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FIRST CAPITAL RESEARCH

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El Niño 2026: Economic Impact Pathways

How a Climate Shock Transmits Through Sri Lanka's Agriculture, Energy, and Inflation

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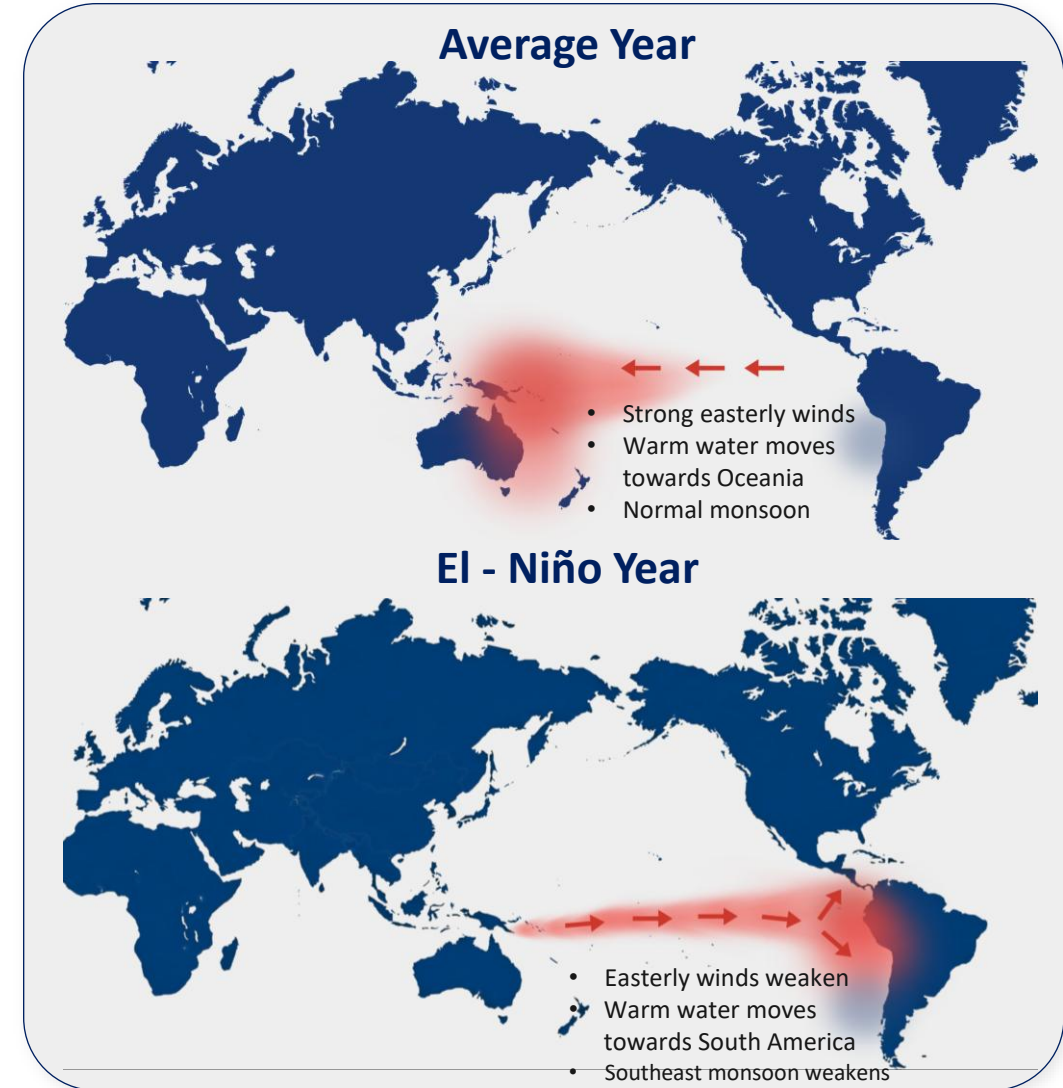


El-Niño: Disrupting Climate Norms



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- El Niño is a cyclical warming of the central and eastern Pacific, measured via the Oceanic Niño Index (ONI).
- It weakens easterly trade winds toward Asia, shifting warm waters eastward toward South America and disrupting monsoon and rainfall patterns.
- This results in reduced rainfall across parts of Asia and increased precipitation elsewhere, creating drought-flood imbalances.
- A potential El Niño event in 2026 may trigger similar weather-related disruptions.

