Sri Lanka: Post-war Economic Development in a Changing Global Landscape

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Sri Lanka: Post-war development challenges

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Background

- May 2009 saw end to 30 year armed separatist conflict long identified as a key factor in below par economic performance

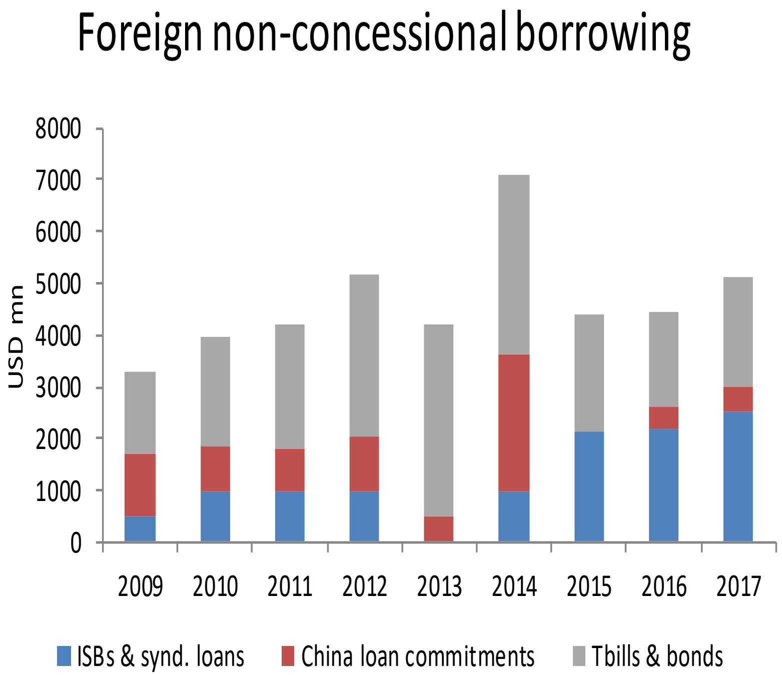
- Immediately faced with volatile domestic/external conditions
  - Weak domestic economy (growth of 3.5%, fiscal deficit of 10% of GDP)
  - Downturn in traditional global export markets (US/EU absorbs 50% of exports)
  - Enters into IMF program mid-2009

- Under international pressure on allegations of human right issues
  - EU-GSP+ withdrawn
  - US curtails funding

New challenges & opportunities

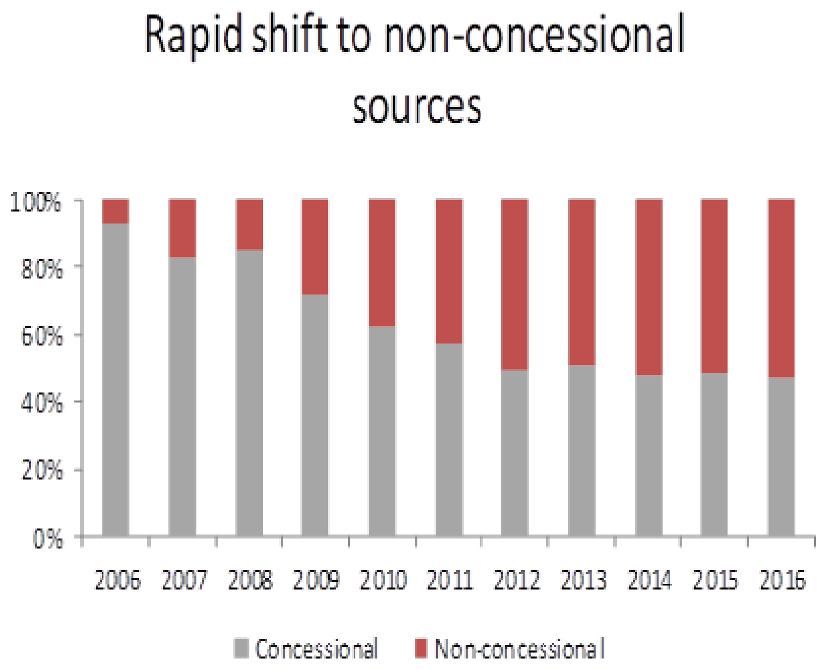
- Challenges
  - Govt. under pressure to deliver swift peace dividend
  - Search for financing as SL graduates to low middle income in January 2010
- Opportunities
  - Scope for ambitious public investment program to revive flagging economy
  - MFIs advocate more public investment to keep economies buoyant
- Global economic conditions and geopolitical shifts coincide
  - Access to capital for emerging economies eases with QE/search for higher yields
  - Emergence of new sources of development finance (China)

