MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Sri Lanka's rating to Caa2; outlook stable

28 Oct 2021

Singapore, October 28, 2021 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Sri Lanka's long-term foreign currency issuer and senior unsecured debt ratings to Caa2 from Caa1 under review for downgrade. The outlook is stable. This concludes the review for downgrade initiated on 19 July 2021.

The decision to downgrade the ratings is driven by Moody's assessment that the absence of comprehensive financing to meet the government's forthcoming significant maturities, in the context of very low foreign exchange reserves, raises default risks. In turn, this assessment reflects governance weaknesses in the ability of the country's institutions to take measures that decisively mitigate significant and urgent risks to the balance of payments.

External liquidity risks remain heightened. A large financing envelope that Moody's considers to be secure remains elusive and the sovereign continues to rely on piecemeal funding such as swap lines and bilateral loans, although prospects for non-debt generating inflows have improved somewhat since Moody's placed Sri Lanka's rating under review for downgrade. Persistently wide fiscal deficits due to the government's very narrow revenue base compound this challenge by keeping gross borrowing needs high and removing fiscal flexibility.

The stable outlook reflects Moody's view that the pressures that Sri Lanka's government faces are consistent with a Caa2 rating level. Downside risks to foreign exchange reserves adequacy remain without comprehensive financing and narrow funding options. Should foreign exchange inflows disappoint, default risk would rise further. However, non-debt generating inflows particularly from tourism and foreign direct investment (FDI) may accelerate beyond Moody's current expectations, which, coupled with the track record of the authorities to put together continued, albeit partial, financing, may support the government's commitment and ability to repay its debt for some time.

Sri Lanka's local and foreign currency country ceilings have been lowered to B2 and Caa2 from B1 and Caa1, respectively. The three-notch gap between the local currency ceiling and the sovereign rating balances relatively predictable institutions and government actions against the very low foreign exchange reserves adequacy that raises macroeconomic risks, as well as the challenging domestic political environment that weighs on policymaking. The three-notch gap between the foreign currency ceiling and local currency ceiling takes into consideration the high level of external indebtedness and the risk of transfer and convertibility restrictions being imposed given low foreign exchange reserves adequacy, with some capital flow management measures already imposed.

RATINGS RATIONALE

RATIONALE FOR THE DOWNGRADE TO Caa2

Moody's initiated a review for downgrade on Sri Lanka's ratings to assess the prospects for significant external financing to materially and durably lower the risk of default stemming from the country's very low foreign exchange reserves adequacy. Although the potential for non-debt generating inflows has increased somewhat in recent months, the improvement in tourism and FDI prospects is highly tentative. At the same time, a large external financing envelope that Moody's considers to be secure remains highly unlikely. In turn, external liquidity risks for Sri Lanka's government will remain heightened over the coming years, raising the risk of default.

Sri Lanka's foreign exchange reserves adequacy has fallen further since Moody's initiated the review. Foreign exchange reserves (excluding gold and SDRs) amounted to $2 billion as of the end of September, compared to $3.6 billion as of the end of June and $5.2 billion at the beginning of the year. The reserves are sufficient to cover only around 1.3 months of imports and are significantly below the government's external repayments of around $4-5 billion annually until at least 2025.

Moody's baseline scenario continues to assume that the authorities will manage to obtain some foreign exchange resources and financing through a combination of project-related multilateral financing, official sector bilateral assistance including central bank swaps, commercial bank loans, the divestment of state-owned assets, and measures by the Central Bank of Sri Lanka (CBSL) to capture some export receipts and remittances. However, the amounts are generally modest, the arrangements piecemeal, and of relatively short maturity besides multilateral funding for project loans.

Meanwhile, ongoing efforts under the authorities' six-month roadmap to promote macroeconomic and financial stability will likely boost FDI somewhat, and the reopening of international borders without quarantine requirements for fully vaccinated travellers will support the gradual recovery of tourism-related receipts. However, while Sri Lanka's potential suggests that sizeable foreign exchange receipts could be generated, this potential has remained only partially realised for many years and realising it now is subject to the confidence and risk appetite of investors and travellers, both of which are highly uncertain.

Therefore, although reserves are likely to rise slightly over the next few months on the back of some of these inflows materialising, Moody's expects them to remain insufficient to provide a buffer to meet the government's external repayment needs.

Meanwhile, Moody's assumes that Sri Lanka will not participate in a financing programme with the International Monetary Fund or other multilateral development partners for the foreseeable future, while international bond markets remain prohibitive as a source of external financing.

Heightened liquidity risks are compounded by Moody's expectation that the government's fiscal deficit will remain wide over the next few years, which will keep borrowing needs high and remove fiscal flexibility.

