

SRI LANKA DEVELOPMENT UPDATE

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Fall 2016

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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 is available online at:


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Executive Summary



1. Recent Developments

Global economy is not yet out of doldrums; however, South Asia remains a bright spot.

In a year characterized by weak oil and commodity prices, slowing capital flows and shrinking global trade; global growth continued to disappoint slowing to 2.4 percent in 2015. Growth in advanced economies remained modest while China's transition to a more consumption oriented growth model decelerated its growth. Emerging markets and developing countries are facing stronger headwinds, including weaker growth among advanced economies and persistently low commodity prices, as well as lackluster global trade. However, economic activity in South Asia has remained relatively resilient benefitting from low commodity prices despite the signs of weak capital flows and remittances.

Sri Lanka's macroeconomic performance deteriorated in many ways in 2015.

With no exception, Sri Lanka also faced the challenges of a trying global environment in 2015. Uncertainties in an election year that saw a major political transition contributed to elevate the risks stemming from global context. The accommodative policy choices supported economic growth. However, they were of little help in addressing the global and domestic economic challenges; leaving the country with higher public debt, lower external buffers and rising core inflation. Citing growing external and fiscal vulnerabilities Fitch downgraded Sri Lanka's long-term rating by one notch to B+ from BB- with a negative outlook while S&P kept Sri Lanka's long-term sovereign credit rating at B+, but changed the outlook to negative from stable.

Authorities took policy measures aimed at stability, beginning 2016.

After passing the 2016 budget, the government proposed a few key revisions as measures to reduce the projected fiscal deficit from 5.9 to 5.4 percent of GDP. These include increasing the (Value Added Tax) VAT rate to 15 percent from the existing 11 percent; imposing a capital gains tax; and revising personal and corporate income tax regimes to yield more revenues. In parallel, monetary policy was tightened in the

first quarter, which was followed by another rate hike in July due to stubbornly high credit growth and rising inflation.

Notwithstanding difficulties, the government plans to continue with structural reforms.

The government's policy statement that was presented in November 2015 envisioned promoting a globally competitive, export-led economy with emphasis on inclusion. It identified generating one million job opportunities, enhancing income levels, development of rural economies, creating a wide and a strong middle class as key priorities. The government aims to implement fundamental changes to taxation to reverse a longstanding decline in tax revenues as a share of GDP with a view to reduce the fiscal deficit and return the public debt level to a sustainable path while making the system fairer. Broad reforms on the state owned enterprise were proposed to reduce fiscal burden, increase transparency and improve commercial viability of operations.

Fiscal risks remain with larger deficit and debt.

The fiscal deficit rose sharply in 2015 due to increased expenditures in salary hikes and subsidies, one-off charges, reduced consumption taxes and increased interest costs on resultant deficit financing. Although one-off revenues and amplified motor vehicle excise tax collection helped mitigate the impact, the deficit increased to 7.4 percent of GDP from a budgeted 4.4 percent of GDP for 2015. A persistently high primary deficit, rising real interest rates and the exchange rate depreciation increased the public debt to GDP ratio to 76.0 in 2015, while treasury guarantees are estimated at 5.4 percent of GDP. The fiscal deficit in the first five months of 2016 marginally improved on increased tax collection. However, a Supreme Court ruling halted the implementation of new VAT proposals in July, one month after the introduction.

A new IMF program is providing a solid platform for macro-fiscal stability

The International Monetary Fund (IMF) approved a 36-month Extended Fund Facility (EFF) for about USD 1.5 billion in June 2016. The program aims to provide a policy anchor for macroeconomic stability and structural reforms, while strengthening external resiliency in a challenging global environment. It is also intended to add to the market confidence and catalyze additional financing from other multilateral and bilateral loans as well.

World Bank supports the government's reform agenda.

Complementing the EFF, the World Bank approved a USD 100 million Development Policy Financing (DPF) operation. This facility supports the government to carry out reforms to eliminate obstacles to private sector competitiveness, enhance transparency and public sector management and improve fiscal sustainability.

Growth decelerated through to 1H 2016; inflation bottomed and showed pressures since late 2015.

In 2015, economic growth marginally decelerated to 4.8 percent compared to 4.9 percent in 2014 mainly on account of the decline in the construction sector and the increased base due to a GDP revision for 2014. The first half of 2016 saw the growth further declining to 3.9 percent reflecting the impact of inclement weather in the second quarter. Downward price revisions in key consumer items, including energy; low commodity prices in the global market; and overall improved domestic supply conditions eased annual average inflation to 0.9 percent in 2015. However, the base effect, adverse weather conditions and demand pressures pushed the inflation up to 3.0 percent by August 2016.

External developments and some policy choices led to deterioration of external buffers.

Net outflows from the government securities market, sluggish FDI inflows, slower than expected project execution and debt repayment presented a challenging external landscape despite low oil prices and increased tourism flows. In the domestic front, a large fiscal deficit and an accommodative monetary policy led to an increase in consumption and non-oil imports driven by autos. Although swap facilities from

India and fresh Eurobonds partially negated resultant balance of payments pressures, the external buffers deteriorated while the currency depreciated by 10 percent against the US dollar 2015. Official reserves declined to an estimated 3.5 months of imports of goods and services by July 2016 from 3.8 months reported in end-2015 despite issuance of fresh Eurobonds.

2. Outlook and risks

A relatively favorable outlook is projected in the backdrop of policy reforms; downside risks are substantial.

Monetary tightening and enhanced currency flexibility have contributed to improve short-term stability. Meanwhile, the IMF program will add to the confidence while helping reform the tax system to generate more revenues with a view to ensure fiscal sustainability. The government has undertaken to implement a medium-term reform agenda that aims to improve competitiveness, governance and public financial management that would bring in long-term benefits. These developments have contributed to an improved outlook.

Growth is expected to remain unchanged in 2016 and grow marginally over 5.0 percent beyond, driven by private consumption and postponed FDI in 2015. The reduced drag from imports thanks to low commodity prices and recent policy measures to curb import growth will contribute to the increase in growth. The impact of past currency depreciation along with the increase of VAT rate will increase inflation in 2016 and 2017 although low international commodity prices will maintain the downward pressure.

The external current account deficit is projected to reach its narrowest point in 2016 and rise thereafter due to the increase in global commodity prices. The reduction of merchandise imports and strong tourism receipts will improve the trade balance in 2016; although, the cushion received from the remittances is projected to be subdued with continued low oil prices affecting the Middle East. Inflows to the government and FDI inflows will help closing the external financing needs with no Eurobond falling due in 2016. External financing requirement is poised to increase in outer years when state bank and government Eurobonds fall due.

The fiscal deficit is projected at 5.7 percent of GDP for 2016 after considering the key policy measures and related delays in 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 planned action on tax expenditure analysis will improve tax policy making process and transparency while effective use of information systems will help an efficient administration.

Key risks include a growth slowdown, which would lead to a fast rising public debt burden. In such an eventuality, fiscal consolidation through strengthening revenue and more efficient debt management will become key to reduce the public debt. While the direct impact of a slowdown in China and the Brexit would be limited, continued economic woes in the Middle East, the EU and Russia could adversely affect exports and remittance inflows. Tightening global financial conditions could further elevate capital outflows and currency pressure, and make borrowing more expensive.