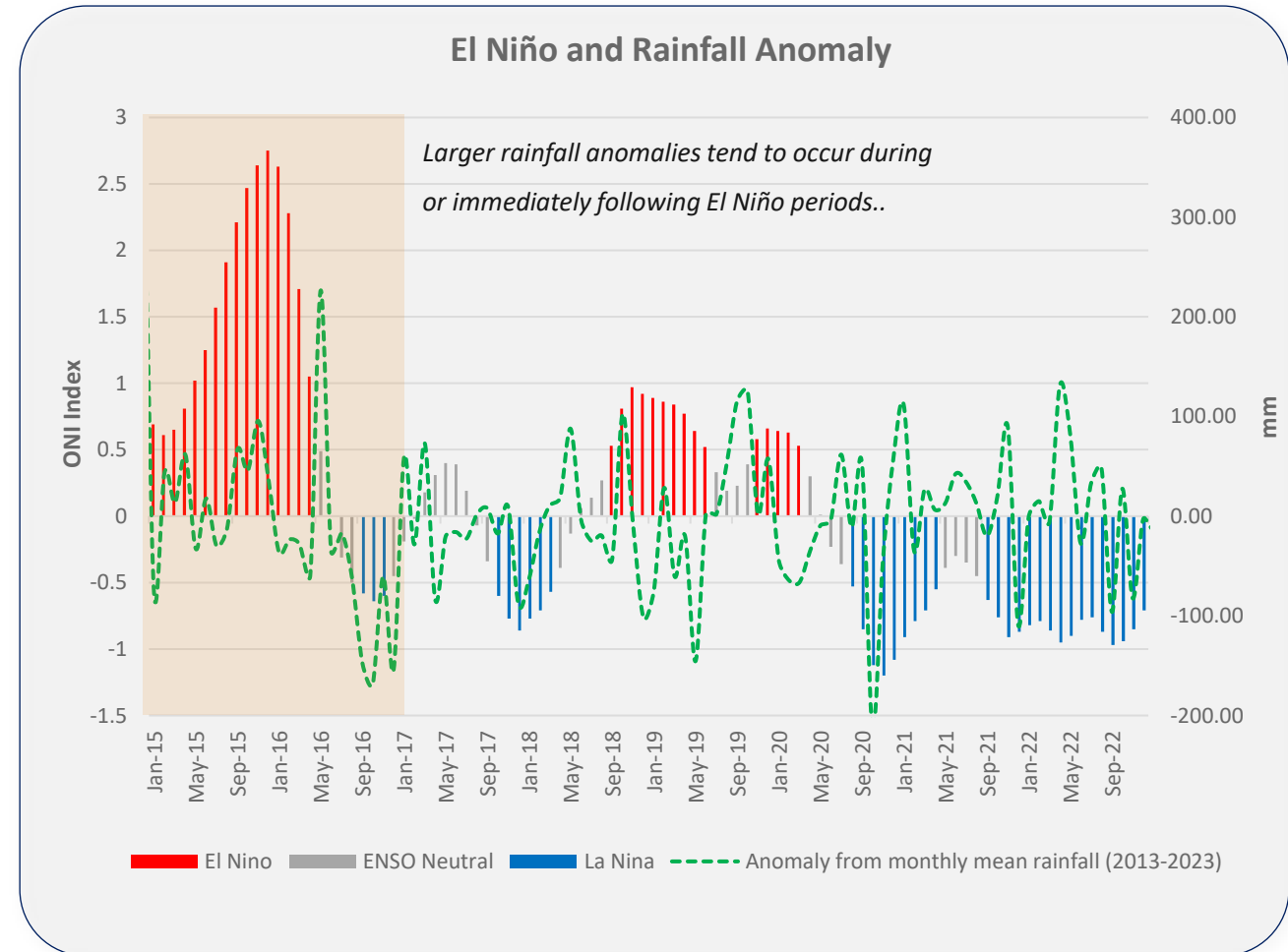


How Has El Niño Shaped Sri Lanka's Climate?



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- In the past, Sri Lanka experienced a severe El Niño event during 2015-2016, one of the strongest on record.
- Rainfall patterns became highly volatile, shifting from deficits to intense precipitation across regions.
- This volatility increased exposure to both drought and flood risks.
- This episode highlights El Niño as a key driver of climate variability relative to more stable baseline conditions.



How Did El Niño Shape Weather Across Regions in Sri Lanka?



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- During the 2015-2016 event, impacts varied significantly across regions.
- Inland agricultural areas were affected more severely than coastal regions.
- Inland zones recorded sustained and extreme negative anomalies.
- Coastal regions, by contrast, experienced comparatively milder deficits.
- Negative anomalies inland persisted beyond the event period, indicating prolonged agricultural water stress.

Anuradhapura - % Rainfall anomaly vs 2013 -14 monthly mean

Month	2013	2014	← El Niño Years →		2017	2018
			2015	2016		
Jan	Reference Years		-91	-82	-40	-89
Feb		+166	-53	-35	-38	
Mar		-78	-92	+20	-50	
Apr		+36	-46	-45	-30	
May		+123	+290	+89	+89	
Jun		+1022	+689	+856	+156	
Jul		-100	+119	+75	-100	
Aug		+191	-100	+139	-58	
Sep		-5	-100	-27	-42	
Oct		+53	-47	-12	+108	
Nov		+59	-42	+48	-32	
Dec		-26	-83	-81	-69	

Severe Drought

Colombo - % Rainfall anomaly vs 2013 - 14 monthly mean

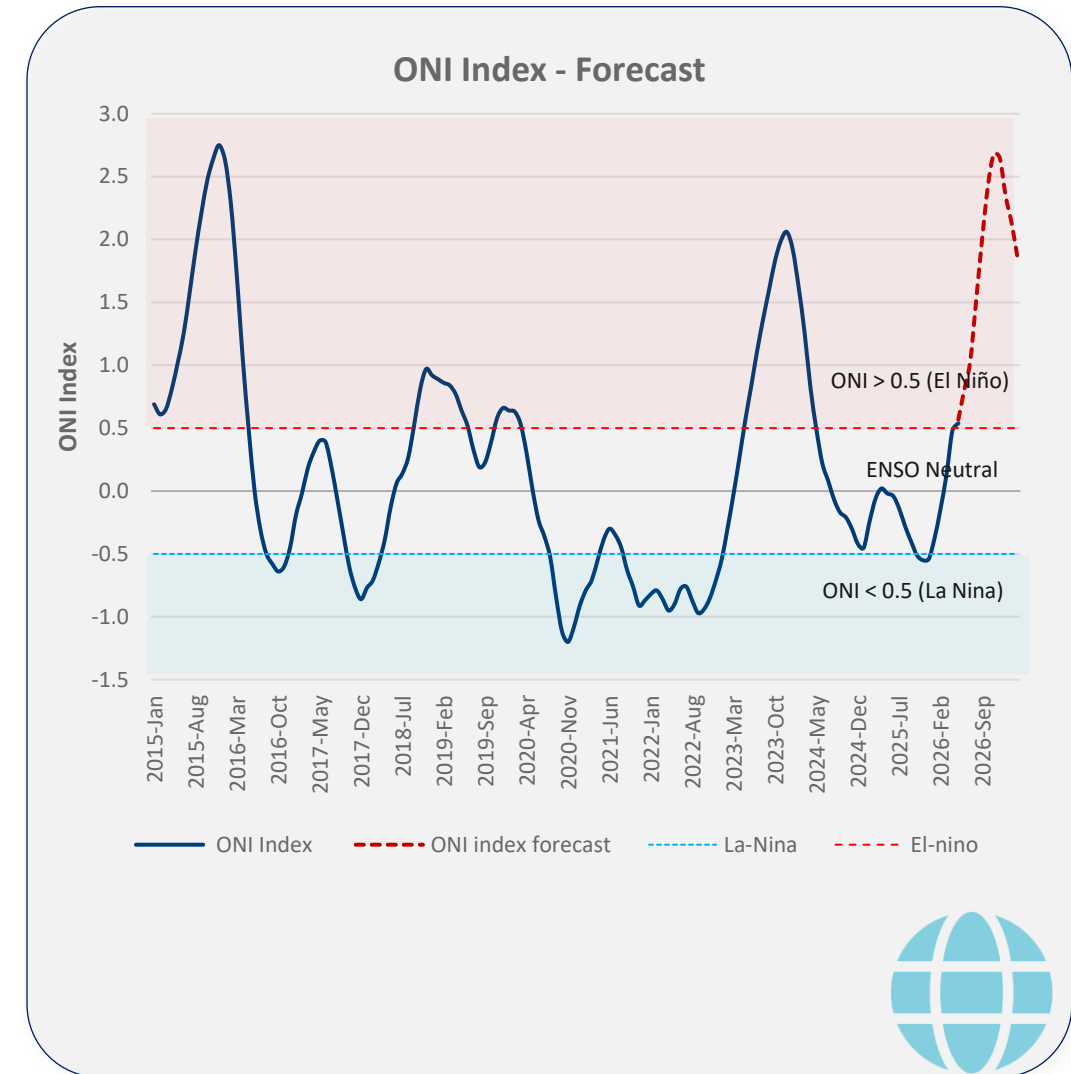
Month	2013	2014	← El Niño Years →		2017	2018
			2015	2016		
Jan	Reference Years		-63	-26	-6	-48
Feb		+33	+16	-	+18	
Mar		+75	-28	+6	-46	
Apr		+33	-8	-60	+32	
May		-31	+208	+41	+73	
Jun		-5	-47	-43	-38	
Jul		-68	-58	-60	-41	
Aug		-35	-99	-49	-54	
Sep		+138	-89	+34	-	
Oct		-20	+27	+58	+83	
Nov		+117	+67	+22	+74	
Dec		+48	-35	-32	-45	

2026 El Niño: What We Know So Far



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- Early indicators point to an emerging El Niño phase in 2026, based on global climate monitoring.
- The cycle is expected to strengthen through late 2026, with peak intensity from Q4 2026 to early 2027.
- Early comparisons suggest similarities to the 2015-2016 event, raising risks of comparable climate disruption.
- Potential impacts are expected across agriculture, water availability, and energy supply, with effects likely to persist for up to 24 months.

