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Sri Lanka Economy: Present Situation and Risk Factors
～Will Diversification of Exports be Achieved by Sophistication of the Economy?～

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＜Summary＞

1. Sri Lanka’s economy achieved a high growth of more than 8% for three successive years from 2010 to 2012, followed by more stable growth of around 4% in 2013-15. Mainly supported by the robust growth of the economy, unemployment came down to the low level of 4.0% by 2012, but it has risen a bit in line with the deceleration of the economy.
2. On the other hand, the consumer price continued to move stably thanks to the fall of oil price and the effect of tight monetary policy, dropping to around 1% in 2015. However, entering in 2016, the consumer price started to rise again due to drought-related increase in food prices and a hike of value added tax (VAT), and recorded a relatively high level of 3.7% on an annual average.
3. No special improvement has been seen on the external imbalances. The current account has continued to be in red mainly due to a large trade deficit. Foreign exchange reserves declined since 2015, to reach \$5.64 billion or an equivalent to 3.5 months of imports at the end of February 2017. The economy is expected to face vulnerability against external shocks due to a fall of foreign exchange reserves and an increase of short-term external debts.
4. In April 2016, the government of Sri Lanka agreed with the IMF on the three-year

extended arrangement of $1.5 billion dollars under the Extended Fund Facility (EFF). The government, accepting the structural reform program in compliance with the agreement, started to implement various economic policies. The central part of the structural reform program has been the strengthened fiscal base supported by an increase of revenues.

5. The fundamentals of the Sri Lanka's economy seem to be in a comparative lull after the implementation of the structural reform program. Structural reforms under the credit arrangement by the IMF have been generally going smoothly. Macroeconomic situation has been stable with all of economic growth, price development and fiscal balance going relatively well toward stability. Although there is a concern over the low level of foreign exchange reserves, short-term risks for the future seem to have been lowered.
6. In the medium- to long-term perspective, in order to enhance the reputation of the Sri Lanka's economy and lower its credit risks, it is necessary for the country to reduce its external vulnerabilities by realizing the surplus in the current account balance and promoting a reduction of external debts and an increase of foreign exchange reserves. It will not be easy, however, to diversify and sophisticate the industries that are needed to increase exports as the specifics and policies on the growth industries are not still available. Therefore, the medium- to long-term risk of overdependence on a specific industry and the continued external imbalance arising from it is considered to stay unchanged for long.

1. From High Economic Growth After the End of Civil War to More Stabilized Growth

Sri Lanka's economy achieved a high growth over 8% in real terms in three successive years from 2010 to 2012 mainly supported by the reconstruction demand and revitalized economic activities after the end of the civil war. After peaking at record high growth of 9.1% in 2012, the growth rate declined to a more stable rate of around 4% in three years from 2013 to 2015. Unemployment rate also declined to 4.0% in 2012 supported by a robust economic growth, although it has hit a bottom since along with the slowdown of economic expansion.

The consumer price tended to move on a stable path reflecting the fall of oil prices and effect of tighter monetary policy, dropping to a level of around 1% in 2015. However, after turning of the year to 2016, it began to rise again due to a drought-related increase in food prices and a VAT hike, rising by relatively high rate of 3.7% on an annual average.

