ICRA LANKA

Insights

October 2021

Pandemic to Endemic | Implications for Sri Lankan Economy

Key Takeaways

- Increasingly, many experts feel transitioning to an endemic is a realistic endpoint for the current pandemic. Endemic means the governments will have to deal with COVID in a more localised fashion while the public will have to continue with the current pandemic-induced lifestyles to some degree.
- Tourism may resume but we are likely to see is a much more restricted form of tourism for some time.
- One inevitable consequence of endemic COVID is heightened expenditure on public health. The government may have to bear considerable cost yearlong due to relatively higher utilization of public health facilities, containment measures, vaccination programme including booster shots, partial lockdowns and so on.
- The legacy of the pandemic may leave permanently higher unemployment and lower wage levels in the economy which would in turn affect the spending power of consumers.
- We expect the demand for services to gradually pick up over the course of the next few months and help to recover consumer spending.
- Overall energy consumption may meet the pre-crisis level with occasional dips (in times of full or partial lockdowns). Consequently, this will push up fuel imports leading to more pressure on the balance of payment situation.
- Trajectory of domestic inflation in the post-pandemic era will most likely be determined by the path of global commodity prices as well as how soon the global supply chain disruptions are going to fade.
- The CBSL has pledged to maintain inflation at mid-single digit level and continue its intervention in the forex market to stabilise exchange rate in its the Six-Month Road Map. Given the limited forex reserves in hand, achieving the above is going to be very challenging. Therefore, we expect tighter monetary policy moving forward.

Future of the Pandemic

The case numbers of the Delta-variant are receding in many countries including in Sri Lanka, and in about another six months, 75% of the world's population is projected to be fully vaccinated strengthening global immunity level [1]. The Delta-variant is the most contagious and the deadliest mutation of the COVID-19 virus so far. Therefore, it is reasonable to assume that the chances of an emergence of another variant that could outperform it would be slim (but not nil). This is echoed by a consortium of researchers advising the US Centers for Disease Control and Prevention which has stated that the worst of the pandemic may be over [2]. In this backdrop, transitioning to an endemic is one possible path for the current pandemic. Increasingly, more and more experts find this to be a more realistic endpoint [3] [4] [5]. Looking ahead, some cautious optimism is on the horizon.

Endemic does not mean COVID is going to go away. It means COVID will stick around longer and the governments will have to deal with it in a more localised fashion while the public will have to continue with the current pandemic-induced lifestyles to some degree. Few countries such as Malaysia, Indonesia, Thailand, and Singapore have either declared or planning to declare COVID as an endemic [6] [7] [8] [9]. On a similar note, countries that follow the 'Zero COVID-19' strategy are facing pressure from the public, and most recently, New Zealand has abandoned it [10]. In September, Norway joined a small but growing number of countries, including Denmark and Britain, to lift all domestic restrictions [11]. Sri Lanka ended the lockdown on 1st October and allowed for gradual reopening.

In this article we set out to investigate how an endemic scenario would play-out in key aspects of the Sri Lankan economy.

Tourism

The economy suffered its worst recession in 2020 and the services sector was the hardest hit as tourism came to an abrupt stop. In the meanwhile, complete loss of tourism receipts pushed the country to a balance of payment crisis.

One of the most crucial factors for economic recovery as it stands is the revival of tourism. Tourism has displayed faster rebound and ability to generate jobs rapidly as demonstrated in the past[1]. Domestic tourism can pick up faster but what is critical for the economy is inbound tourism. Sri Lanka is still in the red or amber list of several key tourist source markets such as the UK and Germany. Revival of inbound tourism is pretty much predicated on how soon these travel advisories/restrictions will be lifted. In any case, it is likely that the tourism industry might not see its former arrival numbers immediately. What we are likely to see is a much more restricted form of tourism for some time. It is too early to predict the extent of the recovery of tourism in 2022 at this moment, but even a partial recovery would help to ease the balance of payment pressure and reduce unemployment. However, Sri Lanka from time-to-time may have to

[1] One example is the LTTE suicide attack on the Bandaranaike International Airport in 2001. Tourist arrivals plummeted by nearly 16% and over 10,000 tourism related jobs were lost in the aftermath. But with the beginning of the cease-fire between the GoSL and LTTE the following year, the arrivals rose by over 70% from the 2000 level, and over 21,000 new jobs were created.

