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With Support of the IMF, Sri Lanka Makes efforts on Structural Reforms

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Introduction

Under the administration started in 2015 and headed by President Sirisena and Prime Minister Wickremesinghe, Sri Lanka began to transform its policies of overemphasizing China and protecting domestic industries that were promoted by former President Rajapaksa toward a diplomacy with more balanced emphasis between China and India and open-door economic policy to the outside world. However, progress has been slowed recently as is seen in such cases as Sri Lanka was forced in 2017 to turn over to China the right of use of its Port of Hambantota, located in Southern part of the country[1], and the faction of former president Rajapaksa who attaches much weight on domestic protectionist policies won the regional election held in February 2018.

On the macro-economy and finance, the economy maintains stable growth and price stability while the expansion of fiscal deficit has become apparent since 2014, and the foreign exchange reserves started to decline in 2015, indicating worsening economic fundamentals. To tackle the worsening situation, the government formally agreed in June 2016 with the IMF on the Extended Fund Facility (FFF) of $1.5 billion for a period of three years, receiving several installments under the agreement since then. Structural reforms were a condition for the IMF financing, and thanks to the favorable effects of its efforts, negative aspects of the economy have shown improvement with fiscal deficit narrowing and foreign reserves increasing. In 2017, however, the growth rate of real output decelerated with inflation accelerating, suggesting uncertainties remain over enormous public debts and external debts. In this article, the author would like to analyze the present situation of the Sri Lankan economy which has reached a difficult stage with various problems emerging, and look into its future.

1. **The economy maintains stable growth following a high growth after the end of civil war**

The Sri Lankan economy performed a high growth of more than 8% for three consecutive years from 2010 to 2013, supported by reconstruction demands and activated economic activities following the end of the civil war. Economic growth reached 9.1% in 2012, the highest as ever, and then slowed, yet achieving stable growth of 4-5% in the three year period from 2014 to 2016. In 2017, however, the growth decelerated to 3.1%, the lowest in the past 10 years, mainly due to an unseasonable weather and growing effects of structural reforms promoted under the IMF lending program (Figure 1).

On the other hand, inflation (rise in consumer price index) remained on a stable track due to a fall of oil prices and effect of monetary tightening, dropping to around 2% in 2015. It started to rise again in 2016, however, reflecting a rise in food prices caused by drought and a hike of value added tax (VAT), and it rose by 6.5% on average in 2017, reaching the highest level since 2013 (6.9%) (Figure 2).

Figure 1: Real GDP Growth Rate

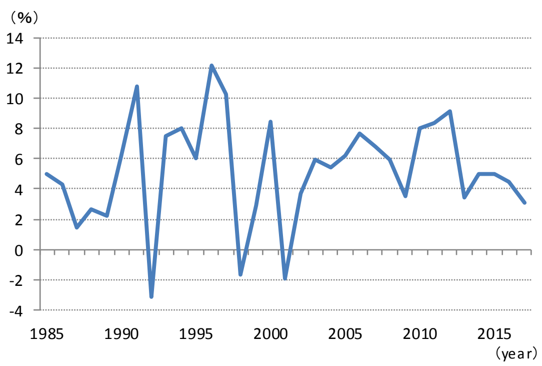
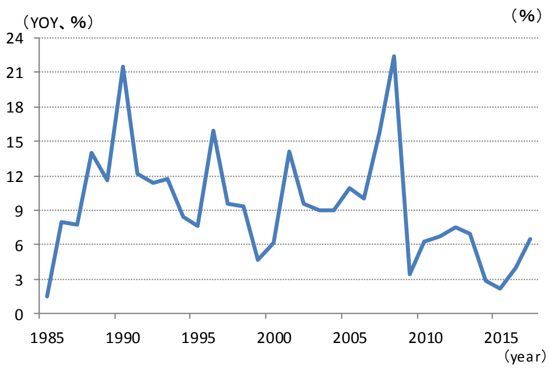