Chart 1 ： Real GDP Growth Rate

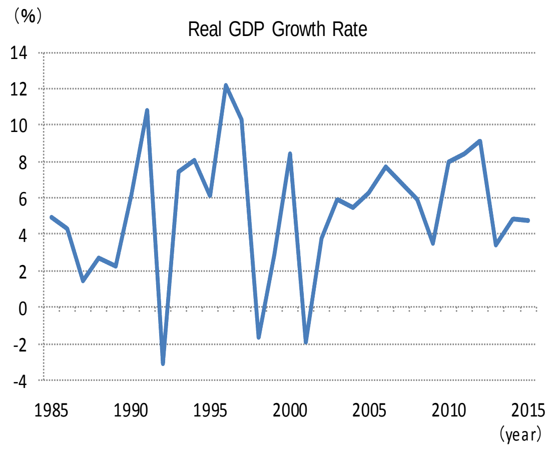
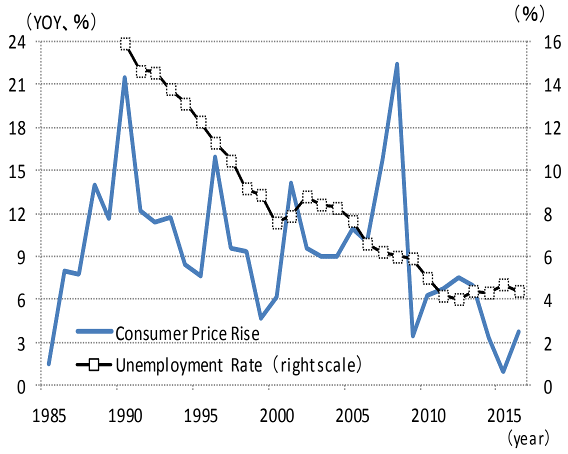


Chart 2 ： Consumer Price and Unemployment Rate



(Source) IMF, Central Bank of Sri Lanka

The budget balance had been in a relatively larger red as compared to its economic scale. In the background there is a fact that Sri Lanka has been a socialist country which has pursued for long an economic policy focused on the distribution and social welfare rather than the economic growth and effectiveness. As it has approved the active intervention by the state in the economy, like renationalization of once privatized companies in airline, gas, banking industries, it had tended to have a bloated government. The budget deficit started to increase again since 2013, reaching 7% of nominal GDP in 2015. The public debt outstanding also rose to 76% of nominal GDP, the highest among the Asian emerging economies.

Chart 3 ： Fiscal Balance of Sri Lanka

(% of nominal GDP)

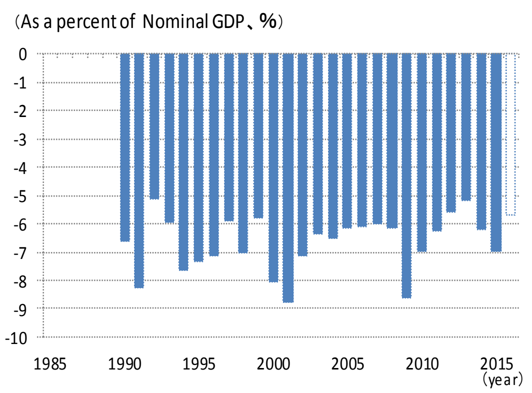
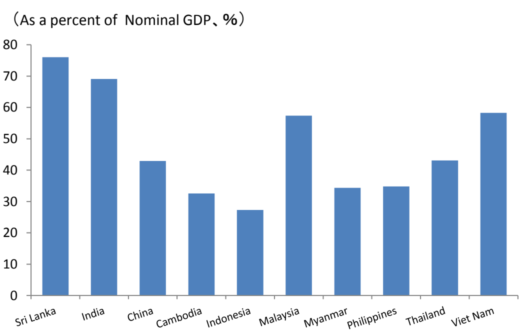


Chart 4 : Public Debt Outstanding

(% of nominal GDP, end 2015)



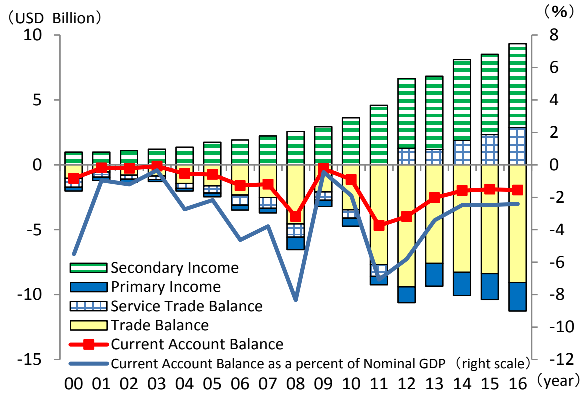
(Note) Fiscal balance for 2016 is an estimate of the IMF.

