Economic impacts of and policy responses to the coronavirus pandemic: early evidence from Sri Lanka

Angela Hüttemann

8 April 2020

Key messages

- Sri Lanka's government has reacted quickly to curb the spread of COVID-19. At the time of writing 189 cases have been confirmed, with 44 recovered and 7 dead.
- A slowdown in tourism and garments, which together account for more than 14% of total employment and 48% of total exports, is likely to suggest a decline in economic activity, which may be exacerbated by an increase in unemployment.
- Various fiscal and monetary stimulus measures have been set up to mitigate the impact on businesses and individuals.
- These efforts have been complemented by multilateral and bilateral support in the form of cash grants, medical equipment and capacity-building. Together, they are likely to cushion the negative impact of COVID-19 on Sri Lanka's economy.

Introduction

As of 8 April 2020, Sri Lanka has reported 189 cases of COVID-19; 44 patients have recovered and 7 have died. The government has implemented a variety of measures to curb the spread. Since 16 March, Sri Lankan authorities have closed schools and offices, with all non-essential business to be carried out from home. A strict island-wide curfew has been imposed. Before the spread of COVID-19, Sri Lanka's economy was recovering from adverse weather events, fiscal consolidation efforts by the previous government and the more recent Easter Sunday bombings in 2019, which impeded economic growth. Government health expenditure per capita accounts for $212 (PPP, current international $), which compares favourably with expenditures from regional neighbours such as India ($61) and Myanmar ($59) but lags more advanced neighbouring economies such as Thailand ($496) and Malaysia ($531). External per capita health spending (measuring external financial inflows into Sri Lanka's health system) stands at $5.2 (PPP, current international $) and is higher than in many neighbouring countries such as India ($2.5), Thailand ($1.5) and Malaysia ($ 0.22).

Economic and social impacts

Trade and production impacts
Sri Lanka's GDP growth was subdued in 2019 (2.3%), facing headwinds after the Easter Sunday bombings. ADB expects a similar growth rate (2.2%) in 2020. Fitch is more critical of the COVID-19 impact on the economy and has revised the 2020 GDP forecast from 3.5% down to 1.4% given the likelihood of a slowdown in services (57% of GDP) and manufacturing (27% of GDP).

The pandemic will likely hit the key sectors of garments and tourism. Tourism accounts for 12.7% of GDP, 22% of exports and 4.8% of jobs (388,000 employees) and will come under stress from a contraction in arrivals following international travel restrictions and airline suspensions. February saw an 18% y-o-y drop in arrivals; this will be aggravated by the suspension of all inbound flights since 18 March. The garment sector is also facing headwinds. Garments have driven economic development since the 1970s and account for 26% of exports and 9.5% of employment (777,000 employees). Weaker global demand and a 20–30% anticipated drop in orders are already affecting the sector. The economy is thus likely to face a fall in export revenues and an increase in unemployment, which will weigh on domestic demand.

Finance
Since 20 March, trading has been suspended in Sri Lanka's stock market after the CSEALL Price Index declined to its lowest level in eight years. Year to date the index has lost 25%, in line with some of the major global stock markets. This is in part a reflection of foreign investors' flight into 'safe haven' assets, selling outstanding stock in Sri Lankan T-bills and T-bonds. Foreign-owned government securities fell by more than 55%, or $260 million (circa 0.3% of GDP) between the end of February and 1 April. Further, the rupee has depreciated against safe haven currencies such as the US dollar (7.4%) and the yen (6.5%) since the start of the year. Remittances, which account for 7% of GDP, may be affected over the next months; 51% are earned in the Middle East and 19% in Europe, both regions significantly affected by the spread of COVID-19.

The fall in foreign-owned debt stock and the weakness in the exchange rate could pose financial risks. In February 2020, the country was projected to have 3.4

months of imports. A drop in foreign exchange earnings needs to be anticipated going forward, given the expected drop in remittances and export earnings from the garment and tourism sectors, which together are the top three foreign exchange earners in Sri Lanka. This said, certain measures have been put in place by the Central Bank to limit foreign exchange loss (see *monetary and financial policy* below).

