Monthly Economic Update (MEU)

October 2024

Economic Intelligence Unit
The Ceylon Chamber of Commerce

Highlights

Sri Lankan Economy

World Bank Revises Sri Lanka's 2024 Growth Forecast to 4.4%, Doubling April Projection of 2.2%

The World Bank has revised Sri Lanka's 2024 growth forecast to 4.4%, doubling its earlier April projection of 2.2%. This reflects short-term stability, but long-term growth hinges on structural reforms, with poverty remaining high and inflation under control. The recovery is fragile, with risks like debt restructuring and financial instability, but strong reforms could attract capital inflows and boost prospects.

Energy Sector Deflation pushes Sri Lanka's Inflation below Target

Sri Lanka experienced deflation of 0.5% in September 2024, driven by sharp reductions in energy and transport prices, marking the first deflation since 2015. Despite this, core inflation remains above 3%, and the Central Bank is required to submit a report to Parliament as inflation has fallen below the target range for two consecutive quarters.

EU Green Deal and Its Implications for Sri Lanka's Exporters

The EU Green Deal's ambitious climate goals, including the Carbon Border Adjustment Mechanism (CBAM), will require Sri Lankan exporters to meet strict sustainability standards, particularly in sectors like apparel and rubber. While aligning with these policies presents challenges, it also offers opportunities for Sri Lankan businesses to gain a competitive edge in the European market by adopting greener production methods and advancing sustainability initiatives.

Sri Lanka Nears Completion of External Debt Restructuring

In the past two months, Sri Lanka has made progress toward completing its external debt restructuring, with agreements reached with ISB holders and China Development Bank, covering USD 17.4 billion in debt. This, along with USD 10.3 billion of bilateral debt restructured through the Official Creditor Committee (OCC), has received approval from the OCC and IMF for aligning with debt sustainability targets. Once finalized, Sri Lanka will pay a USD 225 million consent fee and installment payments on past due interest, with a 27% nominal GDP haircut under the baseline scenario.

Financial Sector Review- Sri Lanka

In early 2024, financial system stability improved, driven by domestic macrofinancial enhancements that eased pressures on household and institutional balance sheets, resulting in positive credit growth despite an elevated Non-Performing Loan (NPL) ratio. The banking sector's profitability increased due to rising net interest income and investments in government securities, while credit demand from households and institutions expanded, although debt levels remained below 2022 figures. Looking ahead, as demand for financial services grows, institutions must navigate challenges related to credit quality, profitability, and high sovereign exposure, all while managing the complexities of external and fiscal adjustments to ensure continued financial stability.

Global Economy

Global Economic Outlook 2024: Stable Growth Amid Persistent Risks and Challenges

The global economy is projected to grow at 3.2% in 2024 and 2025, with strong U.S. performance offsetting challenges in Europe and emerging markets, while inflation eases but remains a concern. Key risks include geopolitical tensions, financial market volatility, and China's property sector, requiring structural reforms, fiscal adjustments, and multilateral cooperation to ensure long-term stability.

Global Trade: Outlook for 2024-2025

Global trade is expected to grow by 2.7% in 2024 and 3% in 2025, following a contraction in 2023, driven by falling inflation and lower interest rates. However, the recovery remains fragile, with risks from geopolitical tensions, financial volatility, and diverging monetary policies posing potential challenges to sustained growth. Additionally, while goods trade shows moderate improvement, the outlook for services trade, particularly in tourism and digital sectors, is even more promising.

Dashboard

Y-o-Y changes, otherwise specified

Economic Growth

4.7% in Q2-2024

-3% (Q2-2023)

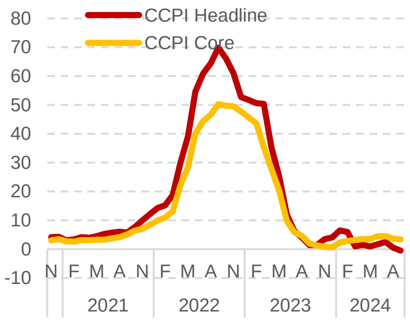
Movement of Purchasing Managers' Index-Sep 2024

Manufacturing PMI	54.1
Services PMI	53.4
Construction PMI (Aug)	51.4

All three indices recorded expansion.