The government policy statements have indicated the appetite to implement much needed reforms in the areas of fiscal operations, competitiveness and governance. These policy reforms, if successfully implemented while paying attention to the

related policy trade-offs could uplift the country into the Upper Middle Income state in the medium term. Although a turbulent external environment and domestic political considerations makes it challenging, a strong political will and the support of the bureaucracy should help advancing the reform agenda. Steps are needed to ensure the support of private sector and the civil society.

3. Special focus

Systematic Country Diagnostic provides a platform to identify development challenges.

The special focus section discusses the Systematic Country Diagnostic (SCD)¹ for Sri Lanka, launched by the World Bank in February 2016. The objective of the SCD is to identify the most critical constraints and opportunities facing Sri Lanka in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. The SCD is an objective, evidence-based, candid assessment of the main challenges facing the country, without limitation to the areas where the WBG is currently engaged.

The key development challenges identified in the Sri Lankan context are:

1. The fiscal challenge
2. Promoting more and better jobs for the bottom 40 percent
3. Inward versus outward orientation of the economy
4. The relationship between the public sector and private sector
5. Social Inclusion Challenges

¹ The numbers are based on the GDP data available at the time of the publication; hence, it does not take into account the subsequent GDP revisions.

A. Recent Developments



South Asia performed reasonably well, but the challenges are substantial going forward.

At 2.4 percent, the global growth remained sluggish and lower than expected in 2015 and is expected to remain the same for 2016. The context is characterized by weak oil and commodity prices, slowing capital flows and shrinking global trade. Growth in advanced economies remained modest while China's experienced deceleration in its transition to a more balanced growth path after a decade of strong credit and investment growth. Although emerging market and developing economies grew faster than advanced economies, performance across countries remained uneven and generally weaker than the historical performance. South Asia defies a sluggish world economy and continues its path of gradual growth acceleration during 2016. Led by a solid India, the region remains a global hot spot. South Asian economies proved resilient vis-à-vis external headwinds, such as China's slowdown or uncertainty surrounding monetary policy in advanced economies. But some are beginning to feel the sting from slowing remittance flows or waning oil price dividends. Against this backdrop of relative stability but fading tailwinds, South Asia will need to activate the full potential of two core growth drivers - private investment and exports - to sustain and further increase its economic dynamism.²

Growth decelerated in the first half of 2016 following moderation in 2015.

Inclement weather weakened growth in the first half of 2016

Torrential rains and floods in the month of May took a heavy toll on economy's performance in the first half.³ Agriculture sector suffered the most, reporting a negative contribution to growth in the second quarter, for the first time in five years while industry and service sectors also faced severe disruptions leading to subdued

² Based on Global Economic Prospects June 2016 and South Asia Economic Focus Fall 2016 (see Box 3 and 5).

³ The Government declared a state of disaster in 6 affected provinces on June 8, and started a post-disaster needs assessment (PDNA) with assistance from the European Union, World Bank and United Nations agencies with the full report on the impact, damages, losses and needs expected in the second half of August.

performance. Coupled with the base effect, the impact of inclement weather decelerated growth in the second quarter to 2.6 percent. Despite the impact of the disaster, the first half posted an overall growth of 3.9 percent thanks to the growth of 5.2 percent in the first quarter, which received a boost from strong expansion of private credit.

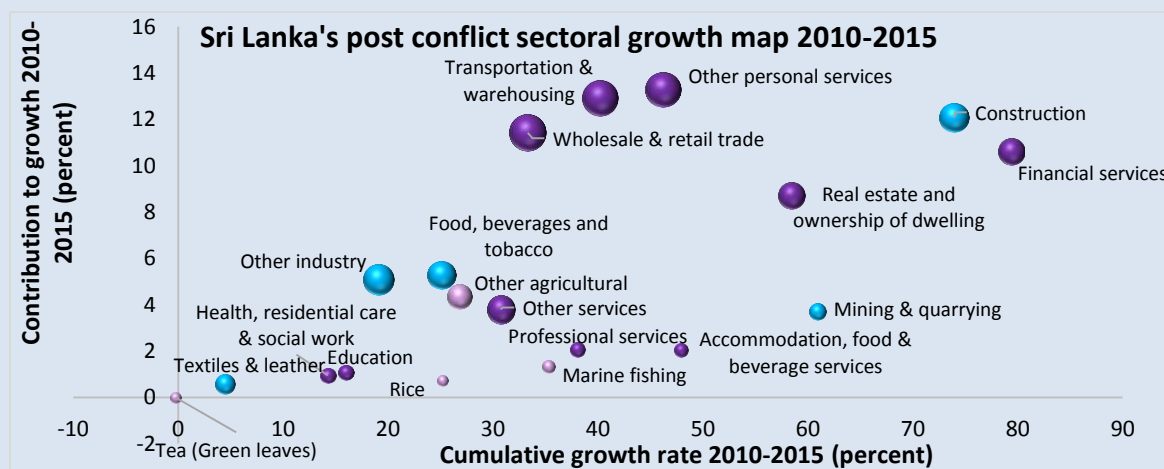
Box 1: Sri Lanka's growth has been driven by non-tradable sectors

Led by growth in non-tradable sectors, Sri Lanka's real GDP expanded by 34.4 percent from 2010 to 2015.

The top six sectors contributing to 69.0 percent of the total growth during the period were all non-tradable sectors: transport, other personal services, construction, wholesale & retail trade, financial services, and real estate (see chart). Other personal services, a category added to GDP in the rebasing exercise in 2014, alone contributed to 13.3 percent of the total growth. Reflecting the performance of improving transportation network and an increasing motor vehicle fleet, the transportation sector contributed to 12.9 percent of the overall growth. The post-conflict infrastructure development thrust drove the construction sector's contribution to growth to 12.1 percent of the total growth. Wholesale & retail trade, financial services and real estate sectors contributed to growth at 11.4, 10.6 and 8.7 percent respectively. However, the agricultural sectors contributed to only 6.4 percent of the growth while all other manufacturing/service sectors collectively accounted for 24.6 percent of the growth.

The tradable sectors declined in importance, but can be important future drivers of sustained growth.⁴

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.⁵ Sri Lanka's share of manufacturing output, which was 18.7 percent in 2000, rose to 19.5 percent in 2005, and declined to 17.3 percent by 2015 due to faster growth in the services sector. The government's vision recognizes that while the economy has grown rapidly in the last decade, the current drivers of economic growth are unlikely to remain adequate for inclusive and sustainable growth in the coming decade. Authorities have identified the need to strengthen competitiveness not only in traditional sectors such as apparel, natural resources transformation, and tourism but also to establish the necessary conditions for a thriving knowledge economy, the integration of productive local companies in global value chains, and the attainment of higher value addition in the manufacturing sector.



Note: Bubble size corresponds to the industry size within the GDP composition in 2015. Bubble colors indicate the relevant subsector: pink-agriculture, blue-industry, purple-services.

Source: Central Bank of Sri Lanka and staff calculations

⁴ Yusuf, Shahid. (2012). "From Technological Catch-up to Innovation: The Future of China's GDP Growth." World Bank, Washington, DC.

⁵ World Bank (2013), 'Island of Prosperity? Ideas for Accelerating Inclusive Economic Growth in Sri Lanka', Washington, DC.

