Economic Update

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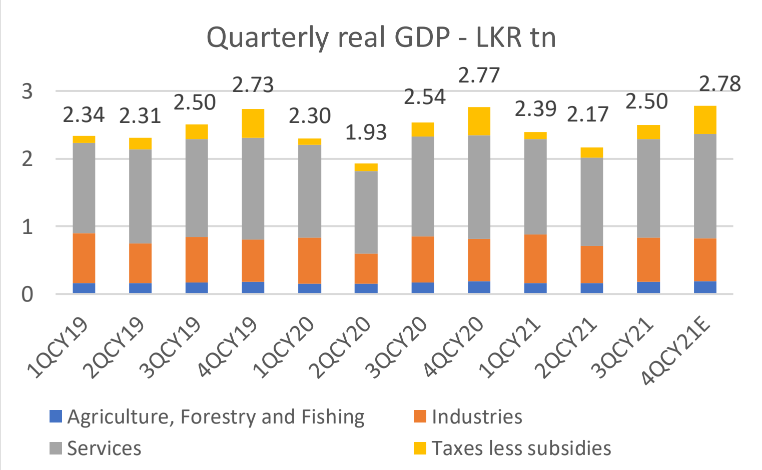
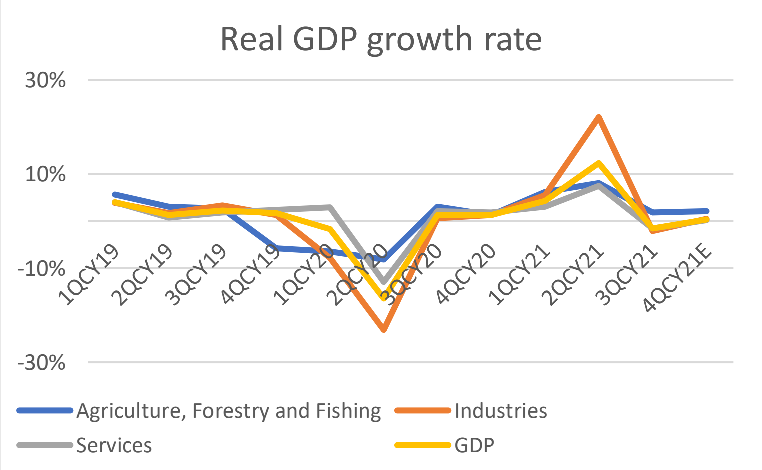
Summary

- **LRA estimates GDP growth rate for CY21 to be 3.3% and for CY22 to be 4.5%.**
- **Double digit inflation levels are expected to continue to mid CY22.**
- **Trade deficit for CY22 is expected to be USD 8 bn of which some would be financed using credit facilities.**
- **Sri Lanka would need significant help from friendly nations to weather the forex crisis this year.**

Real sector



Source – CBSL and LRA calculations



Source – CBSL and LRA calculations

The economy shrunk by 1.5% (YoY) in the 3rd quarter of CY21, after recording a 12.3% recovery in the previous quarter. The largest contributors to this decline were the industries and services sectors which recorded YoY declines of -2.2% and -1.6%. Even though the agriculture, forestry and fishing sector however grew by 1.8%, since its contribution to the GDP is very small, it didn't have a big impact on the overall GDP.

A nationwide quarantine curfew was imposed on the 20th of August which went on until the 1st of October. However, essential services and certain selected sectors were allowed to operate. According to the Department of Census and Statistics, there had been a clear decline in the economic activities, especially in the wholesale and retail trade, manufacturing industry, construction industry, transportation, accommodation & food service and providing of private services.

