AmCham Sri Lanka Publication Series:

Sri Lanka Economic Outlook 2021

Researched & written by

***Deshan Gonawela** BSc (UK) MBA (UK)*

***& Mariyam Zeenath Musafer** ACCA (UK)*

with comments & conclusion by

***Dr. Kapila Senanayake,** Director General Fiscal Policy*

of the Department of Treasury of the Ministry of Finance of Sri Lanka

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Deshamanya Professor W. D. Lakshman, Professor Ranjith Bandara MP & Dr. Kapila Senanayake

Click the Link above to watch the full discussion

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Sri Lanka Economic Outlook 2021

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The Economy in 2020: Government Policies

The Sri Lankan economy, which experienced below potential growth in recent years, encountered unprecedented challenges amidst the outbreak of COVID-19 globally.

Reflecting the combined effects of the spread of COVID-19 locally, the introduction of lockdown measures, and the slowdown in global economic activity, the economy contracted by 1.6 per cent in the first quarter of 2020, year-on-year, as per the provisional estimates of the Department of Census and Statistics (DCS). At the time of writing, only provisional GDP estimates for the second quarter had been released by the DCS citing difficulties in capturing the true nature of disruptions and new activities as well as novel ways of working that emerged this year with the onset of the pandemic.

Given the impact of the pandemic, the primary economic policies revolved around guaranteeing sustenance of existing business and ensuring liquidity availability, moratoriums to minimize financial liabilities that were to be incurred by businesses and offering facilities to encourage foreign remittances amidst risk of Foreign exchange shortfalls.

In terms of trade, the Government took steps to ban all non-essential imports into the country, while also restricting importation of certain commodities in its import substitution scheme to encourage domestic production.

Among the policy decisions taken to ensure survival of businesses in the face of the challenges faced owing to the spread of Covid-19, The Central Bank initiated a series of monetary easing measures, including;

- Multiple reductions of the policy rates and the Statutory Reserve Ratio (SRR), injecting ample liquidity into the market and lowering borrowing costs
- Introduction of concessional credit schemes to fulfil the needs of small and medium scale enterprises (SMEs)
- Debt moratoria for businesses and individuals affected by the pandemic.

The policy with regard to commodities has also been amended in 2020 with,

- Special commodity levy on sugar and sugar substitutes, milk powder, canned fish, turmeric, coconuts, pepper and many others to encourage local production
- Complete ban on importing Motor vehicles except for those related to agricultural, service and construction related vehicles.

In terms of Macro-economic variables, the Government's policies remained consistent with a focus on maintaining a single-digit interest rate, low and steady inflation as well as steady reserves to meet debt obligations over the short and medium term.

MP Prof. Ranjith Bandara, speaking at the 'Economic Outlook 2021' Webinar presented by the AmCham Sri Lanka, spoke of the necessity to impose some of these restrictions in the face of what he called 'unprecedented' circumstances in the face of the Covid pandemic, adding that it compounded the economic deficits the current Government inherited.

External Sector Developments

Sri Lanka's external sector was disrupted significantly in the first half of 2020, with the outbreak of the COVID-19 pandemic. However, timely policy measures implemented by the Central Bank and the Government in restricting non-essential merchandise imports and certain outward capital flows as well as lower petroleum import expenditure and the pickup in workers' remittances in recent months helped contain the pressure in the external sector.

