

SRI LANKA DEVELOPMENT UPDATE



June 2017

Standard Disclaimer:

This volume is a product of the staff of the International Bank for Reconstruction and Development/ The World Bank. The findings, interpretations, and conclusions expressed in this paper do not necessarily reflect the views of the Executive Directors of The World Bank or the governments they represent. The World Bank does not guarantee the accuracy of the data included in this work. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries

Copyright Statement:

The material in this publication is copyrighted. Copying and/or transmitting portions or all of this work without permission may be a violation of applicable law. The International Bank for Reconstruction and Development/ The World Bank encourages dissemination of its work and will normally grant permission to reproduce portions of the work promptly.

For permission to photocopy or reprint any part of this work, please send a request with complete information to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, USA, telephone 978-750-8400, fax 978-750-4470, <http://www.copyright.com/>.

All other queries on rights and licenses, including subsidiary rights, should be addressed to the Office of the Publisher, The World Bank, 1818 H Street NW, Washington, DC 20433, USA, fax 202-522-2422, e-mail pubrights@worldbank.org.

Photo Credits:

Cover, Executive Summary, Recent Developments and Challenges: Joseph C. Qian; Outlook, Risks and Policy Options: Janaka Thilakaratne; and World Bank Group Assistance: Anuki Premachandra.

SRI LANKA DEVELOPMENT UPDATE

June 2017

Preface

The Sri Lanka Development Update has two main aims. First, it reports on the key developments over the past six months in Sri Lanka's economy, and places these in a longer term and global context. Based on these developments, and on policy changes over the period, it updates the outlook for Sri Lanka's economy and social welfare. Second, the Update provides a more in-depth examination of selected economic and policy issues, and analysis of medium-term development challenges. It is intended for a wide audience, including policymakers, business leaders, financial market participants, and the community of analysts and professionals engaged in Sri Lanka's evolving economy.

This report was prepared by Kishan Abeygunawardana and Ralph van Doorn (Macroeconomics and Fiscal Management Global Practice), with inputs from David Newhouse (Poverty and Equity), Emanuel Salinas-Munoz, Amila Dahanayake and Dinesha Samaranyake (Trade and Competitiveness), Suranga Kahandawa (Social, Urban, Rural and Resilience), Raffy Dominguez (IFC) and Juri Oka (Country Management Unit). Sashikala Jeyaraj provided formatting support. The report was prepared based on published data available on or before June 20, 2017. Data sources included World Bank, International Monetary Fund, Central Bank of Sri Lanka, Ministry of Finance, Department of Census and Statistics, and press reports. For questions, please contact: infosrilanka@worldbank.org.

This report and more information on the Sri Lanka program can be found at

 <http://www.worldbank.org/en/country/srilanka>

Stay in touch with the World Bank in Sri Lanka and South Asia via

 [@WorldBank](https://twitter.com/WorldBank), [@WorldBankSAsia](https://twitter.com/WorldBankSAsia)

 <http://www.facebook.com/worldbank>,
<http://www.facebook.com/worldbanksrilanka>

 <https://instagram.com/worldbank/>

 <http://www.linkedin.com/company/the-world-bank>

Table of Contents

EXECUTIVE SUMMARY	6
1. Recent Developments	6
2. Outlook and risks	8
3. Special focus	9
A. RECENT DEVELOPMENTS	11
B. OUTLOOK, RISKS AND POLICY PRIORITIES	22
1. Outlook.....	22
2. Risks	25
3. Challenges and policy priorities	26
C. SPECIAL FOCUS	29
1. Special Focus: Unleashing Sri Lanka's Trade Potential	29
D. WORLD BANK GROUP ASSISTANCE.....	36
KEY ECONOMIC INDICATORS	38

LIST OF FIGURES

Figure 1: Sri Lanka compared to peer countries.....	10
Figure 2: Sri Lanka compared to peer countries.....	10
Figure 3: Contributors to growth (production side)	12
Figure 4: Contributors to growth (demand side)	12
Figure 5: Inflation Drivers (CCPI: 2013=100)	14
Figure 6: Headline versus core inflation (CCPI: 2013=100)	14
Figure 7: Overall Fiscal Balance	16
Figure 8: Public Debt Drivers.....	16
Figure 9: External Debt Indicators	17
Figure 10: Gross Official Reserves	17
Figure 11: Breakdown of guarantees, end-2016	17
Figure 12: Treasury bond and bills outflows were facilitated by foreign exchange sales	17
Figure 13: Credit Leverage	20
Figure 14: Drivers of Domestic Credit	20
Figure 15: Fiscal balance	23
Figure 16: Public Debt	23
Figure 17: Eurobond Repayments	26
Figure 18: Sri Lanka's post conflict sectoral growth map 2010-2016.....	30
Figure 19: Sri Lanka's competitiveness indicators compared to peer countries	31

LIST OF TABLES

Table 1: Budget and Fiscal Outcomes	16
Table 2: Balance of Payments	19
Table 3: Growth prospects for key partners of Sri Lanka	25

LIST OF BOXES

Box 1: Sri Lanka: country context.....	10
Box 2: The impact of recurring natural disasters	12
Box 3: Global economic context	24
Box 4: Policy recommendations to improve trade and business environment and FDI.....	29
Box 5: Impact of mega-regional trade agreements on South Asia and Sri Lanka	34

Executive Summary



Sri Lanka has the opportunity to sustain growth, job creation and poverty reduction in the medium term, provided it shifts from a public investment, non-tradable sector-driven growth model to a private investment, tradeable sector-led model, and benefit from its location close to the largest fast-growing economies in the world. To get there it needs to maintain macro-fiscal stability and increase its resilience to natural disasters, while pursuing structural reforms to promote competitiveness and attract more FDI, use policy instruments to support the structural adjustment and protect the poor, and improve accountability.

1. Recent Developments

Sri Lanka recorded broadly satisfactory performance in 2016.

Despite significant challenges, Sri Lanka's economic performance remained broadly satisfactory in 2016 and early 2017. The corrective policy measures taken in 2016 following expansionary fiscal and monetary policies implemented in the previous year have led to early signs of stabilization. The construction sector's rapid recovery supported by strong rebound in investment was able to partially mitigate the impact of inclement weather conditions on real sector. However, external buffers remained weak on account of a challenging external environment and continued low FDI flows. Inflation has been rising since the second half of 2016 on account of drought and changes to the VAT law.

Reform implementation was slower than expected.

Authorities pursued the economic reform agenda presented in the policy statement of the Prime Minister in 2015, albeit at a slower pace, owing to the difficulties faced in a complex coalition political environment and institutional constraints on policy implementation. During the year, the government was able to pass the Right to Information Law, which marked a major improvement in transparency and governance. Although yet to be in full compliance, the progress made in 2016 helped

the country regain concessions under the Generalized System of Preferences Plus (GSP+) from the European Union in May 2017. Amendments to the VAT law were introduced in November 2016, advancing on the fiscal consolidation agenda. However, some other vital reforms were lagging behind; these included introduction of the proposed Inland Revenue Law, implementing the One-Stop Shop for FDI, reforms to the investment climate and trade, SOE reforms such as for Sri Lankan Airlines, drafting of a comprehensive public financial management law, progressing on the debt management agenda and passing of the Audit Law.

Improvement in public finance was a key highlight; however, fiscal risks remain high.

A combination of increase in revenues and rationalization of expenditures helped reducing the fiscal deficit from a reported 7.6 percent in 2015 to a 5.4 percent of GDP in 2016. While the boost received from increased profits and dividend income from State Owned Enterprises (SOEs) played a key role in increasing revenues; the changes to the VAT Act implemented late 2016 and improved revenue administration helped strengthen the tax collection. As in the past, low execution and cuts to public investment helped reduce the budget deficit while savings on purchase of goods and services kept current expenditures in check. Despite the favorable impact of a reduced primary deficit, rising real interest rates and past currency depreciation increased public debt to 79.3 percent of GDP. Treasury guarantees issued mainly for SOEs and state agencies increased to 7.1 percent of GDP.

Impact of adverse weather was a drag on real and external sectors in 2016.

Floods and droughts that emerged within a single year had an adverse effect on the economic growth and exports performance. Despite significant contributions from construction, trade, financial and other services, the real GDP growth for 2016 slowed to 4.4 percent followed by a slow-down in Q1 2017, due to a significantly large negative contribution to growth from agriculture sector. Agriculture and related exports also weakened due to the shrink in production along with weak external demand. Inflationary pressures were seen in the second half of the year due to supply disruptions while measures to increase the VAT collection and demand pressures amid high monetary growth also contributed to a hike in inflation

Reserves declined on structural weaknesses and subdued global demand.

An expanded trade deficit, net outflows from the government securities market, sluggish FDI inflows and debt repayment presented a challenging external landscape despite strong tourism receipts and stable remittance inflows. Fresh Eurobonds and syndicated term loans partially negated resultant balance of payments pressures. However, official reserves declined to 3.1 months of imports of goods and services by end-2016 compared to 3.8 months reported in end-2015. The Sri Lankan rupee depreciated by 4 percent against the US dollar over the year.

IMF, World Bank and other development partners supported the reform work.

The key fiscal and monetary policy measures aimed at reinstating stability, in 2016, were supported by the IMF program.¹ The reforms in the program are mainly focused on revenue led fiscal consolidation; transition to flexible inflation targeting; and reforms in SOE oversight and trade and competitiveness. The IMF reached a staff-level agreement with Sri Lankan authorities on the second review subject to submission of a new Inland Revenue Act to the Parliament by June 2017. During the year 2016, the World Bank and Japan International Cooperation Agency provided budget support reinforcing policy reforms to improve private sector competitiveness, transparency, public sector management,² and fiscal sustainability while the Asian Development Bank provided support to strengthen the capital markets.

¹ These included some important steps to increase government revenues and tighten the monetary policy.

² The Development Policy Financing (DPF) Program Document is available online at: <http://www.worldbank.org/en/news/loans-credits/2016/08/01/sri-lanka-dpf>

2. Outlook, risks and policy priorities

A relatively favorable outlook is projected in the backdrop of policy reforms.

The government is committed to implement an ambitious medium-term reform agenda aimed at improving competitiveness, governance and public financial management that would bring in long-term benefits. Continuation of reforms along with the IMF program will add to the confidence while helping reform the tax system to pursue revenue led fiscal consolidation. Monetary policy has shown that it stands ready to take appropriate action in the direction of stability. These developments have contributed to an improved outlook.

Growth is expected to reach 4.7 percent in 2017³ and grow marginally over 5.0 percent beyond, driven by private consumption and investment. The impact of past high monetary growth along with the increase of VAT collection will increase inflation in 2017 although low international commodity prices will maintain some downward pressure.

The external sector is poised to benefit from the reinstatement of GSP+ preferential access to European Union and rapidly growing tourism, although the drought could adversely impact exports and increase petroleum imports. Foreign capital inflows to government securities and FDI inflows will help closing the external financing needs with no Eurobond falling due in 2017. External buffers are projected to improve, with emphasis placed on purchasing foreign exchange, maintaining a more market-determined exchange rate, using monetary policy and the sale of selected government assets.

The fiscal deficit is projected to narrow to 5.2 percent of GDP for 2017 creating space for planned increase in public investment thanks to the impact of VAT changes in its first full year of implementation. Further revenue-increasing policy measures along with improved tax administration will help increase revenues and reduce the deficit to 3.5 of GDP by 2020.

The outlook is subject to domestic and external risks.

External risks include disappointing growth performance in key countries that generate foreign exchange inflows to Sri Lanka: exports, tourism, remittances, FDI, private portfolio and official financing. Steeper than expected global financial conditions would increase the cost of debt and would make rolling over the maturing Eurobonds from 2019 more difficult. Faster than expected rises in commodity prices would increase pressure on the balance of payments and make domestic fuel and electricity price reforms more difficult. On the fiscal side, risks include the delay in passing structural revenue measures and slower than expected improvement in tax administration. Finally, the increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal consolidation path, the trade balance and poverty reduction.

Tackling challenges through reforms is crucial for sustained and equitable growth.

