Sri Lanka: Recent Economic Trends
Agenda

- Summary
- Economic Growth
- Inflation and Monetary Policy
- External Account
- Fiscal Scenario of Government of Sri Lanka (GoSL)
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Summary

- Real GDP recorded an improved growth of 3.7% in Q1 CY2019 from 1.8% in Q4 CY2018, led by healthy performances from the agriculture, industrial and services sector.
- ICRA Lanka expects GDP growth to slow down to 2.5%-3.0% in CY2019 from 3.2% in CY2018 led by the drop in tourism arrivals and spending following the April terror attacks.
- Headline inflation mildly rose to 2.2% in July CY2019 from 2.1% in June 2019; inflation has been moderate during CY2019, driven by the base effect led disinflation in food prices.
- A favourable inflation outlook and the modest economic growth prospects, prompted the Central Bank of Sri Lanka (CBSL) to reduce policy rates in May 2019 and August 2019, in total by 100 bps, in order to accelerate economic growth.
- A contracting trade deficit continues to support the LKR in CY2019, although the loss of tourism earnings and capital outflows from government securities have led to some near-term depreciation pressure. The LKR has appreciated by ~1% relative to the US$ so far this year.
- The tourism sector is expected to recover in the near term, boosted by promotional campaigns. In terms of the current industry outlook, the drop in tourism earnings may be ~US$ 0.5 to 1.0 billion in CY2019.
- The Balance of Payments (BoP) recorded a surplus of US$ 1.8 billion in H1 CY2019 from the US$ 1.1 billion surplus recorded in the same period last year, driven mainly by a 37% contraction in the trade deficit and sovereign bond issuances amounting to US$ 4.4 billion.
- The budget deficit has widened by 45% year on year (YoY) during Jan- April 2019, due to a decrease in tax revenue, higher recurrent spending and growth in capital expenditure. The support given to the tourism industry, compensation payments due to recent events and additional welfare measures ahead of the Presidential election may weigh on the fiscal deficit in CY2019.
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Real GDP growth has been lacklustre in recent years

- Real GDP growth picked up pace to 3.7% in Q1 CY2019 from 3.2% and 3.4% in CY2018 and CY2017, respectively.
- Real GVA growth improved to 3.8% in Q1 CY2019 from 3.6% and 3.4%, respectively in CY2018 and CY2017.
- The real GVA growth of 3.8% in Q1 CY2019, was supported by the expansion in the services (+4.1%) agriculture (+5.5%), and industrial (+3.0%) sectors
- The composition of the GDP in Q1 CY2019, continues to reflect the dominant contribution from the services sector (54% of GDP), followed by industry (32%) and agriculture (7%). Taxes less subsidies accounted for 8% of the GDP.

Source: Department of Census and Statistics, GoSL; ICRA research
Growth improves overall in Q1 CY2019

YoY Growth of GDP and GVA at basic prices stood at 3.7% and 3.8%, respectively, in Q1 CY2019

- The YoY GDP growth rose to 3.7% in Q1 CY2019 from the modest growth of 1.8% in Q4 CY2018
- The YoY GVA growth recovered to 3.8% in Q1 CY2019 from 2.1% in Q4 CY2018, led by the faster pace of growth in the agriculture, services and industrial sectors.
- ICRA Lanka expects the terror attacks of April 2019, which significantly impacted the tourism and other related sectors, to weigh upon growth in CY2019. Moreover, the heightened political uncertainty in the run – up to the Presidential election this year could dampen investor sentiment and policy decision making, further constraining the growth outlook.

Source: Department of Census and Statistics, GoSL; ICRA research
Sequential YoY growth recorded in the agriculture, services and industrial sectors in Q1 CY2019

The agriculture sector has indicated strong recovery in the recent quarters, owing to favourable weather

- The agriculture sector continued to record a robust growth of 4.5% and 5.5% in Q4 CY2018 and Q1 CY2019, led by the significant expansion in Rice and Oleaginous Fruits including Coconut.
- The services sector recorded a growth of 4.1% in Q1 CY2019 from 4.3% in Q4 CY2018; the fastest growing sub-sectors in Q1 CY2019 were Telecommunication, Information Technology Services and Financial Services (growth of +15.1%, +11.7%, +9.8% respectively)
- The industrial sector expanded by 3.0% in Q1 CY2019 in contrast to the 3.6% de-growth in Q4 CY2018, partly reflecting the trend for Construction (+6.9% growth). Industrial growth in Q1 CY2019 was also led in absolute terms by the Coke and Petroleum Products, Mining and Quarrying, and Food and Beverage subsectors (YoY growth of 94.8%, 5.8%, and 2.3% respectively).

