

Sri Lanka economy update: November 2020

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An update on the economy of Sri Lanka during January to September 2020 has been presented here where the domestic economic situation, external sector scenario, fiscal position, banking and monetary policy stance have been analysed. For a few indicators like inflation and interest rates, the data upto October is also available and the same has been presented below. Key developments like rating action by Fitch Ratings, announcement of Budget 2021 and Monetary policy announced in November have also been discussed. The update also provides a brief overview of the recently concluded parliamentary elections in the country.

Highlights:

Rating action – Downgrade by Fitch Ratings

- **Fitch Ratings has downgraded Sri Lanka’s long term foreign currency issuer default rating to “CCC”.**
- The downgrade reflects Sri Lanka’s increasingly challenging external debt position over the medium term. There has been a sharp increase in debt to GDP ratio associated with the coronavirus outbreak and narrowing financing options. Fitch ratings believe that the risks to the government’s ability to meet its external debt servicing obligations have increased.
- The government's external-debt obligations amount to \$23.2 billion between 2021 and 2025 or about \$ 4 billion annually, against FX reserves at end-October of just \$ 5.9 billion.
- The Ministry of Finance has issued a press release wherein they do not accept this downgrade as it fails to recognize the robust policy framework of the new Government for addressing the legacy issues and ensuring ongoing economic recovery and macroeconomic stability.

Budget announcements:

- **The Budget 2021 target fiscal deficit of 8.8% of GDP in 2021 with a revised target of 7.9% of GDP for 2020 and expect fiscal deficit to remain above 8% through 2023** in light of persistently adverse fiscal dynamics and slow economic recovery.
- The government expects the debt to GDP ratio to increase to 100% of GDP in 2020-21 and only begin to gradually decline in subsequent years.
- **The government expects Sri Lanka’s economy to contract by more than 3% in 2020** with prospects of gradual rebound in 2021 increasingly at risks given renewed spread of coronavirus and lockdown measures globally.

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- **Medium term macro-fiscal framework** – Targets a reduction in the fiscal deficit to 4% of GDP and debt to GDP to 75.5% by 2025. This goal is supported by medium term goals of real GDP growth at 6% and revenue – GDP over 14%.
- **Tax measures:**
 - A 50% tax exemption for local Companies listed in the Colombo Stock Exchange until December 31, 2021
 - A 50% income tax exemption to local companies if they register before 31 December 2021 to be listed in the Stock Market
 - Value Added Taxes kept unchanged at 8% for businesses that record a turnover of more than 25 million a month except for bank, finance and insurance companies
 - Tax exemption on dividends of foreign companies for three years, if the money is invested in Sri Lankan sovereign bonds or in the stock market.
 - 5 year tax relief for private educational institutions

Central Bank Policy Announcement – November 25, 2020

- **The Monetary Board of the Central Bank of Sri Lanka decided to maintain the Standing Deposit Facility Rate (SDFR) at 4.5% while Standing Lending Facility Rate (SLFR) at 5.5% respectively. The Board has also continued with its prevailing monetary policy stance.**
- The Board noted the decline in overall market lending rates, following the unprecedented monetary easing measures taken by the Central Bank thus far during the year, and stressed the need for continued downward adjustment in lending rates to boost economic growth in the absence of demand driven inflationary pressures.
- The Sri Lankan economy was seen as having recovered strongly during the third quarter of 2020, before the disruptions caused by the second wave of COVID-19.
- Complementing the concessional loans schemes proposed by the Government in the Budget 2021, the Monetary Board decided to introduce a maximum interest rate on mortgage backed housing loans obtained by salaried employees from licensed banks. Accordingly, licensed banks will be made to charge only 7% per annum for such loans, at least for the first five years of the loan tenure. The remaining tenure of the loan is to be charged at the monthly Average Weighted Prime Lending Rate (AWPR) plus a margin of up to 1 percentage point.

Real economy

a. GDP growth

- In the first quarter of 2020, Sri Lanka's real GDP growth fell by (-)1.6% compared with 3.7% growth in the corresponding quarter last year. This was the first economic contraction since Q3-2003 as the COVID—19 pandemic and the associated containment measures weighed on the economic activities.
- **The IMF's outlook for Sri Lanka suggests the economy is likely to contract by 4.6% in 2020 and recover to 5.3% in 2021.** The IMF has projected a medium term forecast of 4.8% in 2025.

b. Industrial Production – increases in September 2020

- Industrial production, measured by IIP, rose by 1.1% in September 2020 with the growth during the month primarily on account of double digit growth seen in textiles (27.9%), tobacco products (25.7%), printing and recorded media (61.4%), basic metals (30.9%) and chemicals (30.8%). There are some segments of the IIP index which have seen negative growth during September (YoY) as well which include wearing apparels (-19.1%), wood (-19.3%) and electrical equipment (-11%).

