HSBC Global Research

20 June 2023

Sri Lanka

A story of hope, and some progress

Economics
Sri Lanka

- Sri Lanka has been engaging in debt restructuring discussions which it hopes to conclude before the end of 2023
- Some progress on the macro stability front has been made with economic activity recovering, inflation easing, and external sector improving
- Sri Lanka is pressing ahead with reforms; the economy should gradually recover from its 2022 lows

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The recently approved IMF program and the first meeting with the official bilateral creditors committee have kindled hopes of quick completion of the restructuring exercise. In recent media interaction, the president made assurances that restructuring talks will conclude before the end of 2023.

Sri Lanka has a total public debt (foreign and domestic currency) of USD81.8bn. As per the official statement, about 46% of this will be considered for debt treatment, which includes bilateral and private creditors, and T-bills held by the central bank. A voluntary domestic debt optimization operation is also being envisaged, in which the government and its advisors will initiate consultations with major T-bonds holders. It is important to note that Sri Lanka has a diverse set of creditors with possibly different loan terms. Debt restructuring discussions with this diverse set of creditors could take time.

Meanwhile, some progress has been made on the macro stability front. The growth engines of tourism and remittances are humming now. Tourist arrivals started to look up in 1Q and are likely to rise more strongly in 4Q23 (the peak tourist season). Remittance inflows have recovered to their pre-pandemic five-year average, aided by the stabilisation of the LKR. Softness in global demand has resulted in weaker exports in 2H22. However, exports have improved a tad recently (on a seasonally adjusted sequential basis). That said, private sector credit remains particularly weak.

A recovery is underway, but it is not yet broad-based. After a deep contraction in 2022, we expect the sequential momentum to turn positive. In annual terms, 2H23 is likely to see growth but the full year figure may remain in contraction due to base effects.

Inflation is set to moderate to single-digit by the end of 2023 thanks to base effects, and tighter monetary and fiscal policy. The recent rupee appreciation and its likely pass-through effect are likely to accelerate the disinflation process in the next few months. As the structural reforms gain traction and the ongoing recovery gains momentum, we think the CBSL is likely to ease by another 5ppt over the next few quarters.

The June monetary policy statement touched upon a gradual phasing out of the existing import restrictions. On June 10, restrictions on 286 items were relaxed. This could lead to some widening in the trade deficit. Thankfully, rising tourism and remittance earnings can help fund this, and keep the current account deficit at manageable levels, in our view.

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Hope

With the IMF program finally starting off, all eyes are on the debt-restructuring discussions (see *Sri Lanka: Finally docked at IMF shores*, 22 March 2023). The country hopes to complete the restructuring exercise by the first review of the program, which is in September or October of this year[1]. In recent media interaction, the president made assurances that restructuring talks will conclude before the end of 2023[2].

The investor presentation released by the government in March 2023 clarified the following:

- Of the USD45.5bn foreign currency public debt, **USD30.8bn (68% of the FX debt) will be considered for debt treatment**. Debt which is excluded from the debt treatment parameter includes multilateral creditors (USD11.5bn), emergency assistance credit lines (USD0.8bn), bilateral swaps (USD2bn) and CPC and CEB FX Payables (USD 0.3bn).
- Of the USD36.3bn local currency public debt, **only the T-bills held by the CBSL (cUSD7.1bn) will be considered for treatment** to create some fiscal space. A voluntary domestic debt optimization operation is also being envisaged in which the Sri Lankan government and its advisors will initiate consultations with major T-bonds holders to gauge options and constraints around it.

Putting it all together, about 46% of the total public debt (USD81.8bn, see table 1) will be considered for debt treatment.

In the first meeting of the official bilateral creditors committee, the Sri Lankan authorities formally requested debt treatment. China, one of Sri Lanka's biggest bilateral creditors, attended the meeting as an observer[3]. Note that Sri Lanka owes USD7.1 billion to bilateral creditors, with USD3 billion owed to China, USD2.4 billion to the Paris Club and USD1.6 billion to India[4].

Sri Lanka has a diverse set of bilateral and private creditors, and possibly different loan terms. Reaching an agreement with these diverse creditors could take time. Until then, the uncertainty around debt restructuring will likely remain a drag on investor sentiment.