In 2015, all key sectors except construction contributed positively to growth.

Economy grew by 4.8 percent in 2015, which was well below the regional growth rate and its own growth rate of 4.9 percent reported for 2014. Nevertheless, all three key sectors; namely, agriculture, industry and services positively contributed to growth despite contractions reported in a few subsectors. While the construction subsector that accounted for 7.5 percent of the economy was the largest to contract, growing of tea and rubber, education and professional services also reported contractions. On the other hand, the upward revision of GDP by 4.2 percent in level terms for the year 2014 increased the base, reducing the previously anticipated growth rate of around 5.4 percent for 2015.^{6,7}

The strong growth in services was the key driver of growth.

The services sector contributed to 3.0 percentage points of the total growth in 2015 underlying strong contributions from transport, wholesale and retail trade, financial services, real estate and other personal services related sectors. An accommodative monetary environment that led to a 25.1 percent year-on-year expansion of credit to the private sector played an important role in fueling many of the subsectors classified under services (Figure 1).

Figure 1: Contributors to growth (production side)

(Percent)

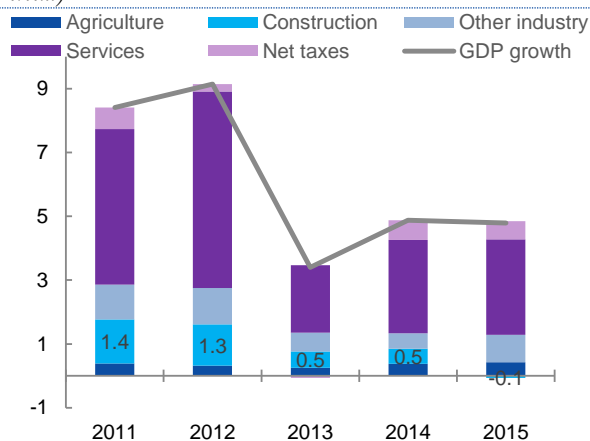
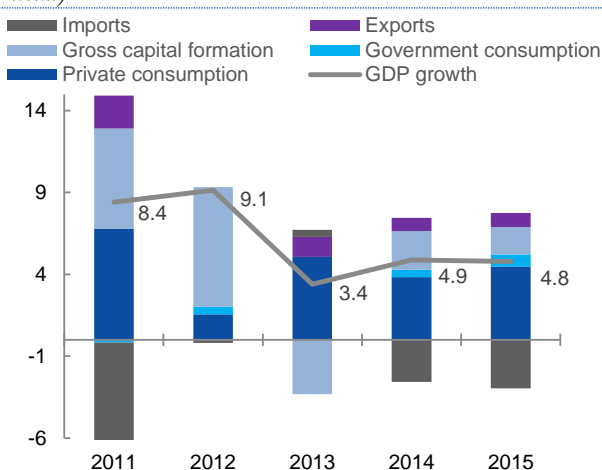


Figure 2: Contributors to growth (demand side)

(Percent)



Source: Department of Census and Statistics and staff calculations

Subdued performance of construction was a drag on industry.

As the new government was reassessing the construction led growth model, the sector became a drag on the growth for the first time in the post-conflict period, in 2015. Its contribution to growth became a negative 0.1 percent during the year compared to an average of 0.9 percent positive contribution to growth during the period between 2011 and 2014. Moreover, the subdued performance of the construction subsector indicated a diversion of the overall growth pattern in the 2010-2015 period during which the post-war construction activities helped boosting the economic growth (Box 2). Nevertheless, with significant contributions from manufacturing subsectors such as food and beverages and repair and installation of equipment, the industry sector contributed to 0.8 percentage points of the overall growth in 2015.

Favorable weather conditions improved

The agriculture and fisheries sector that employs approximately 1/3 of the labor force contributed to 0.4 percentage points of the overall growth. Favorable weather

⁶ As a result of the revision, the growth rate for 2014 jumped to 4.9 percent compared to a previously reported 4.5 percent for 2014.

⁷ The economy grew by 5.5 percent, year-on-year in the first quarter of 2016 with strong contributions from industry and services sectors.

performance of the agriculture sector.

conditions resulted in a bumper harvest for rice and vegetable sectors that collectively contributed to 79 percent of the agriculture sector's total contribution to growth. However, low productivity and reduced demand from Russia and the Middle East forced the tea production, the single largest agriculture crop of the country, to retreat slightly in 2015.

Reduced private investments offset positive impact from consumption.

From the expenditure side, the civil service's wages hike⁸ and the rapid private credit growth amplified the contribution to growth from private consumption while the contribution from government consumption also increased on the increased wage and subsidies bill. However, this increased contribution was offset mainly by reduced private gross capital formation, which indicated muted performance due to uncertainties in an election year and the new government's policy to reassess the already approved FDI projects by the previous administration. The marginal positive impact of increased exports, on the other hand, was offset by the increased negative contribution to growth from import sectors (Figure 2).

Headline inflation remained benign; however, demand side pressures and the impact of currency depreciation appeared since the last quarter of 2015.

Rising inflation led to price controls.

Since the latter half of 2015, inflation has been on the rise with the impact of past currency depreciation and demand side pressures as reflected in the credit growth. The year-on-year headline inflation measured by the widely watched Colombo Consumer Price Index (2006/07=100) increased to 4.0 percent in August 2016 after closing the year 2015 at 2.8 percent. On a similar note, the annual average inflation that showed a declining trend for the most of the year 2015 slightly increased in the second half to close the year at 0.9 percent and rose to 3.0 percent by August 2016. Core inflation computed excluding fresh food and energy remained high at 4.1 percent in the month of August.

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 based on the Household Income and Expenditure Survey (HIES) reported a year-on-year inflation of 5.8 percent and an annual average inflation of 3.4 percent by July 2016 (Figure 3 and 4).

Figure 3: Movements of CCPI inflation
(Percent)

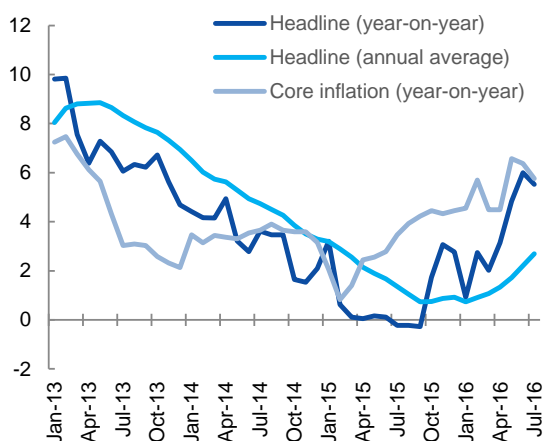
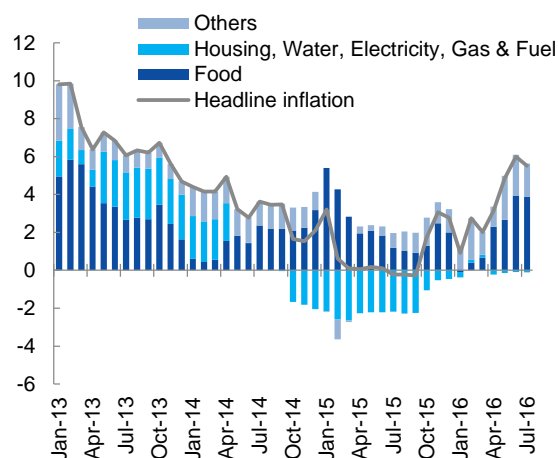


Figure 4: Contributors to headline inflation
(Percent)



Note: Housing, water, gas electricity and fuel subcomponent and transport subcomponent are included in the non-food category
Source: Department of Census and Statistics and staff calculations

⁸ The wage bill as a share of GDP increased from 4.2 percent in 2014 to 5.0 percent in 2015.

