Sri Lanka opens the door to economic reform

2015-12-28 18:30:00

The direction of Sri Lanka's post-civil war socio-political and economic development took a pivotal turn in 2015 with the election of a new President in January and, seven months later, a new government to parliament. In the absence of an overall parliamentary majority for any one party, Sri Lanka's two main political parties — the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP) — joined to form a loose national unity government for at least the first two years of a five-year term. This now offers Sri Lanka the opportunity to focus on the economy, having spent much of 2015 grappling with political imperatives.

Sri Lanka's economic policy direction is set to shift away from the public investment and infrastructure-led development initiatives that dominated 2010–14. While it delivered steady growth, the economy continued to suffer from inherent structural weaknesses showing skewed growth, weak export performance, a growing external debt overhang and limited private investor appetite for capital accumulation.

To make the transition from an overwhelmingly foreign debt-financed, consumption-driven growth model to one that is driven by private investment and exports requires the implementation of a broad-based economic reform effort. A much-awaited economic policy statement by the Prime Minister on 5 November signalled Sri Lanka's intention to undertake reform in several key areas. In particular, the new government committed to tackling Sri Lanka's bloated, unproductive state-owned enterprise sector and its fiscally unsustainable state pension systems. The 2016 Budget presented on 20 November reiterated this policy direction as well as a shift in spending towards education and health.

There are difficult trade-offs to be confronted in delivering and implementing an economic reform agenda. The first of these relates to the fiscal arena. A strong fiscal position often helps, allowing the 'losers' of reform initiatives to be compensated. By the same token, it is harder to carry out reforms at the same time as tightening the budget.

The Sri Lankan government finds itself in this unenviable position. Sri Lanka's overall fiscal conditions have weakened, with the fiscal deficit for 2015 edging up to 6 per cent of GDP, partly on the back of populist spending measures announced in the run up to elections. The deficit is expected to remain at the same level in 2016. There have been some immediate attempts to raise revenues through tax adjustments, but the squeeze on bilateral loan financing for development projects will continue to create budgetary pressures. Sri Lanka will therefore continue to rely on foreign commercial borrowing to bridge the deficit in 2016.

With fiscal stability at the forefront, Sri Lanka issued a sovereign bond to the tune of US$1.5 billion in October 2015. This followed a previous issue for US$650 million in May. Aside from helping to finance the fiscal gap, such monies are also needed for balance of payment support as the currency comes under pressure. The Sri Lankan rupee depreciated by 7.8 per cent in the first nine months of the 2015. The country's export performance is not helping: export earnings have contracted by 3.4 per cent in the first eight months of 2015 and growth in remittance inflows are stagnant, partly due to currency uncertainties. The Budget has drawn criticism for lacking any meaningful attempt to tackle fiscal consolidation efforts. This is largely because there is still no medium-term economic policy framework that details the government's development vision. The delay is perhaps unsurprising given a loose governing coalition that is burdened by an unwieldy state administrative apparatus. In the absence of such a policy framework, the 2016 budget is still a loose assortment of policies, rather than a firm step towards consolidating macroeconomic stability and laying the groundwork for a coherent reform agenda.

A second immediate challenge on the economic front is to push through the already-announced policy reforms under the unusual governing arrangement currently in place. Loose coalition arrangements are susceptible to policy gridlock. This is even more apparent when the coalition involves political archrivals such as the UNP and SLFP. At least for now, the two parties depend on each other for their own survival and the stability of the parliamentary term. If the government can use its comfortable majority to deliver on the economic front in the near term, the coalition stands a better chance of staying the course and building on an economic reform process more substantively in the medium term.

Sri Lanka's GDP growth moderated in 2015 but official forecasts for 2016 are optimistic, projecting a more robust pick-up. Much will depend on investor confidence to drive growth. The budget was welcomed by Sri Lanka's business sector as 'investment and development oriented'. The solutions required to get the economy back on track in a more sustainable fashion are mainly political. The government must instil confidence that it not only has a progressive medium-term economic agenda, but also the political will and leadership to deliver through the legislative phase and the technocratic machinery to implement it.

(Dushni Weerakoon is Deputy Director at the Institute of Policy Studies of Sri Lanka)