Table 1: Ownership of Sri Lanka's public debt

Currency	Ownership details	USD bn
Foreign currency (USD 45.5bn)	Official bilateral creditors & ECA backed commercial loans	10.6
	Private creditors	20.3
	Multilateral credits	11.5
	Emergency assistance credit lines	0.8
	Bilateral swap lines	2.0
	CPC and CEB payables	0.3
Local currency (USD 36.3bn)	T-bill owned by CBSL	7.1
	T-bill owned by others	4.3
	T-bonds	24
	Other loans	0.3
	CBSL advances	0.6
Total debt		**81.8**
Debt which is considered for treatment (highlighted in grey)		*38.0*
% of total public debt considered for treatment		*46%*

Source: Central Bank of Sri Lanka, Ministry of Finance, HSBC

1 Transcript of IMF Press Briefing in Sri Lanka, 16 May 2023
2 Reuters | Sri Lanka president vows to conclude debt-restructuring talks by Sept or Nov, May 25, 2023
3 Reuters | China attends as observer first meeting of Sri Lanka's creditor nations, May 9, 2023
4 Reuters | Sri Lanka requests debt treatment in first bilateral committee meeting, May 9, 2023. The committee, co-chaired by India, Japan and France, consists of 17 members and includes Paris Club creditors and other official bilateral creditors.

Some progress

Two growth engines, tourism and remittances, are humming now. Between Jan-Apr 2023, there have been at least 100k+ tourists arrivals per month (about 50% of the normal times[5]). We expect arrivals to pick up more strongly in 4Q23 (the peak tourist season). Tourism is also likely to be supported by Chinese tourist arrivals which are yet to normalise (chart 1). While the tourist arrivals are improving in numbers, the revenue per tourist is still low (chart 2). We believe that once the volume (number of tourist arrivals) stabilizes, the value (revenue per tourist), too, will begin to pick up.

Remittance inflows have almost recovered to the pre-pandemic five-year average. A sharp depreciation of the Lankan rupee in 2022 had adversely impacted the inflow of remittances. Since the start of the year, the currency has appreciated c17%, along with an improvement in remittance inflows. That said, excess volatility in LKR could adversely impact remittance inflows.

Other indicators, too, are showing early signs of stabilisation. PMI services indicate a normalisation but manufacturing remains weak (chart 3). Part of it can be explained by the softness in exports as global demand slows. However, the last few readings of industrial production indicate a small improvement after many months of weakness (chart 4).

Private sector credit growth remains particularly weak. It has been contracting since June 2022 and its percentage point contribution to overall credit is now negative (chart 5). The CBSL expects a moderation in bank credit to government with the receipt of foreign financing. Likewise, bank credit to state-owned enterprises is likely to fall, thanks to the adoption of cost recovery pricing by major SoEs.

A recovery is underway, but it is not yet broad-based. After a deep contraction in 2022, we expect the sequential momentum to turn positive. In annual terms, we believe the second half of 2023 is likely to report growth of c3.5% y-o-y. However, on a full-year basis, this figure is likely to remain in contraction territory in 2023e (HSBC estimate: -2.5% y-o-y, IMF: -3.1%, WB: -4.3%, CBSL: -2%)[6].

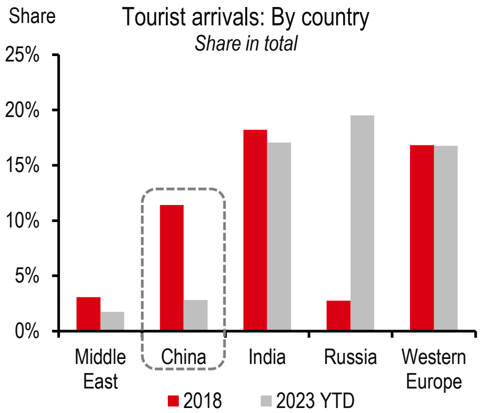
We worry about the country's growth potential which directly affects its debt sustainability. Sri Lanka's potential growth rate had already fallen from 5% to 3% at the eve of the pandemic (chart 6). This is partly because it has been battling challenges for a while now and hasn't had a single normal year since 2017. Years of underinvestment in productive capital have lowered the growth potential – gross fixed capital formation has fallen by 8ppt in the past four years. As Sri Lanka builds back, it will have to start from a sub-3% growth potential. The IMF's GDP growth estimate of 3% in 2026e is in line with our expectation. The president, however, recently commented that the country needs to grow by 6% or higher by 2028 or 2029 to repay debt and develop[7]. This, in our view, is a little too ambitious.

Inflation is set to moderate to single-digit by the end of 2023e, in our view, thanks to base effects, tighter monetary and fiscal policy. The recent normalisation in food prices and a reduction in fuel and gas prices have provided further support (chart 7). The recent rupee appreciation and its likely pass-through effects are likely to accelerate the disinflation process in the next few months. We expect inflation to reach single-digit by end-2023e. However, we believe it will be back in CBSL's target range of mid-single digit only by mid-2024e (chart 8).