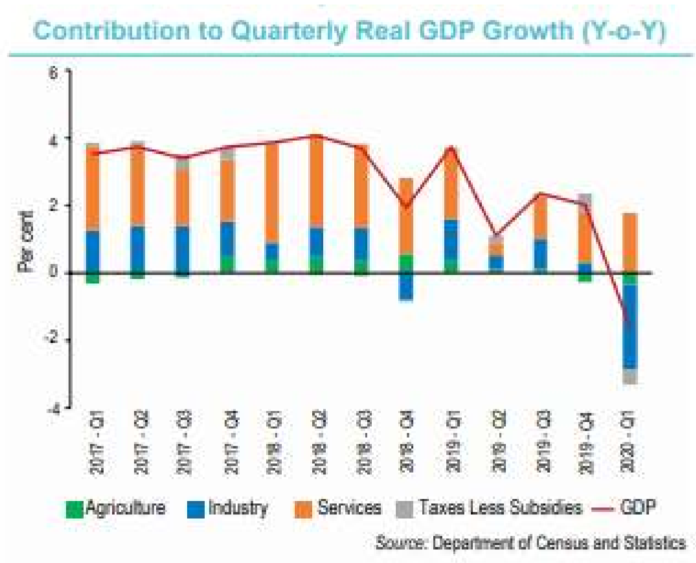
Exports	Imports	Trade Balance (Deficit)
Jan – Oct 2020 $ 8.29 BN Jan – Oct 2019 $ 9.96 BN -16.7%	Jan – Oct 2020 $ 13.15 BN Jan – Oct 2019 $ 16.41 BN -19.9%	Jan – Oct 2020 $ 4.85 BN Jan – Oct 2019 $ 6.45 Bn

As experienced globally, the country was closed for international tourists from late March 2020 onwards. Workers' remittances, which also declined in the second quarter of 2020, rebounded and recorded a notable year-on-year growth since June 2020.
With the reopening of airports on 21 January 2021, the Tourism Development Authority of Sri Lanka targets 1.5 million tourist arrivals during the year.

Worker's Remittances	Earnings from tourism	
Jan – Oct 2020 $ 5.68 BN Jan – Oct 2019 $ 5.53 BN 2.6%	Jan – Oct 2020 $2.81 BN Jan – Oct 2019 $ 956 MN (66.1%)	

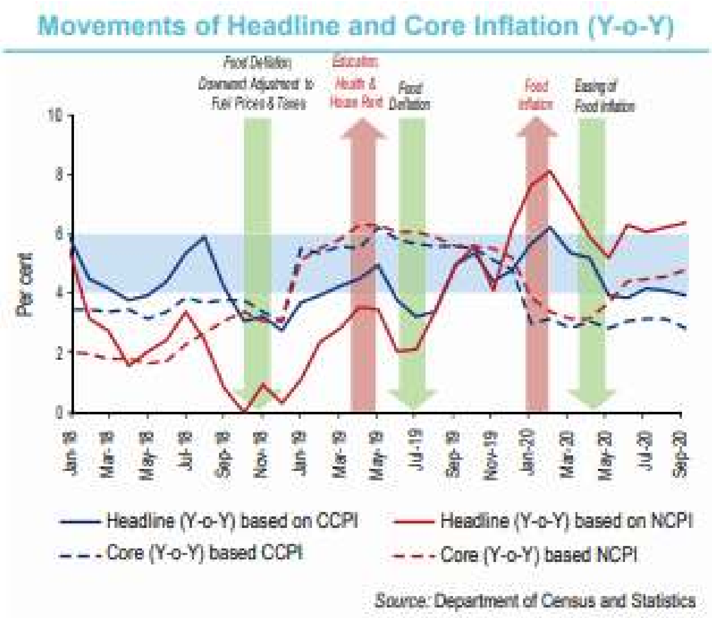
Foreign direct investment (FDI) inflows were low, similar to all emerging economies, while outflows were recorded from the rupee denominated Government securities and equity markets, although the latter performed notably well with active participation of domestic investors. On the foreign investment front, the CSE in 2020 recorded a net foreign outflow of Rs. 51 Bn. However, during the same period, Sri Lankan equities attracted purchases worth Rs. 53 Billion. The stock market at present continues to indicate attractive valuations relative to other markets in the region.

The Domestic Economy



Official statistics revealed that the agriculture sector contracted by 5.6% in the first quarter of 2020, compared to a growth of 5.0 % recorded in the first quarter of 2019. Figures further revealed that the industry sector also contracted by 7.8% in the first quarter of 2020, in comparison to the growth of 3.9% registered in the same quarter of the previous year. Despite the immediate impact of the pandemic on the services sector, it recorded a moderate growth of 3.1% in the first quarter of 2020, in comparison to a growth of 3.7% recorded in the corresponding period of 2019.