The high fiscal deficit due to low revenues continues to be a key macro concern; meeting fiscal targets for 2016 will be challenging with some revenue proposals yet to be implemented.

In 2015, the fiscal deficit worsened on increased expenditures.

The fiscal deficit rose sharply as a share of GDP to 7.4 percent compared to a target of 4.4 percent in 2015 due mainly to escalation of expenditures.^{9,10} Salary hikes, increased subsidies, and reduced consumption taxes contained in the budget 2015 and increased interest costs on resultant deficit financing elevated the current expenditure by 2.6 percentage points to 15.2 percent of GDP. While public investment and net lending was reduced to manage the deficit, the recording of an approximate volume equivalent to 1 percent of GDP in the 2015 accounts, which represented cost overruns of capital projects for 2013 and 2014 pushed up the recorded public investment and net lending to a four-year high. With increased current and capital expenditures, total expenditure rose to 20.5 percent of GDP. Although government revenues increased by 1.6 percentage points to 13.0 percent of GDP primarily on one-off revenue measures¹¹ and increased motor vehicle excise taxes on a record high motor vehicle imports surge, it was not sufficient to return the deficit to a consolidation path in 2015 (Figure 5, 6 and 7).^{12,13}

The deficit was financed mainly using domestic sources, pressure was seen in domestic markets.

Foreign sources provided about 28 percent of net financing or LKR 237 billion, which included USD 1.65 billion worth of sovereign bonds.¹⁴ The remaining 72 percent was financed through domestic sources by bank and non-bank sources. Non-bank domestic sources led by the Employees' Provident Fund, National Savings Bank and other savings and insurance institutions financed over 50 percent of the net domestic financing requirement of LKR 593 billion.¹⁵ Commercial banking sector financed 37 percent of the total net domestic financing requirement while the rest was financed by the central bank mainly through purchasing of treasury bills in the primary market.

⁹ The 2015 deficit also represents a worsening vis-à-vis the previous year deficit of 5.9 percent of GDP.

¹⁰ Official provisional estimates. The IMF estimates the deficit for 2015 to be 6.9 percent of GDP (Country report 16/50, IMF, June 2016) reflecting an accounting arrangement whereby cost overruns for capital projects amounting to LKR 62 billion or 0.6 percent of GDP (which were paid but not recorded in 2014) were recorded in the 2015 account.

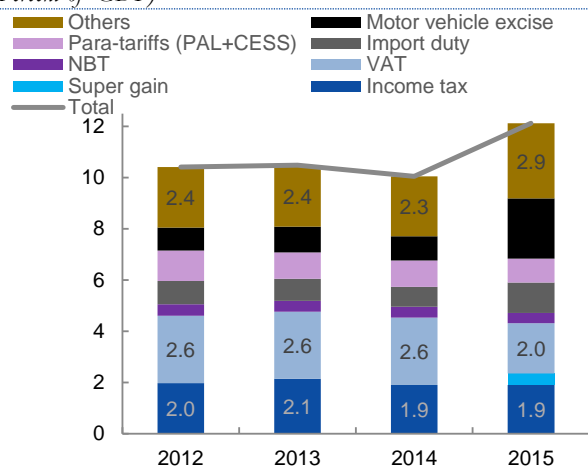
¹¹ Included was a retrospective super gain tax at 25 percent imposed on corporates that generated profits over LKR 2.0 billion in 2013/14

¹² Sri Lanka has one of the lowest tax-to-GDP ratios in the world at 10.1 percent for 2014. In the past, between 2009 and 2014 in particular, the fiscal consolidation was mainly took place through expenditure reduction leading to relatively low allocations for social welfare, public investment, and expenditure on education and health. Although this consolidation effort is impressive, the total spending at or below 20 percent of GDP seems low, given the needs of a middle-income country

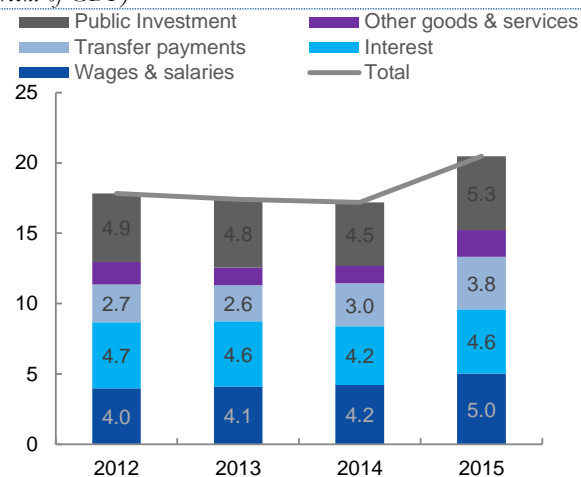
¹³ The fiscal deficit in the first five months of 2016 marginally improved on increased tax collection. However, a Supreme Court ruling halted the implementation of new VAT proposals in July, after one month of introduction.

¹⁴ During the year, USD 2.15 billion maturing in ten years were issued at yields between 6.125 and 6.85 percent while USD 500 million issued in 2009 was repaid.

¹⁵ Employees' Provident Fund, the private sector superannuation fund managed by the CBSL, and National Savings Bank, a licensed specialized bank owned by the government are the main local investors in government treasury bills and treasury bonds.

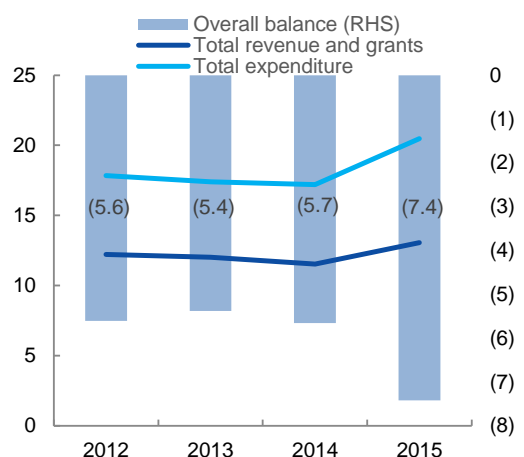
Figure 5: Tax revenue trends*(Percent of GDP)*

Source: Ministry of Finance and staff calculations

Figure 6: Public expenditure trends*(Percent of GDP)*

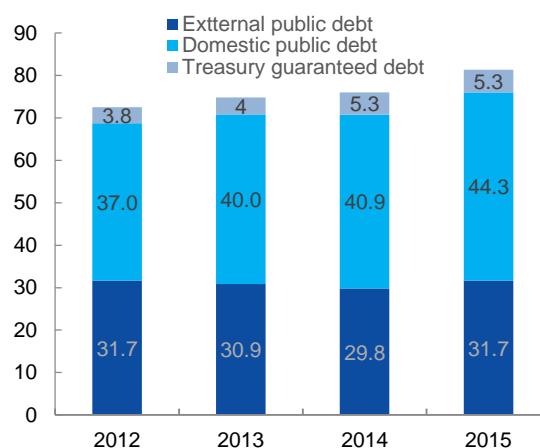
Note: Official provisional estimates. 2015 public investment includes charges incurred in 2014 but accounted in 2015. The IMF estimates public investment in 2014 and 2015 as 5.1 and 4.7 percent of GDP, respectively (see footnote 10).

