Economic Update

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Saniya Tauseef |Team Lead Research | saniya.tauseef@pacra.com
Aqeela Albar | Research Analyst | aqeela@lra.com.lk

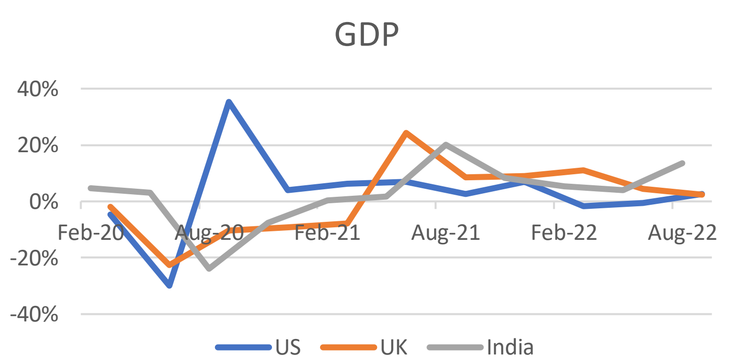
Summary

- **The economy shrunk by 7.0% in 9MCY22. With subdued demand and various supply constraints, the economy moved at a slow pace for the rest of the year, and LRA forecasts a year-end GDP growth rate of -7.8 for 2022.**
- **The world bank forecast for the year 2022 is a decline of 9.2% while the ADB forecasts a decline of 8.8%.**
- **Inflation, which peaked in September, has declined to 57.2% (CCPI) by December 2022. It is expected to decline further in the next few months, reaching single-digit values by the end of 2023.**
- **Export earnings are increasing with import expenditure being controlled well. Export earnings plus remittances have been sufficient to cover the import expenditure since June 2022. Industrial exports (mainly textiles and garments) increased by USD 823 Mn. Imports of investment and other goods declined by USD 1,187 Mn and imports of consumer goods declined by USD 858 Mn.**
- **Many changes were proposed to tax laws with the 2023 budget expecting a 69% increase in tax revenue compared to CY2022E.**
- **Discussions with the IMF have concluded with a staff-level agreement for a USD 2.9bn extended fund facility.**
- **Local government elections, scheduled to take place in March, would push back the economy further with about 2-3 months of deadlock, with the primary focus shifting towards-- the elections.**
- **EU countries deciding to supply heavy weapons to the war in Ukraine, which is expected to escalate, has created further pressure on the global economy which is already suffering from the war. This will add further upward pressure on global commodity prices. In the event there is upward pressure on oil prices, the Sri Lankan economy is expected to come under further pressure.**

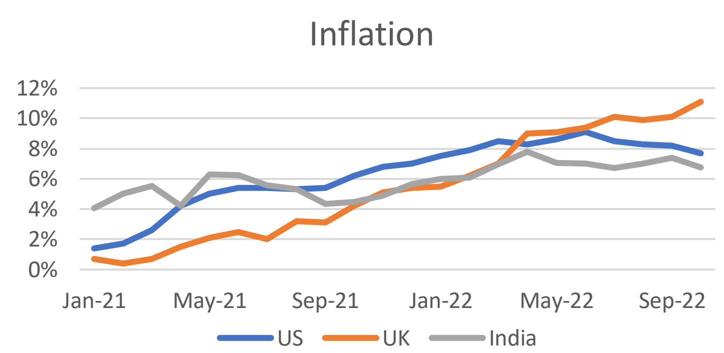
Global economy

The global economy is expected to grow at 3.2% in CY22 (IMF) down from the 6% growth rate recorded in CY21. CY22 has been a very turbulent year. The war in Ukraine broke out a severe energy crisis, resulting in rising inflation in many countries. The Covid lockdowns in China added further pressure to prices. While inflation has started declining in many countries, we can't be sure if this trend will continue since China is experiencing yet another wave of Covid, and this time it is quite significant. Also with China deciding to take down its Zero-Covid policy and open up the country, further pressure could be added to the oil prices.

Global interest rates too have been rising, and while there is an indication that the rate of interest rate hikes will decline, this too would depend on how inflation performs.