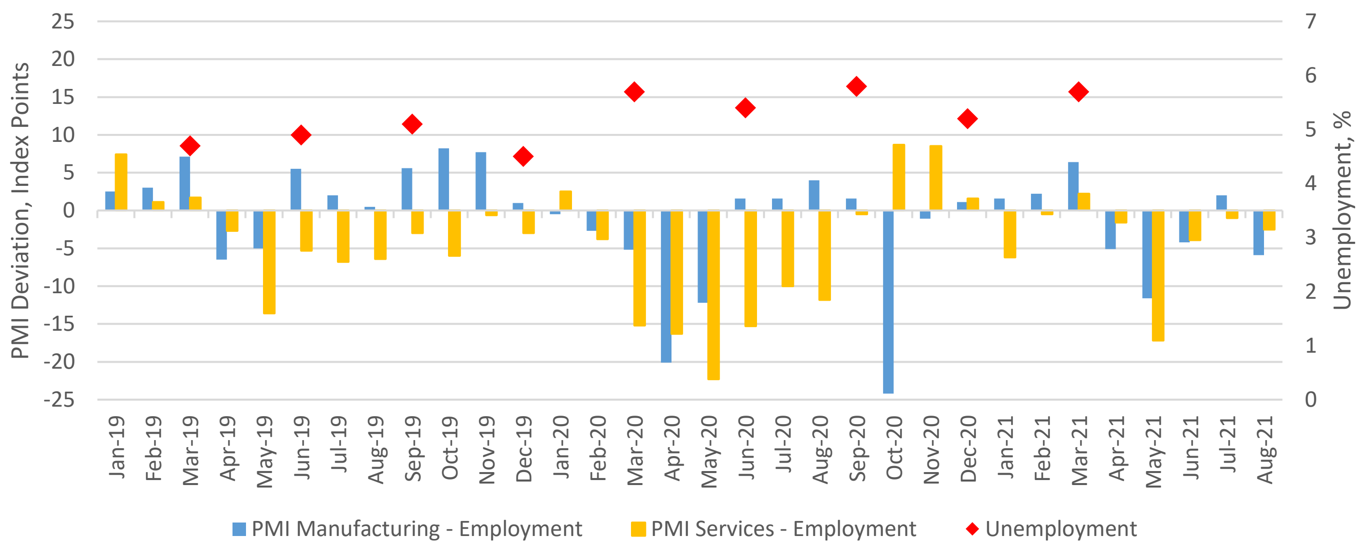
implement border restrictions to shield itself from new variants temporarily interrupting the tourism sector.

Fiscal Sector

On the fiscal front, one inevitable consequence of endemic COVID is heightened expenditure on public health. The government may have to bear considerable cost yearlong due to relatively higher utilization of public health facilities, containment measures, vaccination programme including booster shots, partial lockdowns and so on. LKR 12.8 Bn is allocated to the State Ministry of Primary Health Care, Epidemics and Covid Disease Control in the 2022 Appropriations Bill. To what extent these costs are going to strain the budget deficit depends on how the government is going to finance these.