The CBSL had delivered considerable monetary adjustment by hiking policy rates by 10.50ppt since the start of the 2022. As the structural reforms gain traction and the ongoing recovery gains momentum, we think the CBSL is likely to ease monetary policy further. The recent cut of 2.50ppt is in line with the IMF's suggestion to the authorities to bring down domestic interest rates in a bid to restore stability[8].

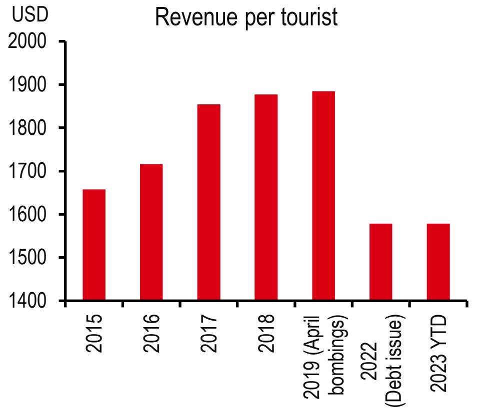
5 We refer 2018 as a normal year in Sri Lanka when the monthly tourist arrivals averaged 200k. In 2019, there were bombings in April and 2020 and 2021 had COVID-19 related disruptions which had impacted tourism in the country.
6 Reuters | Sri Lanka's economy to shrink by 2% in 2023, central bank says, April 27, 2023
7 Reuters | Sri Lanka trying to reduce overall debt by $17 billion, president says, April 26, 2023
8 Reuters | IMF official says Sri Lanka reforms critical, evaluating progress, May 15, 2023