Source – U.S. Bureau of Economic Analysis; Office for National Statistics, UK; Ministry of Statistics and Programme Implementation, India



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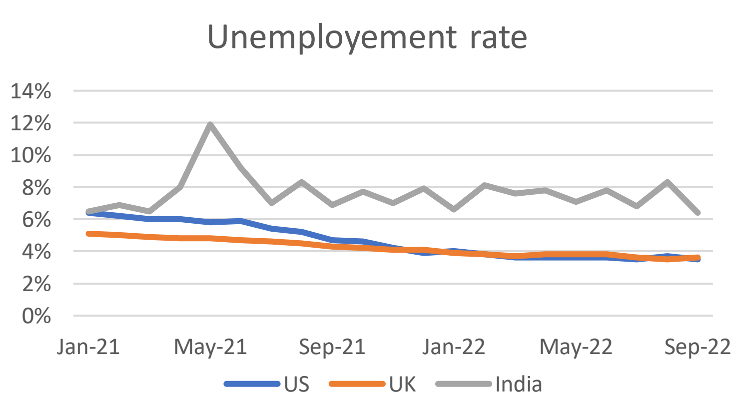
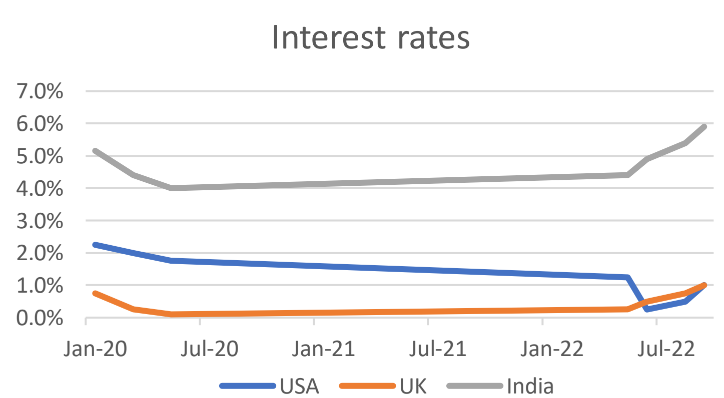


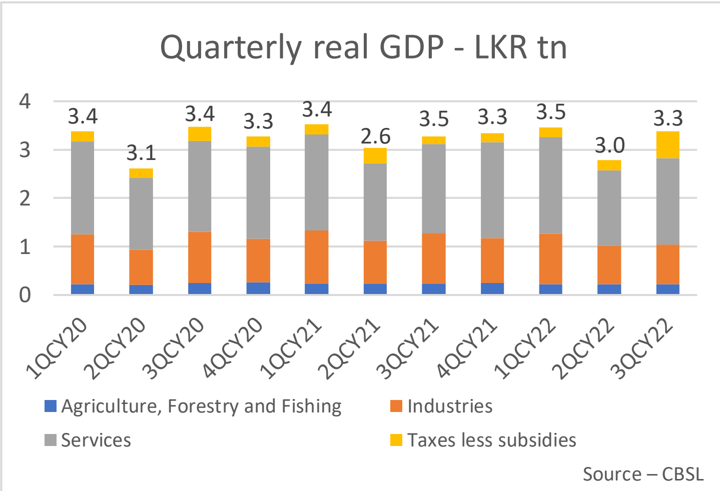
Source – U.S. Bureau of Labour Statistics; Office for National Statistics, UK; Centre for Monitoring Indian Economy