Figure 2: Consumer Price Development



(Source) IMF, Central Bank of Sri Lanka

The fiscal balance had been in relatively large deficits compared to its size of economy. In the background, there is a fact that Sri Lanka is a socialist country which has long taken economic policies that put more emphasis on distribution and social welfare than growth and effectiveness. The country tended to have a bloated government as it allowed an active state intervention to the economy, as is seen in the re-nationalization of airlines, gas, and banking industries which were once privatized. Fiscal deficit started to increase in 2014, reaching 7% of nominal GDP in 2015. In 2016, the fiscal deficit shrank due to effects of economic structural reforms including tax increases and expanded revenue base under the IMF programs (for details see Chapter 3, Section 1 below) to record a small deficit in 2017. Yet, the public debt outstanding stood at 76% of nominal GDP, on a higher level than in other Asian emerging countries (Figures 3 and 4).

Figure 3 : Fiscal Balance (% of Nominal GDP)

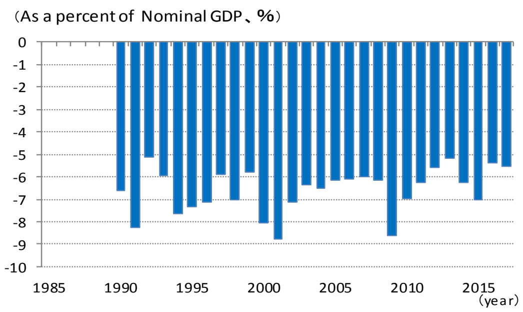
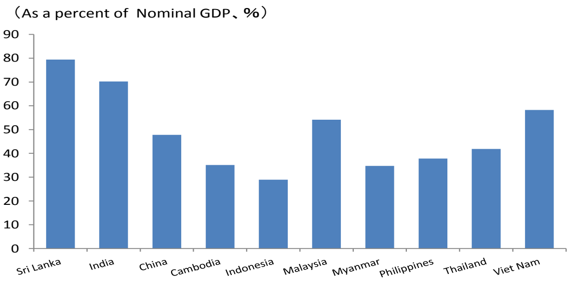


Figure 4 : Public Debt Outstanding in Asian Countries (% of Nominal GDP, end 2017)



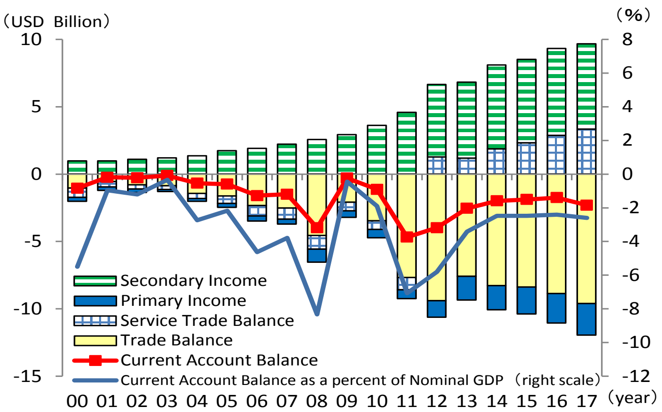
(Note) IMF estimates for public debt outstanding figures for Cambodia, Indonesia, Malaysia and Vietnam.

(Source) IMF, Central Bank of Sri Lanka

2. Expanding external debts with continued current account deficits

No noticeable improvement has been seen in the external imbalance. The current account continues to run a deficit mainly due to sizable trade deficits. Although the expansion of current account deficit has been halted by an increased surplus in services account centering on travel account and overseas workers remittances despite increasing trade deficit, there is no visible sign for an improvement in the current account deficits (Figure 5).