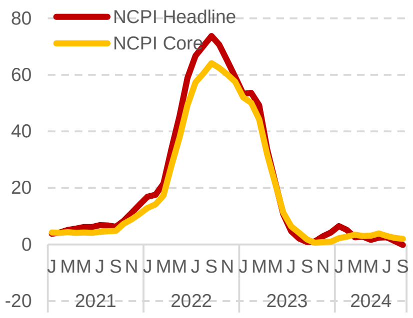
Inflation

CCPI Inflation (%)-*Base 2021*



Sep 2024	Headline	Core
	-0.5%	3.3%

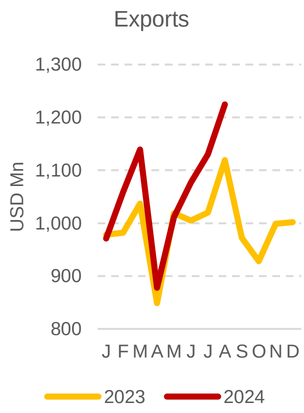
NCPI Inflation (%)-*Base 2021*

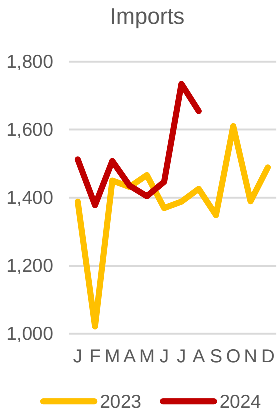


Sep 2024	Headline	Core
	-0.2%	1.9%

External Sector

Merchandise Trade





Trade Deficit
Aug 2024
40%

Services Account Balance
Aug 2024
19%

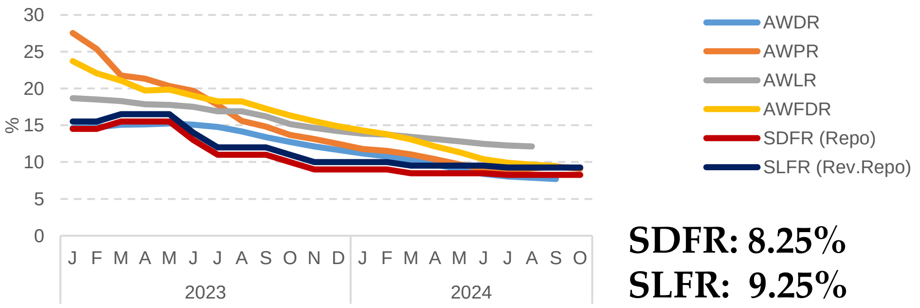
Tourism
Sep 2024

Arrivals **9%**

Earnings **19%**

Workers' Remittances
Sep 2024 **15%**

Interest Rates



SDFR: 8.25%
SLFR: 9.25%

Growth in Credit to Private Sector

July 2024

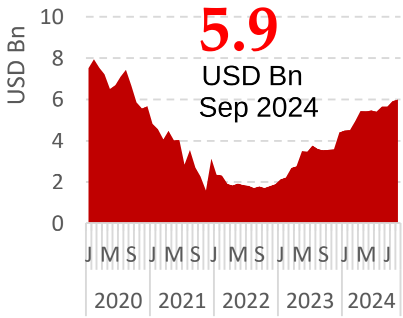
6.9%

Exchange Rate

Appreciation of LKR thus far 2024

10%

Official Reserves



KEY INSIGHTS
Sri Lankan Economy

World Bank Revises Sri Lanka's 2024 Growth Forecast to 4.4%, Doubling April Projection of 2.2%

As per the latest Development Update published by the World Bank, Sri Lanka's GDP is projected to grow by 4.4% in 2024, which is higher than the 2.2% forecast made by the World Bank in April this year. This improved short-term growth outlook was driven by macroeconomic stabilization of the country. However, the continued implementation of structural reforms is crucial for unlocking the medium- to long-term growth potential. While poverty (below USD 3.65 per person per day, 2017 PPP) is forecasted to decline gradually, it is expected to stay above 20% until 2026. Inflation will likely remain under the central bank's 5% target for 2024 but may rise toward the medium-term target as demand increases.

The current account is projected to stay in surplus, driven by tourism and remittances, with vehicle import restrictions being eased only after 2025. Debt restructuring and fiscal consolidation efforts are expected to reduce the overall fiscal balance over the medium term, but the outlook remains vulnerable.

Despite recent progress, the economy's stability is fragile, contingent on the consistent execution of fiscal, financial, and monetary policies. Downside risks include the potential for a prolonged or incomplete debt restructuring, policy uncertainty (especially around reforms and electoral promises), and the medium-term scarring from the crisis. Financial sector risks, such as elevated non-performing loans and significant exposure to sovereign debt, must be monitored closely to ensure stability.

On the positive side, strong implementation of reforms could restore confidence, attracting capital inflows and boosting economic prospects. However, poverty, inequality, and challenges such as malnutrition and stunting will remain critical issues unless comprehensive compensating mechanisms and sustained growth are ensured.