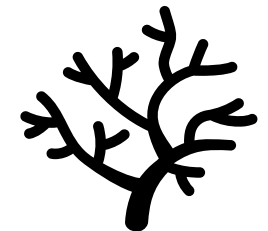
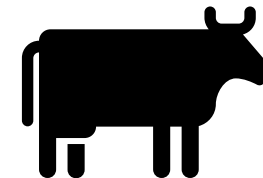
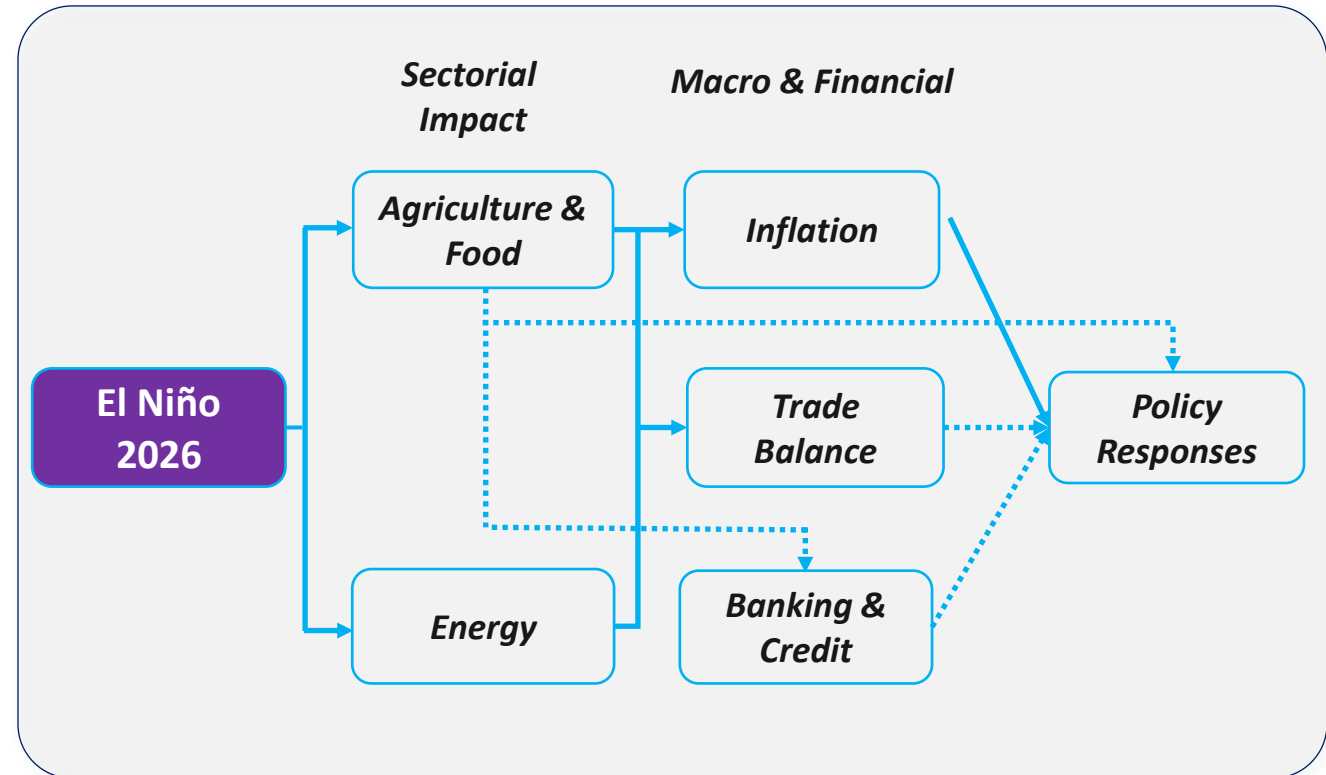


Impact Pathways: From Climate Shock to Economic Outcomes



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- El Niño impacts the economy through key transmission channels, with initial effects on agriculture, energy, and water.
- These sectoral disruptions feed into broader macro pressures, driving inflation and external imbalances.
- Financial stress emerges with a lag, affecting banking and credit conditions.
- The impact ultimately triggers policy responses, requiring fiscal and monetary adjustments.

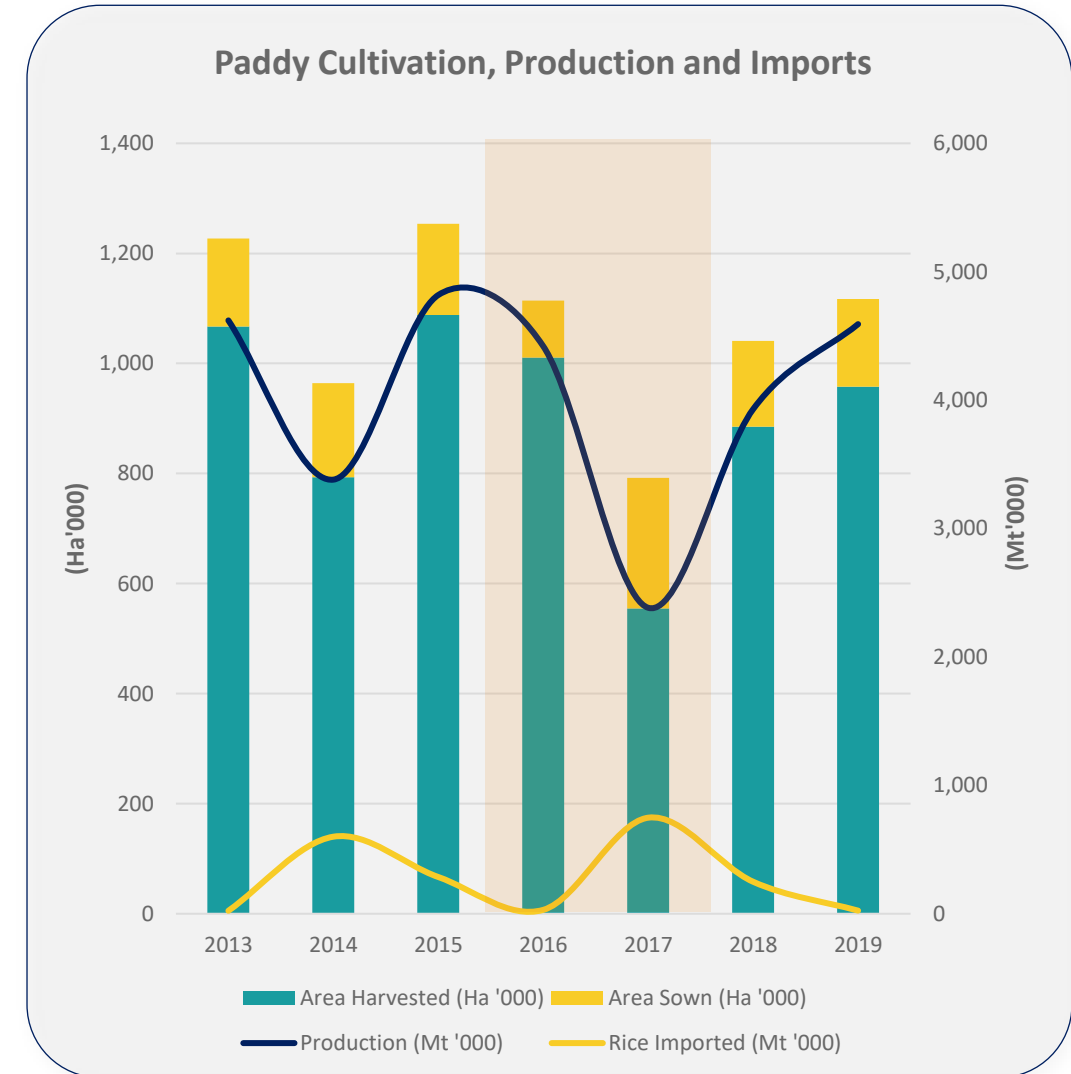


How Does El Niño Disrupt Agriculture and Food Supply?