Source: Department of Census and Statistics, GoSL; ICRA research
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National Consumer Price Index inflation (NCPI) was subdued in H1 CY2019

Headline inflation has remained below 4% since February 2018

- Headline NCPI inflation was modest at 2.1% in CY2018, and has increased mildly to 2.6% in H1 CY2019, led by Non Food inflation
- Nonetheless, disinflation in the Food category led by the base effect has contributed towards subdued inflationary pressure in the past few months
- The twelve month moving average inflation has remained low in CY2019 and recorded a downtick to 1.9% in July 2019 from 2.0% in June 2019 and May 2019
- Inflation is forecast by the CBSL to remain in the lower bound of the 4-6% range during the remainder of CY2019, supported by favourable supply side conditions, well anchored inflation expectations, and appropriate inflation targeting measures.

Source: Department of Census and Statistics, GoSL; ICRA research
NCPI inflation and core inflation stood at 2.2% and 6.1%, respectively in July 2019

- NCPI inflation recorded a slight uptick to 2.2% in July 2019 from 2.1% in June 2019, although lower than the 3.5% and 3.6% recorded, respectively, in May and April 2019.
- Food items recorded a disinflation of 2.9% and 2.5%, respectively, in June 2019 and July 2019; the favourable domestic conditions are expected to keep Food inflation low in the near term.
- In contrast, Non-Food NCPI inflation has trended upwards and stood in the range of 6.0% - 7.5% in the period January – July 2019, compared to the 2.5% - 4.5% range, in the same period last year.
- The NCPI core inflation (which reflects underlying inflation, excluding food, energy and transport) stood at 6.1% in July 2019 and June 2019, from 5.1% in January 2019.

Source: Department of Census and Statistics, GoSL; ICRA research
Non-Food NCPI inflation has risen in 1H CY2019 relative to CY2018

Most non-food categories have indicated higher inflation in Q2 CY2019

- Inflation for alcoholic beverages and tobacco eased to 12.9% in July 2019, from 13.4% and 14.9%, respectively, in June 2019 and May 2019; inflation in this group remained relatively elevated in H1 CY2019, in comparison to the same period last year.

- Healthcare inflation has been elevated, although fairly stable (in the range of 8.0-9.0%) in CY2019.

- Inflation in restaurants and hotels dipped to 5.0% in July 2019 from 5.5% in June 2019. The recent reduction in hotel rates may ease inflation in this group, in the near term.

- The inflation for miscellaneous goods and services recorded a downtick to 6.4% in July 2019 from 6.9% and 7.0%, respectively, in June 2019 and May 2019.

Source: Department of Census and Statistics, GoSL; ICRA research
Subdued global oil prices have helped contain inflationary pressure in Q2 CY2019

- Inflation in the housing, water, electricity, gas and other fuels category rose to 8.2% in July 2019 from 7.5% in June 2019, and 1.7% in December 2018, led by the price increases in Housing rent.
- However, transportation inflation has declined to 3.0% in July 2019 from 4.2% in June 2019 and 6.2% in May 2019, partially driven by the recent price decreases in Petrol and Diesal.
- Global crude oil prices have spiked by ~ 20% in September 2019 due to the supply outages in Saudi Arabia, amidst rising Middle East tensions. The outlook on oil prices currently remains indeterminate.

Source: Department of Census and Statistics, GoSL; ICRA research
The LKR has witnessed depreciation pressure subsequent to two rate cuts in CY2019

- Upto April 2019, the LKR had strengthened relative to the US$ led by monetary tightening, contraction in the trade deficit, and improved investor sentiment stemming from more stable political conditions.

- However, following the April 2019 terror attacks and the resulting dent in foreign investor confidence, the LKR has weakened on account of foreign investor outflows.