Labor Market

Figure 1: Employment and unemployment



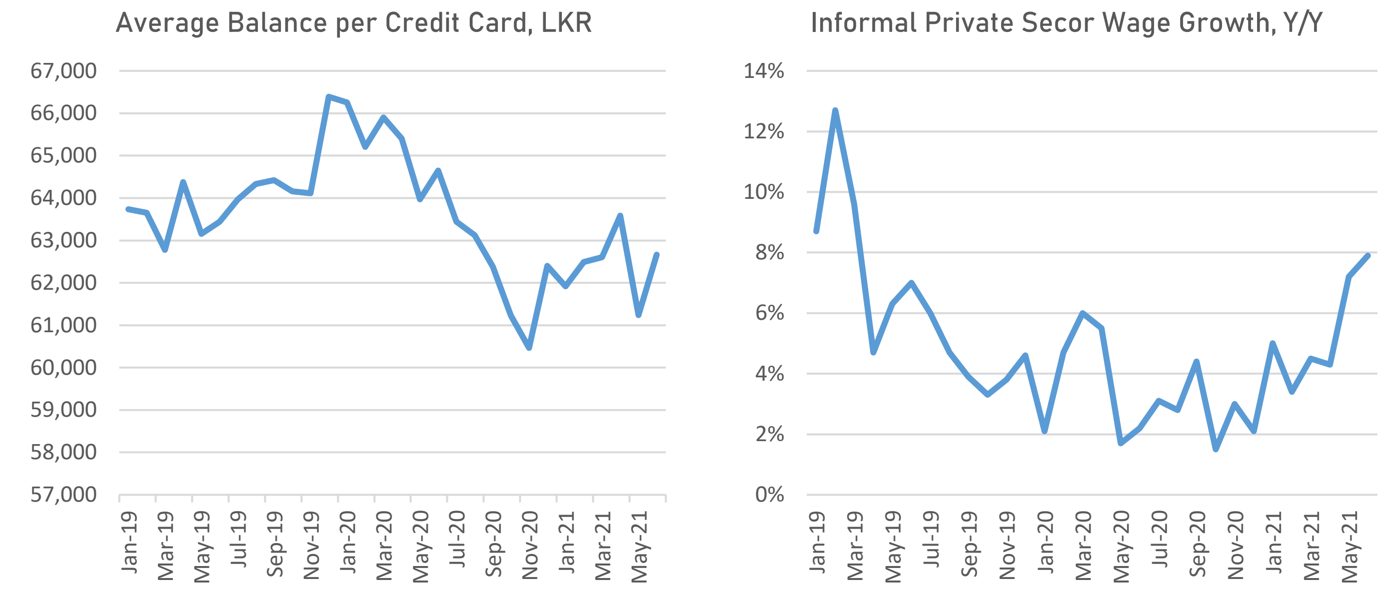
Notes: Purchasing Managers Index (PMI) - negative values indicate the sector is generally contracting on a month-on-month basis while positive values indicate the sector is expanding. The strength of contraction or expansion is manifested by the magnitude of the figure. Index value > 0 means an increase; Index value < 0: decrease; Index value = 0: unchanged. Unemployment figures are for quarterly national unemployment

Source: CBSL, DCS, ICRA Lanka Research

During the first wave of the COVID crisis in 2020, unemployment shot up to 10-year highs as it reached 5.8%. Latest figures as of 1Q 2021 (5.7%), is not very far off from it. Businesses are still not yet confident to beef up their workforce. Furthermore, one big learning from initial waves for businesses is how to operate with minimal staff. Therefore, hirings may remain weak. If the current unemployment level is prolonged enough, that might drive down wages. Fear is whether the legacy of the pandemic would leave permanently higher unemployment and lower wage levels in the economy which would in turn affect the spending power of consumers.