Source: Ministry of Finance and staff calculations

Figure 7: Overall fiscal operations*(Percent of GDP)*

Note: Official provisional estimates. 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 8).

Source: Central Bank of Sri Lanka and staff calculations

Figure 8: Public debt by residency and explicit contingent liabilities*(Percent of GDP)*

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

The budget 2016 highlighted the need to further fiscal consolidation.

The budget 2016 presented in November 2015 included a few promising business-friendly measures in relation to the overall policy direction.¹⁶ However, it did not signal the necessary fiscal consolidation with the fiscal deficit projected at 5.9 percent of GDP for 2016, only marginally below the preliminary estimate of 6.0 percent of

¹⁶ These included a) removing of a number of “nuisance taxes”, which did not yield much in revenue, but are a burden on business; b) announcing of TA by the IMF to help redraft the laws to ensure clarity, consistency and simplicity and eliminate loopholes by end-2016; c) proposing management reforms to SOEs; d) removing legal, fiscal and regulatory obstacles to FDI attraction; and e) announcing institutional and governance reforms needed for implementation of the national economic policy statement.

GDP for 2015. Both revenue and expenditure were projected to increase strongly by 3.3 and 3.2 percent of GDP, respectively. The main drivers of revenue were an increase of the Nation Building Tax rate and a revision of fees and charges while there were proposals that effectively reduce the collection of VAT, personal income tax and corporate income tax. Further, the proposed strengthening of indirect taxes while relaxing income taxes seemed to deviate from the announced government policy.¹⁷ Implementation of the budget could potentially have further increased deficit and debt given the relatively optimistic macro framework implied in the budget.

A few additional proposals were approved in March 2016 improve fiscal operations.

In March the Cabinet approved a few key revisions to the already passed 2016 budget as measures to reduce the projected fiscal deficit from 5.9 to 5.4 percent of GDP. The revisions included increasing the VAT rate to 15 percent from 11 percent; revising personal and corporate income tax regimes to yield more revenues¹⁸ and considering imposition of a capital gains tax, which was gradually abolished between 1987 and 2002. The proposal in the original budget to increase the NBT rate was not implemented.

An IMF program was approved to support the fiscal consolidation efforts.

In June 2016, the IMF approved a 36-month Extended Fund Facility for 185 percent of Sri Lanka's quota in the IMF (about SDR 1.1 billion or USD 1.5 billion to support the Government in dealing with global and domestic macro-fiscal challenges. The key objectives of the program relate to fiscal policy and the balance of payments, and include measures to: (a) implement a structural increase in revenues, facilitating a reduction in the fiscal deficit to 3.5 percent of GDP by 2020; (b) reverse the decline in central bank foreign exchange reserves; (c) reduce public debt relative to GDP and lower Sri Lanka's risk of debt distress; and (d) enhance public financial management and improve the operations of state owned enterprises. The program also aims to transition toward inflation targeting with a flexible exchange rate regime and to promote sustainable and inclusive economic growth. Although challenging, the implementation of the program will help the government to return to a sustainable fiscal path.¹⁹

Legal obstacles for VAT proposals could impact achieving fiscal targets.

The key proposal announced for fiscal consolidation in support of the IMF program was suspended by the Supreme Court due to some technical fault in the month of July, after one month of introduction. Rectifying the technical fault and getting the proposals through the parliament appears to be cumbersome in a challenging political environment. Delay or suspension of implementation of VAT proposals could adversely affect the fiscal consolidation path of the IMF program. However, the fiscal deficit of the first half stood at 2.7 percent of estimated GDP for 2016 compared to the 3.6 percent reported for 2015.

Fiscal risk has increased due to a sharp rise in public debt as a share of GDP and has led to a downgrade of credit rating.

¹⁷ Although the Prime Minister announced that the current ratio of indirect-to-direct taxes of 81:19 was expected to change to 60:40 in the medium term, the budget plans would have led to a ratio of 85:15 for 2016. The budget proposed to raise the personal income tax (PIT) threshold from LKR 500,000 to LKR 2.4 million while unifying the rate at 15 percent. The new threshold would be about 5 times the per capita income, and as such it could further erode the tax base of PIT. The changes to corporate income tax (CIT) were also expected to reduce revenue.

¹⁸ The proposal in the 2016 budget to increase the tax-free threshold was withdrawn and the corporate tax rates were increased on a few sectors that enjoyed concessionary rates.

¹⁹ <http://www.imf.org/external/pubs/ft/scr/2016/cr16150.pdf>.

Public debt rose sharply in 2015.

Currency depreciation, relatively slow growth, high primary deficit and rising real interest rates collectively led to a sharp increase in the public debt-to-GDP ratio to 76.0 percent in 2015 from 70.7 percent in 2014. Meanwhile, the debt profile also indicated significant exposure to a variety of risks. A high proportion of foreign currency denominated debt,²⁰ a significant share of domestic debt in the form of T bills and 1/3 of the domestic debt maturing within a year continued to expose the public debt to exchange rate, interest rate and refinancing risks. 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 (Figure 8 and 9).

Fiscal risks emanating from state owned entities are substantial.

Treasury guarantees issued to State-Owned-Enterprises to borrow from the markets increased from 1.4 percent to 5.3 percent of GDP between 2006 and 2015. While this includes debt by state-owned business enterprises with own sources of revenue, increasingly guarantees have been given to entities with limited sources of revenue, such as the Road Development Authority (RDA). In addition to guaranteed debt, many of these entities have also borrowed without a guarantee. Moreover, the staff estimates that the volume of non-financial SOE debt amounted to approximately 11.6 percent of GDP as of end 2015.²¹

Concessional external borrowing sources are drying up while debt profile show some pressures.

The country's external concessional sources are being replaced by borrowings on commercial terms, with its graduation to a lower-middle income country. In the recent past, the authorities have been successful in tapping international markets consistently with sovereign bond issues. Between 2007 and 2015, the government sold USD 7.65 billion of sovereign bonds. As a result of increased commercial borrowings, the non-concessional and commercial component of the government foreign debt rose from 1 percent in 2000 to 51 percent in 2015. Meanwhile, the interest rate risks on foreign currency debt has risen while average interest rate also increased.²² Similarly, the debt profile showed some deterioration in average time to maturity as well as reserve adequacy in relation to share of foreign currency commercial debt component in the recent years (Figure 10, 11 and 12).

Deterioration of public debt profile adversely affected credit rating.

