



FOR IMMEDIATE RELEASE
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Impact of the U.S. Credit Rating Downgrade on Sri Lanka

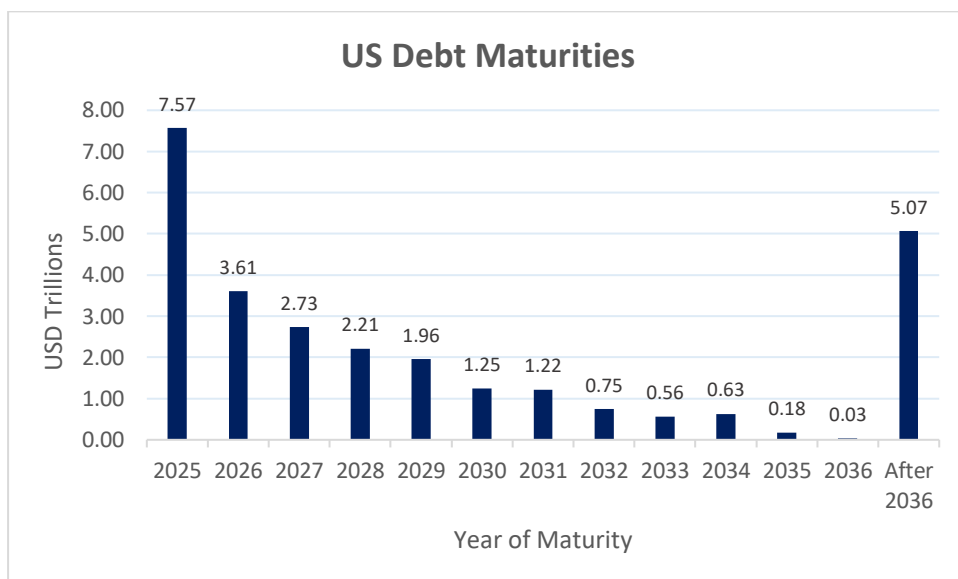
This analysis is in response to Moody's Ratings downgrade of the United States' sovereign credit rating from Aaa to Aa1 on May 16, 2025 which is a one notch downgrade. Aaa rating is the highest attainable sovereign credit rating issued by Moody's and this rating is no longer in effect for the U.S., and the new rating given indicates that it is still high quality but subject to risk that is still low, but higher than before.

This downgrade, following S&P's action in 2011, stems from concerns over the U.S. federal debt, projected to reach 134% of GDP by 2035, driven by persistent fiscal deficits, rising debt-servicing costs, and political challenges to implementing reforms. LRA evaluates the consequences for Sri Lanka's foreign exchange reserves and export sectors, urging strategic measures to address emerging risks.

U.S. Fiscal Dynamics and Global Repercussions

The U.S. debt-to-GDP ratio has risen to 109% in 2025, up from 98% in 2024, reflecting deepening fiscal pressures. Yields on U.S. 5-year Treasuries have increased from approximately 3.86% to 4.17% in recent months, indicating higher borrowing costs. In addition, Moody's highlighted the tax cuts to also be a major contributor towards the sovereign downgrade, where the tax cuts contributed to persistent fiscal deficits which rose from 6.4% of GDP in 2024 to a projected 9% by 2035.

Below chart shows a breakdown of the US debt by year of maturity. As displayed, approximately USD 7.5 trillion of the U.S. debt matures in 2025, which accounts for approximately 26.75% of the USD 28.2 trillion of debt. The high short-term obligations of the U.S. have placed the economy in a difficult position in-terms of managing short-term liquidity and certain maturity mismatch risks.



Source: Lanka Rating Agency, LSEG

Therefore, with the high short-term debt obligations and despite the U.S. dollar's status as the global reserve currency, Moody's stable outlook highlights growing uncertainties in financial markets, posing challenges for emerging economies like Sri Lanka.

Exposure of Sri Lanka's Reserves

Sri Lanka's foreign exchange reserves, valued at USD 6.326 billion as of March end 2025, are heavily allocated to U.S. Treasuries. Rising Treasury yields trigger mark-to-market losses, reducing the value of these assets. This depreciation weakens reserve adequacy, constraining Sri Lanka's capacity to stabilize the rupee and service external debt.

It should be noted that there is a significant amount of U.S. debt in the form of treasuries that is held by some of the largest economies in Asia. There is a possibility of the condition turning out to be worse if it comes to a point when these large economies sell off their holdings in U.S. treasuries, as this could trigger, and drastically impact the final value of the foreign assets held by some of the emerging economies like Sri Lanka who are overly reliant on U.S. reserves. This therefore will be a global

market sentiment driven by interest rate change rather than a monetary adjusted, which could have a much more negative effect on the value of U.S. treasuries.

As such, lack of diversification in reserves can have damaging effects on the economy, particularly the balance sheets of emerging economies who hold U.S. treasuries. Therefore, it is of vital importance to have proactive reserve management in Sri Lanka to mitigate these vulnerabilities especially by way of diversification.

Pressure on Sri Lanka's Exporters

The U.S. downgrade amplifies global borrowing costs, adversely affecting Sri Lanka's export-oriented industries, particularly apparel, a critical economic driver. Elevated financing costs, combined with limited ability to secure premium pricing in risk-averse markets, compress profit margins and undermine export competitiveness. This threatens economic growth, requiring urgent policy support to sustain the sector's viability, most importantly in its export-linked working capital requirements.

To delve further, it should not be ignored that with the rising borrowing costs, particularly interest rate spreads of U.S. treasuries, majority of the U.S. based exporters would find it difficult to maintain the same levels of margins and profits. This could lead to downscaling of businesses, and most importantly there will be downsides to local (Sri Lankan) importers from high import costs when there is an increase in overall borrowing costs and cost of production, as now the U.S. exporters will pass down the increased cost in the form of high prices. This can be very damaging to the local exporters who depend on certain imports from the U.S. that are used to manufacture the value-added products which are exported back to global markets.

It is therefore of great importance to implement correct fiscal policies to support the local exporters, especially giving special consideration to the working capital requirements.

Why Should Sri Lanka be Concerned?

The Moody's downgrade of the U.S. sovereign credit rating from Aaa to Aa1 highlights growing fiscal risks in the world's largest economy, with significant implications for Sri Lanka. Given Sri Lanka's substantial holdings in U.S. Treasuries, rising yields reduce the value of its foreign reserves, weakening its ability to stabilize the rupee and service external debt.

Additionally, higher global borrowing costs threaten Sri Lanka's export sector- particularly apparel-by squeezing profit margins and limiting access to affordable financing. This could lead to reduced competitiveness and slower economic growth. The increased cost of U.S. imports may also raise production costs for local businesses.

This situation underscores the critical need for Sri Lanka to diversify its reserve portfolio and implement strategic policies to strengthen export resilience and manage external vulnerabilities. Proactive measures are essential to safeguard economic stability amid heightened global financial uncertainty.

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