SL embarked on a borrowing spree



- Debut issuer of sovereign bonds in 2007
- Accessed loans from China for major infrastructure
- Opened govt. securities to foreign investors

Rapid change in external debt composition



- Share of non concessional foreign debt has risen from 7% in 2006 to 53% today

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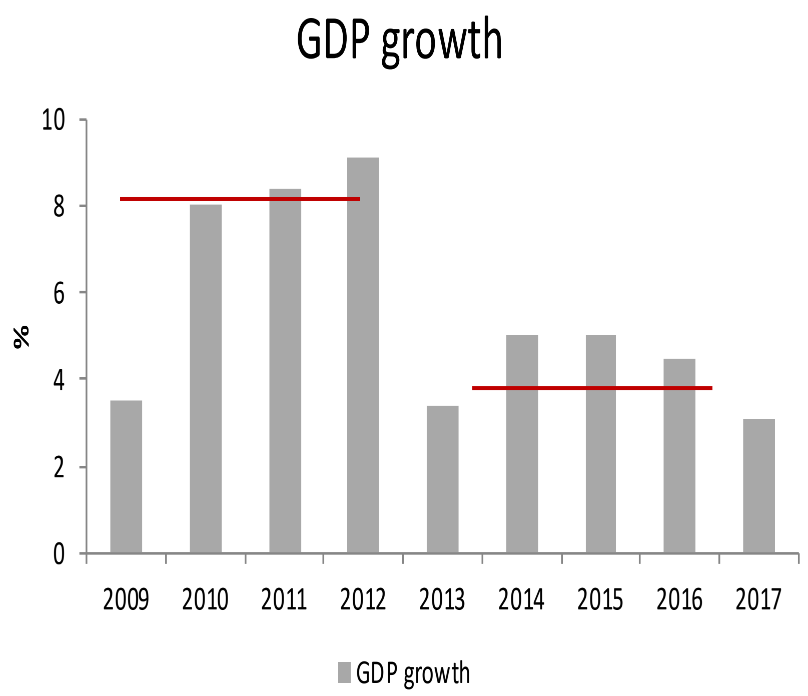
New forms of development finance attractive

- Advantages of volume, ownership, alignment and speed of project delivery
  - Free of conditions, lengthy negotiating processes
  - Access to large volumes more quickly
  - Disbursed according to presumed needs

- But, carries heavy risks in the presence of poor analysis of investment projects, incentive problems and interest group influenced investment choices

- Growing body of literature to suggest unproductive investment outcomes can worsen where lenders follow a policy of non-interference in national economic strategies when making loans

