Sri Lanka
State of the Economy Report 2016

Chapter 1
Policy Perspectives

by
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1. Policy Perspectives

The Sri Lankan economy grew at a modest 4.8 per cent in 2015, capping a year of socio-political transformation in which electoral politics dominated the headlines. Presidential and Parliamentary elections in January and August 2015, respectively, witnessed a redrawing of traditional political battle-lines, bringing a section of the Sri Lanka Freedom Party (SLFP) led by the President and the United National Party (UNP) led by the Prime Minister into an alliance to form a national unity government.

Attempts to overhaul Sri Lanka's institutional governance structures received the attention of policymakers for much of 2015. Although there were notable successes - the passage of the 19th Amendment to the Constitution being the most obviously successful outcome - other legislative enactments pertaining to abolition of the Executive Presidential system of government and electoral reforms dragged on through the year and into 2016. In the midst of the socio-political transition, the economy received little attention despite worrying signs of a deteriorating macroeconomic environment, particularly in the arena of public finances.

Sri Lanka's already shaky public finances received a further set-back with a rush for votes under its practice of 'competitive populism' - the political compromises that have driven much of the country's ill-disciplined fiscal policy. With Parliamentary elections yet to come, electoral

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pledges made to attract votes in the run-up to the Presidential polls were met by handing out large wage and pension increases to Sri Lanka's sizeable public sector employees, and higher transfer and subsidy payments to households.

The government had a rough start in its attempts to finance the additional expenditures. Ad hoc taxation measures announced in the January 2015 interim budget failed to find safe passage through Parliament. In addition, budgetary support by way of long-term foreign loans to the government began to shrink as progress of on-going infrastructure projects slowed or were put on hold. Foreign investors took their cue from both domestic and external developments to exit from government debt securities putting a further strain on public expenditure financing.

Sri Lanka's fiscal policy induced excesses quickly spiralled into the monetary and exchange rate policy spheres. Government domestic borrowing surged, nudging up interest rates. However, the impact on interest rates was stifled to a large extent owing to subdued economic activity that meant more spare capacity in the economy. Nonetheless, the increase in household disposable incomes translated into a surge in consumer imports, particularly of motor vehicles, draining foreign exchange from the country. As the government loosened fiscal policy, the Central Bank of Sri Lanka (CBSL) prematurely slashed its benchmark policy rates by 50 basis points in April 2015, adding fuel to the import-related consumption bubble. It then compounded the downward macroeconomic spiral by attempting to hold the exchange rate by dipping into Sri Lanka's already declining holdings of foreign exchange reserves.

By mid-2015, an incipient balance-of-payments (BoP) crisis was held-off by a mix of short-term financing arrangements. The Reserve Bank of India (RBI) granted a 3-year US$ 400 million currency swap arrangement in March 2015; in May 2015, Sri Lanka issued a US$ 650 million Sovereign bond; in July 2015, a further 6-month US$ 1.1 billion swap facility was arranged with the RBI.

The delayed August 2015 general elections cleared any remaining political snags on putting forward a medium term economic agenda. The broad cross-party consensus under a minority UNP government that had held together from January 2015 was formalized under a 'national unity government', with a majority of UNP seats. While Sri Lankan voters did not deliver a sweeping win to any one party, the UNP's electoral mandate can be viewed as sufficiently decisive to set and pursue its own economic agenda.

A foretaste of the government's economic thinking was spelt out by the Prime Minister in a statement to Parliament in November 2015. In a nutshell, it envisioned a transformational change of course - from an overwhelmingly foreign debt financed, consumption driven growth model to one that is private investment-led and export driven. The underpinning reforms indicated moves towards fiscal consolidation as the first priority to tackle Sri Lanka's dismal revenue generation, bloated loss making state owned enterprises (SOEs), and unsustainable state pension systems, to name a few.

The much awaited policy statement was followed by the government's first post-election budget. The 2016 Budget proposals, however, failed to establish any firm steps towards a coherent and prioritized fiscal consolidation agenda. Rather, it brought together a loose assortment of policies that were in some instances at odds with the government's economic policy statement. Ultimately, the ungainly mix of proposals floundered under continuous revisions, and Sri Lanka was left without a credible fiscal policy consolidation plan.