Growing external and fiscal vulnerabilities led to a credit rating downgrade by Fitch Ratings and a negative outlook by S&P and Moody's. Fitch Ratings downgraded Sri Lanka's long-term credit rating by one notch to B+ from BB- with a negative outlook in February 2016. The key drivers of the downgrade were the increasing refinancing risks, significant debt maturities, weaker public finances, a decline in foreign exchange reserves and a high foreign-currency debt portion in the portfolio. At the same time, favorable economic growth, human development indicators, a clean debt service record and a smooth transition of power are identified as positive factors.²³ S&P and Moody's kept Sri Lanka's long-term sovereign credit rating at B+ and B1, respectively, but changed the outlook to negative from stable for similar reasons in March and June 2016, respectively. These rating actions can heighten the refinancing and interest rate risks mentioned above. The trading spread for the country's bond sovereign bonds edged up in the recent months (Figure 14).

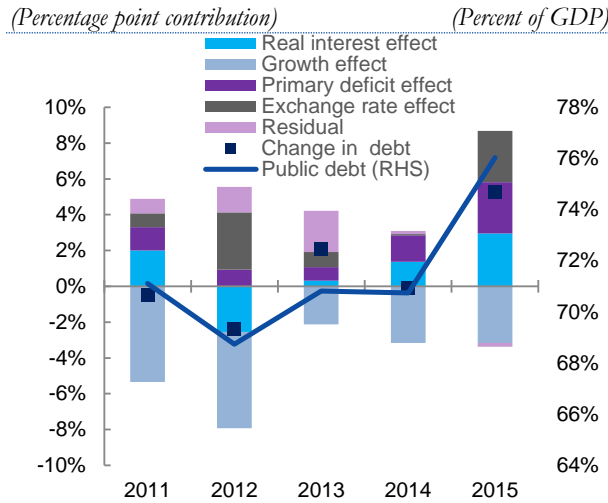
²⁰ 42 percent of the total public debt as of end 2015.

²¹ This includes treasury guaranteed debt of State Owned Business Enterprises (SOBEs) (2.7 percent of GDP), other debt of SOBEs (6.5 percent of GDP) and guaranteed debt of non-commercial SOEs (2.4 percent of GDP) (Ministry of Finance Annual Report 2015).

²² Central Bank of Sri Lanka Public Debt Management Reports.

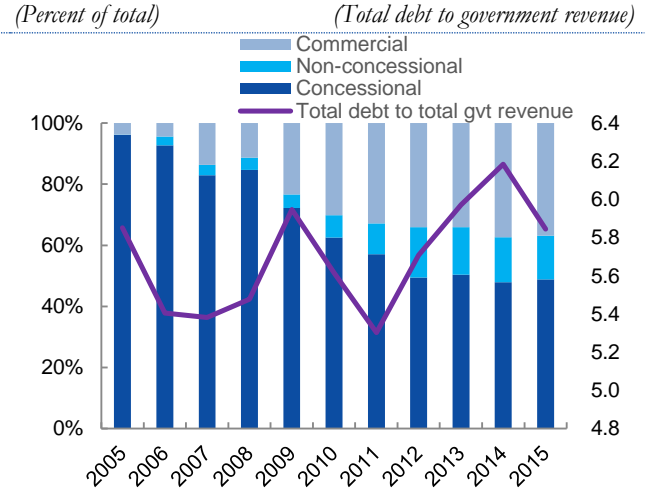
²³ <https://www.fitchratings.com/site/fitch-home/pressrelease?id=1000143>.

Figure 9: Drivers of the public debt-to-GDP ratio



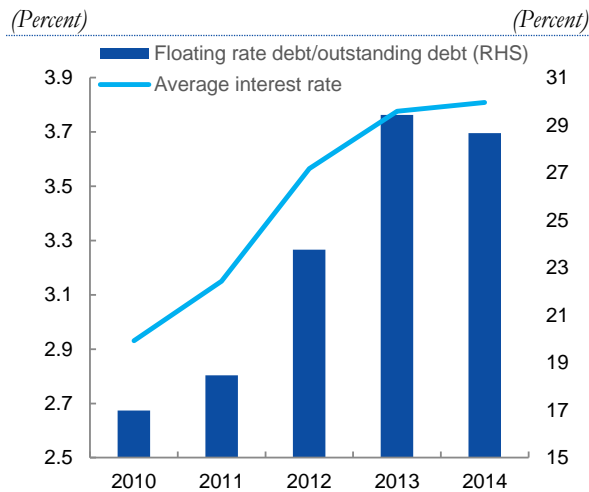
Source: Central Bank of Sri Lanka and staff calculations

Figure 10: Trends in public external debt and concessional debt



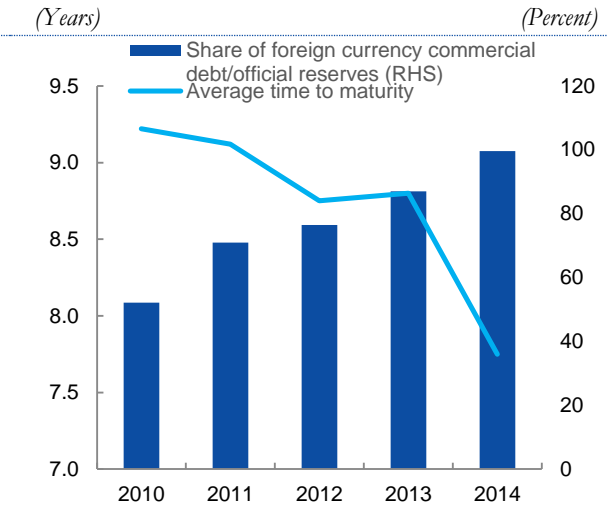
Source: Central Bank of Sri Lanka and staff calculations

Figure 11: Interest rate trends in external public debt

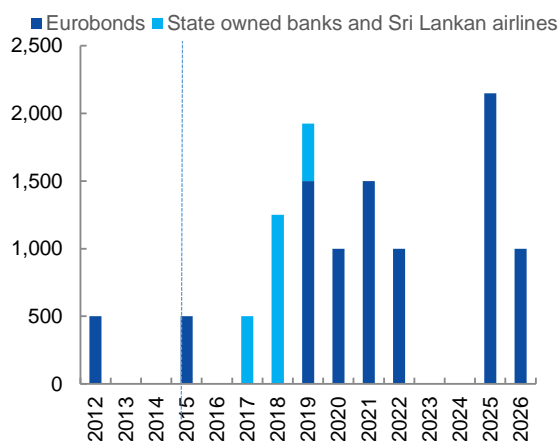


Source: Central Bank of Sri Lanka

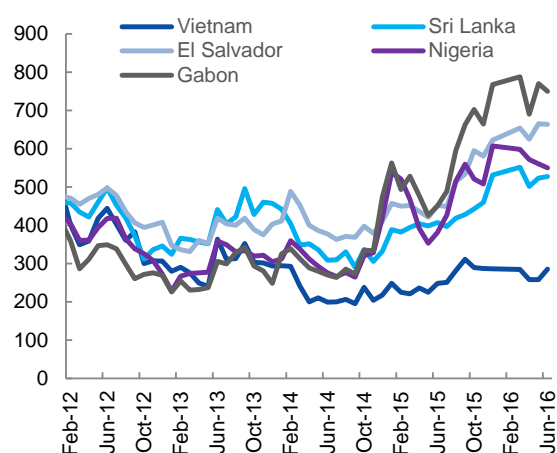
Figure 12: Other risk indicators for external public debt



Source: Central Bank of Sri Lanka

Figure 13: Main public and private Eurobond redemptions during 2012-2026*(USD million)*

Source: Central Bank of Sri Lanka, Annual Reports of Bank of Ceylon, National savings Bank, and staff calculations

Figure 14: Bond spreads over US Treasury, selected countries with similar credit rating*(Basis points)*

Note: comparison with similar countries with ratings of Baa3/B1 (Moody's), BB-/B+ (S&P/Fitch)
Source: EMBIG, staff calculations

Mixed external sector performance led to deterioration of external buffers.