- Moreover, two policy rates cuts by the CBSL in May 2019 and August 2019, have contributed to an outflow of foreign funds from the government securities market, further laying pressure on the LKR; as on September 06, 2019, LKR has appreciated by 1.2% relative to the US$.

- Although the loss of tourism earnings may create some level of pressure on the LKR in the near term, a contracting trade deficit is expected to negate the impact.

Source: CBSL; ICRA research
Benchmark rates reduced in August 2019 monetary policy review

- The Monetary Board of the CBSL reduced the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 bps to 7.00% and 8.00% in August 2019.
- The reduction in policy rates was in view of the slow-down in private sector credit growth (+7.7% YoY growth in July 2019), modest economic growth outlook and low inflationary environment.
- The yields on government securities have considerably eased in the year to date 2019, subsequent to the two rate cuts totaling 100 bps, in May 2019 and August 2019.
- The rate cuts and imposition of deposit caps by the CBSL on financial institutions in April 2019, in order to accelerate monetary policy transmission, is expected to result in a downward adjustment to commercial lending rates, in the near term.

Source: CBSL; ICRA research.
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Cumulative trade deficit contracts by 37% in H1 CY2019

- Total exports increased to US$ 6.0 billion in H1 CY2019 from US$ 5.7 billion in H1 CY2018, led by growth in textiles and garments (+9.6% to US$ 2.8 billion) and transport equipment (+110.3% to US$ 0.1 billion).
- However, total imports contracted to US$ 9.6 billion in H1 CY2019 from US$ 11.4 billion in H1 CY2018, augmented by the LKR weakness and imports restrictions introduced in CY2018.
- Although most categories of imports declined in H1 CY2019, significant YoY de-growth was observed in Vehicles (from US$ 0.8 billion to US$ 0.3 billion ) and Gold (from 0.4 billion to 2.0 million)
- In view of the improved trade deficit, the GoSL in Mar 2019, removed the restrictions imposed during Aug-Nov 2018, which curtailed the importation of personal vehicles and non essential consumer durables
- The prevailing higher tariffs on vehicles imports and the flexible exchange rate may continue to favourably impact the trade gap in the next few months.

Source: CBSL; ICRA research
Imports contract by 23.1%, while exports grew by 5.8% YoY in June 2019

The pace of growth of merchandise exports improved to 5.8% in Jun 2019 from 4.0% in May 2019, led by textiles and garments exports (to +11.4% from +6.5%)

Merchandise imports have de-grown by -23.1% YoY in Jun 2019 compared to the -3.9% YoY de-growth in May 2019, driven by a contraction in almost all categories of goods.

Cumulatively, exports rose by 4.7%, while imports contracted by -16.1% in YoY terms in H1 CY2019, compared to the growth of 6.2% and 12.7%, respectively, in the same period last year.

The contraction of the merchandise trade deficit in H1 CY2019, has supported an improvement in the balance of payments surplus to US$ 1.8 billion, from US$ 1.1 billion in H1 CY2018.

Source: CBSL; ICRA research
A mild current account surplus was recorded in Q1 CY2019 led by the trade deficit

The merchandise trade deficit reduced to 7.9% of GDP in Q1 CY2019 from 13.0% in Q1 CY2018

- Driven by the contraction in imports, the current account recorded a surplus of US$ 0.4 billion in Q1 CY2019, in comparison to the current account deficit of US$ 0.6 billion in Q1 CY2018.
- The improvement in the current account balance was also augmented by the higher tourism earnings in Q1 CY2019.
- The inflows to the financial account in Q1 CY2019, were led by an international sovereign bond (ISB) issuance, although the positive impact of same was offset by the repayments of borrowings.

Source: CBSL; ICRA research
Tourism sector is expected to rebound

Tourism earnings stood at US$ 4.4 Billion in CY2018

- The terror attacks of April 2019 impacted Sri Lanka’s booming tourism industry with foreign tourist arrivals reducing significantly in the May-July 2019 period.
- The YoY drop in tourist arrivals improved in August 2019 to 28.3% from 46.9% in July 2019, boosted by the Dawoodi Bohra event held in Colombo.
- However, tourism authorities are expecting a fast paced recovery in this sector, with the total tourist arrivals projected at 2.1 Mn in CY2019 (10% drop), compared with the 2.3 Mn arrivals in CY2018.
- In terms of the current outlook on the industry, the loss of tourism earnings may be ~ US$ 0.5 – 1.0 billion in CY2019, as per ICRA Lanka’s estimates.

