

SRI LANKA

# MACRO ROUNDUP

**Potential Fiscal Challenges from Populist Proposals;**  
*Navigating Surpluses and Political Challenges*

**ASIA SECURITIES RESEARCH**

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02 September 2024

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- Sri Lanka's fiscal revenue has surged during 2024 YTD, leading to better-than-expected primary surpluses. While this momentum could support fiscal consolidation efforts into 2025, potential fiscal challenges arise from populist political proposals. These include a proposed 24% public sector salary hike, increased cash transfers, reduced personal income taxes, and higher subsidies, which could significantly strain fiscal resources in 2025.
- We anticipate upward interest rate pressure in the near term due to substantial treasury financing needs from September to December 2024. Although loan demand grew across various sectors in 2Q CY24, a contraction in lending is expected in 3Q CY24, particularly in the retail sector.
- Given the limited fiscal space, we expect the newly elected regime to mobilize revenue through the implementation of, i) an implied rental income tax from April 2025, ii) removal of specific tax exemptions, and iii) tax increases for tobacco, alcohol, and gaming industries.
- The current account has maintained a surplus in 2024, supported by remittance inflows and tourism recovery, with gross official reserves at USD 5.7bn by July 2024. We analyze the potential scenarios influencing the LKR, while also emphasizing the real growth drivers within the industry, services, and construction sectors.
- Inflation is projected to remain subdued in the near term. Despite the highest trade deficit in July 2024 at USD 604mn, the external sector remains positive, driven by higher export and import volumes.
- The banking sector has shown improved credit risk stability with better stage 3 ratios, delinquency coverages, and enhanced capital buffers.



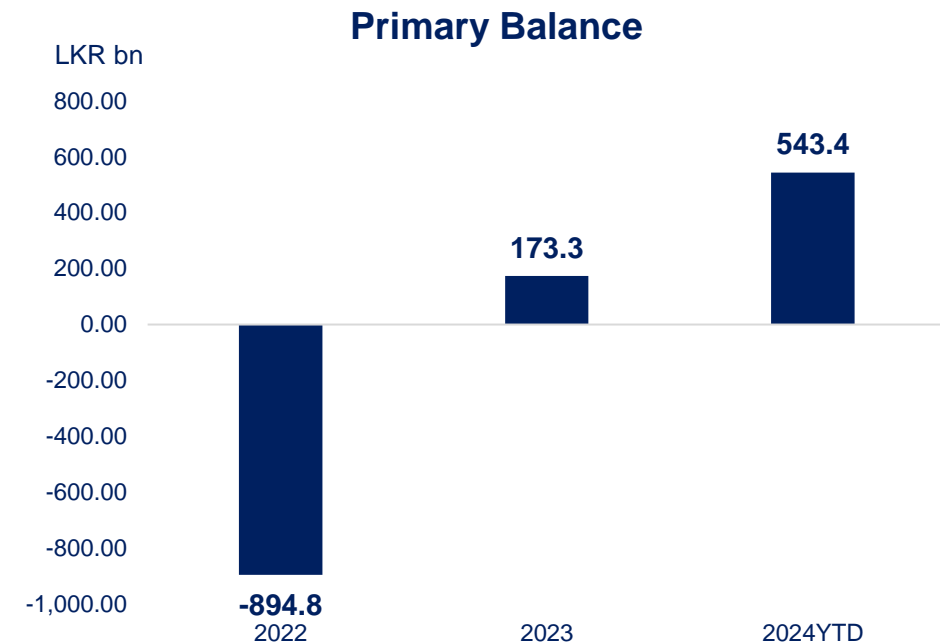
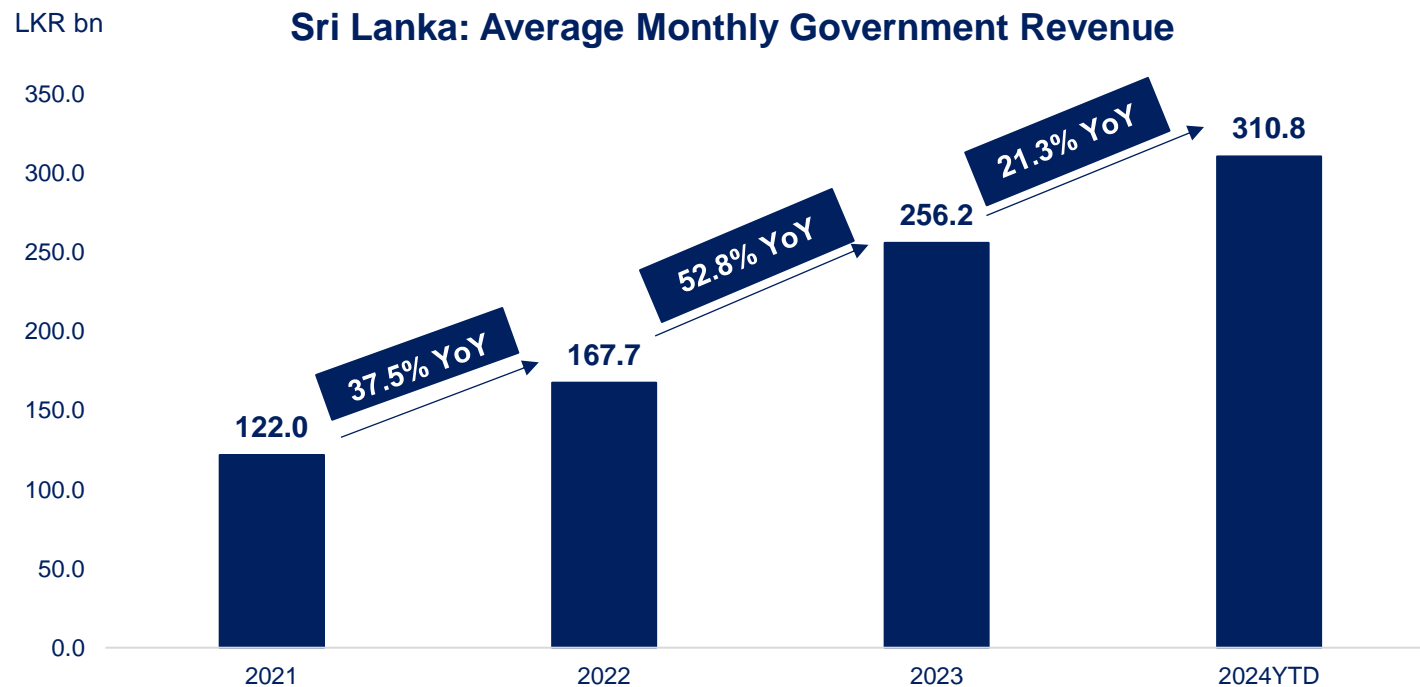
## FISCAL CHALLENGES, INTEREST RATE PRESSURES, AND LENDING CONTRACTION

1. POTENTIAL FISCAL CHALLENGES AHEAD FOR SRI LANKA AMID POPULIST POLITICAL PROPOSALS
2. MARKET ANTICIPATES UPWARD INTEREST RATE PRESSURES IN THE NEAR-TERM AMIDST SUBSTANTIAL TREASURY FINANCING NEEDS
3. QoQ LENDING CONTRACTION EXPECTED IN Q3 CY24?



# POTENTIAL FISCAL CHALLENGES AHEAD FOR SRI LANKA AMID POPULIST POLITICAL PROPOSALS

- Despite Sri Lanka's concerted efforts to adhere to the IMF's envisaged fiscal path, the populist nature of recent political proposals by popular candidates may potentially lead to a fiscal drain in 2025. The estimated primary surpluses for 2024E and 2025E are LKR 309bn and LKR 781bn, respectively. However, **the proposed public sector salary hikes are expected to increase fiscal costs by approximately LKR 250bn in 2025E.** Additionally, **the proposed increases in cash transfers, personal income taxes, and subsidies are projected to amount to around LKR 300bn.** These measures pose a threat to the continuation of the IMF program unless they are balanced by incremental revenue streams proposed through new taxes.