(Source) IMF, Central Bank of Sri Lanka

2. Continued Current Account Deficits and Expanding External Debts

No noticeable improvement has been seen in the external imbalances and the current account balance has continued to be in deficit mainly due to enormous trade deficit. Although since 2012 the worsening of the current account deficits has been halted to some extent by the surplus in the services account balance including the travel balance together with the increase in the surplus in the secondary income balance led by workers' remittances, there is no sign for the deficit to improve markedly.

Chart 5 : Development of Sri Lanka's Current Account Balance

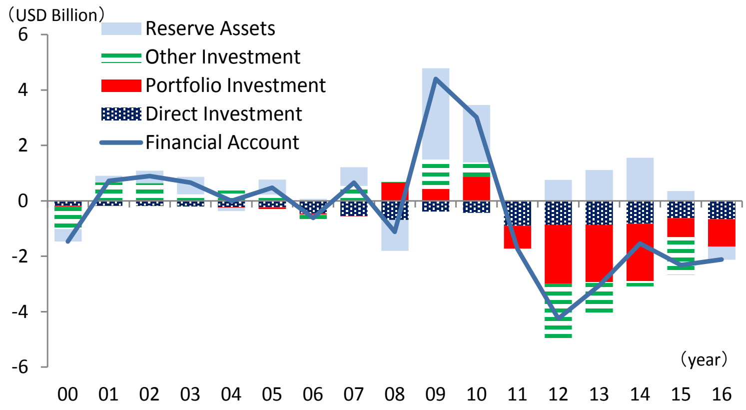


(Note) The ratio of the balance to nominal GDP for 2016 is that estimated by the IMF.

(Source) IMF・Central Bank of Sri Lanka

In the meanwhile, in the financial account balance, the purchase of assets in Sri Lanka by foreign capital (inflow of capital) had exceeded since 2011 the purchase of foreign assets by investors of Sri Lanka (Chart 6). In addition to the continued net inflow of direct investment, net inflow of portfolio investment began to show up since 2012, with a greater share in the total financial account balance. In other words, the role of portfolio investment has been rising in the finance of current account deficits.

Chart 6 : Financial Account of Sri Lanka



(Note) Positive sign in financial account means net purchase of foreign assets by Sri Lanka (capital outflow from Sri Lanka) and negative sign means net purchase of assets in Sri Lanka by foreigners (capital inflow to Sri Lanka)

(Source) IMF・Central Bank of Sri Lanka

The foreign exchange reserves which had been increasing for some time started to decrease in 2015 by declining to $5.64 billion, or equivalent to 3.5 months of imports by the end of February 2017(Chart 7). This decrease will be attributable mainly to the dollar selling and rupee buying intervention of the central bank of Sri Lanka which had made efforts to maintain the exchange rate of Sri Lankan rupee from falling sharply.

In line with the protracted deficits in the current account, short-term external debts also increased with its ratio to the foreign exchange reserves reaching 103.9% at the yearend of 2015. Its level is one of the highest in emerging economies (Chart 9).