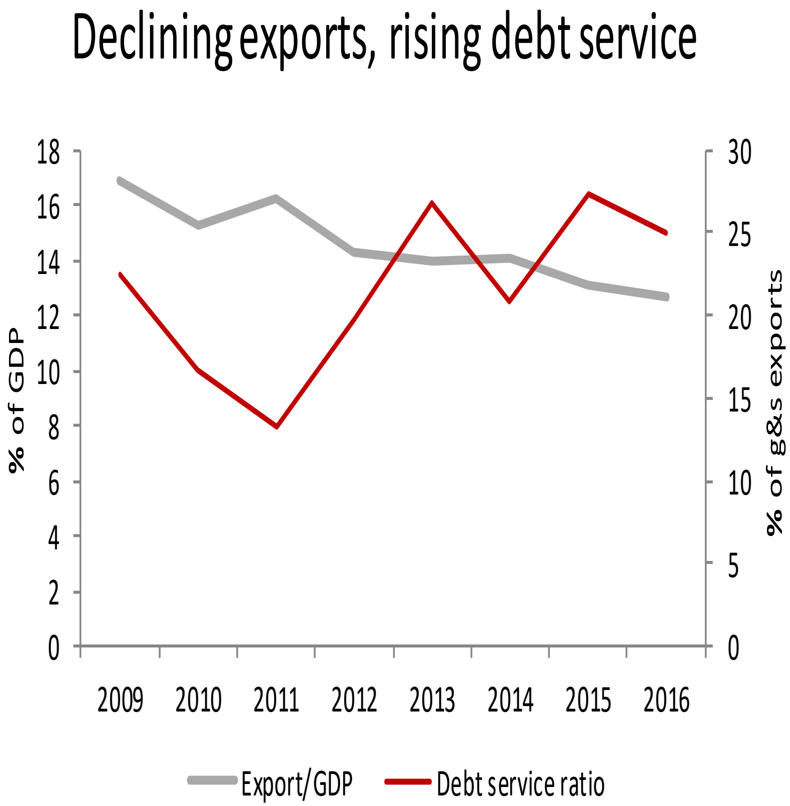
Recent studies cast doubts on sustainability of infrastructure led growth



- Suggests major public investment drives in infrastructure have been followed by slumps rather than booms

- SL saw immediate boost to growth, and sharp decline

Economic strategy clearly unsustainable



- With a sole focus on infrastructure, export share in GDP declining progressively

- At the same time, high foreign borrowing translating into a rising debt service burden

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2015: Change of govt. and change of policies

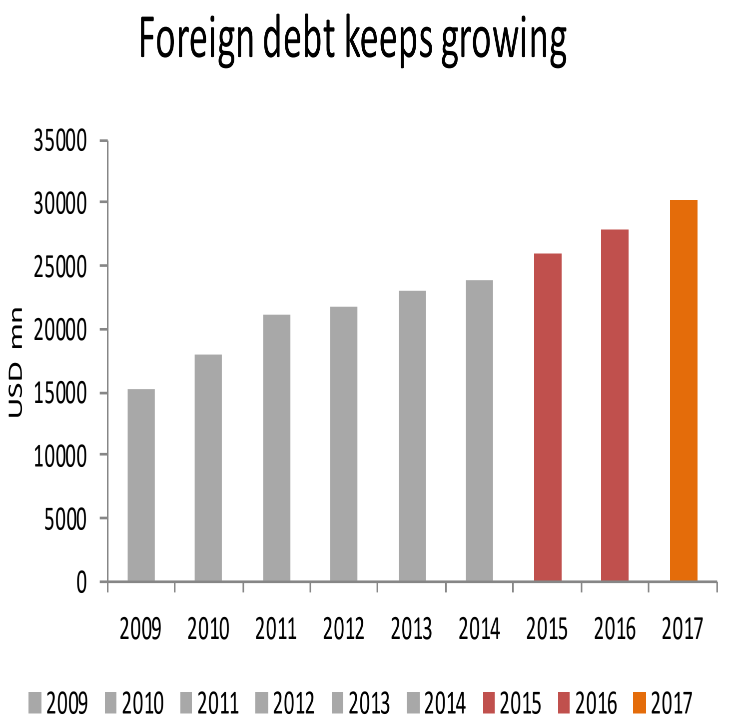
- Two-fold objectives
  - Reorient growth to private investment led, export driven economic model
  - Reduce SLs economic reliance on China