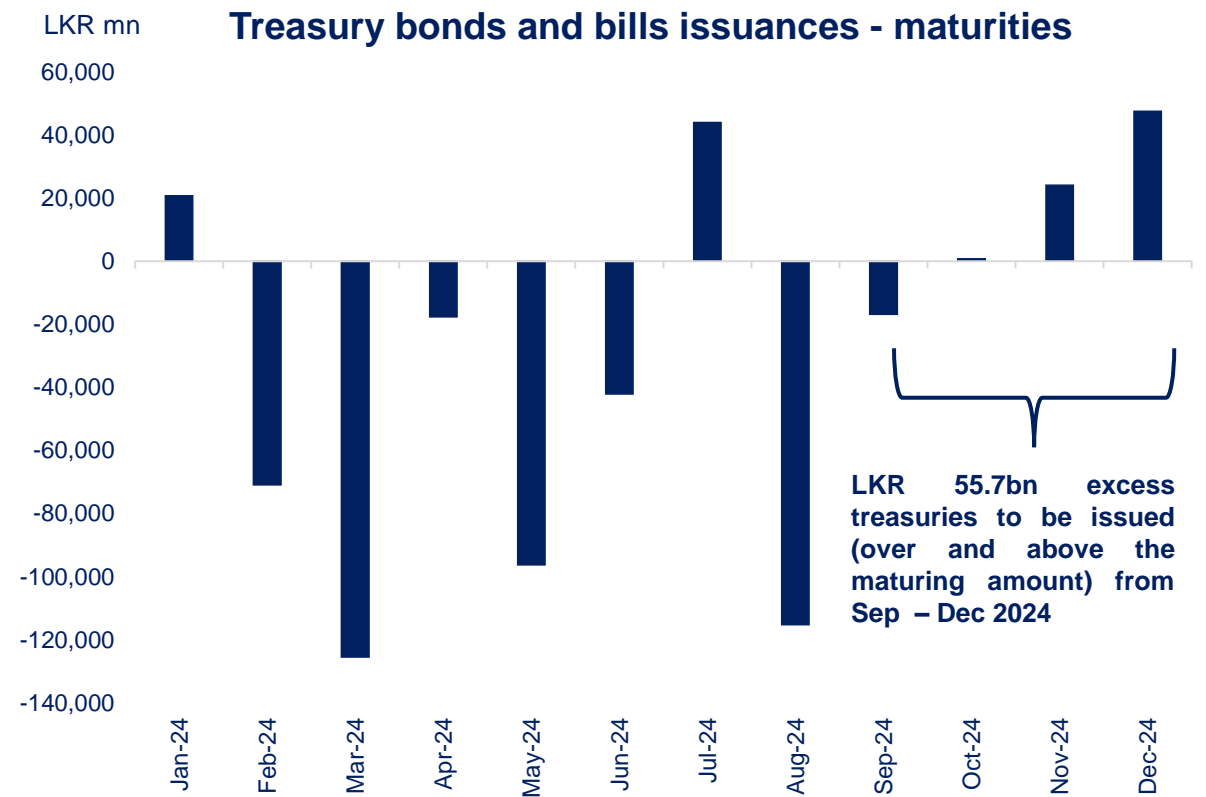
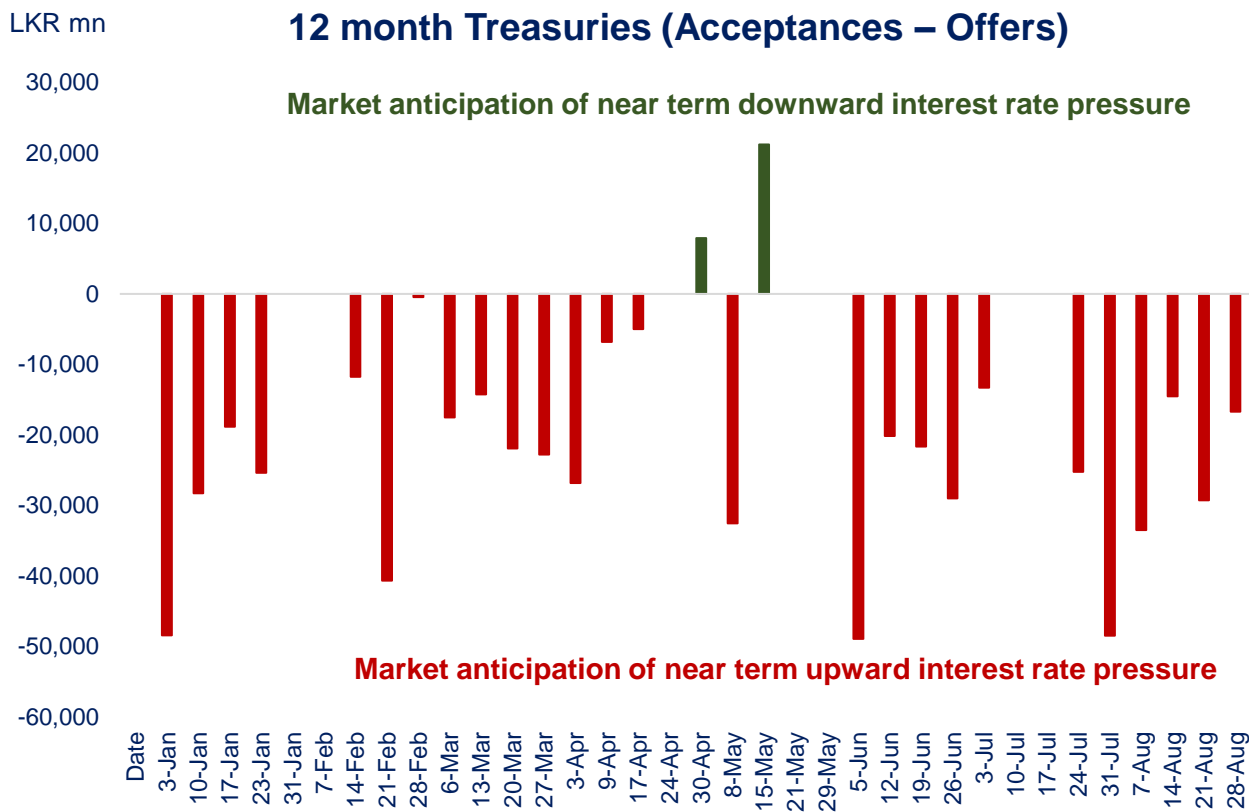


Refer [annexure 01](#) for a comparative analysis of the election manifestos of the leading three candidates

**Note: IMF's estimated primary balances for 2024E and 2025E stand at LKR 309.2bn and LKR 781bn respectively**

# MARKET ANTICIPATES UPWARD INTEREST RATE PRESSURES IN THE NEAR-TERM AMIDST SUBSTANTIAL TREASURY FINANCING NEEDS

- The Central Bank's yield curve projections are consistent with market expectations for the short term (refer graph on 12 month G-sec acceptances – Offers). However, the market foresees an increase in interest rates over the near term. This perspective is underpinned by the significant Treasury financing requirements from September 2024 to December 2024, amounting to LKR 887.5bn, compared to the maturing obligations of LKR 831.8bn.

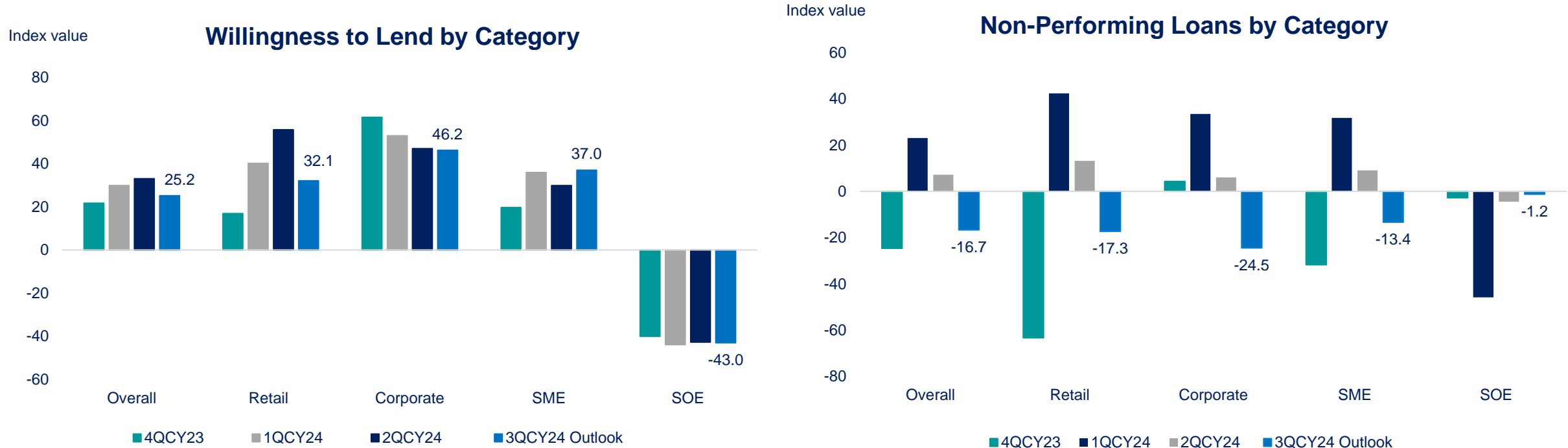




# QoQ LENDING CONTRACTION EXPECTED IN Q3 CY24?

- During the 2Q CY24, loan demand experienced substantial growth across the retail, corporate, and SME sectors, while the SOE sector saw a decline. Willingness to lend during 3Q CY24 is likely to contract on account of a decline in willingness to lend to the retail sector.

## Sri Lanka – Credit Estimates (all LCBs and LSBs) for 3Q CY24E



**Note:** Indices are calculated as 'Diffusion Indices', that take values between -100 and 100, by weighting responses of the licensed banks using exposure of each bank to total gross loan portfolio of the banking sector.