A surge of non-oil imports significantly reduced the benefit of low oil prices in 2015.

The low interest rates driven private credit and increased disposable income due to wage hikes drove up non-oil imports; in particular, motor vehicles and non-food consumables. As a result, the decline in imports was limited to 1.3 percent of GDP in 2015 compared to 2014 despite the fuel bill reducing by 2.4 percentage points of GDP during the same period. On the other hand, weak global demand took a toll on exports, with the country's major merchandise exports textiles and tea contracting.^{24,25} Strong tourism flows²⁶ and large but slightly declining worker remittances²⁷ were able to cover the trade deficit. However, significant investment return outflows including interest, and remittances outflows led to a sizeable current account deficit as a share of GDP at 2.4 percent compared to 2.5 percent reported for 2014 (Figure 15).²⁸

Low FDI inflows and significant capital outflows reduced net external financing in 2015.

Capital outflows from the government securities market²⁹ in the wake of rising global interest rates and lower than expected FDI inflows³⁰ amid the government reassessing a few key committed FDI projects exerted pressure on the external financial account in 2015. Along with external debt obligations of USD 4.7 billion, reduced foreign exchange inflows contributed to heightened exchange rate pressures and led to more than expected foreign financing. The government issued sovereign bonds worth of USD 2.15 billion in international financial markets at relatively higher yields in

²⁴ Collectively accounted for approximately 60 percent of the exports in 2015. Tea exports suffered from both price and volume reduction while textile declined mainly due to volume effect.

²⁵ As a result of these developments, the non-oil trade deficit rose sharply from 4.6 to 7.0 percent of GDP although overall trade deficit improved by a marginal 20 basis points to 10.2 percent of GDP.

²⁶ The significance of tourism receipts in the GDP increased from 3.0 in 2014 to 3.7 percent in 2015.

²⁷ Remittances reported a negative year-on-year growth and declined as a share of GDP from 8.8 percent in 2014 to 8.6 percent in 2015, showing early signs of the impact of challenges in the Middle East.

²⁸ The external current account improved in the first quarter of 2016 thanks to reduced oil bill and strong tourism flows.

²⁹ USD 903 million for 2015 and an estimated USD 570 million year-to-date end-March 2016; foreign holding of treasury securities of the total outstanding volume more than halved during the period from end-2014 to March 2016.

³⁰ FDI net inflows declined as a share of GDP from 1.1 percent in 2014 to 0.7 percent in 2015.

addition to project financing related debt flows of USD 1.3 billion. Nevertheless, net inflows to financial account reduced as a share of GDP to 3.2 percent in 2015 compared to the previous year. The external debt to GDP ratio increased marginally from 53.6 to 54.4 during the same period on account of new borrowings. Along with past bonds issued by the government and the state banks, the Eurobonds are expected to push up the external financing requirement from 2018 (Figure 13).

Figure 15: Composition of the current account
(Percent of GDP)

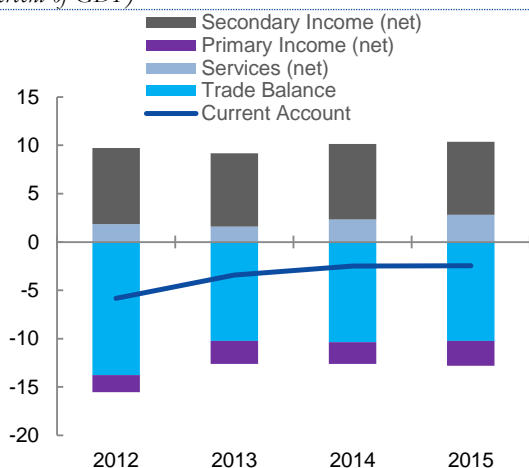
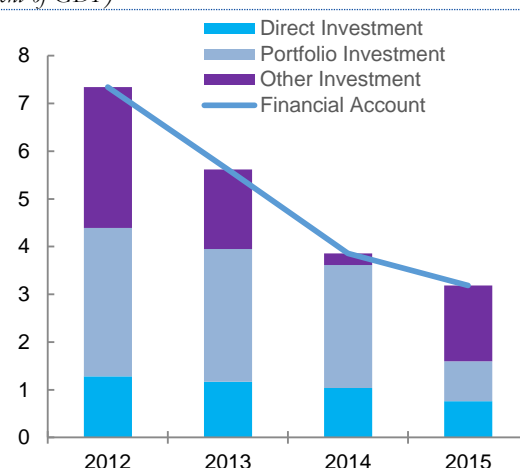


Figure 16: Composition of the financial account
(Percent of GDP)



Source: Central Bank of Sri Lanka

Gross official reserves declined due to forex sales.

Sustained currency depreciation pressures driven by adverse external sector developments and debt repayment obligations were partially set-off by the central bank's market intervention.³¹ Although the central bank decided to allow the market to play a greater role in the determination of the exchange rate in September 2015, net sales of foreign exchange continued into the year 2016 as well with the requirement to facilitate capital outflows in a thin market. As a result, despite borrowing more than budgeted on commercial terms and receiving support from the Reserve Bank of India (RBI) in swap arrangements, the reserve level declined to USD 7.3 billion in December 2015 (equivalent to 3.8 months of imports of goods). Despite the support received from the central bank, the currency depreciated by 10 percent in 2015 partially offsetting the past real effective exchange rate appreciation.³²

New sovereign bonds and reduced forex market intervention

Thanks mainly to the issuance of USD 1.5 billion sovereign bonds,³³ gross official reserves increased to USD 6.6 billion in August after bottoming at USD 5.3 billion in

³¹ In net terms, the central bank sold USD 2.4 billion in the 12 months to August 2015 before the currency float and sold another USD 2.3 billion in the seven months from September 2015 to March 2016.

³² Given the relatively stable exchange rate of the LKR against the USD, the depreciation of major and emerging markets currencies against the USD between mid-2014 and mid-2015 also led to a strong appreciation of the LKR on a trade-weighted basis. The recent LKR depreciation corrects this appreciation in the nominal and real effective exchange rate (NEER and REER) to some extent.

³³ The government issued sovereign bonds worth of USD 1,500 million in two tranches: USD 500 million 5.5-year and USD 1,000 million 10-year on July 11, 2016. The bond with 5.5-year tenure attracted a coupon of 5.75 percent, reflecting a spread of 470 basis points over the corresponding US treasury rate. The bond with 10-year tenure was issued at a coupon of 6.825 percent with a spread of 540 basis points, compared to a spread of 480 basis points reported at the last 10-year bond issuance in October 2015.

provided a welcome boost to reserves in med-2016

June.³⁴ The central bank also remained a net buyer in the forex market in the months of July and August reversing a trend of selling reserves to defend the currency. Meanwhile, after three episodes of strong outflows (2014, August 2015, first quarter 2016) holdings of securities by non-resident investors have stabilized and increased slightly since April (Figure 18 and 22). However, foreign exchange obligations for the 12 months starting from July 2016 would amount to USD 8.4 billion, implying that official reserves net of short-term liabilities are low; nevertheless, about USD 2.8 billion or one third of these liabilities represent swap arrangements with domestic banks (which issued medium-term international bonds) that may be rolled over and the swap arrangement with the Reserve Bank of India.