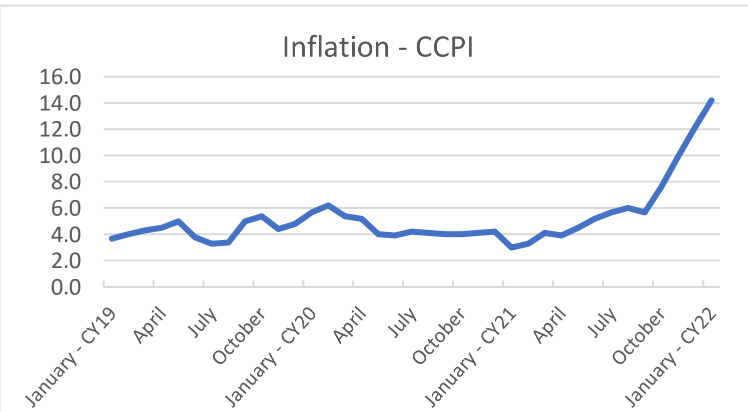
In addition, import restrictions, forex shortages and disruptions in global logistics resulted in certain industries being unable to source their raw material which further contributed to a decline in economic activities.

High inflation, forex shortages and covid related disruptions are woes that the economy carried on to the end of the year and which also affected performance in the last quarter of the year. Therefore, we could expect an annual GDP growth of about 3.3% for the year CY21.

The year CY22 is expected to perform much better because the economy is now open fully and the tourism sector is also expected to boom this year. The IT sector is expected to perform really well this year too. Sri Lanka Association for Software and Service Companies (SLASSCOM) is targeting an annual revenue of USD 5 bn by CY25. The low availability of foreign currency reserves has been hindering certain sectors that require imports as inputs, however with the many credit lines being negotiated we hope that these industries would be able to import their raw materials without an issue this year. Due to the low GDP of ~3.3% recorded in CY21, we expect a GDP growth of about 4.5% for the year CY22.

It should also be noted that there is a high efflux of migrant workers from the country, reducing the labour force available to drive the economy. This has been largely felt by the travel and tourism industry which is finding it difficult to reinstate their workforce to pre-Covid levels. A factor that is hindering Sri Lanka's prospects of maximizing tourism incomes.

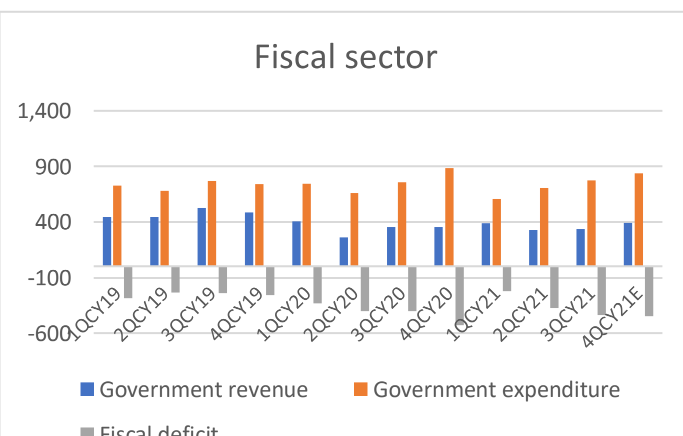
Inflation



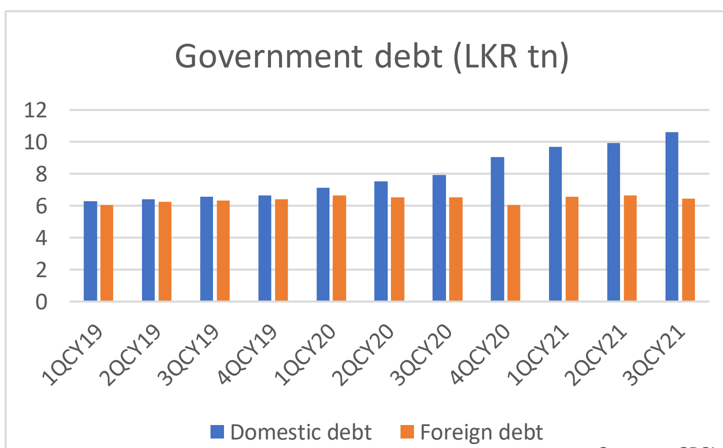
Source – CBSL

Inflation (CCPI) has been rising rapidly since September CY21, hitting double digits in December. CCPI in January 2022 was 14.2%. Inflation woes are expected to continue due to high prices of fuel and other vital imports due to the foreign exchange limitations and supply chain issues. The high inflation is expected to continue to mid CY22 after which it would reduce since the base would be high. Increasing interest rates could curb demand, however it will not be able to resolve supply chain issues.

