FitchRatings

Fitch Downgrades Sri Lanka to 'B'; Outlook Stable

Fitch Ratings-Hong Kong-03 December 2018: Fitch Ratings has downgraded Sri Lanka's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'B' from 'B+', with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

The downgrade reflects heightened external refinancing risks, an uncertain policy outlook, and the risk of a slowdown in fiscal consolidation as a result of an ongoing political crisis following the President's sudden replacement of the Prime Minister on 26 October 2018.

Fitch believes the ongoing political upheaval, which has disrupted the normal functioning of parliament, exacerbates the country's external financing risks, already challenged by the tightening of global monetary conditions amid a heavy external debt repayment schedule between 2019 and 2022. Investor confidence has been undermined, as evident from large outflows from the local bond market and a depreciating exchange rate. The sovereign's foreign currency-denominated debt repayments (principal and interest), as of end-September 2018 are about USD20.9 billion between 2019 and 2022, while its foreign-exchange reserves are currently about USD7.5 billion.

The authorities plan to raise funds through a combination of bilateral and commercial borrowing and the exercise of foreign-currency swaps, but there are risks to this strategy that could arise from a prolonged period of political uncertainty accompanied by an adverse shift in investor sentiment. In addition, the benefits from the government obtaining parliamentary approval for an Active Liability Management Bill in October - which raises its borrowing limit and could help smooth upcoming debt maturities - are unlikely to materialise if the political standoff continues.

Fitch expects fiscal slippages as the current political climate is likely to lead to delays in setting policy priorities and to disrupt progress on future reforms. The 2019 budget has already been pushed back, while the IMF programme has been put on hold. The agency now expects the budget deficit for 2019 and 2020 to be closer to 5% of GDP, up from 4.0% of GDP in 2019 - forecast at the time of our previous review. The political strife has also exacerbated a depreciation of the Sri Lankan rupee, which had weakened in 2018 by around 17% against the US dollar up until end-November, contributing to a deterioration in the debt profile - with about half the debt denominated in foreign currency. Fitch has therefore revised up our general government debt-GDP forecast to over 80% by end-2018, from 77.2%. We believe a speedy resolution of the political situation and a return to credible macroeconomic policies could eventually lower fiscal risks.

Sri Lanka's 'B' IDR also reflects the following key rating drivers:

Greater exchange-rate flexibility provides a cushion for external finances against shocks. The shift towards more flexibility since 2H15 has helped restore foreign reserve levels, which had fallen to around USD6 billion in 2016. This is despite a weak external balance sheet, characterised by high net external debt, the sovereign's large net debtor position and weak international liquidity.

Fitch expects the current account deficit to gradually narrow to 3.4% of GDP by 2020, after widening to 3.7% of GDP in 2018. Our forecasts are based on growth remaining subdued and oil prices recovering moderately. Fitch forecasts oil prices averaging USD65/barrel (bbl) in 2019 and USD57.5/bbl in 2020. Downside risks to our forecasts remain, possibly stemming from a shift towards expansionary fiscal and monetary policies or weaker-than-expected export performance.

Monetary policy has been geared towards maintaining macro-stability, under the framework of the IMF programme that began in 2016. The Central Bank hiked its main policy interest rates earlier in December 2018, raising the deposit rate by 75bp and the lending rate by 50bp while reducing the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points, to 6 percent. Inflation has been falling steadily this year after weather disruptions pushed up food prices, lifting inflation to 7.7% in 2017, and the agency expects headline inflation to average less than 3%. The authorities' planned shift towards flexible inflation targeting could enhance monetary policy credibility.

Under Fitch's baseline assumptions, we forecast overall government debt-GDP to decline marginally in 2019 and 2020, but to remain above 80%, which is far higher than the peer median. Previous revenue reforms such as the VAT rate hike in 2015 and a new Inland Revenue Act effective from 1 April 2018 partly support our expectation of continued primary surpluses, and hence declining debt ratios. Nevertheless, there are downside risks to these assumptions, possibly arising from either a reversal of tax reforms and/or a shift towards more populist policies.

Macroeconomic performance is likely to remain comparatively weak. Growth slowed to 3.3% in 2017 following droughts and floods, and Fitch expects a recovery to 3.7% in 2018. We forecast growth in 2019 and 2020 to remain below 4%, given the uncertain political and policy outlook. Supportive factors include a recovery in the agriculture sector and construction activity related to some commercial and real-estate and infrastructure projects. Remittances are likely to remain supportive of domestic demand.

Sri Lanka's basic human development indicators, including education standards, are high compared with the 'B' and 'BB' medians, as indicated by the United Nations Human Development Index Score. Sri Lanka is in the 60th percentile against the historical 'B' median's 40th percentile. Furthermore, the country's per capita income at USD4,043 (Fitch estimates as of end-2018) is higher than its historical 'B' median of USD3,422.

Fitch's outlook for the banking sector remains negative, based on the expectations that operating conditions are likely to remain difficult. In our view, the challenging domestic and external conditions are likely to affect banks' performance through 2019, mainly on asset quality. Credit risks are likely to linger in 2019, as reflected in a rise in rescheduled loans across banks alongside a surge in NPLs in 2018. Capital-raising could continue in 2019 among banks that plan to/need to strengthen capital buffers, but banks could face execution risks in light of the macro instability.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns Sri Lanka a score equivalent to a rating of 'B+' on the Long-Term Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final Long-Term Foreign-Currency IDR by applying its qualitative overlay (QO), relative to rated peers, as follows:

- External Finances: -1 notch to reflect high refinancing needs and greater uncertainty surrounding financing availability in the short term, as well as a relatively low level of FX reserves which leave the external position vulnerable to any adverse shift in investor sentiment.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The main factors that individually, or collectively, could trigger a positive rating action are:

- Improvement in external finances supported by higher non-debt inflows, or a reduction in external sovereign refinancing risks from an improved liability profile
- Improved policy coherence and credibility
- Stronger public finances underpinned by a credible medium-term fiscal strategy

The main factors that, individually or collectively, could trigger negative rating action are:
- Further increases in external funding stresses that threaten the ability to repay external debt
- Continued political uncertainty that contributes to a loss of investor confidence, possibly affecting the macroeconomic outlook
- A deterioration in policy coherence and credibility that leads to an increase in general government debt and deficit levels

KEY ASSUMPTIONS
- Global economic outcomes are consistent with Fitch's latest Global Economic Outlook

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR downgraded to 'B' from 'B+'; Outlook Stable
Long-Term Local-Currency IDR downgraded to 'B' from 'B+'; Outlook Stable
Short-Term Foreign-Currency IDR affirmed at 'B'
Short-Term Local-Currency IDR affirmed at 'B'
Country Ceiling downgraded to 'B', from B+
Issue ratings on long-term senior unsecured foreign-currency bonds downgraded to 'B' from 'B+'
Issue ratings on long-term senior unsecured local-currency bonds downgraded to 'B' from 'B+'
Issue ratings on short-term senior unsecured local-currency bonds affirmed at 'B'

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Additional information is available on www.fitchratings.com
Applicable Criteria
Country Ceilings Criteria (pub. 19 Jul 2018)
Sovereign Rating Criteria (pub. 19 Jul 2018)

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