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- Agriculture is highly sensitive to El Niño, with clear contraction during 2015-2017.
- Output declined sharply, with production falling about 50% from peak levels.
- Disruptions to cultivation were significant, with both sown and harvested areas contracting alongside weaker yields.
- Resulting supply constraints drove food price pressures, contributing to broader inflation.
- A similar El Niño episode would likely generate comparable downside risks to agricultural output and food supply.

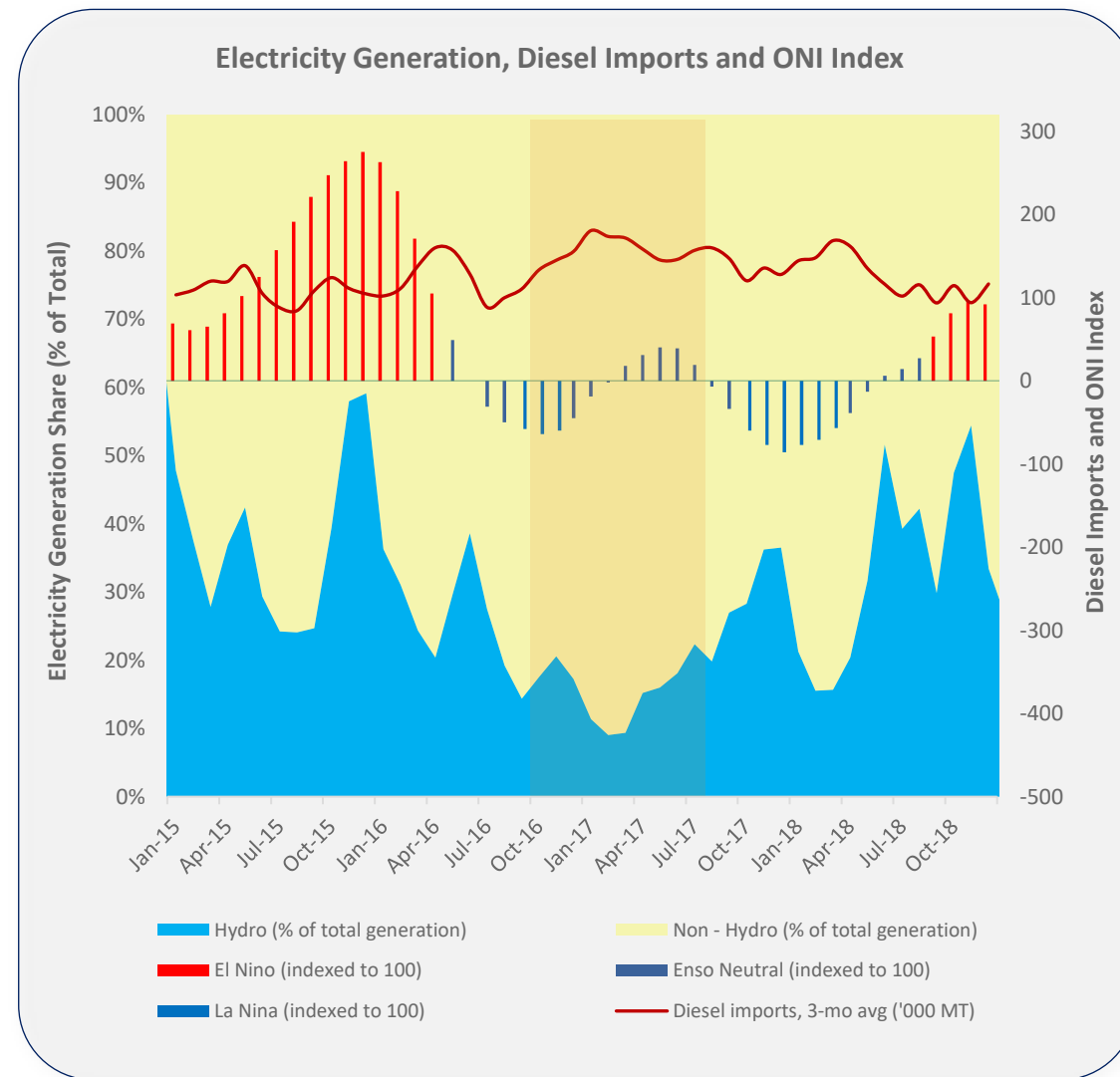


How Does El Niño Create Energy Supply Stress?



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- The energy sector is highly exposed to El Niño, primarily through reduced hydro power generation.
- Hydro output declines as reservoir levels weaken, with pressure building gradually over time.
- The shortfall is offset by increased thermal (diesel) generation, driving higher fuel imports and cost pressures.
- Energy impacts lag the El Niño cycle, with thermal reliance peaking 1-2 years post-event, amplifying fuel imports and broader macro pressures.

