

## Fitch Ratings: Political Risks to Sri Lanka's Debt Restructuring Agreement Recede

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Fitch Ratings-Hong Kong-09 October 2024: The Sri Lankan authorities' confirmation that they endorse the targets set under the country's IMF programme, and intend to implement debt restructuring based on the terms agreed with international sovereign bondholders in September, reduces risks to the debt treatment process associated with the outcome of the presidential election on 21 September, says Fitch Ratings.

The election of Anura Kumara Dissanayake, of the opposition Janatha Vimukthi Peramuna (JVP), as president in September had increased policy uncertainty, raising the risk that the government could launch challenges to key elements of the IMF programme, potentially delaying Sri Lanka's foreign-currency debt restructuring. However, the Ministry of Finance announced on 4 October that consultations with the IMF and Sri Lanka's Official Credit Committee had been successfully concluded, suggesting that any policy changes are unlikely to threaten the IMF programme or the debt treatment agreement-in-principle reached under the previous administration.

The Ministry also indicated that the consultation had agreed that the preliminary agreement adhered to the principle of comparability of treatment between official creditors and bondholders, and was compatible with the IMF programme's terms. We view this as a positive sign for the restructuring process's prospects.

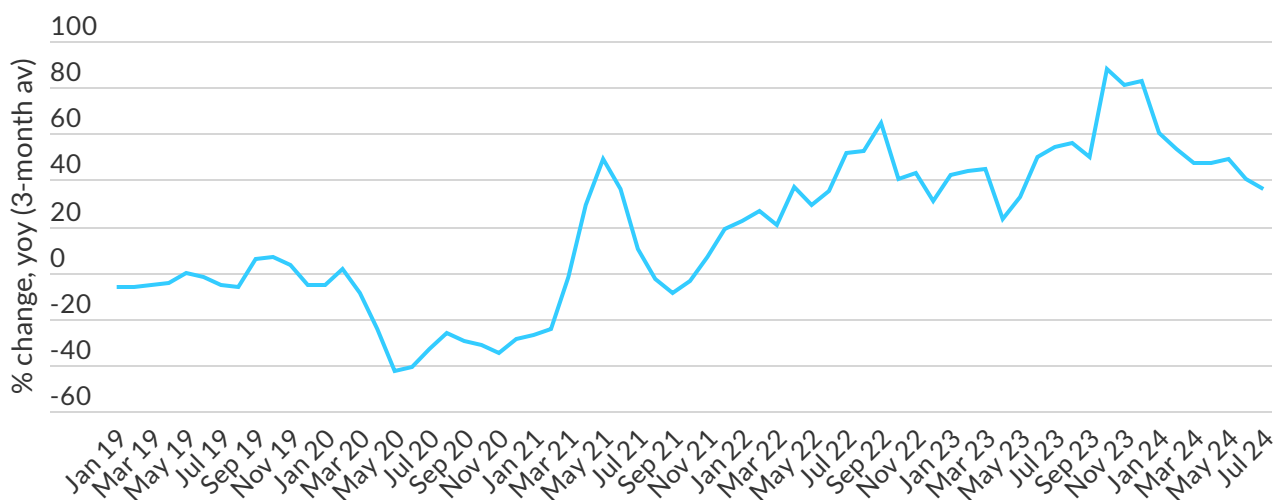
Fitch has rated Sri Lanka's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'RD' (Restricted Default) since May 2022, and the government is not currently servicing its foreign-currency debt. We may move the IDR out of 'RD' upon the sovereign's completion of a commercial debt restructuring that we judge to have normalised the relationship with the international financial community. Sri Lanka's post-default rating would depend upon our assessment of its credit profile. Fitch upgraded Sri Lanka's Long-Term Local-Currency IDR to 'CCC-' in September 2023, reflecting the completion of the local-currency portion of Sri Lanka's domestic debt optimisation plan.

We expect Sri Lanka's government debt to remain relatively high, even if debt restructuring is completed successfully along the lines laid out in the agreements with its creditors. The IMF forecasts Sri Lanka's gross general government debt/GDP ratio to decline only gradually to about 103% of GDP by 2028, from about 116% in 2022, after building in a local- and foreign-currency debt restructuring.

# Sri Lanka's Fiscal Revenue is Rising Strongly



(Central government revenue, % change yoy, 3-month rolling average)



Source: Fitch Ratings, Haver Analytics, Central Bank of Sri Lanka

## Fitch Ratings

The government's revenue/GDP ratio remains low, but the effects of several revenue-raising measures passed since May 2022 are beginning to be felt. Revenue collection in 7M24 rose by about 43% yoy, well above the nominal GDP growth rate of 9.5% in 1H24. Our baseline projections assume an increase in revenue/GDP, from 11.4% in 2023 to 15.5% in 2026, reflecting the measures already in place. However, these forecasts could be affected, if the new government introduces fiscal reforms. The IMF programme's targets offer some flexibility for changes in the government's fiscal policy approach.

The president's capacity to push through policy changes may depend partly on the outcome of the parliamentary election on 14 November. The JVP and its allies had relatively few seats in the outgoing legislature, though the trends evident in the recent presidential election suggest that there will probably be large changes in the make-up of the new chamber.

The economy more broadly remains on a recovering trend. Real GDP growth was 5.0% yoy in 1H24, after contracting by 7.3% during 1H23. We expect the economy to expand by 3.9% in 2024 and to average growth of 3.6% over 2025-2026. External liquidity stresses have also eased, with foreign-exchange reserves hitting USD6.0 billion in August 2024, up almost 66% yoy. Nevertheless, the speed of the recovery in reserves is likely to be set back when Sri Lanka resumes external debt-service payments.

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