reduce the fiscal deficit, and the domestic financing of the deficit, to achieve fiscal sustainability. The recently introduced Fiscal Management (Responsibility) Act requires the Government to reduce the budget deficit to 5% and the government debt level to 85% of GDP by 2006.

2. The civil war fought between the Government and the Liberation Tigers of Tamil Eelam (LTTE) for nearly 20 years has ravaged the country's north and east and drained the country's resources. The cease-fire agreement signed by the two sides in February 2002 has brought a welcome respite from the fighting. With the cessation of hostilities, there has been an improvement in consumer and investor confidence and an acceleration of economic activity in the country. While continued progress in achieving a lasting peace is a critical element for the country's overall development, the rehabilitation of the conflict-affected areas of the country requires public investments beyond what is needed to achieve the ambitious growth targets. The country's rehabilitation needs are roughly \$3 billion over the next 6 years.²

3. Sri Lanka now finds itself at a crossroads: the Government must bring the fiscal deficit and debt burden under control at a time when its public investment needs are most pressing. While much of the rehabilitation work will need to be financed with foreign grants if the budget targets are to be maintained, the availability of these resources is limited and other countries in need of postconflict support—most notably Afghanistan and Iraq—are also vying for their share. As such, foreign debt financing will continue to play a big part in the total financing package. While the Government's foreign debt amounts to 45% of its total outstanding debt, foreign borrowing has been on highly concessional terms, with the interest cost on foreign loans being only about 9% of total interest payments. Here again though, concessional foreign debt resources may not be sufficient to achieve the ambitious growth and rehabilitation plans such that the Government may need to consider alternative funding sources.

4. With the most recent Asian Development Fund (ADF) replenishment, the Asian Development Bank (ADB) instituted a system of "performance-based allocation" of its concessional resources.³ Country allocations are determined by a formula that takes into account a country's size, income level, and a range of performance indicators. Under this formula, the ADF allocation to Sri Lanka would be \$90 million annually. However, an exception for Sri Lanka has been made during the transition to the new ADF allocation system and to help address the postconflict rehabilitation needs such that the actual ADF lending levels have averaged \$140 million per year. As ADB faces constraints on the availability of ADF resources, which have necessitated a general reduction in ADF lending to its eligible borrowing countries, the higher levels of ADF lending will be difficult to continue in the future. Moreover, the resource

¹ Appendix 1 shows the key economic indicators for recent years and Appendix 2 has data on debt and debt service.

² *Assessment of Needs in the Conflict Affected Areas: Districts of Jaffna, Kilinochchi, Mullaitivu, Mannar, Vavuniya, Trincomalee, Batticaloa and Ampara*. 2003. Colombo.

³ ADB. 2001. *Policy on Performance-Based Allocation for Asian Development Fund Resources*. Manila.

needs of the country to support the growth and rehabilitation goals are even greater than the current allocation.

5. Beginning with the 2000 lending program, Sri Lanka has had limited access to ADB's ordinary capital resources (OCR) in addition to continued access to concessional ADF funds, as the country had crossed the threshold of per capita income and debt service capacity.⁴ As the country had just graduated to ADF-OCR blend status, and given the political and economic environment at the time, OCR lending averaged only \$50 million annually and has been used exclusively for program lending (which disburses quickly) and lines of credit (which have high financial rates of return). ADB is currently revising its country strategy and program (CSP) for Sri Lanka, which will provide the framework for our assistance to the country in the medium term. An important element of the CSP preparation is determining the levels of assistance to the country, both concessional and nonconcessional, and the priority sectors for ADB interventions. This study will analyze Sri Lanka's borrowing capacity, with a particular focus on the prudent levels of OCR that can be allocated to the country during the strategy period.

II. SRI LANKA'S NATIONAL DEBT

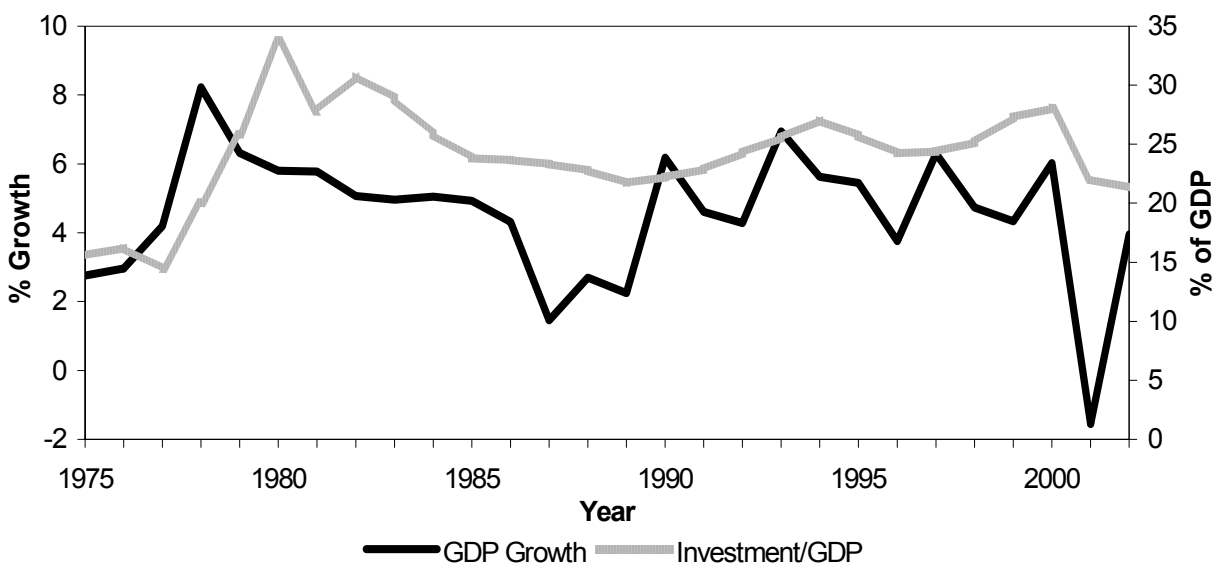
A. Political and Economic Environment

6. Over the past two and a half decades, various political and economic factors have led to Sri Lanka's current debt problems. Two parties—the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP)—have dominated Sri Lankan politics since independence. When the UNP came to power in 1977, the Government adopted a new constitution where the executive president system was established. The constitution also instituted a system of proportional representation in parliament. As a result, in recent years ruling governments have been formed by coalitions led by either of the two major parties and comprising various minority parties cobbled together to achieve the required majority in parliament. This has created a political environment where governments are often weak coalitions vulnerable to demands of minority parties, thereby hindering the pursuit of required policy and legislative reforms.

7. In addition to the constitutional changes in 1977, the UNP government also began to open the economy, introducing radical policy changes and undertaking large-scale public investments. In the early 1980s, rapid development of irrigation schemes, power stations, roads, and rural housing programs were initiated, which were financed mainly by concessional funds. Investment as a percentage of GDP increased significantly to one of the highest levels ever, averaging 29% of GDP during 1979–1984 (Figure 1). With the implementation of large infrastructure development projects such as the Mahaweli Development scheme, more employment opportunities were generated and the unemployment rate reduced to around 11% in 1981/82 from a peak of 23% in 1973.

⁴ ADB. 1998. *A Graduation Policy for the Bank's DMCs*. Manila. The ADF-eligibility cutoff point for gross national product per capita is \$875 in 2001 prices (\$975 in 1997 prices at the time the policy was approved), based on the eligibility cutoff point for the World Bank's concessional funds. Debt repayment capacity is measured as a composite of several quantitative and qualitative indicators.

Figure 1: GDP Growth and Investment, 1975–2002



Source: Central Bank of Sri Lanka.

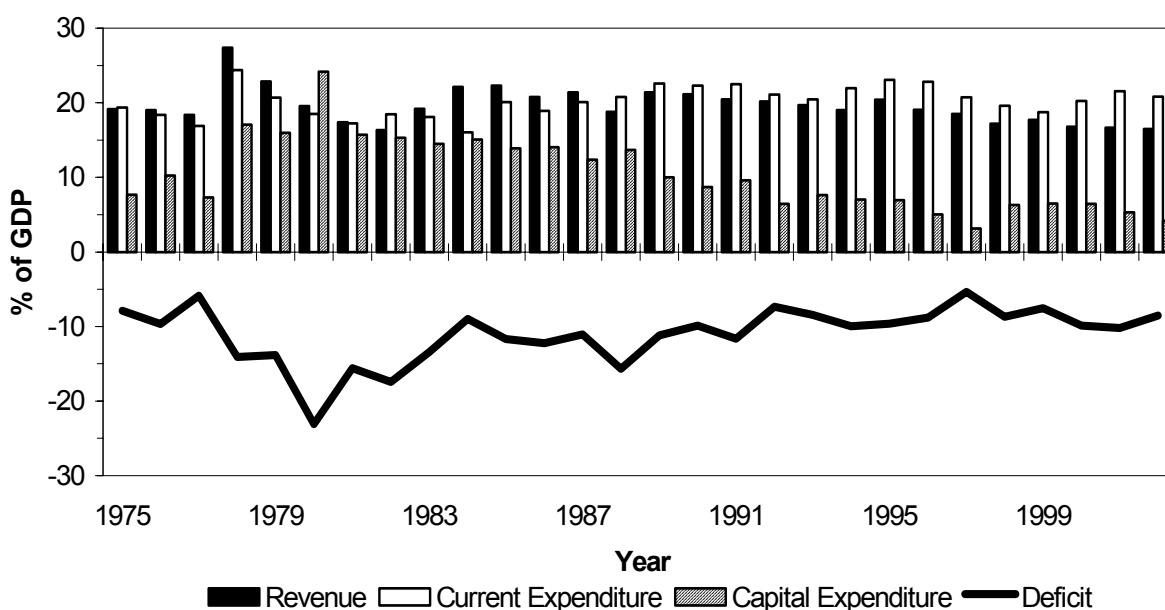
8. In 1983, an attack by the LTTE on a Sri Lankan army patrol in Jaffna led to widespread violence against Tamils, including in the nation's capital. The 1983 riots are seen as the turning point that led to the escalation of hostilities culminating in the civil conflict between the Government and the LTTE. Despite the onset of the civil conflict in the north and east, the country's annual GDP growth averaged nearly 6% during 1977–1985. The growth was largely attributed to the implementation of the large-scale public investment program and the liberalization of the economy. Budget deficits continued to be a problem rising to 23% of GDP in 1980 as a result of high capital expenditure, but reducing to 12% of GDP in 1985 as the public investment program scaled down and capital expenditures reduced to around 13% of GDP from 24% of GDP in 1980. With high levels of investment financed through foreign borrowing, the current account turned from a surplus in 1977 to a deficit that widened to 16.4% of GDP in 1980.