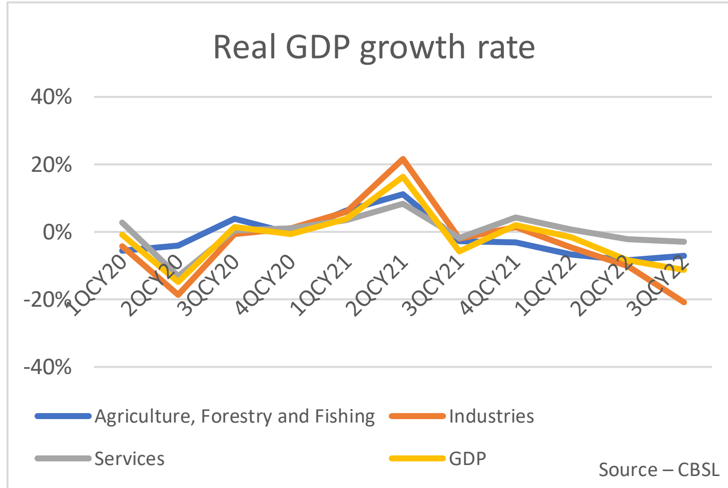


Source – U.S. Federal Reserve; Bank of England; Reserve Bank of India

Local Economy

Real sector

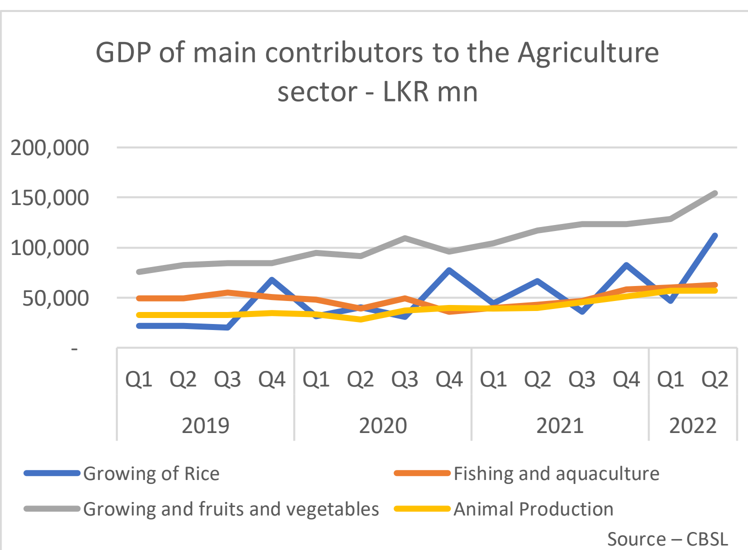


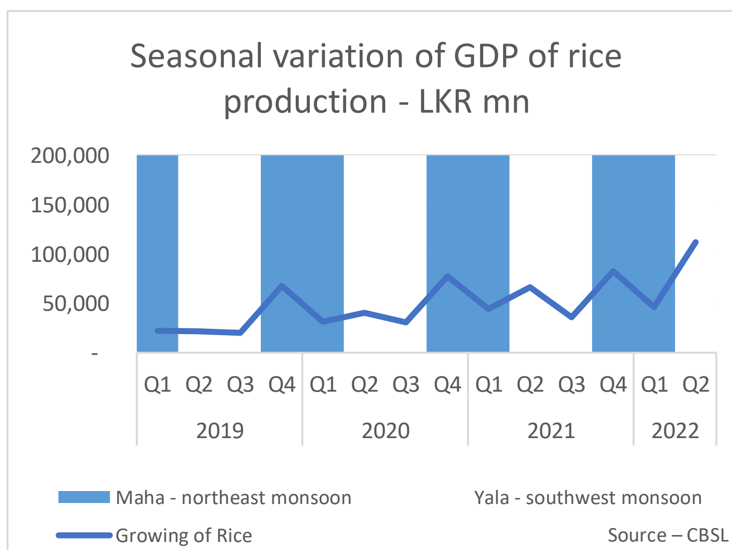


The economy experienced a decline by 1.6%, 8.4% and 11.3% in the first, second and third quarters of CY22. As of 9MCY22, it was a decline of 7.0%. This was due to the slowdown of the economy due to the unavailability of fuel and the presence of power cuts.

- ### Agriculture, forestry and fishing

The agriculture, forestry and fishing sector declined by 7%. This is a trend that continued from the first and second quarters when the sector declined by 7% and 8% respectively. The unavailability of fuel for transportation and issues with fertilizer were the main challenges faced by the sector. The suggestion in the interim budget to use the railway to transport fruits and vegetables (which was implemented since the beginning of CY23) will alleviate this issue to a certain extent. Also, suggestions bought about in the budget speech for 2023, including LKR 150mn allocated for the reduction of post-harvest crop losses (which amounts to over 30% at present) and leasing of unutilized land to grow exportable crops would help increase overall agricultural output provided these budget policies are implemented on time.





The four largest sectors that contribute to the GDP of agriculture - rice, fruits and vegetables, fishing and aquaculture, and animal production show a general growth trend from 2019. The GDP of rice shows a distinct seasonal pattern with the GDP increasing in Q2 and Q4 and decreasing in Q1 and Q3. The growth periods also correspond to the Yala season (May to end August) which is synonymous with the Southwest Monsoon and the Maha season (September to March next year) which is synonymous with the Northeast Monsoon.

- **Industries**

The industrial sector declined the largest in the 9MCY22, declining by ~21%. Construction activities, which contribute to about 30% of the GDP in the industries sector have been largely underperforming due to the halting of many public and private projects. The decline in construction activities has a multiplier effect on the GDP as this affects many other areas of the economy. Government debt to construction contractors has been compensated by the issue of Treasury bonds. However, going forward a further decline in construction could be expected due to the unavailability of steel and cement.