Chart 1: Chinese tourists arrivals are yet to normalise



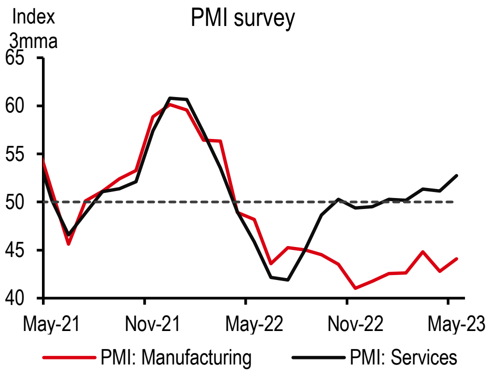
Source: CEIC, HSBC

Chart 2: Tourist arrivals are improving, but revenue per tourist remains low



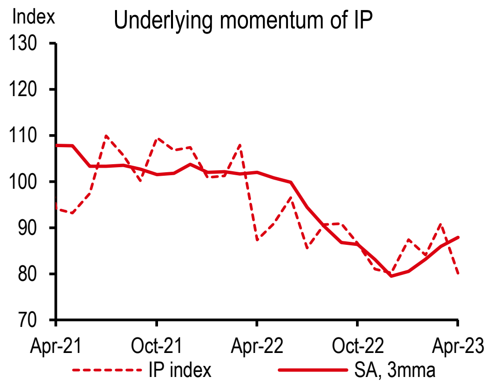
Source: CEIC, HSBC

Chart 3: Services have normalised but manufacturing remains weak



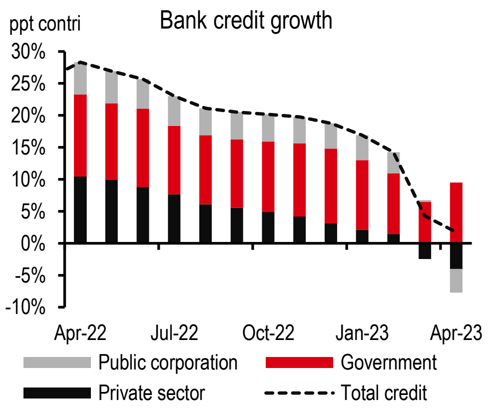
Source: CEIC, HSBC

Chart 4: IP indicates a small improvement after many months of weakness



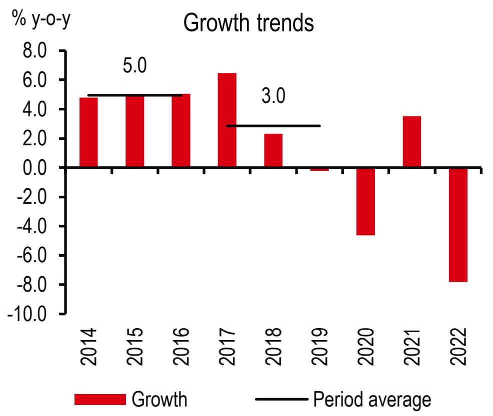
Source: CEIC, HSBC

Chart 5: Private sector credit growth remains particularly weak



Source: CEIC, HSBC

Chart 6: Growth potential had fallen from 5% to 3% at the eve of the pandemic



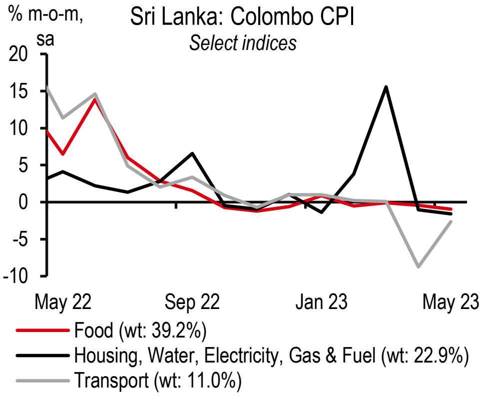
Source: CEIC, HSBC

We expect another 5ppt cut in the policy rates over the next few quarters (1.5ppt cut each in 3Q23 and 4Q23, followed by a 1ppt cut each in 1Q24 and 2Q24), taking the Standing Lending Facility Rate (SLFR) and Standing Deposit Facility Rate (SDFR) rates to 9% and 8%, respectively (see *Central Bank of Sri Lanka: Policy rate normalisation begins*, 2 June 2023).

Exports have improved a tad on a seasonally adjusted % m-o-m basis, after a weak 2H22 (chart 9). However, in absolute terms, export earnings have come off while the import bill remains steady at cUSD1.4bn. The June monetary policy statement touched upon a gradual phasing out of the existing import restrictions. On June 10, import restrictions on 286 items were relaxed[9]. This could lead to some widening in the trade deficit.

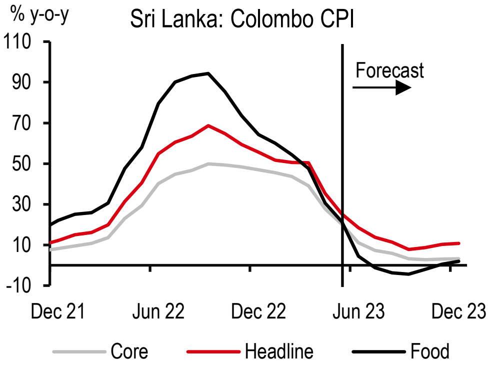
Thankfully, we believe rising tourism and remittance earnings can help fund this, keeping the current account deficit at manageable levels. Going by the current trends, we think tourism and remittance income combined can lead to dollar inflows of cUSD7.5-8.5bn (8-9% of GDP) in 2023 (chart 10).

Chart 7: Normalisation of food prices and a fall in fuel and gas prices have helped bring down inflation



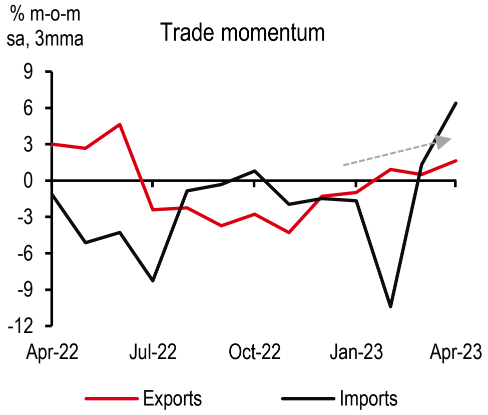
Source: CEIC, HSBC

Chart 8: Inflation will be back in CBSL's target range of mid-single digit only by mid-2024



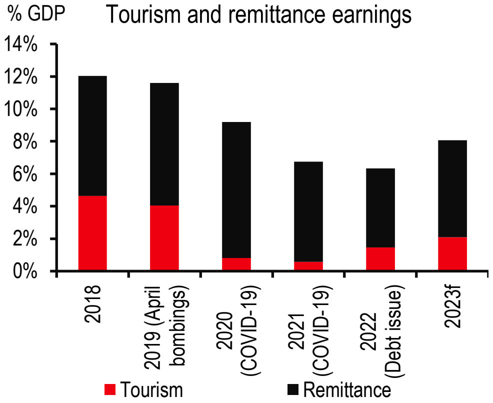
Source: CEIC, HSBC estimates

Chart 9: Imports are growing faster than exports



Source: CEIC, HSBC

Chart 10: Tourism and remittance income can lead to dollar inflows of c8-9% of GDP



Source: CEIC, HSBC estimates

9 Economynext | Sri Lanka relaxes import restrictions on nearly 300 items, June 10, 2023

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