POLICY BRIEF

Supporting MSMEs amid Mounting Macroeconomic Challenges in Sri Lanka

Small enterprises are more vulnerable to supply chains disruptions and sudden drops in demand for goods and services. Photo credit: ADB.

Explore equity, quasi-equity, and other non-debt assistance and structural reforms to protect small businesses from COVID-19 and other shocks.

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Introduction

Macroeconomic challenges limited Sri Lanka's policy options to confront disruptions caused by the coronavirus disease (COVID-19) pandemic. The country’s responses were largely restricted to debt finance and monetary policy interventions. Most other countries were able to support micro, small, and medium-sized enterprises (MSMEs) through debt finance schemes, tax concessions, and other policies, including fiscal stimulus initiatives.

This article evaluates the policy responses directed at supporting MSMEs in Sri Lanka since the onset of the pandemic and discusses additional policy interventions to address the latest hardships faced by businesses.

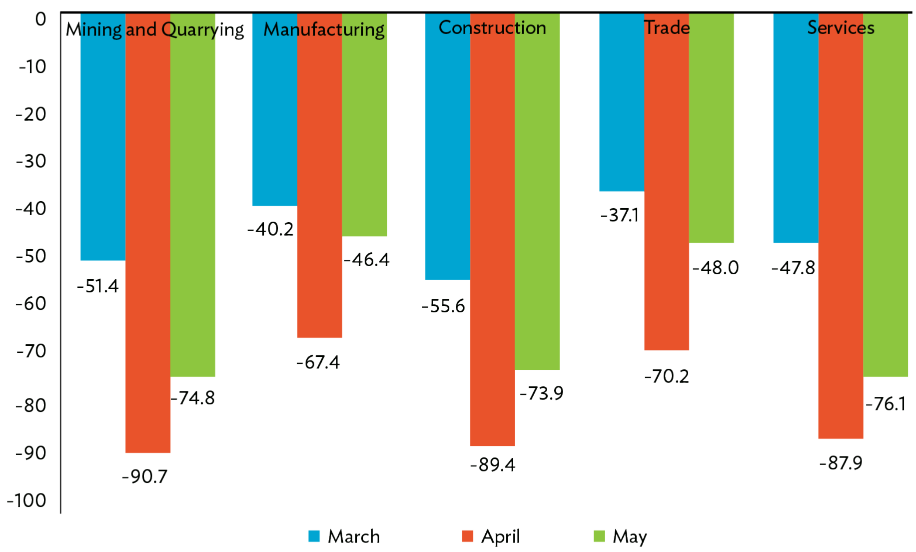
Analysis

Impact of COVID-19

The immediate impacts of the pandemic on industries in Sri Lanka can be broadly categorized into two major periods: (i) the initial lockdown phase between March and June 2020; and (ii) the post-lockdown period from July 2020 onwards.

The country experienced huge revenue losses during the March–May 2020 lockdown period. It was experienced across all major sectors, especially construction, mining and quarrying, and services. Education, real estate, arts, entertainment and recreation, administrative and support services, and accommodation and food were among the service sub-sectors that suffered the most losses, which exceeded 75% in April 2020 when a strict lockdown was imposed.

Figure 1: Revenue Loss of MSMEs in Sri Lanka



MSMEs= micro, small, and medium-sized enterprises

Source: Department of Census and Statistics. (2020). *Survey to Assess the Impact of COVID-19 (MSME Sector)*. Colombo.

Micro-enterprises lost a greater proportion of revenue during the lockdown compared to small and medium-sized enterprises (SMEs). These firms tend to have very limited savings and depend on continuous revenue to sustain their operations.

Employment fell by 62.4% in the MSME sector during the lockdown months, compared to pre-lockdown levels in January 2020. While losses were felt across all economic sectors, the highest impacts were noted in largely labor-intensive sectors that require a physical presence or those with functions that cannot be continued remotely.

Following the initial lockdown period and relative success in containing the spread of the virus, Sri Lanka appeared to be on course to return to some form of economic normalcy. Most domestic industries reopened between June and September 2020, leading to a resurgence of economic activity. However, this period was short-lived as the second wave of COVID-19 cases swept through the country at a much faster rate.

These lockdowns once again disrupted supply chains, reduced public trust, and curtailed retail activity, renewing the challenges for all stakeholders. Overall, Sri Lanka’s GDP contracted by 3.6% in 2020, affecting the growth of the MSME sector. The pandemic-induced economic effects continue into 2022 challenging the recovery of the MSME sector.