9. The 1986–1993 period, still under the leadership of the UNP, was one of great turmoil. The Government was faced with an uprising in the south while at the same time making efforts to resolve the civil conflict in the north and east. In 1987, the Government signed a peace accord with the Government of India—with the agreement of the Tamil militant groups—which provided some local autonomy through the establishment of the provincial council in the north and east and provided for the disarmament of Tamil combatants. For its part, the Government of India sent a peacekeeping force to monitor the terms of the accord and oversee the disarmament, with the Indian force effectively taking military control of the northeast. Both Sinhalese nationalists and Tamils (militants and civilians) opposed the presence of Indian troops in Sri Lanka and the military control they had in the country. During 1988–1990, a further threat to the country's stability emerged from the south. The Janatha Vimukthi Peramuna (JVP—People's Liberation Front), a Marxist-oriented Sinhalese-nationalist movement, attempted to violently overthrow the government. The Government managed to overpower the rebellion, but at a great cost in human life. The presence of the Indian peacekeepers became a key issue in the 1989 presidential elections, with both main parties calling for their removal. Indian troops

were withdrawn in 1989–1990 at the request of the newly elected president, and the fighting between the LTTE and the Government began again after a brief pause.

10. The unemployment rate during the late 1980s rose to around 15%, which helped feed the JVP insurgency. Growth fell to as low as 1.5% in 1987 and averaged 4% during 1986–1993. This period marks a turning point in fiscal policy as well. In 1988, current expenditures exceeded total revenue (Figure 2), a situation that has still not been reversed, and foreign concessional loans began to dry up. During the late 1980s there were no new large-scale public infrastructure projects, largely due to the uncertain political climate, and total investment began to fall averaging 23% of GDP for the period.

Figure 2: Government Finance, 1975–2002



Source: Central Bank of Sri Lanka.

11. In the early 1990s, the UNP Government took many radical measures to revive the ailing economy, and regain the confidence of the private sector. A privatization program to restructure public enterprises was initiated and several programs to attract foreign investors were launched. The Board of Investment extended support through incentives and tax holidays to investors starting up export-oriented industries in the country. In 1993 the economy grew at 6.9%, the highest rate since 1978. Stock market indexes rose, as foreign portfolio investment moved in. Foreign investment climbed to \$187 million in 1993, from \$18 million in 1989, while private long-term borrowing increased to \$188 million.

12. In 1994, a new government formed by the People's Alliance—a coalition led by the SLFP—was elected to office. Under the new administration, the privatization program was accelerated, and the Public Enterprise Reform Commission was set up in 1996 to oversee the privatization of several public enterprises. Several privatization deals were concluded including the country's national air carrier, telecommunications, and plantation companies. The country

experienced a severe drought in 1996, affecting agriculture and resulting in power cuts that lowered industrial production. However during this year export earnings from tea increased significantly by 28% due to favorable tea prices. The Government continued to incur large budget deficits in the range of 9–10% as the conflict in the north heightened and war-related expenditures increased. The conflict has taken a sizeable portion of the Government's total expenditure, with defense expenditure averaging around 5% of GDP.

13. As foreign aid flows decreased, the Government resorted to domestic borrowing to fund its deficits, driving interest rates up, peaking at 25% in 2000. During the late 1990s, the financial position of some of the larger state-owned enterprises deteriorated, resulting in heavy short-term borrowing from the two state banks. This, combined with the high government borrowing to finance the deficit, had an expansionary impact on money supply and crowded out private sector borrowing. Imports grew significantly in 2000, with the purchases of airbuses and defense-related equipment, and the impact of an oil price increase. The foreign reserve position deteriorated to less than 5 weeks of import coverage, which led to the Central Bank floating the exchange rate in January 2001.

14. In the December 2001 Parliamentary elections, the United National Front—a coalition led by the UNP—achieved a majority and formed the Government. However, the President is from the opposition Peoples' Alliance, a situation that has created a rather unstable cohabitation arrangement. The President has the power to dissolve Parliament and is the commander-in-chief of the armed forces. Despite this inherent weakness, the UNP Government is continuing the efforts of past administrations to resolve the ethnic conflict. In February 2002, the Government and the LTTE entered into a cease-fire agreement and formal peace talks between the two parties began in September 2002. Six rounds of peace talks have been held, but the LTTE suspended talks in April 2003. While some progress has been made at the peace talks with the LTTE agreeing to a federal model as an alternative to an autonomous state for the Tamils, details of the degree of devolution have not yet been determined and is one of the contentious issues in the negotiation process. The question of an interim administration arrangement, with greater participation of the LTTE in planning and implementing rehabilitation projects in the north and east, will determine the LTTE's further participation in the peace talks.

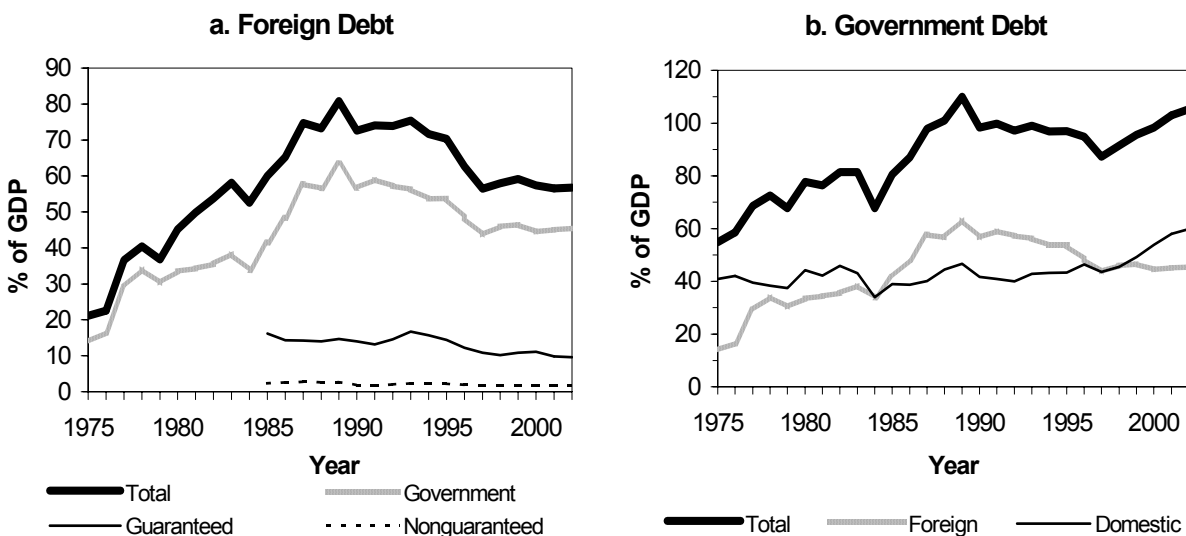
15. Nevertheless, the cessation of hostilities and the ongoing peace process have given a boost to consumer and investor confidence. The year 2002 has seen an increase in economic activity with the economy growing at 4%, compared with a contraction of 1.5% in 2001. Progress has been made in bringing the government finances under control as well. In 2002, the budget deficit was 8.9% of GDP. While still large, this is an improvement over the previous year's level of 10.9%. The Government has also managed to pay off high-interest short-term debt and issue longer-term bonds. However, revenue mobilization is still lagging, with current expenditures still exceeding total revenue.

B. Government Debt and Debt Management

16. The country's debt dynamics reflect the underlying political and economic events of the period. The public debt in particular mirrors the chronic budget deficits experienced throughout the last three decades. Foreign debt began at the low level of 21% of GDP in 1975 (Figure 3), about 65% of which was government debt. Foreign debt rose during the late 1970s and early 1980s, driven by the high levels of concessional external borrowing that financed large-scale infrastructure projects at that time. The level of foreign debt peaked at nearly 81% of GDP in 1989, 78% of which was government debt with nearly all of the remainder covered by government guarantee. With the increased fighting in the civil conflict and the decline in the

public investment program, concessional foreign funding became increasingly scarce. The level of foreign debt declined from its peak, with a particularly steep drop in the mid-1990s, falling to 57% in 2002. Again, the bulk of the accumulated external borrowing is by the Government or carries a government guarantee.

Figure 3: Debt Stock, 1975–2002

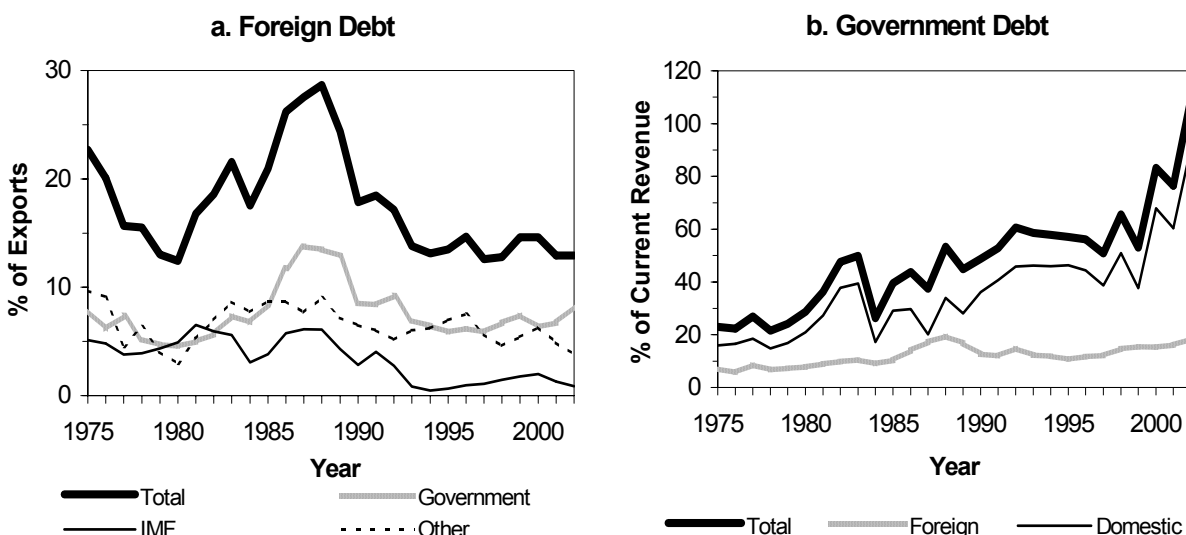


Source: Central Bank of Sri Lanka.

17. Unlike the foreign debt dynamics, government debt is generally on an upward trend throughout 1975–2002. However, the underlying composition of that debt fluctuates considerably. In 1975, total government debt was about 55% of GDP, the majority of which—nearly 75%—was from domestic sources. As was seen with the country's external debt, concessional foreign loans financing large infrastructure projects raised the overall level of government debt. This altered the composition of the national debt as well since domestic public debt was relatively stable during this period. By the end of the 1980s, the stock of public debt exceeded total GDP, with foreign loans making up 58% of the total. In the 1990s, the drop-off in availability of concessional foreign lending decreased the government's foreign debt stock, but the high fiscal deficits were now financed primarily through domestic borrowing. From 1997 in particular, the government's domestic borrowing surged such that by 2001 public debt was again in excess of GDP, with domestic debt accounting for 56% of the total.

18. Trends in debt service have been more volatile than the debt stock (Figure 4). In the late 1970s, foreign debt service actually fell despite the rising debt stock, going from 23% of exports in 1975 to 12% in 1980. On average during the late 1970s, the composition of debt service was roughly equally split among payments on government foreign borrowing, payments to the International Monetary Fund (IMF), and payments from other borrowers. This is in spite of the fact that the Government was the single largest borrower, indicating the level of concessionality of its foreign loans. As grace periods on concessional foreign loans began to expire, the debt service again rose, peaking at 29% of exports in 1989. However, with access to concessional resources drying up, foreign debt service as well tapered off, reaching 13% of exports by 2002.