**Interpretation:** Index value > 0 : QoQ increase, Index value < 0 : QoQ decrease and Index value = 0 : QoQ unchanged



## POTENTIAL OPTIONS TO BRIDGE THE NEAR-TERM MANIFESTO PROMISES

1. IMPLIED RENTAL INCOME TAX
2. REMOVAL OF SPECIFIC EXEMPTIONS
3. TAX INCREASES FOR TOBACCO, ALCOHOL, AND GAMING





## Proposed Implied Rental Income Tax

- **Introduction and Purpose:** The imputed rental income tax is introduced to sustain revenue mobilization efforts. Initially planned as a property tax for 2025, it faced institutional impediments and is now substituted by this tax.
- **Implementation Date:** The tax will be introduced by April 1, 2025.
- **Scope and Exemptions:** This tax applies to owner-occupied and vacant residential properties. There will be an exemption threshold and a graduated tax rate schedule to ensure fairness.
- **Revenue Impact:** Expected to raise about 0.3% of GDP in 2025. This tax is imposed on the income of individuals rather than the property itself, aligning with the constitution.
- **Historical Context:** A similar tax was included in the Inland Revenue Act No. 10 of 2006 but generated minimal revenue due to broad exemptions and outdated valuation methods.
- **Supporting Measures:** Establishing a property valuation database, operationalizing a nationwide digital Sales Price and Rents Register, and enhancing data sharing among government entities to streamline the introduction of the property tax.

## Removal of Specific Exemptions

- The CIT exemption on the export of services will be removed, contributing approximately 0.04% of GDP.

## Tax Increases for Tobacco, Alcohol, and Gaming

- The government plans to increase the Corporate Income Tax (CIT) rate on the betting and gaming, tobacco, and liquor industries from 40% to 45%. This measure is expected to contribute approximately 0.08% of GDP.

*If implemented correctly, the proposals promised by the current Minister of Finance and the Central Bank Governor could enable Sri Lanka to boost its average sustainable revenues to over LKR 400bn per month from 2H CY25E*



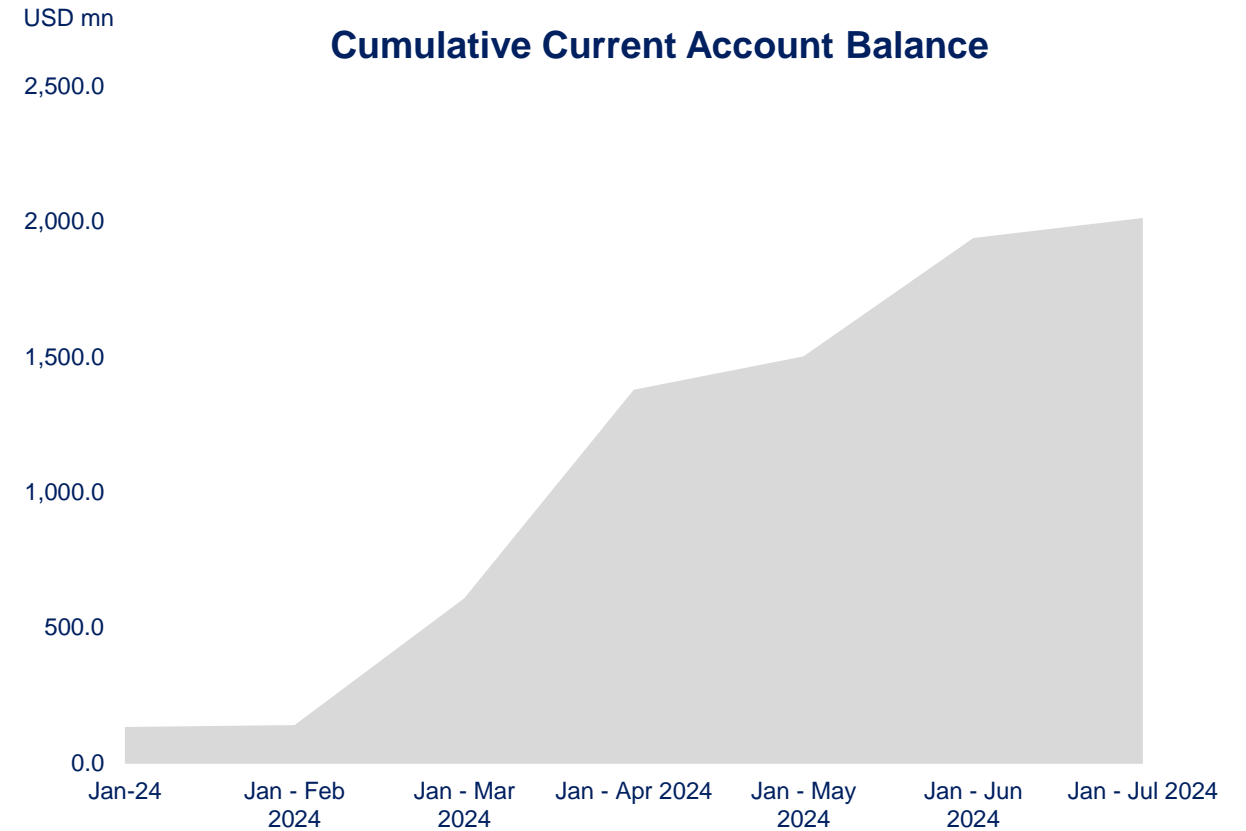
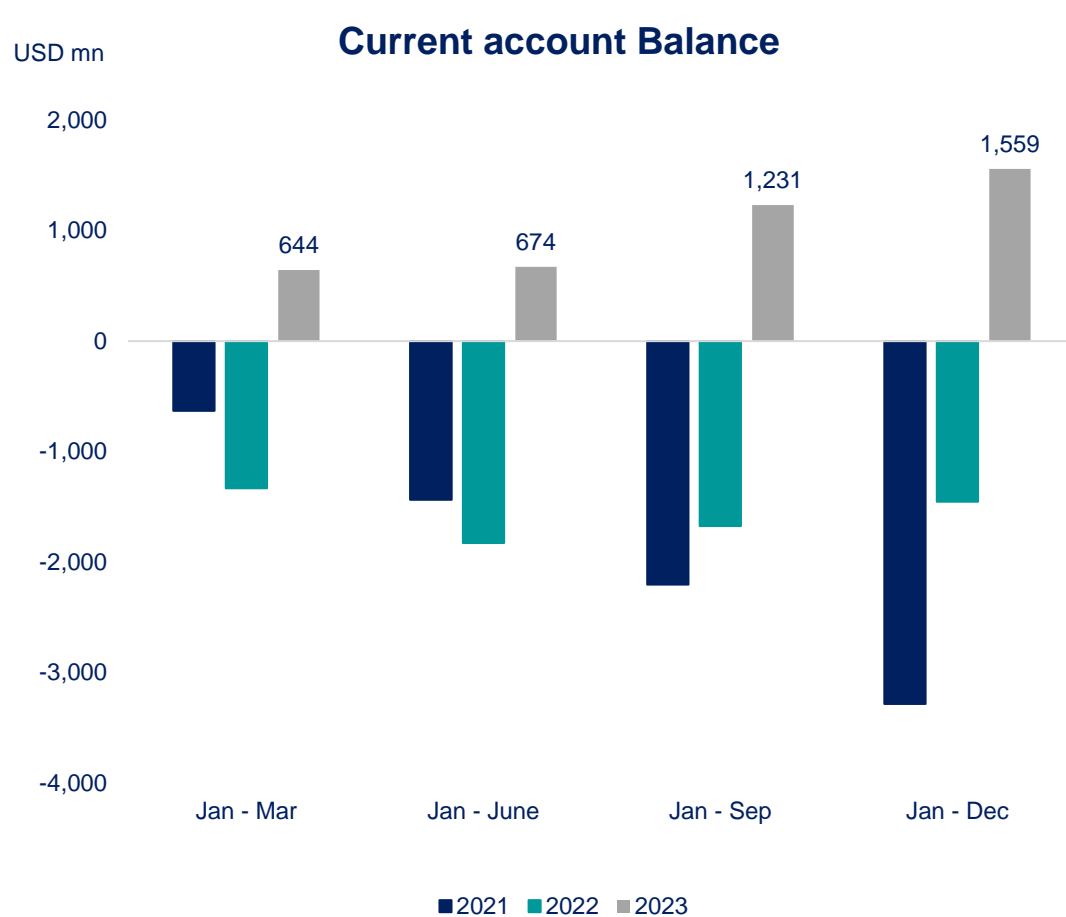
## **SURPLUSES, RESERVES, AND FUTURE LKR SCENARIOS LEADING TO OUR PROJECTIONS**

- 1. CURRENT ACCOUNT SURPLUSES CONTINUE INTO  
2024**
- 2. IMF SUPPORT AND MARKET ACQUISITIONS  
STRENGTHEN SRI LANKA'S FOREIGN RESERVES**
- 3. NEAR TERM MULTILATERAL INFLOWS &  
RESTRUCTURED DEBT**
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# CURRENT ACCOUNT SURPLUSES CONTINUE INTO 2024