Fiscal Sector



Source – CBSL and LRA calculations

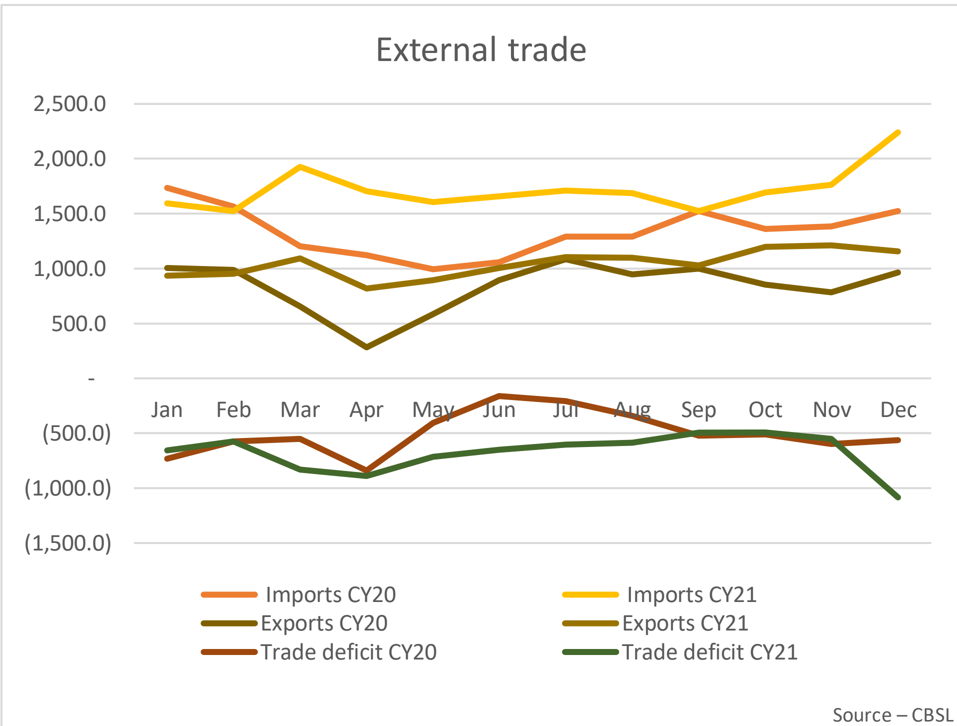


Source – CBSL

Considering the period Jan-Sep CY21, the total government revenue stood at LKR1.1tn, while the total expenditure was LKR 2.1tn, resulting a budget deficit of LKR 1tn (8.35% of GDP). The annual fiscal deficit for the year CY21 is expected to be around LKR 1.5tn.

This deficit would be financed largely with domestic debt since the government has taken a stance to reduce foreign debt as much as possible. Domestic debt at the 3QCY21 end was LKR 10.6tn while the foreign debt stood at LKR 6.5tn (38% of total debt). By September CY21, government debt was 107% of GDP.