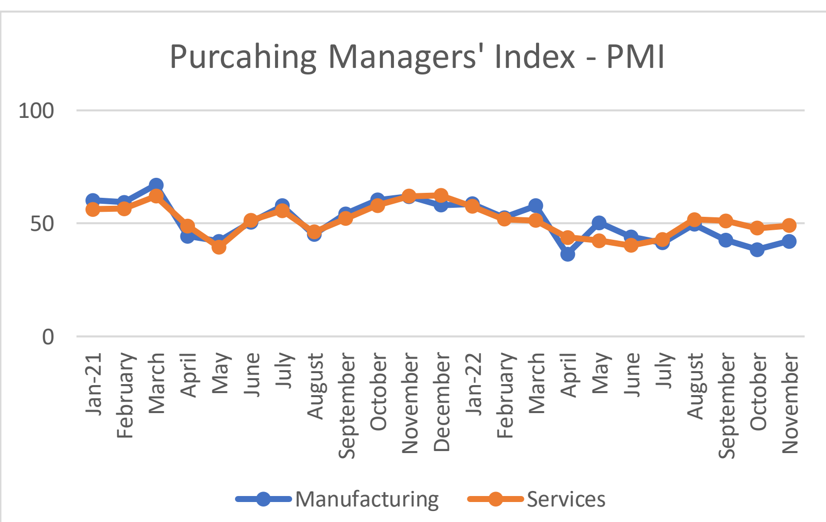
Other significant declines include the decline by 21% in the GDP of the manufacture of food, beverages and tobacco products, which is also a repercussion of the declining purchasing power of the consumers. This sector however is expected to perform better in the 4th quarter due to the festive season and the improvement in tourism activity.

The manufacture of textiles and wearing apparel etc. grew by 9% in the 3QCY22. This trend could not be expected to continue in the 4th quarter because the orders for the December season are usually fulfilled by Q3, and Q4 is relatively less active.

- **Services**

The services sector declined marginally by 3%. The decline in real estate activity, financial and related services were notable declines. Wholesale and retail trade too declined by 2% in the 9MCY22, this however is expected to recover in Q4, with an increase in demand.

Purchasing Manager's Index



The PMI for manufacturing recorded an index value of 42.1% in November, a contraction, albeit an increase of 3.7 index points compared to October. Subdued performance observed in all the sub-indices, except for Suppliers' Delivery Time contributed to the contraction of the Manufacturing PMI. New orders and production declined because of subdued demand conditions due to the deteriorating purchasing power of consumers, particularly in the manufacture of food & beverages and textile and wearing apparel sectors. Manufacturers in exportoriented industries like wearing apparel experienced a weaker demand mainly due to the fear of an economic slowdown in the major export destinations and the shift of orders to other countries amidst stiff competition.

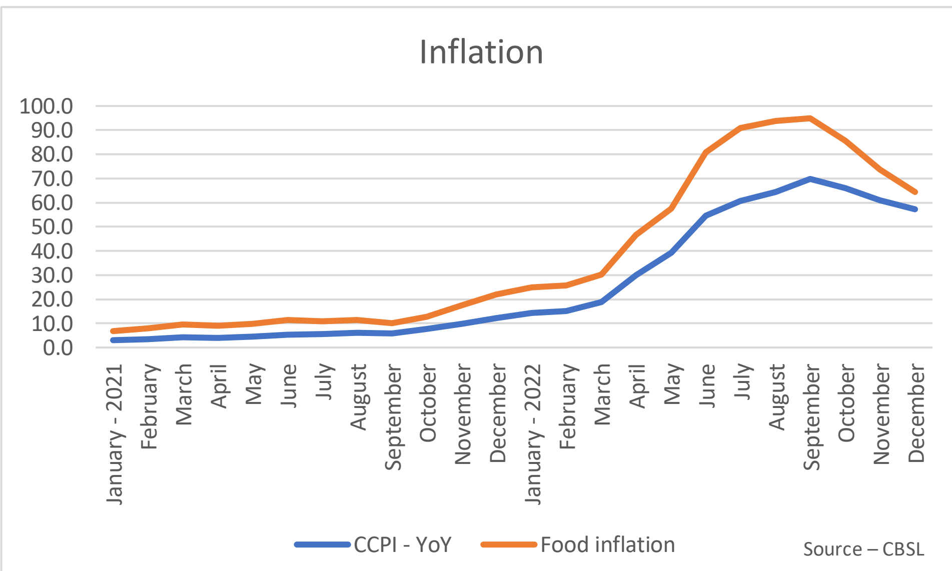
Services PMI recorded an index value of 49.0 in November 2022 an increase of 1.1 index points compared to October. New businesses improved in November, particularly with increases observed in the financial, insurance and personal services.

Business activities in the services sector continued increasing in November due to the upcoming festive season and the increase in tourist arrivals. However, business activities related to wholesale and retail trade declined further amid the continued cost of living challenges.