"Sri Lanka's recent economic stabilization, marked by four quarters of growth and a current account surplus in 2023, is a significant milestone. At this moment, Sri Lanka has a real opportunity to realize its export potential, which we estimate at $10 billion annually. There is an opening for Sri Lanka to deepen its participation in global value chains and take advantage of its geography and an evolving global landscape to generate jobs and sustain growth. The continued implementation of important economic and governance-related reforms will allow Sri Lanka to fully benefit from this moment."

David Sislen
World Bank Regional Country Director for Maldives, Nepal and Sri Lanka

Data Source:WB

KEY INSIGHTS
Sri Lankan Economy

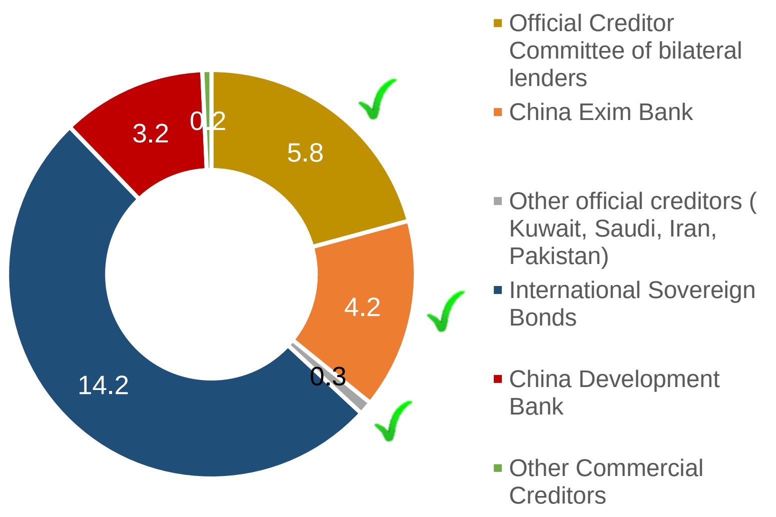
Sri Lanka Nears Completion of External Debt Restructuring

During the last two months, Sri Lanka has announced steps to complete the external debt restructuring. In mid-September the International Sovereign Bondholders and China Development Bank announced that they had reached agreement in restructuring the debt. Together this comprises USD 17.4 billion of external debt that is being restructured in addition to the USD 10.3 billion of bilateral debt that has been restructured through the Official Creditor Committee (OCC).

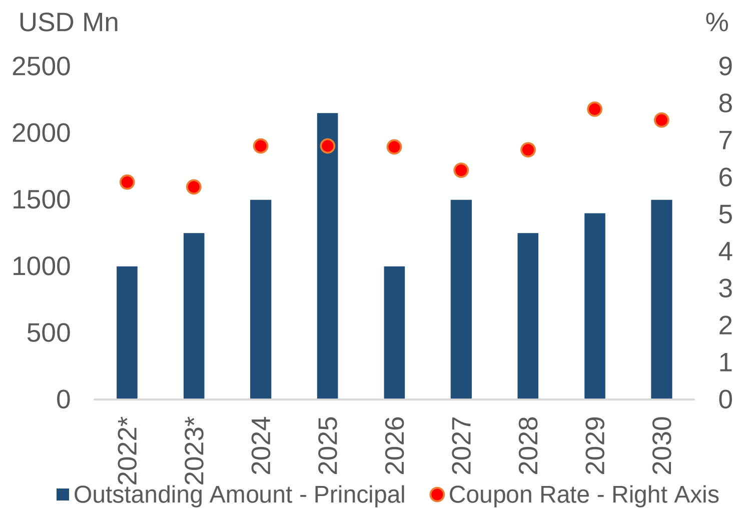
The OCC and the IMF has provided their go ahead in terms of the agreement being in line with the debt sustainability analysis and providing for inter-creditor equity. The new Government has committed to go ahead with the restructuring and as such the next steps will be to conduct the exchange offer for the issuance of the new bonds.

When this is completed, Sri Lanka will have to pay consent fee of USD 225 million and commit to paying the Past Due Interest for the bonds between 2022-2024 in instalments during the period leading up to 2028. Sri Lanka will receive an overall haircut of 27% on the baseline scenario for nominal GDP.