An overall fiscal deficit estimate of 6 per cent of GDP for 2015 presented with the 2016 Budget proved to be unduly optimistic. By early 2016, it was clear that the country's fiscal situation was in fact far weaker, with the final deficit number put at 7.4 per cent of GDP - an increase of 1.7 percentage points of GDP compared to 2014. Much of the expanded fiscal deficit came via higher current spending - up by 1.5 percentage points of GDP - as a result of generous salary increments, and higher payments on subsidies and interest costs. The wage increases to the public sector allowed consumers to borrow more, which encouraged still more spending.

Against this background, the CBSL's monetary policy directives also looked timid. The CBSL only resorted to monetary tightening - via an increase in the Statutory Reserve Ratio (SRR) by 1.5 percentage points in December 2015 - despite strong credit growth to the private sector in the second half of 2015. As inflation began to edge up, the CBSL followed up with a 50 basis point policy rate hike in February 2016.

The task of pulling the economy back from the brink of fiscal oblivion - and a weakening macroeconomic environment overall - fell on the International Monetary Fund (IMF) in its role as the lender of last resort. Despite allowing a sharp adjustment to the exchange rate in September 2015, followed the next month by a US$ 1.5 billion Sovereign bond issue, official

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reserves were down to 4 months of imports (or US$ 6.3 billion) by January 2016. A sovereign ratings downgrade by Fitch in February 2016 - to be followed by both Standard & Poor's and Moody's in March and June 2016, respectively - further dimmed Sri Lanka's options to test the waters once again in international capital markets. Thus, the government's formal approach to the IMF for a loan programme in February 2016 was a foregone conclusion.

The agreement with the IMF came in the form of an Extended Fund Facility (EFF) of US$ 1.5 billion (185 per cent of Sri Lanka's quota), spread over three years. The EFF is built on six pillars: i) lower budget deficits; ii) higher government revenues; iii) stronger public financial management; iv) state enterprise reform; v) monetary policy reform; and vi) supporting higher trade and investment. The 'conditions' are to be found in the fine print: fiscal tightening, a soft inflation target, and a flexible exchange rate regime.

Clearly, the proposed adjustments are meant to address a set of interrelated problems on the economic front.[1] The Sri Lankan economy suffers from fundamental imbalances that produces 'twin deficits': budget deficits that mean debt is piling up and current account deficits that indicate the economy is reliant on foreign capital inflows. At the heart of it, the imbalances denote i) national expenditure exceeds national income; and ii) production of tradable goods and services is inadequate. So long as foreigners are willing to finance the external current account deficit, the economy can drift along. But, if there is a tightening of such inflows, as happened in 2015, painful adjustments have to be made.

A current account deficit can be addressed by either cutting national expenditure or raising income. The latter cannot be increased sufficiently in the short-term as GDP growth typically increases expenditures, and productivity improvements take time. Alternatively, governments can attempt to switch resources to produce more tradable goods and services. This calls for a depreciation of the currency. A nominal depreciation alone is insufficient; expenditures must also be reduced to keep domestic cost increases at bay, and ensure that a real depreciation of the currency takes place.

The medium term macroeconomic framework under the EFF suggests government current expenditure is to be reduced from 15.2 per cent of GDP in 2015 to 13.9 per cent in 2016. On the revenue side too, the near term increases in taxes will be a drag on demand. The share of VAT and income taxes is set to increase incrementally, impacting households' disposal incomes and firms' profits. There is also very limited scope for monetary policy to act as a counterweight to fiscal policy; indeed, in order to allow the exchange rate to adjust to underlying economic fundamentals, policy rates were tightened by 50 basis points in August 2016. Not surprisingly, the accompanying overall macroeconomic framework suggests there is little or no room for an immediate fiscal or monetary policy stimulus, with the economy expected to see a modest GDP growth of 5 per cent in the medium term. Already, the adverse impact of inclement weather on agriculture has seen growth plummet to 3.9 per cent in the first half of 2016 compared to 5.7 per cent in the first half of 2015.

1 Weerakoon, D., (2016), http://www.ips.lk/talkingeconomics/2016/07/07/sri-lankas-extended-fund-facility-arrangement-with-the-imf-its-mostly-fiscal/.

The IMF-led programme will draw the usual criticism that fiscal austerity can lead to a stagnant or shrinking economy, at least in the short run, and exacerbate debt burdens needlessly. Monetary policy also cannot compensate under the proposed macroeconomic framework; a targeted low inflation environment automatically reduces the growth in nominal GDP and all else equal, raises the debt-to-GDP ratio.

