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VERITÉ RESEARCH
Strategic Analysis for Asia

Verité Research provides strategic analysis and advice to governments and the private sector in Asia.

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3.38
PERCENT
Latest risk premium on 5 year GoSL bonds

4.34
PERCENT
Latest risk premium on 10 year GoSL bonds

8.26
PERCENT
Latest risk premium on 5 year GoSL connected corporate bonds

Image courtesy: TIME

Sri Lanka's international borrowing costs are not declining

The government first raised international debt through bonds in October 2007. Since then several international bonds have been issued to feed the government's twin demands: financing its spending and propping up foreign reserves. While this trend of foreign borrowing is on the rise, what is happening to the cost of borrowing? And what is the prognosis for the future?

The government and media have created the perception that Sri Lanka's borrowing costs have declined. For instance after issuing a 10 year bond for one billion in July 2012 at the rate of 5.875%, the Central Bank press release had this to say:

> With this transaction Sri Lanka succeeded in achieving a cost of funds which is progressively lower compared to the previous issuances. Sri Lanka's previous four issuances... [since 2007]... were priced at yields of 8.25%, 7.40%, 6.25% and 6.25% respectively (17 July, 2012).

THE REAL ECONOMIC POSITION

This *insight* explains that Sri Lanka's country-cost of borrowing is turning upwards, even though the total interest rates paid for borrowing has been trending downwards. This seeming contradiction requires explanation.

There are two sets of factors that can reduce the total interest rate paid for international borrowing: (1) Global-factors, that is the increased supply of money relative to demand in international financial markets, (2) Country-factors, that is greater confidence in lending to Sri Lanka.

Therefore, the total interest rate paid is made up of the addition of two parts (1) the global-rate, determined by global factors and (2) the country-cost – the premium that Sri Lanka pays for being considered a risky borrower – which is determined by confidence in the country.

What has been happening is that the global-rate has been trending down, even while Sri Lanka's country-cost is pointing upwards. That means that the boast of borrowing at a lower rate is unwarranted.

THE ACHIEVEMENT: SHORT-TERM COUNTRY COSTS ARE DOWN FROM 2009

Economists have standard measures for the global-rate and the country-cost. The first is called the "risk-free rate". The second is called the country "risk premium" – the rate that a country has to pay in addition to the risk free rate to attract lending. The standard measure of the risk-free rate (global-rate), say for a five year bond, is the United States treasury yield rate of the same duration.

Exhibit 1 shows in different colours the country-cost (risk premium) of Sri Lanka for 5 year and 10 year bonds issued by the government. On the five year bonds the country-cost rose dramatically soon after the war ended – up from 3.88 percent in 2007 to 5.14 percent in 2009.

The achievement, however, is that since 2009, it has come down significantly. The latest risk premium that Sri Lanka paid on a 5 year bond (in April 2014) was 3.385 percent, which is a reduction of 129 basis points (1.29 percent) (see also Exhibit 3).

CAVEATS: MULTIPLE HIGHER RATES AND NO POST-WAR REDUCTION

The above stated achievement must be evaluated together with two caveats.

1) Multiple higher rates: The government induced borrowing through proxies (state owned institutions and government controlled third parties) have not been showing this trend – their rates have fluctuated: falling, rising and falling again (Exhibit 2).

2) No post-war reduction: The country risk assesed for Sri Lankan bonds in 2014 is in the same ball park (plus or minus 50 basis points – see Exhibit 3) as the country risk assesed for the 5 year bonds in 2007, during a period of significant instability and conflict. Therefore the assessment of country risk premium does not yet show the expected post-war reduction.

