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The Sri Lankan government’s honeymoon period is over

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Tough economic issues are getting harder to ignore for Sri Lanka’s new political leaders. Sri Lanka witnessed a change of government in early 2015 with the surprise defeat of the political strongman and war-winning president Mahinda Rajapaksa.


[1]With Maitripala Sirisena from the Sri Lanka Freedom Party (SLFP) as the new President [2], and Ranil Wickremasinghe from the United National Party (UNP) as Prime Minister, a new coalition government was formed. The UNP was instrumental in ensuring Sirisena’s victory — Sirisena defected from the SLFP under Rajapaksa and ran against him — and so the party was able to bargain for key positions in the government.

Sirisena put his ‘100 Day’ program for good governance [3] and transparency into operation in January. The program was more focused on political issues like constitutional amendments than on pressing economic policy issues [4]. The key areas on the economic side that the program addressed were populist issues like salary increases for public servants and reducing the cost of living.

The first budget of the new government presented in late January fulfilled these promises. Fuel taxes were removed and vehicle duties were reduced, encouraging a vehicle boom in the country. But many projects related to infrastructure, including those funded by the Chinese [5], were either halted or curtailed. Direct taxation was also increased with a new super gains tax and a mansion tax, although they could not be immediately implemented due to lack of parliamentary majority.

The government implemented these measures despite macroeconomic problems with a view of gaining victory in the August 2015 general elections.

The final outcome of the elections was a UNP victory of 106 seats, falling short of majority by 7 seats. Although the SLFP lost the election it still secured 95 seats and Sirisena with close to 45 other SLFP members joined the UNP to form a government.

Since then, previously neglected economic issues [6] have become more prominent. The new government's stability will depend very much on these.

Although the Prime Minister's economic policy statement [7] articulated a much needed economic reform [8] agenda, the budget presented in November could not fully support it. With a growing budget deficit of 6.8 per cent of GDP [9], the revenue mobilisation measures in the budget seem inadequate unless the government depends heavily on privatising loss-making state-owned enterprises — a policy normally opposed by the SLFP. Policymakers have already backtracked on some revenue proposals like restoring [10] the duty free permit for public servants importing motor vehicles.

Sri Lanka's current account of the balance of payments have not benefited from the decline of international fuel prices. The benefit was offset by large scale vehicle and consumer durable imports and sluggish export growth. Foreign exchange reserves declined from US$9 billion in August 2014 to just above US$6 billion in August and there was continuous pressure on the exchange rate to depreciate. In early September the currency was given more flexibility to float and the rupee subsequently depreciated by 9 per cent.

The pressure for depreciation would have been more if not for a US$1.1 billion swap arrangement [11] worked out with the Reserve Bank of India. In October, Sri Lanka went for a sovereign bond [12] of US$1.5 billion at a rate of 6.85 per cent [13] — quite high compared to some earlier rates. The space for international borrowing is becoming increasingly restricted due to Sri Lanka's high debt and low credit rating, and the United States gradually tightening its monetary policy.

Sri Lanka will have no option but to approach the IMF if the current account worsens in the coming months.

Meanwhile, the government is working on several fronts to address the growing macroeconomic problems. Sri Lanka is seeking to regain its lost GSP trading scheme with, and lift the fisheries export ban in, the European Union. The government also wants to re-establish normal relations [14] with China through reactivating the earlier halted Colombo Port City project. Other projects include reformulating the abandoned Comprehensive Economic Partnership Agreement with India as an Economic and Technology Cooperation Agreement, and making use of the international goodwill toward Sri Lanka to attract more foreign direct investment (FDI). The goal is to make Sri Lankan growth more FDI- and export-driven rather than debt-driven, as it was during the decade of the Rajapaksa regime.

The growth forecasts for 2015 vary — according to the Central Bank of Sri Lanka it will be close to 7 per cent [15] while the IMF forecast between 5 and 5.5 per cent [16]. However, there are a number of uncertainties on the political front. There is the possibility of the UNP–SLFP joint government pulling in different directions and paralysing the policy implementation process.

Moreover, if the UNP gains a clear victory at the local government elections in June 2016, President Sirisena's leadership will weaken both in the SLFP and in the government and create political undercurrents.

All indications are that the Sri Lankan economy will maintain its post-war recovery growth levels at a subdued 5.5 to 6.5 per cent in the coming years. With all the uncertainties, however the 'honeymoon' period of the new government has ended and the hard economic issues [17] are coming to the fore.

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This article is part of an EAF special feature series on 2015 in review and the year ahead [18].

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