Operating Environment

Global performance

During the year under review, global growth decelerated to its weakest pace since the financial crisis of 2008. The uncertainty arising from trade barriers dampened global business sentiment and activity. In advanced economies and China, existing cyclical and structural slowdowns added to the pressure while country-related weaknesses in large emerging markets such as Brazil, India, Mexico, and Russia contributed to the downturn. Contributing further to this grim picture were geopolitical tensions in countries such as Iran and social unrest in others such as Venezuela, Libya, and Yemen.

Global outlook

With global growth projected to rise to 3.3% in 2020 and 3.4% in 2021, there was cautious optimism about the fact that manufacturing and international trade would halt their downward trajectory. The global outbreak, however, is already disrupting supply chains across the map and shutting down travel, putting further stress on an already overburdened world economy. This pressure is in addition to predictions of sluggish growth in the "Group of Four"– systemically important economies which comprise nearly half of the global GDP, namely: United States, China, the Euro area, and Japan.

COVID-19-related disruption to economic activity is expected to be severe and to sink the world economy into a global recession. With person-to-person contact being restricted, a demand collapse is expected that will take activity sharply lower in the second quarter before a recovery begins later in the year – assuming that the outbreak is brought under control by mid year. Risk-aversion is on the rise and views on economic activity, earnings, and credit quality are already in sharp decline. The Association of German Banks began lobbying for a "more flexible handling" of risk provisions under IFRS 9, warning that the existing accounting rules could "massively amplify" the looming crisis.

Focus on the coronavirus has overshadowed issues such as tensions between the United States and Iran, but should conflict erupt in the Middle East it would disrupt oil supply and weaken market confidence, severely impacting investment and growth. The effects of climate change cannot be ignored either. At the launch of the UN's assessment of the global climate in 2019, the year was described as record-breaking for heat with rising hunger, displacement and loss of life owing to extreme temperatures and floods around the world. Scientists even noted that the threat from climate change was greater than that from the coronavirus. Faith in governments and financial institutions as they grapple with these issues will impact the hoped-for global rebound so it is particularly important that countries across the world, particularly in emerging markets, manage the knock-on impact of these issues with great prudence.

Local performance

The Sri Lankan economy began making a slow recovery following a series of setbacks – the unexpected terror attack in April preceded by a political crisis in the third quarter of 2018. Despite significant gains from macro reform measures in fiscal, monetary and exchange rate policy management from mid-2016 the overall positioning of the economy in 2019 was weak, with lacklustre GDP growth of around 3% and high foreign debt settlements.

A range of tax concessions was introduced in November 2019 to increase disposable income, which accounts for roughly 70% of the GDP (2018), and to stimulate aggregate demand and consumption in the country. They included reductions to the Value Added Tax (VAT) and upward revisions to the VAT registration threshold, abolition of Economic Service Charge (ESC), Nation Building Tax (NBT), Pay As You Earn (PAYE) tax, Withholding Tax (WHT) on interest, rent, service fees, dividend, widening of Income Tax slabs of individuals and reduction in Corporate Income Tax rates. To revive the construction, tourism and SME sectors incentives and moratoriums were also extended. These measures were taken to realise the new regime's goal to achieve a per capita income of USD 6,500 by 2025 and an economic growth rate of 6.5% per annum across 2020-2025 while maintaining macroeconomic stability.

Local outlook

The outlook for 2020 and beyond will need to be reassessed depending on the economic agenda of the newly-elected government, but current estimations – but current estimations are pessimistic. Forecasts for growth in 2020 ranged between 4.5% (CBSL) and 3.3% (World Bank), while Fitch Ratings and the World Bank predicted growth of 3.7% for 2021. Plans to boost short-term growth include fiscal stimulus measures, higher agricultural outputs, recovering investments, exports, and tourism, along with strong remittances.

Expecting the management of debt dynamics over the next few years to be tough for Sri Lanka, Fitch Ratings has revised the Outlook on the country's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Negative from Stable, while affirming the IDR at "B" on 18 December 2019. S&P Global Ratings also downgraded its outlook on Sri Lanka's credit rating from stable to negative, affirming "B" long-term and "B" short-term foreign and local currency credit ratings for Sri Lanka. These downward revisions were strongly disputed by the CBSL. The latter posits the lack of recognition given to mechanisms aimed at compensating for revenue loss from the tax cuts and the positive impact of these stimulus measures on the macroeconomic environment as reasons for cautious optimism.

These early COVID-19 projections notwithstanding, overall, we can expect a general decline in growth in terms of business volumes. Regulators and government will need to intervene, offering relief packages and moratoriums to borrowers and imposing restrictions on foreign exchange. Deteriorating asset quality, declining cash inflows from loan repayments, rising impairment provisions and higher deposit withdrawals can also be expected. Depleting capital, rising operating costs due to enhanced recovery efforts, lower margins and lower profitability will significantly impact businesses and, in turn, the economy.

Banking sector performance

Cautious optimism was also the sentiment for the banking sector with 2019's subdued performance showing signs of an upward trajectory towards the fourth quarter. The Government's commitment to boosting SMEs was strengthened by the relief package launched in January 2020. SMEs included in the scheme were offered a moratorium on capital repayments on all eligible Sri Lankan rupee loans until the end of 2020. Other efforts to support this sector included concessionary short-term working capital loans, interest payment waivers, and suspension of legal action against delinquent accounts. Depressed loan growth in 2019 led to sufficient liquidity in the banking system, dispelling concerns that a delay in capital repayments would lead to shortfalls. To encourage start-ups, banks are reconsidering less risk-averse credit disbursement policies at the request of CBSL.

Should the evolving COVID-19 outbreak impact Sri Lanka, as seems inevitable, it will on the one hand reduce the demand for credit, while on the other, affect the repayment capacities of existing borrowers. This will lead to a significant decline in credit quality. In line with provisions in IFRS 9, these developments will be viewed as "material changes in circumstances." Banks must recognise this early and make provisions for the entire life span of the loans under the expected credit loss model. Rising provisions will diminish available capital, requiring capital infusions. If this does not come to pass, banks will be forced to curtail their growth plans when credit demand begins to rise once more.