Sri Lanka finds itself in an unenviable position of having a high public debt ratio - at over 75 per cent of GDP - and a low government revenue ratio - at 13 per cent of GDP - relative to comparable low middle income country thresholds. A high public debt ratio holds two important downside effects: the government is forced to allocate a large share of expenditure toward servicing its liabilities - estimated at 22 per cent of total expenditures in 2015; excessive public debt also weighs down an economy, leaving it vulnerable to shocks. Whilst there is no conclusive evidence pinpointing to a debt threshold at which growth begins to falter, few would question the idea that there is some point at which markets and investors will get jittery as debt piles up, and the economy appears more prone to crises.

Sri Lanka's stock of debt has grown substantially over the last few years. In the euphoria of post-war economic optimism, the stockpiling of debt as a claim on future wealth was viewed sanguinely. The appetite for such borrowing was helped by a weak dollar and ample global liquidity. High nominal GDP growth in post-war Sri Lanka kept the debt ratios down to manageable levels. Thus, more than the stock of debt what matters more is the size of the debt relative to the size of the economy. But, even more importantly, the mix of debt is also critical. For Sri Lanka, the immediate problem lies in the rapid changes to the structure of its debt portfolio - an unprecedented shift from lower cost external concessional borrowing to higher cost domestic and non-

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concessional external borrowing. This has clearly raised both the costs and risks of the total debt portfolio.

Funding choices to meet domestic debt provides much greater flexibility to governments - at one extreme, countries can inflate their debt away. With international creditors, those options are much more limited. External debt also carries additional risks of currency mismatches that can lead to debt servicing difficulties in the event of a rapid currency depreciation. The risks are compounded for an emerging economy such as Sri Lanka that carry current account deficits and has failed to build up its foreign exchange reserves as a bulwark against a sudden exit of foreign capital.

Reliance on foreign borrowing can also make exchange rate management an obsessive compulsion and renders monetary policy powerless. Monetary authorities could be compelled to set exchange rates to make dollar denominated debt manageable rather than to keep prices in check. Indeed, the Sri Lankan economy has been regularly subject to the resultant consumption bubbles and BOP crises in the recent past where both fiscal and monetary policies tended to be pro-cyclical, accentuating rather than damping economic volatility.

Thus, the pressure to address fiscal problems is mounting on several fronts. High fiscal deficits and public debt, and growing currency mismatches constrain fiscal and monetary policy responses. If the Sri Lankan economy is to escape the trap of fiscal dominance in macroeconomic policy setting - leading to volatile inflation and/or an unfavourable exchange rate dynamic - then steps towards fiscal consolidation is a must.

Cutting spending and raising taxes are easier to implement when economic growth is high. Generating surpluses in good times and borrowing only to finance public investment means a more effective counter-cyclical fiscal policy. Sri Lanka, however, has failed to do this even during the post-war growth spurt; paradoxically, the government lowered taxes and did little to broaden the tax base. As a result, tax revenue kept declining to reach its lowest of 10 per cent of GDP in 2014.

It seems then that only a crisis helps enforce change in the Sri Lankan economy. Fiscal tightening in the current circumstances is less avoidable than critics of austerity might acknowledge. The converse will be the government continuing to spend more than it taxes, adding to the debt and having to tax even more to service interest payments on debt. The best hope is that the impact of austerity measures on Sri Lanka's growth outlook can be softened by how it is imposed and what other policies to stimulate growth accompany it.

Restructuring public finances in the midst of sluggish growth will require a careful calibration of taxes and expenditures to harness growth and equity outcomes. Sri Lanka like many developing countries uses an array of subsidies, tax incentives and grants, with varying levels of success. A particular mix of fiscal policy measures has impacts not only on macroeconomic stability but also on employment, investment and productivity through tax and spending policies at the micro level. Thus, the effectiveness of fiscal consolidation is likely to be enhanced when reforms reinforce each other and are accompanied by complementary structural reforms. Indeed, fiscal consolidation can pave the way for reforms by generating fiscal space -

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i.e., by setting aside money in advance as a compensatory measure for those expected to lose from reforms.

Structural reforms - a variety of policies to raise productivity and competitiveness and lift the economy's growth rate - are needed to shift the balance away from consumption and towards investment in the Sri Lankan economy.[2] Overhauling Sri Lanka's regulatory systems to improve public service delivery, enhance labour market efficiency, and fill skill gaps in the workforce, to name a few, are amongst a menu of reforms that need attention. A stronger fiscal stance makes it easier to design and implement such a structural reform effort.