Figure 4: Debt Service Indicators, 1975–2002



Source: Central Bank of Sri Lanka.

19. While also more volatile than the debt stock, government debt service has been on an upward trend for most of 1975–2002. Interestingly, domestic debt service was always the main component of total public debt service, even in the years where foreign debt outstanding was greater than the domestic debt stock. This is due to two factors. First, again is the concessional terms on which the bulk of the Government's foreign borrowing is contracted. However, this is also a reflection of the longer maturity periods of the foreign debt. Note that the sharp rise in government debt service in 2000—to a level that today exceeds total current revenues—corresponds to the period of high local interest rates when only shorter-maturity government instruments were floated on the market.

20. The previous discussion did not consider the currency composition of the outstanding debt and debt repayments. Japan is Sri Lanka's largest lender, accounting for 22% of total disbursed loans outstanding in 2002, followed by the World Bank (17%) and ADB (16%). Loans from Japan are denominated in yen, while World Bank and ADB concessional loans are in special drawing rights (SDRs).⁵ While approximately one fourth of the country's debt is denominated in yen, foreign currency earnings from trade are mainly in dollars and euros. Exports to Japan accounted for only 3% of the total in 2002, compared with 38% to the United States and 30% to the European Union. Including earnings from tourism and remittances only further skews the balance. As such, the effects of fluctuations in cross-currency exchange rates on the country's debt situation also need to be properly managed.

⁵ While loans from ADB's ADF are denominated in SDRs, the currency of repayment depends on what is actually disbursed, which in turn depends on the currency that is available in the fund at the time of disbursement. Unfortunately, a more detailed breakdown of the currency of Sri Lanka's outstanding debt and repayments is not available.

21. The Government's foreign borrowing has been on highly concessional terms throughout the period of analysis. As Appendix 3 shows, the grant element associated with loans from Sri Lanka's main external sources—the Government of Japan, ADB, and the World Bank—are in the range of 55–72%. However, even nonconcessional loans allow the Government to borrow longer-duration loans than it could if it went to the international capital market on its own, and at lower interest rates.

22. There are several institutions in charge of public debt management in Sri Lanka: (i) the Public Debt Department of the Central Bank of Sri Lanka (CBSL), (ii) the External Resources Department of the Ministry of Policy Development and Implementation, and (iii) the Department of State Accounts of the Ministry of Finance. Under the Monetary Law, the Public Debt Department is the primary institution to raise local financing for the Government, and it is responsible for managing domestic debt in the form of treasury bills, treasury bonds, and rupee loans. The Domestic Debt Management Committee of CBSL is responsible for coordinating the raising of domestic debt, deciding on the timing and terms of new treasury issues. In addition to the Public Debt Department, the legal framework permits other institutions/agencies to raise debt as well. The Treasury in the Ministry of Finance raises loans and overdrafts from commercial banks, mainly from the two state-owned banks. The External Resources Department is responsible for contracting debt with foreign governments and multilateral development banks. The Department of State Accounts also plays a role in debt management, as it serves as an intermediary in the flow of government funds, including debt disbursements and repayments. The Government plans to set up an independent debt management office to centralize some public debt management functions, but these proposed reforms are still in the early stages.

C. Borrowings of State-owned Enterprises and Private Sector Foreign Debt

23. There are approximately 75 commercial public enterprises and more than 130 nonprofit statutory-board enterprises providing goods and services or administrative functions in Sri Lanka.⁶ Of the 75 commercial public enterprises, seven firms—Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), Cooperative Wholesale Establishment (CWE), National Water Supply and Drainage Board, Sri Lanka Ports Authority, State Pharmaceuticals Corporation of Sri Lanka, and State Timber Corporation—account for 75% of total turnover in the sector. Financial information is generally not available from public enterprises in a timely fashion and may not accurately reflect the true financial state of the organization,⁷ which makes it difficult to develop a complete picture of the public debt situation, particularly with respect to domestic borrowings. However, a rough estimate of the relative magnitude of the problem can be inferred from existing data sources.

24. According to CBSL data, when the debt of nonfinancial public corporations is added to the central government debt, the total public debt is 2.7% of GDP greater than the level of government debt. CEB, CPC, and CWE account for about 90% of the debt of state-owned enterprises. The three corporations have suffered chronic losses in recent years, due in part to government price controls. With the implementation of an automatic price adjustment formula for petroleum products, CPC managed to return to profitability in 2002, but still has a considerable level of debt outstanding. Including the loans outstanding to the Government, CEB, CPC, and CWE's current debts amounted to about 3.5% of GDP at the end of 2002 and

⁶ IFG Development Initiatives Ltd. 2002. Final Report. Report prepared under TA 3567-SRI: *Governance and Institutional Support for Private Sector Development*. ADB, Manila.

⁷ For example, inaccuracies due to underreporting of debt service arrears to Government and out-of-date asset valuations are common.

their total debt was more than double that amount. Bank loans and overdraft—particularly from the state-owned People's Bank and Bank of Ceylon—account for the majority of the current debts of these three institutions.

25. As discussed, the Government is the largest borrower from external sources, but contingent liabilities from the government-guaranteed debt of public enterprises and the private sector add an additional risk to the public debt situation. Since 1985, the stock of government-guaranteed debt, excluding borrowings from the IMF, has been steady around 10% of GDP. The private sector cannot freely borrow from abroad because of the exchange controls in place, and access to foreign borrowing is approved on a case-by-case basis. Much of the outstanding private sector guaranteed foreign debt is from recently privatized enterprises such as Sri Lanka Telecoms and Sri Lankan Airlines (formerly Air Lanka). The decline in guaranteed debt to 8% of GDP in 2002 (14% of total foreign debt) was in part because of principal repayments made by privatized former public enterprises. Nonguaranteed foreign debt is small, between 1.5% and 3.0% of GDP, a reflection of the exchange controls.

26. Although the foreign debt of nongovernment entities is much less than the Government's accumulated foreign borrowings, the debt service is another issue. Interest and principal repayments on guaranteed and nonguaranteed borrowings of public enterprises and the private sector have averaged 6% of exports since 1985 and have been higher than government foreign debt service in some years. This is a result of the borrowing being less concessional and shorter term than the Government's foreign debt. In 2002, the level of debt service had dropped to less than 4% of exports. While similar in magnitude to the level of public debt service, the foreign debt service burden of public enterprises and the private sector is at a manageable level.

27. Another source of claims on the foreign exchange earnings of the country is the foreign liabilities of the banking sector. In 2002, banking sector liabilities added another \$1 billion to the total foreign exposure of the country, which is equivalent to another 6% of GDP in foreign debt and is generally short-term in nature. The foreign debt of commercial entities (both public and private) and foreign liabilities of banking institutions was nearly 16% of GDP in 2002, compared with the Government's foreign debt of 45% of GDP.

D. Summary of National Debt Situation

28. The current debt situation is an accumulation of years of high fiscal deficits. In the late 1970s and early 1980s, the deficits were driven by an ambitious public investment program that centered on large-scale infrastructure projects. As the financing was mostly through foreign concessional borrowing and the investments enhanced the country's growth prospects, the Government was able to contain the servicing of the debt. However, with the intensification of the civil conflict, the nature of the fiscal deficits changed. Recurrent expenditures surpassed revenue mobilization while the public investment program shrank. As a result, government debt service ballooned, as concessional foreign financing became scarce and the Government had to rely on shorter-term domestic debt instruments. The borrowings of public enterprises do not have a big effect on the stability of the country's external debt—even less private sector borrowings—but the possibility of defaults on government-guaranteed debt adds a further element of risk that must be managed within the context of the Government's loan portfolio. Moreover, the domestic borrowing of public enterprises exacerbates the effect of government domestic borrowing in crowding out local private sector investment.

III. DEBT SUSTAINABILITY

A. Key Indicators of Debt Sustainability

29. A country's debt situation must be viewed from various perspectives when considering its overall sustainability. First, and most commonly cited, are measures of the overall magnitude of the debt burden. These indicators can be thought of as measures of the country's "solvency" in that they consider the stock of debt at certain time in relation to the country's ability to generate resources to repay the outstanding balance. Examples of debt burden indicators include the debt to GDP ratio, foreign debt to exports ratio, and government debt to current fiscal revenue ratio. This set of indicators also covers the structure of the outstanding debt including the share of foreign debt, short-term debt, and concessional debt in the total debt stock.

30. A second set of indicators focuses on the short-term liquidity requirements of the country with respect to its debt service obligations. These indicators are useful early-warning signs of debt service problems, but also highlight the impact of the intertemporal trade-offs arising from past borrowing decisions. Examples of liquidity monitoring indicators include the debt service to GDP ratio, foreign debt service to exports ratio, and government debt service to current fiscal revenue ratio. The final indicators are more forward looking as they point out how the debt burden will evolve over time, given the current stock of data and average interest rate. The dynamic ratios show how the debt burden ratios would change in the absence of repayments or new disbursements, indicating the stability of the debt burden. An example of a dynamic ratio is the ratio of the average interest rate on outstanding debt to the growth rate of nominal GDP.

31. To develop a basis for gauging Sri Lanka's future borrowing capacity, we will first consider the current situation of the various indicators of debt sustainability. In general, there are no predetermined critical values for the indicators beyond which a country's debt is deemed unsustainable. As such, the debt sustainability indicators will be viewed vis-à-vis recent trends in Sri Lanka as well as across other countries in the region to provide the appropriate context.

1. Debt Burden Indicators

32. The country's foreign debt burden has declined dramatically over the last decade, as illustrated in Table 1. As discussed in the previous section, the foreign debt stock peaked at 81% of GDP (290% of exports) in the late 1980s, due mainly to the high rates of public investment in that period, before declining to about 57% of GDP in 2002. The bulk of the lending has been on a long-term basis with over 70% on concessional terms. The government debt burden as a share of GDP, on the other hand, had been on the decline, but the trend was reversed toward the end of the 1990s. The trend is even more pronounced when considering the debt burden as a share of government revenues because of the weak performance of revenue collections. Although much of the public borrowing is also on a long-term basis, the shift toward greater reliance on domestic borrowing has been detrimental to the local private sector, raising interest rates and crowding out private investment. Moreover, the maturity of new domestic government borrowings (nonbank borrowings in particular) had been declining in recent years, but with the 2002 budget the situation has begun to improve. The Government made a concerted effort in to repay outstanding overdraft in 2002 and to issue longer-term treasury bonds (4–6-year maturities) in the market.

Table 1: Debt Burden Indicators, 1985–2002
(percent)

Item	1985– 1990	1991– 1996	1997	1998	1999	2000	2001	2002 ^a
Debt Stock								
Foreign Debt/GDP	71.1	71.3	56.4	58.0	59.2	57.4	56.6	56.7
Foreign Debt/Exports of G&S	258.7	210.2	148.1	154.6	161.3	141.5	141.8	155.5
Government Debt/GDP	96.4	97.5	87.2	91.5	95.6	98.3	103.0	105.3
Government Debt/Current Revenue	462.5	493.6	471.3	532.2	539.7	585.2	619.3	641.8
Debt Structure								
Foreign Short-term Debt/Foreign Debt	5.7	7.0	5.8	5.6	5.2	6.4	6.2	6.5
Concessional Debt/Foreign Debt	68.3	71.4	72.1	75.6	76.0	74.1	75.8	77.8
Government Foreign Debt/ Government Debt	56.6	56.1	50.1	50.2	48.6	45.3	43.7	43.2
Government Short-term Debt/ Government Debt	21.0	21.0	17.2	17.5	16.6	16.8	19.2	15.5

GDP = gross domestic product, G&S = goods and services (factor and nonfactor services).

