Sri Lanka
State of the Economy Report 2016

Chapter 2
Macroeconomic Performance

by
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2. Macroeconomic Performance

2.1 Introduction

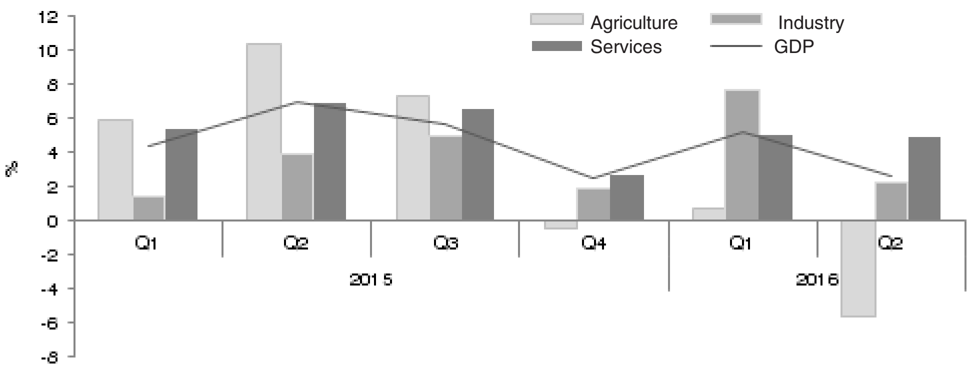
Sri Lanka's macroeconomic environment weakened considerably in 2015, marked by deteriorating public finance indicators and a currency continually under pressure. The fiscal deficit widened to 7.4 per cent of GDP in 2015 from 5.7 per cent in the previous year, while the rupee depreciated by 10 per cent by year end compared to a near stable rate in 2014. A decade of a near continuous decline in the country's debt indicators was reversed in 2015 with the public debt to GDP ratio climbing to 76 per cent from 70.7 per cent in 2014.

In the absence of credible policy initiatives to address the above noted weakening of the country's macroeconomic fundamentals, external rating agencies not surprisingly saw fit to downgrade Sri Lanka's sovereign rating in early 2016. The task of pulling Sri Lanka out of this muddle has clearly fallen to the 'lender of last resort' - the IMF with its technocratic tradition of exerting external discipline on fiscal, monetary and exchange rate policy management.

Of necessity, the focus of the IMFs programme with Sri Lanka is on public finance management; that too, less on controlling expenditure and more on raising revenues. Reforming the tax code and improving tax administration, it is hoped, will lead to lower deficits as soon as growth and tax revenues revive. A period of fiscal austerity - an increased tax burden and curtailments on expenditure increases - in an environment of modest economic growth will call for strong political acumen to deal with any public disaffection on the economic front. Sri Lanka's underlying economic fundamentals suggest that a period of painful adjustment lies ahead in the near term; the onus is on the government to ensure that prudent macroeconomic reforms are implemented early and decisively so that the policy space is created for growth enhancing structural reforms to follow.

Sri Lanka's underlying economic fundamentals suggest that a period of painful adjustment lies ahead in the near term.

Figure 2.1
Quarterly GDP Growth



Source: DCS and CBSL, *Annual Report*, various years.

2.2 Growth Dynamics

The revised GDP estimates (2010 base year) compiled by the DCS strongly suggest that Sri Lanka's growth outlook is moderating to around 5.0-5.5 per cent in the near term. The new series displays considerable volatility in growth on a quarterly basis across all three sectors of agriculture, services and industry (Figure 2.1). Frequent revisions to announced quarterly estimates suggest that the new methodology is still in the process of being fine-tuned.[1]

A sector-wise breakdown shows agriculture sector growth to have performed reasonably well in 2015, despite poor performance in key export products such as tea and rubber (Table 2.1). Indeed, with an overall growth of 5.5 per cent, agriculture fared better than overall GDP growth, raising its share of GDP marginally to 7.9 per cent. According to first half 2016 estimates, agriculture sector growth dropped sharply to -2.5 per cent, with slower growth resulting from adverse weather conditions. Aside from tea and rubber production, rice and fishing sectors experienced notable contractions.

By contrast, the industrial sector which accounts for 26 per cent of GDP saw a decline in overall growth from 3.5 per cent in 2014 to 3 per cent in 2015. This was largely on account of a sharp slowdown in growth in construction, textiles and apparel, and mining and quarrying – three of the largest contributors to industrial share of GDP. Only the food, beverages and tobacco sub-sector performed strongly in 2015 (Table 2.2).

[1] For instance, 2015 first quarter estimates released in July 2015 (6 per cent) was subsequently revised in September (4.4 per cent), December (4.9 per cent) and June 2016 (4.4 per cent). 2015 second quarter estimates released in September (6.7 per cent) was revised in December (6 per cent) and June 2016 (7 per cent).