The unemployment rate increased to 5.6 per cent in the first half of 2020, compared to the unemployment rate of 4.8%in the corresponding period in 2019. The unemployment rate, estimated to be at 5.7% in the first quarter of 2020, declined to 5.4 per cent in the second quarter which suggests that economic activity continued without much deterioration in the second quarter.



Central Bank data further stated that NCPI based headline inflation peaked at 8.1% in February 2020, before easing to 6.4% in September 2020. Core inflation remained low over the course of the year, reflecting subdued demand conditions. CCPI based core inflation eased to 2.9% in September 2020 from 4.8% at end 2019, while NCPI based core inflation eased to 4.8% by September 2020, from 5.2% at the end of 2019.

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Key points from of Budget 2021

Prime Minister and Minister of Finance Hon. Mahinda Rajapaksa presented the budget for the year 2021 in November of 2020 with the focus very much on encouraging a V-shaped recovery from the effects of the Covid-19 pandemic.

In order to do so, the Government carried forward some of the proposals including the reduction of VAT from 15% to 8%.

In addition, the budget proposed that,

- Value Added Taxes remained unchanged at 8% for businesses that record a turnover of more than 25 million a month except for bank, finance and insurance companies.
- A 50% tax exemption for local Companies listed in the Colombo Stock Exchange until December 31, 2021. A 50% income tax exemption to local companies if they register before 31 December 2021 to be listed in the Stock Market.
- Migrant workers to receive Rs. 2 for every dollar remitted and a contributory pension scheme.
- Repayment of refinancing loan facilities provided by CBSL to Tourism sector be extended to cover the period up to 30th September 2021

The Proposals in the budget for 2021 also looks at more 'micro' proposals including,

- Daily wage of estate workers to be increased to Rs.1,000 from January 2021.
- Business organizations engaged in agriculture, fisheries, livestock farming industries, to be exempted from taxes during the next 5 years.
- Non-residents to be allowed to purchase super-luxury condominiums using foreign currency.
- Amend EPF Act to expand the retirement age for both men and women up to 60 years.
- New loan scheme for Samurdhi beneficiaries on 7% interest.

Budget 2021: Economic revival via production driven economy

The Budget 2021 envisaged the revival of the real economy supported by measures aimed at encouraging a production-driven economy, through domestic as well as foreign investment, along with a more rational view on openness in external trade. The boost received by agricultural production and related higher value chain activities has been substantial. These measures, taken as a whole, would help the country to build buffers to sustain macroeconomic stability over the medium-term.

The 2021 budget concentrates on continuing its infrastructure drive, consolidating the NBFI segment and providing tax holidays for targeted selective sectors. As the Government takes forward its fiscal and monetary stimulus package, the budget deficit for 2021 is expected to exceed 9% of GDP for 2021, while the Debt to GDP ratio is expected to surpass 96%.

Key proposals to boost domestic production, exports and accelerate economic growth

Proposals in the Budget 2021 to develop the Colombo Port City Special Economic Zone as an attractive business gateway, to promote the Colombo and Hambantota ports as commodity trading hubs, and to establish a modern investment zone for local and foreign private investors under the Strategic Development Act, are expected to entice a sizable flow of foreign capital into the country in the period ahead and create employment opportunities for Sri Lankans.

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The rapid development of the Colombo Port City Special Economic Zone is expected to boost growth performance in the financial sector as well. Dr. Kapila Senanayake, Director General of Fiscal Policy at the General Treasury recognized this potential, speaking of how the project is expected to create up to 200,000 direct jobs, while also creating a new avenue for Foreign exchange inflows. He also recognizes that the special laws in place will make the Port City a more attractive proposition for investors owing to the tax holidays on offer.

