

## ISSUER COMMENT

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## Government of Sri Lanka

Political crisis throws up policy uncertainty, could undermine growth, external financing, a credit negative

On 26 October 2018, [Sri Lanka's \(B1 negative\)](#) President Maithripala Sirisena dismissed Ranil Wickremesinghe as prime minister, and appointed former president and opposition leader Mahinda Rajapaksa as his replacement. Sirisena later suspended parliament until 16 November 2018. Wickremesinghe disputes the constitutionality of his dismissal. The unfolding political crisis is credit negative for Sri Lanka because it heightens policy uncertainty, could weigh on growth if social tensions rise, and threatens international investors' confidence and the flow of foreign capital, at a time when the government faces large external debt maturities.

The change of prime minister and cabinet raises uncertainty about the direction of policy. In particular, fiscal consolidation beyond the conclusion of the International Monetary Fund programme in mid-2019 and especially ahead of elections due in 2020 is at risk of delays. Some planned measures, such as electricity price reform, which is already politically contentious, will be even more difficult to implement. If it falls through, this will hurt the financial health of some state-owned enterprises and, as a result, the country's fiscal position.

Amid a fractious political environment, a higher likelihood that the country's fiscal and current account deficits will widen again could reduce investor appetite for Sri Lankan debt and spur capital outflows, weigh on the currency and raise financing costs. With a persistently high debt burden and weak debt affordability – we expect that debt will remain above 70% of GDP by 2020 and that interest payments will continue to absorb about 40% of revenue in the next couple of years – along with sizeable external and foreign currency borrowing needs, lower capital inflows and higher financing costs would hurt Sri Lanka's fiscal strength and credit profile.

Renewed fiscal pressure would heighten Sri Lanka's external vulnerability risks. Foreign exchange reserves fell to \$6.4 billion in September 2018, covering about 3.4 months of imports, down from their peak of \$9.0 billion in April 2018, close to five months of imports. With low reserve coverage of external debt repayments, Sri Lanka has smaller buffers to manage repayments and faces greater refinancing risks in an environment of rising political tensions and tightening financing conditions globally. We project our External Vulnerability Indicator, the ratio of external debt due over the next year to foreign exchange reserves, to stand at 160% at the end of 2019.

Moreover, simmering civil unrest – as reflected in recent protests linked to underlying religious and social tensions – poses a threat to economic stability. Already, GDP growth was

low at 3.7% in the second quarter of 2018, compared to an average of 5.6% in the ten years to 2017.

Trading partners including the [US \(Aaa stable\)](#) and [European Union \(Aaa stable\)](#) have voiced concern, calling on the government to follow the constitutional process for leadership changes.

As the basis for the dismissal, the president cited Article 42, which states that the president appoints as prime minister the member of parliament who, in the president's opinion, has the confidence of parliament. According to Articles 46 and 48, the prime minister's office can end in case of death, resignation, if he or she is no longer a member of parliament, or if the government loses the confidence of parliament.

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## Moody's related publications

### Sector In-Depth

- » [Sovereigns - Frontier markets: Maturing international bonds contribute to exposure to financing risks](#); October 2018
- » [Sovereigns - Global US dollar appreciation raises credit risk for sovereigns with large external funding needs](#); June 2018

### Sector Comment

- » [Sovereigns - Global: Contagion risks greatest where external vulnerability, weak debt affordability meet low policy credibility](#); August 2018

### Credit Analysis

- » [Government of Sri Lanka – B1 Negative: Annual credit analysis](#); August 2018

### Credit Opinion

- » [Government of Sri Lanka – B1 Negative: Update following rating affirmation, outlook unchanged](#), July 2018

### Rating Action

- » [Moody's affirms Sri Lanka's ratings at B1; maintains negative outlook](#); July 2018

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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