



Correction: Fitch Downgrades Sri Lanka's Long-Term Foreign-Currency IDR to 'CC'

Fitch Ratings - Hong Kong - 17 Jan 2022: This is a correction of a release published on 17 December 2021 to correct the ESG Relevance Score for Rule of Law, Institutional and Regulatory Quality and Control of Corruption and the accompanying text.

Fitch Ratings has downgraded Sri Lanka's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'CC', from 'CCC'. Fitch typically does not assign Outlooks or apply modifiers for sovereigns with a rating of 'CCC' or below.

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

KEY RATING DRIVERS

The downgrade reflects our view of an increased probability of a default event in coming months in light of Sri Lanka's worsening external liquidity position, underscored by a drop in foreign-exchange reserves set against high external debt payments and limited financing inflows. The severity of financial stress is illustrated by elevated government-bond yields and downward pressure on the currency.

We have affirmed the Long-Term Local-Currency IDR at 'CCC', as authorities have continued access to domestic financing, despite high and still-rising government debt and an elevated debt service burden.

Sri Lanka's foreign-exchange reserves have declined much faster than we expected at our last review, owing to a combination of a higher import bill and foreign-currency intervention by the Central Bank of Sri Lanka. Foreign exchange reserves have declined by about USD2 billion since August, falling to USD1.6 billion at end-November, equivalent to less than one month of current external payments (CXP). This represents a drop in foreign-currency reserves of about USD 4 billion since end-2020.

We believe it will be difficult for the government to meet its external debt obligations in 2022 and 2023 in the absence of new external financing sources. Obligations include two international sovereign bonds of USD500 million due in January 2022 and USD1 billion due in July 2022. The government also faces foreign-currency debt service payments, including principal and interest, of USD6.9 billion in 2022, equivalent to nearly 430% of official gross international reserves as of November 2021. Cumulative foreign-currency debt service, including interest and principal, amounts to about USD26 billion from 2022 through to 2026.

The timing and availability of external resources is unclear and may not be readily available for debt service. The central bank published a six-month roadmap in October that outlined plans to raise additional external borrowings through a number of channels, including bilateral and multilateral sources, syndicated loans and through the monetisation of under-utilised assets in 1Q22.

A drawdown on the existing currency swap facility with the People's Bank of China (PBOC) could boost reserves by up to CNY10 billion (USD1.5 billion equivalent). However, even with resources from the swap facility, foreign exchange reserves are likely to remain under pressure, in our view. Additional sources of financing could come from an economic support package from India, which contains a swap facility under the South Asian Association for Regional Cooperation currency framework of USD400 million, a swap facility with the Qatar Central Bank, remittances securitisation and a revolving credit facility with the Bank of China Limited (A/Stable). However, even if all these sources are secured, we believe it will be challenging for the government to maintain sufficient external liquidity to allow for uninterrupted debt servicing in 2022.

Press reports suggest the government may be contemplating IMF financing; an IMF programme would unlock multilateral financing, but we believe the Fund could well suggest restructuring to bring about debt sustainability.

Sri Lanka's external finances are further challenged by a persistent current account deficit, resulting in downward pressure on the exchange rate. We estimate that the deficit widened to about 5.7% of GDP in 2021 and expect it to remain at about 4.0% in 2022, before falling to 2.1% by 2023. A plunge in remittances, a weak tourism recovery and rising imports have contributed to the wider current account deficit. Travel and tourism, an important economic driver, has been hit hard by the COVID-19 pandemic and the outlook for a recovery remains uncertain given the emergence of new highly transmissible virus variants.

The Sri Lankan rupee/US dollar spot exchange rate depreciated by 7%-8% since end-2020, and the central bank intervened to support the currency, exacerbating the decline in reserves.

Wide fiscal deficits continue to worsen the outlook for debt sustainability. The 2021 fiscal deficit target of 8.9% of GDP was missed by a wide margin, and we expect the government deficit to widen to about 11.5% of GDP in 2022. We believe 2022 revenue targets are optimistic, especially in light of our expectation of weak economic activity. We forecast general government debt to reach about 110% of GDP by 2022, and to keep rising under our baseline, absent major fiscal consolidation.

We also believe it is unlikely that Sri Lanka will meet its 2025 government debt reduction target of about 89% of GDP or narrow the fiscal deficit to 4.8% of GDP. Rising interest payments are a major driver of the widening deficit and the interest/revenue ratio of at about 95.0% is well above the peer median of 11.3%.