The budget has a special focus on investing in infrastructure with funds being allocated to expand the expressway network, road network and continuing housing projects supported by low-cost housing loans. Removal of import duties have been proposed for raw materials not available in the country; machineries and equipment with modern technology; and cement, premix, iron rods and bitumen that cannot be produced locally and are imported in bulk.

Reductions in customs and other import duties have also been introduced for vehicle spare parts; cold room facilities; and modern equipment for investing in value addition to local crops such as pepper, cloves, cardamom and coffee suitable for the export market.

The 2021 Budget also introduces a Temporary Import for Export (TIEP) scheme which will provide temporary import facilities for raw materials not available in Sri Lanka, and a Goods & Services Tax in lieu of the multitude of levies on motor vehicles and other specified goods. Hence, import duties on motor vehicles will be affected by this.

Key tax policies in the 2021 Budget

In the 2021 Budget, the government introduced several corporate tax exemptions, while tax holidays were provided to selective sectors such as agriculture, fisheries, renewable energy and ship building. In order to support the tourism sector, the debt moratorium granted was further expanded as well.

Further strengthening policy stability and delivering on its promise, no changes were made to the withholding tax and non-corporate tax for the year. The last changes were made in January 2020.

As Capital Market Development measures, tax holidays were proposed for newly listed firms with multiple benefits granted to promote REITs within the capital market sphere.

Other notable proposals

Strengthening the NBFI sector has been identified as a critical point with proposals placed for consolidation within the sector while also recommending a National Development Banking Corporation, merging multiple small state banks.

Impact of Budget Proposals
Positive GDP Growth trajectory for Sri Lanka in 2021

The Central Bank of Sri Lanka projects a GDP growth of 5.5 percent for 2021, driven by improved investor sentiment and consumer demand, an accommodative monetary policy environment, and a pickup in global demand. This is a rebound from the predicted economic contraction for the year 2021.

Sri Lanka suffered a notable economic setback in 2020, particularly in the second quarter due to disruptions caused by the COVID-19 pandemic. The Central Bank of Sri Lanka forecasts a negative GDP Growth of 3.9% for the local economy, in 2020.

GDP GROWTH FORECAST FOR 2021	**GDP growth in 2020**
CBSL – 5.5% World Bank – 3.3% International Monetary Fund – 5.3%	CBSL projection – (3.9%) Department of Statistics 1 Quarter 2020 – (1.6%) 2 Quarter 2020 – (16.3%) 3 Quarter 2020 – 1.5% 4 Quarter 2020 – Yet to be published

Source : CBSL, Ministry of Finance

While the outlook for 2021 remains largely positive due to improved policy certainty and a stable government, several challenges still remain.

Positives	**Challenges**
Greater political and policy certainty	Risk of prolonged impact from COVID-19 with possible new strains and/or a rise in case numbers.
Emphasis on domestically driven growth	Increasing government revenue whilst maintaining a loose fiscal policy
Low lending rates and high liquidity to drive credit	Low credit rating disrupting access to foreign capital markets
Low direct tax environment to stimulate consumption.	Managing debt repayments of USD 4.5 Bn/ per annum from 2021-2023
A more deliberate focus on attracting and executing investments driven by FDI including launch of Port City related and Hambantota Port zone-related investments.	Ramping up local food production in time to meet the shortfall from lower imports
Improving business and consumer confidence	
Opening of airports to drive tourism sector	

Source : Asia Securities Outlook for 2021

Monetary Policy, Interest Rates, Money & Credit

The Government of Sri Lanka's development-oriented budget for 2021, coupled with the prevailing low interest rate environment is expected to support the Govt.'s target of reaching a 6% GDP growth during the next 5 years, commencing from 2021. With improving business and consumer confidence seen following the end of the first lockdown, a continued low interest rate environment bodes well for investments in the short-medium term.