THE PROBLEM: LONG TERM COUNTRY COST IS POINTING UPWARDS

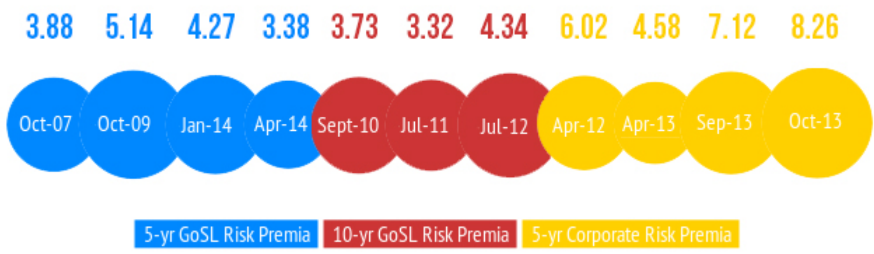
Exhibit 1 and Exhibit 3 show that on 10 year bonds the country-cost declined a little bit between 2010 and 2011, but increased sharply in 2012.

Notice that the surge was in July 2012 precisely when the Central Bank, in its press release, boasted of having achieved the lowest borrowing cost to date. The Central Bank was quoting the total interest rate, which had reduced to 587 basis points from the 6.250 percent paid in 2011. However, the reduction was driven by the global-rate (international risk free rate) falling 294 basis points. It came down to 1.53 percent. At the same time Sri Lanka's cost (country risk-premium) had in fact risen by 102 basis points from 3.322 percent to 4.345 percent, it had not gone down.

INTERPRETING THE LONG TERM VS SHORT TERM RATES

The difference between the changes in mid/long term (10 year) country-cost and the changes in short/mid term (5 year) country-cost signals how global lenders are viewing the future of Sri

Exhibit 1: The Evolution of Sri Lanka's Risk Premia



Source: Central Bank of Sri Lanka, Verité Research data and calculations
DFCC: Development Finance Corporation of Ceylon, NSB: National Savings bank, BoC: Bank of Ceylon (the government through Bank of Ceylon, Insurance Corporation and the EPF controls over one third of the shares of DFCC, and is the largest stakeholder)

Exhibit 2: Bonds issued by institutions controlled by government

Amount	Bond Issue Date	Entity	Tenor	Yield	UST Yields 1 week prior	Risk Premium
500 mn	27 Apr 12	BoC	5 Yr	6.875%	0.85%	6.025%
500 mn	08 Apr 13	BoC	5 Yr	5.325%	0.74%	4.585%
750 mn	12 Sep 13	NSB	5 Yr	8.875%	1.75%	7.125%
100 mn	24 Oct 13	DFCC	5 Yr	9.625%	1.36%	8.265%

Source: cbonds.com

Exhibit 3: Bonds issued by the Sri Lankan government

Year	Amount	GOSL bond issue date	Tenor	Yield (Total interest paid)	UST yields 1 week prior	Sri Lanka country risk premium
5 Year Bonds						
2007	500 mn	17-Oct-07	5-Yr	8.250% .	4.37% .	3.880% .
2009	500 mn	15-Oct-09	5-Yr	7.400% ↓	2.26% ↓	5.140% ↑
2014	1 bn	6-Jan-14	5-Yr	6.000% ↓	1.73% ↓	4.270% ↓
2014	500 mn	7-Apr-14	5-Yr	5.125% ↓	1.74% ↑	3.385% ↓
10 Year Bonds						
2010	1 bn	27-Sept-10	10-Yr	6.250% .	2.66% .	3.731% .
2011	1 bn	21-Jul-11	10-Yr	6.250% .	2.94% ↑	3.322% ↓
2012	1 bn	17-Jul-12	10-Yr	5.875% ↓	1.53% ↓	4.345% ↑

Source: Central Bank of Sri Lanka and the Federal Reserve Board

Lanka. If the long term outlook is more optimistic despite short term concerns, then the 10 year country-cost would be increasing at a slower rate than the 5 year country-cost. But the increase in mid/long term rates while shorter term rates decreased fits the interpretation that Sri Lanka is seen as capable of meeting short term commitments with a short term strategy – but setting itself up for difficulty in the longer term.

Global financial markets tend to be hard-nosed. They don't care much for human rights or for democracy per se but only for the resulting consequences. They are simply concerned for maximising returns, subject to risk. So the pessimistic estimation they are making of Sri Lanka's future is based simply on estimates of Sri Lanka's future economic stability and strength to pay back its loans.