Table 2.1
Agriculture Sector Growth (% of GDP)

	Share (%) 2015	Annual Growth (%) 2014	2015	First Half Growth (%) 2015	2016
Agriculture	7.9	4.9	5.5	8.1	-2.5
Rice	0.9	-7.0	23.3	51.0	-10.5
Vegetables	0.8	2.1	24.9	31.1	5.0
Fruits	0.6	9.4	16.5	28.1	-0.4
Oleaginous fruits	0.8	20.1	5.1	4.6	5.3
Tea	0.8	-1.1	-2.6	0.0	-11.9
Spices	0.7	13.1	1.3	-1.8	-4.3
Rubber	0.3	-24.5	-10.2	-17.4	-5.0
Forestry	0.6	10.2	1.9	11.1	-4.0
Fishing	1.4	3.7	-2.7	0.0	-6.5

Source: DCS and CBSL, *Annual Report*, various years.

Overall, industrial sector growth at 3 per cent in 2015 remained well below GDP growth. First half 2016 GDP estimates suggest a recovery in the industry sector with a growth rate of 5.2 per cent, with a strong recovery in the construction sector. However, Sri Lanka's apparel sector - as well as the food and beverage sector - continues to perform poorly, registering a growth rate of only 1.6 per cent and 0.8 per cent, respectively.

The largest contributor to growth, the services sector that accounts for 56.6 per cent of GDP did reasonably well to grow steadily at 5.3 per cent in 2015 (Table 2.3). Services sector growth was helped by strong growth in financial services. Other sectors such as wholesale and retail trade and transportation also fared reasonably well. Financial services continued to be the driver of the services sector growth even in the first half of 2016.

Table 2.2
Industry Sector Growth (% of GDP)

	Share (%) 2015	Annual Growth (%) 2014	2015	First Half Growth (%) 2015	2016
Industry	26.2	3.5	3.0	2.5	5.2
Construction	6.8	6.6	-0.9	-2.8	8.5
Textile, apparel & leather	3.2	4.6	5.6	1.5	1.6
Food, beverages & tobacco	6.3	1.3	0.0	9.3	0.8
Mining & quarrying	2.3	2.2	-0.7	-3.9	1.5

Source: DCS and CBSL, *Annual Report*, various years.

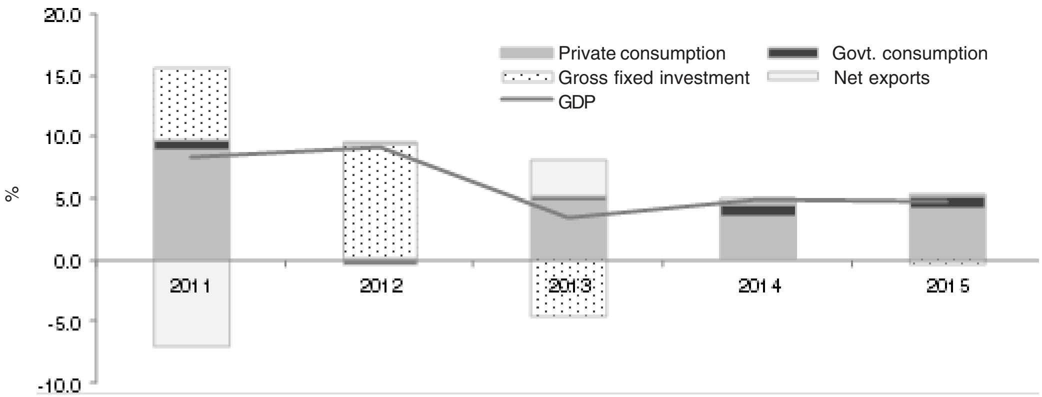
Table 2.3
Services Sector Growth (% of GDP)

	Share (%) 2015	Annual Growth (%) 2014	2015	First Half Growth (%) 2015	2016
Services	56.6	5.2	5.3	6.2	4.9
Wholesale & retail trade	10.9	4.5	4.7	1.7	4.5
Transportation	10.8	3.6	5.5	11.4	2.1
Food & beverage service activities	1.5	4.0	-1.3	1.9	3.7
Financial service activities	5.7	10.3	15.8	15.6	15.1
Real estate activities	5.6	6.5	9.6	13.3	1.8
Professional services	1.8	2.8	-7.1	-5.2	-5.4
Public administration & defence	5.0	5.2	6.9	7.5	5.2
Education	1.8	10.3	-7.5	-9.7	8.1
Health activities	1.8	1.0	5.5	9.3	5.2
Other personal services	10.3	4.6	2.9	3.0	4.4

Source: DCS and CBSL, *Annual Report*, various years.

The newly computed national accounts appear to suggest that Sri Lanka's growth has been heavily dependent on private consumption (Figure 2.2). Indeed, the contribution of private consumption to growth increased sharply to 4.1 per cent in 2015 from 3.4 per cent in 2014. This is to be expected in view of generous salary increments granted to public sector employees in 2015 following election pledges that fed into an import expenditure related consumption boom.

Figure 2.2
Growth Decomposition



Source: DCS and CBSL, *Annual Report*, various years.

Sri Lanka's growth has been heavily dependent on private consumption.

Table 2.4
Consumption, Savings and Investment

% of GDP	2013	2014	2015
Private consumption	67.6	67.7	68.6
Domestic savings	24.6	24.0	22.6
Total investment	33.2	32.0	30.1

Source: DCS and CBSL, *Annual Report*, various years.