External Debt of $27.9 billion being restructured



ISB Schedule and Coupon Rate- Pre Restructure



ISB Schedule and Coupon Rate- Proposed

Data Source: MoF,

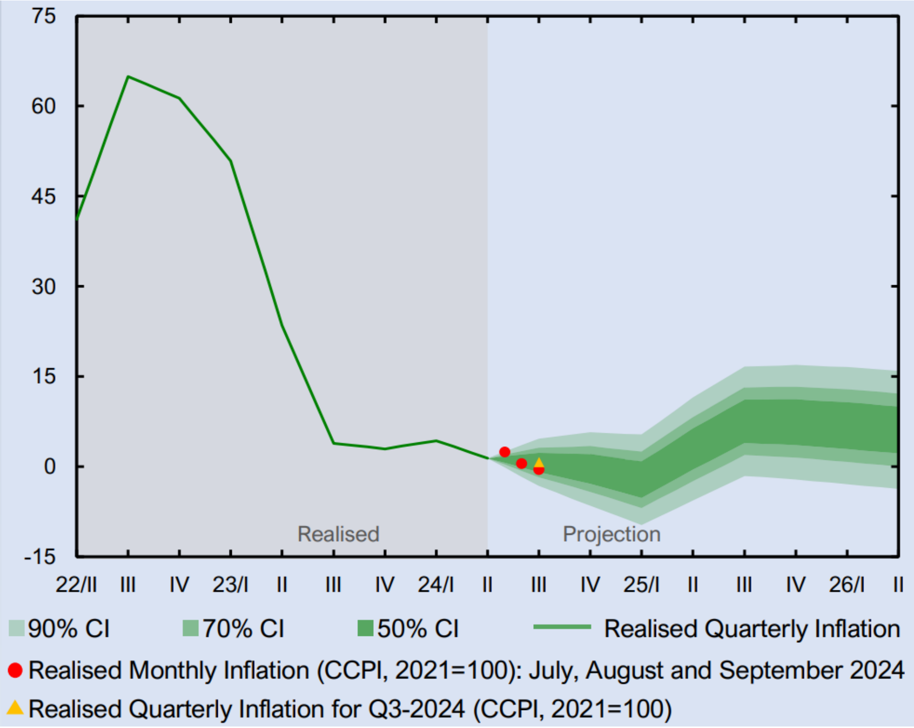
KEY INSIGHTS
Sri Lankan Economy

Energy Sector Deflation pushes Sri Lanka's Inflation below Target

The Colombo Consumer Price Index (CCPI) entered negative territory in September 2024, registering deflation of 0.5%. This marks the first instance of deflation since September 2015, when a deflation rate of 0.3% was recorded. The current deflation is primarily driven by substantial price reductions in the energy and transport sectors. Electricity tariffs saw a sharp reduction of 21.9% in March, followed by an additional average reduction of 22.5% in July. These cuts, along with declines in petroleum and LP gas prices, have significantly contributed to the downward pressure on overall prices. Despite this, core inflation remains above 3%, indicating that the deflation is mostly attributed to fluctuations in energy and other volatile prices, rather than a broad-based reduction in price levels across all sectors.

Under the new Central Bank Act and the Monetary Policy Framework Agreement with the Ministry of Finance, the Central Bank is mandated to maintain headline inflation at 5%, with an acceptable margin of ±2%. Should inflation deviate from this target for two consecutive quarters, the Monetary Policy Board is required to submit a report to Parliament. This report must explain the reasons for missing the inflation target, propose corrective measures, and estimate when inflation is expected to return within the target range. With inflation in Q2 and Q3 recorded at 1.37% and 0.80%, respectively, it has fallen below the lower bound of 3%, necessitating the preparation of such a report by the Central Bank.

While Q3-2024 inflation remains within the Central Bank's forecasts, headline inflation is expected to stay significantly below the 5% target in the near term, with deflation likely to persist for a few months. Over the medium term, however, inflation is projected to gradually align with the target level, supported by appropriate policy adjustments.



Month	Monthly inflation	Quarterly Inflation
April	1.5%	
May	0.9%	1.37%
June	1.7%	
July	2.4%	
August	0.5%	0.80%
September	-0.5%	