Figure 5 : Current Account Development

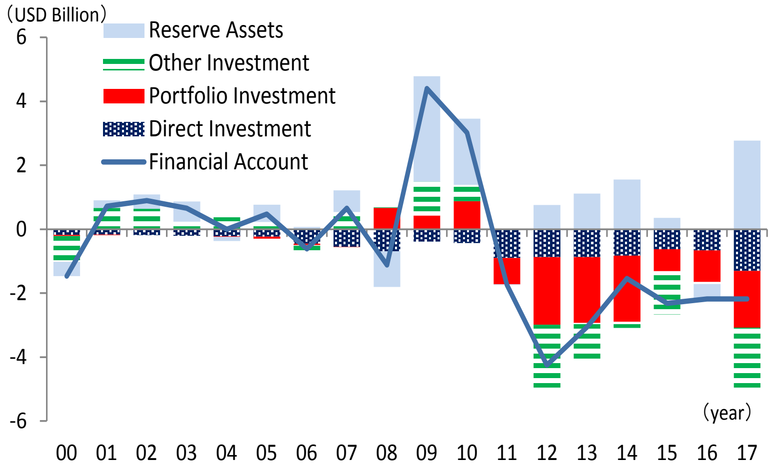


(Note) The current account ratio to nominal GDP for 2016 is based on the IMF estimate for 2016.

(Source) IMF and Central Bank of Sri Lanka

On the other hand, while the balance of financial account has remained in deficit, acquisition of Sri Lankan assets by foreign capital (capital inflows) have exceeded the acquisition of foreign assets by Sri Lankans (capital outflows) since 2011. Direct investment maintains net inflow positions but net inflow in portfolio investment has become noticeably large since 2012, increasing its share in the total financial account. The role of portfolio investment has been rising in financing the current account deficit (Figure 6).

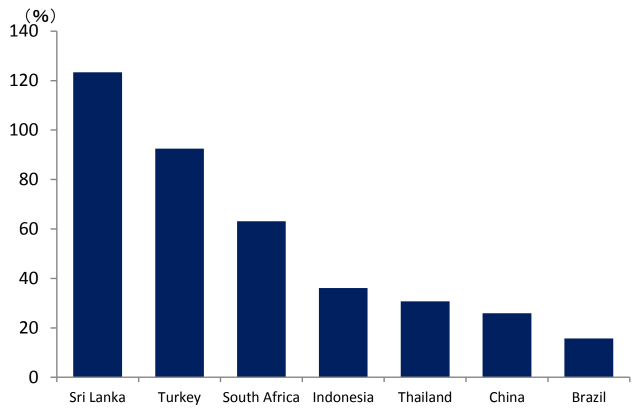
Figure 6：Development of Financial Account Balance



(Note) Positive figures in the financial account indicate net acquisition of foreign assets by Sri Lankans (capital outflows) and negative figures indicate net acquisition of Sri Lankan assets by foreigners (capital inflows).
(Source) IMF and Central Bank of Sri Lanka

With continued current account deficits, external liabilities have also increased, with the ratio of short-term external liabilities to reserves reaching 123.4% in 2016, showing a higher level than any other emerging countries (Figure 7).

Figure 7：Ratio of short-term external debts to reserves (end of 2016)



(Source) World Bank Database

Foreign exchange reserves turned to decline in 2015 after taking a rising trend for a long time, decreasing to $6.02 billion, or equivalent of 3.8 months of imports at the end of 2016 (Figure 7) . It is seen that the decline primarily reflected the active intervention of the Central Bank of Sri Lanka that purchased rupee against dollar to put the brakes on the fall of exchange rate of Sri Lankan rupee (Figure 8). After that foreign exchange reserves started to increase in 2017, suggesting that the efforts of the CBSL to make exchange rate system more flexible while refrain from intervening, one of the targets under the IMF program, have taken effect (for more details see Chapter 3 Section 1 below).

Figure 8 : Sri Lanka’s International Reserves

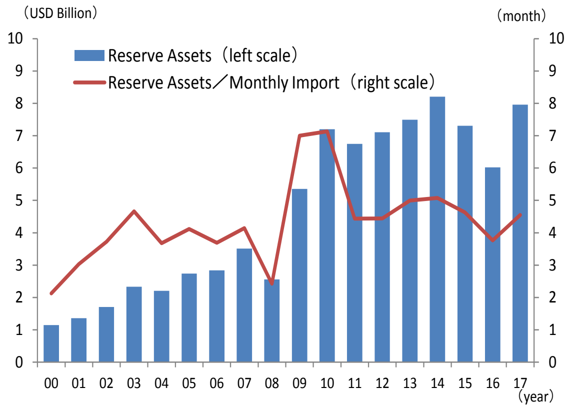
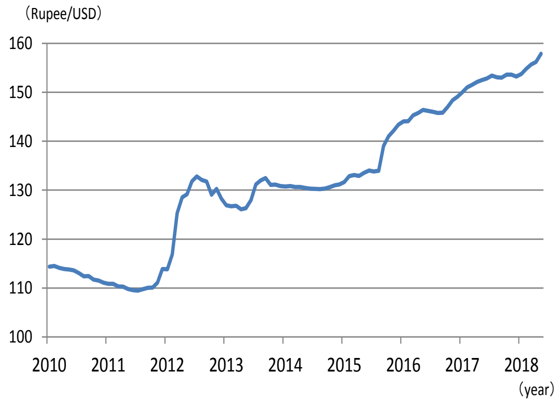