Amidst the below potential economic growth, headline inflation remained muted, despite some acceleration in food inflation. The Colombo Consumer Price Index (CCPI) based headline inflation remained broadly within 4-6 per cent range over the year. Inflation is expected to remain within this target threshold in 2021. CBSL expects credit to the private sector to expand by around 14.0 per cent in 2021 and at least by around 12.0-12.5 per cent annually over the medium-term, which will further accelerate economic growth.

Inflation	**Interest rates**
CCPI 4.2% November 2020	AWPR - 5.75 % AWDR - 5.80 % AWFDR - 7.14 % **Policy rates** SLFR – 5.50% SDFR – 4.50% SRR – 2.00%

Debt obligations amidst a low credit profile will be one of the main challenges for Sri Lanka, in 2021. With a commitment to repay more than USD 4.5 Bn in 2021, the Government would need to ensure that reserves are maintained at relatively healthy levels.

As indicated in the 2021 Budget, the Government of Sri Lanka will continue to depend on domestic financing. By the end of September 2020, the government's domestic to foreign debt ratio had improved to 55:45, from a previous 51:49 reported in December 2019.

Gross Official Reserves
$ 5.9 BN **End Oct 2020**

Impact on Businesses

The Covid-19 pandemic in Sri Lanka is now in its second wave after a fresh outbreak was reported in October 2020 after the initial wave was managed successfully.

However, in this context the Government has decided against nationwide lockdowns and instead is focusing on zonal lockdowns coupled with strict health protocols.

This has brought in considerable restrictions to gatherings, large meetings and even travel in certain areas. In addition, existing procedures in place in overseas travel has restricted the freedoms of carrying out international business, although the availability of digital media has cushioned this blow to a great degree.

While the continuous impact of the of the pandemic have drastically impacted a number of industries including Food and Beverage, hospitality, entertainment and others, the financial markets as well as the export sector seem to be thriving in the face of the current challenged leaving a positive impression regarding potential for the future.

The proposals in the 2021 Budget focuses very much on recovery. This is elaborated by the continued debt moratoria, credit facilities and liquidity injections into the market. Further, the decision to promote import substitution has reaffirmed the Government's efforts in empowering local manufacturers, at a short run cost to consumers in some areas.

While the US continues to be Sri Lanka's single largest trading partner, the impacts of Covid-19 and the ensuing lockdown led to the total exports in goods decreasing when compared to the same period in the year 2019. While the year 2019 saw $2.75 Billion in goods exports, this decreased to $2.27 Billion in the year 2020 as per statistics released by the United States Census Bureau.

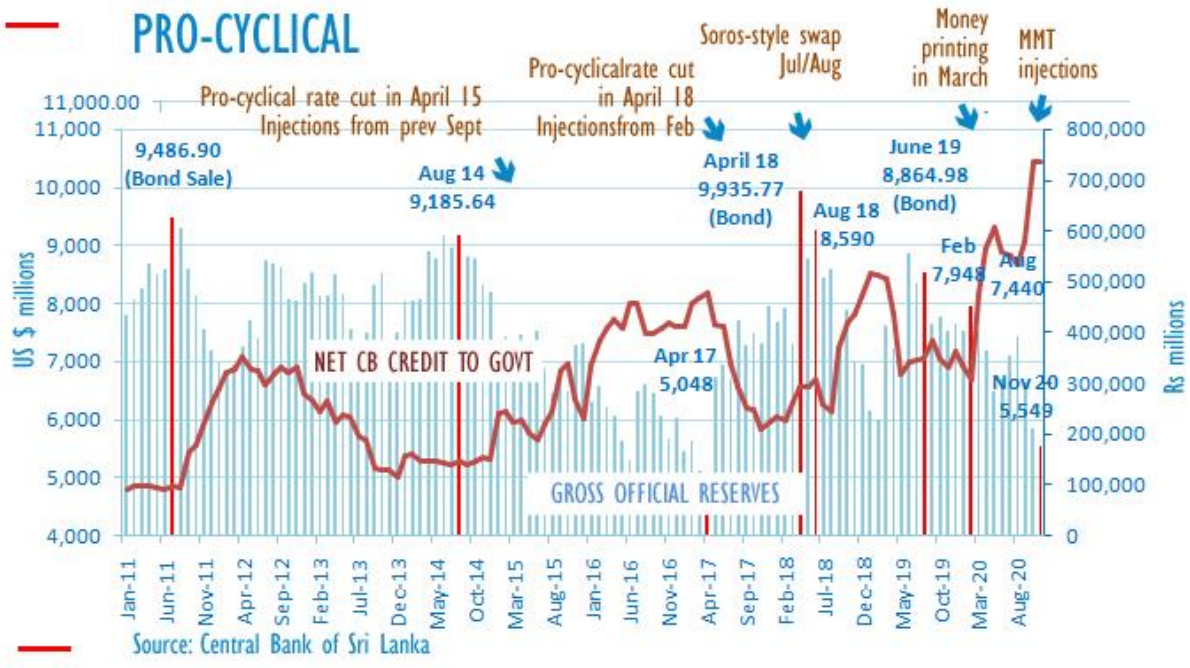
The visit by the US Secretary of State Mike Pompeo towards the end of the year, and his commitment towards collaboration leaves a positive outlook towards the future of Sri Lanka-US trade relations.

