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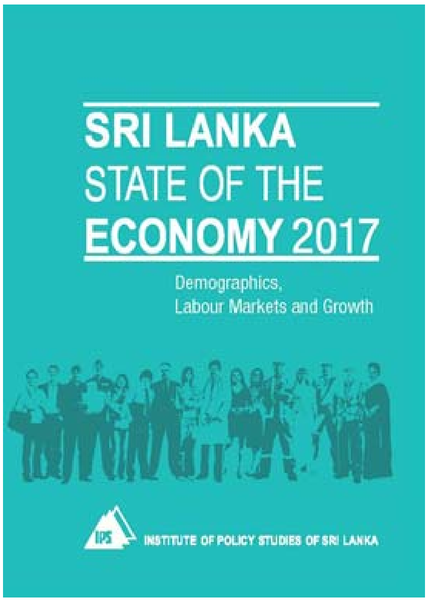
POLICYINSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

MACROECONOMIC PERFORMANCE

From the IPS flagship publication 'Sri Lanka: State of the Economy 2017 Report'



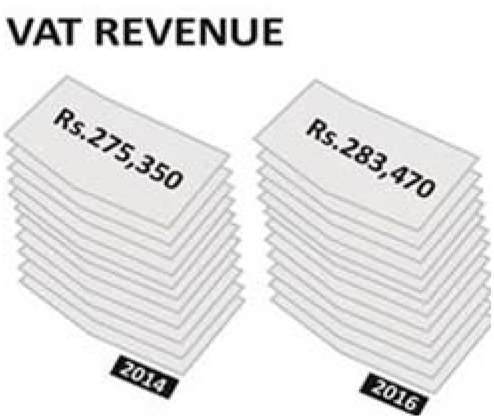
Sri Lanka's emerging macroeconomic environment post-2016 holds both pluses and minuses. On the plus side, the most critical improvement is to be seen in fiscal management. Under the IMF programme with its attendant focus on revenue mobilization, Sri Lanka's past record of a progressive decline in revenue collection has been reversed through a more streamlined tax revenue collection process in 2016. Largely as a result, the broader fiscal consolidation process is on track with a significant shrinking of the deficit financing gap. Additionally, fiscal consolidation efforts have also been supported by a more prudent monetary policy framework and exchange rate management policy. Overall, therefore, the signals of a much improved macroeconomic environment and policy stability on key fiscal and monetary policy fronts will offer investors considerable comfort in firming up medium term investment decisions.

On the downside, economic growth is continuing to slow down. According to revised GDP estimates, Sri Lanka's economic growth fell to a relatively modest 4.4 per cent in 2016, well below the projected 5.8 per cent set out under the medium-term macroeconomic framework. Notwithstanding the impact of inclement climatic conditions that has impacted agriculture production at periodic intervals and therefore, economic output at large, a prolonged slowdown in growth is a cause of some concern.

Fiscal Policy Outlook and External Sector Performance

The Sri Lankan economy faces elevated vulnerability to exogenous shocks and debt sustainability over the medium term. As such, on-going fiscal consolidation efforts, implemented from mid-2016, are generating revenue gains to the Treasury. Upward tax adjustment to meet immediate fiscal revenue generation targets under the IMF programme is being complemented by efforts to broaden the tax base and strengthen tax administration and compliance. Some of the notable reforms include the adoption of an Inland Revenue Act aimed at clarifying and setting guidelines on future taxation principles and the introduction of an electronic tax filing and management system - the Revenue Administration and Management Information System (RAMIS). In addition, reforms in the digital sphere intended to introduce a unique biometric identity for all nationals is also expected to help in widening the tax net and tax compliance.

Attempts by the monetary authorities to head-off a sustained depreciation by drawing down foreign reserves proved counter-productive. As the official reserve cover dropped to 3.4 months of imports in June 2016, Sri Lanka was compelled to enter into a three-year US$ 1.5 billion EFF arrangement with the IMF in June 2016. Immediately thereafter, the government resorted to external borrowing of US$ 1.5 billion in the form of an ISB in July 2017 and raised a further US$ 700 million as a syndicated loan in September 2016.

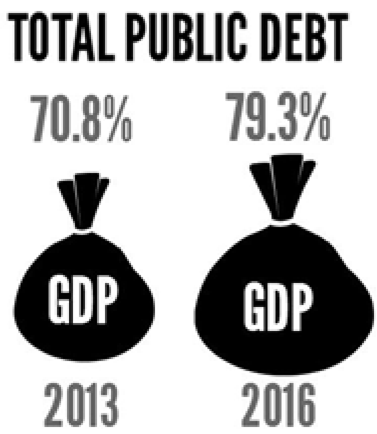


These capital injections helped to stem dwindling official reserves and steady the exchange rate from mid-2016.

However, ten months into the EFF programme, official reserves were at a low US$ 5 billion, sufficient for only 3 months of import cover - the recommended minimum rule-of-thumb threshold. Once again, the government raised an ISB to the tune of US$ 1.5 billion in May 2017 to build the official reserves position to US$ 6.7 billion (equivalent to about 4 months of imports) by mid-2017. Building up official reserves and managing the exchange rate remain as priorities for Sri Lanka in its overall attempts to sustain a stable macroeconomic environment and induce investor confidence on the country's medium term economic outlook. Emphasis on the above is all the more critical in view of Sri Lanka's emerging debt dynamics.

Debt Sustainability

The Sri Lankan economy is witnessing a growing debt overhang. Total public debt has risen to 79.3 per cent of GDP in 2016 from 70.8 per cent of GDP in 2013. It is notable is that Sri Lanka's growing dependence on costly forms of foreign debt appears to be continuing despite its recognized risks and drawbacks to the economy at large. The medium-term trajectory of macroeconomic indicators suggests that debt indicators will worsen before they stand a chance of getting better. A decline recorded in Sri Lanka's debt service ratio to 25 per cent in 2016 owes more to the overall drop in debt service payments rather than to a surge in



earnings from exports of goods and services. The latter is stagnating at 20 per cent of GDP for a third consecutive year. The medium term risks are high in terms of Sri Lanka's capacity to withstand and ride-out any exogenous shocks to the economy.

A start has been made towards stronger debt sustainability with on-going revenue-based fiscal consolidation efforts under which the primary account deficit has shrunk from 2.9 per cent of GDP in 2015 to 0.2 per cent of GDP in 2016. Thus, the real test of debt sustainability will come into effect with progress on fiscal consolidation efforts where improved domestic resource mobilization will lessen dependence on foreign borrowing. In the interim, the next two years are critical; Sri Lanka must urgently address the current dip in export performance and build hard currency buffers in view of its risky ISB redemption profile post-2019.

Conclusion

Fiscal policy lies at the heart of Sri Lanka's macroeconomic crises. The current revenue-based fiscal consolidation efforts are a step in the right direction. They aim to rationalize and broaden the tax structure and tax base through a new Inland Revenue Act, and improve tax administration in the country. In addition, the financial performance of large loss-making SOEs is also receiving policy attention. If sustained, such reforms will allow a re-allocation of spending towards neglected areas such as education, health and social protection. With the gains made in fiscal consolidation so far under the IMF's watchful eye, achieving and retaining macroeconomic stability appears more probable.

This Policy Insight is based on the comprehensive chapter on "Macroeconomic Performance" in the 'Sri Lanka: State of the Economy 2017 Report' - the flagship publication of the Institute of Policy Studies of Sri Lanka (IPS). The complete report can be purchased from the publications section of the IPS, located at 100/20, Independence Avenue, Colombo 7. For more information, contact the Publications Unit on 0112143107/ 0112143100.

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