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POLICY INSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

ECONOMIC PERFORMANCE

Sri Lanka's overall economic outlook for 2014 was perceived to be sufficiently positive for the government to face early elections in 2015. The electoral defeat at presidential polls in January 2015 had little to do with economics and more to do with perceived problems on governance and corruption. In the first six months of the year, the economy continued to function in a near policy vacuum as political parties fought over constitutional and electoral reforms, well beyond the 100-day limit that was to end on 23 April 2015 with the dissolution of Parliament. In the interim, cracks are appearing in the Sri Lankan economy with fiscal policy consolidation under threat, pressure on the exchange rate and a moderation in GDP growth.

This Policy Insight is based on the 'Sri Lanka: State of the Economy 2015' chapter, which provides an outlook of the country's recently "Economic Performance".

The Sri Lankan economy is estimated to have grown by 7.4% in 2014, in line with annual average growth registered since 2010. GDP growth in 2015 was a marginal improvement on the 7.2% recorded in the previous year, but below the 7.8% target set for the year. Inclement weather conditions that had adverse impacts on agricultural output pulled overall growth down despite faster growth in industry, especially from construction.

The Central Bank of Sri Lanka (CBSL) set a revised growth target of 7% for 2015, the first time that the growth forecast has been revised downwards since 2011. Then, it was a deliberate policy decision to allow growth to slow in the wake of high growth (8.2%) and signs of overheating.

The decision to lower Sri Lanka's growth outlook for 2015 is for different reasons, primarily to allow for a political transition that could well impact on economic policy direction. The revised estimate set in April 2015 is beginning to look ambitious, with growth moderating to 6.4% in the first quarter of 2015 and the country's policy deadlock continuing well beyond the 100-days and into the second half of the year.

Realigning GDP Growth

The most telling feature of Sri Lanka's impressive GDP growth averaging a near 7.5% per annum since 2010 is the weak contribution of net trade, in an economy driven by private consumption and public investment. From 2006 onwards, the country's development programme relied massively on an infrastructure drive, with public investment jumping to over 6% of GDP from 4%. Infrastructure projects were rolled out more strongly after the conclusion of the war in 2010.

Not surprisingly, the infrastructure-led economic expansion is echoed in the breakdown of GDP growth. The contribution to growth from the industry sector increased markedly post-2010 as

"In Sri Lanka, current levels of consumption are associated with over-extended government fiscal positions, high debt levels, and current account deficits."

a result primarily of construction related activities. The services sector contribution also expanded post-2010, driven by transport and communication and retail trade. Indeed, the government has viewed infrastructure as Sri Lanka's opportunity to unlock growth. Many of the big road infrastructure projects offering better internal connectivity do meet growing demand for public goods. At the same time, however, these and other high cost public infrastructure investments in ports, airports and such that have been powering the Sri Lankan economy cannot continue indefinitely without greater private sector investment in the economy.

Public Finance Management

For many decades, the perilous state of Sri Lanka's public finances acted as a drag on economic growth and broader development objectives, hindering the delivery of efficient and effective public services.

Despite improvements in overall macroeconomic indicators, Sri Lanka's fiscal situation remains fragile. This stems largely from lack of progress in rationalizing and streamlining government expenditure at all levels; and reversing Sri Lanka's deteriorating government revenue collection.

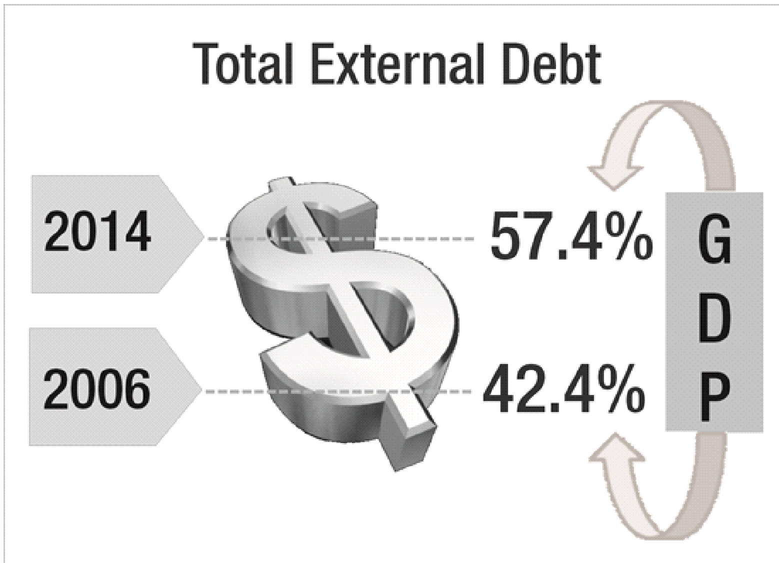
There has also been no progress in halting losses incurred by state-owned enterprises (SOEs). Since 2005, there has been a clear policy reversal with further privatization efforts ruled out in favour of 'restructuring' SOEs.

Rising expenditures and declining revenues have seen Sri Lanka rely increasingly on foreign borrowing for budgetary support. Where domestic borrowing implies a higher interest rate as the government competes with firms for limited investment funds, the effect is muted when a country accesses foreign capital, because the budget deficit can be financed from abroad.

Monetary Policy and Exchange Rate Misalignment

In the presence of a growing foreign currency denominated debt portfolio, a depreciating currency leads to a growing public debt to GDP ratio. In the meantime, the relatively inflexible exchange rate policy stance is hurting exports – the very sector that needs to generate foreign exchange earnings if Sri Lanka is to service its growing external debt comfortably.