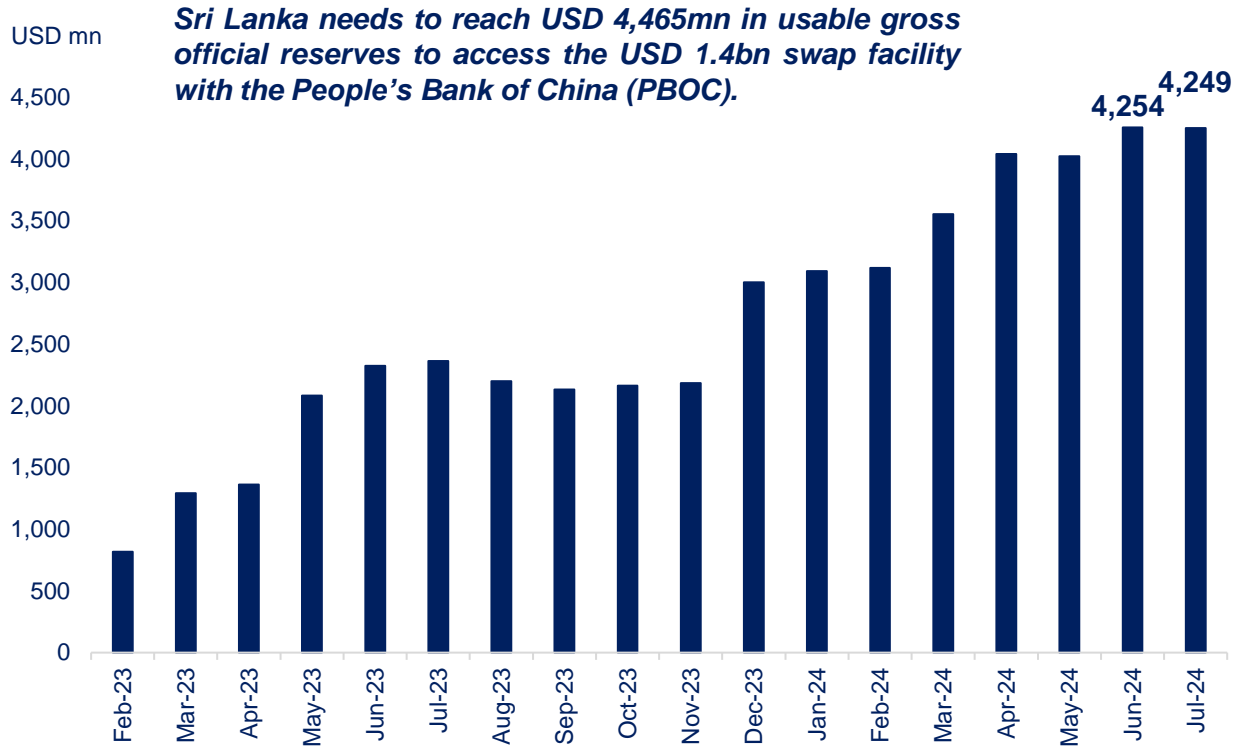
- The current account has maintained a surplus throughout 2024, bolstered by robust remittance inflows and a recovery in tourism. This positive balance, although controlled to an extent via vehicle import restrictions and paused debt settlements, has resulted in the CBSL improving its gross official reserves during 2024 YTD.



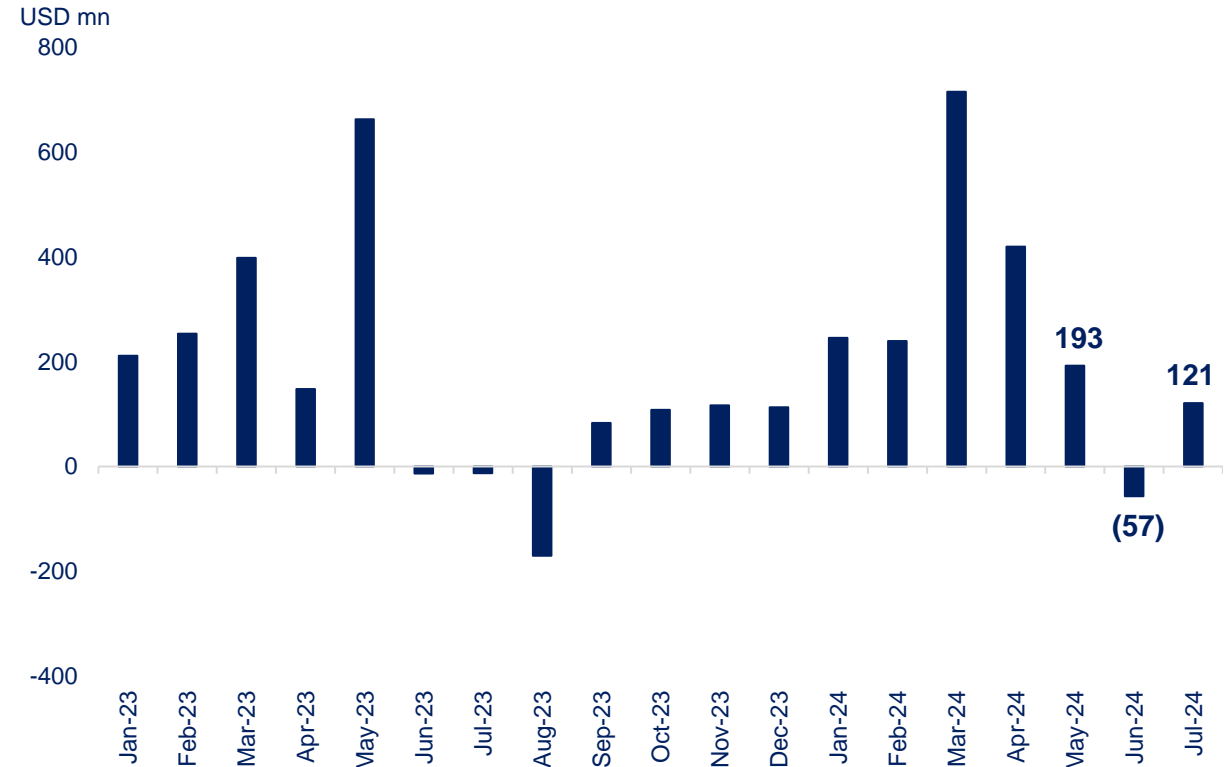
# IMF SUPPORT AND MARKET ACQUISITIONS STRENGTHEN SRI LANKA'S FOREIGN RESERVES

- By the end of July 2024, the Gross Official Foreign Reserves (GOFR) were reported at USD 5.7bn, including the USD 1.4bn SWAP facility with China. Reserves remained strong in 2024YTD due to the infusion of USD 336mn from the IMF following the successful second review of the 48-month EFF program. Additionally, from January to July 2024, the Central Bank's net foreign exchange acquisitions from the local market totaled USD 1.9bn.

## Sri Lanka – Usable Foreign Reserves (Ex PBOC SWAP of USD 1.4bn)



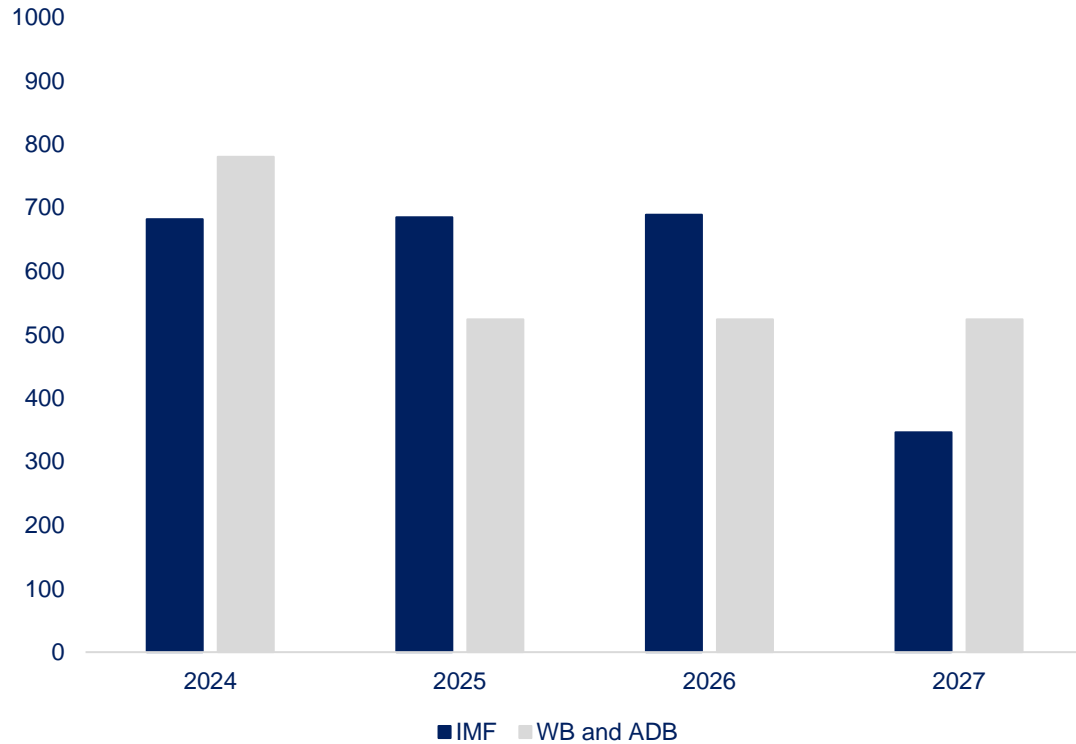
## CBSL: Net Purchase of Foreign Reserves