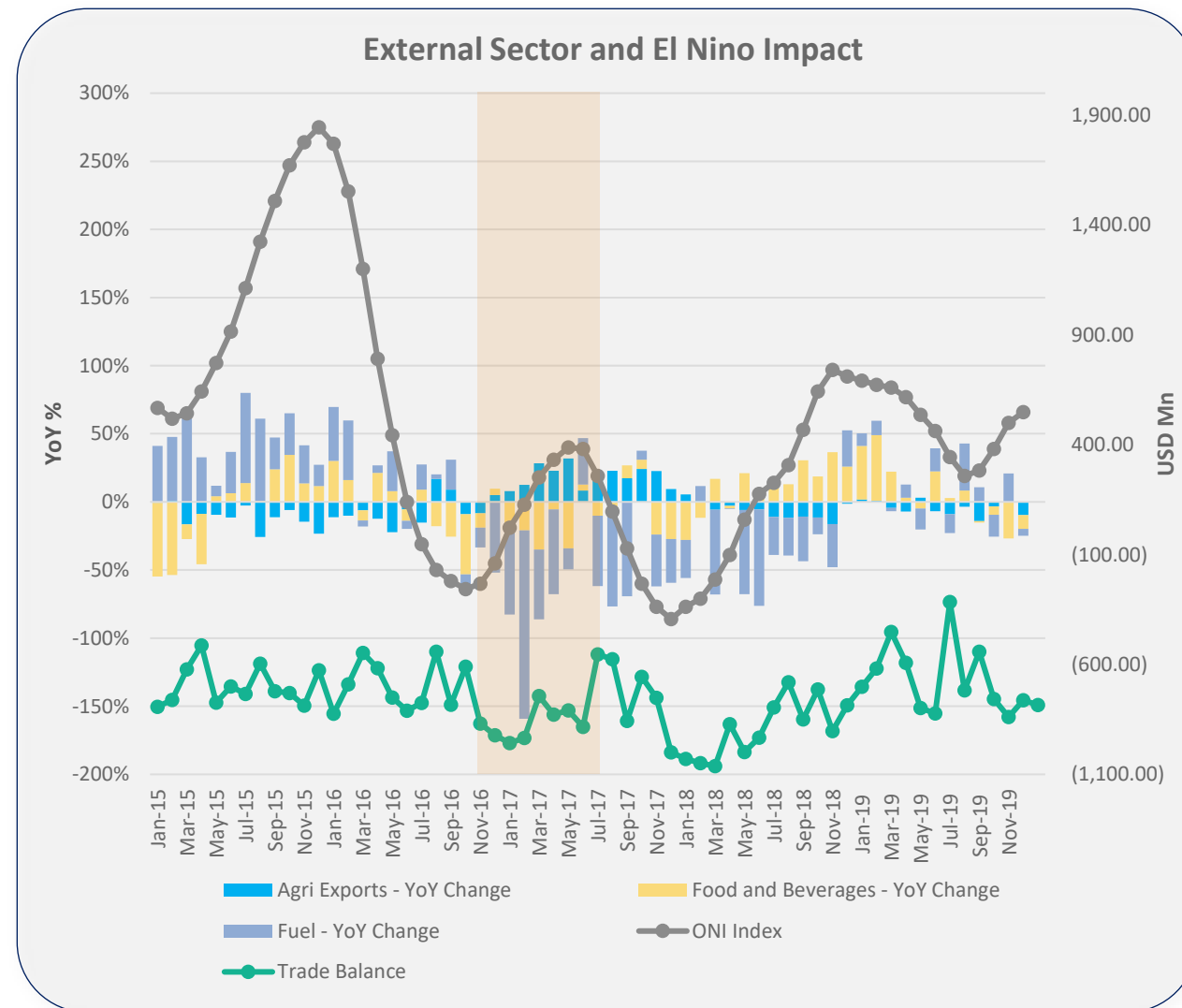


Macro & Financial Impacts: Trade Balance



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- The trade balance remains as a key channel through which El Niño shocks materialize, with impacts unfolding sequentially across sectors.
- The initial impact is observed in agriculture exports, which weaken under adverse climate conditions, reducing export earnings.
- This is followed by a rise in food imports to offset domestic supply shortfalls, further widening external imbalances.
- Subsequently, increased reliance on thermal energy drives higher fuel imports, compounding trade pressures.
- As a result, trade balance deterioration typically peaks with a lag, extending beyond the El Niño event period.

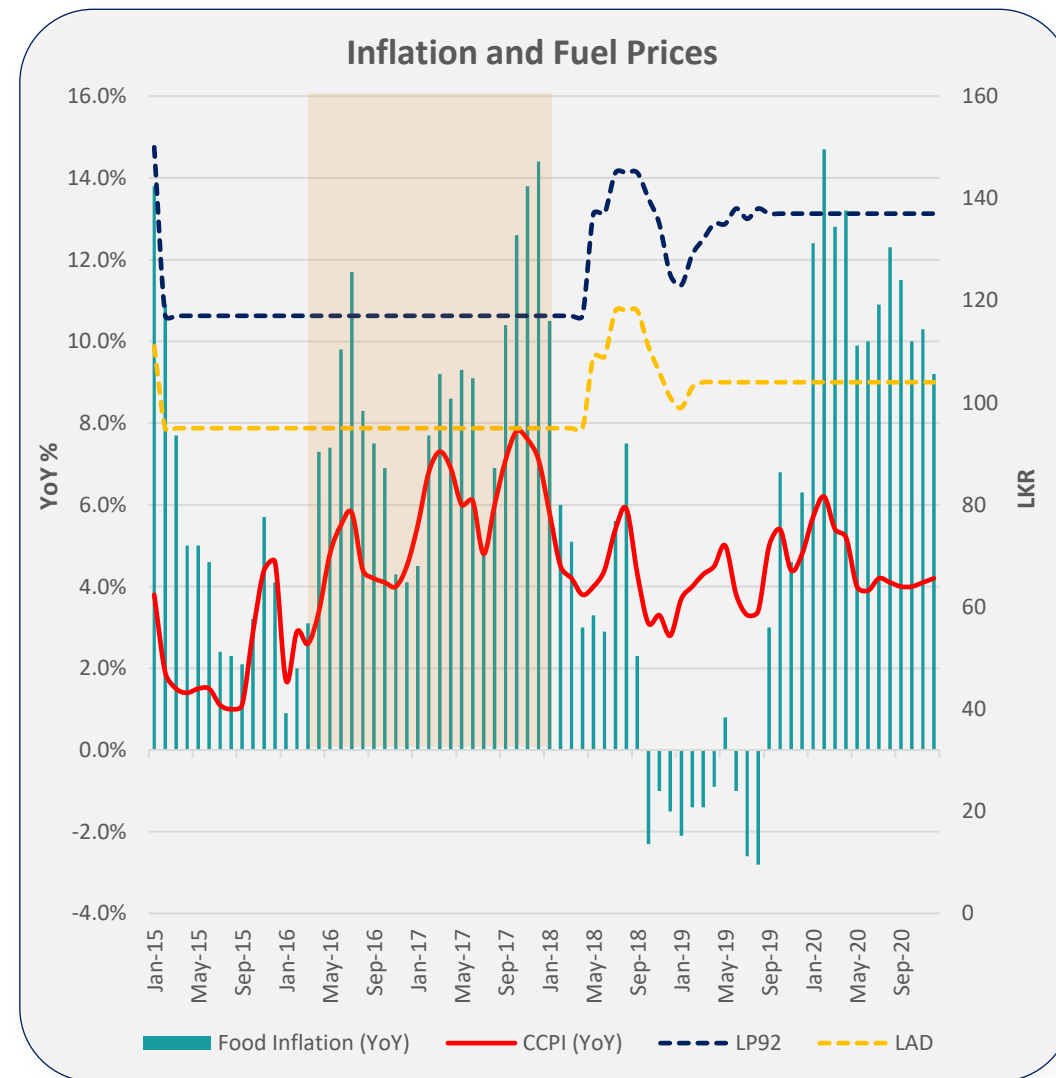


Macro & Financial Impacts: Inflation



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- We identify inflation as a key transmission channel for El Niño shocks, driven primarily by food supply disruptions.
- The 2015-2016 cycle shows a clear alignment between El Niño conditions and rising food inflation, with effects persisting into the post-event period and feeding into headline inflation (CCPI).
- Inflationary pressures intensified despite relatively stable domestic fuel prices (LAD, LP92), underscoring the dominance of food-driven supply shocks.
- CCPI increased from around 2% to 8% over 24 months, highlighting the magnitude and persistence of climate-driven inflation dynamics.