External Sector

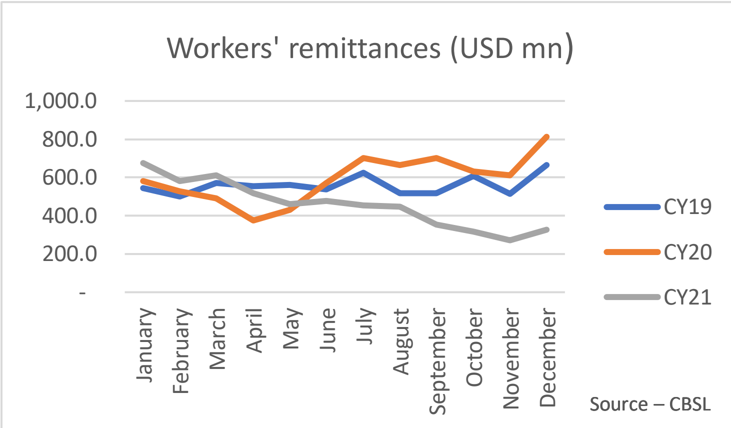


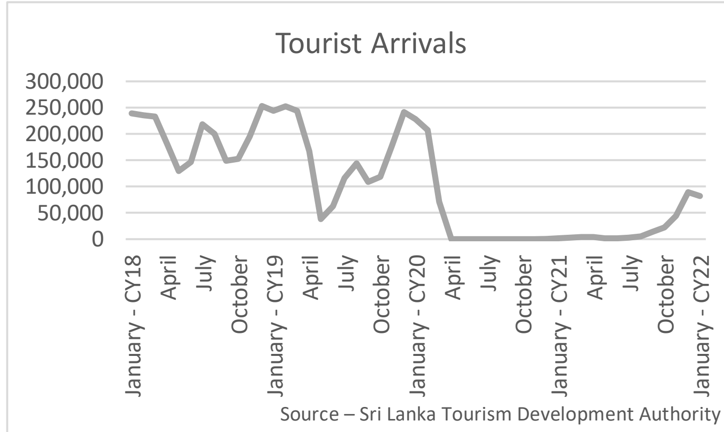
Merchandise exports for the year CY21 was USD 12.5bn a 24.2% increase from the previous year and a 4.5% increase from CY19. It is important to note that while exports during CY20 were low, especially in April with the global economy slowing down due to Covid-19, recording an increase in exports compared to pre-Covid numbers indicates that the external trade sector has settled to a new-normal. Therefore, it is forecasted that exports will be around USD 14.4bn in the year CY22. (USD 21bn including the services sector)

Imports for the year CY21 too have increased from USD 16bn in CY20 to USD 20.6bn. However, imports for CY19 too stood at almost USD 20bn. Trade deficit for the year CY21 was USD 8.1bn up 26.7% since CY20. Imports for the year CY22 are forecasted to be around USD 22.4bn, of which USD 500mn will be financed through the credit line given by India, and a further USD 200mn from the credit line given by Pakistan, resulting in a trade deficit of USD 7.3bn.

Sri Lanka is in the process of negotiating further credit facilities with a few other countries.

Current Account





The current account was hit badly this year due to a widened trade deficit and decline in workers remittances. While tourism picked up in the last quarter of the year, with December recording 89,000 arrivals. The trade deficit for the year was USD 7.6bn which was an increase of 26% from the previous year. However, on a positive note during the final four months of the year, the country managed to reduce its trade balance to match the value recorded for the corresponding months of CY20. It is expected that the current account balance will be a negative USD 3.0bn for the year CY21.

It is estimated that amidst improved exports and restricted imports, the trade balance for CY22 would be around USD 8bn of which USD 700mn will be financed through the credit lines given by India and Pakistan. With about one million tourists expected to visit the country, proceeds from tourism are expected to improve to USD 2.7bn and foreign remittances are expected to be around USD 6.6bn in CY22. This would result in a closing current account balance of negative USD 800mn (after considering the USD 700mn credit lines). While the number of migrant workers from Sri Lanka has been on the rise, it cannot be expected to increase the remittances in the same proportion since most workers have been resorting to unofficial channels due to the higher rates offered.

The government has also stated that it wishes to monetize under-utilized assets, proceeds of which are expected to be around USD 1bn.

Sri Lanka has to pay approximately USD 6.9bn as debt repayments for the year, most of which are Sri Lankan-based loans and bi-lateral loans which are expected to be rolled over. International Sovereign Bond (ISB) payments of USD 1.5bn is due in CY22 of which USD 500mn was paid in January and according to the Governor of the Central Bank, alternative sources would be used to finance the remaining USD 1bn which too would be paid promptly.

Sri Lanka has received support from many friendly nations to weather the ongoing forex crisis and come out strong. In the month of January, the Reserve Bank of India confirmed a USD 500mn currency swap and deferment of USD 515mn due to Asian Clearing Union. India has also confirmed a USD 500mn credit facility for the import of fuel.

The government of Sri Lanka is also pursuing to attract foreign investment in government securities worth about USD 1bn.

At a minimum, if all the expected inflows are received Sri Lanka would have a reserve balance of USD 3.2bn at the end of the year. However, more swaps and further credit facilities are being negotiated other countries and if these or any other arrangements materialize, it would further reduce the pressure on the country's foreign exchange reserves.