Sri Lanka faces a number of challenges that increasingly put its future economic growth and stability at risk, and thus must be addressed through determined reforms. These key challenges are inter-linked and require a comprehensive and coordinated approach. Adopting a piece-meal solution to address the challenges is unlikely to be successful. Although a turbulent external environment, domestic political

³ This does not yet the impact of the 2017 floods, as the full damage and loss have not yet been estimated.

considerations and institutional constraints on policy implementation make it challenging, a strong political will and support of the bureaucracy could help advancing the reform agenda. Steps are needed to ensure the support of private sector, civil society and other stakeholders through improved communications on costs and benefits of the reform agenda.

These challenges include:

- dealing with the weak external liquidity position and refinancing risks through managing liabilities actively;
- improving the debt management function with requisite institutional, legal and strategy frameworks to manage the costs and risks of domestic and external debt portfolios;
- staying on the fiscal consolidation path creating fiscal space for health, education, social protection and other public investments, and mitigating the impact on the poor by replacing untargeted effective subsidies to the non-poor by targeted spending;
- improving the economy's competitiveness and promoting trade and FDI to facilitate a shift in the growth model driven more by private investment and exports;
- making progress on and completing the already started governance reforms such as Right to Information, the National Audit Law and the Public Finance Law; and
- enhancing the country's resilience and disaster preparedness to deal with frequent natural disasters more pro-actively.

3. Special focus

Trade and FDI reforms are needed for sustained economic progress.

Given the significance of improving the country's outward orientation in order to realize its development goals and march towards an Upper Middle Income Country, this Edition's Special Focus Section is dedicated to a policy discussion on promoting trade and investment.

Box 1: Sri Lanka: country context

Sri Lanka is a Lower Middle-Income country with a GDP per capita of USD 3,835 in 2016 and a total population of 21.2 million people. Following 30 years of civil war that ended in 2009, Sri Lanka's economy grew at an average 6.2 percent during 2010-2016, reflecting a peace dividend and a determined policy thrust towards reconstruction and growth; although there were some signs of a slowdown in the last three years. The economy is transitioning from a previously predominantly rural-based economy towards a more urbanized economy oriented around manufacturing and services.

The country has made significant progress in its socio-economic and human development. Social indicators rank among the highest in South Asia and compare favorably with those in middle-income countries. The economic growth has translated into shared prosperity with national poverty headcount ratio declining from 15.3 percent in 2006/07 to 6.7 percent in 2012/13. Extreme poverty is rare and concentrated in some geographical pockets; however, a relatively large share of the population subsists on little more than the extreme poverty line. The country has comfortably surpassed most of the MDG targets set for 2015 and was ranked 73rd in Human Development Index in 2015.

The economy's weak competitiveness is an issue to address. Restrictive trade policies over the past decade have created a strong anti-export bias, which has been reflected in a dramatic decline in trade. While growth in Sri Lanka has been strong over the past few years, it has been inward-oriented and based on growth of non-tradable sectors. Sri Lanka also attracts a much lower volume of FDI than peer economies and the shortcomings in the investment climate pose obstacles for new firms. Moreover, significantly large state participation in the economy has implications on competitiveness in a number of sectors and labor market dynamics.

Low revenues critically impact Sri Lanka's fiscal position. The major causes of this decline are the low increase in the number of tax payers (less than 7 percent of the labor force and formal establishments pay income tax), reductions in statutory rates without commensurate efforts to expand the tax base, inefficiencies in administration and numerous exemptions. Low revenues combined with largely non-discretionary expenditure in salary bill, transfers, and interest payments has constrained critical development spending have squeezed expenditure on health, education and social protection, which are low compared to peers.

Sri Lanka has a 3-year Extended Fund Facility (EFF) program with the IMF, which is primarily focused on increasing revenues. The program calls for fiscal consolidation; transition to flexible inflation targeting; and reforms in public financial management, state enterprises and trade and competitiveness. The IMF announced that the second review reached a staff-level agreement with Sri Lankan authorities subject to submission of a new Inland Revenue Act to the Parliament by June 2017.

The government that came to power in 2015 envisions promoting a globally competitive, export-led economy with an emphasis on inclusion. It has indicated the keenness to undertake reforms in the areas of public finance, competitiveness, and governance and education sectors.

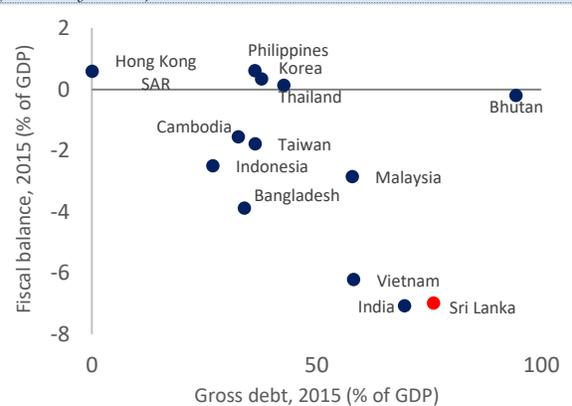
Figure 1: Sri Lanka compared to peer countries

(Percent annual change)



Figure 2: Sri Lanka compared to peer countries

(Percent of GDP)



Source: World Economic Outlook, April 2017

A. Recent Developments



Sri Lanka's growth slowed in 2016 due to a deceleration of consumption amid inclement weather.

The real sector was adversely affected by weather.

The impact of floods in the month of May and droughts in the second half of 2016 reduced the year's economic growth to 4.4 percent compared to 4.8 percent recorded in 2015. Adverse weather turned the agriculture sector's contribution to growth into a negative 0.3 percentage points⁴ while impacting related industry and service sectors (Box 2). In contrast, the construction sector's contribution to growth increased to 1.0 percentage point indicating a strong rebound from a negative contribution to growth in the previous year. This was mainly due to resumption of a few large-scale infrastructure projects and increased private construction activities. Nevertheless, the construction rebound was not sufficient to fully compensate for the dampened performance of other industry and service sectors amid unfavorable weather conditions, leading to a lower growth rate for 2016 compared to the previous year (Figure 3).

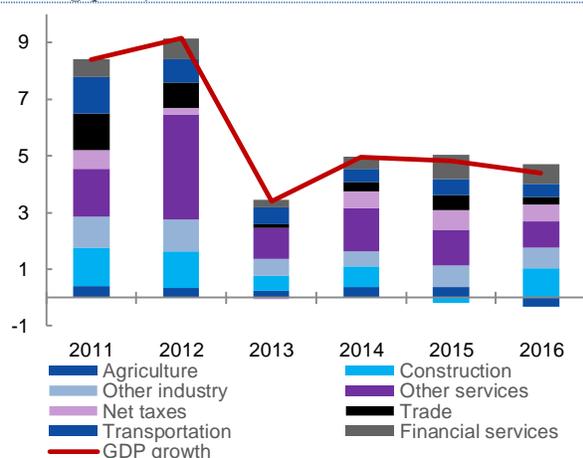
Consumption and net exports recorded subdued performance.

Contribution to growth from consumption reached a six-year-low at 0.7 percentage points with both private and public consumption growing marginally. The increase in interest rates and taxes and the impact of past currency depreciation affecting import prices reduced private consumption's contribution to growth to 0.5 percentage points. Meanwhile, on-going fiscal consolidation efforts kept public consumption in check in real terms in 2016, after the 2015 fiscal budget increased public consumption significantly. However, mirroring construction sector growth, gross fixed capital formation made a significant contribution to growth at 6.2 percentage points⁵ while net exports had a negative impact on growth of 2.5 percentage points due to increase in imports compared to exports (Figure 4).

⁴ Compared to a 0.4 percentage point positive contribution in the previous year

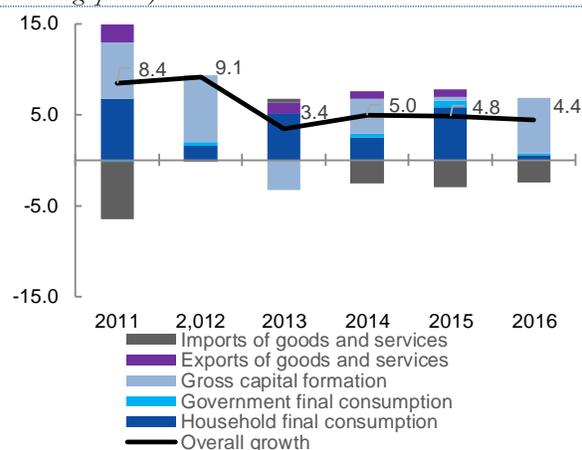
⁵ Compared to 0.4 percent recorded in 2015

Figure 3: Contributors to growth (production side)
(Percentage points)



Source: Department of Census and Statistics and staff calculations

Figure 4: Contributors to growth (demand side)
(Percentage points)



Source: Department of Census and Statistics and staff calculations

Box 2: The impact of recurring natural disasters

Sri Lanka is vulnerable to recurring natural disasters with a significant economic, fiscal and social impact:

- The **May 2016 floods and landslides** had a total estimated impact of LKR 100 billion. It was estimated that the damage was mainly to the private sector (housing, industry and commerce, LKR 90 billion), while the effect on the public sector was mainly through infrastructure and transport sector damage (LKR 8 billion). In the aftermath, the Government drew the USD 102 million World Bank's Disaster Risk Management Development Policy Loan with a Catastrophe Deferred Drawdown Option (Cat-DDO) to provide immediate liquidity. The disaster affected mainly the Colombo and Gampaha urban areas, which has a large number of people living in or close to poverty.¹
- The **late 2016 drought's** impact mainly affected the agricultural sector, and led to widespread food insecurity in the affected regions. It led to decreased exports of agricultural exports, mainly tea, and increased imports of petrol, as hydropower reservoirs ran dry. The impact can also be seen on GDP growth, where the negative impact on agriculture dragged down growth.²
- **Floods and landslides in late May 2017** have affected districts in the South-West, affected more than half a million people and caused 213 deaths and 77 people missing. This disaster destroyed over 3000 houses and partially damaged more than 20,000 houses. The economic impact of the event is being currently studied.³

On average over the long term, annual losses for housing, infrastructure, agriculture, and relief from natural disasters are estimated at LKR 50 billion (or around USD 327 million), with the highest annual expected losses from floods (LKR 32 billion), cyclones or high winds (LKR 11 billion), droughts (LKR 5.2 billion) and landslides (LKR 1.8 billion). This is equivalent to 0.4 percent of GDP or 2.1 percent of government expenditure.⁴

The execution of the budget is knocked off track continuously due to the impact of natural disasters, which seem to have increased in frequency, severity and economic impact as Sri Lanka's economy has grown and has become more sophisticated. Although fewer people were impacted than in previous floods, the damage caused by the 2016 floods and landslides was more than twice as high in US dollar terms than the worst flood disasters between 1992 and 2011.⁴

It is of utmost importance for Sri Lanka to increase its physical resilience (to reduce impact of disasters) and financial resilience (to deal with the impact when the disaster happens). To improve **physical resilience**, the World Bank is supporting the Government's Climate Resilience Improvement Project (CRIP)⁵ and recommends:

1. Identify current climate risk, and implement immediate risk mitigation interventions
2. Identify future drivers of risk
3. Create basin-level long-term risk mitigation investment plans, followed by physical investments

To improve **financial resilience**, the World Bank recommends the following options to increase the Government's immediate financial response capacity against natural disasters and better protect its fiscal balance as well as to achieve timely response, relief and recovery:

Short term

- (a) Streamline damage-and-loss data collection and reporting system
- (b) Develop a national disaster risk financing strategy
- (c) Review the sustainability of the current catastrophe insurance program implemented by the government; Enhance data sharing for insurance market development

Medium to long term

- (d) Develop financial tools to support decision making, including a disaster risk model for Ministry of Finance; Establish a National Disaster Reserve Fund as fast-disbursement mechanism for the financing of post-disaster operations;
- (e) Explore catastrophe risk insurance options for public assets;
- (f) Strengthen the agricultural insurance program

¹ "Sri Lanka: Post-Disaster Needs Assessment. May 2016 Floods and Landslides", Ministry of Disaster Management and Ministry of National Policies and Economic Affairs, in collaboration with the European Union, World Bank and United Nations, November 2016

² Sri Lanka. Joint Assessment of Drought Impact on Food Security and Livelihoods 15 March 2017, Ministry of Disaster Management, National Disaster Relief Centre, Disaster Management Centre and Hector Kobbekaduwa Agrarian Research & Training Institute.