Chart 7 : Reserve Assets in Sri Lanka

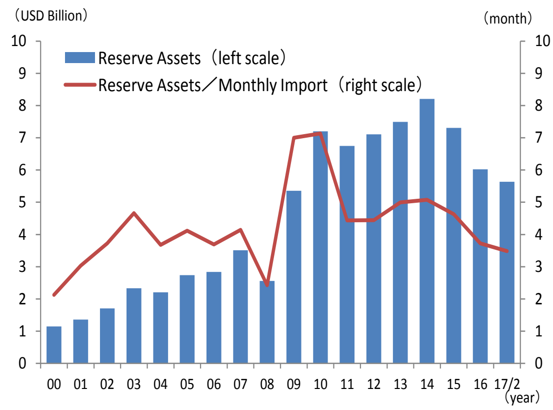
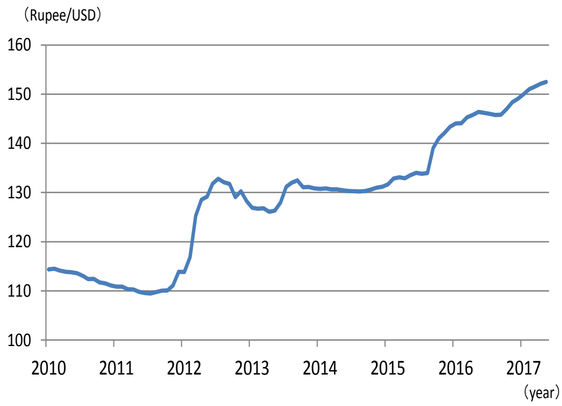
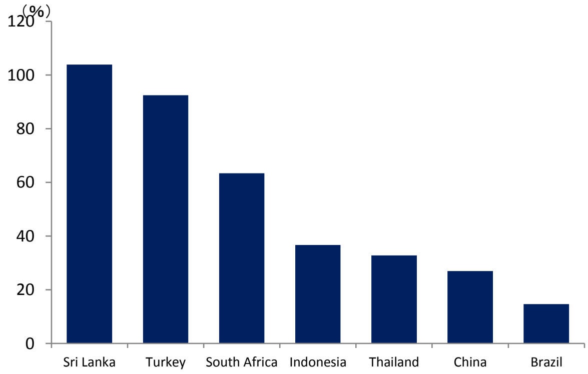


Chart 8 : Development of Sri Lankan Rupee



(Source) IMF・Central Bank of Sri Lanka

Chart 9：Ratios of Short-term External Debts to Reserves（end of 2015）



(Source) World Bank Database

Although the short-term debts increased relatively at a fast pace in the last 10 years to reach the same level of the foreign exchange reserves in 2015, the growth of total external debts coupled with the long-term debts increased at more stable pace and the ratio to nominal GDP remained at around 50% as of 2015, despite it being on a rising trend. (Charts 10, 11)

Chart 10：Short-term External Debts and Reserves

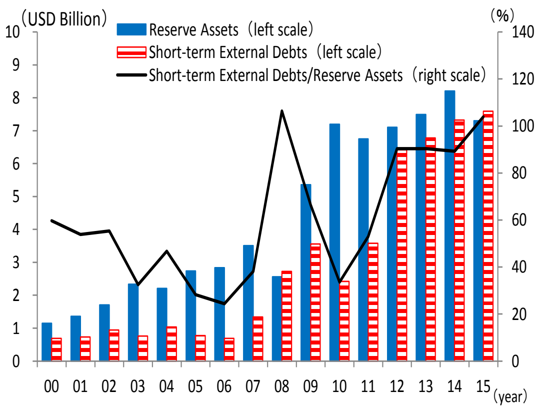
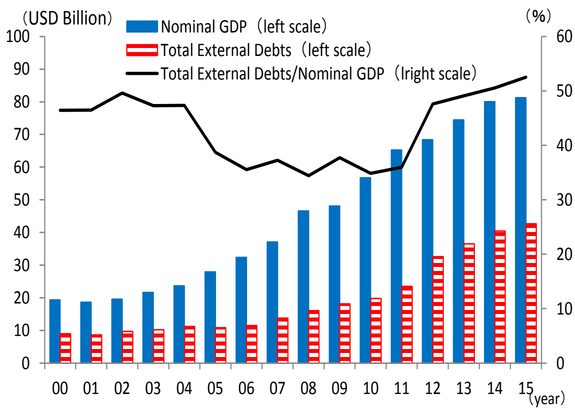


Chart 11 ：Total External Debts and Ratios to Nominal GDP



(Source) World Bank

As is seen above, it can be said that Sri Lanka has continued to face with a vulnerable situation to external shocks because of the persistent current account deficits and dependence of their finance on the inflow of portfolio investment on the flow side, and the decrease of foreign exchange reserves and increase of short-term external debts on the stock side.