Foreign Currency Position

In the face of economic challenges arisen from the COVID-19 outbreak, the Government has taken several measures to preserve the international reserve position of the country. These measures include entering into a currency swap arrangement amounting to USD 400 million with Reserve Bank of India and a repurchase agreement with the Federal Reserve Bank as a temporary source of USD liquidity. In addition, the Central Bank introduced Sell-Buy Forex SWAP auctions for Licensed Commercial Banks to provide foreign currency liquidity on term basis. These measures along with receipt of financial assistance from multilateral development partners for COVID-19 related financing and introduction of a Special Deposit Account helped improve the liquidity conditions in the domestic foreign exchange market.

In addition, rationalization of non-essential merchandise exports and restrictions on outward remittances on certain identified capital transactions including the reduction in the maximum limit on migrant transfers helped further easing the pressure on the Exchange Rate. Going forward, Government has initiated further action to enter into swap facilities with China and India.

The government has identified further measures to improve net foreign exchange inflows maintaining the external sector stability and to preserve the gross official reserves and macroeconomic stability.



Conclusion & Way Forward

Dr. Kapila Senanayake, the Director General of Fiscal Policy at the General Treasury of Sri Lanka highlighted that he expects the economy to rebound to 6% growth over the year 2021 and in the medium term. He further stated that he expects the fiscal stimulus offered by the Government at the end of 2019 will more effectively reap rewards over the course of 2021.

While recognizing the existing challenges, Prof. Ranjith Bandara MP, spoke of the need to be positive in the face of the oncoming challenges as the Government has worked to focus on and support vital sectors of the economy while ensuring that investment on human resource development should be concentrated on.

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Governor W.D. Lakshman echoed similar sentiments, stating that Sri Lanka should look to 'take off' in the year 2021, using it as a platform to take Sri Lanka towards sustainable growth, elaborating that Covid-19 has given the country an opportunity to change its economic path and mindset as it creates an environment for necessary reforms and restrictions.

While the overall sentiment globally is far from positive, as we enter the Post-Covid era with the beginning of vaccinations, there is now an opportunity to realign the economic strategies to propel the country towards progress.

In such a backdrop, there is cause for optimism, while it is important to acknowledge the enormous challenges that await the country in the short and medium term. This is particularly the case in the Foreign Exchange crisis facing the country at present, as well as the challenges faced in meeting debt obligations.

Notwithstanding the unprecedented challenges posed by COVID-19, Sri Lanka aspires to reposition itself as a strong emerging economy with the continuous backing through precise fiscal and monetary interventions. This is facilitated by the Budget 2021 that forms the foundation for a production economy that enables the production of local goods and services geared to competitively enter the global economy. The coordinated approach of the macro-fiscal framework will ensure the country is moving towards the growth and sustainability.

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