³ Rapid Impact Assessment Report, June 1, 2017,

http://www.dmc.gov.lk/attachments/20170602_SLA%202017%20flood%20%20Rapid%20Impact%20Assessment.v02.pdf

⁴ "Fiscal Disaster Risk Assessment and Risk Financing Options: Sri Lanka", World Bank, January 2016.

<https://openknowledge.worldbank.org/handle/10986/24689>

⁵ <http://crip.lk/>

Inflation rose due to weather, VAT changes and demand pressures.

Inflation has been rising from the second half of 2016.

A combination of factors including crop losses due to adverse weather, past currency depreciation and increased indirect taxes have contributed to a rise in inflation since the second half of 2016 while low inflation levels observed in the year 2015 also pushed up the change in prices through the base-effect. Accordingly, year-on-year inflation measured by the widely watched Colombo Consumer Price Index (2013=100) reached 6.0 percent in May 2017 from 4.8 percent recorded a year earlier. Annual average inflation followed suit by rising to 5.4 percent from 2.7 during the same period. In addition to food inflation, larger contributions to the rise in prices came from health,⁶ education restaurant and hotel segments with the increase in VAT rate. Reflecting demand pressures in the economy amid continued high monetary

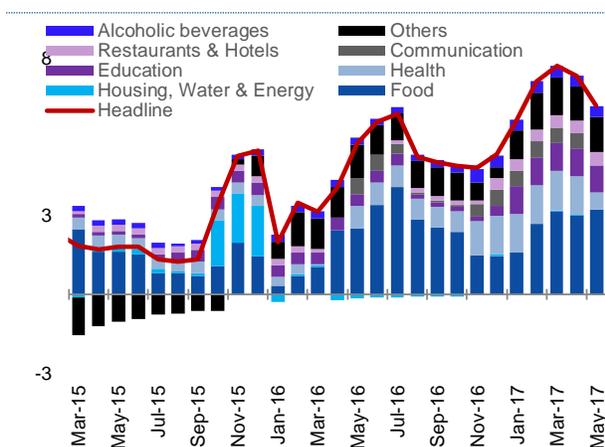
⁶ Private health activities were brought into the VAT net in November 2016 amendments.

growth, core inflation measured excluding fresh food and energy moved up to 5.5 percent by May 2017, on an annual average basis (Figure 5 and 6).

The new national price index echoed same trends.

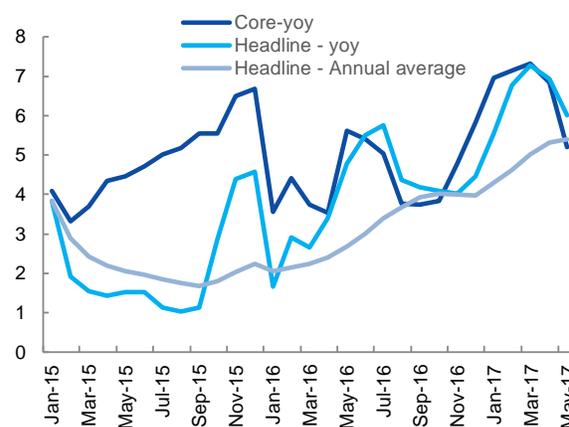
The recently introduced National Consumer Price Index (NCPI, 2013=100) that reflects price movements of all provinces of the country based on the Household Income and Expenditure Survey (HIES) reported a higher year-on-year inflation of 8.4 percent and an annual average inflation of 6.0 percent by April 2017.

Figure 5: Inflation Drivers (CCPI: 2013=100)
(Percent)



Source: Department of Census and Statistics and staff calculations

Figure 6: Headline versus core inflation (CCPI: 2013=100)
(Percent)



Source: Department of Census and Statistics and staff calculations

Rationalization of expenditure and improved revenue collection helped meeting fiscal targets.

Expenditure was rationalized to meet the deficit target as revenue disappointed the budget despite improvements.

The government revenue collection increased by 1.0 percentage point as a share of GDP in 2016 compared to the previous year, thanks to stronger than expected profits and dividends from SOEs. In addition, both policy and administration reforms⁷ helped raise tax collection; however, the improvement was masked by the previous year's one-off boost in tax revenues.⁸ In spite of recording an impressive growth, the overall revenue collection was below the budget.⁹ This warranted a disciplined approach to expenditure management in order to meet the deficit target as a share of GDP for 2016. As in the past, low execution of and cuts in public investment¹⁰ helped reduce the budget deficit while savings on purchase of goods and services kept current expenditures in check notwithstanding the rising interest costs. These measures

⁷ The measures included a hike in VAT rate hike, removal of several exemptions on VAT and Nation Building Tax, some upward rate revisions of other taxes, such as Economic Service Charge (ESC), and progressing on the implementation of Revenue Administration Management Information System.

⁸ In 2015, tax collection increased to 12.4 from 10.1 percent of GDP in 2014. Included in 2015 were a retrospective super gains tax at 25 percent imposed on corporates that generated profits over LKR 2.0 billion in 2013/14 and a spike in motor vehicle excise taxes in a vehicle imports boom.

⁹ The actual collection was 8 percent below the budget.

¹⁰ Due to "delay in land acquisition, lack of technical staff, shortage of construction material, procurement delays, delay in release of imprest from Treasury, delay in submission of bills by contractors, weak performance of contractors". "Progress of the Projects Implemented through the Capital Budget in the year 2016", Department of Project Management and Monitoring, Ministry of National Policies and Economic Affairs.

contained the fiscal deficit for 2016 at the envisaged level of 5.4 percent of GDP as against a 7.6 percent reported for 2015 (Table 1, Figure 7).¹¹

The deficit was financed mainly using foreign financing.

Foreign sources provided about 61 percent of net financing, which included sovereign bonds worth of USD 1.5 billion¹² and syndicated loans amounting to USD 700 million raised in external financial markets. The remaining 39 percent was financed through domestic sources predominantly by the banking sector, especially by the central bank. This was manifested in the treasury bill stock held by the central bank almost tripling by end-2016 compared the previous year. As in the past, Employees' Provident Fund, National Savings Bank and other savings and insurance institutions made a significant contribution to the domestic non-bank financing component.

Exchange rate depreciation and high interest rates pushed up central government debt further.

In spite of fiscal achievements, the central government debt increased by 1.6 percentage points to 79.3 percent of GDP in 2016 due mainly to exchange rate depreciation and the real interest rate effect (Figure 8). Meanwhile, the debt profile also indicated significant exposure to a variety of risks. The non-concessional and commercial component of the government foreign debt rose from 1 percent in 2000 to 53 percent in 2016. The interest rate risks on foreign currency debt has risen, while average interest rates also increased. The average time to maturity has shortened, while reserve adequacy in relation to share of the foreign-currency commercial debt component has deteriorated. Given the bunching in external Eurobond repayments, external debt service could become a matter of concern starting from 2019. These factors suggest that, in the absence of high growth rates seen in earlier years, fiscal consolidation and more efficient debt management are key to improving debt profile and bringing it back debt to a sustainable path.

The fiscal risk posed by Treasury guarantees has increased.

Treasury guarantees primarily granted to SOEs and state agencies to borrow from domestic and foreign financial institutions also showed a significant increase in 2016 although the utilization remained relatively low.¹³ Moreover, the composition of guarantees has been changing over time, with the significance of guarantees given to institutions with stable revenue streams, such as Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB), declining from 90 percent in 2006 to 36 percent in 2016 while guarantees given to state establishments, primarily dependent on the state budget, are on the rise (Figure 11).¹⁴

¹¹ The final fiscal deficit was 13 percent lower than the approved deficit estimate.

¹² During the year, USD 1.5 billion worth of sovereign bonds were issued at yields between 5.75 (5-year) and 6.825 (10-year).

¹³ Issued treasury guarantees increased as a share of GDP from 5.6 percent in 2015 to 7.1 in 2016 while the used guarantees also moved up from 3.7 to 4.4 percent of GDP during the same period.

¹⁴ Among others, these include Road Development Authority, General Sir John Kotelawala Defence University and Urban Development Authority. These agencies have no significant sources of revenue and the debt repayment will likely come from the Treasury in the future.

Table 1: Budget and Fiscal Outcomes
(Percent of GDP)

	2015		2016
	Actual	Approved	Provisional
Total Revenue and Grants	13.3	14.7	14.3
Total Revenue	13.3	14.6	14.2
Tax Revenue	12.4	13.2	12.4
Non-Tax Revenue	0.9	1.4	1.9
Grants	0.1	0.1	0.1
Expenditure and Net Lending	20.9	20.6	19.7
Recurrent Expenditure	15.5	13.7	14.8
Interest Payments	4.7	4.2	5.2
Capital Expenditure and Net Lending	5.4	6.9	4.9
O/W Public Investment	5.5	7	5
Current Account Balance*	-2.3	0.8	-0.6
Primary Balance	-2.9	-1.8	-0.2
Overall Fiscal Balance	-7.6	-5.9	-5.4
Total Net Financing	7.6	5.9	5.4
Net Foreign Financing	2.2	2.3	3.3
Net Domestic Financing	5.4	3.7	2.1

* Revenue minus current expenditure

Source: Ministry of Finance, staff calculations

Figure 7: Overall Fiscal Balance

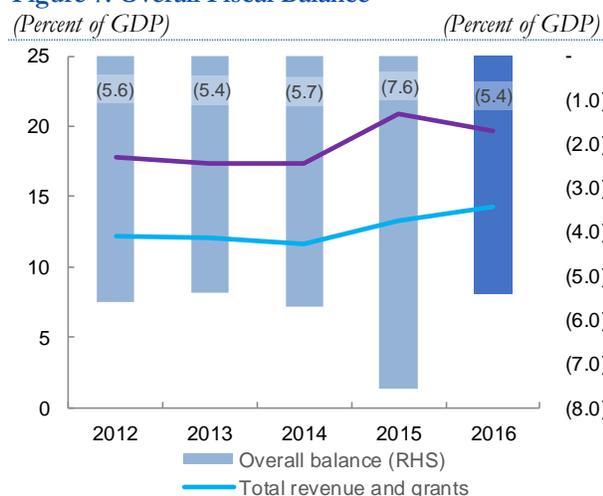


Figure 8: Public Debt Drivers

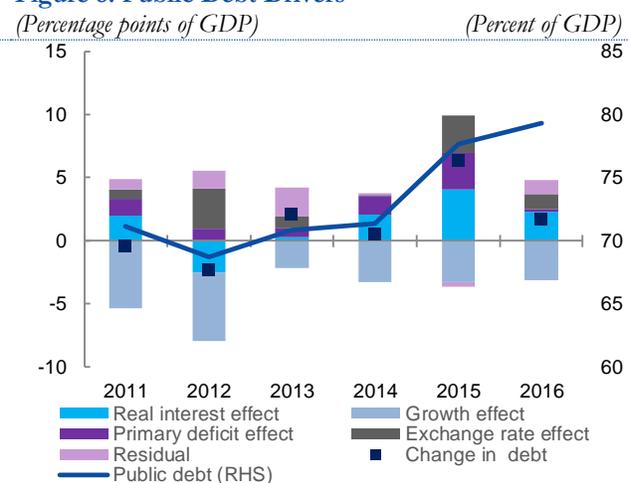
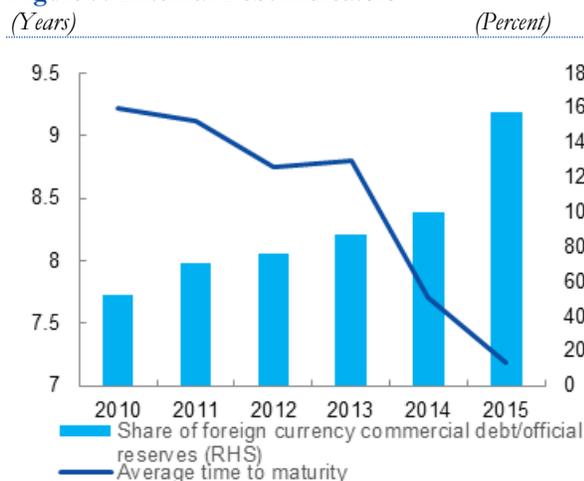
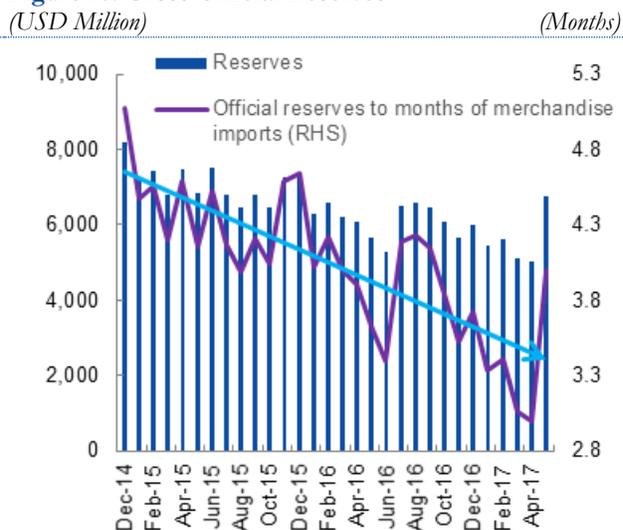