"Contingent liabilities have increased sharply from 1.6 per cent of GDP in 2006 to 5.7 per cent of GDP in 2014 heightening systemic risks for overall fiscal stability."

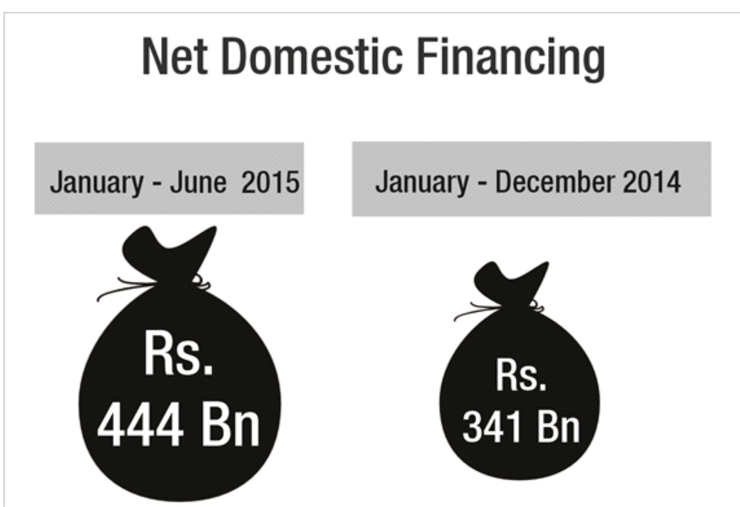


Economic Performance 2015 and Outlook

The electoral outcome of January 2015 signalled a change of course for the Sri Lankan economy on several fronts. The most immediate was a slowdown of some of the infrastructure development initiatives of the previous regime, the implementation of electoral pledges through a revised budget for 2015, and enunciating a new economic policy direction for the country.

Any new government revisiting Sri Lanka's ambitious publicly funded infrastructure projects to assess their economic viability and funding is to be expected. As a result, some key initiatives, such as the Colombo Port City Expansion project undertaken by China, were suspended. There was also, however, a more general slowdown in infrastructure spending as fresh fiscal estimates were worked out. The budget presented in end January 2015 delivered on many of the pre-election promises such as a reduction in fuel prices and an increase in public sector salaries and pension payments, whilst attempting to introduce new revenue generating measures by way of one-off taxes on private businesses, imposition of a 'mansion tax' on housing, etc., to meet additional expenditure commitments.

The government was forced to tap domestic financing not only because of the failure to implement new revenue measures, but also as a result of slowdowns and delays in accessing foreign financing. The rolling back of the infrastructure push meant that the inflow of funds by way of long-term loans declined quite sharply in the first five months of 2015.



"Sri Lanka's unabated practice of competitive populism ensures that political parties routinely discount the economic costs of electoral promises and handouts."

In the first half of 2015, there has been a significant slowdown of foreign capital inflows overall, as well as a deterioration in the trade deficit

Just as today's policy focus on taxation, spending, deficits, and debt affect current economic growth, they will also have an equally, if not more important bearing on economic growth and stability in the long-term. The fiscal costs, and the related broader consequences on macroeconomic stability, are ignored.

With two closely contested elections in one year – seven months apart – the impact of such profligacy can be high. Sri Lanka's fiscal situation is already straining under additional expenditure commitments undertaken following presidential elections in January 2015. Similarly, in parliamentary polls, election handouts are being offered as inducements such as cost of living allowances to the public sector workers, payments to school leavers, public sector jobs for unemployed youth, etc. Even as the full cost of such electoral pledges are realized, leading to further weakening of fiscal consolidation efforts, Sri Lanka will be called on to implement some tough economic reforms for long-term macroeconomic stability and sustainable growth.

The most pressing of these relate to tax and SOE reforms. Sri Lanka has to focus on reversing declining government revenues as a matter of urgency. Similarly, Sri Lanka's loss making SOEs need to be restructured and better managed as a key priority. Better management of SOEs need not necessarily go down the route of privatization; the options are many through a spectrum of ownership structures that can bring the public and private sectors together.

In addition, there are other outstanding public finance related issues that need policy attention. These include rationalizing Sri Lanka's many transfer and subsidy schemes, reforming the existing non-funded public sector pension system, improving debt management, etc. It is only from a thorough review that Sri Lanka can reconsider how it taxes and spends in order to support long-term development objectives. Fiscal and monetary expansion is not interchangeable; stronger public finances will allow fiscal and monetary policy to play independent roles to provide an economic stimulus as and when needed.

A strong fiscal foundation can also have an important bearing on a successful broader structural reform effort. Sri Lanka has a long to-do list of reforms which has been around for years without making much headway. Fiscal consolidation will help compensate potential losers of a reform initiative; by the same token, it is more difficult to implement structural reforms at the same time as tightening fiscal budgets. Sri Lanka is already faced with the likely prospect of slower economic growth and narrower fiscal space in the near term; fiscal reforms should start early before the situation becomes sufficiently fraught to make reforms unavoidable.

This Policy Insight is based on the comprehensive chapter on "Economic Performance" in the 'Sri Lanka: State of the Economy 2015 Report' (SOE 2015). The State of the Economy Report is the flagship publication of the Institute of Policy Studies of Sri Lanka. 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 0112143100.

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