Figure 9 : Development of Sri Lankan Rupee



(Source) IMF, Central Bank of Sri Lanka

Incidentally, short-term external debt outstanding increased at a relatively fast pace in the past10 years, largely exceeding the level of the reserves, but in 2017 the debt outstanding came down below the reserves due to an increase in the reserves (Figure 10). Gross external debt outstanding that adds long-term external debt to the short-term debt continued to rise, with its ratio to nominal GDP slowly rising to reach around 60% as of 2017 (Figure 11).

Figure 10：Short-term Debts and International Reserves

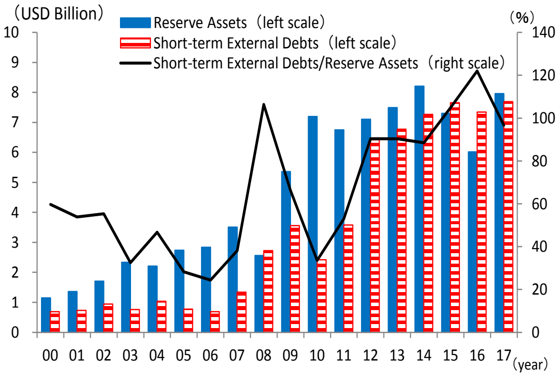
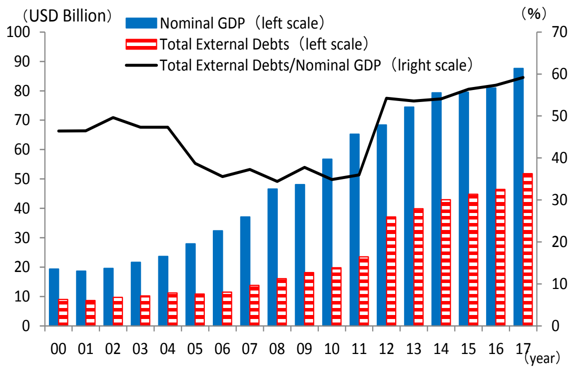


Figure 11：Gross External Debts and Nominal GDP



(Source) World Bank Database

As described above, while there is a sign of improvement in the foreign exchange reserves, the economy remains vulnerable to external shocks given the continued current account deficits and reliance of its finance on the inflows of portfolio investment on the flow aspect and increasing external debts on the stock aspect.

3. Support of the IMF and structural reform program as a conditionality for it

(1) Agreement on the IMF support and structural reform program

In an environment of worsening fundamentals and increasing economic uncertainties that include expansion of fiscal deficits and decrease of international reserves, the Sri Lankan government concluded an agreement with the IMF on a three-year Extended Fund Facility (EFF) totaling $1.5 billion. The agreement was formally endorsed by the Executive Board of the IMF in June, and the country started to receive the loan sequentially. The EFF is a facility to provide assistance to member countries experiencing serious payments imbalances in the medium-to long-term because of structural impediments that require comprehensive economic reforms to make efforts to solve them[2]. So the agreement means that the IMF judged that the Sri Lankan economy has faced a relatively large problem that requires time to deal with.

With the approval of the IMF on the EFF, the government accepted a structural reform program based on the procedures of the agreement and started to implement various policy measures. The central part of the structural reform program the government accepted in June 2016 included a strengthened fiscal foundation through increase in revenues. With other items taken together, the objectives of the structural reform program under the IMF assistance can be summarized as the following 6 points (Table 1).