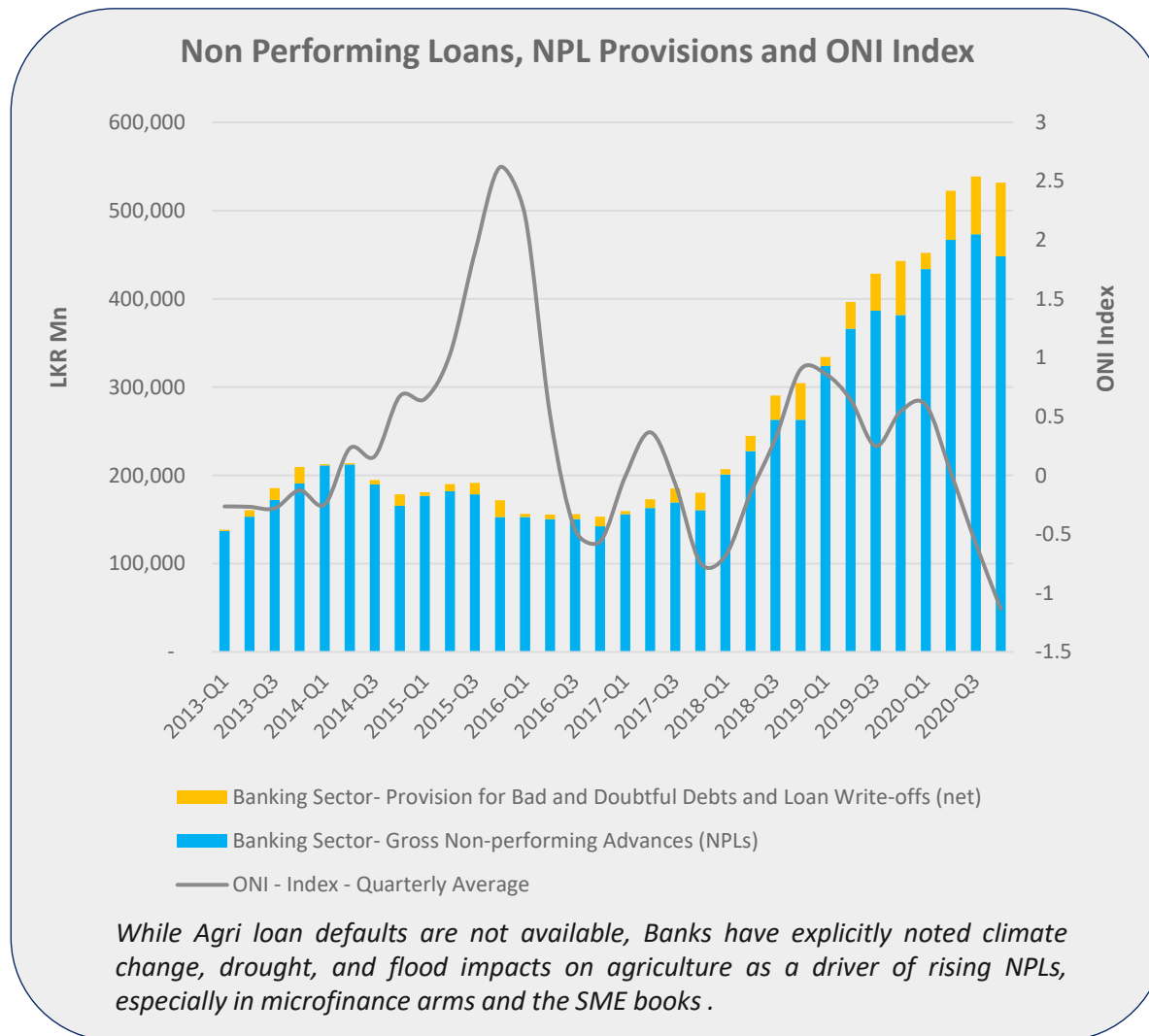


Macro & Financial Impacts: Banking & Credit



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- The banking sector act as a lagging transmission channel with impacts materializing through asset quality deterioration.
- Previous cycle shows that NPLs rising happened with a delay from early 2017, reflecting delayed stress.
- This deterioration is accompanied by increased provisioning for bad debts, indicating a broad-based weakening in credit quality.
- Also, the impact on banking sector balance sheets emerges with a notable lag, consistent with delayed transmission of shocks into borrower repayment capacity.