What is of concern is the decline in the investment share of GDP in 2015 (Table 2.4). Whilst a breakdown of the private and public sector shares for 2015 are not available, fiscal data suggest that public investment increased to 5.4 per cent of GDP in 2015 from 4.7 per cent in 2014; it would appear then that the decline in overall investment is largely on account of weak private investor sentiment. This is clearly not helpful in the context of the government's overall policy objectives of shifting to a private investment and export led growth process. Clearly, private sector investment appetite can be expected to slow down during a major political transition as that of 2015, but other contributory factors were also at play. The most important of these was a general weakening of Sri Lanka's public finance management that spilled over into the broader macroeconomic policy arena. This, coupled with a seeming lack of policy decisiveness no doubt had a dampening effect on investor sentiment despite the rhetoric on a more liberal economic policy approach.

2.3 Fiscal Policy Developments

Sri Lanka's key fiscal indicators took a turn for the worse in 2015. Amidst much confusion on the actual fiscal estimates, the numbers suggest a significant weakening with the overall deficit ending at 7.4 per cent of GDP in 2015 from 5.7 per cent in 2014, with the public debt to GDP ratio climbing to 76 per cent from 70.7 per cent in the previous year (Table 2.5).

Table 2.5
Fiscal Indicators

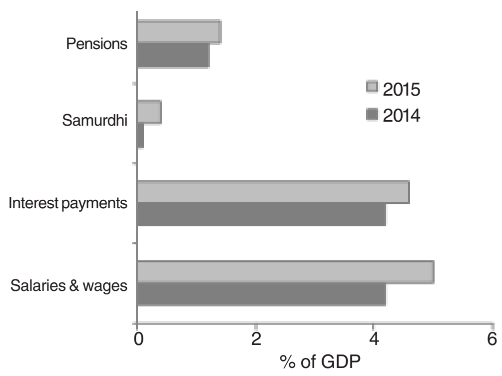
% of GDP	2013	2014	2015
Total revenue	13.3	11.5	13.1
Tax revenue	11.6	10.1	12.1
Total expenditure	19.2	17.2	20.5
Current	13.9	12.7	15.2
Overall balance	-5.9	-5.7	-7.4
Public debt	70.8	70.7	76.0

Source: DCS and CBSL, *Annual Report*, various years.

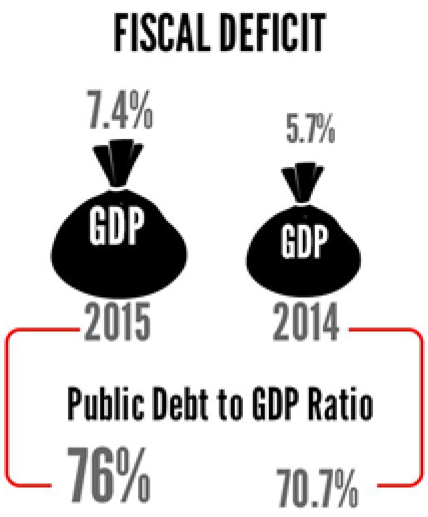
The sharp increase in the overall deficit arose from higher expenditures – a rise of 3.3 per cent of GDP, with current spending alone rising by 2.5 per cent of GDP. The overall deficit would have been much larger if not for higher revenue collections in 2015, particularly an increase in tax revenues of 2 per cent of GDP due largely to "one-off" taxes imposed in 2015 .

Sri Lanka's fiscal woes of 2015 thus lie squarely with political economy imperatives of electoral related populist spending sprees. The interim budget presented in January 2015 delivered on electoral pledges to raise public sector salaries and pension payments. The increase in wages and emoluments – adding Rs. 160 billion in payments – was the most notable contributor to higher government current expenditures in 2015 (Figure 2.3). In addition, transfers to households such as pension and Samurdhi payments also rose noticeably in 2015.

Figure 2.3
Current Expenditures



Source: DCS and CBSL, *Annual Report*, various years.



The interim budget introduced 'one-off' revenue proposals to finance the increase in expenditures; the super-gains tax on corporate entities - applied retrospectively on profits earned in 2013/14 - could only be passed in Parliament in the aftermath of Parliamentary elections in August 2015, imposing significant revenue constraints on the government in the interim. Other revenue proposals such as the imposition of a 'mansion' tax on the value of a building quietly faded from being implemented.

As a result of the one-off interim revenue measures, as well as higher revenues from taxes on imports, Sri Lanka's tax-to-GDP ratio reversed in 2015 to 12.1 per cent from a progressive decline to 10.1 per cent of GDP in 2014 (Figure 2.4). Revenues collected from

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income taxes saw an increase primarily as a result of the 'super gains' tax that netted Rs. 50 billion to government coffers. In addition, excise duty collection was also helped by a surge in vehicle imports subsequent to easing of taxes on smaller vehicles, salary increases to the public sector and a low interest rate environment. It is clear, therefore, that the reversal in Sri Lanka's tax-to-GDP ratio in 2015 was a transient occurrence, calling for focused attention on a substantive revenue reform agenda for medium term fiscal consolidation.