OVER-SUBSCRIPTION ON BONDS: IT DOESN'T MEAN HIGHER CONFIDENCE

The Sri Lankan media often reports the over-subscription on a bond issue as a sign of investor confidence. But this is a mistake.

Over-subscription means there is more money offered as lending than there is interest in borrowing. This can occur simply because investors are looking to make a killing: offering to lend at very high rates of interest, sensing the country will be desparate enough to accept. The central bank, however, would take the cheapest offers it receives, which would be a fraction of the high priced offers.

For instance, on the 1 billion 10 year bond issue in 2012 (where the country cost went up) the Central Bank reported that 'the final order books stood at US$ 10.5 billion, an oversubscription ratio of 10.5 times'. That means, despite being oversubscribed 10.5 times, the cheapest offers available to clear the 1 billion mark was still at a high rate – a rate that increased the country-cost by 102 basis points from a year earlier.

The highest rate of oversubscription that Sri Lanka had seen is 13 times what was on offer. This was in October 2009, when international markets could have expected Sri Lanka to be desparate for borrowing (even at high cost) towards post war reconstruction. In short, because the statistic can reflect estimates of desperation as well as estimates of confidence, it is meaningless as a means of singularly assessing either.

Attempting to lock-in mid/long term international borrowing, while rates were relatively low, was a sensible move, despite the rumblings of critics. But inability to generate interna-tional confidence and reduce country-cost has diminished that potential benefit.

INTERNATIONAL COMPARISON CONFIRMS CONSENT

On international comparison this analysis is also corroborated. Standard and Poor's, Moody's, and Fitch's ratings of Sri Lanka's creditworthiness are B+, B1, and BB-, respectively. Countries of comparable credit ratings include Mongolia, Zambia, Kenya, and Gabon. Risk premia on recent issuances of 5 year bonds by these countries indicate that the Sri Lankan country-cost is roughly comparable (see Exhibit 4).

The tendency for oversubscription is similar as well. Sri Lanka has seen oversubscription ranging from 3.2 to 13 times since 2009. Comparable countries show a range between 1.2 to 15.8 times since 2012.

THE PROGNOSIS FOR FUTURE BORROWING

The global-rate of borrowing (international risk-free rate) is driven by global economic and political forces that are beyond the control of Sri Lanka. A combination of very special circumstances have caused them to be very low in the last five years. But they are tipped to gradually increase over time.

What Sri Lanka can influence is the country-cost (risk premium of Sri Lanka). This initially trended downwards after the war but is now signaling upwards in the long term. Even the short term rate remains high and without a serious post-war improvement when compared to the rate paid in 2007.

Attempting to lock-in mid/long term international borrowing, while the rates were relatively low, was a sensible move by the government despite the rumblings of its critics. But inability to generate international confidence in Sri Lanka, and reduce the country-cost, has diminished that potential benefit.

The full economic costs of borrowing from bilateral donors, such as China, have been approximately on par with, or higher than, the cost in international financial markets. International markets are now signalling that they consider Sri Lanka in its current trajectory to be more risky in the long term, and global risk-free rates are also tipped to go up. The sun is settting on Sri Lanka's run of relatively cheap borrowing in international markets.

Exhibit 4: Country cost and over-subscription for similar credit ratings to Sri Lanka

	Amount	Bond issue date	Tenor	Effective yield	UST yields 1 week prior	Risk premium	Over subscription
Zambia BB-/Baa3	750mn	13 Sep 12	10 Yr	5.625%	1.67%	3.955 %	x 15.8
Mongolia B+ /BB-	1bn	28 Nov 12	10 Yr	5.125%	1.65%	3.475 %	x 10
Gabon B+ /BB-	1.5bn	5 Dec 13	10 Yr	6.375%	2.79%	3.585 %	x 1.2
Kenya B+ /B1	500mn	16 Jun 14	5 Yr	6.000%	1.68%	4.320 %	x 5
Mongolia B+ /B2	500mn	29 Nov 12	5 Yr	4.125%	0.67%	3.455 %	x 10

Source: Cbonds.com, the Federal Reserve