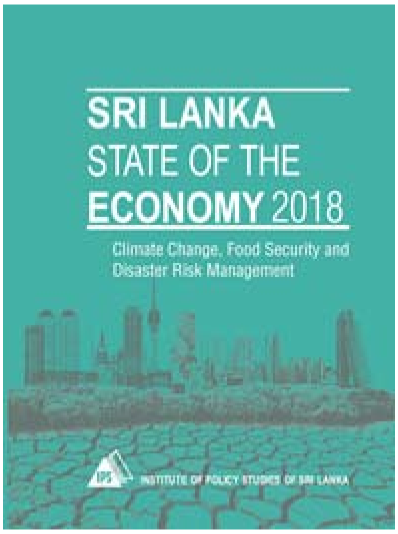
17 September 2018

POLICYINSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

MACROECONOMIC PERFORMANCE

From the IPS flagship publication 'Sri Lanka: State of the Economy 2018 Report'



Sri Lanka's economic performance report card for 2017 is mixed. The most significant economic milestone in 2017 was the gradual reclaiming of macroeconomic stability with prudent fiscal, monetary and exchange rate policy management. Gains were made in macroeconomic indicators, export performance and foreign direct investment (FDI). However, if overall economic performance is to be measured by GDP growth, Sri Lanka is clearly in the throes of a growth slump.

Fiscal Policy: Balancing Budgets

The most critical gains on economic policy management have been on the fiscal front. Despite missing the overall fiscal balance target, public finances are in a much sounder footing with the decisive revenue reforms expected to yield sustained gains to the Treasury. However, the overall tax mix is becoming more regressive. Ongoing reforms to automate revenue collection and introduce unique digital identity systems, amongst others, is expected to improve efficiency of tax collection and help broaden the tax base through better compliance. Recent research by the IPS on the potential equity implications of the new Inland Revenue Act suggests a positive outcome in relation to at least the personal income tax (PIT) and pay-as-you-earn (PAYE) tax structures.

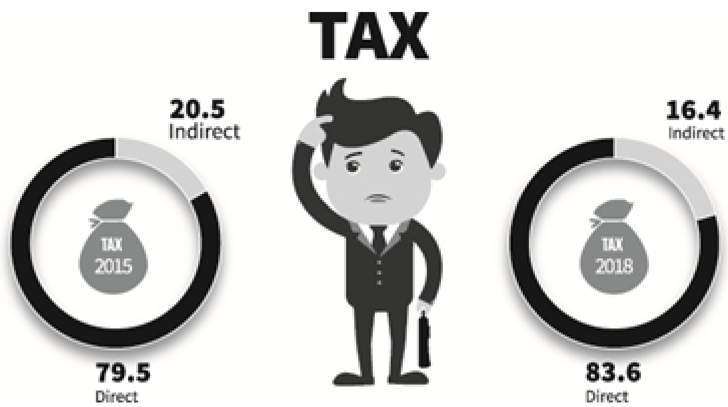
Monetary Policy: Price Stability

Sri Lanka's recent inflationary bout has symptoms of both demand-pull and supply-push factors. The monetary policy response has been measured, with a 25 basis point rate hike as a precautionary measure against the return to a consumption driven, short lived credit boom. With inflationary pressures and credit growth moderating substantially by the first quarter of 2018, the CBSL chose to cautiously ease monetary policy; by narrowing the gap between deposit and lending policy rates, the CBSL is aiming to nudge short term interest rates downwards.

Exchange Rate: Pegged, Managed or a Free Float?

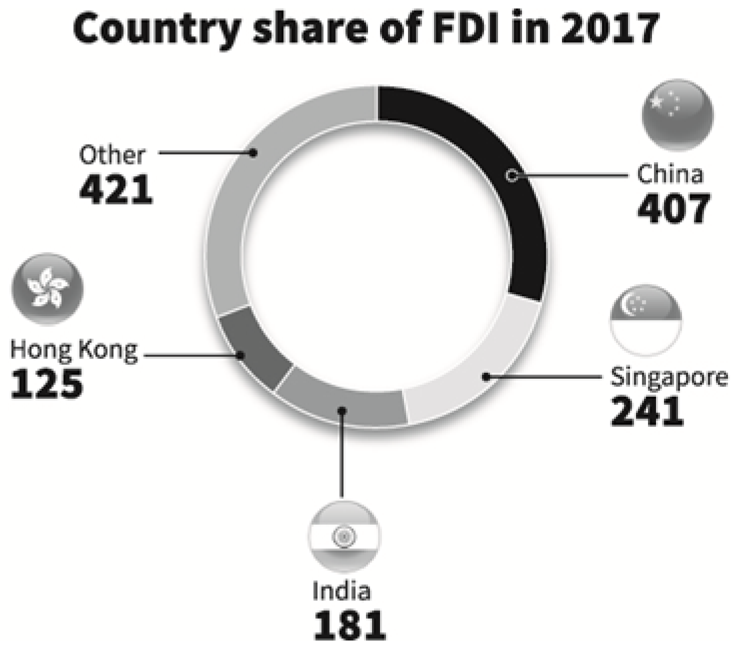
The CBSL has been a net purchaser of US dollars in the market, shoring up its stock of non-borrowed official reserves. However, the rupee began to come under pressure in April 2018 owing to a host of factors, both economic and non-economic.