With an expenditure overrun of 2.5 per cent of GDP from approved estimates for 2015, and a revenue shortfall 0.5 per cent of GDP, the

Figure 2.4
Tax Revenues

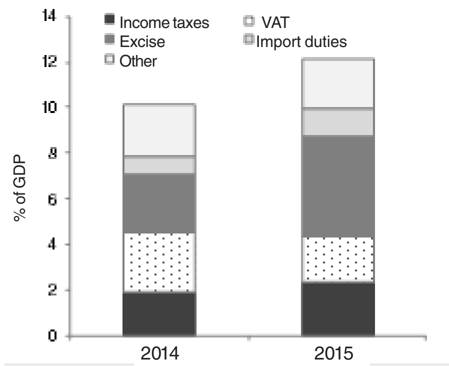
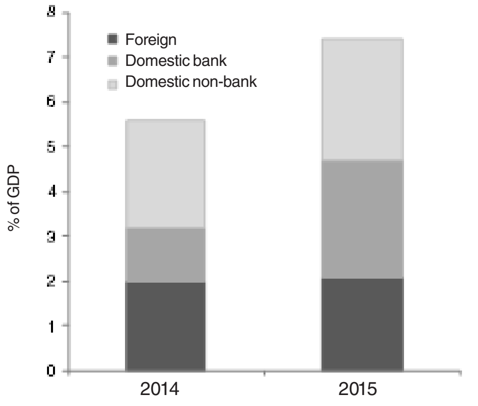


Figure 2.5
Deficit Financing



Source: DCS and CBSL, *Annual Report*, various years.

government resorted to heavy domestic bank borrowing to bridge the deficit financing gap (Figure 2.5). In turn, this raised the government's recurrent expenditures on interest payments as seen in Figure 2.3.

Amidst a weakening fiscal outlook, the government prepared to present its first full budget in November 2015. The Prime Minister's Economic Policy Statement delivered in early November attempted to set out the broad parameters not only on the overall economic policy direction, but critically on fiscal policy as well. The most significant was the stated policy to minimize regressive taxation - i.e., to shift the ratio of indirect and direct taxes to 60:40 from the prevailing 80:20 ratio - broaden the tax base, eliminate tax holidays and exemptions, etc. However, the Budget for 2016 presented later in the month appeared to go against some of these broad principles; for example, there was to be a further lowering of income tax rates to a single standard rate and raising taxable thresholds, whilst raising direct taxes such as the Nation Building Tax (NBT) and the Value Added Tax (VAT).

The 2016 Budget ran into controversy almost immediately, with both expenditure and revenue proposals subject to appeals and revisions on a continuous basis. In addition, fiscal estimates presented to Parliament underwent substantial revisions; at the time of presenting the 2016 Budget, the forecast overall fiscal deficit for 2015 was put forward as 6 per cent of GDP, whereas the final deficit turned out to be 7.4 per cent of GDP. [2] Thus, lack of clarity and confusion dogged the budgetary process in an unprecedented fashion.

With the government making a formal approach to the IMF for a loan programme in early 2016, reworking and revising the Budget 2016 proposals and estimates was thus of highest priority. Significant changes to revenue proposals were made as a precondition for a credible fiscal consolidation plan to place before the IMF. These included amending the initial proposal on a 3-tier VAT - at zero per cent, 8 per cent and 12.5 per cent, including reductions to taxable gross revenue thresholds - to a single rate of 15 per cent from the existing 11 per cent, dropping plans to raise the NBT to 4 per cent from the existing rate of 2 per cent, etc. Additionally, the VAT was also extended to the retail and wholesale sector.[3]

Thus, the overall impression of public finance management has been overwhelmingly one of policy confusion and uncertainty. Weak public finance management also spilled over into the conduct of monetary policy, setting in motion an emerging BOP crisis on the external front.

The overall impression of public finance management has been overwhelmingly one of policy confusion and uncertainty.

[2] The MF's Staff Report for the 2016 Article IV Consultation issued in June 2016 places the overall fiscal balance for 2015 at -6.9 per cent of GDP.