Figure 9: External Debt Indicators



Source: Ministry of Finance, staff calculations

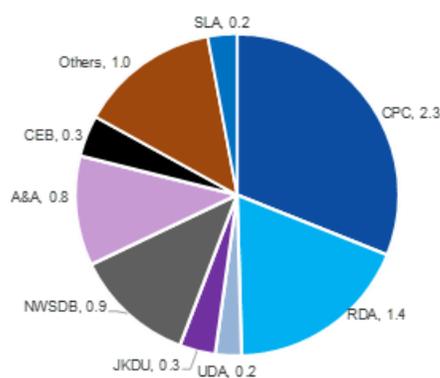
Figure 10: Gross Official Reserves



Source: Central Bank of Sri Lanka, staff calculations

Figure 11: Breakdown of guarantees, end-2016

(Percent of GDP)

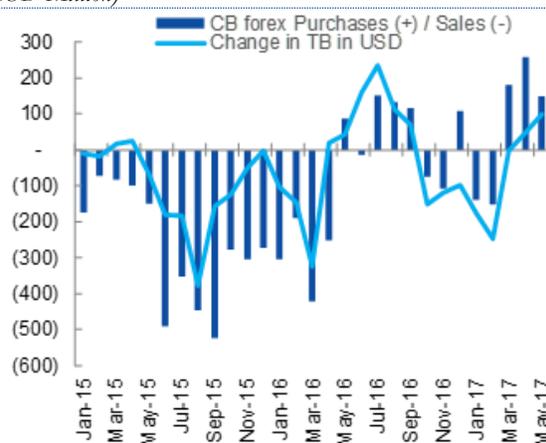


Source: Ministry of Finance, Central Bank of Sri Lanka, Sri Lankan Airlines, staff calculations

Note: CEB – Ceylon Electricity Board, CPC – Ceylon Petroleum Corporation, RDA- Road Development Authority, UDA – Urban Development Authority, NWSDB – National Water Supply and Drainage Board, JKDU – Sir John Kotelawala Defence University, SLA - Sri Lankan Airlines, A&A – Airport and Aviation Company. UDA, RDA and JKDU may not have stable revenue streams.

Figure 12: Treasury bond and bills outflows were facilitated by foreign exchange sales

(USD Million)



Source: Central Bank of Sri Lanka, staff calculations

Mixed external sector performance led to deterioration of external buffers.

Trade performance weakened the external sector in 2016.

The trade deficit expanded by 8.4 percent to USD 9.1 billion in 2016 compared to the previous year. Despite a marginal recovery of garment exports, the total exports declined with lackluster performance of agricultural exports amid drought conditions and weak demand for tea from the main buyers: Russia and the Middle East. Imports grew by 2.5 percent on a year-on-year basis due mainly to increased imports of

investment goods reflecting the impact of FDI, which increased in the last quarter. Prolonged drought conditions led to the depletion of hydropower capacity and increased petroleum imports for thermal power generation towards the end of the year. Although strong growth in tourism flows along with stable worker remittances continued to cover the trade deficit, service outflows and interest payments are expected to have led to a current account deficit of 2.4 percent of GDP.

Debt-creating flows dominated the financial account.

Volatile capital in- and outflows from the government securities market in the wake of rising global interest rates and political developments (Figure 12), external debt service payments and lower than expected FDI inflows¹⁵ exerted pressure on the external financial account in 2016. Project financing-related debt flows¹⁶ and proceeds from sovereign bonds and the syndicated loans mentioned above remained the key inflows. Reflecting external sector pressures, the end-period exchange rate depreciated by 4.0 percent against a strengthening dollar and 3.2 percent against the euro during the year.

After hitting a low in April 2017 due to adverse external developments, reserves recovered.

Swap repayments¹⁷ and the central bank's market intervention to stabilize the currency albeit in a limited scale led to loss of reserves. Despite substantially large debt-related inflows, gross official reserves declined to USD 6.0 billion by end-2016¹⁸ from USD 7.3 billion in 2015.¹⁹ They recovered to USD 6.7 billion by end-May 2017 on the back of a sovereign bond issue and purchases of foreign exchange since April. Foreign exchange obligations for the 12 months starting from March 2017 are estimated at USD 7.0 billion, implying that official reserves net of short-term liabilities are negative; nevertheless, about USD 2.3 billion or one third of these liabilities represent swap arrangements with domestic banks (which have issued medium-term international bonds) that may be rolled over.²⁰ The central bank expects that the foreign inflows related to the setting up of Hambantota PPP, the issuance of sovereign bonds²¹ and purchases of foreign exchange would shore up reserves in the coming months.

¹⁵ Direct investments were just 0.8 percent of GDP.

¹⁶ USD 2.2 billion, 2016

¹⁷ USD 700 million was repaid to settle the swap facility in 2016, which was made available by the Reserve Bank of India in 2015.

¹⁸ Equivalent to 3.1 months of imports of goods and services

¹⁹ Equivalent to 3.8 months of imports of goods and services

²⁰ However, some of the underlying Eurobonds are expected to mature in the coming year: e.g. National Savings Bank USD 750 million, Bank of Ceylon USD 500 million, DFCC Bank USD 100 million.

²¹ Sri Lanka issued its eleventh sovereign bond worth of USD 1.5 billion (having a tenure of 10 years) in May 2017. The coupon rate of 6.20 percent reflected a spread of 380 bps over the US Treasury rate for a 10-year security, which compares well with a 540 bps spread recorded in the previous issuance in July 2016. The issuance rated 'B1', 'B+' and 'B+' by Moody's Investors Service, Standard and Poor's and Fitch attracted bids over USD 11 billion achieving an oversubscription ratio of over 7 times (compared to an oversubscription ratio of 3 times in the previous issuance)

Table 2: Balance of Payments
(Percent of GDP)

	2014	2015	2016
Current Account	-2.5	-2.3	-2.4
Trade Balance	-10.4	-10.4	-11.2
Exports	14	13.1	12.7
Imports	24.5	23.5	23.9
Services (Net)	2.4	2.9	3.5
Of which: Tourism	3.1	3.7	4.3
Payments	4.7	5.1	5.2
Primary Income (Net)	-2.3	-2.5	-2.7
Secondary Income (Net)	7.8	7.7	7.9
Of which: Workers' Remittances	8.8	8.7	8.9
Capital and Financial Account	1.9	2.9	2.4
Direct Investment	1.0	0.8	0.8
Portfolio Investment	2.6	0.9	1.2
General Government	1.8	0.9	1.2
Other Investment	0.2	1.7	0
Loans	2.2	0.9	0.9
General Government	0.8	0.6	1.6
Change in Reserves	1.7	-0.6	-0.7
Memo:			
Official Reserves (Imports of Goods and Services)	4.3	3.8	3.1

Source: Central Bank of Sri Lanka, staff calculations

The monetary policy was tightened belatedly to curb rapid credit growth and rising core inflation.

Amid high monetary growth, the central bank tightened policy in 2016 and 2017.

The central bank increased the Statutory Reserve Ratio (SRR) in January and followed it up with two policy rate hikes of 50 basis points each in 2016 in order to curb high private credit growth and rising inflation. Notwithstanding the resultant overall increase in market interest rates,²² private credit granted by the banking sector recorded a 21.9 percent year-on-year growth on account of the expansion of loan book in the trade, financial and other personal service categories and construction, consistent with the large contribution to gross fixed capital formation to GDP growth in 2016.²³ The central bank increased the policy rates by 25 basis points in March 2017 as a precautionary measure to check inflationary pressures. Mirroring the high credit growth, reserve money also grew rapidly with increased central bank financing to the government to reach a record high annual average growth rate of 25 percent for the year 2016 while broad money (M2b) posted a growth of 18 percent (Figure 14). Despite high growth in monetary aggregates, market experienced occasional liquidity shortages, pushing up interest rates.

²² Driven mainly by policy rate tightening, average weighted prime lending rate increased by about 400 basis points between January

²³ The sluggish response of private credit growth to policy tightening at least in part reflects the lags in monetary policy transmission.

Listed equity returns were subdued due to political uncertainty and decelerating net foreign inflows; banking sector remained broadly stable

Listed equity market saw lackluster performance.

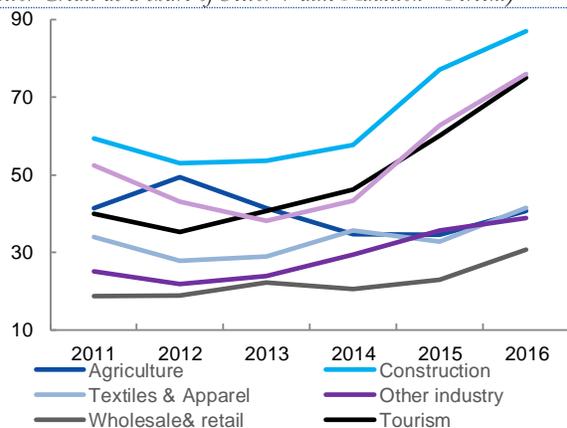
Rising domestic interest rates shifting capital to fixed income securities weighed on the results of Colombo Stock Exchange (CSE). The benchmark All Share Price Index (ASPI) declined for a second consecutive year by 9.7 percent in 2016 following a 5.5 percent decline in 2015. Market capitalization also declined as a share of GDP reflecting the trend of overall index performance.²⁴ Although dividend yield increased thanks to the decrease in stock prices, Price-Earnings ratio (PER) decreased by about 30 percent during the year 2016. However, some limited upward momentum of the indices was observed in the first quarter of 2017.

The banking sector continued to remain stable.

The banking sector remained well capitalized and adequately liquid. The regulatory Capital Adequacy Ratio (CAR) requirement under Basel II was maintained well above the required level of 10 percent and the Statutory Liquid Asset Ratio was also maintained well above the minimum statutory requirement of 20 percent during the year 2016. The expansion of the loan book was supported by the growth in deposits in a high interest environment. Faster growth in lending rates compared to deposit rates led to increased net interest income resulting improved Return on Assets (ROA) and Return on Equity (ROE) for the banking sector. Non-Performing Loan (NPL) ratio recorded its lowest level for the last two decades thanks to fast credit growth and aggressive credit recovery. However, NPL ratio could be elevated in 2017 when the pace of credit growth decelerates following two years of rapid credit growth. Moreover, increasing leverage, shown by the strong increase in credit relative to the size of the sector, such as construction, tourism and financial business, warrants attention (Figure 13). Although the sector remains well-capitalized, implementation of Basel III will require the banks to strive hard to increase the capital base.

Figure 13: Credit Leverage

(Sector Credit as a share of Sector Value Addition - Percent)

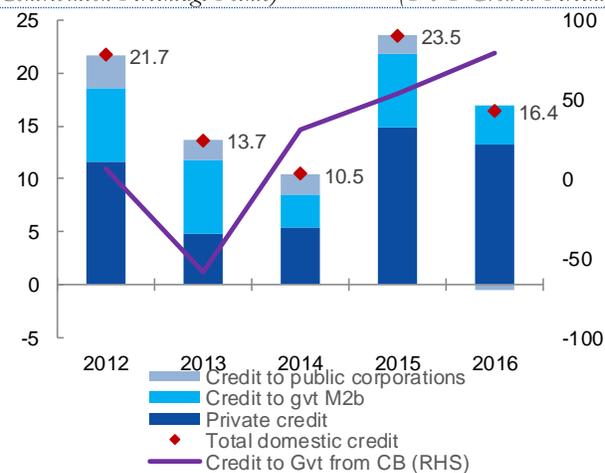


Source: Central Bank of Sri Lanka, staff calculations

Figure 14: Drivers of Domestic Credit

(Contribution Percentage Points)

(Y-o-Y Growth Percent)



Source: Central Bank of Sri Lanka, staff calculations

²⁴ Declined from 26.8 percent in 2015 to 23.2 percent of GDP in 2016

Despite the fast poverty reduction, there remain areas with significant poverty; a large share of the population subsists on little more than the extreme poverty line.