The most unsettling factor was electoral politics. Following the results of the delayed local government elections held in February 2018 in which the ruling coalition suffered a setback, political infighting and uncertainty began to dominate the headlines. External sector developments continued to make inroads into investor and exporter confidence on the medium term outlook on the currency front. There has been no easing up on Sri Lanka's growing exposure to external debt. In fact, the stock of external debt grew by a high 15.6 per cent in 2017 to USD 31.4 billion compared to a 10 per cent growth in 2016. Sri Lanka enacted the Active Liability Management Act in March 2018 to help manage medium term external



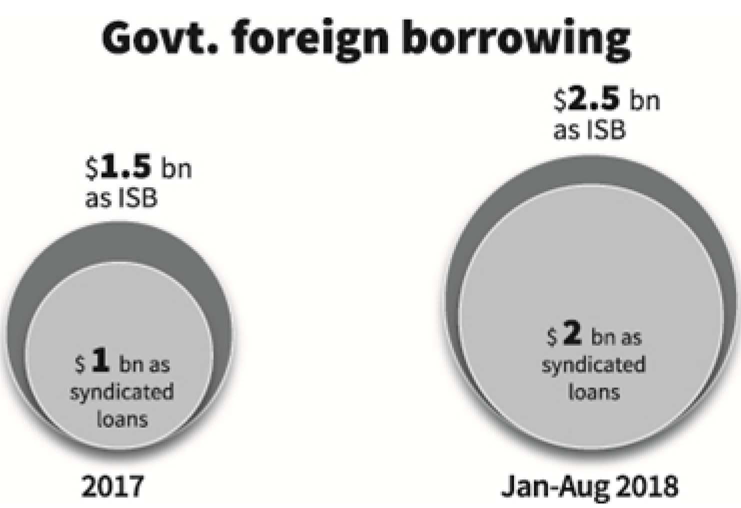
debt settlements. Under this Act, the government is permitted to raise funds over and above the Parliament approved annual borrowing limit.

Early preparations to meet the debt resettlements are the most advisable course in the circumstances. A decisive interest rate tightening phase in global financial markets - and a draining of investor appetite for emerging market debt - raises the risks of refinancing at higher costs. The current upswing in capital flows to some 'risky' emerging market economies is raising concerns regarding potential downside impacts of rate tightening.



Sluggish Growth Needs a Boost

As Sri Lanka gears up to meet a large volume of medium term external debt settlements, maintaining sound macroeconomic fundamentals to reassure investors of the country's positive economic outlook will be critical. Attention must now focus on reviving Sri Lanka's sluggish GDP growth through reforms that can help raise economy-wide productivity and efficiency.



Efforts to stimulate growth through fiscal and/or monetary policy interventions will undo the gains made on the macroeconomic front and prove destabilising. Sri Lanka is still struggling to lower a still fairly large fiscal deficit of 5.5 per cent in 2017 to 4.6 per cent in 2018. First quarter 2018 fiscal estimates suggest a slight dip in revenue collection, possibly the result of the general slowdown in economic output.

There is little additional room for further easing of monetary policy. Credit growth to government and SOEs picked up in April/May, keeping market interest rates at the same levels. It is also noteworthy that there has been a sharp pick-up in consumer import expenditures, growing by over 18.0 per cent in the first half of 2018 compared to 5.5 per cent in the same period last year. The increase has been led by a resurgence in vehicle imports that precipitated previous bouts of BOP crises.

With the downward revision of GDP growth to around 4 per cent for 2018, Sri Lanka's politics bring the biggest uncertainty to any economic forecasts. From 2018, an electoral cycle kicks in until all the way to presidential elections in late 2019/early 2020. The implications are two-fold: first, is the impact on the speed of reforms, policy consistency and predictability; second, is the potential downside risk of looser macroeconomic management to allow more populist measures to creep in on the fiscal policy front and/or easing of monetary policy measures to provide financial relief to both businesses and households. For Sri Lanka's foreign debt refinancing risks to be contained, continuing with fiscal and monetary policy discipline will be quite critical.

This Policy Insight is based on the comprehensive chapter on "Macroeconomic Performance" in the 'Sri Lanka: State of the Economy 2018 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.

ThinkTank Initiative

IPS
100/20, Independence Avenue,
Colombo 7,
Sri Lanka
T: +94 11 2143100 / 2665068,
F: +94 11 2665065