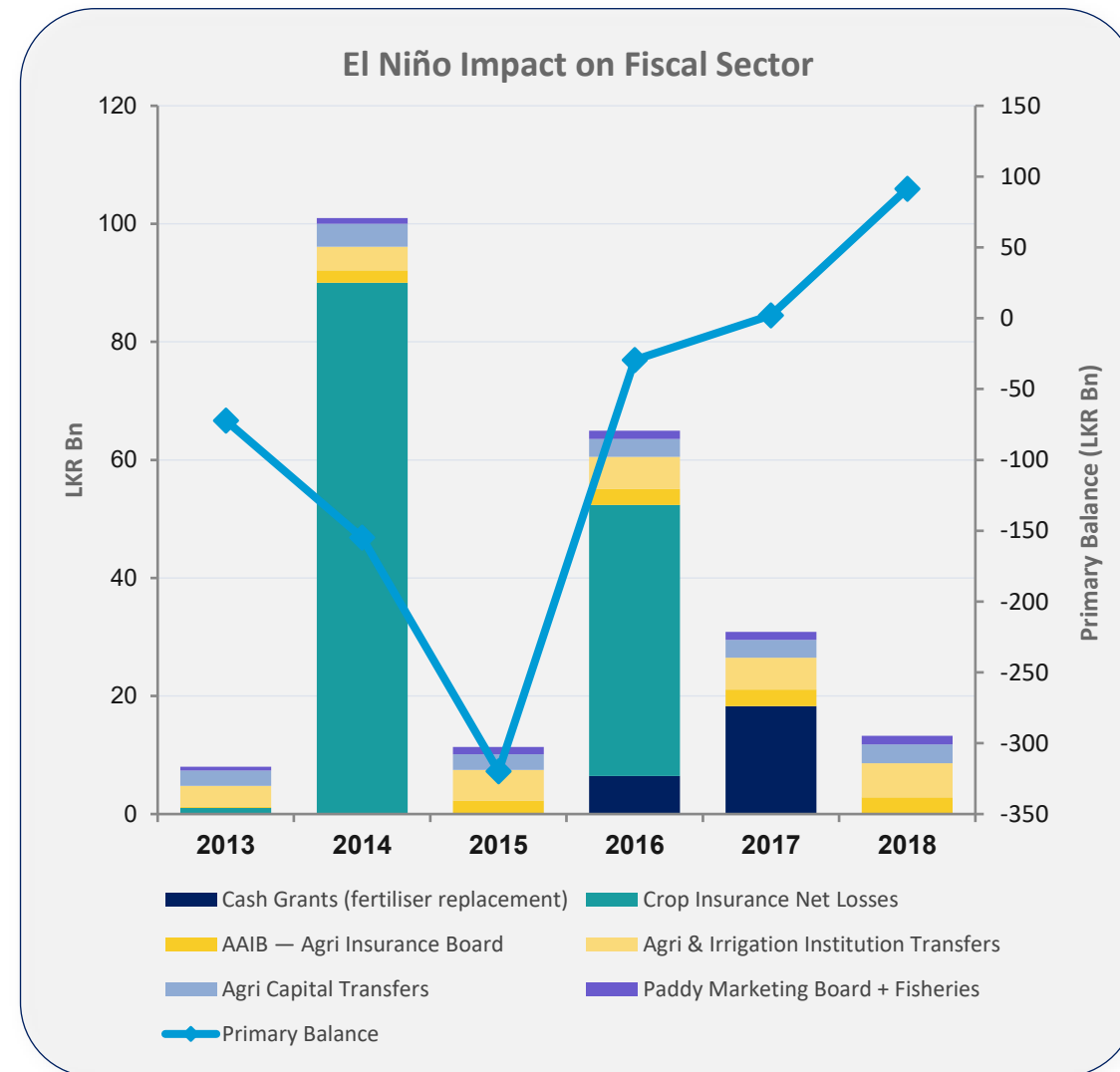


Policy Responses - Fiscal



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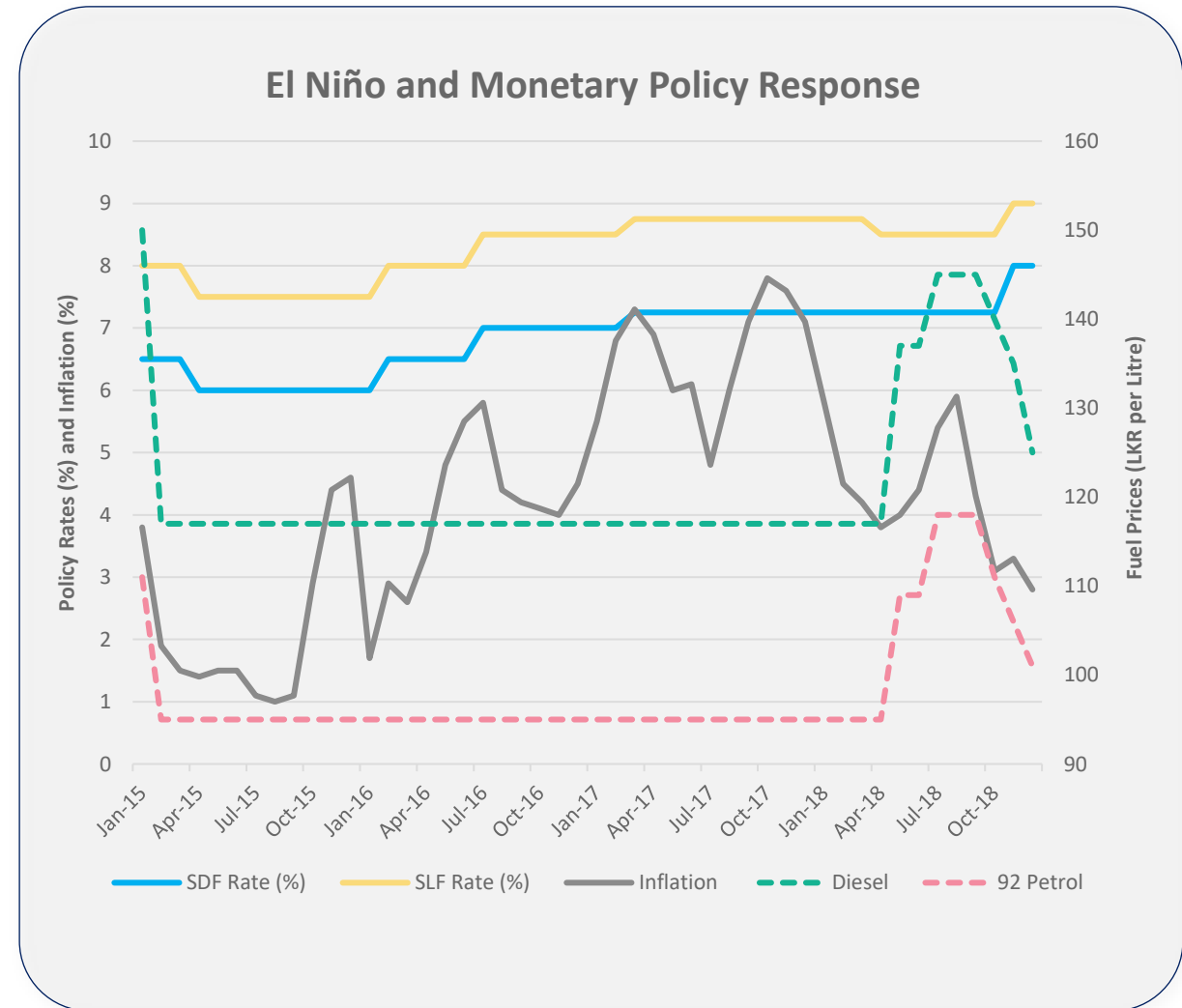
- Fiscal policy acted as a key shock absorber during El Niño events during the previous event.
- The response included targeted support alongside higher institutional transfers and capital spending.
- This resulted government spending rose temporarily, peaking in 2016 with spillovers into 2017, due to large-scale intervention.
- This led to a short-term weakening of the primary balance, despite overall expenditure discipline.
- The 2026 cycle is expected to exert similar fiscal pressures.



Policy Responses - Monetary



- The 2015-2016 El Niño-driven supply shocks pushed inflation higher, prompting the Central Bank of Sri Lanka (CBSL) to raise policy rates by 100-125 basis points.
- Inflation (CCPI) was largely driven by food prices, while relatively stable fuel prices helped contain broader cost pressures.
- Although inflation began to ease towards end-2017, a resurgence in fuel-driven pressures limited the scope for monetary easing.
- A potential 2026 El Niño cycle could reintroduce similar supply-side pressures, posing upside risks to inflation and constraining policy flexibility.