^a Preliminary figures.

Source: Authors' calculations.

33. As an indication of the sustainability of the debt burden, the level of foreign debt can be viewed in light of the critical values under the Heavily Indebted Poor Country (HIPC) Initiative.⁸ Under the HIPC framework, a ratio of the net present value (NPV) of debt service to exports of less than 150% is considered sustainable. This differs somewhat from the debt burden calculation in Table 1 in that the NPV of debt service takes into account the concessionality of the outstanding loan portfolio. If a country's loans are all on a commercial basis, the NPV of debt service will equal the outstanding debt. Using data from the World Bank,⁹ the NPV of Sri Lanka's foreign debt service was about 80% of the level of the outstanding debt in 2001. Assuming this ratio is roughly constant over the past few years, the current level of Sri Lanka's foreign debt is well below the HIPC threshold.¹⁰ From the debt burden indicators, it appears that the primary issue with respect to Sri Lanka's borrowing capacity is not sustainability of its foreign debt, but the strain on the fiscal budget from the Government's accumulated borrowings.

2. Liquidity Monitoring Indicators

34. In terms of the liquidity monitoring indicators (Table 2), Sri Lanka's foreign debt follows a similar pattern as the debt burden indicators. The ratio of debt service to exports peaked at nearly 30% in the mid-1980s, but generally declined since then reaching about 13% in 2002 (less than 5% of GDP). The manageable level of foreign debt service, despite relatively high debt burden ratios, is a reflection of the concessional nature of much of this debt. Debt service in terms of official reserves has fluctuated more erratically than the other indicators, which is a reflection in the rundown of reserves prior to the currency float in 2001 and the subsequent

⁸ The comparison with the HIPC threshold is for illustration only. To be eligible for consideration under the HIPC Initiative, a country must first avail itself of traditional debt restructuring mechanisms, through the Paris Club for example, and still have an unsustainable level of debt.

⁹ World Bank. 2003. *Global Development Finance 2003*. Washington, DC.

¹⁰ For very open economies, defined as those with exports of at least 30% of GDP, that have fiscal revenue of at least 15% of GDP, a lower threshold applies, which is NPV of foreign debt service less than 250% of fiscal revenue. Sri Lanka's foreign debt burden is sustainable by this criterion as well.

buildup under the IMF Standby Arrangement. Government debt service, on the other hand, shows considerable weakness. The ratio of government debt service to current revenue has been on the rise due to the shift to greater domestic borrowing. In 2002, government debt service was almost 18% of GDP and exceeded the total value of current revenue. However, this is expected to be a temporary condition and partly a reflection of (i) the short-term debt of the late 1990s coming due and (ii) the policy to pay back bank borrowings on overdraft.

Table 2: Liquidity Monitoring Indicators, 1985–2002
(percent)

Item	1985– 1990	1991– 1996	1997	1998	1999	2000	2001	2002 ^a
Foreign Debt Service/GDP	6.6	5.1	4.8	4.8	5.4	5.9	5.2	4.7
Foreign Debt Service/Exports of G&S	24.3	15.1	12.6	12.8	14.6	14.6	12.9	12.9
Foreign Debt Service/Official Reserves	135.6	42.0	35.6	38.2	51.3	92.7	60.7	45.9
Government Debt Service/GDP	9.3	11.3	9.4	11.3	9.4	14.0	12.7	17.9
Government Debt Service/ Current Revenue	44.6	57.3	50.8	65.7	53.0	83.2	76.5	109.4

GDP = gross domestic product, G&S = goods and services (factor and nonfactor services).

^a Preliminary figures.

Source: Authors' calculations.

3. Dynamic Ratios

35. The dynamic ratios are more forward-looking indicators as they consider the conditions under which the underlying debt burden would be stable. For example, in the case of the domestic debt-to-GDP ratio, the debt burden indicator would be constant as long as the nominal growth of GDP is sufficient to cover the domestic interest payment. Mathematically, a dynamic ratio is the rate of change of its associated debt burden indicator, in the absence of new borrowing or repayments. For the domestic debt-to-GDP example, the dynamic ratio is calculated as

$$\% \Delta DB = \frac{(1+i)}{(1+g)} - 1,$$

where $\% \Delta DB$ denotes the dynamic ratio (the percentage change in the domestic debt burden), i the average nominal interest rate on the debt stock, and g the growth rate of nominal GDP.¹¹ Negative values of the dynamic ratio imply the underlying debt burden is tending to improve, while positive values indicate an unsustainable situation, as the country would have to borrow simply to make interest payments. The calculation is complicated somewhat when comparing foreign debt with a rupee-denominated base (such as nominal GDP or fiscal revenues), as the

¹¹ For small values of nominal interest and nominal growth, the dynamic ratio can be approximated by the difference: $i - g$.

effect of currency depreciation on the outstanding debt burden also needs to be considered.¹² However, the principle of the calculation remains the same.

36. As Table 3 shows, the debt situation was generally stable in earlier years, even at the time of the peak levels of the foreign debt burden indicators. In 1998–2002, however, several factors coincided that weakened the stability of the debt situation. Depreciation of the rupee and erratic export performance combined to undermine the foreign debt situation, such that, on average during that period, the debt burden would have expanded by almost 1% a year in terms of GDP and 2.5% per year in terms of exports in the absence of repayments. Government debt was somewhat better, as depreciation does not have as large an impact on it because of the domestic debt, but rising interest rates and poor revenue performance created their own challenges. While government debt as a share of GDP was generally stable during 1998–2002, the public debt burden with respect to current revenue would have grown by 2% annually from interest payments alone.

Table 3: Dynamic Ratios, 1985–2002
(percentage change)

Item	1985– 1990	1991– 1996	1997	1998	1999	2000	2001	2002 ^a
Foreign Debt /GDP	(0.6)	(5.4)	(3.5)	(0.0)	1.2	1.0	6.8	(5.5)
Foreign Debt /Exports of G&S	(0.6)	(7.9)	(9.1)	0.4	6.6	(10.2)	8.5	6.5
Government Debt /GDP	(1.7)	(4.1)	(3.6)	(1.7)	1.1	(1.4)	2.8	(2.6)
Government Debt /Current Revenue	(0.7)	(2.5)	(0.9)	5.8	(1.9)	3.9	3.8	(1.2)

GDP = gross domestic product, G&S = goods and services (factor and nonfactor services).

^a Preliminary figures.

Source: Authors' calculations.

4. Overall Assessment of Sri Lanka

37. Taken together, the debt sustainability indicators do not show an obvious threat with respect to the country's external debt. The foreign debt burden has declined to a somewhat high, but manageable level. Moreover, as the bulk of the external debt is long-term loans on a concessional basis, the debt service does not pose any problems from a liquidity perspective. However, the dynamic ratios do highlight the risks posed by exchange rate depreciation and export fluctuations on foreign debt sustainability.

38. Looking across the region, Sri Lanka's foreign debt indicators in 2001 compare favorably with the other South Asian countries (see Appendix 4). Sri Lanka's debt-to-income ratio is on a par with Bangladesh and Pakistan—the two other ADF/OCR-blend borrower countries in the region—and its debt-to-export ratio is much lower because of Sri Lanka's relative openness.

¹² In the case of total government debt-to-GDP, both foreign and domestic, the dynamic ratio would be

$$\% \Delta DB = \frac{\alpha(1+\delta)(1+i^f) + (1-\alpha)(1+i^d)}{(1+g)} - 1,$$

where α is the share of foreign debt in total debt, i^f and i^d are the nominal interest rates on foreign and domestic public debt, δ is the rate of depreciation of the currency, and g is the growth in nominal GDP.

Only the Maldives has a lower foreign debt burden ratio with respect to exports. The countries generally have high shares of concessional borrowing and low levels of short-term foreign debt. As a result, the liquidity monitoring indicators for the region are relatively low, with the exception of Pakistan, which underwent a restructuring of its debt in the late 1990s.

39. The public debt situation is a concern. The current public debt burden, whether considered in terms of GDP or current revenue, is clearly unsustainable. The high levels of government debt service may pose future liquidity problems if they are not well managed. There is a need to substitute longer-term, foreign financing for local borrowing, but this must be in the context of tighter fiscal policy to bring the total public debt under control. While recent moves by the Government to reduce its outstanding bank overdrafts and to issue treasury bonds with longer maturities are steps in the right direction, poor revenue performance must be addressed urgently to bring the deficit down in the medium term.

B. Borrowing Capacity Model

40. This study uses the World Bank's Revised Minimum Standards Model—Extended (RMSM-X) to simulate the evolution of the debt burden under plausible assumptions for the macroeconomic environment. The model has been calibrated to Sri Lankan data, and is used by the Government's National Planning Department to prepare its medium-term macroeconomic forecasts that support the annual budgeting exercise.¹³ The model brings the public sector, private sector, foreign sector, and monetary sector together under a consistent national accounts framework. The RMSM-X model is linked to a debt module that includes the terms of country's existing foreign loans and assumptions on new foreign debt.¹⁴

41. On the production side, the model begins with projections on the growth path of real GDP. The equality between real output and its uses (public and private consumption, public and private investment, and net exports) provides overall consistency within the model among the various sectors. RMSM-X is a long-run model, with labor assumed at full employment, so the production function is a simple linear relationship with investment. The change in GDP in a given year is the previous year's investment multiplied by the incremental capital output ratio (ICOR).¹⁵ From the assumptions on the GDP growth rate and ICOR, the model determines the level of investment needed to achieve the growth target.

42. The Government's fiscal accounts provide the basis for the public sector in the model. The levels of capital expenditures, recurrent expenditures, and revenue are projected to correspond with fiscal policy assumptions to determine the overall budget deficit. Following the convention in Sri Lanka, foreign grants are included below the line as a financing element rather than with revenue. In the financing of the deficit, foreign grants and loans are determined exogenously and domestic borrowing is a residual. For consistency, capital expenditures are equated with public investment in the national accounts, and the values for foreign grants and lending to the Government are reflected in the balance of payments. There is no differential

¹³ The calibration of the model, as used by the National Planning Department, was supported by ADB technical assistance. ADB. 1999. *Technical Assistance to the Democratic Socialist Republic of Sri Lanka for Strengthening Public Expenditure Management Systems*. (TA 3301-SRI). Manila.

¹⁴ For a detailed description of the RMSM-X model with the debt module, see Everaert, Luc; Fernando Garcia-Pinto; and Jaime Ventura. *A RMSM-X Model for Turkey*. World Bank Working Paper Series no. 486. Washington, DC: World Bank.

¹⁵ Cyclical fluctuations (e.g., departures from full employment) could be factored into the model by changing the assumptions on the ICOR over time. Rather than taking this approach, the simulations in this study use conservative assumptions on the ICOR throughout.

efficiency between public and private investment assumed in the model so a single ICOR is used for both types of capital.