Extreme poverty is low in Sri Lanka and fell slightly further between 2009/10 and 2012/13.

Despite the recent macroeconomic challenges, extreme poverty remains low, as the \$1.90 (PPP 2011) poverty rate fell half a percentage point, from 2.4 to 1.9 percent between 2009/10 and 2012/13. The real per capita consumption of the bottom 40 percent increased 2.2 percent annually between 2006/07 and 2012/13, and improved living standards is reflected in rising asset ownership, declining shares of food consumption, and a rise in reported household per capita income among the poor. A new poverty estimates for Q1 2016 is expected to be released in May, 2017.

During the past year, labor market trends have been mixed.

Employment in agriculture continues to fall, boosting productivity and contributing to continued declines in poverty. Between 2013 and 2016, the share of employment in agriculture fell from 30.2 to 27.1 percent. Unemployment remained constant during that period, at a manageable 4.4 percent. Furthermore, perhaps due to the shift out of agriculture, the share of workers 40 hours or more increased from 65.5 to 67.9 percent of the workforce. Female labor force participation remains low and lags male rates by nearly 40 percentage points.

A large share of the population subsists on little more than the extreme poverty line.

Moderate poverty remains high. In 2012/13, nearly 15 percent of the population, and a quarter of the Estate sector, lived on less than \$3.10 per day. Furthermore, pockets of poverty persist in the North, East, Estate Sector and Moneragala district where equality of opportunities in terms of access to services and linkages to the labor market are weaker. Spending on social assistance declined in real terms between 2004 and 2014, and suffers from inefficient targeting. The decline in social assistance comes as consumption growth became markedly less pro-poor between 2009/10 and 2012/13, causing the Gini coefficient of inequality to rise sharply from 0.363 in 2009/10 to 0.389 in 2012/13. Other challenges also remain, including high rates of malnutrition, low rates of female labor force participation, and a rapidly aging population.²⁵

Drought and floods in 2016 affected poor and led to wide-spread food insecurity.

Sri Lanka underwent two severe weather events in 2016: floods and landslides in the spring of 2016 and a severe drought in the fall of 2016 (see also Box 2). The floods and landslides largely effected more urban areas. The most severely affected were Colombo and Gampaha districts, which are less poor (poverty headcount of 6.1 percent) than the national average (6.7 percent). However, their high population density makes these districts home to majority of the poor as well as the bottom 40 percent. The population affected in these two districts was 302,874, which is more than 50 percent of the total population affected by the floods.²⁶ The 2016/17 drought, which followed the floods, was one of the worst in Sri Lanka, and caused around 227,000 households to become food insecure in the affected areas.²⁷ It is expected that the deterioration of the food security status will continue until the next harvest in March 2018. The areas affected were poorer on average (11.7 percent) than the national average.

²⁵ "Sri Lanka - Poverty and welfare : Recent progress and remaining challenges", World Bank, January 2016, <http://documents.worldbank.org/curated/en/2016/02/25918944/sri-lanka-poverty-welfare-recent-progress-remaining-challenges>

²⁶ Sri Lanka: Post-Disaster Needs Assessment. May 2016 Floods and Landslides. Ministry of Disaster Management and Ministry of National Policies and Economic Affairs, in collaboration with the European Union, World Bank and United Nations, November 2016

²⁷ Sri Lanka. Joint Assessment of Drought Impact on Food Security and Livelihoods 15 March 2017, Ministry of Disaster Management, National Disaster Relief Centre, Disaster Management Centre and Hector Kobbekaduwa Agrarian Research & Training Institute.

B. Outlook, Risks and Policy Priorities



1. Outlook²⁸

A relatively favorable outlook is projected in the backdrop of policy reforms.

The continuation of the IMF program will add to the confidence while helping reform the tax system to pursue revenue led fiscal consolidation. The government has already undertaken to implement an ambitious medium-term reform agenda aimed at improving competitiveness, governance and public financial management that would bring in long-term benefits. Monetary policy has shown that it stands ready to take appropriate action in the direction of stability. This is supported by a strengthening global growth outlook, including in some countries important to Sri Lanka (Box 3). These developments have contributed to an improved outlook.

Growth is expected to pick up with manageable inflation.

Growth is expected to reach 4.7 percent in 2017²⁹ and grow marginally over 5.0 percent beyond, driven by private consumption and investment growth. Although the short to medium term growth will continue to be driven by non-tradable sectors, successful implementation of reforms should help the country to rely on productive tradable sectors in the long run. Inflation will pick up towards upper single digit level in the first half of 2017 because of past high monetary growth along with the increase of VAT collection. However, the base-effect will see inflation stabilizing around mid-single digit level towards the end of 2017. Low international commodity prices, though gradually increasing, will help maintain the downward pressure. In the medium term, the announced shift by the central bank to flexible inflation targeting will keep inflation in the single digits, while the exchange rate is left to adjust to market forces.

²⁸ Table 1 on last page

²⁹ This does not yet include the impact of the 2017 floods, as the full damage and loss have not yet been estimated.

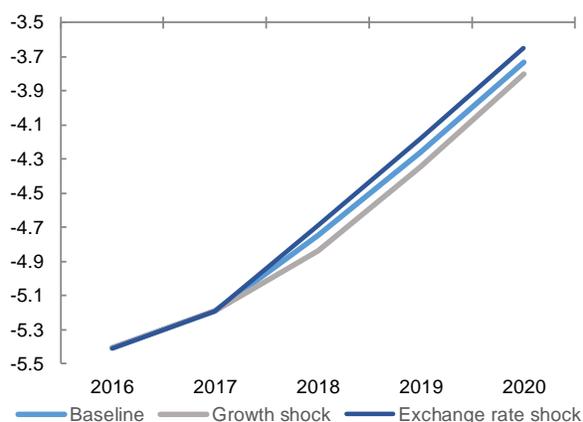
Fiscal consolidation will put the debt back on a declining path.

The fiscal deficit is projected to fall to 5.2 percent of GDP for 2017. This is thanks to the impact of VAT changes in its first full year. In outer years, the new Inland Revenue Act is expected to expand the tax base for corporate and personal income tax while shifting from tax holidays to a performance-based incentive regime, where the incentives depend on actual rather than promised investment. Further revenue increasing policy measures, especially on corporate and personal income tax, along with improved tax administration will help increase revenues. On the expenditure side, staff projects the increased fiscal space will benefit primarily public investment, assuming no major additional recurrent expenditure commitments. Under this baseline, the fiscal deficit to narrow the deficit to 3.5 of GDP by 2020. The primary fiscal balance is projected to become marginally positive in 2017.

Public debt levels are projected to fall, provided fiscal consolidation remains on track.

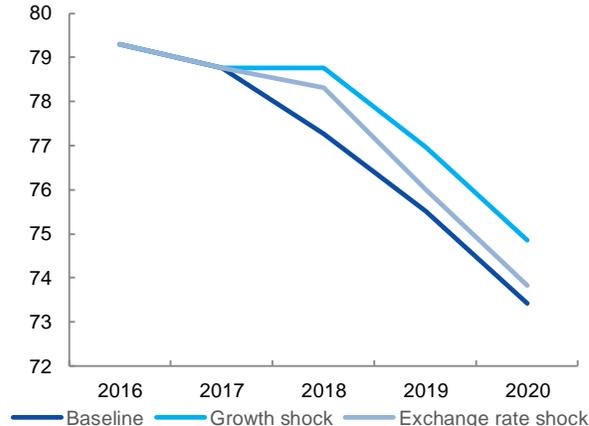
This continued fiscal consolidation is projected to bring the public debt burden on a downward path again. Fiscal discipline is even more important in an environment of rising domestic interest rates, an expected gradual tightening of global financial conditions and an expected gradual depreciation of the exchange rate, as the central bank moves to inflation targeting. Under the baseline scenario, this would return the debt-to-GDP ratio to 72 percent of GDP by 2020. However, this is subject to shocks. A shock to the growth rate or exchange rate would widen the fiscal deficit (Figure 15) and would mainly affect the path of public debt (Figure 16).³⁰ In addition, there is a risk that guarantees and other contingent liabilities are called.

Figure 15: Fiscal balance
(Percent of GDP)



Source: Staff projections

Figure 16: Public Debt
(Percent of GDP)



Source: Staff projections

The external current account deficit will remain unchanged for 2017 and widen marginally in the outer years.

With an improving external environment, with accelerating growth in the US and EU and a recovery in the Middle Eastern countries (see Box 3), the external environmental for Sri Lanka has improved, which would be favorable for exports, further tourism growth and for the stability of remittances. This may compensate the lingering impact of the 2016 drought manifested through a decline in exports and increase in petroleum imports. In outer years, while Sri Lanka will continue to benefit from continued tourism growth and the benefits of the EU's GSP+, recovering global commodity prices and external interest payments will lead to a widening deficit. These projections do not yet take into account the impact of intended structural reforms

³⁰ Shocks considered were: (a) 10 percent currency depreciation for 2018 and; (b) a reduction of real GDP growth rate to 3 percent in 2018.

and the expected signing of trade agreements, which would be an upside risk to exports.

With emphasis on market forex purchases, external buffers are to improve in 2017.

Inflows to the government and FDI inflows will help closing the external financing needs with no Eurobond falling due in 2017. A pick up in FDI is projected with a boost received from the Colombo International Financial Centre project and earmarked large investment projects. External buffers are projected to improve, with emphasis placed on purchasing foreign exchange, maintaining a more market-determined exchange rate, using monetary policy and the sale of selected government assets. Supported by forex disbursements under the IMF EFF, project loans, other multilateral borrowings and planned sovereign bonds, the official reserve cover to imports of goods and services is projected to increase above 3.7 months by 2018. In the outer years, unless export and FDI growth accelerates, more external borrowing will be needed when large repayments are due in Eurobonds issued by the government and the state banks. Emphasis, therefore, is needed on improving non-debt creating forex flows in the financial account.

Box 3: Global economic context

Growth and prices: Global growth is firming, contributing to an improvement in confidence. A recovery in industrial activity has coincided with a pick-up in global trade, after two years of marked weakness. In emerging market and developing economies (EMDEs), obstacles to growth among commodity exporters are gradually diminishing, while activity in commodity importers remains generally robust. As a result, and despite substantial policy uncertainty, global growth is projected to accelerate to 2.7 percent in 2017, up from a post-crisis low of 2.4 percent in 2016, before strengthening further to 2.9 percent in 2018-19 (Table 3.1).

Commodity prices have continued to rise moderately, although prospects for increased U.S. shale oil production are weighing on the outlook for oil prices.

Financial markets: Global financing conditions have been benign and benefited from improving market expectations about growth prospects. Financial market volatility has been low despite elevated policy uncertainty, reflecting investor risk appetite and, perhaps, some level of market complacency. Renewed risk appetite has supported EMDE financial markets and led to a narrowing of corporate bond spreads globally. Capital inflows to EMDEs were robust in the first half of 2017, partly in a rebound from late-2016 weakness. Over time, however, a gradual tightening of international financing conditions may weigh on capital flows to EMDEs.

Risks: Substantial risks cloud this outlook, despite the possibility of fiscal stimulus in some major advanced economies, particularly the United States. Escalating trade restrictions could derail a fragile recovery in trade and undo gains from past liberalization efforts. A further increase in policy uncertainty from already high levels could dampen confidence and investment and trigger financial market stress, after a period of unusually low financial market volatility. Market reassessment of advanced-economy monetary policy, or disorderly exchange rate developments, could contribute to swings in EMDE asset prices and capital flows, potentially amplified by vulnerabilities in some countries. Over the longer term, persistent weakness in productivity and investment growth would erode potential growth.

