

**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](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 ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on [www.moodys.com](http://www.moodys.com).

For any affected securities or rated entities receiving direct credit support from the primary entity(ies) of this rating action, and whose ratings may change as a result of this rating action, the associated regulatory disclosures will be those of the guarantor entity. Exceptions to this approach exist for the following disclosures, if applicable to jurisdiction: Ancillary Services, Disclosure to rated entity, Disclosure from rated entity.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

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.

Please see the ratings tab on the issuer/entity page on [www.moodys.com](http://www.moodys.com) for additional regulatory disclosures for each credit rating.

Marie Diron  
Senior Vice President/Manager  
Sovereign Risk Group  
Moody's Investors Service Singapore Pte. Ltd.  
50 Raffles Place #23-06  
Singapore Land Tower  
Singapore 48623  
Singapore  
JOURNALISTS: (852) 3758 -1350  
SUBSCRIBERS: (852) 3551-3077

Anne Van Praagh  
MD - Sovereign Risk  
Sovereign Risk Group  
JOURNALISTS: 212-553-0376

SUBSCRIBERS: 212-553-1653

Releasing Office:  
Moody's Investors Service Singapore Pte. Ltd.  
50 Raffles Place #23-06  
Singapore Land Tower  
Singapore 48623  
Singapore  
JOURNALISTS: (852) 3758 -1350  
SUBSCRIBERS: (852) 3551-3077



© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE. MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or

incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at [www.moodys.com](http://www.moodys.com) under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be reckless and inappropriate for retail investors to use MOODY'S credit ratings or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser.

Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000. MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.