43. The foreign sector is represented by the balance-of-payments accounts in the model. Exports of goods and nonfactor services—which have been disaggregated into several key products such as tea and garments—are increasing functions of foreign national income and the real exchange rate (which is in units of local currency to the dollar). Imports of goods and nonfactor services—which are similarly disaggregated into key products such as oil—are increasing functions of domestic income (or domestic investment in the case of capital goods) and decreasing with respect to the real exchange rate. Factor payments and transfers are determined exogenously. In a given year, the debt module provides data on disbursements, interest payments, and amortization of foreign debt contracted in previous years. This includes the country’s actual foreign debt obligations and those resulting from foreign borrowing in earlier years of the simulation. Official foreign reserves, in months of import coverage, are set exogenously as a policy variable. The model then determines the additional amount of foreign borrowing (that is, beyond the net disbursements received from loans contracted in earlier periods) needed to bridge the gap between total foreign currency inflows and outflows.

44. The monetary sector links real flows with financial flows in the model. Money supply is given by its relationship with nominal GDP and the velocity of money; that is, money supply is equal to real GDP multiplied by the GDP deflator divided by the velocity. Inflation is a monetary policy target and velocity is an exogenous variable. Changes in the nominal exchange rate are based on the differential between the domestic inflation assumptions and the projections for world inflation, plus any assumed or targeted real exchange rate adjustments.

45. In this study, the model is computed using the “private sector closure”; that is, the model calculates the private sector variables. As the level of investment is determined by the assumptions on growth and ICOR, and public sector values are based on the assumed government policy, the private sector acts as the “marginal economic agent” to ensure the model’s internal consistency.¹⁶ This includes foreign borrowing in the balance of payments, where the additional borrowing not accounted for by the Government’s fiscal operations is allocated to the private sector. However, the baseline scenario has been calibrated to achieve plausible values for the residual private sector variables.

C. Baseline Scenario for Sri Lanka

46. The RMSM-X model provides a very flexible framework for exploring Sri Lanka’s future debt dynamics, while simultaneously ensuring internal consistency across the sectors within the model. In setting the values for the underlying parameters, the baseline scenario has been calibrated to provide plausible forecasts for various macroeconomic variables. As a starting point, the baseline scenario’s projections are derived from the objectives given in the Government’s *Regaining Sri Lanka*, the targets in the Fiscal Management (Responsibility) Act, and CBSL’s medium-term projections in its 2002 Annual Report. However, the baseline projections are often more conservative than those in these official sources, to ensure that the debt dynamics are sustainable even if the Government’s targets are not fully achieved. Moreover, a higher rate of reconstruction activity in the conflict-affected districts is assumed than that implicit in the government projections.

¹⁶ When “public sector closure” is used, the government becomes the marginal economic agent and the values for public investment, borrowing, etc. are determined by the model rather than policy. Because the effect of public policy decisions on the debt sustainability indicators is a primary focus of this study, the private sector closure rule is used in all simulations.

47. Several assumptions are implicit in the baseline scenario. First, and foremost, the projections assume continued progress on achieving a permanent settlement to the ethnic conflict. The cessation of hostilities is a necessary condition for achieving the growth targets and for containing government recurrent expenditures. Second, the baseline assumes sufficient political stability for the economic reform program to continue. The country will only move from its 4–5% annual GDP growth to higher sustained levels if the Government pursues the reforms outlined in *Regaining Sri Lanka* persistently, without backtracking on the reforms already achieved. Consistency in the approach to economic reforms is also necessary to foster the investor confidence needed to raise the level of private investment to support the higher growth rate. Finally, external factors, such as weather conditions and the level of global economic activity, are assumed to be at their usual levels. As Sri Lanka is an open economy highly dependent on trade, developments in the international economy play a significant role in the economic prospects in Sri Lanka. Because of the large share of agriculture in the country's total production and the importance of hydropower in electricity generation, the economy is very sensitive to weather fluctuations.

48. In addition to these implicit assumptions, the baseline scenario includes the following projections on key macroeconomic variables (Table 4).

- **Output, Investment, and Saving:** The growth path for real GDP is based on CBSL projections, but are more conservative, with the country achieving 7% growth only in 2009. Total investment rises steadily from 26.5% of GDP in 2003 to 32.5% at the end of the 10-year period, with the initial surge coming from an increase in public investment. Saving rates also rise steadily under the baseline scenario. The key model parameter on the production side is the ICOR, as this determines the total investment level for the assumed growth path. The ICOR rises initially, to allow for the construction period of the new investment, then declines over time.
- **Fiscal Policy:** While budget deficit figures are not directly entered into the model, the various parameters on revenue and expenditure have been calibrated to produce a declining trend in the fiscal deficit that is similar to CBSL projections but somewhat slower. Under the baseline, the target deficit given in the Fiscal Management (Responsibility) Act is not achieved until 2007, a year later than what is stipulated in the Act. Foreign grant financing increases from its recent levels during the early periods, to account for funding for the reconstruction of the north and east and disaster relief for the flood victims in the south, but tapers off over time. Similarly, foreign borrowing as a percentage of GDP increases in the early years, driven by the rise in public investment, and then declines over time.

Table 4: Key Macroeconomic Variables under the Baseline Scenario

Item	1998– 2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Output, Investment, and Saving											
Real GDP Growth (%) ^a	3.5	5.0	5.5	6.0	6.0	6.5	6.5	7.0	7.0	7.0	7.0
Domestic Investment (% of GDP)	24.8	26.5	30.2	30.4	31.7	31.8	32.3	32.4	32.5	32.6	32.6
National Saving (% of GDP)	21.7	23.1	25.8	25.7	27.2	27.6	28.4	28.6	28.7	29.0	29.4
ICOR ^a	5.0	4.8	5.0	5.0	4.8	4.8	4.5	4.5	4.5	4.5	4.5
Government Finance (% of GDP)											
Revenue (excluding grants)	17.0	17.8	18.7	18.8	18.9	18.9	18.8	18.8	18.8	18.8	18.9
Current Expenditure	20.2	19.8	18.6	17.7	16.8	16.0	15.9	15.6	15.4	15.2	15.1
Capital Expenditure and Net Lending	6.0	6.0	7.6	8.1	8.1	7.9	7.9	7.7	7.7	7.8	7.8
Current Fiscal Balance	(3.2)	(2.6)	(0.6)	0.7	1.7	2.6	2.7	3.0	3.4	3.6	3.8
Overall Fiscal Balance ^b	(9.3)	(8.0)	(7.5)	(7.0)	(6.0)	(5.0)	(5.0)	(4.5)	(4.4)	(4.2)	(4.0)
Foreign Borrowing ^a	0.5	1.5	2.5	3.0	3.0	2.5	2.5	2.0	2.0	1.5	1.5
Foreign Grants ^a	0.5	0.5	0.9	1.1	1.1	0.9	0.7	0.6	0.6	0.6	0.6
Domestic Borrowing	8.0	6.0	4.2	2.9	2.0	1.7	1.8	1.9	1.8	2.1	1.9
Prices and Exchange Rates											
Domestic Inflation (%) ^a	6.8	7.5	7.0	6.0	5.0	4.5	4.5	4.5	4.5	4.5	4.5
World Inflation (%)	1.3	1.5	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Nominal Depreciation (%) ^a	10.2	8.0	7.4	6.4	5.4	4.9	4.9	4.9	4.9	4.9	4.9
Balance of Payments											
Growth in Exports of G&S (\$, %)	1.6	10.5	10.6	10.8	12.7	13.0	13.4	13.7	14.1	14.4	14.9
Growth in Imports of G&S (\$, %)	1.5	13.5	12.9	11.0	11.9	12.0	12.2	12.9	13.0	13.1	13.3
Current Account Balance (% of GDP)	(2.9)	(3.4)	(4.5)	(4.7)	(4.5)	(4.2)	(3.9)	(3.8)	(3.7)	(3.6)	(3.3)
Gross Official Reserves (months of import) ^a	2.5	3.2	3.4	3.7	3.8	4.1	4.2	4.3	4.4	4.5	4.5

GDP = gross domestic product, G&S = goods and services, ICOR = incremental capital output ratio.

^a Values for indicated series are entered directly into the model; other values are calculated within the model.

^b Overall fiscal deficit excluding foreign grants and privatization proceeds.

Source: Authors' calculations.

- Money, Inflation, and Exchange Rates:** The declining trend in inflation in the baseline scenario follows CBSL projections, but the deceleration of price changes is at a slower pace. Money supply growth supports the projected inflation and real growth rates, under the assumption of constant velocity of money. World inflation is based on projections for changes in the GDP deflator for advanced economies in the *World Economic Outlook*.¹⁷ Depreciation in the nominal exchange rate is set to allow for a constant 2% real depreciation each year.
- Balance of Payments:** Overall, the current account balance is in deficit, as Sri Lanka will be a net importer of capital throughout the period of analysis. The model has been calibrated such that the current account deficit widens at first, as

¹⁷ World Bank. 2003. *World Economic Outlook*. (April) Washington, DC.

rising investment outstrips the increase in the saving rate, then narrows again to 3.3% of GDP by 2012. The magnitude of the deficit is somewhat larger than the Government's projections. The country will continue to accumulate foreign reserves to bring the level to 4.5 months of import coverage by the end of the period, which is much slower than CBSL's projections.

49. The debt module includes all existing active loans as of 31 December 2002, including projected annual disbursements, interest and fees, and contracted principal repayments. The model includes three types of loans for new borrowing during the simulation period: official concessional, official nonconcessional, and commercial loans. The assumed terms, shown in Table 5, are a rough average of the term structures shown in Appendix 3. The model does not include any up-front fees or commitment charges on undisbursed balances, and a single fixed rate of interest is applied on the disbursed balance. For the Government's borrowing, the baseline assumes 65% is from official concessional loans, 35% from official nonconcessional loans, and no commercial loans. Private sector foreign borrowing, computed as a residual, is all on a commercial basis.