Employment in the services sector continued to fall at a higher rate, with the employment sub-index recording a value of 37.4 due to increasing resignations, migrations and retirements besides a slowdown in new recruitments. Employment in the manufacturing sector also declined albeit to a higher value of 48.0.

Expectations for manufacturing and business activities for the next three months (Dec-Feb) improved, with the anticipation for improvements in economic conditions. Nevertheless, the service sector is concerned about supply-side constraints, and increases in taxes and cost of capital that could negatively impact business operations.

Inflation

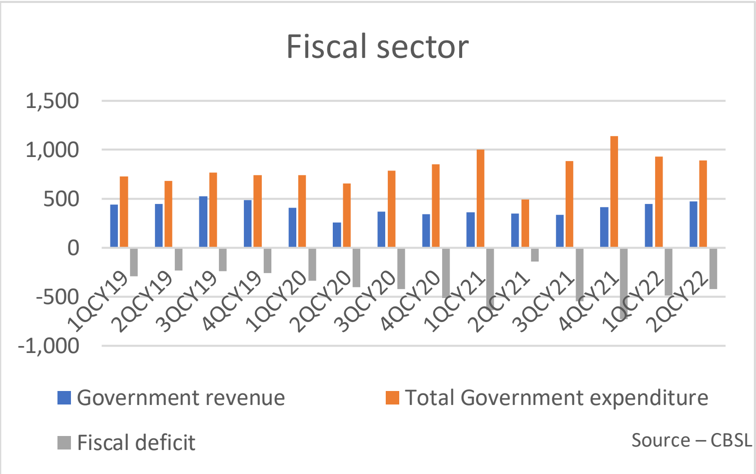


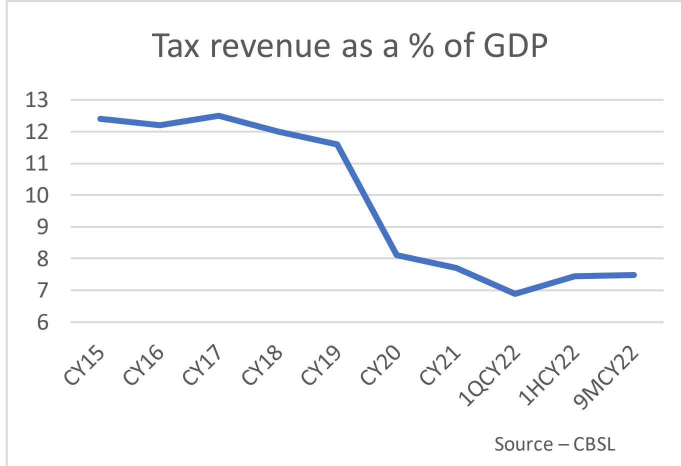
Inflation (CCPI) which had been rising rapidly since September CY21 due to high prices of fuel and other vital imports due to foreign exchange limitations, supply chain issues, and the depreciating LKR, peaked in September CY22 at 69.8%, and has since declined to 57.2% in December CY22. This is mainly due to the value of the base year being high rather than a reduction in prices. Food inflation too declined to 64.4% in December.

Inflation is expected to continue declining until it stabilizes by around September-October CY23, recording single-digit values by end 2023.

Global oil prices too have dropped from the high of USD 120/barrel of WTI crude (in March 2022) to less than ~USD 80/barrel at the time of writing, however, this is expected to increase in CY23 with the increase in demand from China and the lower output from Russia due to fresh sanctions from the West.

Fiscal Sector





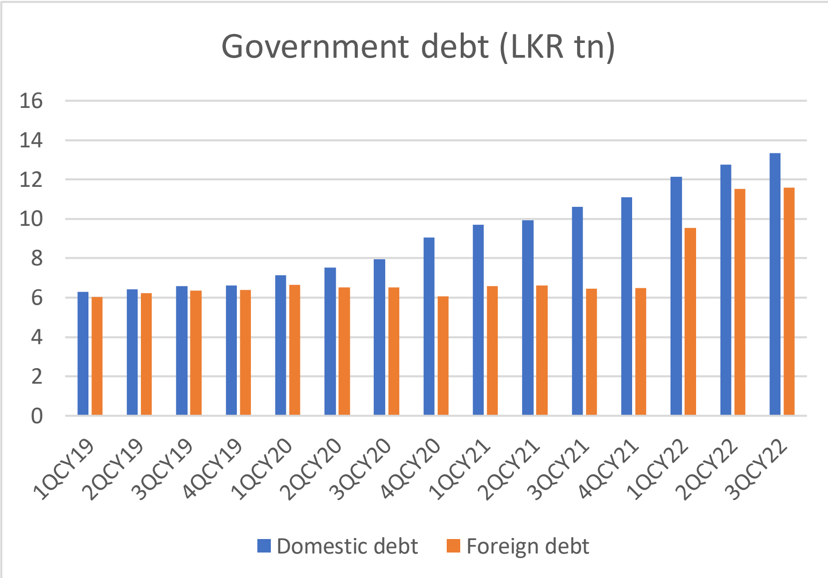
Total government revenue and grants for 1HCY22 were LKR 920bn, a 28.7% increase from the previous year. And the total government expenditure was LKR 1,822bn, a 21.8% decrease from the previous year. The fiscal deficit is LKR 903bn, a 15.6% increase from 1HCY21.