Table 1 : Objectives in the structural reform program under the IMF support to Sri Lanka

① Fiscal consolidation	Sustained reduction of fiscal deficits to reduce public debt outstanding
② Strengthening of revenue bases	Simplify the tax system and strengthen the tax revenues. Ensure the transparent and fair tax system. Increase the room for expenditures for infrastructure and human resources
③ Strengthened management of public expenditures	Strengthen expenditure management by maintaining expenditures to meet the targets and eliminating the wastes.
④ Reform of State Owned Enterprises (SOEs)	Strengthening of supervision and fiscal discipline of SOEs. Fiscal supports to SOEs by the government should be implemented based on the rules.
⑤ Deepening of monetary policy	Maintain inflation at low and stable level. Shift to more flexible exchange rate system and inflation targeting policy.
⑥ Promotion of trade and investment	Promote deregulations to expand export opportunities and competitiveness. Promote inflows of direct investment connected with the global value chains.

(Source) IMF Website

(2) Hike of value added tax (VAT) rates and new Inland Revenue Act (IRA)

The main policy measures of strengthening revenue base, a central part of the structural reform program, is a raise of VAT rates. The amendment of the VAT system was implemented in May 2016. The major points included (i) hike of basic rate from 11% to 15% except for some specific items, (ii) abolition of tax exemptions for telecommunication and healthcare related items, and reduction of taxable sales amounts for wholesalers and retailers.

Incidentally, the amendment of VAT system was judged invalid by the Supreme Court on the ground that the amendment did not go through relevant procedures by the Parliament and the basic rate was tentatively pulled back to 11% from July to October 2016. Despite such twists and turns the VAT rate was again raised to 15% from November, 2016, after the formal adoption of a tax increase bill by the Parliament.

Also the Inland Revenue Act (IRA) that gives a legal basis to the disposition of revenues in the fiscal management was modified in 2017. The previous IRA had been too outdated to deal with the present-day industrial structures and commercial transactions and with its ineffective and insufficient tax incentives, the Act had incurred an investment loss. It had covered only a narrow range of taxpayers and provided a weak right to collect taxes. The enactment of a new

IRA was a response to these problems and is positively evaluated by the IMF as a means to pave the way to improvement of fiscal situation through strengthening of revenue base.

(3) Assessment of structural reform program

In November 2016, the IMF completed its first review under the Extended Arrangement under the EFF, which was published in December 2016. In that process, Acting Chair of the Executive Board and Fund Deputy Managing Director commented that, "Sri Lanka's performance under the Fund-supported program has been broadly satisfactory." "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." He also said 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."

With regard to fiscal management, the IMF staff highly valued Sri Lankan efforts saying that progress in revenue-based fiscal consolidation has helped preserve space for public investment and social spending while bringing down public debt. They also pointed out that further revenue mobilization was needed to meet the 2018 primary surplus target and reduce the overall deficit to 3.5 percent of GDP by 2020.

On April 20, 2018, summary of Fourth Review of Sri Lanka's EFF prepared by the Fund staff was published ahead of the main part. In the summary, the IMF requested Sri Lankan government to make further efforts to mitigate the financial burden and risks through (i) smooth operation of the Inland Revenue Act, (ii) stronger governance of SOEs, and (iii) reform of energy pricing mechanism. Meanwhile, following subdued growth in 2017 due to the lingering effects of weather-related shocks, the economic recovery is underway as agriculture has started to rebound and exports are also recovering. Real GDP growth is expected to reach 4 percent in 2018. Inflation is expected to decline below 5% due to falls in food prices after reaching 6.5% in 2017.

Incidentally, the IMF forecasted the growth rate for Sri Lanka at 4.0% and 4.5% for 2018 and 2019 respectively in the World Economic Outlook it published in the same month, expecting its solid growth for the coming two years. Consumer prices are expected to remain stable, rising at 4. 8% for both 2018 and 2019. Thus the sustained implementation of structural reform program is expected to help improve the Sri Lankan economy gradually.