3. Support by the IMF and Structural Reforms as its Conditions

(1) Agreement with the IMF on its Support and Structural Reform Program

In the midst of greater instability of the economy with worsening fundamentals such as an increase of fiscal deficit combined with the persistent current account deficits and decline in the foreign exchange reserves, the government of Sri Lanka agreed in April 2016 on a three year extended arrangement with the IMF in the amount of totaling US$1.5 billion under the Extended Fund Facility (EFF) arrangement. The arrangement was formally approved by the Executive Board of the IMF in June, with immediate disbursement in June of its first installment followed by the second provision in November. The EFF is a loan facility of the IMF under which it can assist with the adjustment process of a country which faces serious medium-term balance of payments problems because of structural weaknesses that require time to address[1]. The agreement meant that the IMF judged Sri Lanka has faced a relatively big problem that requires time to address.

Responding to the IMF support under the EFF, the Sri Lankan government accepted to make structural reform programs and started to implement numerous policy measures. The linchpin of the programs is a consolidation of fiscal foundation through increase of revenues. Other measures taken into consideration, the targets of the structural reform programs the government has accepted can be summarized as the following 6 areas (Table 1).

Table 1 : Targets of Sri Lanka's Structural Reforms

① Fiscal consolidation	A durable reduction of the fiscal deficit in order to reduce public debt
② Improved revenue base	Fiscal consolidation to be achieved mainly through measures to broaden the tax base with simplified tax system which is more transparent and fairer. Expanded room for expenditures for infrastructure and human resources
③ Improved management of public spending	Stricter disciplined management of spending by cutting waste while maintaining the spending for targeted expenditures.
④ Reforms of State Owned Enterprises (SOEs)	Enhanced oversight and financial discipline of the SOEs. More rule-based financial assistance by the government to the SOEs.
⑤ More effective and efficient monetary	Keeping inflation in the lower single digits. Transition toward more flexible exchange rate regime and inflation targeting

1 IMF Website.

policy	framework.
⑥ Promotion of trade and investment	More deregulation to increase export opportunities and improve competitiveness. Promoting inflows of direct investment with greater integration into regional and global supply chains.

（Source）IMF Website

（2）Hike of VAT Rates and New Inland Revenue Act

The hike of VAT rates constitutes a linchpin of the strengthened revenue base, one of the main pillars of structural reform programs. Changes related to VAT were implemented in May 2016. The main changes included (i) hike of basic rate from 11% to 15% except for some specific items, (ii) elimination of tax exemptions on telecommunication and healthcare related items, and (iii) lowering the floor of taxable sales of wholesalers and retailers.

The revision of basic VAT rate was decided invalid by the Supreme court for a reason that the revision had not gone through the necessary procedures in the Parliament, and the rate was returned to 11% during the period of July to October 2016. However, it was again raised to 15% in November after the Parliament approved the tax increase bill. In this way, the hike of VAT rate had some twists and turns before it was realized.

The Inland Revenue Act (IRA), which provides legal base for executing the revenues, was revised in early 2017. The old act had been too outdated for the current industrial structures and commercial transactions, and there were investment losses because of ineffective and insufficient tax incentives. The taxation power of Sri Lanka was also weak with narrow and eroding tax base. In this regard, the new IRA has been evaluated favorably by the IMF as it has dealt with the above issues and will pave the way toward improved fiscal condition through strengthened revenue base.

（3）Evaluation of Structural Reform Program

In November 2016, the IMF completed the First Review under the Extended Arrangement under the EFF and published its report in December. In that process, one of the Deputy Managing Directors expressed the views that “macroeconomic and financial conditions have begun to stabilize, inflation has trended down, and the balance of payments has improved. Meanwhile, international reserves remain below comfortable levels”. At the same time he stated that, “fiscal performance has been encouraging. The reinstatement of the amendments to the value added tax will help boost revenues. The 2017 budget proposal aims to strengthen government finances through revenue mobilization. The new Inland Revenue Act scheduled for early next year should result in a more efficient, transparent, and broad-based tax system.”