Data Source: CBSL

KEY INSIGHTS

Sri Lankan Economy

EU Green Deal and Its Implications for Sri Lanka’s Exporters

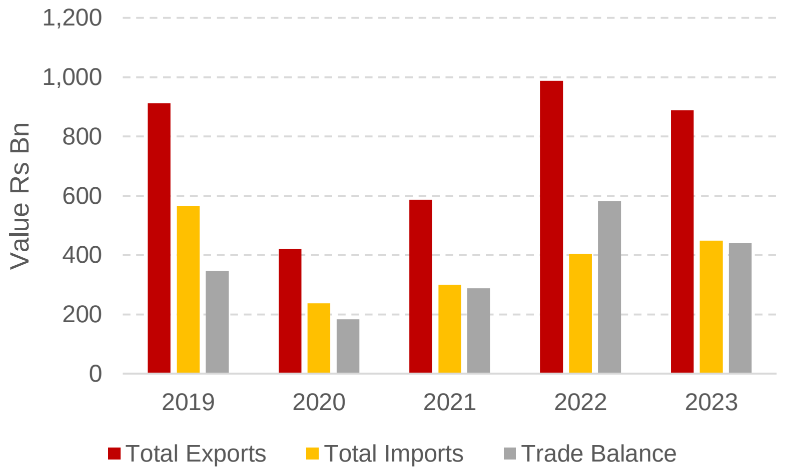
The European Green Deal aims to make the EU climate-neutral by 2050, setting ambitious goals for emission reduction and promoting a clean, resource-efficient economy. The initiative includes legally binding targets, such as a 55% reduction in greenhouse gas emissions by 2030 compared to 1990 levels, with a proposed 90% cut by 2040. Additionally, the Green Deal focuses on several key areas: transitioning to renewable energy, increasing energy efficiency, promoting sustainable agriculture, and enhancing biodiversity.

One significant component in EU green deal is the expansion of the EU Emissions Trading System (ETS), which places a price on carbon emissions to incentivize businesses to reduce their environmental impact. The introduction of the Carbon Border Adjustment Mechanism (CBAM) aims to ensure that imported goods are subject to the same environmental standards as those produced within the EU, further driving compliance among trading partners. As the EU pursues these ambitious targets, its trade relationships will increasingly hinge on adherence to sustainability criteria. For countries like Sri Lanka, this presents both challenges and opportunities. Many large companies and SMEs in Sri Lanka adhere to sustainability standards, yet several challenges persist, particularly in developing sustainable supply chain mapping. This is becoming increasingly important as international regulations evolve. Sectors such as apparel, textiles, and rubber will need to adopt greener production techniques to avoid penalties associated with carbon emissions and to benefit from the growing demand for sustainably produced goods.

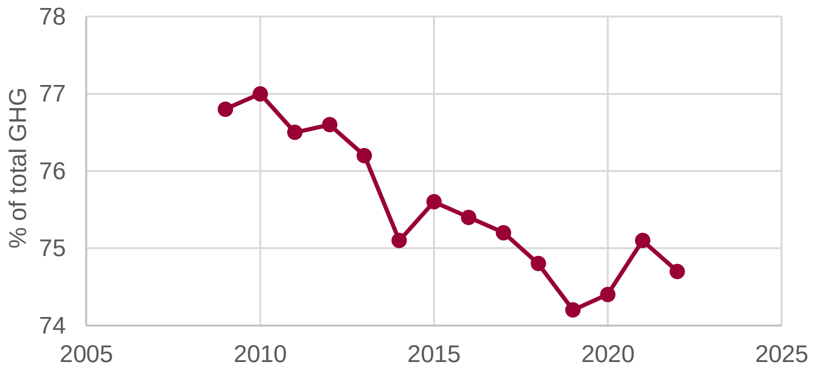
Furthermore, the CEO of Waste & Resources Action Program (WRAP) highlights that, in terms of ESG standards, Sri Lanka faces challenges due to short-term thinking among buyers and manufacturers. This mindset hinders long-term planning and investment in important areas such as social responsibility and sustainability.

Aligning with the EU’s Green Deal policies can provide Sri Lankan exporters with a competitive edge, opening doors to the environmentally-conscious European market while advancing the country’s sustainability goals. Investing in renewable energy, green technologies, and efficient resource use, similar to the EU’s strategies, can support Sri Lanka's long-term climate resilience.