- Immediate outcomes
  - Grappled with worsening fiscal situation related to election-related largesse
  - Related currency/BOP crisis, partly from sudden stoppage of Chinese funded infrastructure projects

Foreign borrowing resumes

- Reduced loans from China offset by tapping higher ISBs & syndicated loans

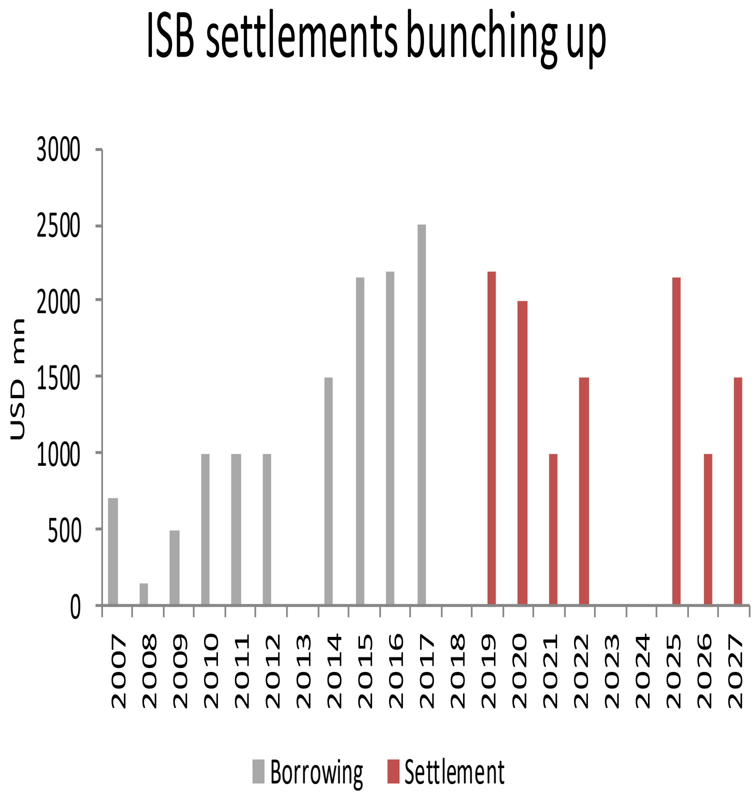
- China financed infrastructure projects resume 2016/17
  - Colombo port/financial city project
  - 70% equity stake given on China built Hambantota port



Macro stability being restored under IMF program

- Improvements in fiscal outcomes
  - Upturn in revenue collection, fiscal deficit narrowing,
- However, adjustments at a cost
  - Impact of revenue reforms (tax hikes) contractionary
  - Tax increases and inclement weather have led to higher cost of living
- Weak growth, is now biggest worry
  - Records growth of 3.1% in 2017, lowest in 16 years

Next 18 months critical for economy



- Settlement of ISBs bunching up 2019-2022
- Rollover risks high on both domestic and external factors
  - global financial market conditions
  - political stability and impacts on eco. management
- Economy expected to take a backseat to politics in ensuing months

Weak economic performance blamed on ‘coalition politics’

- Outlook for reforms dim, mid-term
  - Governing coalition suffered sharp setback in first test of popularity
  - Tight economic conditions identified as a critical factor
- May trigger a reversal of macroeconomic stability efforts
  - IMF fiscal consolidation agenda under threat as electoral cycle continues in run up to Presidential elections in early 2020
  - Resistance to reforms may harden
- Policy dilemma for govt. in view of impending debt settlements

Possible scenarios

<u>If efforts towards fiscal stability are reversed</u>

- Credit to government rises, interest rates edge up, capital inflows dry up, exchange rate under pressure.

- Severe economic crisis
  - Slow growth
  - High debt stress

<u>If some semblance of fiscal discipline is held</u>

- Modest growth in the region of 4.5% in the next two years, but no major economic breakthrough.

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