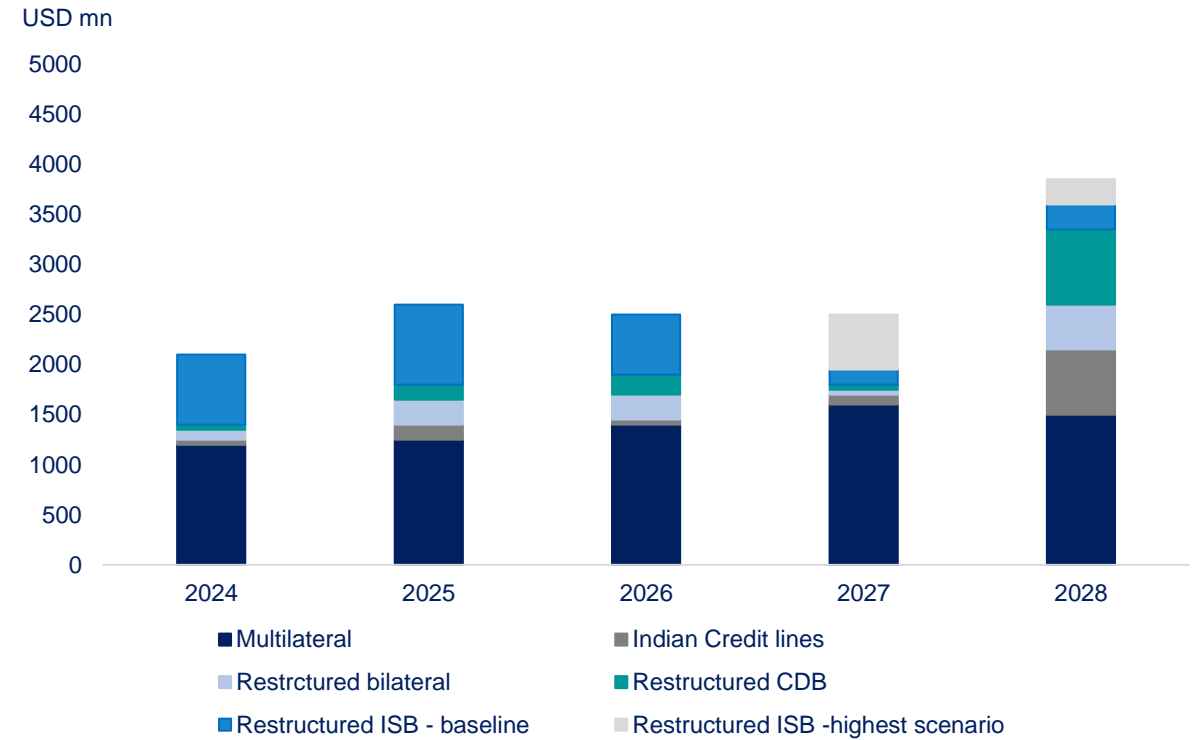
# WHILST NEAR TERM MULTILATERAL INFLOWS ALLOW AN INITIAL CAPITAL A/C CUSHION, COMMENCEMENT OF THE SETTLEMENT OF RESTRUCTURED DEBT TO RESULT IN GRADUAL LKR ADJUSTMENTS IN THE MEDIUM TO LONG TERM

- Adjusted for the second review, inflows from multilateral sources (IMF, WB, and ADB) are expected to total approximately USD 700mn during 4Q CY24E. This funding will provide an initial cushion for the September 2024 outflow of USD 724mn on ISBs (subject to the approval of the Official Creditor Committee of the Bi-lateral creditors), broadly neutralizing the impact on the gross official foreign reserve by 31 December 2024.

**Multilateral Funding (adjusted for the 2nd review)  
= USD6,656mn**



**Sri Lanka: Near to Medium Term External Obligations**



*Excluding the CBSL RBI ACU*

- **Political Stability:** Assuming a pro-market political outcome in September 2024, the LKR is expected to depreciate only gradually, towards our Y/E forecast of LKR 319/USD for 2024.
- **Economic Adjustments:** The LKR is projected to depreciate at an average rate of 5% per annum from 2025 onwards, based on the estimated fundamentals of Sri Lanka's balance of payments (BOP).
- **Delays in the OCC's approval of the ISB-JWF:** Although this kind of a scenario may delay Sri Lanka's debt settlements, the uncertainty this creates will result in the LKR depreciating during the latter part of the year.
- **Election of a non-pro-market candidate as president:** While this may cause some initial volatility in the LKR in late 2024, the limited options available to any potential president for managing the economy, aside from the IMF-agreed path, may eventually stabilize the economy by year-end, aligning with our Y/E forecast of LKR 319/USD for 2024.

**Key:**

**ISB:** International Sovereign Bonds

**JWF:** Joint Working Framework on restructuring ISBs proposed by the ad-hoc bondholder group

**OCC:** Official Creditor Committee of the Bi-lateral creditors



## REAL OUTPUT, PRICE PRESSURES, TRADE AND DELINQUENCY TRENDS

1. POSITIVE GDP GROWTH IN 2Q CY24E DRIVEN BY INDUSTRY, SERVICES, AND CONSTRUCTION SECTORS
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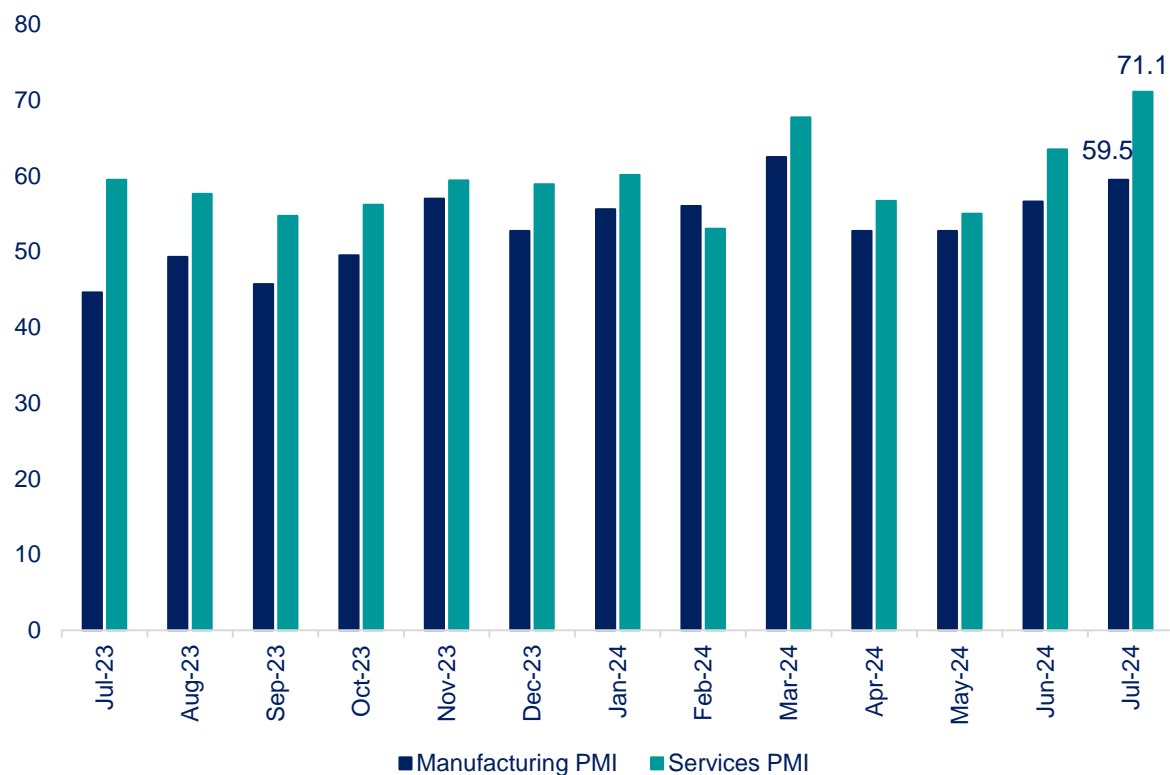