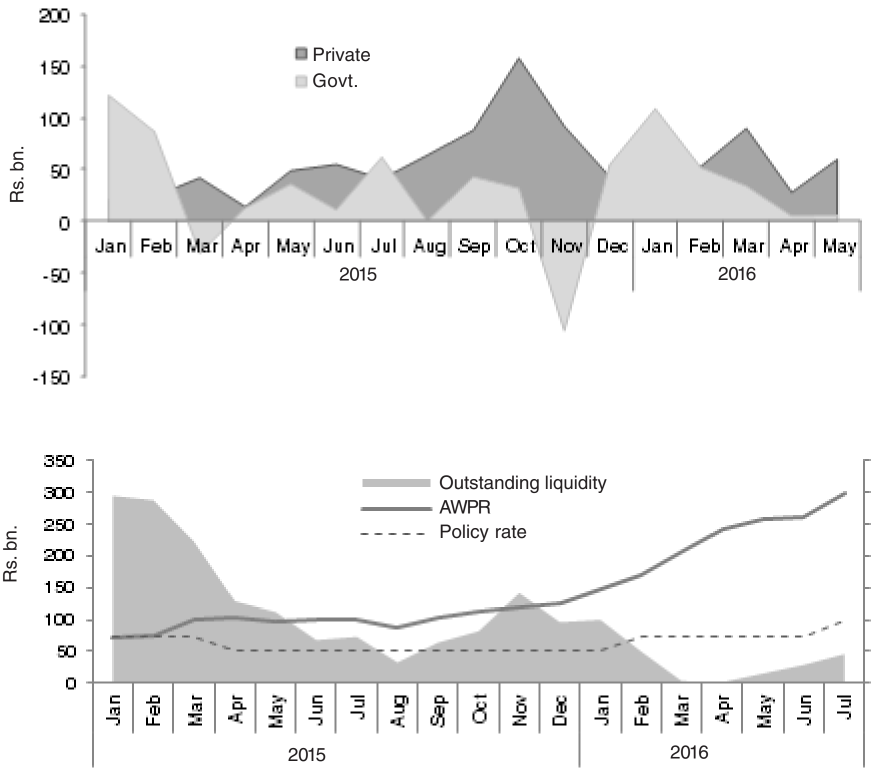
[3] The VAT increase that came into effect in May 2016 was challenged once again in the courts on grounds of non-compliance with approval procedures (i.e., obtaining the required Parliamentary approval) and was temporarily suspended in July 2016.

2.4 Monetary and Exchange Rate Policy Developments

With delays in passing certain revenue Bills, heavy dependence on domestic borrowing to meet government expenditures in 2015 saw domestic credit to the government spiking sharply in the first quarter of 2015, and continuing to expand until mid-year (Figure 2.6). As a result, interest rates began to nudge upwards as total outstanding market liquidity was squeezed sharply. The CBSL responded by lowering policy rates - the Standing Deposit Facility (SLF) previously known as the Repurchase (Repo) and the Standing Lending Facility (SLF) previously known as the Reverse Repurchase - by 50 basis points in April 2015.

The attempt to ease monetary policy was ill advised in the face of growing depreciating pressure on the exchange rate. Indeed, the signs were of rising credit uptake by the private sector to finance consumer import goods, especially on motor vehicles. As previously noted, lower import duties on motor vehicles and generous salary increments to a sizeable public sector cadre was bound to fuel a surge in consumer spending. The Sri Lankan

Figure 2.6
Credit Growth, Market Liquidity and Interest Rates

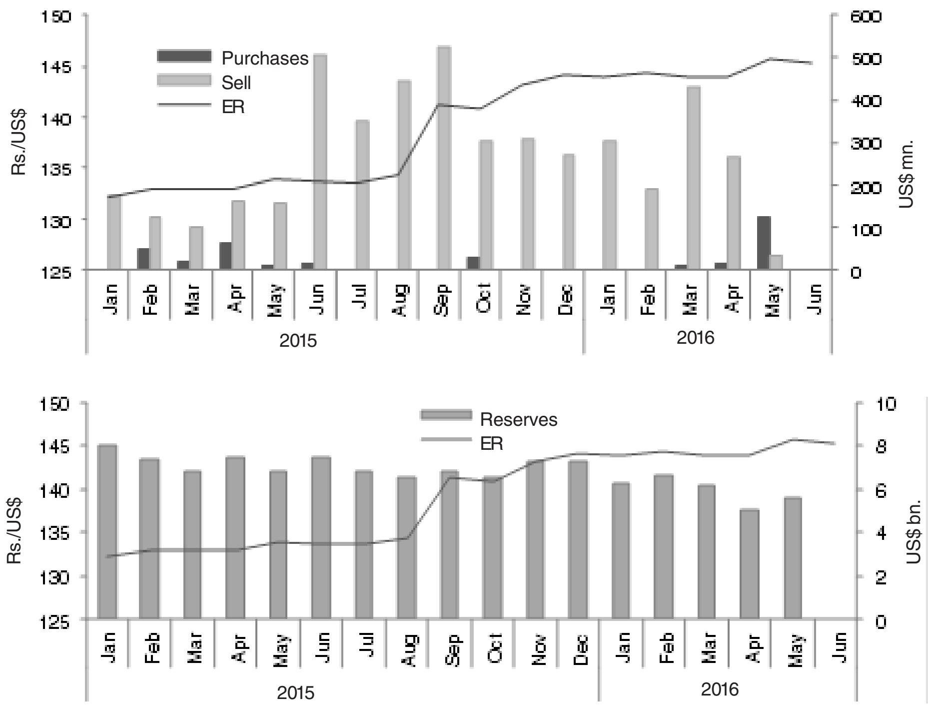


Source: CBSL, "Monthly Economic Indicators", various issues.

economy had last experienced a similar consumption driven bubble in 2011-12 that led to a sharp devaluation of the currency in February 2012.