Social impact
Annual average inflation stood at 4.5% in February, in line with the Central Bank target. Favourable weather conditions in the *maha* season 2019/20 have led to successful paddy harvesting, which should be sufficient to sustain demand till September 2020. That said, a prolonged period of COVID-19 may pose risks to food security for vulnerable groups. In recognition of this, the government has put various measures in place to improve food security (see *fiscal policy* below). Further, loss of income poses risks to the livelihoods of many Sri Lankans on daily wages such as small shop-owners as well as three-wheel and taxi drivers.

Fiscal impacts

Sri Lanka's debt-to-GDP ratio stands at 84.2%. It has faced twin deficits in its fiscal and external accounts for much of its post-independence history, limiting fiscal scope to tackle the pandemic domestically. Its fiscal deficit stands at 6.2% of GDP in 2019, while the current account deficit is 2.5%. Going forward, subdued economic activity and lower domestic consumption are likely to cause a loss in revenue, further limiting government's scope. The country's fiscal efforts in fighting COVID-19 thus require complementary efforts by donors or bilateral agencies to cushion the impact. A widening of the fiscal deficit seems unavoidable in the short to medium term.

Monetary and financial policy

The Central Bank has implemented a series of measures to ease liquidity constraints, lower pressure on the rupee and provide support for businesses. It cut policy rates by 25 bps on 16 March and 3rd April, to 6.25% (Standing Deposit Facility Rate) and 7.25% (Standing Lending Facility Rate), and lowered the reserve requirement ratio on all rupee deposit liabilities of commercial banks by 1 percentage point (to 4%) to ease liquidity constraints. It has further granted a six-month debt moratorium for bank loans from SMEs and vulnerable sectors such as tourism and garment.

The Central Bank has further restricted certain imports to stabilise the foreign exchange market and alleviate pressure on the rupee. As such, commercial banks are restricted from importing motorised vehicles (other than those specified under Banking Act Directions No. 01 of 2020). To stabilise the money market, various government institutions (e.g. Bank of Ceylon, Sri Lanka Insurance Corporation, Employees Provident Fund and Employees' Trust Fund) have joined forces and invested in Sri Lankan Treasury bonds and bills.

A stimulus package at 0.01% of GDP has been pledged to the SAARC COVID-19 Emergency Fund.

Fiscal policy

The government has introduced a range of measures to contain the spread of COVID-19 and mitigate the impact on the population. **Assistance to businesses and individuals:** The government has extended deadlines for income, VAT and other tax payments until 30 April. Further, low-income consumers who currently benefit from the *Samurdhi* programme receive food allowances and concessional loans and an interest-free advance of around $130. In addition, there is a six-month grace period on leasing loans for three-wheelers and a doubling of medical insurance benefits for government employees (health, police and civil security personnel) involved in curbing the spread of COVID-19. **Health measures:** A donation of 0.6% of GDP will be made to the COVID-19 Healthcare and Social Security Fund, set up to mitigate and control the spread of COVID-19. Local and foreign donations have been invited (and will be exempt from tax). In addition, the government has issued tax exemptions for imported masks and disinfectant. **Other measures** include the lowering of prices of some essential foods, the introduction of price ceilings on food items such as eggs, lentils and fish and the issuance of food cards to *Samurdhi* and other low-income families. Beneficiaries will be provided with rice, lentils and other foods.

Donor support

Sri Lanka has received support from both multilateral organisations and regional partners. China has provided $500 million of financial assistance in the form of a concessional loan, plus 50,000 medical masks and 1,008 test kits. Singapore's Temasek Foundation has provided a further 5,000 test kits. In an attempt to aid with infection prevention and control, the United States have committed $1.3 million. The World Bank has issued a wide-ranging relief package ($128.6 million, 0.9% of its global emergency support package for developing countries) in an attempt to help Sri Lanka prevent a further spread and scale up domestic resources to strengthen emergency response mechanisms. ADB has provided $600,000 to finance disease surveillance and provide medical supplies.

Information in this note is correct as of 8 April 2020.

The author is an ODI Fellow with the Lakshman Kadirgamar Institute of International Relations and Strategic Studies (LKI) in Sri Lanka. The views expressed here are solely those of the author and are not to be attributed to the LKI or its Board of Management.

Comments welcome to a.huttemann.fs@odi.org.uk