Fitch Ratings: Sri Lanka Taking Steps to Reduce Fiscal and Economic Risks

Fitch Ratings-Hong Kong-10 March 2019: Sri Lanka's agreement with IMF staff on the fifth review and extension of its programme, together with its recent budget targeting medium-term fiscal consolidation, are steps toward restoring policy certainty after the disruptions caused by political upheaval in 2018, says Fitch Ratings. There remain risks to the government's fiscal projections, which would rise if the approach of presidential election due by end-2019 triggers renewed political tensions.

We downgraded Sri Lanka's sovereign rating to 'B' from "B+" on 3 December to reflect heightened external refinancing risks, an uncertain policy outlook, and the risk of a slowdown in fiscal consolidation following the president's sudden replacement of the prime minister in October, which sparked a political crisis. The subsequent reappointment of the ousted prime minister in mid-December restored calm, but the disruption has led to setbacks in addressing significant economic and fiscal challenges. Submission of the 2019 budget was delayed from its original date of 5 November, for example.

The agreement with IMF staff to extend a three-year Extended Fund Facility that began in 2016, if eventually approved by the Executive Board, would give the Sri Lankan authorities more time to complete the agreed economic reform agenda. The IMF also noted in its press release that fiscal and foreign reserve targets were missed in late 2018. However, Sri Lanka raised USD2.4 billion through a sovereign bond issuance last week, which should help to ease near-term fiscal and external financing constraints.

The budget announced this week sets out plans to get fiscal consolidation back on track. The budget deficit for 2020 is unchanged from before the political crisis, at 3.5% of GDP, despite the deficit reaching 5.3% in 2018, compared with an original target of 4.8%. The target for 2019 is set at 4.4%, an upward revision to the earlier deficit targeted for 2019. Hitting these targets will be challenging as it will require sharper deficit reduction over the next two years than we had expected, and would be more aggressive compared with the government's 2018 budget.

The budget includes measures to boost revenue, such as an increase in excise duty on cars, a new luxury tax on motor vehicles, an increase in the nation building tax for some transactions and higher toll rates. These revenue proposals would generate around 0.9% of GDP based on the figures provided by the government. The benefits of an Inland Revenue Bill that came into effect in April 2018 could also continue to feed through. However, the government's budget estimates incorporate a sharp rise in the revenue-to-GDP to 15.8% in 2019 from 14.1% in 2018, which may not materialise. The government's GDP growth assumptions of 3.5% in 2019 and 4.0% in 2020 are also slightly more upbeat than our own, of around 3.5% in both years.

The government has reinforced its commitment to a medium-term debt management strategy and we still expect the deficit and government debt ratios to continue declining. Nevertheless, fiscal finances will remain a key weakness in Sri Lanka's credit profile. General government debt is around 84% of GDP in 2018, according to provisional numbers provided by authorities, which is well above the 65.4% median for sovereigns rated 'B' or lower. Moreover, nearly half of government debt is in foreign currency, which makes debt projections sensitive to currency movements. The depreciation of the rupee against the US dollar is likely to have held back debt reduction in 2018, for example.

Sri Lanka's external liquidity position also remains weak as the sovereign's foreign currency-denominated debt payments between 2019-2022 amount to USD20.9 billion, compared with foreign-exchange reserves of just USD6.2 billion at end-January.

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