Source: CBSL; ICRA research
External debt rose to 62.6% of GDP in March 2019

- External debt increased to US$ 54.2 billion (62.6% of GDP) at end-Mar 2019 compared to US$ 52.3 billion (58.7% of GDP) at end-Dec 2018
- The increase in external debt was driven by growth in the stock of debt securities, in particular, the ISB of US$ 2.4 billion issued in Mar 2019
- However, the coverage provided by foreign exchange reserves relative to external debt remained low at 14.1% at end-Mar 2019 from 13.2% at end Dec-2018

P: Provisional
Source: CBSL; ICRA research
General Government debt rises to 64% of external debt in Q1 CY2019

Additional ISB issuances have increased the share of general government debt in external debt

- General Government debt increased to US$34.5 billion at end-Mar 2019 from US$32.0 billion at end-Dec 2018, led by the ISBs issued during the period
- General government debt retained the highest share in total external debt at end-Mar 2019 (~64%), followed by other deposit-taking corporations, except the Central Bank (~13%)

P: Provisional  
Source: CBSL; ICRA research
ISB issuances have improved forex reserves in CY2019

- Foreign exchange (forex) reserves stood at US$ 8.5 billion at end Aug 2019 (US$ 8.9 billion in Jun 2019) augmented by the ISB issuances in Mar 2019 and Jun 2019, amounting to US$ 2.4 billion and US$ 2.0 billion, respectively.
- Two successive rate cuts by the CBSL in CY2019 have contributed towards capital outflows from the government securities market and weighed on reserves.
- As at Jun 2019, reserves were strengthened by the inflows from new ISB issuances (US$ 4.4 billion), 6th tranche of IMF’s Extended Fund Facility (US$ 0.2 billion), long term loans to the GoSL (US$ 0.8 billion), investments in government securities (US$ 0.4 billion) and foreign direct investment (US$ 0.3 billion).

Source: CBSL; ICRA research
Active Liability Management Act (ALMA) may help ease pressure related to re-financing

The high near term debt servicing requirements have drawn urgent policy attention

- The GoSL’s external debt servicing for CY2019 – CY2022 is projected in the range of US$ 3.5-5 billion per annum, which creates a significant re-financing risk
- The GoSL is targeting to meet its external debt servicing in the medium term through fresh ISB issuances and other long term borrowings.
- The formulation of a Medium Term Debt Management Strategy (MTDS) is expected to help smoothen out the GoSL’s liability management, along with the ALMA (enacted in Mar 2018)
- The easing of global interest rates amidst trade tensions is expected benefit the GoSL’s debt servicing, although possible slippages in fiscal consolidation remain a concern

Source: Ministry of Finance; ICRA research
The GoSL’s re-financing requirements have led to the steady issuance of ISBs

- The GoSL has raised US$ 4.4 billion with ISB issuances in March 2019 and June 2019; 14 ISB issuances, aggregating to US$ 17.1 billion have been held since 2007.

- Given the near term fiscal vulnerability (Sri Lanka’s country rating is B2, stable outlook by Moody’s) ISBs have been the preferred method of re-financing due to their longer maturity dates relative to other debt.

- Further, Sri Lanka’s graduation to upper middle income status in the World Bank ranking (in July 2019) has reduced its access to concessionary financing, increasing the dependency on commercial borrowings.

