Fitch Ratings: Sri Lanka's Political Standoff Lifts Refinancing Risk

Fitch Ratings-Hong Kong/Singapore-30 October 2018: The Sri Lankan president's sudden replacement of the prime minister on 26 October highlights tensions within the coalition government and creates uncertainty over further progress on reform and fiscal consolidation, says Fitch Ratings. Prolonged political upheaval accompanied by deterioration of policy continuity could undermine investor confidence and make it more challenging for the government to meet its large external financing needs in 2019-2022.

The outcome of the power struggle and possible implications for the sovereign rating (B+/Stable) remain uncertain. Ranil Wickramasinghe, who was sacked as prime minister, has called for a parliamentary vote to demonstrate his support, while members of his party have said they will consider impeachment proceedings against President Maithripala Sirisena on grounds that he exceeded his constitutional authority in replacing the prime minister. The president has responded by suspending parliament until 16 November and, in the meantime, appears set to name a new cabinet. The ultimate shape of the government and its policy stance may not crystallise until parliament resumes.

We last affirmed Sri Lanka's sovereign rating in February 2018. At the time, we noted that potential negative rating sensitivities included deterioration of policy coherence and credibility, a derailment of the IMF support programme or a reversal of fiscal improvements leading to a failure to stabilise government debt ratios.

The IMF-led programme might help to anchor policy if there is a change in leadership, while the benefits of some recent structural reforms are likely to persist. For example, a VAT hike has pushed up the revenue-to-GDP ratio and narrowed the fiscal deficit, while the Inland Revenue Act, implemented from April 2018, is likely to increase revenue further. Moreover, there is no indication that the central bank's autonomy will be undermined by the political upheaval. The central bank has been key to improved economic management under the IMF programme, with greater currency flexibility supporting foreign-currency reserves.

However, the newly appointed Prime Minister Mahinda Rajapaksa, who served as president from 2005-2015, oversaw an aggressive Chinese-financed infrastructure drive and sharp increase in public debt during his second term from 2010-2015. His return to prominence could pose risks to fiscal consolidation, although he has yet to state his policy priorities. Wickramasinghe, if he hangs on, might also be tempted to adopt a more populist fiscal stance, given the political pressure he has faced since the ruling coalition suffered heavy losses in local government elections in February. Sri Lanka's public debt-to-GDP ratio is already 77.6%, which is well above the 62.9% median for sovereigns rated 'B' or lower.

The next test of the government's commitment to the targets set out under its IMF programme will be the 2019 budget, which is due to be delivered on 5 November. A delay to the budget or slippage on targets could further undermine near-term investor sentiment, and might also jeopardise compliance with IMF targets under the IMF-supported programme, which is in any case due to expire in mid-2019. The government is also behind schedule on introducing automatic electricity pricing - a structural benchmark under the IMF programme - which could see continued delays under the political upheaval.

Policy decisions that derail the IMF programme or lead to a loss of investor confidence could increase external financing challenges. The external debt stock is equivalent to around 60% of GDP, and almost 30% of this (around USD15 billion) matures in 2019-2022. Moreover, almost half of public debt is denominated in foreign currency, which may create pressure if the rupee continues to weaken; it has lost 12% against the US dollar this year.

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