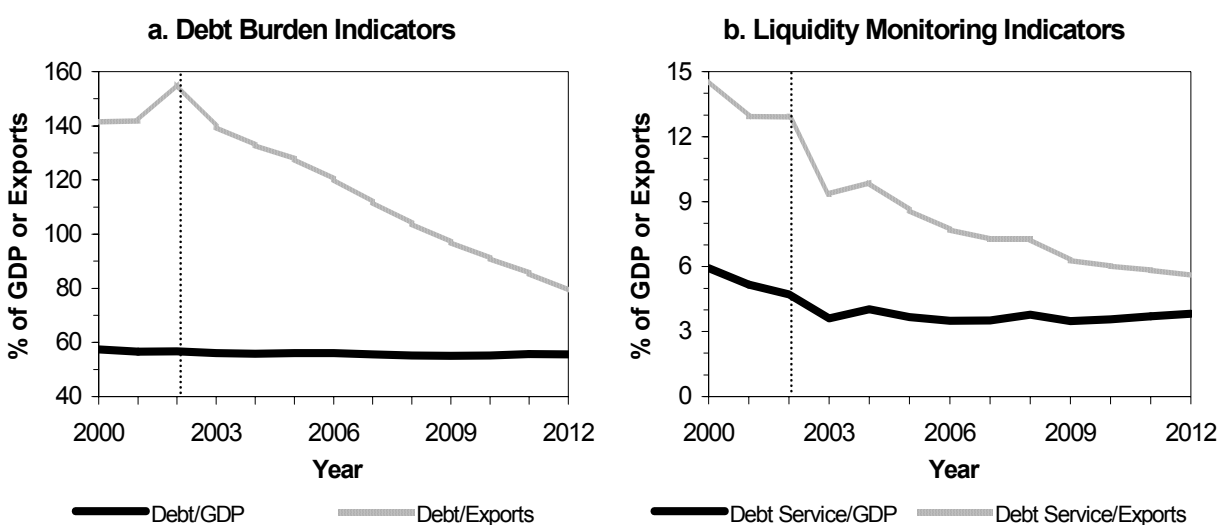
Table 5: Assumed Loan Terms

Loan Type	Repayment Terms (years)		Interest Rate	Years to Disburse
	Maturity	Grace		
Official Concessional	35	8	1.0%	6
Official Nonconcessional	20	5	3.5%	4
Commercial	8	3	6.0%	1

Source: Authors' assumptions.

50. Under the baseline assumptions, foreign borrowing continues to be manageable. As Figure 5 indicates, the foreign debt-to-GDP ratio remains relatively constant throughout the simulation period. As the foreign borrowing is channeled into higher levels of investment—and the consequent higher GDP growth rates—the debt burden remains under control. In comparison, foreign debt as a share of exports declines sharply from over 150% to less than 80% due to the strong export performance. The simulation results with respect to the foreign debt liquidity monitoring indicators are even more positive. As the bulk of the new borrowing is on concessional terms, the debt service-to-GDP ratio declines during the early years rising somewhat toward the end as loan grace periods expire. However, foreign debt service as a share of export earnings declines steadily, again because of the strong export performance under the baseline. As a result, less than 6% of foreign currency receipts from trade in goods and services are needed to cover debt service at the end of the simulation period.

Figure 5: Foreign Debt Sustainability—Baseline Scenario, 2000–2012

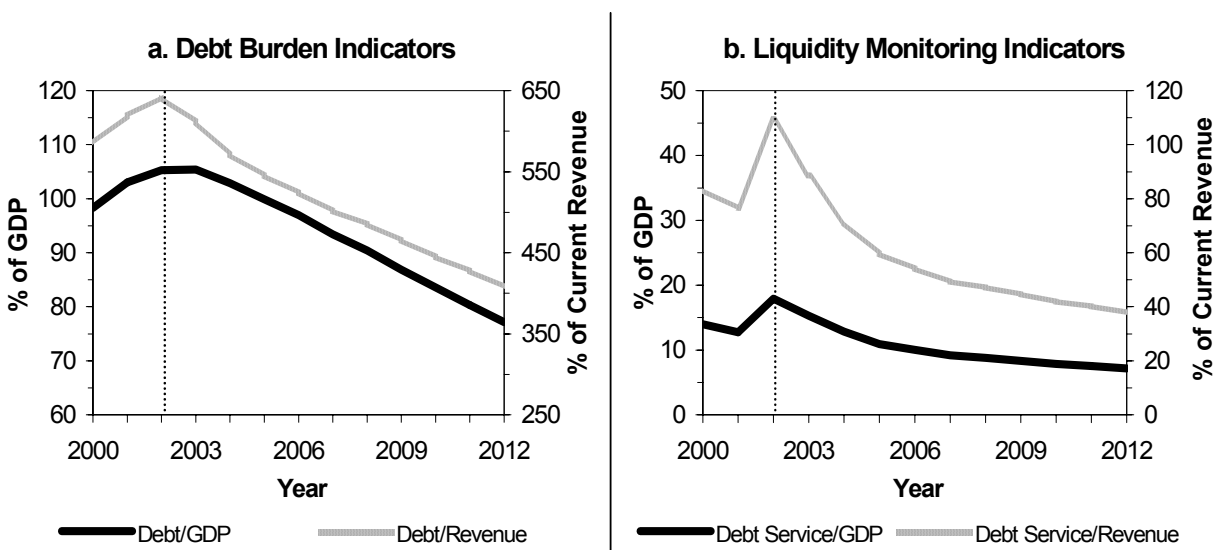


Source: Authors' calculations.

51. While the model results for foreign debt are positive, this is not currently Sri Lanka's main debt management problem. However, the results with respect to the government debt situation are also encouraging. By bringing the budget deficit under control, and through the substitution of domestic borrowing with longer-term foreign loans, the country is able to grow out of its currently unsustainable levels of public debt (Figure 6). Under the baseline assumptions, public debt as a share of GDP falls continuously, although the targets specified under the Fiscal Management (Responsibility) Act are not met. The baseline results in a public debt-to-GDP ratio of 97% in 2006, in contrast to the 85% level stipulated in the Act, and 77% in the end period, whereas the Act calls for 60% by 2013. While the country's achieving the higher GDP growth rates projected by CBSL would mitigate this to some extent, this result does highlight the Government's need to bring recurrent expenditures under control and improve revenue mobilization if its ambitious targets for public debt are to be met.

52. Even more striking than the decline in the debt burden is the improved public debt liquidity situation in the baseline scenario. Following on the sharp rise in 2002, when the Government extended the maturities of its domestic borrowings and repaid its overdraft, the public debt service ratios drop rapidly, falling to roughly 7% of GDP or 38% of current revenue. Of course, the trends would be even more pronounced using the CBSL projections for GDP and revenue growth, but even under the more conservative assumptions of the baseline, the public debt situation returns to more manageable levels during the simulation period.

Figure 6: Government Debt Sustainability—Baseline Scenario, 2000–2012



Source: Authors' calculations.

D. Sensitivity Analysis

53. Alternate scenarios were explored to verify the robustness of the results under the baseline scenario. The following are the alternate scenarios, and how they differ from the baseline.

- **No concessional borrowing:** The source of all new government foreign borrowing is official nonconcessional loans throughout the simulation period. The time to disburse for these loans is increased to 5 years.
- **Export price shocks:** Earnings from the country's main export goods—tea and garments—suffer a temporary shock through a price reduction in 2003, with the prices gradually returning to their baseline trends over a 3-year period.
- **Oil price shock:** Oil prices temporarily increase by 50% in 2003, a shock that persists for two periods before returning to the baseline trend.
- **Exchange rate shock:** The real exchange rate depreciates by 25% in 2003, with quantities of foreign-traded goods and services held constant at their baseline levels.
- **No domestic reforms:** High fiscal deficits, financed mainly through domestic borrowing, and low growth continue throughout the simulation period. Values for growth and inflation are set at their 1998–2002 average levels. Similarly, public investment, the fiscal deficit, and foreign financing (both grants and loans) as a share of GDP are at the 5-year historic average levels. Imports, exports, and the current account balance as a share of GDP are also at their 1998–2002 levels,

with limited foreign capital inflows. Official reserves are at a constant 3 months of import coverage.

54. Table 6 summarizes the results of the sensitivity analysis. The switch to no new concessional loans to the Government does little to the overall debt situation. The biggest effect is in the latter half of the simulation period, due to the shorter grace periods of official nonconcessional loans. The increase in nonconcessional lending slows the decline in the debt burden and liquidity management ratios somewhat—both for foreign debt and government debt—but the overall debt situation remains sustainable. However, this limited impact of less-concessional borrowing is in the context of a general decline in the fiscal deficit and a higher rate of economic growth.

Table 6: Sensitivity Analysis
(percent)

Item	Foreign Debt Indicators				Government Debt Indicators					
	Debt/GDP		Debt Service/Exports		Debt/GDP		Foreign Debt/Total Debt		Debt Service/Current Revenue	
Initial Values (2002 Actual)	57		13		105		43		109	
Scenario	2003–2007	2008–2012	2003–2007	2008–2012	2003–2007	2008–2012	2003–2007	2008–2012	2003–2007	2008–2012
Baseline (Ave. Levels)	56	55	9	6	100	84	47	54	65	42
No Concessional Loans	0	2	0	1	0	1	0	(1)	0	4
Export Price Shock	5	6	1	2	0	0	0	0	0	0
Oil Price Shock	2	2	1	1	0	0	0	0	0	0
Exchange Rate Shock	12	12	0	1	9	6	4	3	1	1
No Domestic Reforms	0	(1)	2	5	10	28	(5)	(14)	20	42

GDP = gross domestic product.

Note: Values for scenarios other than the baseline are in deviations from the baseline.

Source: Authors' calculations.

55. In contrast to the limited effect of switching to only nonconcessional borrowing, the external shocks did have a significant impact on the country's debt sustainability. The temporary oil and export price shocks increased both the foreign debt burden and debt service indicators. The oil price shock raised the foreign debt-to-GDP ratio 2 percentage points over the baseline trend while export price shocks raised the ratio by 5–6 percentage points over the baseline. However, the overall debt dynamics remain sustainable as the debt-to-export ratio still falls to 82% with the oil price shock and 83% with the export price shock by the end of the simulation period. As discussed in the previous section, this is well below the critical value under the HIPC Initiative. Both shocks had an adverse effect on the liquidity management ratios, but foreign debt service was still less than 8% of export earnings under either scenario. The price shocks did not affect government debt or debt service. However, this would change if the Government

provided relief to affected export industries or if the Government absorbed the oil price increase through a subsidy.

56. The impact of a sharp depreciation in the real exchange rate on debt sustainability was much more pronounced. Foreign debt-to-GDP ratios were 12 percentage points over the baseline trend. While this appears large, the foreign debt-to-exports ratio does not exceed 150% in any period. Government debt ratios showed some convergence with the baseline, after an initial jump, but the government debt-to-GDP ratio was still about 6 percentage points higher than the baseline by the end period. In contrast, the effect on debt service was minimal, raising the liquidity management ratios by only 1 percentage point over the baseline for both foreign and government debts. This scenario assumes the rupee depreciation is the same against all foreign currencies. As such, the scenario also shows the direction of the effects of unfavorable cross-currency movements arising from a mismatch of the currency of the country's foreign debt compared with its foreign exchange earnings. However, the effect of a sharp depreciation of the rupee with respect to only some currencies would be smaller in magnitude than what is shown in the simulation.

57. We should note that the "exchange rate shock" scenario exaggerates the effect of a sharp depreciation of the exchange rate on the debt ratios for two reasons. First, the quantities of exports and imports were not allowed to adjust to the price changes. Over time, the quantity of goods and services exported should increase and the quantity imported should decrease in response to the real depreciation, narrowing the funding gap over time. Second, there is no pass-through from the exchange rate movement into local prices. Higher rates of inflation would increase the value of nominal GDP, for a given growth path of real output. Relaxing either of these assumptions would improve the debt indicators so the results should be seen as an upper limit.

58. While other sensitivity tests showed the shocks to be manageable, maintaining the status quo in domestic policies is clearly unsustainable. With high fiscal deficits and low growth, government debt expands to 112% of GDP. This scenario continues the current trend of declining foreign debt that is more than compensated by the accumulation of domestic debt. Although the foreign debt burden is not much different than the baseline, the slow export growth rates create problems for debt service. But in terms of liquidity, it is the government debt that is the more critical problem. With stagnant revenue performance and lower proportion of concessional foreign borrowing, the Government continues to use roughly 85% of its current revenues for debt service.