Factors affecting EMDE growth prospects: Even if the expected modest rebound in investment across EMDEs materializes, slowing capital accumulation in recent years may already have reduced potential growth. Moreover, structural headwinds to global trade, worsening demographics, slowing productivity growth, and governance and institutional challenges could adversely affect EMDE growth.

South Asia: Growth in the region is forecast to pick up to 6.8 percent in 2017 and accelerate to 7.1 percent in 2018, reflecting a solid expansion of domestic demand and exports. Excluding India, regional growth is anticipated to hold steady at 5.7 percent, rising to 5.8 percent, with growth accelerating in Bhutan, Pakistan, and Sri Lanka but easing in Bangladesh and Nepal. India is expected to accelerate to 7.2 percent in fiscal

2017 and 7.5 percent in next fiscal year. Pakistan is expected to pick up to a 5.2 percent rate in fiscal 2017 and to 5.5 percent in the next fiscal year, reflecting an upturn in private investment, increased energy supply, and improved security.

Table 3: Growth prospects for key partners of Sri Lanka

	2015	2016	2017	2018	2019	Key Financial Flows
	Actual	Estimates	Projections			
World	2.7	2.4	2.7	2.9	2.9	
United States	2.1	1.7	1.9	1.8	1.7	Garment Exports, Portfolio Flows
United Kingdom	2.2	1.8	1.7	1.5	1.5	Garment Exports, Tourism, FDI
Euro Area	2.0	1.8	1.7	1.5	1.5	Garment Exports, Tourism, Portfolio Flows
China	6.9	6.7	6.5	6.3	6.3	Tourism, FDI, Official Bilateral Financing
India	7.9	6.8	7.2	7.5	7.7	Tourism, Remittances
Saudi Arabia	4.1	1.4	0.6	2	2.1	Remittances
Russia	-2.8	-0.2	1.3	1.4	1.4	Tea Exports
United Arab Emirates	3.8	2.3	2	2.5	3.2	Remittances
Japan	1.1	1.0	1.5	1.0	0.6	Official Bilateral Financing

Source: World Bank Global Economic Prospects, June 2017

The Global Economic Prospects report is published in January and June each year. The latest report and regional outlooks can be found at: <http://www.worldbank.org/en/publication/global-economic-prospects>

Updates are posted to: Twitter: [@wb_research](https://twitter.com/wb_research) and the Prospects blog: <http://blogs.worldbank.org/prospects/>

2. Risks

The outlook is subject to a number of risks

External risks include disappointing growth performance in key countries and regions, such as the US, European Union, China and the Gulf states that provide foreign exchange inflows to Sri Lanka: exports, tourism, remittances, FDI, private portfolio and official financing (Table 3). Faster than expected rises in commodity prices would increase pressure on the balance of payments and make domestic fuel and electricity price reforms more difficult. On the fiscal side, risks include the delay in passing structural revenue measures and slower than expected improvement in tax administration. Tightening global financial conditions would increase the cost of debt and would make rolling over the maturing Eurobonds from 2019 more difficult. Finally, the increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal consolidation path, the trade balance and poverty reduction.

3. Challenges and policy priorities

Tackling challenges through reforms is crucial for sustained and equitable growth.

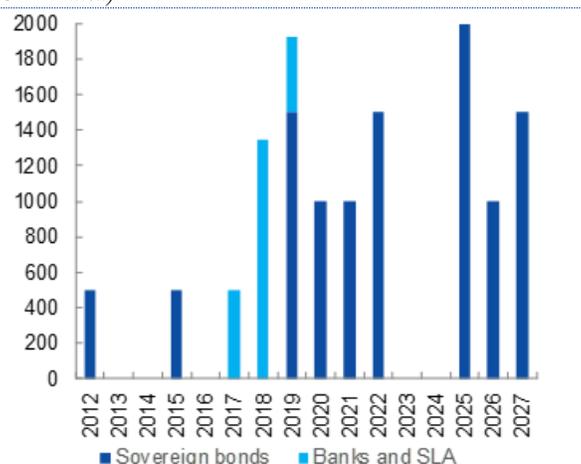
Sri Lanka faces a number of challenges that increasingly put its future economic growth and stability at risk, and thus must be addressed through determined reforms. These key challenges are inter-linked and require a comprehensive and coordinated approach. Adopting a piece-meal solution to address the challenges is unlikely to be successful. Although a turbulent external environment, domestic political considerations and institutional constraints on policy implementation make it challenging, a strong political will and the support of the bureaucracy could help advancing the reform agenda. Steps are needed to ensure the support of private sector, civil society and other stakeholders through improved communications on costs and benefits of the reform agenda.

The immediate challenge is to deal with the weak external liquidity position.

The immediate challenge is to deal with the weak external liquidity position. This is mainly due to significantly large Eurobonds falling due starting 2019 (Figure 17). Rather than waiting until then, the Government can start to actively manage these liabilities now, while financial conditions are still relatively benign. This can be done by buying them back ahead of their maturity, and switching them with longer maturity bonds, which will reduce the refinancing risk. This will require a change in the legal framework to allow for liability management operations.

Figure 17: Eurobond Repayments

(USD Million)



Note: SLA – Sri Lankan Airlines

Source: Central Bank of Sri Lanka, Ministry of Finance, Sri Lankan Airlines, Staff calculations

There are structural debt management challenges.

The country's transition towards Upper Middle-Income status is expected to lead to more commercial borrowing terms and increase the cost and risk. The fragmented legal and institutional framework of debt management and lack of a comprehensive debt management strategy leaves the public sector exposed to a debt portfolio with high cost and risk on the domestic market as well. The Private Public Partnership (PPP) agenda may move the direct fiscal cost of investment to the private sector, but may require the public sector to assume more fiscal risk. In this context, the Government has taken steps to set up a unified Debt Management Office (DMO), but progress has been slow since then. A proactive debt management strategy can provide guidance to the DMO to consider trade-off between the costs and risks of

available domestic and external borrowing options, while enhancing transparency and predictability in the domestic financial market that will contribute to capital market development. Proactive liability management will reduce medium-term external refinancing risks.

Staying on the fiscal consolidation path is a key priority.

Raising more revenue while controlling current expenditure is needed to reduce the fiscal deficit and bring public debt to a sustainable path. Following the success in 2016, emphasis is needed on raising tax revenues structurally without relying much on non-tax revenues driven by SOEs. Continued fiscal consolidation will help the country prepare for additional public spending on expanding pension coverage, old-age health and long-term care in the medium to long term as Sri Lanka's demographic transition advances. Fiscal space is equally important to increase investment in human and physical capital and the provision of other public goods to sustain growth in the medium term with an aging population. A reduced fiscal deficit will also limit exposure to global financial markets, which have become more volatile recently and which are expected to gradually become tighter, and to free up credit for the private sector in the domestic market. A reduced fiscal deficit, a reduced debt level and more predictability in the markets will also reduce the burden on the central bank to provide temporary financing, which gives it more operational independence to pursue an appropriate monetary and exchange rate policy for the country.

Implementing the new Inland Revenue Act is a good start.

The new Inland Revenue Act, to be submitted to the Parliament by June, and further reforms are needed to widen the tax base, make the current tax system simpler and more stable, and make administration more efficient. The government has already announced an incentives structure, which relies on investment allowances to promote investment and job creation instead of pursuing fiscally expensive tax holidays, exemptions and special rates. Although there is room for improvement through sector targeting, investment allowance based incentives could be helpful for simplification and reduce leakages while preserving competitiveness.

The impact of fiscal consolidation on the poor is a key policy consideration.

In order to consolidate the gains in poverty reduction, a careful consideration of distributional impact of tax and spending on poverty will make it possible to increase tax collection, while offsetting the negative impact on the poor. For example, it appears that little of the direct benefits of many current VAT exemptions accrue to the poor. In fact, virtually all tax exemptions are less efficient in helping poor, since wealthier households account for the majority of consumption on almost all specific items. However, removing them does come at the cost to the poor. Replacing them by targeted expenditure under the social safety net could be a more efficient way to protect the poor at a lower fiscal cost, while simplifying the VAT system. Ongoing efforts to reform the targeting system used by the flagship Samurdhi Social Protection program will help in this regard. The increased fiscal space could be used for investment in public health and education provision and infrastructure to benefit poor areas.

Improving trade and FDI is key to ensure growth and strengthen its external position

Sri Lanka needs to shift from a public investment, non-tradable sector-driven growth model to a private investment, tradeable sector-led model, to sustain its growth, strengthen its structurally weak current account, create new, productive jobs in the private sector, and reduce poverty. The Special Focus section below discusses challenges and policy priorities in this area with emphasis and trade and FDI.

Governance reforms will support fiscal

In a landmark improvement of transparency and governance, the Government passed a strong Right to Information Law in 2016. A Constitutional Amendment to

sustainability and overall competitiveness.

strengthen the supreme audit institution was a key first step, which is expected to be followed by an Audit Bill, providing for greater administrative and financial independence. A decision to move forward on drafting a comprehensive Public Finance Act will provide clarity on roles and responsibilities in the management of public assets and improve budget credibility. A legal framework for SOEs strengthened audit function as well as improved public financial management and oversight of public enterprises could improve fiscal performance as well as public sector effectiveness, including for public enterprises.

The ability to deal with recurring natural disasters is becoming important.

The increased frequency, severity and economic impact of natural disasters means that Sri Lanka should increase its physical resilience to reduce impact of disasters, and increase its financial resilience to deal with the impact when the disaster happens. Box 2 discusses a number of policy recommendations to increase resilience.

C. Special Focus



1. Special Focus: Unleashing Sri Lanka's Trade Potential

Box 4: Policy recommendations to improve trade and business environment and FDI

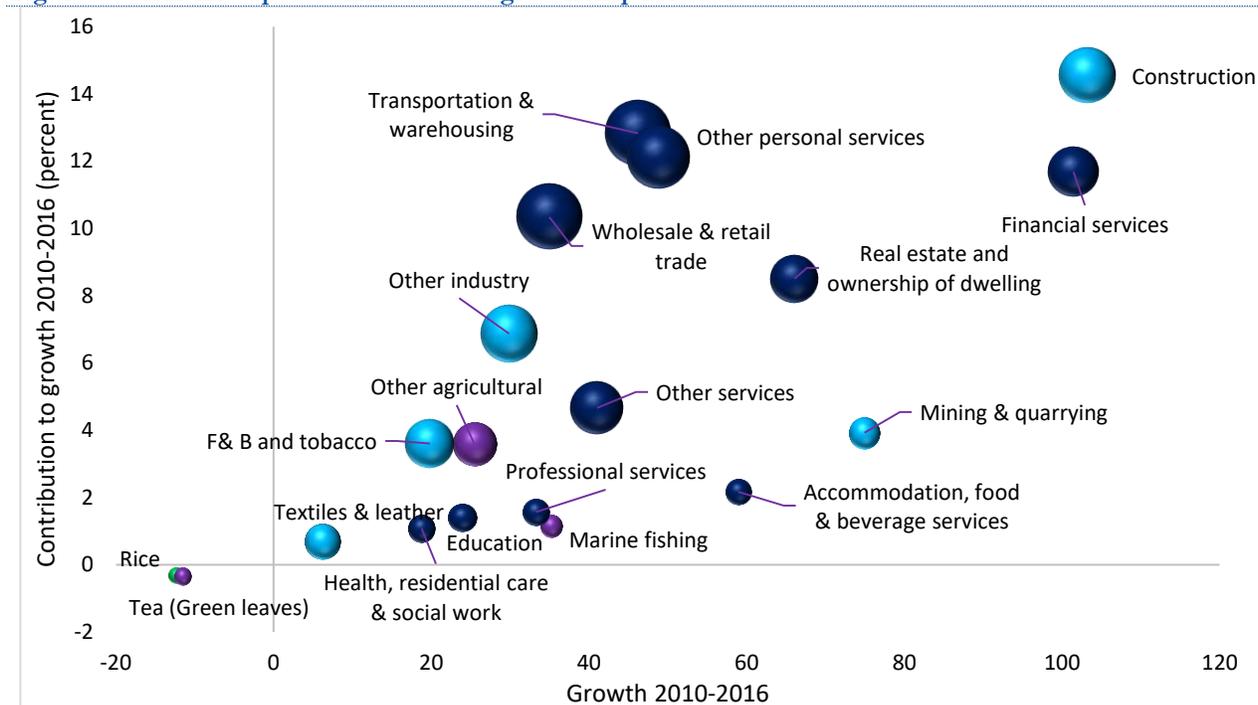
This section contains a number of policy recommendations, which are summarized here:

- Trade policy: (1) adopt trade policy with a gradual but firm liberalization schedule, allowing time for adjustment to avoid a sudden shock to fiscal revenue and the balance of payment; and (2) make progress on bilateral trade agreements while carefully evaluating the costs and benefits to Sri Lanka, with a particular focus on non-tariff barriers and Mutual Recognition Agreements.
- Trade facilitation: (1) adopt a systematic and effective risk management system, the absence of which imposes a huge burden in terms of time and cost, adversely impacting competitiveness; and (2) create a single trade information portal will help meet the informational needs of businesses.
- Innovation: improve the innovation landscape in Sri Lanka especially for SMEs and start-ups.
- FDI attraction: (1) enhance effectiveness of the Board of Investment as a 'one-stop shop' for foreign investors; (2) strengthen BOI's investment attraction capabilities by adopting modern tools and techniques in sector targeting, investor outreach, and investor facilitation; (3) strengthen investment retention capacity through 'after sales services' for existing investors; and (4) address regulatory barriers to FDI in backbone sectors to promote exports.
- Ensure coherence and coordination between investment policy and trade policy with a clear indication of future policy direction.
- Conduct awareness campaigns and adopt an effective communication strategy to dispel concerns regarding PTAs.
- Enhance institutional capacity of GoSL to address the shortcomings in the investment climate undermining the competitiveness of the private sector.
- Formulate a legal framework and policies to help firms and workers adjust to the impact of trade policy reforms and allow them to seize new opportunities.