Sri Lanka’s Trade with the EU



Greenhouse Gas Emissions by Energy Sector - EU



KEY INSIGHTS
Global Economy

Global Economic Outlook 2024:
Stable Growth Amid Persistent Risks and Challenges

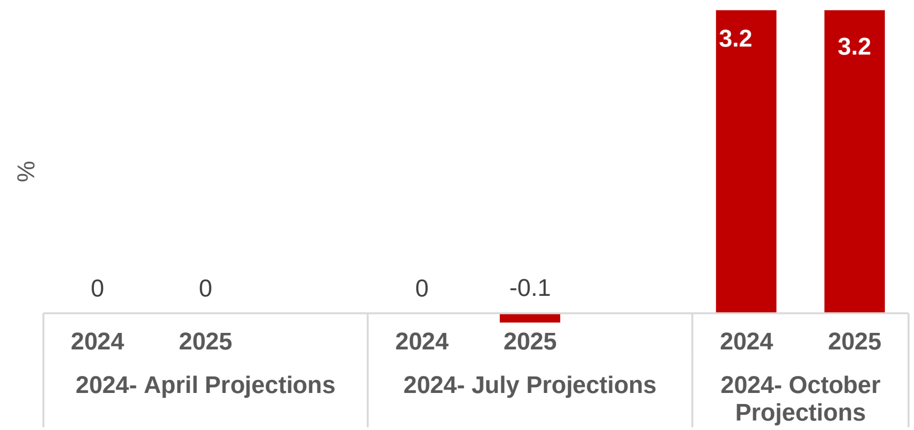
The global economy faces a stable but sluggish growth outlook, with projections for 2024 and 2025 holding steady at 3.2%, according to the October 2024 World Economic Outlook. This performance is largely in line with previous forecasts, but beneath this surface stability lies significant divergence among regions. While upgrades in the U.S. outlook support global growth, advanced European economies face downgrades. In emerging markets, Asia stands out due to strong demand for semiconductors and AI-driven electronics, while regions like the Middle East, Central Asia, and sub-Saharan Africa face setbacks from conflicts, commodity disruptions, and extreme weather events.

Inflationary pressures are gradually easing, with global inflation expected to drop from 6.7% in 2023 to 5.8% in 2024, as major economies align more closely with their inflation targets. However, risks remain, particularly in services price inflation and the potential for new disruptions in commodity markets, which could hinder central banks' efforts to stabilize prices.

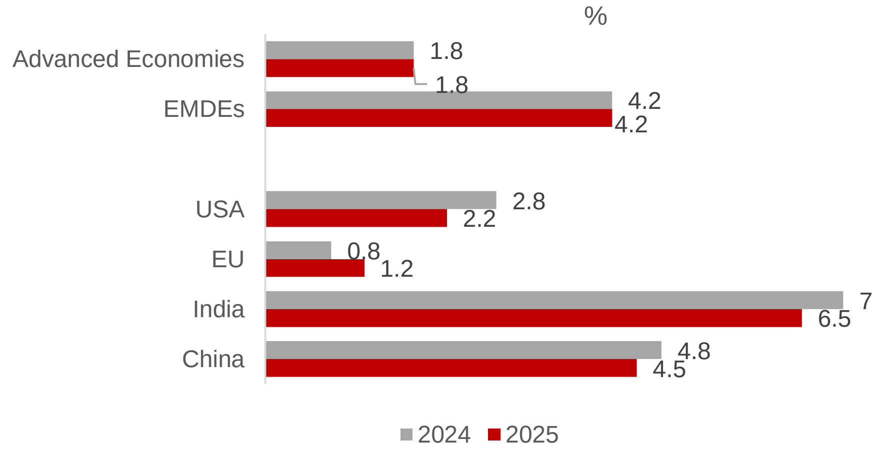
Key challenges for the global economy include rising geopolitical tensions, financial market volatility, and potential spillovers from China's struggling property sector. These could tighten financial conditions, especially in developing economies, leading to capital outflows and debt distress. The persistence of protectionist policies also threatens global trade efficiency and supply chains.

Looking ahead, countries must focus on tailored fiscal policy adjustments to rebuild buffers and ensure sustainable debt levels. Structural reforms are critical to lifting long-term growth prospects, but support for vulnerable populations must remain a priority. Multilateral cooperation will be essential in addressing key global challenges such as debt restructuring, green transitions, and mitigating the risks of geo-economic fragmentation.

