

Sri Lanka GDP

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Economics

A recovery is underway

Sri Lanka

- ◆ 1Q GDP contracted 11.5% y-o-y due to base effects; on a seasonally adjusted sequential basis, the pace of contraction slowed further, indicating that a recovery is underway
- ◆ Manufacturing grew after four quarters of sequential contraction; the recovery in agriculture continued but services reported an unexpected softness
- ◆ Sri Lanka is pressing ahead with reforms; the economy should gradually recover from its 2022 lows

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1Q23 GDP growth contracted 11.5% y-o-y (HSBC: -11%, Bloomberg: -8.9%) due to base effects. On a seasonally adjusted sequential basis, economic activity remained in contraction for the fifth straight quarter. That said, the pace of contraction has slowed further (-0.9% 3m/3m sa in 1Q23 vs -1.4% in 4Q22), indicating that a recovery is underway. In pre-pandemic terms, the country's output is 10% below.

Industrial activity improved after a year of sequential contraction, led by an uptick in manufacturing. Part of this improvement can be explained by a small rise in exports (on a % m-o-m sa basis) after a weak 2H22. Construction, on the other hand, remained in the red. Tighter fiscal policy, weak private credit growth and subdued business sentiment are likely to weigh on new investment activity.

Agriculture continued to grow smartly for the second quarter, led by a rise in the production of rice, fruits, spices, 'aromatic, drugs and pharma' crops.

Services contracted on a sequential basis. This came in as a surprise as the high frequency data were indicating a healthy rebound in tourism. A close look at the services split indicates that the contraction was led by transportation of goods & passenger services and other personal services. We will not read too much into this fall as it could be a breather after two quarters of sequential growth. 'Retail and wholesale trade' too, fell after a strong sequential growth in 4Q22.

Hope, and some progress. 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. Some progress has been made on the macro stability front. Growth engines of tourism and remittances are humming now. Inflation is set to moderate to single-digit by the end of 2023 thanks to the base effects, tighter monetary and fiscal policy. Rupee has appreciated c15% since the start of the year and dollar liquidity has improved.

The central bank recently cut policy rates by 2.5ppt in a bid to bring down domestic interest rates. As the structural reforms gain traction and the ongoing recovery gains momentum, we think the CBSL is likely to ease monetary policy further. We expect a 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 SLFR and SDFR rates to 9% and 8%, respectively.

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 2023. In annual terms, 2H23 is likely to report a growth but the full year growth may remain in contraction due to base effects.

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Table 1: Real GDP by supply components

% y-o-y	Jun-22	Sep-22	Dec-22	Mar-23
GDP	-7.4	-11.5	-12.4	-11.5
NIT	-40.6	-38.7	-32.2	-28.7
GVA	-5.1	-10.1	-11.2	-10.5
Agriculture, Forestry & Fishing	-7.9	-6.7	0.7	0.8
Industry	-10.1	-21.3	-30.1	-23.4
Manufacturing	-5.3	-14.2	-25.2	-14.2
Construction	-16.0	-32.8	-37.2	-38.3
Services	-1.8	-4.2	-3.9	-5.0

Note: *Green* denotes an increase and *grey* denotes a decrease relative to previous reading

Source: CEIC, HSBC

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