MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes outlook on Sri Lanka's rating to negative from stable; affirms government bond rating at B1

Global Credit Research - 20 Jun 2016

Singapore, June 20, 2016 -- Moody's Investors Service has today affirmed the government of Sri Lanka's foreign currency issuer and senior unsecured sovereign ratings at B1 and changed the outlook to negative from stable.

Two key drivers underpin the change in outlook to negative from stable:

1) Our expectation of a further weakening in some of Sri Lanka's fiscal metrics in an environment of subdued GDP growth which could lead to renewed balance of payments pressure.

2) The possibility that the effectiveness of the fiscal reforms envisaged by the government may be lower than we currently expect, which could further weaken fiscal and economic performance.

At the same time, Sri Lanka's B1 rating is supported by the economy's robust growth potential and higher income levels than similarly-rated sovereigns. With the effective implementation of some of the fiscal policy measures and other structural reforms planned under the IMF programme, the government would be able to tap a significant potential revenue base.

RATINGS RATIONALE

RATIONALE FOR ASSIGNING A NEGATIVE OUTLOOK

WEAKENING IN FISCAL METRICS COULD LEAD TO RENEWED LIQUIDITY AND EXTERNAL PRESSURE

The first driver of the negative outlook on Sri Lanka's B1 ratings is our expectation that the government's debt burden will increase further, from high levels, which could intensify external vulnerabilities and refinancing risks.

If there was a further marked deterioration in fiscal metrics combined with heightened balance of payment pressures, Sri Lanka's overall credit metrics would weaken compared to other B1-rated sovereigns.

Moody's expects a more moderate reduction in budget deficits than outlined in the projections published as part of the International Monetary Fund's (IMF) Extended Fund Facility (EFF). This reflects the difficulties in rapidly raising revenues after years of decline in the efficiency of tax collection and administration. We forecast that the budget deficit will narrow to slightly under 5% of GDP by 2020, from 7.4% in 2015 and compared with 3.5% projected by the IMF as part of the EFF.

In addition, a number of state-owned enterprises are under financial stress, pointing to sizeable contingent liability risk for the government. Some of these risks have already crystallised with the government taking responsibility for SriLankan airlines' (unrated) liabilities, worth Rs461 billion or around 4% of GDP. These liabilities will inflate government debt, at least temporarily. We assume that the government will retain responsibility for some of these liabilities.

With nominal GDP growth slower than in the last decade, persistent sizeable deficits will raise the government's debt burden. We expect government debt to rise to just under 80% of GDP and subsequently fall to around 75% by the end of the decade, above the IMF's projections (68.2% in 2020) and debt levels of similarly rated sovereigns.

With persistent elevated government debt and large borrowing requirements, including for external and foreign currency debt financing, latent liquidity and external risks will remain and could escalate in an environment of global financial uncertainty.

Gross reserves declined to $5.6 billion in May 2016, equivalent to 3.6 months of imports, from $7.3 billion six months earlier. Gross reserves include foreign currency reserves which decreased to $4.7 billion in May, from $6.5 billion last November. At these levels, foreign currency reserves are equivalent to around 3 months of imports, a low coverage, and only partially cover external debt due over the year.

Funding from the IMF and other international agencies will likely not fully finance the balance of the current account and foreign direct investment.

The negative outlook captures the risk that without a sustained resumption of portfolio inflows which slowed significantly last year and continued access to international funding sources, foreign exchange reserves could fall further and balance of payment pressures would heighten.

LOWER THAN EXPECTED POLICY EFFECTIVENESS COULD FURTHER WEAKEN FISCAL AND ECONOMIC PERFORMANCE

The fiscal consolidation path targeted by the authorities and outlined in the IMF programme is ambitious. We assume that revenues increase in relation to GDP, albeit by less than envisaged in the programme. However, sustaining such efforts will challenge the government's institutional capacities and present hurdles as GDP growth is negatively affected, at least in the short term, and demands on government spending rise as a result.

Moreover, the significant overhaul of tax administration that is envisaged will necessitate consistent implementation through multiple levels of the administration in geographically diverse areas which will be challenging.

There is a risk that, over time, the effectiveness of fiscal and other structural reforms, including SOE reform and a move towards flexible inflation targeting, is lower than the authorities and we currently expect. In turn, this could undermine the credibility of the fiscal consolidation objectives and reduce commitment to them and ultimately weaken fiscal and economic performance, one of Sri Lanka's relative credit strengths.

RATIONALE FOR AFFIRMING SRI LANKA'S B1 RATING

A relatively large economy and higher income levels compared with similarly-rated sovereigns support Sri Lanka's rating at B1. These features point to the possibility for the government to generate significant revenues should fiscal policy reforms effectively broaden the tax base and enhance tax collection.

Moreover, further progress towards reconciliation would enhance Sri Lanka's growth potential by unleashing production capacity in the North and East of the country. In turn, this would broaden and consolidate the government's revenue base and bolster the effectiveness of fiscal consolidation measures.

Furthermore, if the planned shift to an inflation targeting monetary policy regime is effective, it would increase exchange rate flexibility, reduce the frequency and size of foreign exchange interventions and help preserve foreign exchange reserves.

WHAT COULD CHANGE THE RATING UP/DOWN

Signs that the fiscal consolidation measures are ineffective or that the authorities' commitment towards fiscal consolidation is wavering would point to a higher debt burden for longer and put negative pressure on the rating. In particular, if such developments were accompanied by a marked fall in foreign exchange reserves and lack of market access, a downgrade of the rating would be possible.

The negative outlook signals that an upgrade is unlikely. Evidence of effective implementation of fiscal reforms leading to significant and lasting improvements in tax collection would be positive. Such an improvement, coupled with reforms of macroeconomic policy that lead to more stable external financing conditions, would support a return of the rating outlook to stable.

Economic Data

GDP per capita (PPP basis, US$): 10,566 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.8% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.2% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -7.4% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -2.4% (2015 Actual) (also known as External Balance)

External debt/GDP: 54.4%

Level of economic development: Moderate level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

Rating Committee Minutes

On 16 June 2016, a rating committee was called to discuss the rating of the Sri Lanka, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/framework, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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