IMF Revised their Growth Projections upward for 2024 and 2025



Latest Growth Projections by the IMF



Data Source: IMF

KEY INSIGHTS
Global Economy

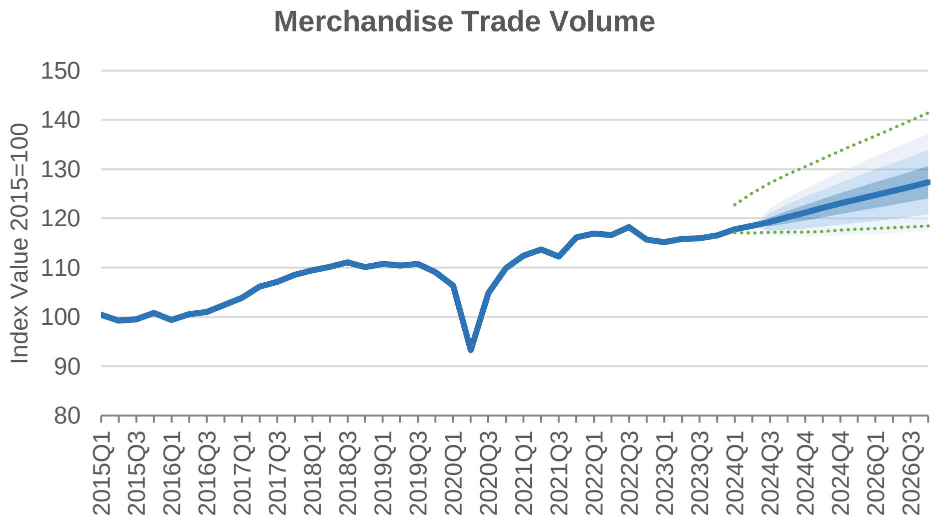
Global Trade: Outlook for 2024-2025

Global trade is poised for a modest recovery in 2024, with projected growth in the volume of goods trade at 2.7%, a slight uptick from previous estimates by the World Trade Organization (WTO). The WTO expects this momentum to carry forward into 2025, with a projected increase of 3% in global merchandise trade. The rebound follows a -1.1% contraction in 2023, triggered by high inflation and rising interest rates, which hampered both global trade and economic growth.

The recovery in 2024 is supported by falling inflation, which is allowing central banks to lower interest rates. This reduction in rates is anticipated to lift real household incomes and stimulate both consumer and business investments. While this provides a more favorable environment for trade expansion, the backdrop remains fragile due to geopolitical tensions and economic uncertainties. Escalating conflicts, particularly in regions like the Middle East, could disrupt global energy prices and shipping routes, adding downward pressure on trade. These tensions, alongside financial volatility driven by diverging monetary policies, pose substantial risks to sustained trade growth.

While the goods trade is set for moderate improvement, the outlook for services trade is even more promising, bolstered by favorable market indicators. Services, such as tourism and digital trade, tend to be less affected by supply chain disruptions and are increasingly driving global economic activity.

Looking ahead, the recovery in global trade will depend on how well economies navigate the challenges posed by geopolitical instability, financial volatility, and diverging monetary policies. If interest rate cuts in advanced economies spark stronger-than-expected growth without reigniting inflation, there is room for cautious optimism. However, the global trade landscape remains complex, with risks continuing to shape the potential trajectory of growth in the near term.



Data Source: WTO

With the aim of keeping our members updated on latest global trends, especially those influencing Sri Lanka, 'Evolving Landscape' section was added to the MEU. This section guide our members in strategic planning, innovation and competitiveness and helping them identify sector-specific opportunities and challenges.

Financial Sector Review- Sri Lanka

Financial system stability was maintained in early 2024, despite spill overs from past macrofinancial challenges. Domestic macrofinancial improvements eased pressures on household and institutional balance sheets, reducing risks to the financial sector. Financial intermediation stabilized as credit growth turned positive, though it lagged behind deposit growth. Falling inflation, lower risk premia, and declining market interest rates—driven by accommodative monetary policy—supported this gradual credit recovery. The financial sector's exposure to the public sector also began correcting, indicating improved resource allocation towards the private sector.

Performance

The resilience of financial institutions improved during the first half of 2024 amid easing macroeconomic conditions, as indicated by key soundness metrics in the banking sector, such as credit quality, liquidity, and capital adequacy. However, the Non-Performing Loan (NPL) ratio remained elevated, signaling persistent challenges, although the provision coverage ratio improved. Credit growth in the banking sector, especially in the private sector, rebounded due to declining market interest rates and rising domestic demand, while State-Owned Enterprises (SOEs) became less dependent on bank financing as the government absorbed certain SOE credit facilities. Nevertheless, sovereign exposure in the banking sector increased with investments in high-yield government securities, contributing to better rupee liquidity and a buildup of high-quality liquid assets.

The banking sector's profitability improved significantly, largely due to rising net interest income as deposit rates fell faster than lending rates, reflecting the sector's lending rate rigidity. This, along with increased investments in government securities and Tier-2 capital raised via debenture issuances, bolstered capital levels. Interbank exposures, though still low relative to total assets, saw an uptick by Q1 2024, with contagion risk in the interbank network deemed moderate.

The Finance Companies (FCs) and Insurance sectors mirrored the banking sector's positive performance, benefiting from improved macrofinancial conditions. FCs reported asset growth, improved liquidity, and higher profitability due to lower interest costs, while capital adequacy also strengthened. The insurance sector saw growth in Gross Written Premiums and assets, particularly in the long-term insurance subsector, with profitability bolstered by sustained investments in government securities. Overall, the recovery and stabilization of these financial sectors were driven by favorable interest rate dynamics and continued investments in government securities.

