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PRESS RELEASE

Rating Action by Fitch Ratings based on Uncorroborated Facts sans due Consideration Given to Recent Economic and Policy Developments

We observe, with disappointment, today's rating action by Fitch Ratings expressing concerns about Sri Lanka's external debt repayment capacity over the medium-term, financing options and debt sustainability risks, at a time when the newly appointed Government has just announced its medium term policy framework in its Budget 2020. We do not accept this downgrade as it fails to recognize the robust policy framework of the new Government for addressing the legacy issues, including the concerns raised by Fitch Ratings, and ensuring ongoing economic recovery and macroeconomic stability of the Country.

It is surprising to note that Fitch Ratings' assessment has ignored several key proposals presented in the Government Budget 2021 with regard to deficit financing in the period ahead. As indicated in the Budget 2021, the Government has adopted a novel approach in relation to foreign financing while enhancing the effectiveness of already secured financing channels, aimed at reducing the share of foreign financing of the budget deficit over the medium term. Yet, Fitch Ratings builds up its argument based on the 'existing financing model', thus adopting a backward looking approach. In contrast, the forward looking financing model of the Government, which is skewed heavily towards domestic financing and will capitalize on the benefits of increased domestic savings and the low interest rate regime already

regime already in place given subdued aggregate demand conditions and well anchored inflation expectations. It is also noteworthy that the low interest rate regime will improve economic growth prospects in the period ahead, alongside the incentives being offered for capital investment, thereby supporting the envisaged debt consolidation efforts significantly. As the relative share of outstanding foreign debt has already fallen to 44 per cent as per the latest available data, projecting a rise in foreign debt servicing obligations in the period ahead cannot be corroborated with facts. Based on such unfounded assumptions, Fitch Ratings project a government debt to GDP ratio of 100 per cent at end 2020 and 116 per cent at end 2024, while grossly overestimating the budget deficit at around 11.5 per cent of GDP in 2021 and 2022. The rating action announced today is based on these ill-informed model projections, without any evidence-based and objective analysis. Further, as the share of domestic government debt rises in a low interest rate regime, some increase in overall public debt to GDP in the near term is not considered as a significant concern. Furthermore, with the strong pro-growth policy orientation of the Government as clearly articulated in the Budget 2021, a possible rise in local currency denominated government debt in the near term can be effectively managed within the envisaged fiscal consolidation path in the medium term, as government revenue increases helped by the envisaged take-off of the economy. It is also unrealistic to assume that the Government will take a rigid expenditure path, if by any chance, the expected improvement in revenue does not materialize.

Sri Lanka, similar to many of its peers in the emerging market group, experienced initial capital outflows, exchange rate depreciation, slowdown in activity, and pressure on government finances, in response to the effects of the first wave of the COVID-19 pandemic. However, Sri Lanka recognized its priorities early, and swiftly introduced a policy package to withstand and mitigate potential adverse effects of slowing economic activity, while building buffers for countering possible external financing challenges. With the decisive conclusion of

the Parliamentary election in August 2020, the Government of Sri Lanka is now moving along a recovery path towards growth and stability even in the midst of the transitory disruptions caused by the second wave of the pandemic. The Sri Lankan economy is expected to have recovered strongly during the third quarter of 2020, when the second wave hit economic activity. Earlier than expected return of merchandise exports to pre-COVID monthly averages of US dollars 1 billion and the curtailment of non-essential imports have reduced the trade deficit notably for the sixth consecutive month in October 2020, saving US dollars 3.3 billion in import expenditure so far during the year. Meanwhile, larger than expected increase in workers' remittances, together with other services exports, including IT services and shipping, helped mitigate the impact of the pandemic. Improvements in trade balance and workers' remittances have helped cushion the current account deficit to a large extent in spite of the downturn in tourism, thereby reducing pressure on the exchange rate and official reserves.

Foreign Direct Investments, which slowed in the first half of the year, appear promising in the period ahead, particularly with the expected inflows to the Colombo Port City project and for new manufacturing projects in industrial zones, including Hambantota. The new legal framework conducive to promote commercial services and investment in Port City will be presented to the Parliament in January 2021. The first phase of the Port City project is scheduled to begin in 2021, boosting economic activity and attracting sizable non-debt creating financial flows to the country. Further, from the list of FDIs approved by the Board of Investment totaling over US dollars 5 billion, a considerable share is expected to materialize, supported by the new business-friendly environment of the country, and several major investment projects are already in the process of implementation. Other expected investments include import alternative industries as well as investments by the World Bank and other international development finance institutions. Nevertheless, the Government will adopt a policy of 'guided' imports as the envisaged improvements in growth prospects would experience