Sri Lanka's march towards an Upper-Middle-Income Country hinges on the economy's competitiveness and its ability to pursue an export-led growth model.

While Sri Lanka has grown rapidly in the past, the non-tradable drivers of such growth are unlikely to remain adequate for inclusive and sustainable growth in the coming decade.^{31,32} Given the context of continued weak external liquidity, foreign exchange generated through tradeable sectors is even more important for Sri Lanka. In order to benefit from an export-led growth model, which is necessarily based on trade, it is important that Sri Lanka strengthens its competitiveness in order to promote trade and FDI, leverage its locational advantage of geographical proximity to the powerhouses, establish the necessary conditions for a thriving knowledge economy, integrate productive local companies in global value chains, and attain higher value addition in the manufacturing sector. This reform process will be key for Sri Lanka's sustained economic prosperity (Figure 18).

Figure 18: Sri Lanka's post conflict sectoral growth map 2010-2016



Note: Bubble size corresponds to the industry size within the GDP composition in 2017. Bubble colors indicate the relevant sub-sector: purple-agriculture, light blue-industry, dark blue-services
Source: Department of Census and Statistics and staff calculations

Sri Lanka can choose the path that allows realization of its

Sri Lanka was a pioneer in trade liberalization among South Asian countries, where export-oriented jobs were strong contributors to poverty reduction and inclusion.

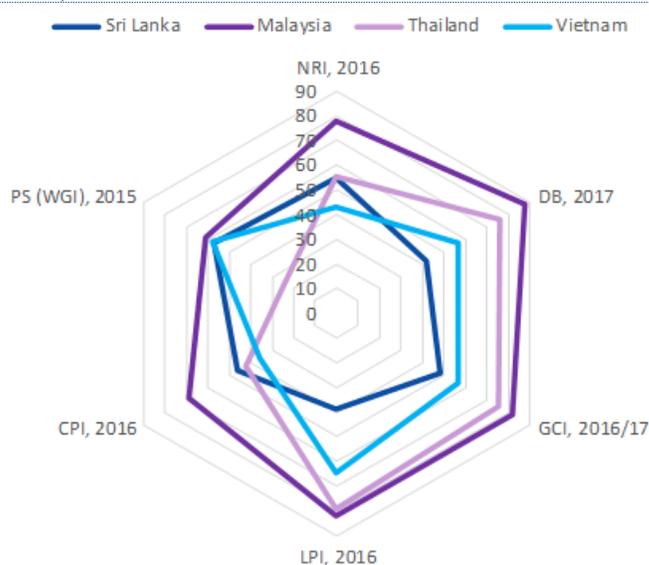
³¹ Tradable activities can be an engine of economic growth, job creation and poverty reduction; particularly in the small open economy context. In general, shifting resources into tradable sectors, led by manufacturing, is desirable for emerging markets because productivity gains are higher in tradable sectors than in non-tradable sectors. (World Bank (2013), 'Island of Prosperity? Ideas for Accelerating Inclusive Economic Growth in Sri Lanka', Washington, DC.) In Sri Lanka, the share of manufacturing output, which was 18.7 percent in 2000, rose to 19.5 percent in 2005, and declined to 16.3 percent by 2016 due to faster growth in the services sector.

³² The real GDP expanded by 40.5 percent from 2010 to 2016 with the top six sectors contributing to 70.0 percent of the total growth were all non-tradables: construction, transport, other personal services, financial services, wholesale and retail trade, and real estate. However, agriculture that employs around 28 percent of the total labor force contributed to only 4.1 percent of the growth while all other manufacturing/service sectors collectively accounted for 25.9 percent of the growth.

growth potential and the aspirations of its people.

However, policy reversals since the mid-2000s have led to a regression back to the trade restrictiveness of the 1970s. Restrictive trade policies over the past decade have created a strong anti-export bias, which has been reflected in a dramatic decline in the trade-to-GDP ratio (from 89 percent in 2000 to 48 percent in 2016) and an unchanged composition of exports. While growth in Sri Lanka has been strong over the past few years, it has been inward-oriented and based on growth of non-tradable sectors. Sri Lanka also attracts a much lower volume of FDI (less than 2 percent of GDP) than peer economies, reducing its ability to improve production processes, diversify production, and enhance trade. At the same time, the investment climate, which is lagging behind those of its peers (Figure 19), pose obstacles for new firms to be created and for existing ones to grow and compete. The decline in openness and stagnating FDI took place when the rest of the world was integrating more strongly, thus resulting in a decline in Sri Lanka's world market share to the levels last seen in the 1980s.

Figure 19: Sri Lanka's competitiveness indicators compared to peer countries
(USD Million)



Note: Cobweb shows the percentile rankings of countries under each of the index.

Sources: CPI – Corruption Perception Index; NRI – Network Readiness Index; DB – Doing Business; LPI – Logistics Performance Index; PS (WGI) - Political Stability (World Governance Indicators)

GCI – Global Competitiveness Index

A new trade policy can help to reduce anti-export bias in the economy.

The introduction of para-tariffs during the last decade has effectively doubled the protection rates (from an average Most Favored Nation, MFN, tariff rate of 13 percent to average total nominal protection rate above 28 percent), making the present import regime one of the most complex and protectionist in the world. Additionally, para-tariffs' dispersion leads to prices that distort production and consumption patterns. Higher rates of protection on final products than on inputs used in their production has created an anti-export bias, since producers have strong incentives to sell goods domestically. This is particularly worrying for the agricultural sector, where high protection of import-competing crops along with fertilizer subsidies have created strong disincentives for crop and export diversification. On the one hand, the protection afforded to agriculture encourages expansion of production of import-competing crops (rice, maize), and, on the other hand, the introduction of high export taxes ("cesses") on raw materials such as tea, rubber,

cinnamon, coconut and spices, with the notion that this would increase value addition of exports, discourages the production of exportables. Trade barriers also make it difficult for firms to access world-class inputs at competitive prices, thus reducing the ability of firms to compete and integrate into Global Value Chains (GVCs) and Regional Value Chains (RVCs).

Trade policy reforms can be devised with potential revenue neutrality or even gains if imports (and exports) increase due to reforms.

Sri Lanka's structurally low tax-to-GDP ratio and its heavy reliance on trade taxes (on average 40 percent from import related taxes³³ and 13 percent from protective taxes³⁴ in the total tax revenue) complicates trade reform. However, if Sri Lanka's trade-to-GDP ratio increased back to what it was in 2000 (89 percent) or even more to 160 percent (as in the case of Vietnam), even low tariffs could yield significant import revenues. Thus, the new trade policy, while being mindful of the impact of tariff reform on fiscal revenue and balance of payments, needs to incorporate a gradual but firm liberalization schedule, allowing time for adjustment, with a fixed phase-out schedule (sunset). It is clear that para-tariffs need to be consolidated, reduced in magnitude, and eventually eliminated, as they are non-transparent in nature and their ad-hoc imposition as an easy "go-to" for revenue generation takes away predictability, which is critical for production and investment decisions. Similarly, export taxes on agricultural commodities need to be revisited as the rationale behind them is no longer clear. Policy simulations suggest that the expected increase in economic activity and trade, and other ongoing tax revenue reforms will offset the possible losses from reducing the tariff and para-tariff rates.

Sri Lanka can use Preferential Trade Agreements (PTAs) as an instrument of its trade policy, and pursue them strategically to maximize benefits.

While Sri Lanka is committed to multilateralism and needs to remain engaged in the WTO to safeguard its interests, it cannot ignore the fact that nearly 50 percent of global trade now takes place through regional, plurilateral, and bilateral trade agreements. Given that it will have to increasingly depend on the growing markets of Asia for export growth, PTAs with Asian countries like China and India need to be viewed as opportunities rather than threats, while carefully evaluating the costs and benefits to Sri Lanka from each PTA. Also, in negotiating new PTAs, Sri Lanka needs to be mindful of the lessons from existing PTAs – non-tariff barriers are as important to address as tariff barriers, Mutual Recognition Agreements are critical for trade facilitation, widespread awareness campaigns are vital for information dissemination, and an effective communication strategy is essential to dispel concerns regarding PTAs.

Improved trade facilitation is also key to capitalize on the strategic location and excellent port facilities in order to become a distribution and logistics hub.

Sri Lanka ratified the WTO's Trade Facilitation Agreement, which is a good step, but needs to be done to improve the trade facilitation environment. Sri Lanka requires a coordinated border management policy and strategy that allows for a more coordinated approach to management of the import and export processes and related requirements by all involved government agencies. Establishment of the National Trade Facilitation Committee (NTFC), in June 2014, should help towards this. While automation has been introduced by Customs through implementation of ASYCUDAWorld as its Customs processing system, all the various agencies that are involved in import and export processes are not connected to the system; there is no national electronic single window facility. A systematic and effective risk management system needs to be adopted to reduce the huge burden in terms of time and cost on firms, adversely impacting competitiveness. The creation of a single trade information portal will help meet the informational needs of businesses more easily given that more than 30 agencies are involved in import and export processes.

³³ Import duty, PAL, SCL, CESS and excise taxes on petroleum and motor vehicles

³⁴ PAL, SCL, CESS

Firm competitiveness needs to be improved as opportunity widens to compete in global markets.

Sri Lanka is keen to expand its role in international trade through various FTAs and the recently renegotiated GSP+ concessions. However, the positive effects of these engagements are likely to be suboptimal if Sri Lankan firms are limited in capacity to respond to global demand (Box 5). Therefore, it is important that the domestic producers invest in new production processes to improve quality and reliability and adopt new technologies to identify ways in which they could compete in the global markets.

This would require the policy makers undertake targeted policy reforms to improve the innovation landscape in Sri Lanka by:

1. Revitalizing the export-oriented small and medium enterprises (SMEs) through reducing the barriers to entry and operate in the domestic business environment;
2. Fast-track the formation and scaling of growth-oriented start-up companies;
3. Rationalize and upgrade the research and development (R&D) sector.

Sri Lanka also needs to enhance its ability to attract and retain FDI.

In addition to boosting investment necessary for growth and providing long-term balance of payments financing, FDI can help to enhance the sophistication of Sri Lankan products and exports through introduction of new technologies and production processes. It can also give rise to positive spillovers to the rest of the economy through diffusion of better skills, technology and management practices. Finally, FDI can enhance access of Sri Lankan producers to global production networks and facilitate the development of new activities within existing value chains. However, FDI in Sri Lanka has been disappointing. Even five years after the end of armed conflict, FDI remains below 2 percent of GDP, much lower than in other MICs such as Vietnam or Cambodia. Moreover, FDI inflows to Sri Lanka have largely focused on infrastructure (inclusive of real estate development), with a relatively small proportion reaching sectors of the economy that are associated with global networks of production. Poor FDI performance has reinforced poor trade outcomes given the strong trade-investment nexus.

