

**Rating Action: Moody's downgrades Sri Lanka's ratings to Caa1, outlook changed to stable**

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28 Sep 2020

Singapore, September 28, 2020 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Sri Lanka's long-term foreign currency issuer and senior unsecured ratings to Caa1 from B2 and changed the outlook to stable. This concludes the review for downgrade initiated on 17 April 2020.

The decision to downgrade Sri Lanka's rating to Caa1 reflects Moody's assessment that the coronavirus-induced shock, which Moody's regards as a social risk, will significantly weaken Sri Lanka's already fragile funding and external positions. Heightened liquidity and external risks stem from Sri Lanka's limited secured funding sources to meet its material external debt service payments over the coming years, during which period market refinancing will remain vulnerable to shifts in investor sentiment. At the same time, fiscal and external pressures will continue to limit the scope for reforms to address long-standing credit vulnerabilities, denoting weakening institutions and governance, an important driver of today's rating action.

The stable outlook denotes balanced credit risks at the Caa1 rating level. On the downside, Sri Lanka's very large and recurring financing needs over the near- to medium-term risk putting more pressure on the sovereign's external and liquidity position than Moody's currently assess. On the upside, Sri Lanka's rating is supported by the country's relatively high levels of per capita income and modest economic competitiveness, which provide some prospects for growth to recover to more robust rates. Moderate institutions strength in some areas also provides some support compared to similarly rated peers.

Concurrently, Moody's has lowered Sri Lanka's local currency bond and bank deposit ceilings to B1 from Ba2, lowered its long-term foreign currency bond ceiling to B3 from Ba3 and lowered its foreign currency bank deposit ceiling to Caa1 from B3. These ceilings act as a cap on the ratings that can be assigned to the obligations of other entities domiciled in the country.

**RATINGS RATIONALE**

**RATIONALE FOR THE DOWNGRADE TO Caa1 FROM B2**

**EXTERNAL DEBT SERVICING REQUIREMENTS AND FISCAL FRAGILITY RAISE GOVERNMENT LIQUIDITY RISKS**

Sri Lanka continues to face very tight external financing conditions and a significant decline in revenue from a sharp and prolonged economic slowdown. This shock occurs at a time when Sri Lanka's credit profile is highly vulnerable given low reserve coverage of large forthcoming external debt payments, and very weak debt affordability.

Moody's expects government liquidity and external risks to intensify, as the government's external debt service payments amount to approximately \$4 billion between 2020 and 2025[1], and wide budget deficits in the next few years are likely to require at least partial external financing. International sovereign bonds account for a sizeable portion of maturing government debt over this period, which leaves Sri Lanka exposed to shifts in investor sentiment.

While external financial conditions have eased somewhat in the last few months, they remain very tight with spreads on Sri Lankan international sovereign bonds over US Treasuries hovering around 1000 basis points[2], indicating still impaired market access.

Moody's expects the government to settle its October 2020 \$1 billion maturity by drawing down on the country's foreign reserves, which will further deplete already thin external buffers. This may also contribute to a more protracted economic recovery, should import controls be extended as a means to preserve exchange rate stability.

Beyond this next maturity, with material external risks remaining due to persistently weak revenue from textile & garment exports, tourism and overseas remittances, investor sentiment is likely to be highly sensitive to the

credibility of government policy. While a government is now in place, its policy objectives and in particular the prioritization and effectiveness of fiscal consolidation to reduce a very high debt burden have yet to be ascertained. Partly as a result, financing conditions are likely to remain tight for the foreseeable future.

The government has reoriented its annual borrowing towards domestic sources. Domestic financing conditions have eased alongside the collapse in aggregate demand and easing in inflation, with the Central Bank of Sri Lanka's (CBSL) cumulative 250 basis point reduction in its policy rate corridor since January transmitting into lower government bond yields. However, a substantial increase in domestic borrowing by the government may hurt private sector liquidity, constraining the economic recovery and putting pressure on interest rates and the Sri Lankan rupee.

Since the beginning of the year, the government has also secured some financing from nonmarket sources, including both lending and swap facilities. In March, the government secured a syndicated loan of \$1.2 billion from China Development Bank (A1 stable) while in July, Sri Lanka finalized a \$400 million currency swap with the Reserve Bank of India[3]. Moody's expects negotiations for further assistance, whether through liquidity relief on bilateral debt payments or further lending, to complement these two facilities.

Nevertheless, delays in securing additional funding from multilateral and bilateral creditors, in addition to the IMF's Rapid Financing Facility, mean that the financing sources for upcoming repayments in the next few years are not secured and risk coming at high costs.

Overall, high and higher debt servicing costs, lower revenue and increased fiscal spending will widen the budget deficit, to 8% - 9% of GDP in 2020-21 according to Moody's projections. Combined with slower nominal GDP growth and a weaker exchange rate, the government's debt burden will rise to around 100% of GDP, above the Caa-rated median of 86% of GDP. This year's economic contraction, after GDP growth has been dampened by several domestic shocks in recent years, will shrink revenue from an already very narrow base. Debt affordability, already the weakest amongst the sovereigns that Moody's rates, will worsen further with interest payments comprising between 55% -- 60% of revenue in 2020-21.

#### FISCAL AND EXTERNAL RISKS TO IMPEDE POLICY EFFECTIVENESS, FURTHER DAMPENING THE SCOPE FOR REFORMS TO ADDRESS LONG-STANDING CREDIT VULNERABILITIES

Moody's expects the currently challenging macroeconomic environment to impede the government's policy effectiveness in managing the country's twin deficits. Navigating these pressures will further dampen medium-term prospects for reforms that would meaningfully strengthen Sri Lanka's fiscal and external position.