Debt relief and other policies

The Saubhagya COVID-19 Renaissance Facility is the most direct relief measure granted to MSMEs in response to the pandemic. Under this credit scheme, businesses could get a loan to cover working capital requirements for 2 months. Any business engaged in tourism or exports, related logistics suppliers, and any enterprise with a turnover below LKR 1 billion (around $2.7 million) were eligible for this scheme. The loans were to be repaid at a subsidized interest rate of 4% for 24 months, including a 6-month grace period. This grace period was extended by another 6 months since the second wave. The Central Bank of Sri Lanka allocated LKR 50 billion ($138 million) to this facility and subsequently increased it to LKR 150 billion ($416 million). Since March 2020, the central bank has introduced three phases of the scheme in response to prevailing economic conditions.

The average working capital loan approved during the first phase was LKR 1.8 million ($4,998.29), while loans for the second and third phases averaged LKR 3.5 million ($9,718.89) and LKR 2.9 million ($8,052.80), respectively. The increase in relief disbursement during the second phase was due to businesses exhausting their available savings and other capital inflows before availing of this credit facility.

In addition to the Saubhagya COVID-19 Facility, concessions were also granted to enterprises with nonperforming loans (as of 25 March 2020) by waiving the penal interest charge, rescheduling loans and advances, and suspending recovery action for 6 months. The 6-month debt moratorium on capital and interest payments was extended by a further 6 months in November 2020 because of the second wave of COVID-19 and the prolonged disruption in activities.

Import restrictions aimed at addressing Sri Lanka’s balance of payment (BOP) crisis is another significant policy measure introduced by the government beyond debt relief which impacted MSMEs.

At the micro-level, government departments and agencies along with support from international organizations and chambers of commerce took capacity development measures. Primarily, these measures focused on transitioning toward online and e-commerce platforms. In addition, government agencies, such as the Department of Commerce, enabled online submission of documents to accommodate public sector work-from-home directives and reduce the necessity to visit offices to gain approvals.

Working capital concerns and supply chain breakdowns

Amid the above relief measures, the emergence of the second wave of COVID-19 cases since October 2020 and another resurgence of cases and associated lockdowns in April 2021 have renewed challenges faced by MSMEs, namely: (i) working capital concerns and (ii) supply chain breakdowns.

Although the government provided working capital relief, capacity and structural impediments make it difficult for MSMEs to avail of this assistance.

Even with a subsidized loan scheme, banks still require suitable collateral (which MSMEs lack) to balance the associated risks. Many MSMEs operate informally and lack a formal banking relationship. Therefore, these firms are "priced out" of accessing much-needed finance to address working capital concerns, which were further heightened by the increase in operational costs during the year 2020 to comply with COVID-19 guidelines. For instance, small and medium apparel factories saw costs rising nearly 20%.

The raw material shortages faced by MSMEs were largely due to import restrictions imposed by the government to ease the balance of payment pressures. Continuous import restrictions beyond its initial application have been counterintuitive due to ensuing increases in production costs and inadequate domestic capacity to supply primary and intermediate inputs. The foreign exchange shortages have restricted the MSME sector's access to vital raw materials.

Large manufacturers, which tend to have higher levels of ownership over its supply chain, possess a wide network of factories and outlets across the country and have the capacity to move production overseas.

MSMEs, however, are likely to be reliant on single-source supply chains and production locations, and face high switching costs, unlike large enterprises. Export-oriented enterprises are disproportionately affected by supply chain disruptions, as they must contend with regional competitors. Thus far, government initiatives toward addressing continuous disruptions have been limited.

Implications

Sri Lanka's policy response cannot solely focus on addressing liquidity concerns. Prolonged debt injections and the way the current debt moratoriums are structured can lead to a long-term insolvency crisis. Policy makers and relevant authorities, therefore, should consider a proactive rather than a reactive approach by exploring equity, quasi-equity, and other non-debt support. At the same time, responsible exit strategies for emergency liquidity support should also be developed. In addition, the government would be best placed to account for the increase in operational costs for MSMEs in implementing current COVID-19 restrictions and guidelines and support initiatives to subsidize these costs.

The efficacy of current relief is diminished due to structural issues impeding financial access of MSMEs. The government should invest more in addressing structural weaknesses that slow down the path to recovery. Furthermore, supporting digitalization efforts through public–private partnerships will not just support recovery among MSMEs from the current crisis but also place these firms in a much stronger position in years to come.

MSMEs are a highly heterogeneous group of firms, not just in terms of size but also in terms of other factors, such as the sector involved and whether a firm is a women-led enterprise, a start-up in a dynamic industry, or integrated into domestic and global supply chains. This high level of heterogeneity means that broad emergency relief measures should be complemented with more tailored policy responses. For instance, current import restrictions support a narrow group of industries while a vast majority of MSMEs suffer directly or indirectly because of supply shortages, difficulty in accessing raw materials, and high input costs. Policies should consider these implications and distinguish emergency short-term measures and those that can be prolonged without incurring negative repercussions.

Given Sri Lanka's narrow fiscal space, it is vital that resources are efficiently allocated. A greater focus on addressing structural factors rather than exclusively responding to short-term shocks would likely have greater marginal utility for the MSME sector.

Resources

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