59. The IMF prepared a debt sustainability analysis for the country assessment supporting the recently approved Poverty Reduction and Growth Facility and Extended Fund Facility.¹⁸ In the IMF's baseline scenario, key macroeconomic variables are in line with CBSL's projections. As a result, the debt burden declines to a much higher degree than in the baseline scenario developed in this study. By 2006 in the IMF baseline, government debt is less than 85% of GDP—which meets criterion under the Fiscal Management (Responsibility) Act—and foreign debt falls to less than 56% of GDP. The IMF study covered a wide range of stress tests, most of which caused deviations from the baseline that maintained the underlying direction of the ratios. The one exception is IMF's modeling of a "pre-standby arrangement policies" scenario, which is similar in spirit to the "no domestic reform" scenario in this study, where government debt rises

¹⁸ IMF. 2003. *Request for a Three-year Arrangement under the Poverty Reduction and Growth Facility, and Use of Fund Resources—Request for an Extended Arrangement*. Washington, DC.

to 114% of GDP by 2007. Overall, the results of the current study, including the sensitivity analysis, are in line with the IMF's debt sustainability analysis.

IV. CONCLUSIONS AND RECOMMENDATIONS

60. The simulation results indicate Sri Lanka's debt situation is sustainable over the medium term, provided the environment for higher growth is established and control of the fiscal deficit is achieved. Under the baseline scenario, the Government requires an average \$1.1 billion annually in new foreign loan commitments during 2003–2006, which includes \$280 million per year in official nonconcessional loans, to support the public investment program. However, an increase in the share of nonconcessional loans does not adversely affect debt sustainability as long as fiscal discipline is maintained. Temporary shocks to prices of key import and export commodities have an adverse effect on the debt situation, but the dynamics remain sustainable. Large exchange rate movements, on the other hand, have a more pronounced effect that could lead to an unsustainable level of debt, if not managed properly. However, a consistent commitment to the Government's reform agenda and fiscal discipline are needed to bring the public debt situation back under control.

61. ADB can prudently commit \$150–200 million in new OCR loans on average per year during the implementation period of the new CSP. The higher end of this range would be considered if concessional financing is not forthcoming, since ADB's OCR terms are softer than alternative financing from commercial loans or even many export credits. To mitigate the impact of this transition to higher levels of nonconcessional borrowing, ADB should maximize the grant element of its OCR assistance to Sri Lanka through longer grace periods and maturities. For example, the grant element of an OCR loan with a 24-year maturity increases on average by nearly 1 percentage point, at current interest rates and depending on the currency chosen, when the grace period is increased from 4 to 5 years. Similarly, the grant element of a loan with a 4-year grace period increases by about 1.25 percentage points when the maturity is increased from 24 years to 26.

62. An increase in project financing on harder terms emphasizes the need for better project management and public investment planning. A critical assumption in the analysis is that the period from loan effectiveness to project completion is such that the country begins reaping the benefits of the investment before it begins loan repayments. In addition to the need for better management of ongoing projects, this will require new approaches to the public investment program. In particular, the up-front activities—such as environmental clearances, land acquisition, and resettlement—need to be completed before the investment loan is contracted. ADB can facilitate this process by providing technical assistance loans using ADF resources to prepare a shelf of projects, followed by an OCR investment loan. The Government could also prepare projects for subsequent ADB funding, using its own resources, or with financing from other funding agencies, subject to the preparation meeting ADB's requirements. Moreover, the increased use of nonconcessional funds necessitates improved planning to direct the resources toward high-return investments.

63. The IMF approved a 3-year Poverty Reduction and Growth Facility coupled with an Extended Fund Facility for Sri Lanka on 18 April 2003. Under the program, the Government will limit its use of nonconcessional borrowing to bring the national debt and debt service down to a manageable level. Nonconcessional loans are defined as any loan with a grant element of less than 35%, which includes OCR. However, program loans from ADB and the World Bank's nonconcessional funds (which Sri Lanka does not currently access) have been explicitly excluded from the ceilings. The ceilings also include any new government guarantees on

nonconcessional borrowing by the private sector (for example, under an ADB Political Risk Guarantee for a private sector project). For 2003, the ceiling has been fully committed, but the 2004 and 2005 ceilings will be set during the reviews of the programs. As such, the use of OCR for project loans needs to be raised with the Government early in the processing cycle to ensure that they are included in the negotiated ceilings for nonconcessional borrowing.

64. The higher levels of OCR lending are contingent on continued progress on the peace front and the economic reform agenda. These two complementary elements are necessary if the Government is to achieve and sustain the higher rates of growth it is projecting. On the one hand, the cessation of hostilities is needed for rehabilitation work in the conflict-affected areas to begin, but it is also needed to foster investor confidence in the island as a whole. Under the cease-fire agreement, economic activity in the country has begun to pick up, but large private-sector investments have not yet been forthcoming, with outside investors mainly directing their funds to portfolio investments rather than foreign direct investment. Maintaining peace is also necessary to keep government spending under control.

65. With regard to the economic reform agenda, the private sector has highlighted numerous long-standing impediments to higher rates of investment, particularly in the labor and finance markets. To further reduce the fiscal deficit—while at the same time the Government is planning a marked increase in its investment program—public sector reforms are needed in various areas. Key priorities include streamlining the civil service, better planning and management of expenditures, and raising the effectiveness of revenue collections. During the annual country programming exercise, ADB will review the prevailing economic and political situation and make adjustments to OCR lending levels as necessary to ensure that the debt burden does not become unmanageable. The model will be updated as part of the CSPU mission, in coordination with the National Planning Department, to monitor any changes in the country's borrowing capacity as new macroeconomic data become available.

KEY ECONOMIC INDICATORS

Item	1997	1998	1999	2000	2001	2002 ^a
Income and Growth						
GNI per Capita (current prices, \$)	840	870	850	870	830	860
Growth in Real GDP at Factor Cost (% change)	6.3	4.7	4.3	6.0	(1.5)	4.0
Agriculture	3.0	2.5	4.5	1.8	(3.4)	2.5
Industry	7.7	5.9	4.8	7.5	(2.1)	1.0
Services	7.1	5.1	4.0	7.0	(0.5)	6.0
Saving and Investment (% of GDP)						
Gross National Saving	21.5	23.4	23.5	21.5	20.3	19.7
Gross Domestic Investment	24.4	25.1	27.3	28.0	22.0	21.3
Gross Fixed Capital Formation	24.4	25.1	27.3	28.0	22.0	21.0
Central Government Finance (% of GDP)						
Total Revenue (including grants)	19.4	17.9	18.3	17.2	17.0	17.0
Tax Revenues	16.0	14.5	15.0	14.5	14.6	14.0
Other Revenues and Grants	3.4	3.4	3.3	2.7	2.4	3.0
Total Expenditure (including net lending)	23.9	25.9	25.2	26.7	26.9	25.0
Current Expenditures	20.8	19.6	18.7	20.2	21.6	20.8
Capital Expenditures and Net Lending	3.1	6.3	6.5	6.5	5.3	4.2
Overall Fiscal Surplus (+)/Deficit (-)	(4.5)	(8.0)	(6.9)	(9.5)	(9.8)	(8.1)
Foreign Borrowing	1.1	1.0	0.1	0.0	1.0	0.1
Domestic Borrowing	3.4	7.0	6.8	9.4	8.8	8.0
Fiscal Surplus less Grants and Privatization Proceeds	(7.9)	(9.2)	(7.5)	(9.9)	(10.8)	(8.9)
Money and Inflation (% change)						
Narrow Money (M1)	9.8	12.1	12.8	9.1	3.2	14.0
Broad Money (M2)	15.6	13.2	13.4	12.9	13.6	13.4
Consumer Price Index	7.1	6.9	4.0	1.5	12.1	10.2
GDP Deflator	8.6	8.4	4.4	6.7	12.4	8.3
Balance of Payments						
Merchandise Trade Balance (% of GDP)	(8.1)	(6.9)	(8.7)	(11.0)	(7.4)	(8.5)
Exports (% of GDP)	30.7	30.4	29.4	33.8	30.6	28.4
Imports (% of GDP)	38.9	37.3	38.2	44.8	37.9	36.9
Current Account Balance (% of GDP)	(2.6)	(1.4)	(3.6)	(6.5)	(1.6)	(1.6)
Export Growth (\$, % change)	13.3	3.4	(3.9)	19.8	(12.8)	(2.4)
Import Growth (\$, % change)	7.8	0.4	1.5	22.4	(18.4)	2.2
External Payments Indicators						
Gross Official Reserves (\$ million)	2,028	1,981	1,636	1,044	1,338	1,700
(in months of imports of G&S)	3.5	3.4	2.7	1.4	2.1	2.7
External Debt (% of GDP)	56.4	58.0	59.2	57.4	56.6	56.7
External Debt Service (% of exports of G&S)	12.6	12.8	14.6	14.6	12.9	12.9
Memorandum Items						
GDP (current prices, SLRs billion)	890	1,018	1,106	1,258	1,407	1,585
Average Exchange Rate (SLRs per \$)	59.0	64.5	70.6	77.0	89.4	95.7
Midyear Population (million) ^b	17.7	17.9	18.2	18.5	18.7	19.0

GDP = gross domestic product, GNI = gross national income, G&S = goods and services (factor and nonfactor services).

^a Preliminary figures.

^b Provisional estimates based on the Census of Population and Housing 2001.

Sources: Central Bank of Sri Lanka (various issues) *Economic and Social Statistics of Sri Lanka* and (various issues) *Annual Report*.