Source: CBSL; ICRA research
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The fiscal targets for CY2019 may be revised

GoSL’s budget deficit moderated to 5.3% of GDP in CY2018 from 5.5% of GDP in the previous year, led by a decrease in public investment expenditure

The budget deficit target of 4.4% for CY2019 is expected to be revised, following the terror attacks which impacted fiscal operations; both government expenditure and revenue generation

The GoSL estimates revenue to come down by ~ LKR 50 billion from sectors such as finance, trade and tourism in CY2019. Further, welfare measures, reconstruction work and interest subsidies on soft loans to the impacted sectors are expected to increase the expenditure in CY2019
Fiscal operations have moderated during the first four months of CY2019

The budget deficit rose to LKR 363 billion in Jan-Apr 2019 from LKR 251 billion in the previous year

- The budget deficit widened YoY in Jan-Apr 2019 in absolute terms, as government revenue de-grew slightly by 3.9%, and expenditure rose by 10.1%
- Total tax revenue has declined by 3.3% in Jan- Apr 2019 (2.9% growth in Jan-Apr 2018), while non-tax revenue has de-grown significantly by 10.3% in the same period (49.5% growth in Jan- Apr 2018) due to the non- receipt of profit transfers from the CBSL.
- Recurrent expenditure has risen by 9.4% in Jan-Apr CY2019 from 9.6% in the same period last year, led by the growth in public sector salaries (+3.9%), interest payments (+9.4%) and pensions (+17.8%)
- Public investment expenditure recorded a healthy YoY growth of 17.0% in Jan-Apr 2019, contributing towards the expansion in the budget deficit

Source: CBSL; ICRA research
GoSL’s current account deficit widened by 45% YoY in Jan- Apr CY2019

- The current account deficit widened to LKR 152.4 billion in Jan-Apr 2019 (despite a targeted surplus of LKR 36.0 billion for CY2019) from a deficit of LKR 63.6 billion in the same period of CY2018, led by a contraction in revenue growth and higher recurrent spending.
- The primary balance recorded a deficit of LKR 66.4 in Jan-Apr 2019, in contrast to the LKR 20.9 billion surplus in Jan-Apr 2018.
- Overall, the budget deficit grew to LKR 363.4 billion in the period Jan-Apr 2019 (at around 53% of the budget target for CY2019), compared with year ago levels of LKR 250.6 billion (around 33% of the CY2018 deficit).

Source: CBSL; ICRA research
**Fiscal consolidation remains a priority**

<table>
<thead>
<tr>
<th></th>
<th>LKR Billion</th>
<th>YoY Growth</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Revenue and Grants</strong></td>
<td>1,840</td>
<td>1,933</td>
<td>2,357</td>
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<tr>
<td>Total Revenue</td>
<td>1,832</td>
<td>1,920</td>
<td>2,344</td>
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<td>Tax Revenue</td>
<td>1,670</td>
<td>1,712</td>
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<tr>
<td>Non Tax Revenue</td>
<td>161</td>
<td>208</td>
<td>267</td>
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<tr>
<td>Grants</td>
<td>8</td>
<td>12</td>
<td>13</td>
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<tr>
<td><strong>Total Expenditure</strong></td>
<td>2,573</td>
<td>2,693</td>
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<td>Recurrent</td>
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<tr>
<td>Capital expenditure</td>
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<td>604</td>
<td>734</td>
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<tr>
<td>Revenue Surplus (+)/Deficit(-)</td>
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<td>-170</td>
<td>36</td>
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<tr>
<td>Budget Surplus (+)/Deficit(-)</td>
<td>-733</td>
<td>-761</td>
<td>685</td>
</tr>
</tbody>
</table>

- Public investment is expected to be maintained at a ~5.0% of GDP, going forward
- The GoSL is targeting lower fiscal deficits (below 5.0%) in line with fiscal consolidation objectives, and also expects to bring down the government debt (debt/GDP ratio is estimated to reduce to 65-75%) in the period CY2020- CY2023

Source: Ministry of Finance; ICRA research
The Central Government debt to GDP ratio stood at 83% at end March 2019

- The Central Government debt to GDP ratio remained stable at 82.8% of GDP at end-Mar 2019 from 82.9% at end-Dec 2018; overall debt stock had risen to LKR 12.3 trillion at end-Mar 2019
- The share of domestic debt in total debt rose mildly to 50.9% in end Mar 2019 from 50.2% at end Dec 2018, while the share of foreign debt dipped to 49.1% from 49.8%,
- The share of commercial debt in total government debt rose to 25.5% at end-Mar 2019, from 24.9% and 19.7% in end-Dec 2018 and end-Dec 2017, respectively. The high debt servicing obligations are expected to further increase the share of commercial borrowings in government debt.

Source: CBSL; ICRA research
Thank you