Although government revenue is likely to rebound alongside the economy -- Moody's projects real GDP will grow by an average of around 5% in 2022-23 -- it will stay low in the absence of revenue reforms. Moody's estimates that revenue will remain around 10% of GDP over the next few years. At the same time, interest payments will continue to absorb around 60-70% of revenue, leaving the government with politically challenging tradeoffs in rationalising across social spending and development expenditure. As such, Moody's sees limited prospects for meaningful expenditure cuts, implying still wide fiscal deficits of 8.0-8.5% of GDP in 2022-23, compared to an average of 5.7% over 2016-19.

The wide deficits correspond to a gross borrowing requirement of around 25-27% of GDP per year over 2022-23. While Moody's assumes that the government can continue to access local currency financing given the size of the domestic savings pool and excess domestic liquidity in the banking system, this comes at a cost on the overall interest bill and does not address foreign-currency debt repayments.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's view that the pressures that Sri Lanka's government faces are consistent with a Caa2 rating level.

The risk that foreign exchange reserves will continue to fall and increase the likelihood of default remains material, since the foreign exchange inflows available so far are generally piecemeal in the case of swaps and bilateral loans, and uncertain in the case of non-debt generating inflows. That said, the authorities have a track record of securing some financing, even if only partial and at some cost, to support the government's commitment and ability to repay its external debt.

Moreover, notwithstanding the significant uncertainty as discussed above, foreign direct investment and in particular tourism-related receipts have the potential to accelerate in an upside scenario and supplement the authorities' ability to keep default at bay. For tourism, the relatively high vaccination rate compared to emerging market and regional peers may support a quicker recovery in arrivals compared to Moody's baseline assumptions. For foreign direct investment, the country's status as a growing regional hub for transport and logistics as well as financial and technological services -- helped by free trade agreements with large neighbouring countries such as India and Pakistan -- may support long-term inflows, although as mentioned above this potential has remained only partially realised for some time.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Sri Lanka's ESG Credit Impact Score is highly negative (CIS-4), reflecting its highly negative exposure to environmental and social risks. Ongoing challenges to institutional and policy effectiveness and a very high debt burden constrain the government's capacity to address ESG risks.

The exposure to environment risk is highly negative (E-4 issuer profile score). Variations in the seasonal monsoon can have marked effects on rural household incomes and real GDP growth: while the agricultural sector comprises only around 8% of the total economy, it employs almost 30% of Sri Lanka's total labour force. Natural disasters including droughts, flash floods and tropical cyclones that the country is exposed to also contribute to higher food inflation and import demand. Moreover, ongoing development projects to improve urban connectivity have increased the rate of deforestation, although the country continues to engage development partners to preserve its natural capital, such as its mangroves.

The exposure to social risk is highly negative (S-4 issuer profile score). Balanced against Sri Lanka's relatively good access to basic education, which has continued to improve throughout the country in the post-civil war period, are weaknesses in the provision of some basic services in more remote and rural areas, such as water, sanitation and housing. As the country's population continues to grow, the government will face greater constraints in delivering high-quality social services and developing critical infrastructure amid ongoing fiscal pressures.

The influence of governance is highly negative (G-4 issuer profile score). While international surveys point to stronger governance in Sri Lanka relative to rating peers, including in judicial independence and control of corruption, institutional challenges are significant, particularly in the pace and effectiveness of reforms. Domestic political developments also tend to weigh on fiscal and economic policymaking.

GDP per capita (PPP basis, US$): 13,223 (2020 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -3.6% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.6% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -11.1% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.3% (2020 Actual) (also known as External Balance)

External debt/GDP: 61.0% (2020 Actual)

Economic resiliency: ba2

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

On 25 October 2021, 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 institutions and governance strength, have not materially changed. 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.

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

The Caa2 rating takes into account a non-negligible probability of default. The rating would likely be upgraded if the risk of default were to diminish materially and durably. This could stem from the government delivering a credible and secure medium-term external 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 mobilisation, that pointed to a material narrowing of fiscal deficits in the next few years and contributed to lower annual borrowing needs, would also be credit positive.

The rating would likely be downgraded if the prospects for foreign exchange inflows were to significantly weaken, resulting in a further deterioration in foreign exchange reserves adequacy and leading to a higher probability of default or greater risk of material losses should default occur than consistent with a Caa2 rating. Additionally, a further rise in the government's debt burden and weakening in debt affordability from already very weak levels that constrained its ability to finance itself domestically 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 . Alternatively, 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.

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.

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The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website www.moodys.com.

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

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288235 .

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

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on www.moodys.com.

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