Instead of tightening monetary policy, the CBSL began to intervene heavily to prop up the rupee in the midst of a slowdown in government foreign loan inflows as well as outflows of foreign funds from the Treasury bills and bonds market. In March 2015, the CBSL negotiated a 3-year US$ 400 million currency swap arrangement with the Reserve Bank of India (RBI). From April 2015, the CBSL began to inject dollars into the market, accelerating such injections after the issuance of a US$ 650 million Sovereign bond in May 2015 (Figure 2.7). In July 2015, a further 6-month US$ 1.1 billion swap facility was arranged with the RBI.[4] However, as Sri Lanka's official reserves dipped to 4 months of imports (US$ 6.5 billion) in August 2015, it was clear that the exchange rate was on an untenable path. The currency was finally allowed to 'float' in September 2015; it saw an immediate devaluation of over 5 per cent before continuing to depreciate further. Despite the market volatility, Sri Lanka successfully raised US$ 1.5 billion through a second 10-year Sovereign bond issue in October 2015, priced reasonably with a coupon of 6.85 per cent, albeit higher than the previous 10-year bond coupon of 5.875 per cent issued in July 2012.

Figure 2.7
Forex Market Intervention and Exchange Rate Movement



Source: CBSL, "Monthly Economic Indicators", various issues.

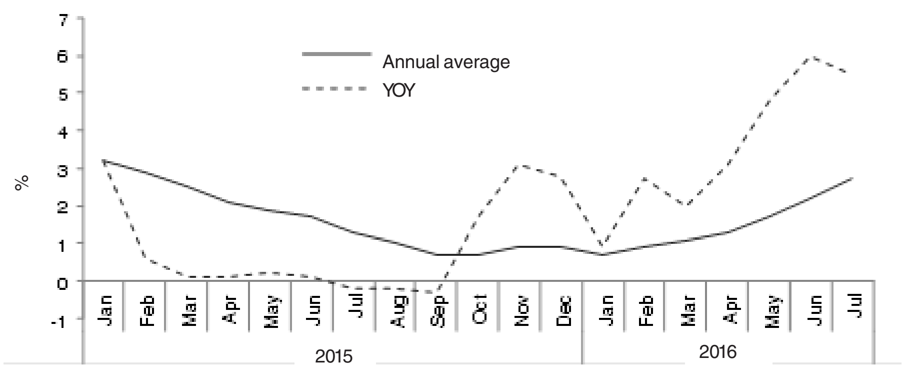
4. This is in addition to the RBI's existing Framework on Currency Swap Arrangement for SAARC countries.

The build-up of rupee liquidity in the market saw a sharp rise in credit growth to the private sector in the latter half of 2015 (see Figure 2.6). Despite signs that inflation was beginning to edge up in the third quarter of 2015 as evident from Figure 2.8, the CBSL continued to hold policy rates steady, opting instead to raise the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of commercial banks by 1.50 percentage points to 7.50 per cent only in December 2015 (effective 1 January 2016). Whilst this move helped to absorb excess liquidity in the market, it also has a downside. The SRR works through quantity rather than price and can be effective if there is no significant variation in levels of liquidity between institutions - i.e., forcing credit rationing in those institutions operating at the margins.

In February 2016, the CBSL raised policy rates by 50 basis points as the year-on-year inflation rate started to climb sharply (see Figure 2.6). At the same time, the exchange rate continued to be under pressure with official reserves dropping once again to 4 months of imports in March 2016. In the same month, the CBSL negotiated a 3-month US$ 700 million swap arrangement with the RBI, ahead of finalizing an Extended Fund Facility (EFF) loan with the IMF.

Sri Lanka had no realistic alternative to an IMF deal for both budgetary and balance of payments (BOP) support. In February 2016, Fitch Ratings was the first to downgrade Sri Lanka's sovereign rating from BB- to B+ with a negative outlook on Issuer Default Ratings (IDRs); this was followed by a sovereign downgrade from stable to negative issued by Standard & Poor's (S&P) in March 2016. Both rating agencies cited worsening external and fiscal indicators and challenges in effectively addressing the imbalances owing to a 'fragmented political landscape'. Moody's, the last of the big three global rating agencies followed suit in June 2016, downgrading Sri Lanka's rating from stable to negative, despite the signing of a US$ 1.5 billion 3-year EFF earlier in the month.

Figure 2.8
Inflation Rates



Source: CBSL, “Monthly Economic Indicators”, various issues.

Table 2.6
Fiscal Adjustments under the IMF (% of GDP)

	2015	2016	2017	201
Total revenue	13.0	12.9	14.0	15.2
Tax revenue	12.1	11.8	12.9	14.1
Total expenditure	19.9	18.4	18.8	19.3
Current	15.2	13.9	13.9	13.9
Overall balance	-6.9	-5.4	-4.7	-4.0
Domestic financing	4.3	2.3	3.0	1.3
Public debt	76.0	77.2	75.5	73.1
Foreign currency	35.0	36.2	35.7	35.8

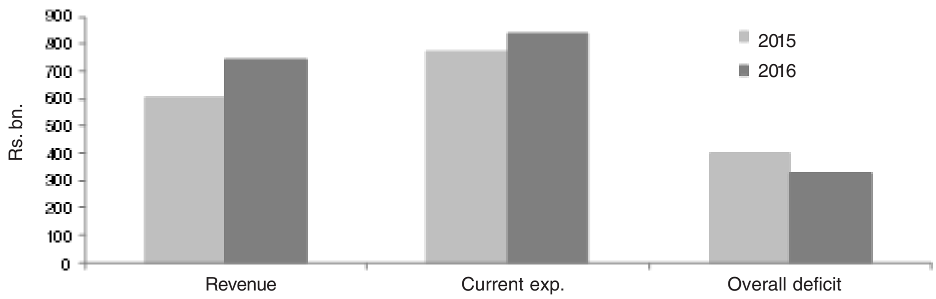
Source: IMF, Staff Report for the 2016 Article IV Consultation.