On the other hand, despite the positive assessment on the structural reform program on the macroeconomic and fiscal fronts, the IMF maintains a cautious view on its international reserves. Despite a recent increase in foreign exchange reserves, Sri Lanka remains vulnerable to external shocks given its scale of imports and short-term external debts and it should continue to build up the reserves further, the IMF said. In fact, although expansion of current account deficit has been halted for the moment, there is a possibility that the reserve situation may be aggravated once the current account deficit starts to increase again. In this regard, possible stagnation in exports to the U.S. and Europe, its main trading partners, due to their economic slowdown and a deceleration of the Chinese economy that has greatly contributed to the surplus in the travel balance will constitute a risk factor to Sri Lanka (Figure 12).

Figure 12：Sri Lanka's Exports to Main Trading partners (2016)

（Million USD、%）

	Amount	Percent Distribution
U.S.	2,810	26.8
U.K.	1,044	9.9
India	554	5.3
Germany	500	4.8
Italy	430	4.1
Belgium	338	3.2
UAE	234	2.2
EU	3,101	29.5
SAARC （South Asia Association for Regional Cooperation）	827	7.9
Others	662	6.3
Total	10,500	100.0

(Source) Central Bank of Sri Lanka Database

4. Overcoming the challenges in Economic Development

(1) Major export industries

From a medium-and long-term perspective, an increased evaluation of the Sri Lankan economy will need strengthening of its export capacity by diversifying and sophisticating domestic industries, thus erasing its chronicle deficits in trade and current account balances.

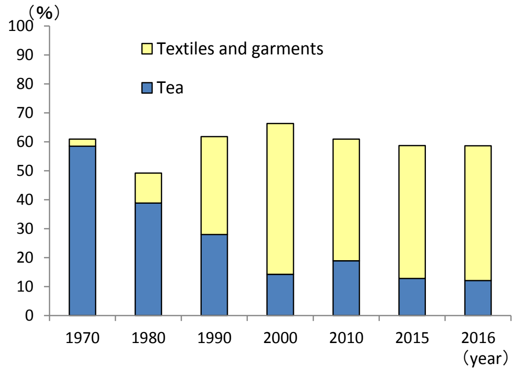
The need to diversify its industries has long been pointed out, with resulting development in some part of services industry including tourism and IT, supported by good quality of sightseeing resources and human resources. However, exports still depend largely on tea in agriculture and textiles and garments in manufacturing industry. Tea and textiles and garments account for almost 60% of total exports. This feature has not changed for more than 40 years since 1970. Undiversified components of products available for exports may be one of the major reasons for the persistent deficits in the current account which never recorded a surplus since the early 1980s just before the civil war broke out (Figures 13 and 14).

Figure 13 : Sri Lanka's Exports by Products (2016)

(Million USD, %)

	Amount	Percent Distribution
Mineral Products	29	0.3
Agricultural Products		
Tea	1,269	12.1
Coconut	366	3.5
Spices	317	3.0
Industria Products		
Food beverage	324	3.1
Textiles and garments	4,884	46.5
Rubber products	768	7.3
Petroleum products	287	2.7
Gems, diamonds and jewellery	332	3.2
Machinery and mechanical appliances	294	2.8
Transport equipment	132	1.3
Others	1,498	14.3
Total	10,500	100.0

Figure 14 : Share of Tea and Textiles and Garments in Total Exports



(Source) Central Bank of Sri Lanka Database

(2) Economic Development Plan "Vision 2025"

The Sri Lankan government has so far held up a policy of increasing exports and promoting inflows of foreign direct investment (FDI) by being itself incorporated into global supply chains. In September 2017 the government revealed a "Vision 2025", an economic development plan extending to 2025. It aims at developing Sri Lanka into an export-oriented economic hub in the center of the Indian Ocean with a highly competitive, knowledge-based economy. The Vision sets it a goal through 2025 to (i) raise per capita GDP to $5000 per year, (ii) create one million new jobs, (iii) increase FDI to $5 billion per year, and (4) increase exports to $20 billion per year. Key priorities include (i) reform of land, labor and capital market, (ii) improvement of economic and social infrastructure, (iii) technology and digitalization, (iv) expansion of social welfare network, and (v) governance and accountability,. The "Vision 2025", however, does not clearly specify what kind of business the government aims to foster.

