

# NEWS & ANALYSIS

*Credit implications of current events*

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## Sri Lanka's Drought-Related Costs Add to Challenge of Achieving Fiscal Targets

On Saturday, the [Government of Sri Lanka](#) (B1 negative) announced that it will continue to provide compensation to households affected by the country's worst drought in 40 years. The government will provide LKR10,000 (or about \$65.95) per acre of unusable, dried out rice paddies and compensation for other crops for a period of four months. The compensation is in addition to LKR82 million of drought-related spending so far. Although these measures provide affected families with income, they will increase government spending at a time when Sri Lanka's fiscal strength is low. Therefore, Sri Lanka's ambitious 2017 fiscal deficit target will be even more challenging to achieve, a credit negative.

Drought-related government spending will add to the challenge of containing public expenditures as specified under Sri Lanka's current International Monetary Fund (IMF) Extended Fund Facility program. The government projects a 17.0% increase in overall spending this year, after a decline of 0.7% in 2016 and annual average increases of nearly 12.0% from 2010 to 2015. The increase in planned spending this year largely reflects higher growth-enhancing infrastructure outlays, leaving limited room to cut current expenditures.

No official information is available yet on the extent of the damage to crops, but if half the paddy acreage sown in 2015 is unusable, that would equal 1.5 million acres and the fiscal cost of the compensation would be 0.1%-0.2% of GDP, plus costs related to compensation for other crops. According to the Sri Lankan Ministry of Disaster Management and World Food Programme, only 35% of cultivable rice paddy land had been farmed as of the end of November, the lowest level in the last 30 years. Meanwhile, Sri Lanka's major reservoirs were at only 29% of capacity as of the end of December, and hydropower availability was only 30% of total installed capacity.

The drought will weigh on GDP growth because of lower overall agricultural production. We expect the drought to weigh on economic activity in the first half of this year, with the summer monsoon rains providing some relief in the second half. Lower agricultural output will reduce exports, household income and consumption in affected areas, posing downside risks to GDP growth. We currently expect real GDP to increase by 5.0% in 2017, which is materially lower than the government's forecast of 6.0%.

Weaker economic activity will weigh on government revenues. We currently forecast a fiscal deficit at 5.2%, which could be revised upward if the negative credit effect of the drought worsens or is not offset by other fiscal measures (see Exhibit 1). Under the IMF's Extended Fund Facility program, the government targets a deficit of 4.6% of GDP in 2017.

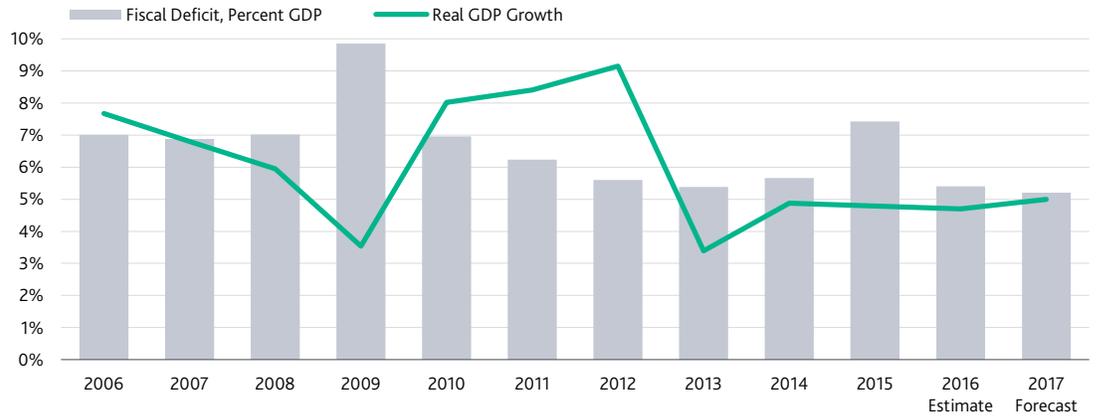
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EXHIBIT 1

## Sri Lanka's Fiscal Deficit and Real GDP Growth

We expect Sri Lanka's fiscal deficit to decline only modestly this year.



Sources: Haver Analytics and Moody's Investors Service estimate and forecast

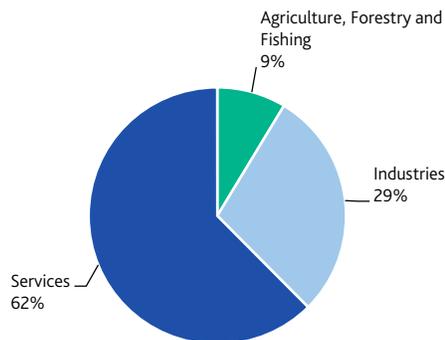
Moreover, lower agricultural exports and higher imports to substitute for the loss in domestic production will weigh on Sri Lanka's current account deficit and foreign-exchange reserve buffers, a key constraint to Sri Lanka's credit quality.

Sri Lanka, like many of its South Asian neighbors, is highly vulnerable to climate change because the magnitude and dispersion of seasonal monsoon rainfall influences agricultural sector growth and rural household consumption. Therefore, droughts can create economic and social costs for the sovereign. For Sri Lanka, the agricultural sector makes up about 9% of GDP and about 28% of the economy's workforce (see Exhibit 2).

EXHIBIT 2

## Sri Lanka's 2015 GDP by Sector (Gross Value Added)

Agriculture contributes nearly 10% of the economy's GDP.



Source: Central Bank of Sri Lanka