MOODY'S
INVESTORS SERVICE

Rating Action: Moody's assigns B2 rating to Sri Lanka's proposed senior unsecured US dollar bonds

07 Mar 2019

Singapore, March 07, 2019 -- Moody's Investors Service ("Moody's") has today assigned a B2 rating to the Government of Sri Lanka's proposed senior unsecured US dollar-denominated bonds.

The rating is based on the preliminary offering memorandum received on 7 March, 2019.

The bonds will rank pari passu with the Government of Sri Lanka's current and future senior unsecured external debt. The B2 rating assigned to the notes mirrors the Government of Sri Lanka's issuer rating of B2.

The proceeds of the bonds are intended to meet government expenditures.

RATINGS RATIONALE

Sri Lanka's credit profile reflects significant government and external vulnerability risks amid ongoing tightening in external and domestic financing conditions, exacerbated most recently by a political crisis. This is balanced against moderate per capita income levels and stronger institutions relative to many similarly-rated sovereigns that support the B2 rating.

Sri Lanka's ongoing high vulnerability to tightening in external and domestic financing conditions, given very high government debt, weak debt affordability, relatively large borrowing needs, reliance on external funding and low reserves adequacy dominates risks that could abruptly lead to further negative pressure on Sri Lanka's credit metrics.

Under its International Monetary Fund programme, the government is focused on implementing important fiscal, monetary and economic reforms that would strengthen the credit profile over the medium term. Realising the government's ambitious fiscal consolidation targets will involve effective implementation of revenue reforms and expenditure restraint, which will remain challenging. Political risk can disrupt fiscal and economic policymaking.

Over the medium term, the planned changes to the Monetary Law Act should strengthen the credibility and effectiveness of Sri Lanka's monetary policy, helping the central bank anchor inflation expectations and prevent fiscal dominance.

Sri Lanka's growth potential, relatively large economy and high income levels compared with similarly rated sovereigns provide the economy with some shock absorption capacity and help limit some of the risks from the country's very high debt burden. Given relatively high incomes, effective reforms of tax collection and administration would allow the government to tap a sizeable potential revenue base.

ISSUER OUTLOOK

The stable outlook denotes balanced credit risks at the B2 rating level. Moody's expects that the government will remain broadly focused on implementing important fiscal, monetary and economic reforms that would strengthen the credit profile over the medium term. However, the rating agency's assessment is that the government's debt refinancing will remain highly vulnerable to sudden shifts in investor sentiment in a period of further tightening in financing conditions and political and policy uncertainty, with limited buffers to face such risk.

WHAT COULD CHANGE THE RATING UP

Moody's would consider upgrading the rating should it conclude that Sri Lanka's vulnerability to refinancing risk, which anchors the rating at B2, is likely to diminish. In particular, a faster and more sustained buildup in non-debt creating foreign exchange inflows, which could stem from policy measures which improve investor confidence and enhance FDI inflows, would bolster reserve adequacy over time and lower government liquidity risks and external vulnerability risks.

The implementation of further reforms that significantly lower fiscal deficits and government debt and enhance debt affordability could also prompt Moody's to upgrade the rating.

WHAT COULD CHANGE THE RATING DOWN

Given repeated large debt maturities over 2019-2023 and Sri Lanka's already high exposure to refinancing risk, Moody's would consider downgrading the rating if external and domestic financing conditions were to deteriorate further than currently expected. In particular, a larger drain on foreign exchange reserves would increase the risk of lower capital inflows and sharply raise refinancing costs. This would contribute to repayment stresses that would be more consistent with a B3 rating.

Moody's would also consider downgrading the rating if the government were to reverse recent reforms or to halt implementation of future reforms to address fiscal and external vulnerabilities and bolster GDP growth potential. That would lead to much wider fiscal deficits, larger gross borrowing requirements and higher government debt than Moody's currently projects, weighing on already very low fiscal strength and further heightening liquidity risks.

This credit rating and any associated review or outlook has been assigned on an anticipated/subsequent basis. Please see the most recent credit rating announcement posted on the issuer's page on www.moodys.com, under the research tab, for related economic statistics included in rating announcements published after June 3, 2013.

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The principal methodology used in this rating was Sovereign Bond Ratings published in November 2018. Please see the Rating 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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