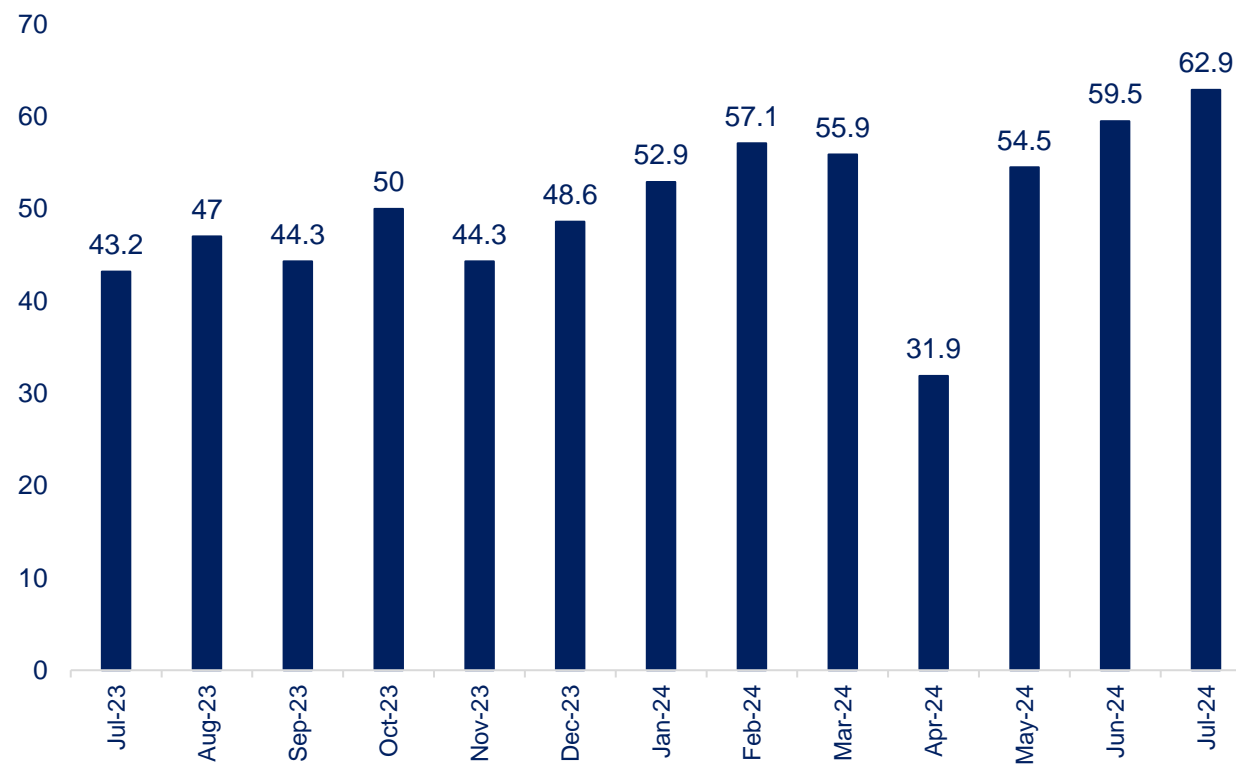
# POSITIVE GDP GROWTH IN 2Q CY24E DRIVEN BY INDUSTRY, SERVICES, AND CONSTRUCTION SECTORS

- Real GDP is anticipated to grow positively in 2Q CY24E, fueled by strong performance in the Industry and Services sectors (refer PMI on manufacturing and services), with the services sector benefitting from increased tourist arrivals boosting accommodation, food and beverage services, and transportation.
- In July 2024 Sri Lanka's PMI for Construction continued its upward trend, with the total activity index rising to 62.9, signaling robust sector growth. Construction activity, driven primarily by multilateral agency-funded projects, increased steadily.

### Purchasing Managers' Index



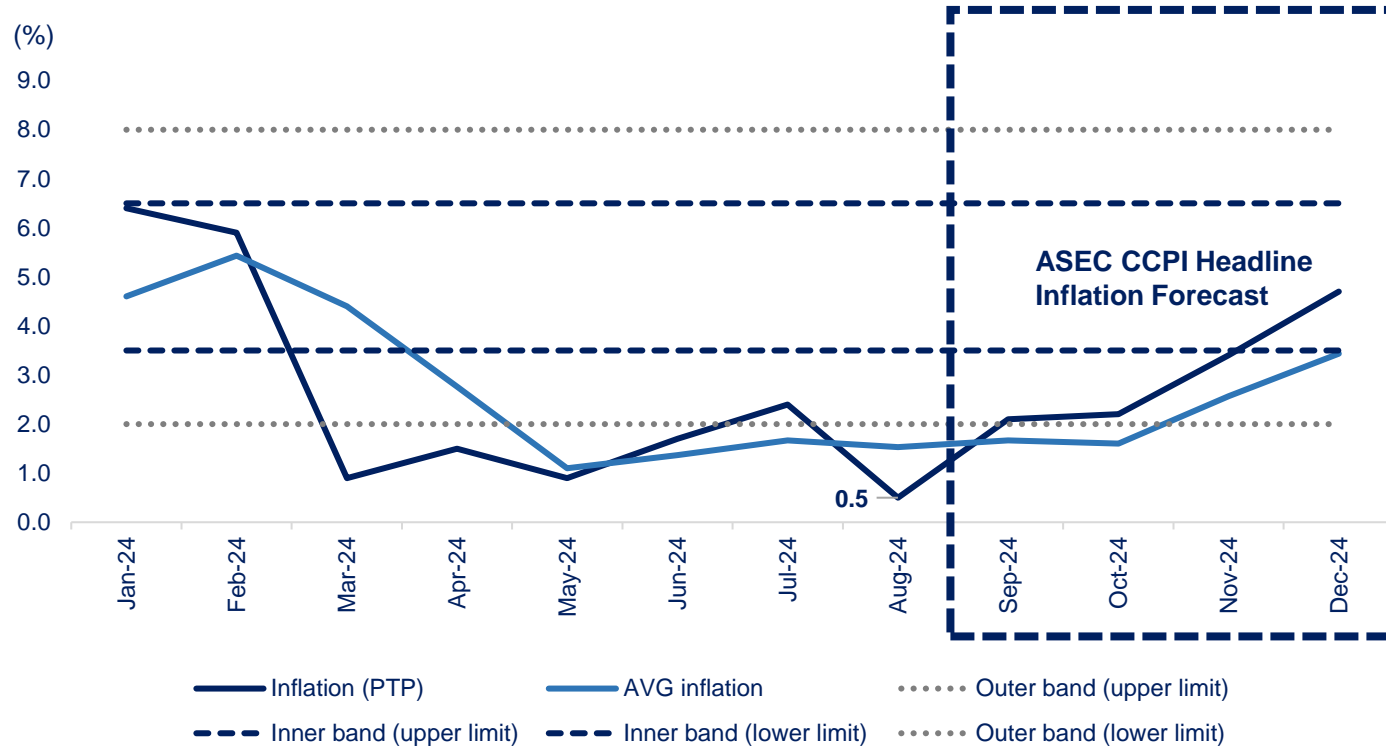
### Construction PMI



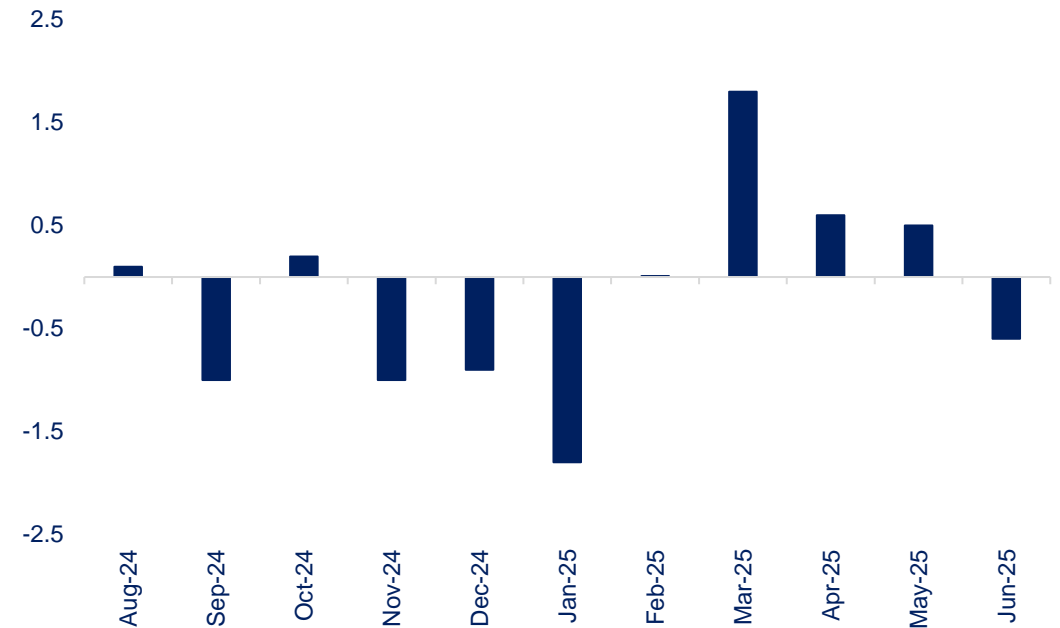
# SUBDUED INFLATION OUTLOOK DRIVEN BY TARIFF REDUCTIONS AND FAVORABLE BASE EFFECT

- Headline inflation is expected to stay below the 5% target in the coming months, primarily due to significant reductions in electricity tariffs and relatively subdued demand pressures. Additionally, a favourable statistical base effect is anticipated to contribute, particularly during 2H CY24 and into early 2025.