some rise in import demand on raw material and investment goods, as the foreign exchange liquidity concerns are expected to wane in the period ahead. It is noteworthy, however, that the Government will remain committed to strengthening the dynamics of the economy based on the principle of self-reliance. With regard to portfolio flows, foreign inflows to the government securities market are yet to resume but no significant outflows were noted in recent months. Stock market indices have improved continuously and surpassed the pre-COVID levels with a record level of activities over the last three months. The tourism sector has been supported by domestic tourism and is expected to flourish once global tourist flows resume after the pandemic subsides. Despite the COVID-19 driven slowdown in economic activities in the first half of 2020, the economy is expected to rebound strongly in 2021 and sustain its growth momentum over the medium term, supported by the stimulus measures already in place and the effective implementation of the pro-growth policy proposals announced in the Government Budget 2021.

Given these developments, the exchange rate remains broadly stable, and the Central Bank was able to absorb foreign exchange of over US dollars 500 million on a gross basis since May 2020. Gross official reserves were estimated at US dollars 5.9 billion at end October 2020, with an import cover of 4.2 months. The Government has repeatedly expressed its ability and willingness to meet all its debt obligations falling due in the period ahead. With the observed rise in foreign debt servicing and public debt in the period ahead, the Government focused more on curtailing government expenditure, by resorting to several self imposed austerity-like economic measures on the onset of the COVID-19 pandemic, through announcing measures such as restricting imports of non-essential goods, encouraging the State Owned Enterprises to curtail non-essential expenditure including purchasing of motor vehicles, instructing the state entities to strictly manage expenditure on fuel and other utilities, non-priority procurement, etc. The Government's strategy in foreign debt management is to avoid total rolling over of

the upcoming maturities, while its strategy in overall debt management is to repay the outstanding debt, while not raising more loans over the existing level over the medium term.

The recently introduced measures to entice foreign investors to the government securities market and the real economy through an attractive foreign exchange swap arrangement are likely to help enhance foreign currency inflows, in addition to the support of friendly countries, such as the swap arrangements and the expected disbursement of the 2nd tranche of the Foreign Currency Term Financing Facility proceeds from the China Development Bank in December 2020. Accordingly, gross official reserves are expected to improve to around US dollars 6.5 billion by end 2020.

Sri Lanka's policy environment remains facilitative of enabling high economic growth beyond the recovery phase while preserving macroeconomic stability. On the back of over 11 years of well anchored mid-single digit levels of inflation, the Central Bank has pursued an increasingly accommodative monetary policy stance. Fiscal policy, as re-emphasized in the Budget 2021, remains focused on supporting the economy, while expecting to return to the envisaged path of consolidation from 2022. Hence, both fiscal and monetary policies have prioritized supporting people, businesses and thereby the economy, without jeopardizing the macroeconomic balance of the country.

In the above context, it is puzzling why Fitch Ratings downgraded Sri Lanka when the well-articulated policy framework presented in the Budget 2021 is receiving wider commendation for consistency and continuity, with a clear medium term view of fiscal consolidation on a realistic economic footing. Such action simply demonstrates the prejudicial approach of Fitch Ratings, and lacks due consideration to alternative strategies that the Government is committed to embark on in the period ahead. Practices of this nature by an international rating agency without a constructive engagement with the Government on the promising

alternative, policy approaches are likely to make the agency concerned completely irrelevant as the country rises strongly in the period ahead.

Given these circumstances, the Government of Sri Lanka wishes to reaffirm to foreign investors that have put faith in Sri Lanka continuously over the past several years that Sri Lanka remains willing and able to meet its debt obligations, as it has done impeccably in the past. Furthermore, Fitch Ratings question Sri Lanka's ability to meet its external debt repayments based on their forecast of a decline in foreign exchange reserves in 2021 and 2022. Fitch Ratings also raise concerns on Sri Lanka's external financing options. The Government categorically denies all such uncorroborated concerns. It is notable, that the Government has honoured all its liabilities so far during the year amounting to over US dollars 4 billion, in spite of the adverse speculation faced by the Sri Lankan economy since the end of 2019. The Government wishes to reiterate that Sri Lanka will engage with all investment and development partners and implement necessary measures to build up reserves through non-debt creating inflows.

Investors are invited to approach the Sri Lankan policy authorities at the highest levels who are dedicated to facilitate any one-on-one or roadshow discussions, without being dissuaded by such baseless rating action.