Thus, fiscal policy is not only to be found at the heart of Sri Lanka's lack of macroeconomic rigour, it is also the pivotal focus to mitigate further risks of economic turmoil and set the stage for sustainable growth. At its simplest, fiscal consolidation efforts should focus on broadening Sri Lanka's tax base and minimizing distortions; expenditure measures should aim at rationalizing spending and improving efficiency.

This year's *Sri Lanka: State of the Economy* report focuses on the many interrelated problems constraining investment and productivity across the economy owing to weak public finance management. For instance, one of the easiest to implement - and one that is politically least controversial - is imposing taxes on trade as an immediate revenue tool. Indeed, Sri Lanka has witnessed a sharp increase in para-tariffs that not only distorts the import duty structure but also leads to policy inconsistency. Conversely, Sri Lanka has granted significant tax exemptions to attract foreign direct investment (FDI) which has contributed to weakening the country's tax base and tax compliance. Both these sectors perform poorly. Exports have continued to decline as a share of GDP, hitting a new low of 14 per cent of GDP in 2015; in the first half of 2016, export earnings have contracted by 6 per cent. Similarly, Sri Lanka has failed to raise its FDI beyond 1.5 per cent of GDP even following the post-war

[2] IPS (2015), "Economic Reforms: Political Economy and Institutional Challenges" in *Sri Lanka: State of the Economy 2015*, Institute of Policy Studies of Sri Lanka, Colombo.

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economic euphoria. FDI inflows fell by 30 per cent in 2015; they have fallen by a further 53 per cent in the first half of 2016.

Fiscal incentives also matter in raising investment and productivity in labour markets. Despite a relatively low unemployment rate of 4.6 per cent in 2015 - albeit up steadily from 4 per cent in 2012 - Sri Lanka's labour market indicates significantly high educated youth unemployment as well as a low level of female labour force participation. So far, well-meaning intentions to generate one million jobs and improve living standards of workers have been spelt out in the government's Economic Policy Statement, but without much guidance on the precise direction or the urgency with which it will be implemented. If one million jobs are to be generated, Sri Lanka will have to rely on those who are economically inactive, particularly females and youth and devise appropriate incentives to get them into the workforce.

Increasing the labour force participation of youth is intrinsically connected to the quality and relevance of education that equip workers with evolving skills demanded in a more globalized world. Sri Lanka has relied heavily on public sector financed general education and tertiary education systems, including other measures such as the distribution of free textbooks, scholarships for disadvantaged students, free uniforms, and subsidized transport facilities, etc., to ensure high education outcomes. However, even with public spending on education set to increase further, the resource gap to meet quality and equity issues in the education sector will of necessity require incentivizing private sector participation, particularly in the tertiary education system.

Private participation - both as providers and consumers of services - is already more heavily present in Sri Lanka's health sector. The current total expenditure on health of 3-4 per cent of GDP falls short of comparable global averages even at present, and expenditure is set to increase with the country's rapid demographic and epidemiological transition. Out-of-pocket expenses by households on health care is rising, raising issues of affordability and equity. Thus, improving allocative efficiency of health care expenditures and finding alternative sources of finance are high on the agenda to address improved health outcomes in the country.

Sri Lanka's demographic transition also holds important implications for fiscal policy reforms, including the provision of adequate social protection systems and social safety nets. Efforts to reform the country's non-funded public sector pension schemes - as outlined in the 2016 Budget proposal - have fallen by the wayside in the face of stiff opposition. Sri Lanka also provides as array of social safety nets. The cost-efficiency and effectiveness of current poverty reduction programmes - primarily, the Samurdhi/Divineguma programme - is doubtful in view of poor targeting and other implementation weaknesses. Although Sri Lanka has made progress in tackling poverty at the national level, the presence of significant pockets of poverty and rising inequality within the country means that considerable attention needs to be paid to bridging such disparities in the coming years.

Targeted efforts to narrow disparities between population groups - especially between urban and rural sectors of the economy - need to accompany Sri Lanka's renewed efforts to fast-track the development of cities. The growing demand for urban lifestyles as incomes rise and the economic arguments for urban agglomeration make a compelling case for planned large scale developments. Sri Lanka has already launched an ambitious US$ 40 billion Western Megapolis project that will require significant new sources of funding. While such infrastructure-reliant projects can have an immediate and more long-term impact on growth, they can also lead to fiscal and broader macroeconomic stress unless financing aspects are managed effectively.

