# SRI LANKA ECONOMY – TURBULENT TIMES

The global pandemic has amplified deep-rooted economic issues for most of the developing economies. Sri Lanka has been no exception. The country adopted strategies of reduction in taxes and higher public spending and subsidies in 2019. Challenges began to surface in the backdrop of two pandemic-triggered repercussions: i) shrinking foreign currency reserves, and, ii) the global commodity super cycle resulting in very high inflation. The country's foreign currency inflows, besides borrowing from international market, are majorly dependent on tourism activities and workers remittances. Tourist arrivals plunged following the pandemic induced lockdowns and restrictions and only recently started to pick up. Meanwhile, a ~61% YoY decline was recorded in workers' remittances in Jan'22 from Jan'21, despite an increase in the number of migrant workers. Sri Lanka largely relies on imports in most of its essential sectors such as oil, food, and machinery. The country's trade balance deteriorated resulting in a deficit of USD~8bln in CY21, a rise of ~35% from the previous year as growth in imports outpaced exports due to lax policies and low interest rates. This coupled with low inflows, widened the current account deficit and the country's foreign currency reserves plunged dramatically to just USD~1.9bln at End-March'2022 (CY19: USD~8bln), exerting massive pressure on the local currency. The Lankan Rupee has devalued by ~50% till March'22 from March'21. The country's CCPI (inflation) was reported at ~14% in Jan'22 and ~19% in Mar'22. This also led to large protests across the Island as people are unable to get essential items such as fuel, food and medicines. The central bank, in response, tightened the monetary policy by increasing policy rate by a massive 700 bps with SDFR and SLFR standing at record levels of 13.5% and 14.5%, respectively.

On the fiscal side, the country's Debt to GDP ratio rose to ~109% in CY21. Foreign debt represents ~37% of Sri Lanka's total debt standing at USD~51bln at End-March'22. This comprises International Sovereign Bonds (ISBs), followed by bilateral loans from China and India – its principal lenders. Given the low foreign reserves and high upcoming debt repayments, the Government of Sri Lanka declared default on its entire foreign debt. This pre-emptive default has come as a last resort decision so that debt restructuring can be done for all lenders on equal terms. The unpaid interest will be capitalized to the principal and will accrue interest. The Government has decided to approach IMF to seek a bailout package for the restructuring of its external debt over time and provide some breather to the economy. While an arrangement with the IMF is yet to be finalized, LRA believes that economic and political challenges will persist for Sri Lanka, going forward. Meeting tough IMF conditions and reducing subsidies will be difficult. As global commodity prices show no signs of slowing down and pressure on Lankan Rupee is persisting, inflation will remain high in the short-term. Other structural reforms will also be needed and remains contingent on IMF conditions. This uncertainty will impact the GDP growth this year and may be beyond before things start to improve.

The impact of overall economic and political turbulence affects the financial position and performance of the corporate and financial sectors of the economy. This necessitates more vigilance to keep our rating opinions in line with the prevailing environment and incorporate its impact on the credit risk profile of rated entities. We believe that under current circumstances, credit risk is expected to elevate in general, especially for entities that have foreign currency debt. Similarly, entities which are dependent on imported items – at raw material, or finished goods stage – and have limited ability to pass on the increase in costs, would be at high risk of squeezed margins and narrowed profits. Interest rate increase will impact profitability of all entities that have borrowings, particularly those with thin margins. Additionally, financial institutions are to be closely monitored to assess asset quality (high risk of default), liquidity (funding lines and cost of funds) and maturity profile (fixed investments or assets).

LRA is closely monitoring the risk profile of its rated entities and would take entity specific rating actions where needed.



**CONTACT**
aqeela@lra.com.lk, saniya.tauseef@pacra.com
Lanka Rating Agency
+94114500099
www.lra.com.lk