Later in March 2017, the IMF staff evaluated the development in Sri Lanka, stating that the macroeconomic performance has been generally good with gradual growth recovery and higher inflation. It also commended the authorities for strong efforts in implementing their IMF-supported economic reform program, especially it evaluated favorably the steady progress of the effort to strengthen the revenue base directed toward the fiscal target to reduce the deficit to 3.5% of nominal GDP by 2020, which is a matter of the greatest concern on the program. On the other hand, the staff expressed concern that the foreign exchange reserves remain below the targeted level, and the progress in the efforts for the improvement has been mixed.

Thus the fundamentals of the Sri Lankan economy after the implementation of structural reform program seem to be in a temporary lull. The real GDP in 2016 recorded a growth of above 4% on a quarterly average, although it fluctuated from quarter to quarter. The IMF forecasts the growth rates for 2017 and 2018 at 4.5% and 4.8% respectively, with a solid growth of 4% level expected for the coming two years. Meanwhile, the rise of inflation rate accelerated a bit, partly influenced by the hike of the VAT rates. The IMF forecasts inflation will remain broadly stable with consumer price rising by around 5% until the end of 2017 supported by the tight monetary policy and stability in international commodity prices. The IMF staff also sees the sign of improvement in the fiscal balance through the government efforts for broadening the revenue base.

In the meanwhile, the IMF continues to express concern over the level of international reserves. In fact, the reserves have been declining untill February 2017, the latest month that can be confirmed by the statistics (Chart 7 above). There is no sign of touching the bottom in the fall of foreign exchange reserves as the deficits in the current account still continue and uncertainties have not been dispelled over the foreign exchange funding. The IMF has been keeping watch for any expansion of the current account deficits which may aggravate the reserve situation, citing as a possible factor the stagnant exports to the U.S. and Europe, the main trading partners of Sri Lanka (Chart 12). Also the deceleration of the Chinese economy is regarded as a risk factor as China has greatly contributed to the surplus in the services account, especially through the surplus in travel balance.

Chart 12 : Sri Lanka's Exports by region (2015)

(Million USD、%)

	Amount	Percent Distribution
U.S.	2,810	26.8
U.K.	1,029	9.8
India	643	6.1
Germany	476	4.5
Italy	434	4.1
China	308	2.9
Japan	216	2.1
EU	3,024	28.8
SAARC (South Asia Association for Regional Cooperation)	891	8.5
Others	669	6.4
Total	10,500	100.0

(Source) Central Bank of Sri Lanka

4. Medium- to Long-term Challenges～Will the Industry Diversification Diversify the Export Items?

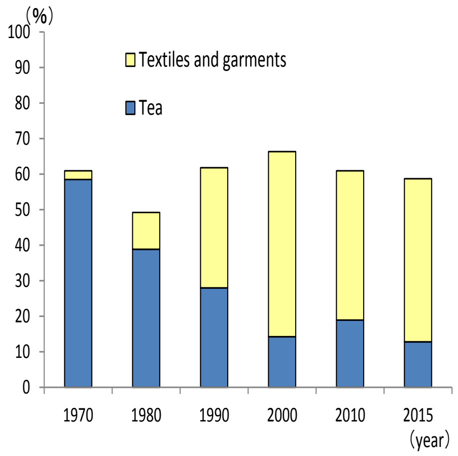
Based on a medium- to long-term perspective, in order to enhance the evaluation of the Sri Lankan economy as well as to lower its credit risks, it will be necessary for Sri Lanka to diversify and sophisticate its industry. The industry in Sri Lanka largely depends on black tea in agriculture, and textile and garments in manufacturing. The share of these items in exports accounts for around 60% and this feature has not changed for more than 40 years since 1970 (Charts 13, 14). The limited availability of products for exports may be the main factor for the continued current account deficits that have lasted without disruption since early 1980s or before the break of civil war.