2.5 Regaining Macro-economic Stability under the IMF's EFF

Sri Lanka's IMF programme rests on six key pillars: lower budget deficits, monetary policy reform, higher government revenues, state enterprise reform, strong public financial management, and supporting higher trade and investment. Fiscal consolidation clearly lies at the heart of the macroeconomic adjustment programme (Table 2.6).

Sri Lanka is expected to reduce the overall fiscal deficit to 5.4 per cent of GDP through stringent controls on expenditures and higher revenue generation measures. Increases to the VAT rate - from 11 to 15 per cent - was implemented in May 2016 but was subsequently suspended by the Supreme Court in July 2016, pending approval by the Parliament. The extension of VAT to retail and wholesale trade (with a reduced threshold) that brought many small businesses into the tax net generated growing opposition, calling into question the ability to sustain VAT increases over the medium term. Nonetheless, with the release of the first IMF tranche in June 2016, Sri Lanka's fiscal position in the first half of the year has shown a significant improvement over the corresponding period in 2015 (Figure 2.9).

Figure 2.9
Fiscal Outcome: First Half 2016



Source: Ministry of Finance.

In July 2016, the government leveraged its IMF agreement to issue a dual-tranche US$ 1.5 billion Sovereign bond. In addition, budgetary support of US$ 650 million is expected from other sources such as the World Bank as well as the ADB. Thus, Sri Lanka's fiscal consolidation efforts in 2016 is expected to be on a sounder footing, opening up policy space for more prudent monetary and exchange rate policy initiatives.

Indeed, the IMF has set out the basic principles towards this end, introducing a soft inflation targeting framework and placing emphasis on moving towards a flexible exchange rate regime. Monetary policy excesses and misaligned exchange rates have combined in the recent past to produce import-driven consumption bubbles that have then necessitated sharp adjustments. The intention is clearly to allow an independent monetary policy to operate - i.e., to set interest rates - rather than 'target' the exchange rate.

Under these circumstances, the health of Sri Lanka's external sector performance is important. The contraction in earnings of the two main foreign exchange earners - export earnings by 5.6 per cent and remittance inflows by 0.5 per cent in 2015 - is of concern (Table 2.7). Export earnings have continued to post negative growth in 2016.

On the capital account, a net outflow of foreign investors from the Treasury bills and bonds market in 2015 is continuing into 2016. In addition, Sri Lanka has done poorly in attracting FDI, despite the emergence of a government viewed as more 'business-friendly' and focused on encouraging more private sector involvement in the economy. Total FDI inflows fell by over 30 per cent in 2015 and have continued to record even a sharper decline of over 50 per cent in the first half of 2016.

As per the medium-term macroeconomic framework outlined in the IMF agreement, there is limited room for CBSL policy intervention to support the currency as practised in the past. Thus, the fragile nature of the country's external accounts position needs to be reversed. In fact, it is not only the immediate macroeconomic

Table 2.7
External Sector Developments (US$ mn.)

	January-December		January-June	
	2014	2015	2015	2016
Current account				
Exports	1,1130	10,504	5,424	5,108
Imports	1,9416	18,934	9,547	9,321
Trade balance	-8,286	-8,429	-4,122	-4,213
Tourism	2,431	2,980	1,375	1,598
Remittances	7,017	6,980	3,433	3,613
Capital account				
Treasury bills & bonds	1,775	1,210	547	601
Sovereign bonds	1,500	2,150	650	-
Long term loans	1,438	1,267	531	790
FDI	894	681	346	165

Source: CBSL, "External Sector Performance", various issues.

Total FDI inflows fell by over 30 per cent in 2015 and have continued to record even a sharper decline of over 50 per cent in the first half of 2016.

adjustment that is at stake, but also the medium term growth outlook for the country.

As per the IMF medium term economic framework, Sri Lanka is expected to see moderate GDP growth in the range of 5 per cent (Table 2.8). The anticipated fiscal policy adjustments under the IMF programme - i.e., a higher tax burden on firms and households - will cause disposable income to shrink as evident from forecasts of declining domestic savings to GDP ratios and stagnant private investment to GDP ratios. GDP growth is expected to be driven by an export-push, with a competitive exchange rate policy in place.

With domestic savings and investment expected to remain somewhat lacklustre, Sri Lanka will be looking to FDI to fill its savings-investment gap, as well as bring in additional spillover benefits for export expansion. The alternative to attracting greater volumes of FDI is continued reliance on external borrowing, as was the case in 2015, but this holds significant risks in terms of debt sustainability and exposure to domestic and external economic shocks.