NATIONAL DEBT AND DEBT SERVICE

Item	1997	1998	1999	2000	2001	2002 ^a
	(SLRs million)					
FOREIGN DEBT						
Foreign Debt Stock	502,366	590,364	654,514	722,080	795,918	898,718
Government	388,925	467,798	513,785	559,544	634,255	719,902
Medium and Long Term	388,925	467,798	513,785	559,544	634,255	719,902
Short Term	0	0	0	0	0	0
Government Guaranteed Debt ^b	70,384	81,506	102,345	128,336	118,997	124,718
Medium and Long Term	41,061	48,673	68,105	82,302	69,349	66,618
Short Term	29,323	32,833	34,240	46,034	49,648	58,100
Use of IMF Credit	26,536	22,271	17,766	11,943	19,463	27,787
Nonguaranteed Debt	16,521	18,789	20,618	22,257	23,203	26,311
Foreign Debt Service	42,645	48,773	59,322	74,554	72,612	74,663
Foreign Principal Repayments	24,764	30,076	38,472	49,410	49,910	54,200
Government	13,251	18,351	21,440	23,282	27,921	37,057
IMF Repurchases	3,290	5,100	6,813	9,700	6,966	4,647
Other Debt ^b	8,223	6,625	10,219	16,428	15,023	12,496
Foreign Interest Payments	17,881	18,697	20,850	25,144	22,702	20,463
Government	6,692	7,300	8,752	9,015	9,747	10,617
IMF Charges	361	443	376	410	348	398
Other Debt ^b	10,828	10,954	11,722	15,719	12,607	9,448
DOMESTIC PUBLIC DEBT						
Domestic Debt Stock	387,740	463,426	543,464	676,660	815,965	948,386
Nonbank Debt	287,204	350,372	403,793	477,630	559,157	700,143
Bank Debt	100,536	113,054	139,671	199,030	256,808	248,243
Domestic Debt Service	63,786	89,215	73,693	143,429	141,404	236,683
Domestic Principal Repayments	15,232	41,617	20,322	81,244	56,844	130,786
Interest on Public Domestic Debt	48,554	47,598	53,371	62,185	84,560	105,897
	(% of GDP at market prices)					
DEBT STOCK						
Foreign Debt Stock	56.4	58.0	59.2	57.4	56.6	56.7
Government Foreign Debt	43.7	46.0	46.5	44.5	45.1	45.4
Gov't Guaranteed Debt & IMF Credit	10.9	10.2	10.9	11.2	9.8	9.6
Nonguaranteed Debt	1.9	1.8	1.9	1.8	1.6	1.7
Government Domestic Debt	43.6	45.5	49.1	53.8	58.0	59.8
Total Government Debt	87.2	91.5	95.6	98.3	103.0	105.3
DEBT SERVICE						
Foreign Debt Service	4.8	4.8	5.4	5.9	5.2	4.7
Government Foreign Debt	2.2	2.5	2.7	2.6	2.7	3.0
IMF Credit	0.4	0.5	0.7	0.8	0.5	0.3
Other Debt ^b	2.1	1.7	2.0	2.6	2.0	1.4
Government Domestic Debt Service	7.2	8.8	6.7	11.4	10.0	14.9
Total Government Debt Service	7.2	8.8	6.7	11.4	10.0	14.9

GDP = gross domestic product, G&S = goods and services (factor and nonfactor services), IMF = International Monetary Fund.

^a Preliminary figures.

^b Debt of public corporations and private sector entities with and without government guarantee. Figures calculated as a residual.

Sources: Central Bank of Sri Lanka (various issues) *Economic and Social Statistics of Sri Lanka* and (various issues) *Annual Report*.

LENDING TERMS OF MAJOR MULTILATERAL AND BILATERAL SOURCES

Funding Source/Loan Type	Currency	Repayment Terms (Years)		Interest Rate	Other Charges/Conditions	Grant Element ^a
		Maturity	Grace			
MULTILATERAL AGENCIES						
1. Asian Development Bank						
a. Asian Development Fund (ADF) ^b						
- Program Loan	SDR	24	8	Grace Period: 1% Repayment: 1.5%	None	55%
- Project Loan	SDR	32	8	Grace Period: 1% Repayment: 1.5%	None	60%
b. Ordinary Capital Resources (OCR) ^c						
- Program Loan	\$,€,¥	15	3	LIBOR-based rate Floating: 6-month rate Fixed: 3-, 5-, 7-, and 10- year fixed swap rates Spread: 0.60%	0.5% front-end fee; 0.75% commitment fee on the undisbursed balance during grace period	15–18%
- Project Loan	\$,€,¥	20-30	3-7	LIBOR-based rate Floating: 6-month rate Fixed: 3-, 5-, 7-, and 10- year fixed swap rates Spread: 0.60%	0.5% front-end fee; 0.75% commitment fee on the undisbursed balance during grace period	18–35%

LIBOR = London interbank offer rate, SDR = strategic drawing right.

^a Approximate grant elements are calculated for illustration only and are based on first quarter 2003 interest rates. For simplicity, the calculation assumes full disbursement of the principal on commitment, equal principal repayments, and a constant interest rate, which is in line with the International Monetary Fund's calculation of grant elements for monitoring Poverty Reduction and Growth Facility performance benchmarks. Actual grant element will depend on the specific loan agreement and interest rates prevailing at the time of contracting. Where no set loan terms are given for a loan type, a range of grant elements is calculated based on combinations of lending terms usually applied for these sources.

^b The SDR is the currency of record, but disbursements are made in the currencies available in the fund at the time of withdrawal. Repayments must be made in the currency of disbursement.

^c The front-end fee on 2003 loans was reduced from 1% to 0.5%. Repayment terms for OCR project loans depend on project- and country-specific conditions. Indicative repayment terms shown in the table are based on recently approved loans bankwide. Grant elements are calculated using 10-year fixed swap rates, as the current low interest rates for floating rate loans would overstate the grant element given the likelihood of rising interest rates over the life of the loan.

Sources: Project documents, information provided directly from lenders, and documentation from lenders' web sites.

LENDING TERMS OF MAJOR MULTILATERAL AND BILATERAL SOURCES (continued)

Funding Source/Loan Type	Currency	Repayment Terms (Years)		Interest Rate	Other Charges/Conditions	Grant Element ^a
		Maturity	Grace			
2. World Bank						
a. International Development Association (IDA) - IDA-only Borrowers	SDR	40	10	Service Charge: 0.75%	0.0–0.5% commitment fee on the undisbursed balance, set 30 June of each year (currently waived for Sri Lanka)	72%
- Blend Borrowers	SDR	35	10	Service Charge: 0.75%	0.0–0.5% commitment fee on undisbursed balance, set 30 June of each year	69%
b. International Bank for Reconstruction and Development (IBRD) ^b	\$,€,¥, other	15-25	3-8	Floating rate; 6-month LIBOR rate plus a fixed or variable spread	1% front-end fee; 0.75%–0.85% commitment fee on undisbursed balance	14–31%
3. International Monetary Fund						
a. Poverty Reduction and Growth Facility (PRGF)	SDR	10	5.5	0.5%	None	37%
b. Extended Fund Facility (EFF)	SDR	10	4.5	Basic Rate: 1.32 × SDR interest rate Surcharge: 1%	0.5% service charge paid up front; 0.25% commitment fee on amount that may be drawn within the year	20%
c. Standby Arrangement	SDR	5	3.25	Basic Rate: 1.32 × SDR interest rate Surcharge: 1%	0.5% service charge paid up front; 0.25% commitment fee on amount that may be drawn within the year	12%

LIBOR = London interbank offer rate, SDR = strategic drawing right.

^a Approximate grant elements are calculated for illustration only and are based on first quarter 2003 interest rates. For simplicity, the calculation assumes full disbursement of the principal on commitment, equal principal repayments, and a constant interest rate, which is in line with the International Monetary Fund's calculation of grant elements for monitoring Poverty Reduction and Growth Facility performance benchmarks. Actual grant element will depend on the specific loan agreement and interest rates prevailing at the time of contracting. Where no set loan terms are given for a loan type, a range of grant elements is calculated based on combinations of lending terms usually applied for these sources.

^b Sri Lanka does not currently have access to IBRD funds, but terms have been included for comparison. Loans can be made in any currency that IBRD can efficiently intermediate. Repayment terms for IBRD loans depend on project- and country-specific conditions. Indicative repayment terms shown in the table are based on the range of usual country terms and the maximum set by policy limits. Similar ADB's ordinary capital resource loans, the grant elements are calculated using 10-year fixed swap rates, as the current low interest rates would overstate the grant element for a floating-rate loan given the likelihood of rising interest rates over the life of the loan.

LENDING TERMS OF MAJOR MULTILATERAL AND BILATERAL SOURCES *(continued)*

Funding Source/Loan Type	Currency	Repayment Terms (Years)		Interest Rate	Other Charges/Conditions	Grant Element ^a
		Maturity	Grace			
4. OPEC Fund	\$	20	10	Interest: 2% Service charge for loan administration: 1%	None	41%
5. Nordic Development Fund	\$	40	10	Service Charge: 0.75%	0.5% commitment fee on undisbursed balance; procurement tied	74%
6. International Fund for Agriculture Development (IFAD)	\$	40	10	Service Charge: 0.75%	None	74%
BILATERAL AGENCIES						
7. Government of Japan^b						
a. General Terms						
- Standard	¥	30	10	1.50%	None	33%
- Option	¥	20	6	0.90%	None	30%
b. Preferential Terms						
- Standard	¥	40	10	0.75%	None	49%
- Option	¥	20	6	0.75%	None	31%
c) Special Terms	¥	40	12	0.75%	Procurement tied	50%
8. Government of Germany						
Kreditanstalt für Wiederaufbau (KfW)	€	40	10	Service Charge: 0.75%	None	72%

OPEC = Organization of Petroleum Exporting Countries.

^a Approximate grant elements are calculated for illustration only and are based on first quarter 2003 interest rates. For simplicity, the calculation assumes full disbursement of the principal on commitment, equal principal repayments, and a constant interest rate, which is in line with the International Monetary Fund's calculation of grant elements for monitoring Poverty Reduction and Growth Facility performance benchmarks. Actual grant element will depend on the specific loan agreement and interest rates prevailing at the time of contracting. Where no set loan terms are given for a loan type, a range of grant elements is calculated based on combinations of lending terms usually applied for these sources.

^b Terms and conditions effective from 1 April 2003.

INTERNATIONAL COMPARISON OF BORROWING CAPACITY INDICATORS

Item	Year	Sri Lanka ^b	Other South Asian Countries						Other ADF-OCR Blend Borrowers ^a	
			Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Indonesia	Viet Nam
Country Indicators										
Population (million)	2001	19	132	0.7	1,018	0.3	23	140	214	79
GNI per capita (\$)	2001	870	350	780	470	1,990	250	410	650	410
Exports of G&S (% of GNI)	2001	45	20	35	17	86	32	20	47	55
Debt Burden Indicators (%)										
Debt Stock:										
Foreign Debt/GNI	1990	75	41	29	27	40	44	53	64	384
	2001	52	33	48	21	43	47	55	97	38
Foreign Debt/Exports of G&S	1990	210	455	88	331	42	313	250	234	—
	2001	115	165	139	123	50	148	279	206	69
NPV Foreign Debt/GNI	1999–									
	2001	43	21	49	15	32	28	43	96	36
NPV Foreign Debt/	1999–									
Exports of G&S	2001	95	113	151	91	38	92	238	198	66
Debt Structure:										
Short-term Debt/Total Debt	1990	7	1	4	10	18	2	15	16	8
	2001	5	2	0	3	23	2	4	16	6
Concessional Debt/Total Debt	1990	72	91	74	46	71	89	59	26	85
	2001	75	94	52	38	60	98	62	21	67
Liquidity Monitoring Indicators (%)										
Foreign Debt Service/GNI	1990	5	2	2	3	5	2	5	9	3
	2001	4	1	1	2	4	2	5	11	4
Foreign Debt Service/										
Exports of G&S	1990	14	27	5	32	5	13	23	33	—
	2001	10	7	3	12	5	5	26	24	7

— = data not available, ADF = Asian Development Fund, GNI = gross national income, G&S = goods and services (factor and nonfactor services), NPV = net present value, OCR = ordinary capital resources.

^a Bangladesh, Pakistan, and some Pacific island economies also have access to both Asian Development Fund and ordinary capital resources.

^b The World Bank data for Sri Lanka are not fully consistent with the Central Bank of Sri Lanka debt data. While some figures may differ from those presented elsewhere in the paper, the World Bank data are used in this table to be comparable across countries.

Source: ADB, *Key Indicators 2002* and World Bank, *Global Development Finance 2003*.