**Sri Lanka: Headline Inflation Forecast – to remain below the target level of 5% in the NT**



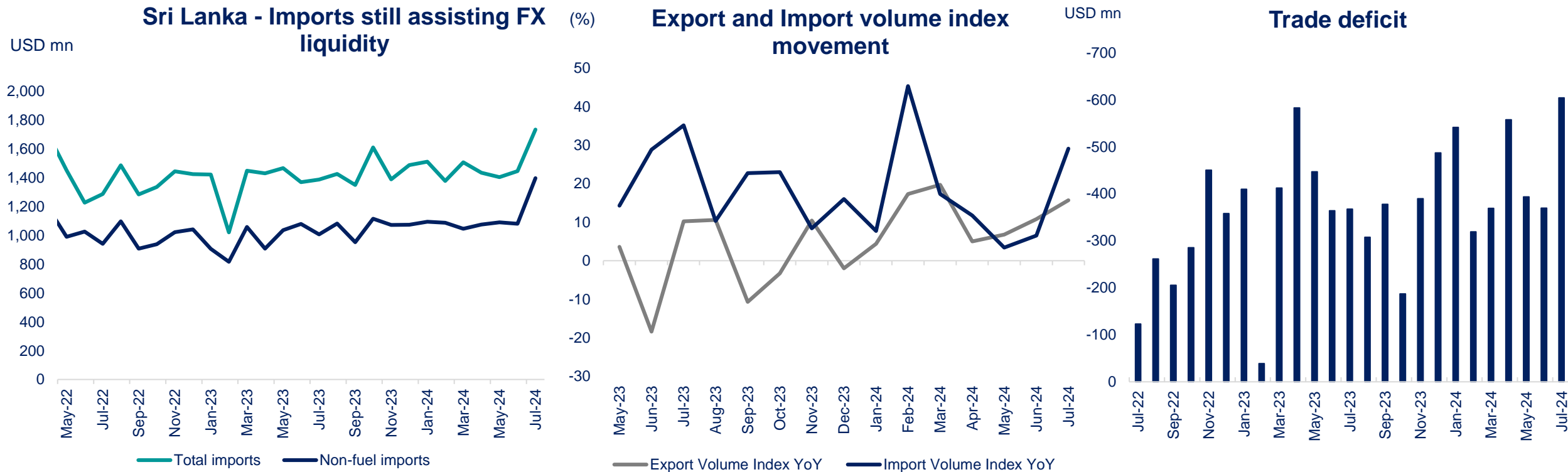
**Base Effect (CCPI, 2021 = 100)**



**Note: Inflation in Sri Lanka has been maintained below the Central Bank of Sri Lanka's target of 5%, with recent figures indicating a rate of 0.5% in August.**

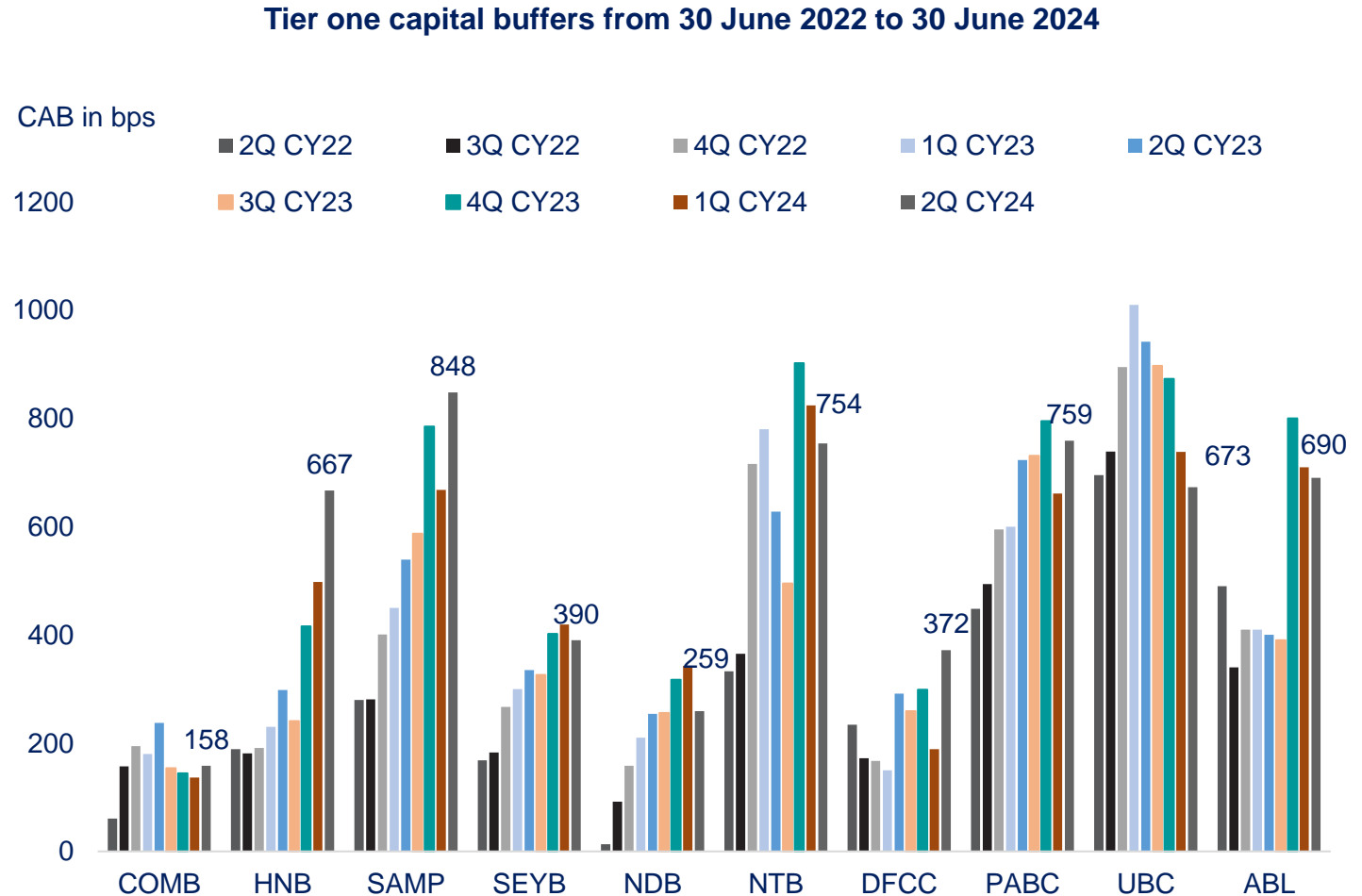
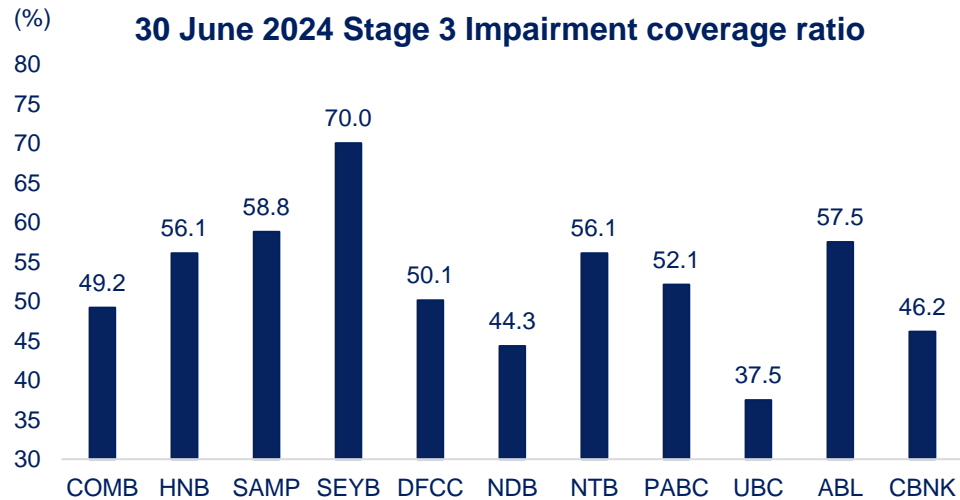
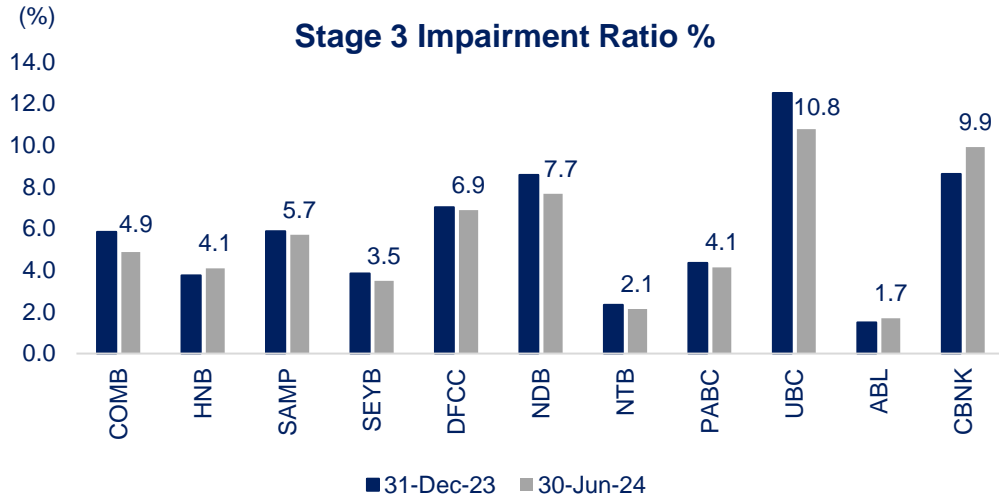
# JULY 2024 SEES HIGHEST TRADE DEFICIT YET, BUT EXTERNAL SECTOR REMAINS POSITIVE

- In July 2024, the trade deficit widened to USD 604mn, marking the highest monthly trade deficit so far in 2024. Although the trade deficit is expected to widen further later in 2024 due to higher import expenses, improvements in the services and secondary income accounts are anticipated to maintain positive momentum in the external sector. As a result, a slight surplus in the external current account is projected for 2024.
- In July 2024, both export and import growth were driven by higher volumes. The export volume index increased by 15.7% YoY, while the import volume index surged by 29.1% YoY. Despite declines in unit prices, export earnings and import expenditures rose due to these volume changes.