The tax revenue as a % of GDP which had been on the continued decline since CY18. However, with new tax measures coming into effect in CY22, the Tax/GDP % has risen slightly to 7.5% in 9MCY22. This is however still significantly low compared with a 12.5% recorded in CY17. This occurred as a result of a low tax regime coupled with increased inflation increasing the nominal GDP.

However, as per the proposals in the budget for 2023, tax revenue is expected to increase to LKR 3,130bn (10.3% of GDP). A 69% increase compared to CY22E - Interim budget (141% increase compared to CY21).

The revised interim budget proposed a VAT increment from 12% to 15% w.e.f. 1st September. This is the 3rd time the VAT rate has changed since December 2019 and manufacturers are not happy about the constant and immediate changes which is proving to be a hassle to them.

LKR Bn.	CY19	CY20	CY21	CY22E – (Interim Budget)	CY23E	Change from CY22E
Total revenue and grants	1,899	1,373	1,464	2,094	3415	63%
o/w Tax revenue	**1,735**	**1,217**	**1,298**	**1,852**	**3130**	69%
Income Tax			302	558	912	63%
Taxes on Goods and Services			646	972	1763	81%
Taxes on External Trade			350	322	455	41%
Total Expenditure	3,338	3,041	3,522	4,427.00	5819	31%
Deficit	(1,439)	(1,668)	(2,058)	(2,333.00)	(2,404)	3%
Deficit/GDP	-9	-10.5	-11.6	-9.8	-7.9	-19%
Tax/GDP	10.9%	7.7%	7.3%	7.8%	10.3	32%