c. Inflation – moderates in October

- Retail inflation (NCPI yoy%) eased to 5-months low of 5.5% in October 2020 compared with 5.6% in October 2019 and 6.4% in the previous month. Food inflation has eased sharply from 12.7% in September (yoy) and 10.6% in October 2020 (yoy). Inflation in the non-food component stood at 1.5% in October, compared with 4.3% in the corresponding month last year and 1.4% in September 2020.

d. Purchaser Manager's Index (PMI) – sharp deterioration

- PMI for Manufacturing dipped sharply to 40.3 in October 2020 compared with 59.8 in September 2020 and 57.6 in the corresponding month last year. PMI services have also fallen to 41.8 in October 2020 compared with 54.3 in the previous month. Both the PMI-manufacturing and services are in the contraction zone after 4 consecutive months of expansion on account of normalizing of economic activities.

External sector

a. Trade and current account – Exports pick-up while imports continue to register negative growth

- **Exports** grew by 4.8% in October 2020 compared with 0% growth recorded in the corresponding month last year and contraction of (-)8.3% in September 2020. Exports during January to September 2020 were \$7.5 bn which is 17% lower than corresponding period last year.
- **Imports** fell by 10.9% in October 2020, 7th consecutive month of negative growth. During January to September 2020, imports were \$11.8 bn, 19.3% lower than corresponding period last year.
- Trade balance in September 2020 was (-)\$525 mn compared with (-)\$757 mn in September 2019. Trade balance during Jan-September 2020 was (-) \$4.3 bn compared with (-) \$5.6 bn during corresponding period last year.
- In the first half of 2020 (Jan-Jun), Sri Lanka recorded a current account deficit of 792 mn as against a current account deficit of 351 mn in the corresponding period last year.
 - Worker's remittances for the period Jan-October 2020 were \$5.6 bn, 2.6% higher than corresponding period last year.

b. Exchange rate

- The average Sri Lankan rupee/ USD exchange rate was Rs 184.43 in October 2020, depreciated by 1.6% compared with corresponding month average last year.
- Based on the latest available data, during the year up to 27th November 2020 the Sri Lankan rupee depreciated against the US dollar (1.9%). Given the cross currency exchange rate movements, the Sri Lankan rupee appreciated against the Indian rupee (1.5%) while depreciating against the Euro (7.7%), the Japanese yen (6.1%) and the pound sterling (3.6%) during this period.

Government fiscal position

- The government fiscal deficit for Jan-July 2020 was Rs 872 bn, almost 27% more than corresponding period last year. The widening of fiscal deficit is largely on account of lower tax revenues. Tax revenues have declined by 29% during this period. Revenue expenditure rose by 8.5% while capital expenditure declined by 51.7% during Jan-July 2020.
- As per World Bank, the central government debt-to-GDP ratio rose to over 90% (from 86.9% at end 2019), with more than half of the debt denominated in foreign currency.

Interest rates

- Both lending rates (weighted average prime lending rate) and deposit rates have seen a notable decline since the start of the fiscal and corresponding month last year. Lending rates have fallen from 9.68% in Jan 2020 to 5.85% in October 2020 largely on account of the cut in the policy rates by the Central Bank of Sri Lanka. Weighted average deposit rates have declined at a slower pace from 8.14% in Jan 2020 to 6.23% in October 2020.

Banking

- Total outstanding deposits (of only domestic business units) for the month ended September 2020 recorded a growth of 18% from September 2019. Total outstanding credit as of September 2020 grew by 17.2% from last year.

Table 1: Summary Table

Variable	Unit	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20
IIP	YoY%	-13.7	2.4	-9	1.1	
PMI – Mfg	Index	67.3	64.6	57.9	59.8	40.3
PMI- Services	Index	50.4	51.4	56	54.3	41.8
NCPI (Retail inflation)	YoY%	6.3	6.1	6.2	6.4	5.5
NCPI (Food inflation)	YoY%	13.6	12.9	13.2	12.7	10.6
Export growth	YoY%	-17.5	8.7	-8.3	4.8	
Import growth	YoY%	-24.6	-24.6	-18.1	-10.9	
Exports	\$ mn	894	1,085	947	1,000	
Imports	\$ mn	1,055	1,294	1,289	1,525	
Trade balance	\$ mn	-161	-209	-342	-525	
Forex reserves	\$ mn	6,693	7,102	7,440	6,652	5,858
SDF rates	%	5.5	4.5	4.5	4.5	4.5
SLF rates	%	6.5	5.5	5.5	5.5	5.5
1 year Tbill rates	%	5.7	4.9	4.9	4.88	4.96
Deposit rates	%	7.4	7.2	6.7	6.44	6.23
Lending rates	%	8.5	7.5	6.7	6.45	5.85
Deposit growth	YoY%	12.3	14.0	16.3	18.0	
Domestic credit	YoY%	15.1	16.8	17.5	17.2	

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