Consumer Spending

Figure 2: Spending power



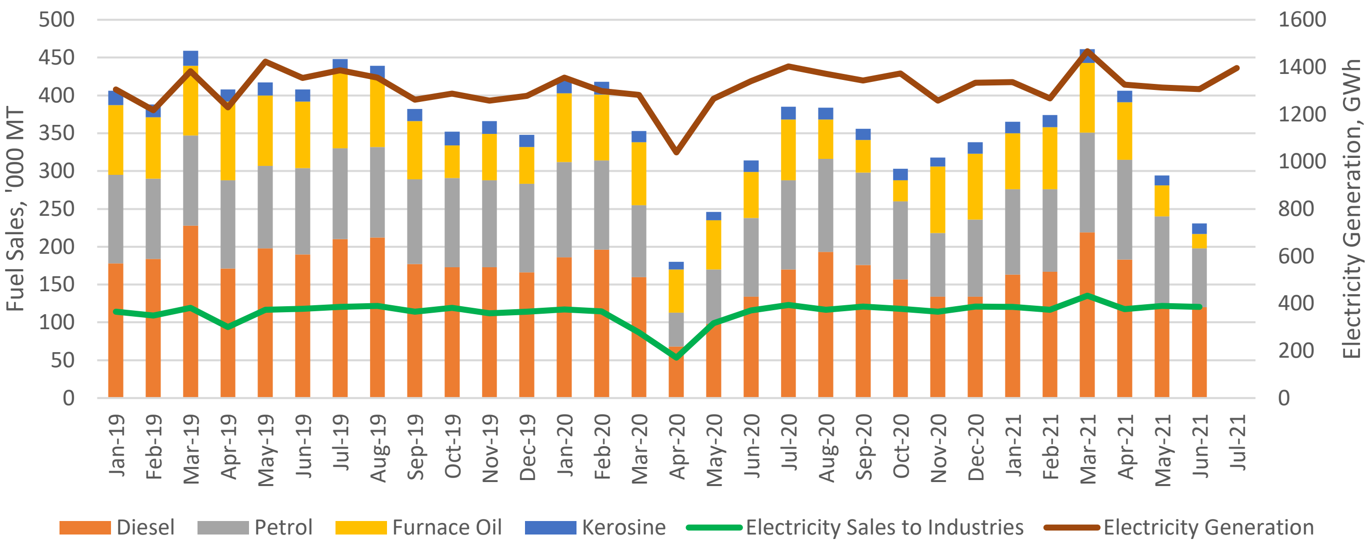
Source: CBSL, ICRA Lanka Research

Consumer spending was weakened amid travel restrictions, social distancing, and lockdowns. Lifting the COVID restrictions does not necessarily mean people are going to flock around shopping malls. A proxy indicator for consumer spending, average balance per credit card is still below the pre-crisis level. We expect the demand for services to gradually pick up over the course of the next few months. It may take months to see full recovery in consumer spending.

Apart from willingness-to-spend, ability-to-spend will also determine how fast consumer spending is going to rebound. Private sector wages decelerated initially as employers were struggling to stay afloat. Latest data show private wages grew on average over 7% a month (Y/Y) from May to July this year, but as the base effect wears off, it will probably moderate. Therefore, consumer spending is expected to be subdued in the medium term.