During the first half of 2024, the household and institutional sectors saw an expansion in credit demand, reflecting their growing need for financial services amid improving macroeconomic conditions. Despite this growth, the debt levels in both sectors remained below those observed in the first half of 2022, suggesting further potential for credit expansion. Declining interest rates and a low inflation environment helped drive credit growth, though this was moderated by lower real incomes and tax adjustments. Household credit quality showed slight improvement, though the NPL ratio remained elevated, especially in the Non-Bank Financial Institutions (NBFI) sector. In contrast, the institutional sector's NPL ratio worsened, indicating challenges in maintaining credit quality.

Non-Financial Corporates (NFCs) reported stronger financial performance, driven by higher revenue and lower finance costs due to reduced interest rates, enhancing sector profitability and creditworthiness. This improvement supported financial institutions' resilience, although sustaining this performance amid further macroeconomic normalization will be crucial.

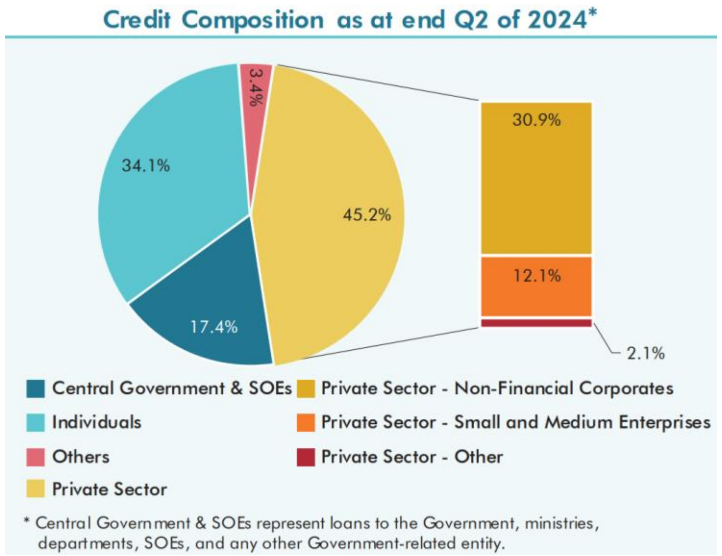
Evolving Landscape cont’d

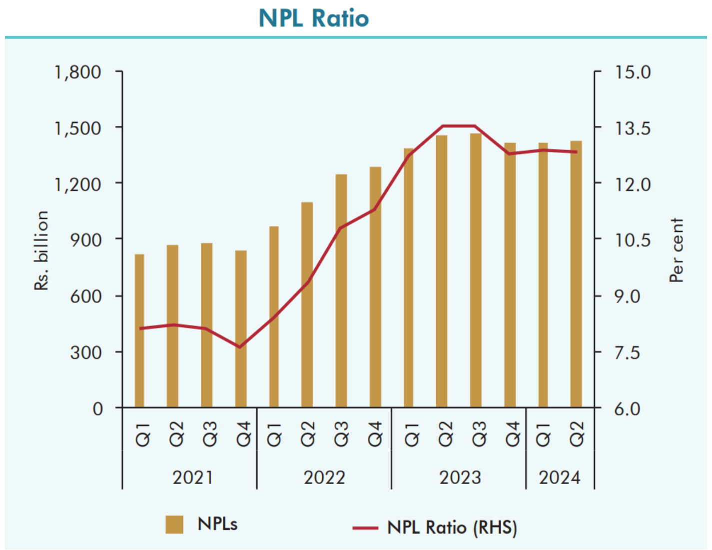
In response to these developments, the Central Bank reinforced macroprudential policies, tightening large exposure caps for Licensed Banks (LBs) and Finance Companies (FCs) to mitigate credit concentration risk. Additional buffers, such as the Capital Conservation Buffer, were maintained to bolster the banking sector's resilience. The Central Bank also issued guidelines to support viable businesses and continued to meet IMF-EFF structural benchmarks, including enacting the Banking (Amendment) Act and developing recapitalization plans for large banks.

Outlook

As economic output rises, demand for financial services will grow, supporting financial intermediation. However, as credit expansion shifts towards the private sector, institutions must manage pressures on credit quality and capital adequacy, especially given elevated NPL ratios and large exposure caps. Additionally, low deposit rates may challenge institutions in attracting funds, and downward pressure on lending rates could compress net interest income, impacting profitability. High sovereign exposure, particularly in government securities, may also yield diminishing returns.

Further adjustment in external and fiscal sectors, especially with suppressed import demand and delayed sovereign debt obligations, must be carefully managed to maintain financial stability. Finalizing external debt restructuring could provide access to more financial resources, but these must be handled prudently as the benefits of recent macrofinancial recovery wane.





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Economic Intelligence Unit of The Ceylon Chamber of Commerce

The Ceylon Chamber of Commerce

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