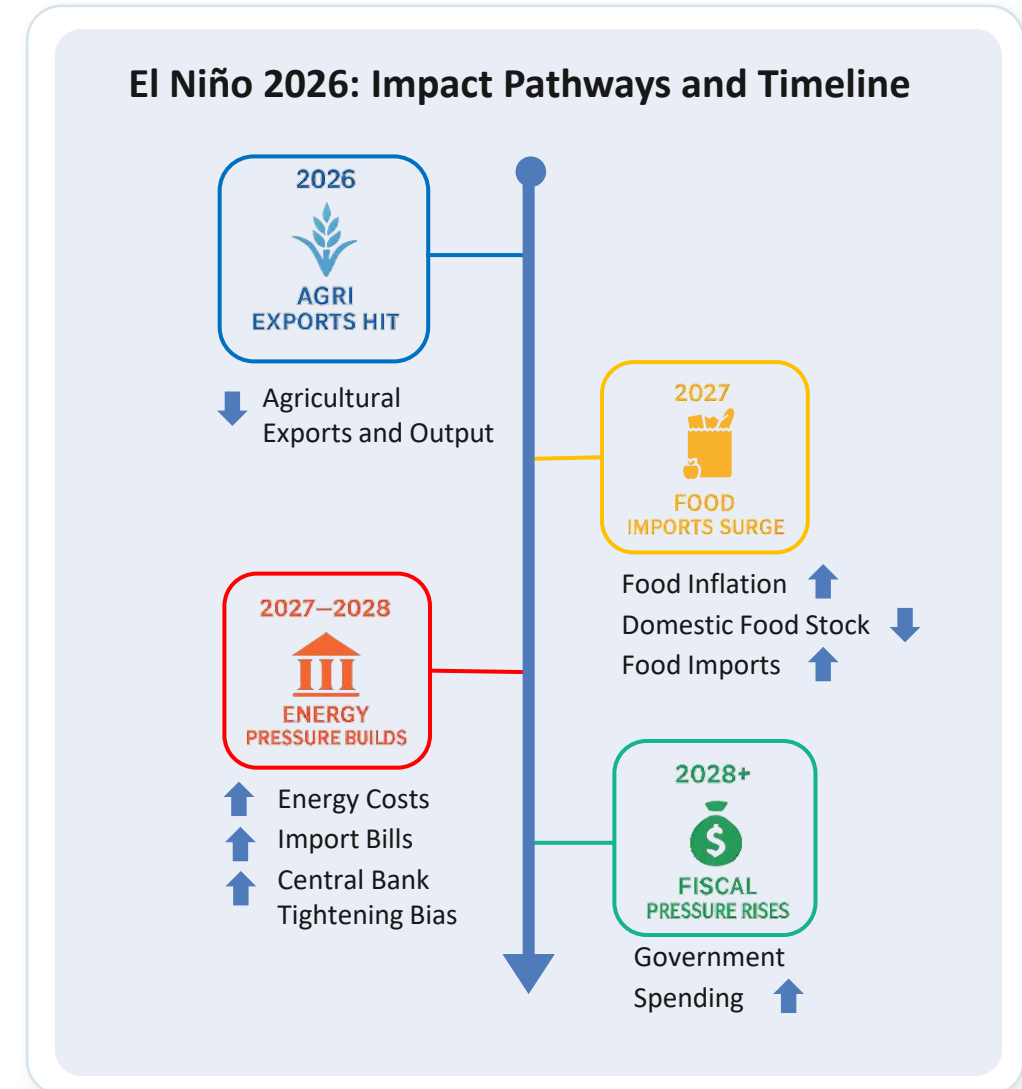


El Niño 2026: Key Economic Impacts in Summary



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- The expected 2026 El Niño cycle effect has staggered impacts on the economy based on its severity.
- We project two possible cases:
 - **Severe El Niño (Comparable to 2016)**
 - Food inflation: +10-12% YoY (late-2026-2027)
 - Fuel-related inflation: +2-3% (2027-2028)
 - Persistence: around 24 months
 - **Moderate El Niño**
 - Food inflation: +5-7% YoY (late-2026-2027)
 - Persistence: 12-18 months

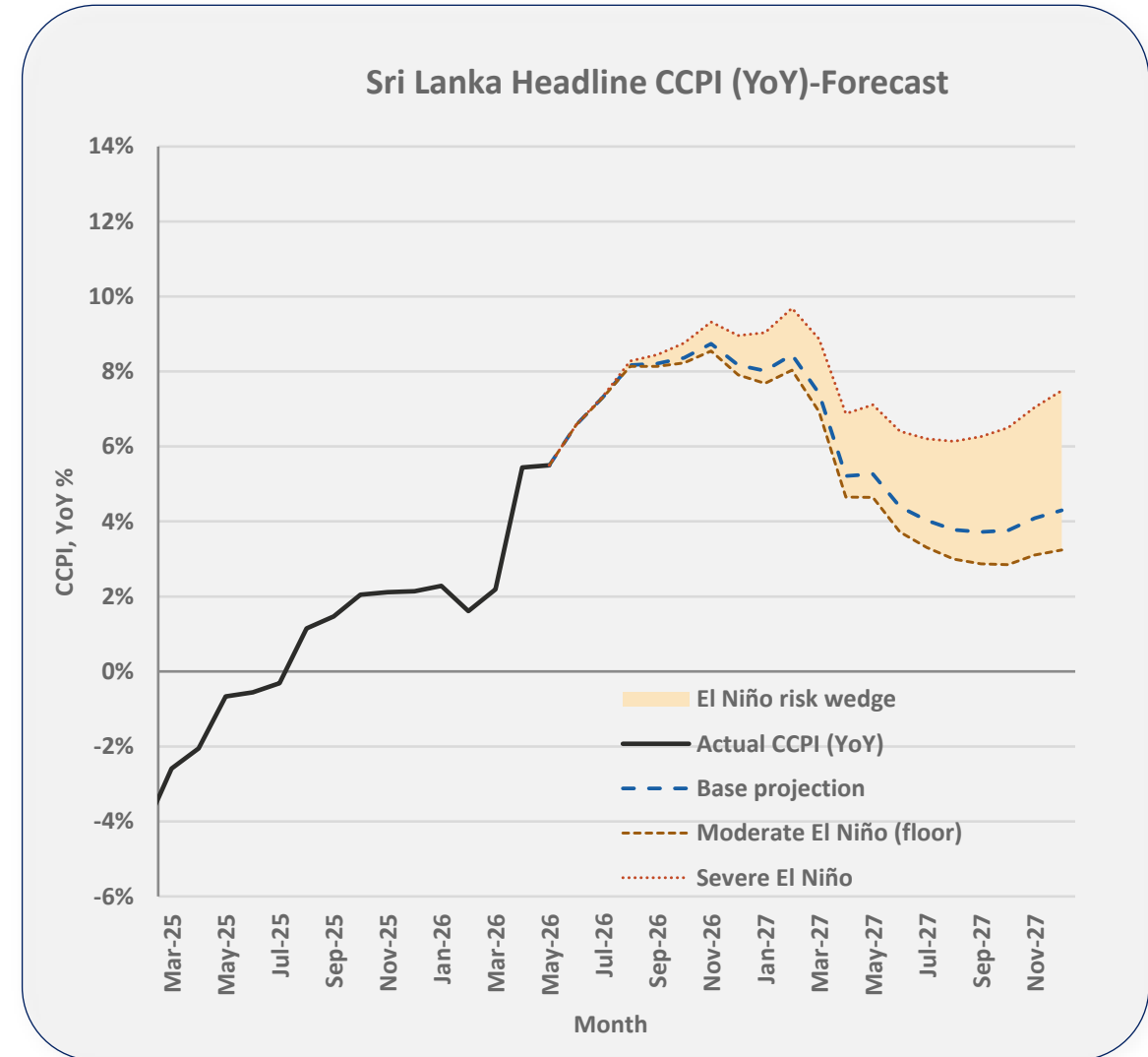


How Might El Niño 2026 Skew the Inflation Outlook to the Upside?



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- We incorporate El Niño risk by overlaying the 2015-2016 realized inflation impact onto the current baseline path.
- Inflation pressures are expected to build gradually and peak with a lag into 2027, driven by sequential transmission through food and energy channels.
- The forecast reflects an asymmetric risk profile, with limited downside and elevated upside potential.
- Overall, a possible El Niño skews inflation outcomes to the upside, which reinforces persistent macro pressures.





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