If large scale urban development initiatives are not well managed, they can also have strong negative impacts on a country's natural resources and environment. Air pollution and urban slums are common undesirable outcomes of ill-planned big projects. With the renewed global emphasis on sustainable development, managing the environment is at the centre of economic policy. In Sri Lanka, environment policy has been dominated by command-and-control instruments based on regulations and standards. However, owing to their limited effectiveness, high cost of implementation, low economic efficiency, and problems of sustainability, market-based instruments (MBIs) have been gaining ground. Such economic instruments - a shift from penalties for non-compliance to payments or adjustments in the systems of ownership rights - offer countries like Sri Lanka a more fiscally effective means of environment management.

Indeed, the lack of user charges for irrigation for instance, has long been identified as reason for over-use of scarce water supply. The development and maintenance of irrigation facilities, however, is an onerous fiscal burden on the government. Similarly, the government spends considerable amounts on other producer subsidies such as fertilizer - a programme which has often been criticized for lack of effectiveness. The sale of subsidized fertilizer and its over-usage that has led to other health related problems are some of the drawbacks. Sri Lanka's growing consumer demand for food and inadequate incomes to farmers do not support the country's moves towards food security and poverty reduction efforts. Thus, Sri Lanka needs to re-examine economic incentives to leverage the existing resources in a more fiscally efficient way to support agriculture sector development in the country.

Thus, Sri Lanka's needed fiscal reforms are not only about attaining macroeconomic stability, although it is a prerequisite. The reforms go beyond the macro to the micro - and will be the more effective if they are self-reinforcing. Progress towards meeting such a broader fiscal reform agenda has been facilitated with financial support for complementary reforms such as liberalizing trade, labour and product markets. Sri Lanka's IMF package is expected to catalyze an additional US$ 650 million from other multilateral and bilateral agencies to support reform efforts.

The big hurdle for the government is to ensure political and social consensus for a successful reform initiative. In government, the reality of hard choices is being felt; tax increases on VAT as a prelude to concluding the IMF agreement is bringing widespread strikes by traders; consumers will also be disaffected by rising prices amidst tighter economic conditions. The government's efforts to foster public support for reforms, including effective communication have fallen short.

The government's policy somersaults have not helped. Many of the tax proposals presented in budget proposals have been either revised or failed to be implemented. The appropriate legislative procedures to enact fiscal proposals have also been mismanaged. Revisions to the VAT introduced in May 2016 were abruptly withdrawn two months later, after being successfully challenged in the courts by opposition parties. Such signals of policy missteps and confusion strengthen the hands of those opposed to reform and make government capitulation easier.

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There is also microeconomic interference in the economy such as price fixing on everyday consumables. The private sector too must feel shortchanged by ad hoc taxes on corporate profits such as the one-off tax on corporate profits, possible reintroduction of capital gains tax and the general environment of policy indecision. By most indicators, private sector business confidence has been flat, as has the performance of the stock market.

The lack of clarity on the direction of economic policy is perhaps not a surprise in the initial settling down period to an awkward partnership of a national unity government. Even by Sri Lanka's fluid political alignments, it is an uneasy alliance involving the country's political arch rivals - the UNP and the SLFP. It is, therefore, bound to be more susceptible to policy gridlock common to coalition arrangements.

But, time is running out for Sri Lanka to unlock its jammed economic policy levers. Settlement of International Sovereign Bond (ISBs) issues is bunching up from 2019; indeed, over the period 2019-2022, Sri Lanka is set to repay US$ 5 billion in ISBs. In the interim, if foreign debt is not matched by foreign currency earnings, Sri Lanka will be looking to roll-over the ISBs; to avoid any elevated risk premia, the government will have to retain the confidence of the three big rating agencies and international creditors.

The immediate task at hand is to instil confidence that the fiscal consolidation process instigated under the IMF arrangement will be pursued. While the IMF deal is not a panacea for all Sri Lanka's economic ills, it can be leveraged as a confidence-restoring measure and generate stimulative benefits. Once a semblance of fiscal control has been restored, the impact of such austerity on the country's growth outlook can be reversed with monetary loosening. Sri Lanka has already lost time in preparing the details of a complementary medium term structural reform agenda to promote growth. That too is a priority to set clear direction on the economic policy front.

With the announcement that the unity government will continue for a further three years till the end of the current Parliamentary term, there is still time in between for the benefits of reforms to be felt before going for fresh polls. The transition period will test the government's political acumen and dexterity in instilling confidence that it has a firm hand on steering the economy, and delivering a better economic future for all Sri Lankans.

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