# IMPROVED CREDIT RISK STABILITY REFLECTS IN BETTER STAGE 3 RATIO FOR BANKS

The banking sector's stage 3 ratio improved during 1H CY24, reflecting a slowdown in Stage 3 loan growth and improved credit risk stability.





MACRO FORECASTS AND  
ANNEXURES



# SRI LANKA : KEY MACRO VARIABLE FORECASTS

|  | 2022   | 2023   | 2024YTD             | 2024E  | 2025E  |
|--|--------|--------|---------------------|--------|--------|
| 1. GDP growth (YoY Real) %                   | -7.3   | -2.3   | 5.3 (1Q CY24)       | 2.7    | 3.2    |
| 2. Inflation CCPI Y/E PoP (Headline) %       | 57.2   | 4.0    | 0.5 (31 Aug '24)    | 3.8    | 6.2    |
| 3. Avg Inflation CCPI Y/E PoP (Headline) %   | 45.9   | 20.5   | 2.5 (31 Aug '24)    | 3.6    | 5.9    |
| 4. AWPLR Y/E %                               | 27.2   | 12.1   | 9.1 (30 Aug '24)    | 10.2   | 13.0   |
| 5. Exchange Rate (Spot mid: LKR/ USD)        | 363.1  | 323.9  | 299.6 (02 Sep '24)  | 319.0  | 334.0  |
| 6. Private Sector Credit Growth % (Y/E YoY%) | 6.4    | -0.6   | 6.2 (30 Jun '24)    | 9.0    | 14.0   |
| 7. 12M government treasury bill yield %      | 29.3   | 12.9   | 10.0 (28 Aug '24)   | 10.7   | 12.6   |
| 8. Trade Deficit (USD mn)                    | -5,185 | -4,900 | -3,144 (31 Jul '24) | -5,963 | -7,625 |
| 9. Remittances (USD mn)                      | 3,789  | 5,970  | 3,711 (31 Jul '24)  | 6,505  | 6,750  |
| 10. Earnings from Tourism (USD mn)           | 1,136  | 2,068  | 1,885 (31 Jul '24)  | 3,500  | 4,300  |
| 11. Gross Official Foreign Reserves (USD mn) | 1,898  | 4,400  | 5,649 (31 Jul '24)  | 5,346  | 7,477  |
| 12. Tourism Arrivals ('000)                  | 720    | 1,487  | 1,342 (25 Aug '24)  | 2,100  | 2,400  |

# ANNEXURE 01: COMPARATIVE ANALYSIS OF THE ELECTION MANIFESTOS OF THE LEADING THREE CANDIDATES

|                   | Ranil Wikramasinghe<br>(Independent)   | Anura Kumara Dissanayake<br>(NPP)  | Sajith Premadasa<br>(SJB)   |
|-------------------|--|--|---|
| Economic Policies | <ul style="list-style-type: none"> <li>Primary Budget Surplus: 2.3% of GDP by 2025-2032</li> <li>Follow IMF DSAs during 2025E to 2029E</li> <li>Gross Official Foreign Reserves: USD 15.1bn by 2028</li> <li>Inflation: To maintain around 5%</li> <li>Treasury Guarantees: Below 7.5% of GDP</li> <li>Establish a debt-free, developed economy by 2048</li> <li>Incremental tax brackets to increase from current LKR 500,000 per annum to 720,000 per annum.</li> </ul>                                | <ul style="list-style-type: none"> <li>Tax-Free Threshold: Increase the annual tax-free threshold from current LKR 1.2mn to LKR 2.4mn.</li> <li>VAT: 0% for essential goods and services.</li> <li>Corporate Income Tax: Increase the allowable deduction for corporate income tax on machinery expenses to 120%.</li> <li>Re-evaluation of the revenue-based fiscal consolidation proposals presented by the IMF.</li> <li>Introduction of new proposals regarding efficient tax administration and government expenditure management.</li> </ul> | <ul style="list-style-type: none"> <li>Personal income tax after the Tax-free slab of LKR 100,000 per month will start at 1% and increase up to 24% income up to LKR 500,000 per month</li> <li>Corporate Income Tax: To reduce up to 6% from the present 30% rate for profits on exports and introduce a 15% Base Erosion and Profit Shifting (BEPS) minimum alternate tax for multinational companies.</li> <li>VAT: Reduce to 15% upon improvement of tax compliance</li> <li>Excise Tax: sin taxes to be adjusted to fund the proposed tax reductions.</li> </ul> |
| Social Policies   | <ul style="list-style-type: none"> <li>Reduce the percentage of the population suffering from various hardships to 10% within the next 5 years.</li> <li>Initiated a comprehensive and extensive program called "Aswesuma" to uplift the people from poverty.</li> <li>Impoverished families will receive allowances of up to LKR 15,000 per month and additional allowances will be provided specifically for families with kidney patients, individuals with disabilities, and the elderly.</li> </ul> | <ul style="list-style-type: none"> <li>National Social Security Fund: LKR 10,000 per month for low-income families.</li> <li>Pensions: Comprehensive policy for all sectors</li> <li>Support for Senior Citizens: Monthly allowance of LKR 5,000 in need of assistance.</li> </ul>   | <ul style="list-style-type: none"> <li>Support for Farmers: Waive off their existing farmer loans (Govi Naya), offer a 50kg fertilizer bag for LKR 5,000.</li> <li>Guaranteed interest rate of 15% on savings to be provided for senior citizens.</li> <li>LKR 10,000/ month (from LKR 7,500) for 50,000 Chronic Kidney Disease of Unknown etiology (CKDu) affected persons.</li> <li>Propose a new poverty alleviation programme that will provide a monthly allowance of LKR 20,000 per month up to 24 months for beneficiary families.</li> </ul>                  |



# ANNEXURE 01: COMPARATIVE ANALYSIS OF THE ELECTION MANIFESTOS OF THE LEADING THREE CANDIDATES..

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|--------------------------|---|--|---|
| <b>Social Policies..</b> | <ul style="list-style-type: none"> <li>Establish the Urumaya program that is designed to transfer land and home ownership to low income earners.</li> <li>Support for Farmers: LKR 25,000 per season subsidy on fertilizer.</li> <li>Support for Women: Relief loans at 3% interest for women-headed households.</li> </ul>   | <ul style="list-style-type: none"> <li>A 5% higher interest rate than the standard bank interest rate for the fixed deposits of senior citizens.</li> <li>Support for Disabled: LKR 10,000 per month for individuals with disabilities from low-income families.</li> </ul>  | <ul style="list-style-type: none"> <li>LKR 5,000 per month (from LKR 3,000) for 820,000 elderly citizens.</li> <li>Continue benefits to disable persons and increase the welfare allowance to LKR 10,000 per month (from the current LKR 7,500) for 410,000 persons.</li> </ul>   |
| <b>Public Sector</b>     | <ul style="list-style-type: none"> <li>Increase living allowance of LKR 25,000, subject to revision every three years. The minimum starting salary in the public service will be increased by a minimum of 24%, and the gross salary, along with the Cost Of Living Allowance (COLA), will be set at LKR 55,000, with basic salaries for all other positions adjusted accordingly.</li> <li>Paid Leave: One year paid leave to be granted for government employees under the age of 40 on training.</li> <li>Vocational Training: New program for youth with a stipend of LKR 35,000 to be introduced.</li> </ul> | <ul style="list-style-type: none"> <li>Establishment and implementation of a broad pension policy.</li> <li>Supervision of the pension fund by the Department of Pensions and the Central Bank.</li> <li>Encouraging every citizen, including farmers and fishermen, who are currently not employed in the public sector or organized institutional sector, to connect with the pension system.</li> <li>To propose a public sector pay hike in line with past average inflation.</li> </ul> | <ul style="list-style-type: none"> <li>Increase the monthly Cost Of Living Allowance (COLA), to all eligible public sector employees to a minimum of LKR 25,000 from the current LKR 17,800.</li> <li>The minimum initial monthly salary for government service will increase by a minimum of 24% (based on the current ratios for grades).</li> <li>This adjustment shall include any terms and conditions of various adjustments and allowances currently being enjoyed. The above two adjustments shall make the gross salary in public service up to a minimum of LKR 57,500 including the COLA.</li> </ul> |

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I, Peshali Colambage, certify that the views expressed in this report accurately reflect my personal views about the company. I also certify that no part of my compensation was, is, or will be, indirectly or directly, related to the specific view or recommendation expressed in this report

I, Sanjeewa Fernando, certify that the views expressed in this report accurately reflect my personal views about the company. I also certify that no part of my compensation was, is, or will be, indirectly or directly, related to the specific view or recommendation expressed in this report

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