Chart 13 : Sri Lanka's Exports by Commodity(2015)

(Million USD、%)

	Amount	Percent Distribution
Mineral Products	28	0.3
Agricultural Products		
Tea	1,341	12.8
Spices	377	3.6
Coconut	352	3.4
Industria Products		
Food beverage	265	2.5
Textiles and garments	4,820	45.9
Rubber products	761	7.2
Petroleum products	374	3.6
Gems, diamonds and jewellery	332	3.2
Machinery and mechanical appliances	294	2.8
Transport equipment	244	2.3
Others	1,312	12.5
Total	10,500	100.0

Chart 14 : Share of Tea and Textile‣Garments



(Source) Central Bank of Sri Lanka

The necessity to diversify its industry has been advocated for long and, supported by the rich tourism resources and highly qualified human resources, some of the services industry such as tourism and IT has made a significant development. However, Sri Lanka is a country with small land area and limited natural resources. Despite its relatively high income level at around $4,000 of per capita GDP, its population of about 20 million is not so large to make market as compared to its neighboring South Asian countries like India and Bangladesh. It also has a limited means for transportation of goods to other countries as it is surrounded by the sea.

Therefore, Sri Lanka will continue to have a tough road ahead. Inward flows of foreign direct investment tended to decline since 2011, the year immediately after the end of civil war, which is worried if it means the peak has passed (Chart 15). Although the government holds up a policy to promote the inflow of foreign direct investment by encouraging its industry to be incorporated into a global supply chain, so far it has failed to show specifics on which business lines it aims to promote. Stimulating inflow of capital requires development of growth industries and policy measures attractive enough to foreign investors, but given the current situation of no emergence of such industries and no specific policy measures taken, the diversification and sophistication of Sri Lanka's industry will be not easy to be achieved.

Chart 15 : Foreign Direct Investment to Sri Lanka

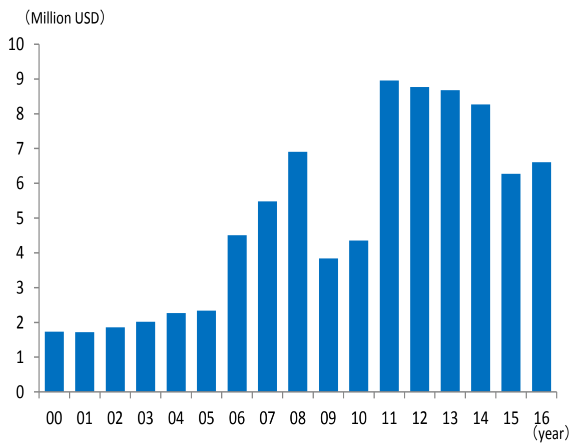


Chart 16 : Inward Direct Investment by Industry

(Million USD)

	2014	2015
Agriculture	6	4
Manufacturing	334	257
Chemical,Mineral,Rubber products	92	75
Base metals,Machinery	7	46
Textiles and garments	83	45
Food beverages	45	43
Others	107	47
Services	506	255
Hotel, Restaurant	68	182
IT	25	14
Others	413	60
Infrastructure	682	453
Housing, Office	339	212
Telecommunication	152	139
Others	191	103
Total	1,528	970

(Source) Board of Investment of Sri Lanka

5. Conclusion

As described above, the structural reform has been proceeding smoothly supported by the credit line of the IMF. Macroeconomic performance has been moving toward stabilization with all indicators on economic growth, prices, and fiscal balance showing relatively favorable development. Although there is some concern over the low level of foreign exchange reserves, as far as it is viewed from a short-term perspective, the risks in the near future are considered to have diminished.

From a medium-term perspective, however, in order for Sri Lanka to get higher evaluation on its economy and have lower credit risks, it is necessary for it to reduce the external uncertainties by achieving a surplus in its current account balance and making efforts to decrease external debts and increase international reserves. Yet, the diversification and sophistication of its industry that is needed for the increase of exports will be hard to achieve because no specifics of growth industry and policies for encouraging it are shown. Accordingly, it is judged that there will be no change in the medium-term risks of continued over-dependence of the Sri Lankan economy on specific industry and continued big external imbalance caused thereof.

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