Energy Demand

Figure 3: Energy consumption trends

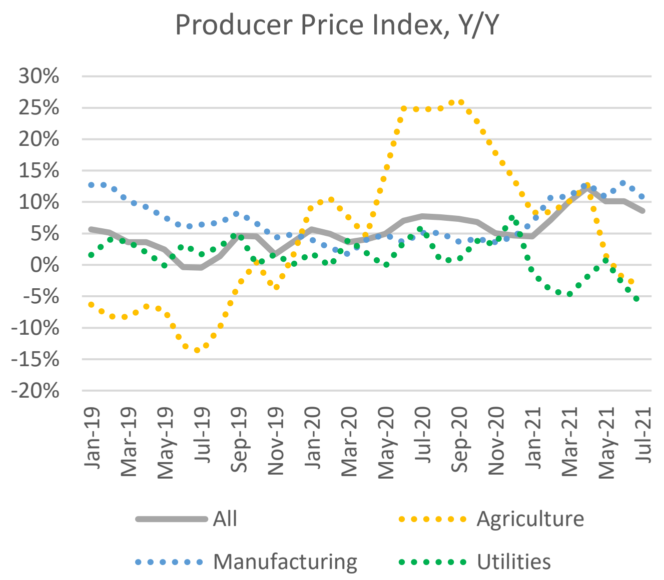


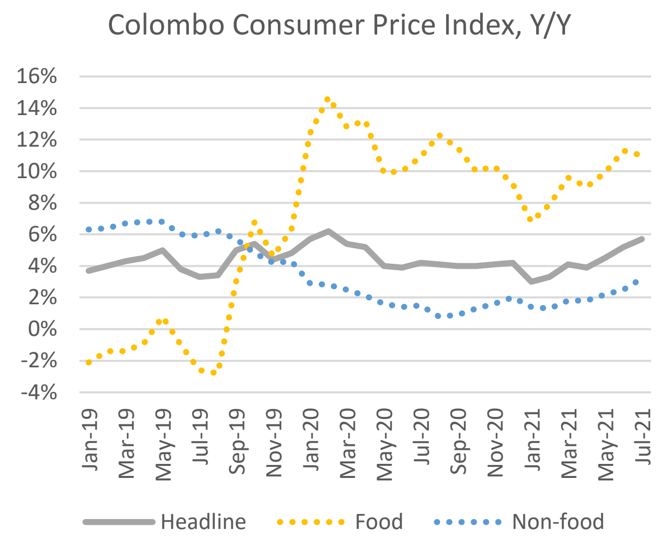
Source: CBSL, ICRA Lanka Research

Understandably, during the periods of lockdowns due to reduced mobility, fuel usage dropped but recovered faster once lockdowns were lifted. Currently, total electricity generation appears to have reached the pre-crisis levels. Industrial electricity usage is more-or-less flat and is on par with the pre-crisis level since July last year indicating the industrial sector is operating with near capacity. All of this points to a period of higher overall energy consumption with occasional dips (in times of lockdowns or partial lockdowns) in the post pandemic era. Consequently, this will push up fuel imports leading to more pressure on the balance of payment situation of the country.

Inflation

Figure 4: Growth in prices





Source: CSD, ICRA Lanka Research

Inflation remained mostly subdued for nearly a year from May last year amid weaker demand. However, as the global commodity markets began to heat up, producers started facing increasing input costs. These costs were passed down to the consumers from this year April onwards. Scarcity of goods rendered by the import restrictions and speculative element that comes with it is also contributing to inflation at the moment.

Trajectory of domestic inflation in the post-pandemic era will most likely be determined by the path of global commodity prices as well as how soon the global supply chain disruptions are going to fade. Endemic does not guarantee smoother supply chains. In fact, the state of the endemic will be highly unequal across countries leading to brief but frequent supply chain disruptions. In addition, pent up demand in developed economies may also add to the commodity inflation pressure but this may be short-lived. In this environment, given the volatile prices, rising shipping costs and supply lags, businesses would compete for resources to maintain higher inventories to absorb shocks feeding in inflation.

In the Six-Month Road Map, the CBSL has acknowledged that there is speculative demand for imports and buildup of inventories but views it more as a threat to the stability of the exchange rate rather than a driver of inflation. In any case, ICRA Lanka welcomes the move to discontinue the cash margin deposit requirement on "non-essential/non-urgent imports", as this was never an appropriate tool to address the underlying challenges.

Monetary Policy

If the endemic scenario is how it is going to be, we should expect frequent but irregular economic cycles in sync with virus flare-ups in the country as well as major trading partners. Domestic energy demand will continue to put pressure on the exchange rate. We expect major central banks around the world to start tightening after the Fed in the 2H 2022. This would leave the CBSL with little room for monetary loosening in the medium term.

From the monetary policy standpoint, the key question is how the CBSL is going to navigate these realities beyond six months. In this context, revival of tourism and the extent of revival will play a crucial role against these headwinds. Channeling remittances through formal channels would be another critical area though it would be challenging if there is a large difference in the exchange rates offered by the formal and informal channels. The CBSL has pledged to maintain inflation at mid-single digit level and continue its intervention in the forex market to stabilise exchange rate in its the Six-Month Road Map. Given the limited forex reserves in hand, achieving the above is going to be very challenging. Therefore, we expect tighter monetary policy moving forward.

Abbreviations

CBSL	Central Bank of Sri Lanka
DCS	Department of Census and Statistics
PMI	Purchasing Managers Index

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