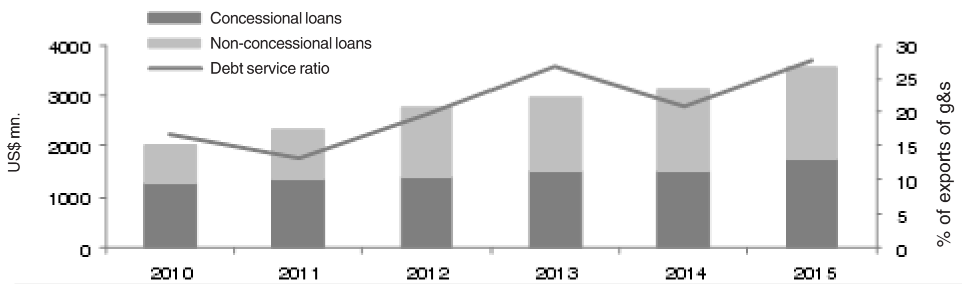
Table 2.8
Medium-term Adjustment: Growth, Savings and Investment (% of GDP)

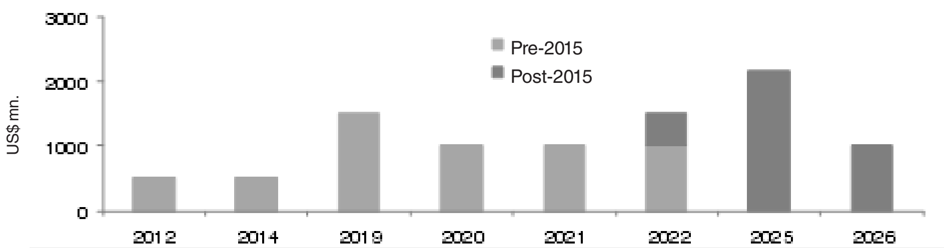
	2015	2016	2017	2018
Real GDP growth	4.8	5.0	5.0	5.0
Inflation	0.9	4.1	5.3	5.1
National savings	25.9	26.9	26.0	26.2
Private savings	28.0	27.8	25.9	24.8
National investment	28.4	28.3	28.8	29.3
Private investment	21.9	21.9	21.9	21.9
Export value growth	-5.6	-0.5	4.6	8.2

Source: IMF, Staff Report for the 2016 Article IV Consultation.

Sri Lanka's public debt-to-GDP ratio at 76 per cent is already high by comparable thresholds for emerging economies, and its gradual reduction is part and parcel of the IMF fiscal adjustment framework. While the increase in the overall public debt ratio in 2015 has been primarily in less riskier domestic debt, Sri Lanka's changing external debt profile of recent years has been a cause of concern and subject to more scrutiny. Since 2006, the share of non-concessional and commercial borrowing in total external debt has crept up steadily to stand at over 50 per cent of the outstanding external debt stock (Figure 2.10). This increases the country's external debt servicing obligations as these funds are raised on much more costlier terms than long-term concessional financing. In 2015, Sri Lanka's external debt service ratio climbed to an all-time high of 27.7 per cent from the previous high of 26.8 per cent in 2013.

Figure 2.10
External Debt Dynamics





Source: CBSL, "Monthly Economic Indicators", various issues.

As shown in Figure 2.10, Sri Lanka's Sovereign bond settlements become heavy post-2019 as the country continues to tap international capital markets. In the event that earned foreign currency resources are insufficient to settle the payments, Sri Lanka will be looking to rollover such payments. The quality of the country's macroeconomic environment and its growth outlook therefore has to improve steadily in the intervening years to retain investor confidence.

2.6 Conclusion

The months of backtracking and confusion with regard to fiscal policy, particularly on taxation issues, has taken a heavy toll on the credibility of government economic policy. To compound matters, Sri Lanka seems to have learnt few lessons in adopting an accommodative monetary policy stance to fiscal excesses. It is not surprising that the country saw its sovereign rating being re-assessed in the wake of significant weakening of both fiscal and external sector indicators. In this context, Sri Lanka's second upward policy rate adjustment of 50 basis points in July 2016 is a welcome signal of independent monetary policy setting in the face of continued upward pressure on inflation.

The decision to approach the IMF for an EFF loan was a foregone conclusion. In the final analysis, the loan amount of US$ 1.5 billion, spread over three years, is relatively small to fully meet budgetary and external debt repayment needs. What it does provide is a useful signalling measure that the government is committed to a fiscal consolidation effort as a foundation for medium term macroeconomic stability. The government made a useful start, leveraging the IMF programme to raise needed foreign capital by way of a Sovereign bond for immediate BOP and budgetary support purposes. However, it has sent mixed signals on tax revisions that were implemented to reach revenue targets; for instance, various opinions are expressed from within the government with regard to the VAT increase and extension of VAT to areas such as wholesale and retail trade, health, etc. Any signs of indecisiveness will call into question the commitment towards implementation of reforms, and thus the status of Sri Lanka's loan agreement with the IMF. In the absence of any other medium term economic policy framework, the IMF agreement at least sets out the broad parameters on the macroeconomic front. It is not merely the funding that is at stake, but the more important considerations - of policy consistency and ability to deliver - by which the government's handling of the economy will be judged.

Sri Lanka's Sovereign bond settlements become heavy post-2019 as the country continues to tap international capital markets.