Since the beginning of this year, in the absence of a seated government, state expenditure was restricted by successive mini budgets. Following elections in August, a government will present its first budget for 2021 in November. Moody's expects significant social and policy hurdles towards medium-term fiscal consolidation. Sri Lanka's already narrow revenue base will be slow to recover amid weaker economic growth, and expenditure pressure from public sector wage hikes and higher debt servicing costs will continue to limit flexibility, likely beyond the most acute phase of the economic and financial shock.

The current shock will also challenge monetary policy effectiveness. CBSL has undertaken substantial liquidity injections over the past month to ease domestic credit conditions. Nonetheless, given Sri Lanka's worsening external position, risks are skewed towards greater pressure on the rupee and rising inflation.

Longer term, Moody's expects the ongoing shock to curtail economic and fiscal reform effectiveness. The newly elected government has stated an objective of fiscal consolidation, along with growth-oriented reforms to support domestic businesses. Despite some greater policy clarity, Moody's expects scope for reform implementation that would address hurdles to economic competitiveness and very weak public finances to be limited for some time.

#### RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's assessment of balanced credit risks at the Caa1 rating level.

On the downside, Sri Lanka's very large and recurring financing needs over the near- to medium-term risk precipitating greater external and liquidity pressures than Moody's currently assesses. Moody's forecasts Sri Lanka's gross financing requirements to remain above 20% of GDP through at least 2022, given still elevated primary deficits, large external debt repayments, and the large rollover of short-term domestic debt, the last of which continues to increase the government's already elevated interest bill. Moreover, further risks relate to an even greater deterioration in debt affordability, should the recovery in government revenue be more subdued

than Moody's baseline forecasts.

On the upside, Sri Lanka's rating is supported by the country's relatively high levels of per capita income and modest economic competitiveness, which provide some prospects for growth to recover to more robust rates. A faster and more durable economic recovery, supported by implementation of growth-enhancing reforms, such as in improvements in the business environment and in export competitiveness, would be supportive for Sri Lanka's medium-term growth outlook and overall credit profile.

## ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental considerations are material to Sri Lanka's credit profile. Variations in the seasonal monsoon can have marked effects on real GDP growth and rural household incomes. Although the agriculture sector comprises only around 7% of the total economy, it employs around 25% of Sri Lanka's total labor force. Moreover, the natural disasters - including drought, flash foods, and tropical cyclones -- that Sri Lanka is exposed to contribute to supply-side inflationary pressures on major food items part of the consumer price basket, as well as higher import needs, both for food stocks and oil imports.

Social considerations are material to Sri Lanka's credit profile. Moody's regards the coronavirus outbreak as a social risk under its ESG framework, given the substantial implications for public health and safety. Acute financing risks explained above are triggered by heightened uncertainty about the economic and financial impact of the global coronavirus outbreak exacerbating Sri Lanka's long-standing weaknesses. In general, social considerations relevant to Sri Lanka's credit profile include relatively good access to basic education and environmental quality, set against weaknesses in provision of some basic services such as water and sanitation and shelter. As Sri Lanka's population continues to grow, the government will face ongoing fiscal pressures to deliver high-quality social services and infrastructure.

Governance considerations are an important driver of today's decision to downgrade the rating. Moody's assessment of Sri Lanka's institutions and governance strength primarily relate to the slow pace of reform implementation, as well as political risks, which impair the effectiveness of fiscal and economic policymaking. Moreover, Sri Lanka's fragile and deteriorating fiscal position will continue to impede fiscal policy effectiveness over the medium term.

GDP per capita (PPP basis, US\$): 13,897 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2.3% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 6.2% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -6.8% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -2.2% (2019 Actual) (also known as External Balance)

External debt/GDP: 66.6% (2019 Actual)

Economic resiliency: ba2

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

On 23 September 2020, 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 materially decreased. The issuer's institutions and governance strength, have materially decreased. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer has become increasingly susceptible to event risks.

## FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Moody's would likely upgrade Sri Lanka's rating if financing risks diminished materially and durably. This could stem from the government delivering a credible and secure medium-term financing strategy that maintained a manageable cost of debt, and a faster and more sustained buildup in non-debt creating foreign exchange inflows. Additionally, implementation of fiscal consolidation measures, particularly greater revenue mobilization, that pointed to a material narrowing of fiscal deficits in the next few years and contributed to lower annual borrowing needs, would be positive for Sri Lanka's rating.

Moody's would likely downgrade Sri Lanka's rating should external and domestic financing conditions

deteriorate to a greater extent than Moody's baseline assumptions, contributing to higher repayment stresses more consistent with a lower rating. Additionally, should the probability increase that Sri Lanka's government debt will continue to rise markedly beyond Moody's baseline projections, with a related further deterioration in debt affordability, this would also likely result in a downgrade of the rating.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at [https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC\\_1158631](https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631). Alternatively, please see the Rating Methodologies page on [www.moodys.com](http://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.

## REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: [https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC\\_79004](https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004).

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at [https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC\\_1133569](https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569).

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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## REFERENCES/CITATIONS

[1] Ministry of Finance 23-Mar-2020

[2] Haver Database 23-Sep-2020

[3] Central Bank of Sri Lanka 27-Jul-2020

Please see [www.moodys.com](http://www.moodys.com) for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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