To boost FDI, there is a need to address challenges in the legal framework including enhancing investor protection and policy predictability.

There is a need to enhance the effectiveness of Board of Investment (BOI) as a ‘one-stop shop’ for foreign investors. At the same time, it is important to strengthen BOI’s investment attraction capabilities by adopting modern tools and techniques in sector targeting, investor outreach, and investor facilitation, as well as to strengthen investment retention capacity through a variety of ‘after sales services’ for existing investors (as in Malaysia). It is important to address regulatory barriers to FDI, including FDI in backbone services, which are also critical for competitiveness of manufacturing exports. The new performance-based incentive regime, rewarding actual rather than intended investment, included in the draft Inland Revenue Act is expected to be more efficient at attracting FDI than the current regime based on tax holidays, which has not attracted sufficient FDI and benefitted mainly firms in the non-tradable service sector with limited impact on employment. Most importantly, there is a need to ensure coherence and coordination between investment policy and trade policy with a clear indication of future policy direction—one of the goals of the new trade policy framework.

Box 5: Impact of mega-regional trade agreements on South Asia and Sri Lanka

Recent global political developments suggest that for many people in advanced economies globalization has gone too far. Political events in the UK and the US have been interpreted as signaling a shift against the international trade architecture including mega-regional trade agreements. However, it is noted that recently stalled mega-regional trade agreements, which did not include any South Asian country, were expected to reduce South Asia's competitiveness. In fact, simulations on the impact of hypothetical new trade barriers applied across the board suggest that the harm for the region would be limited; while a scenario where hypothetical new trade barriers would be applied selectively, South Asia could actually benefit from trade diversion. Sri Lanka also stands to gain from the observed growth recovery in advanced economies, because they are the main markets for its exports. The gains would be larger if its exports were more diversified and its supply response were more elastic. The current globalization backlash should thus not dissuade South Asian countries including Sri Lanka from having a stronger outward orientation.

The recently published World Bank South Asia Economic Focus looks at the impact of recent trade-related global developments on the South Asia region. The full report is available online at: <https://openknowledge.worldbank.org/handle/10986/26373>

Institutional capacity of GoSL needs to be enhanced to address the shortcomings in the investment climate undermining the competitiveness of the private sector.

The challenges in the investment climate are manifold and across most areas of regulation governing the activities of private enterprises, from long lead times for registration of firms, connection of utilities and obtaining permits to construct premises, to costly ongoing processes such as import and export and accessing finance, to uncertain and time consuming legal procedures such as enforcement of contracts and winding up of businesses.

High transaction cost associated in complying with unnecessarily burdensome regulations which undermine entrepreneurship is a factor contributing to the high level of informality prevalent in the country. In turn, unfair competition from informal businesses is one of the main obstacles that has stunted the growth of Sri Lanka's formal sector, which in turn has been a drag on firm productivity.

According to the 2017 survey results, Sri Lanka ranks 110 out of 190 economies in the Ease of Doing Business Index. In October 2016, the Government of Sri Lanka (GoSL) announced the Government's intention to improve Sri Lanka's investment climate and reach a top 70 ranking on the World Bank's Ease of Doing Business Index by 2020.

GoSL needs to recognize that its policies and behaviors play a critical role in shaping the investment climate in Sri Lanka. In this context, a well-defined framework covering set of initial reforms that will be pursued, the timeframe for accomplishment of the reforms expected, the roles and responsibilities of all relevant stakeholders and a mechanism to monitor progress on an ongoing basis and promptly identify and address bottlenecks are essential to lead reforms going forward.

It is clear that investment reform is a cornerstone of meaningful and long-term growth; it attracts investment that generates employment opportunities, provides access to knowledge capital, and plays a significant role in formalizing the informal sector in Sri Lanka's economy.

Reforms have a differentiated impact

The Government will need to be cognizant of the fact that policy reform will lead to gains, which are often dispersed over time and space, as well as losses, which can be

on different segments of the economy.

immediate. There will be sectors, firms, and workers that will succumb to competition unleashed with the opening up of the economy and declining protection for domestic industries. However, it is important to focus on the fact that the costs will be far outweighed by the overall benefits to the Sri Lankan economy. Firms and exporters will gain access to world-class inputs at competitive prices, and thus be able to breach new markets. Since trade and investment complement each other, trade liberalization will also bring FDI, which, in turn, will bring skills, technology, and foreign capital as well as access to GVCs and new markets. Most importantly, Sri Lankan consumers, whose welfare has to be given due consideration, will gain – they will have access to goods of greater variety, better quality, and at cheaper prices.

The Government needs to ensure that those who are negatively affected by reforms are not forgotten.

Keeping that in view, reforms should be carefully sequenced and calibrated, but with a finite schedule, to allow time for adjustment. The phasing in period will also allow the opportunity to address crosscutting competitiveness issues that hamper firm productivity. It will also be important to design appropriate retraining programs to facilitate movement of workers out of the affected firms and sectors. Similarly, it will be important to ensure there are business support programs that help firms, for instance, to negotiate new markets by supplying the requisite market information. Making progress on the Secured Transactions Act, which would facilitate the use of movable assets as collateral for bank loans, would give SMEs improved access to finance and make it easier for them to benefit from new opportunities.

D. World Bank Group Assistance



The World Bank Group is committed to supporting Sri Lanka's transition to an upper middle-income country.

The World Bank Group has been supporting Sri Lanka's development for close to six decades, having accompanied the country as it has grown to join the ranks of middle-income countries. Sri Lanka is in many ways a development success story, and yet faces a number of critical challenges as it pursues its goal of becoming an upper middle-income country. The Systematic Country Diagnostic (SCD)³⁵ carried out in 2015 identifies critical constraints and opportunities that Sri Lanka faces in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. They include: (i) achieving fiscal sustainability; (ii) enhancing competitiveness and promoting more and better jobs for the bottom 40 percent; (iii) providing for social inclusion for disadvantaged segments of the population; and (iv) attaining longer term sustainability, especially of the environment, political stability, and an aging population). In addition, strengthening governance is a cross-cutting challenge. The SCD anchors the World Bank Group Country Partnership Framework (CPF) for FY17–20.³⁶

The Country Partnership Framework is anchored by the Systematic Country Diagnostic.

Under the CPF, the World Bank Group will contribute to Sri Lanka's transition to a more competitive, inclusive, and resilient upper-middle income country. Main areas of support include macro-fiscal stability and competitiveness; promoting inclusion and opportunities for all; and seizing green growth opportunities, improving environmental management, and enhancing adaptation and mitigation potential. Sri Lanka has graduated from IDA and is receiving IDA transition financing during IDA 18 period (FY18-20). IFC gives priority to sustainable infrastructure (through PPP's), financial inclusion, and access to input/output markets, products, services and jobs.

³⁵ The SCD report and video are available online at:

<http://www.worldbank.org/en/news/feature/2016/02/15/sri-lanka-a-systematic-country-diagnostic>

³⁶ The CPF is available at: CPF: <https://openknowledge.worldbank.org/handle/10986/24682>

MIGA is ready to provide guarantees where possible to support foreign investment projects across sectors.

The World Bank portfolio covers a range of areas to support Sri Lanka's transition.

Current active World Bank portfolio comprises 18 projects with a total net commitment value of USD 2.1 billion (15 IDA and 3 IBRD operations). The World Bank has provided a mix of financing – investment project, development policy, and program-for-results – to meet the development needs of Sri Lanka. Urban and rural development sectors account for the largest share of the portfolio both in terms of number of projects (28 percent) and total commitment (38 percent). The second largest sector of engagement is education (22 percent of total number of projects, and 16 percent of total net commitment), followed by water (11 percent of total number of projects, 15 percent of total net commitment). In addition to lending, the World Bank is carrying out analytical work and technical assistance across various sectors, funded both through trust funds and own budget. The World Bank has extended its support in close coordination and collaboration with development partners, including through co-financing of projects and leveraging private sector resources where opportunities arise.

IFC continues to engage in areas where private sector solutions help address key development challenges laid out in the CPS.

IFC's activities in Sri Lanka are supporting the World Bank Group's CPF goals. By working closely with the private sector, the government, and the World Bank, IFC focuses on facilitating inclusive growth by crowding in private sector finance. In the area of financial inclusion IFC is specifically looking at solutions for underserved segments and markets, improved wealth creation and management options in light of the country's demographic profile. In the area of social inclusion IFC is focused on sectors where private sector solutions can improve not just access to services, but the efficiency and quality of those services. Connectivity/logistics through sustainable infrastructure is seen as a key part of the country's economic growth agenda and will be an IFC focus area. To support job creation and the build globally competitive value chains, IFC investments are targeted at export oriented sectors including tourism.

IFC is taking steps to increase the committed investment portfolio.

As of June 30, 2016, IFC's total committed investment portfolio stood at about USD 228 million. In addition, IFC has an advisory program comprising 11 portfolio projects with a combined portfolio value of USD 11 million. IFC's advisory projects are helping boost access to finance and insurance, build business skills for entrepreneurs, develop supply chains, and promote the growth of tourism. IFC has recently launched a gender focused advisory program to improve economic empowerment for women.

MIGA stands ready to support FDI, in support of the WBG's goals.

Sri Lanka is an important country for MIGA, and the Agency looks forward to supporting foreign investment into high development impact operations, which are aligned with the World Bank Group's goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. MIGA stands ready to participate in productive projects, across sectors, in the country, including in partnership with the World Bank and IFC.

Key Economic Indicators

Macroeconomic Indicators	Actual		Projections	
	2015	2016	2017	2018
Real sector				
GDP, (current, LKR billion)	10,952	11,839	12,870	14,229
GDP per capita, (current, US\$)	3,843	3,835	3,876	4,024
Real GDP growth (%)	4.8	4.4	4.7	5.0
CCPI inflation (%)	0.9	4.0	5.2	5.2
Percent of GDP, unless otherwise indicated				
External sector				
Exports of goods	13.1	12.7	13.1	13.3
Imports of goods	23.5	23.9	23.9	23.9
Trade balance	-10.4	-11.2	-10.8	-10.6
Tourism receipts	3.7	4.3	4.7	4.9
Remittances	8.7	8.9	8.9	8.9
External Current Account	-2.3	-2.4	-2.1	-2.0
FDI inflows	0.8	0.8	1.5	1.8
Official reserves (USD billion)	7.3	6.0	6.9	7.8
Official reserves (months of imports of goods and services)	3.8	3.1	3.4	3.7
Exchange rate (end period, LKR/USD)	144.1	149.8
Fiscal accounts				
Total revenue and grants	13.3	14.3	15.0	15.4
Tax revenue	12.4	12.4	13.1	13.7
Total expenditure	20.9	19.7	20.2	20.2
Current expenditure	15.5	14.8	15.3	15.0
Capital and net lending	5.4	4.9	4.9	5.2
Primary Balance	-2.9	-0.2	0.5	1.1
Overall fiscal balance ¹	-7.6	-5.4	-5.2	-4.7
Public debt ²	77.6	79.3	78.8	77.3
Treasury guarantees	5.6	7.1
Monetary/financial sector				
Standing deposit facility rate (% per annum)	6.0	7.0
Standing lending facility rate (% per annum)	7.5	8.5
Private sector credit growth (M2b ³ , %)	25.1	21.9	12.6	15.3

Note: These projections do not yet include the impact of the 2017 floods, as the full damage and loss have not yet been estimated.

¹ 2015 fiscal balance includes charges incurred in 2014 but accounted in 2015. The IMF estimates the fiscal deficit in 2014 and 2015 as 6.2 and 6.9 percent of GDP, respectively (see footnote 9).

² Public debt number excludes: debt contracted by SOEs and state agencies under a Treasury and Treasury bonds amounting to LKR 78,447 million issued to settle dues to CPC in January 2012 and LKR 13,125 million issued to capitalize Sri Lankan Airlines in March 2013 (as reported by the CBSL).

³ Includes currency, demand deposits, time and savings deposits held by the public with commercial banks

Sources: Central Bank of Sri Lanka, Ministry of Finance, staff projections