Sri Lanka's economic performance is likely to weaken in 2022, as the challenging external position and exchange-rate pressure will have knock-on effects on economic activity. Foreign currency shortages in 2021 hampered food and fuel imports, and continued external liquidity stress could worsen supply shortages, hurting economic activity. We expect growth to slow to 2.0% in 2022, from an estimated 3.6% in 2021, before recovering to 4.3% in 2023 partly due to base effects and a gradual easing of domestic pressures, although downside risks to our forecasts remain. Sri Lanka's economy was expanding at a modest pace prior to the pandemic, which led real GDP to contract by 3.6% in 2020.

ESG - Governance: Sri Lanka has an ESG Relevance Score of '5' for Political Stability and Rights. This reflects the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Sri Lanka has a medium WBGI ranking at the 47th percentile, reflecting a recent record of peaceful political transitions and a moderate level of rights for participation in the political process. As Sri Lanka has a percentile rank below 50 for the governance indicator, this has a negative impact on the credit profile.

ESG - Governance: Sri Lanka has an ESG Relevance Score of '5' for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. This reflects the high weight that the WBGI has in our proprietary Sovereign Rating Model. As Sri Lanka has a percentile rank below 50 for the respective governance indicators, this has a negative impact on the credit profile.

Sri Lanka has an ESG Relevance Score of '5' for Creditor Rights, as willingness to service and repay debt is relevant to the rating and is a rating driver for Sri Lanka, as for all sovereigns. Given the increasing possibility of default reflected in the CC rating, this has a negative impact on the credit profile.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Failure to service bonded debt obligations within grace periods stipulated in relevant documentation, or unilateral declaration of a debt moratorium
- Launch of a formal debt renegotiation process by authorities or the start of a process that Fitch deems to constitute a default or default-like event

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- External Finances: Improved external liquidity, supported by higher non-debt inflows or lower external sovereign refinancing risk from an enhanced liability profile that allows for smooth servicing of liabilities
- Public Finances: Implementation of a credible medium-term fiscal consolidation strategy that supports a sustained decline in the general government debt/GDP ratio, increasing financing options and reducing the probability of default
- Structural: Improved policy coherence and credibility, leading to more sustainable public and external finances and a reduction in the risk of debt distress

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

In accordance with its rating criteria, Fitch's has not utilised the SRM or QO to explain the ratings in this instance. Ratings of 'CCC+' and below are instead guided by the rating definitions.

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 Long-Term Foreign-Currency 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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Sri Lanka has an ESG Relevance Score of '5' for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight.

Sri Lanka has an ESG Relevance Score of '5' for Rule of Law, Institutional and Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Sri Lanka has a percentile rank below 50 for the respective Governance Indicators, this has a negative impact on the credit profile.

Sri Lanka has an ESG Relevance Score of '4' for Human Rights and Political Freedoms, as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Sri Lanka has a percentile rank below 50 for the respective governance indicator, this has a negative impact on the credit profile.

Sri Lanka has an ESG Relevance Score of '5' for Creditor Rights, as willingness to service and repay debt is relevant to the rating and is a rating driver for Sri Lanka, as for all sovereigns. Given the increasing possibility of default reflected in the CC rating, this has a negative impact on the credit profile. Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
<input type="text"/>	<input type="text"/>			<input type="text"/>
Sri Lanka	LT IDR	CC	Downgrade	CCC
	LC LT IDR	CCC	Affirmed	CCC
	LC ST IDR	C	Affirmed	C
	Country Ceiling	B-	Affirmed	B-
senior unsecured	LT	CC	Downgrade	CCC

PREVIOUS

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[VIEW ADDITIONAL RATING DETAILS](#)

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

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APPLICABLE CRITERIA

- [Country Ceilings Criteria \(pub. 01 Jul 2020\)](#)
- [Sovereign Rating Criteria \(pub. 26 Apr 2021\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

- Country Ceiling Model, v1.7.2 ([1](#))
- Debt Dynamics Model, v1.3.1 ([1](#))
- Macro-Prudential Indicator Model, v1.5.0 ([1](#))
- Sovereign Rating Model, v3.12.2 ([1](#))

ADDITIONAL DISCLOSURES

- [Dodd-Frank Rating Information Disclosure Form](#)
- [Solicitation Status](#)
- [Endorsement Policy](#)

ENDORSEMENT STATUS

Sri Lanka EU Endorsed, UK Endorsed

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