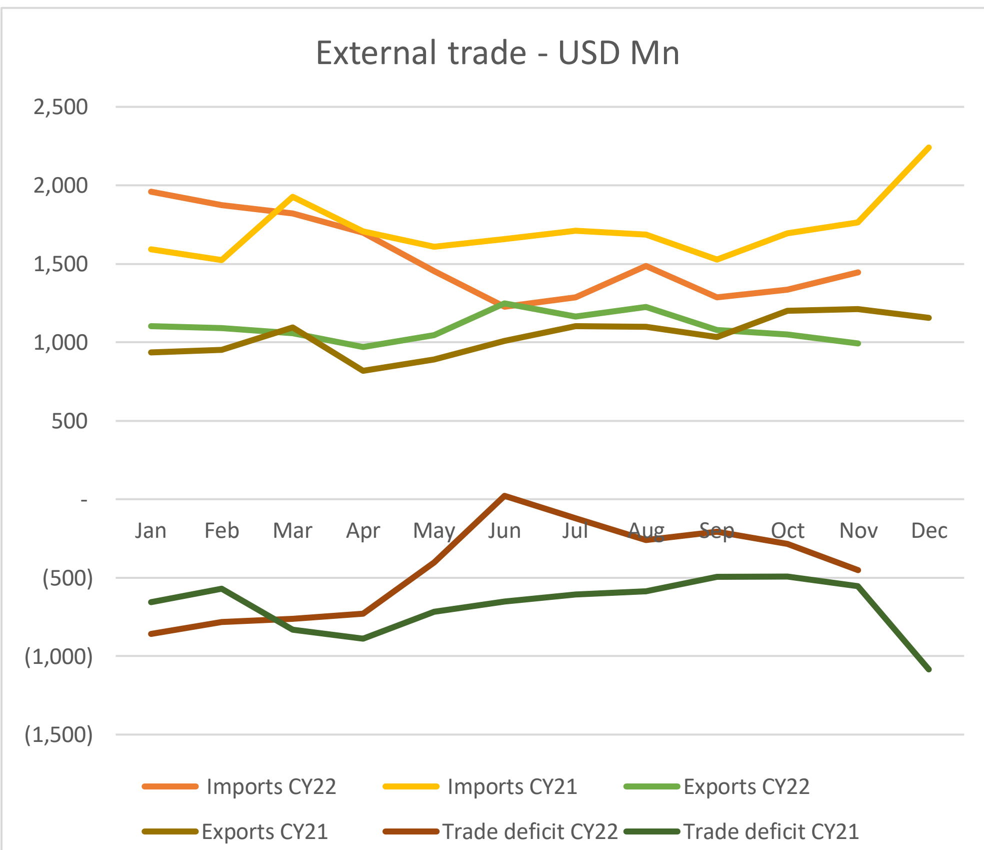


The high fiscal deficit and the ongoing forex crisis have resulted in the government debt increasing by 42% in September CY22 (to LKR 25tn) compared with the LKR 17.6tn by end-CY21.

Foreign debt, which was kept under control, has increased alarmingly over the past few months. The foreign debt of LKR 11.6tn is a 79% increase compared to the LKR 6.5tn by end-CY21.

While a certain portion of this increase is due to the increase in the absolute amount of the debt, the depreciation of the rupee too has contributed largely to the increase in the LKR value of foreign debt.

External Sector



The depreciating rupee has greatly helped the export sector with export earnings from Jan-Nov CY22 increasing to USD 12,026mn, an 6.0% increase compared to the same period last year.

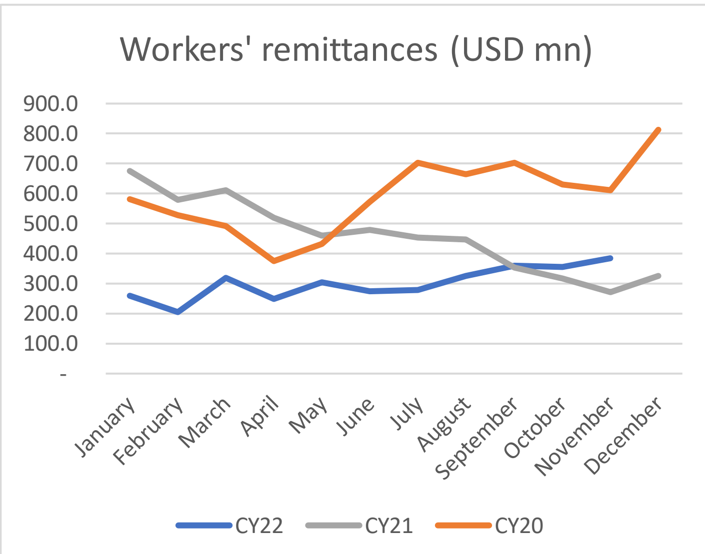
Industrial exports (mainly textiles and garments) increased by USD 823 Mn.

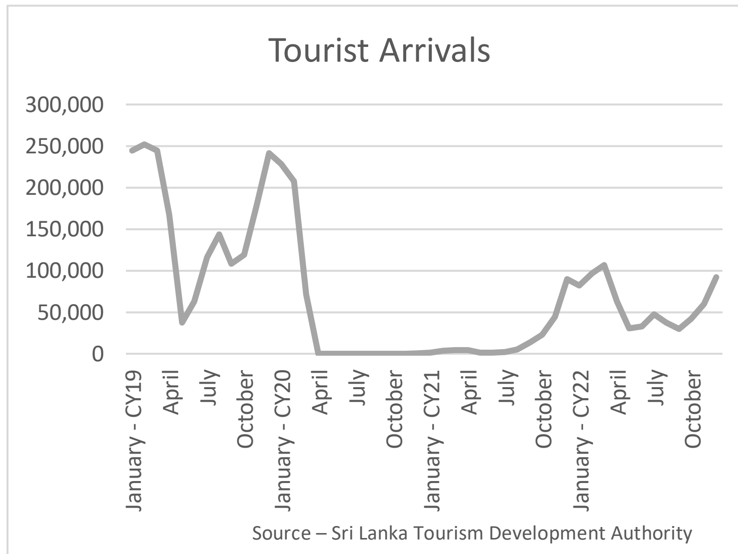
Agricultural exports declined by USD 133 Mn. The production of tea declined greatly in CY22, to a 26-year low of 251 Mn Kg. Low fertilizer application since 2021 due to changes in National policy, removal of subsidies, and increase in the cost of fertilizer due to global supply issues and LKR depreciation all contributed to the decline in tea production. If the climate conditions are supportive, experts feel that the country can be optimistic that a quantity of 280-290 million kg could be produced in the year 2023.