(3) Prospective manufacturing businesses the Board of Investment specifies

On the other hand, the Board of Investment Sri Lanka sees the following 8 businesses in the manufacturing sector (Table 2) highly promising in promoting exportsthrough its connection with the global supply chains[3].

In order for an emerging Sri Lanka to be incorporated in supply chains and make itself an export-oriented hub economy, the government will have to come up with concrete measures in cooperation with the private sector to make these 8 businesses fully attractive to foreign investors. Among these businesses, substantial amounts of exports can be already detected from Figure 13 in such industrial products as rubber products and car parts and agricultural products as coconuts and spices. In addition to the promotion measures noted in the "Vision 2025", making effective use of the experiences in these successful business lines will be the key to diversify and sophisticate the industrial structure.

Table 2：Promising 8 businesses in promoting exports

1	Rubber-based automotive products (tires, tubes, hoses, belts)
2	Electronics and automobile components
3	Medical devices
4	High-performance sports wear
5	Coconut products (including activated carbon)
6	Processed agro, seafood beverages
7	Extracts and concentrates for beverage and pharma
8	Essential oils and nutraceuticals (spices and herbs)

(Source) Based on the speech of Chairman of the Board of Investment of Sri Lanka

Conclusion

As is seen in the above, good progress has been seen in the structural reforms of Sri Lanka supported by the provision of the IMF credit facility. Macro economy is stabilizing with all indicators of growth, inflation and fiscal balance developing relatively well. Although there is some concern in the low level of international reserves, the risks seem to be decreasing as far as looked from a short-term perspective.

Meanwhile, to improve the economic assessment in the medium-to long-term, it is necessary to reduce external vulnerabilities by cutting external liabilities and bolstering foreign exchange reserves through the current account surpluses. To achieve this, Sri Lanka will be required, as the government holds it up as targets, to encourage inflows of FDI through its involvement in global supply chains and improve export capacity by diversifying and sophisticating its industries. It is also expected that concrete measures will be taken to make the promising 8 businesses the Board of Investment specifies fully attractive to foreign investors.

The IMF holds it one of its functions to make consultations with its member countries on macroeconomic management and financial sector and make policy advices through surveillance activities. If so, one may wonder why the IMF could not suggest Sri Lanka through the surveillance to refrain from constructing Port of Hambantota with Chinese money despite difficulty to expect high returns. In the end, the IMF came to provide the fund for economic restoration after Sri Lanka faced with difficulty to repay the loan to China due to unprofitable Port of Hambantota and fiscal difficulties of the government. In the backdrop of China increasing its financial involvement in emerging economies like Sri Lanka, the role of the IMF through its surveillance and advices may (and should) be rising.

[Notes]

(1) Port of Hambantota, located on the southern coast of Sri Lanka, was constructed in the period of the previous president with support of the Chinese government, and started operation in 2011. However, as it did not produce profits due to low utilization, it faced with difficulty to repay the debt, and in December 2017, the Sri Lankan government was forced to sign an agreement to lease the Port to a Chinese company for 99 years in exchange for debt forgiveness equivalent to more than one billion dollars.

(2) The following is the comparison of the purpose and framework of the Extended Fund Facility (EFF) with those of the Stand-by Arrangements (SBA), another major lending facility of the IMF,

	SBA (Stand-by Arrangements)	EFF(Extended Fund Facility)
Significance	To support countries' financing needs for balance of payments problems	To provide assistance to countries experiencing serious payments imbalances because of structural impediments
Duration	1-2 years (no more than 3 years)	3 years (no more than 4 years)
Lending terms	5 years	10 years

(3) It is based on the speech delivered by Mr. Dumindra Ratnayake, Chairman of the Board of Investment of Sri Lanka, at the investment forum hosted by Japan External Trade Organization (JETRO) on March 13, 2018 (also co-hosted by the Embassy of Sri Lanka in Japan and the Board of Investment of Sri Lanka). He identified the promising 8 businesses to be incorporated in the global supply chains by taking advantage of well-trained human resources in Sri Lanka, excellent distribution system, and Sri Lanka's good access to the markets in India, Pakistan, and China.

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