The import expenditure too has been under control with total expenditure from Jan-Nov CY22 being USD 16,866mn, a decline of 8.3% compared to the same period last year. This decline has been mainly due to the restriction of non-essential imports and the forced curtailment of even essential imports due to the unavailability of foreign currency to pay for them.

The trade balance recorded a surplus in June CY22 for the first time in more than 10 years of USD 21.3mn. The months of July-Nov however recorded small deficits with the total deficit for the year to November being LKR 4,839mn compared to the LKR 7,051mn recorded in the same period last year.

Current Account

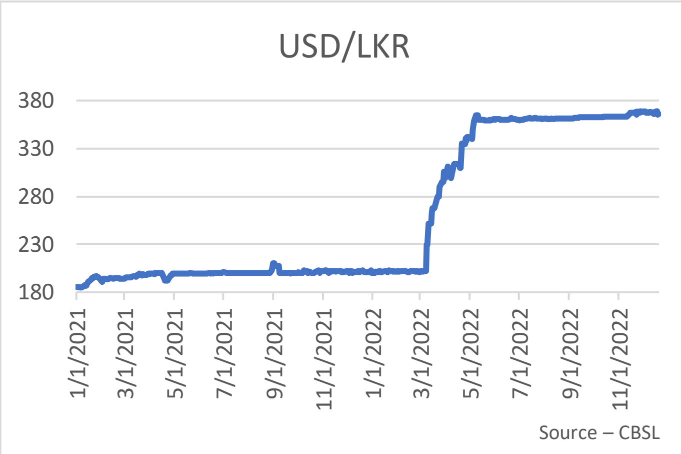


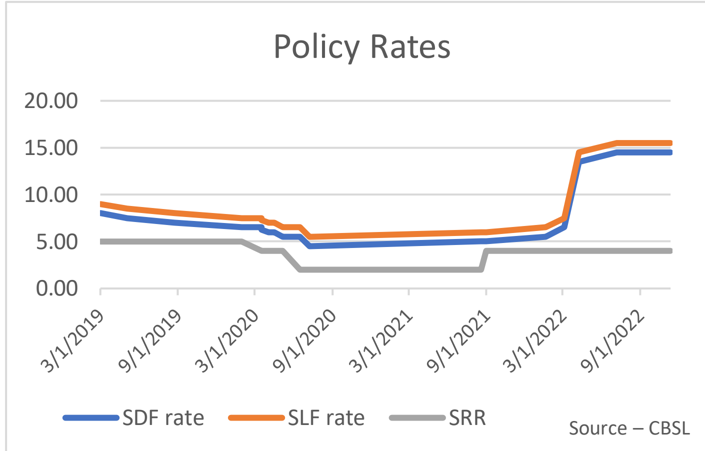


Workers' remittances have been increasing since July CY22 and would be able to reach CY20 levels by mid or end of CY23 if this trend continues. Workers' remittances are an important part of the country's foreign currency earnings and have been a factor that bridged a major portion of the trade gap prior to CY21. With the remittances improving and the import bill reducing, the exports + remittances have exceeded imports since June 2022.

While most travel advisories against travel to Sri Lanka have been lifted, tourist arrivals too have improved. The arrival numbers were especially promising during November and December CY22. However, it will take a long time to reach the numbers that the country is used to having.

The outlook for 1QCY23





After a highly volatile 2nd and 3rd quarter during which the economy underwent many events by which it was adversely affected, the last quarter of the year was relatively calm, and it feels like the worst is finally left behind.

The LKR is expected to stabilize at around 360-365 per USD. Inflation has finally started to decline and is expected to be on a downward trend henceforth. The CBSL maintained policy rates at the current levels of 14.5% and 15.5% for the SDF and SLF rates respectively. As they believed that the current rates would be sufficient to help contain any aggregate demand pressures. As inflation decreases, the interest rates could also be expected to decrease by about April this year.

The economy is gradually picking up, and the country is looking forward to a much better 2023. The budget for 2023, under the theme 'Sri Lanka, towards a new beginning' also gives hope for better economic conditions for the next year.

The discussions with the IMF have been completed with a staff-level agreement of a deal for a USD 2.9bn extended fund facility to be received over a period of 48 months, subject to certain conditions. India has assured the IMF of its support to Sri Lanka's debt restructuring program, while China has offered a two-year debt moratorium. While the moratorium will be helpful at this hour of need, it might increase Sri Lank's debt burden in the long term.

Other measures that the government is taking to help stabilize the economy that were particularly reiterated in the budget for 2023 include the sale of under-utilized assets and the establishment of private-public partnerships in certain state-owned companies. The success of these measures however depends on how well the government implements them amidst the challenging political landscape.