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

Rapid credit growth exerted pressure on interest rates.

In an accommodative monetary environment, private credit³⁵ grew rapidly in 2015 while credit to government also soared due to a high deficit and the emphasis on domestic sources for deficit financing.³⁶ Consequently, the market excess liquidity started declining since late 2015 exerting pressure on interest rates. In fact, the month end excess liquidity was in the negative terrain in March 2016 for the first time in more than two years. The central bank rejected the bids received at a few bill and bond auctions, an indication of interest rates rising above its desired level. Some liquidity injections came in the form of new money from the central bank reducing upward pressure on interest rates while pushing up its holding of treasury bills to a historic high in April 2016.³⁷ Reserve money growth reached a record high at 26.8 percent on a year-on-year basis in February 2016 after closing the year 2015 at 16.5 percent (Figure 17 and 21)

Policy action has been taken since late 2015.

Rapid credit growth, rise in core inflation and spike in in non-oil imports prompted policy action in the last quarter of 2015. These included imposing a maximum Loan-to-Value ratio for leased vehicles, increasing margin requirements for opening letters of credit for imports, and increasing duties on vehicle imports. However, monetary policy instruments were reserved until January 2015, which came in an increase in Statutory Reserve ratio (SRR) by 150 basis points. This was followed by two policy rate hikes of 50 basis points each in February and July 2016, which is an important step to contain core inflation and to become more attractive to non-resident bond investors. Further measures may be needed if the rapid private credit growth continues and core inflation rises while paying due consideration to long and variable lags in monetary transmission (Figure 20).

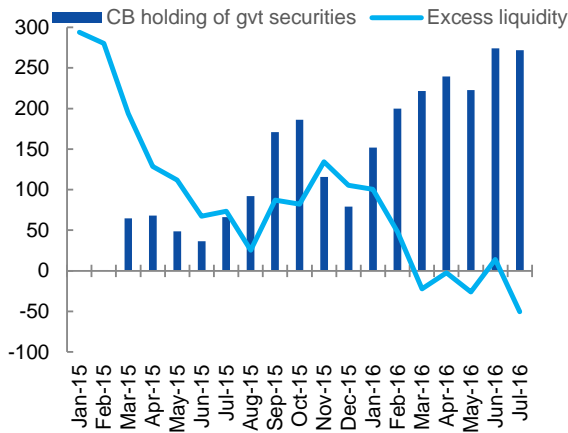
³⁴ Accordingly, the import cover in months of goods and services improved to 3.6 in August from 2.8 months reported in June.

³⁵ Private credit that that grew by 25.1 percent in 2015 was mainly driven by the categories of personal loans and advances, construction and other services.

³⁶ By January 2016, year-on-year growth rates for private and government credit from the banks stood at 25.6 percent and 19.9 percent respectively

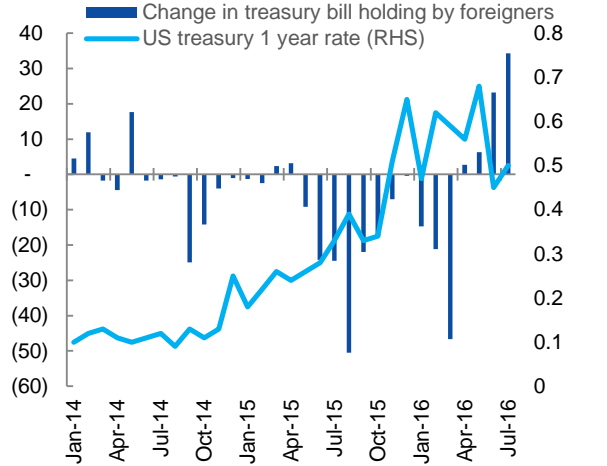
³⁷ At over LKR 308 billion by 12 April 2016

Figure 17: Excess liquidity movements and CB holding of treasury bills
(LKR billion)



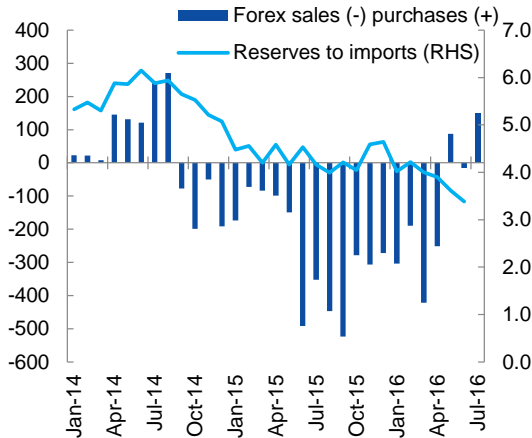
Note: excess liquidity refers to the total volume absorbed by the Central Bank on a daily basis
Source: Central Bank of Sri Lanka

Figure 18: Net foreign capital stock in the government securities market
(LKR billion) (Percent)



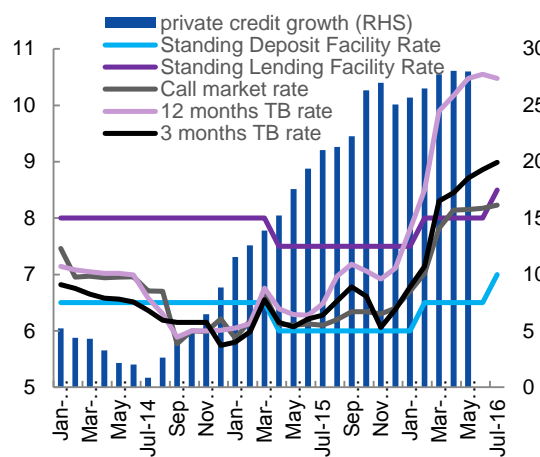
Source: Central Bank of Sri Lanka, US Treasury Department

Figure 19: Reserve movements and monetary authority's intervention in the forex market
(USD million) (Months)



Source: Central Bank of Sri Lanka

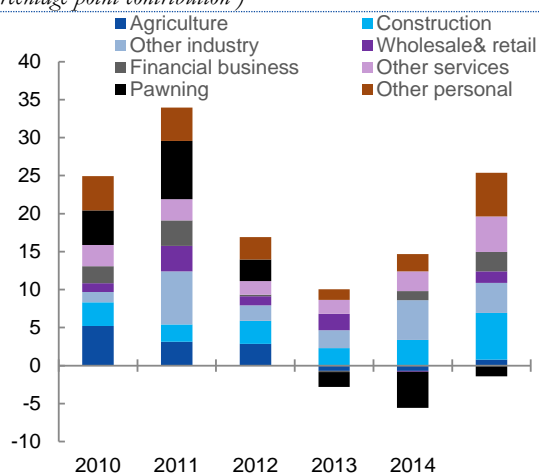
Figure 20: Private credit growth, interest rate movements and policy actions
(Percent) (Year-on-year change percent)



Source: Central Bank of Sri Lanka

Figure 21: Decomposition of private credit growth

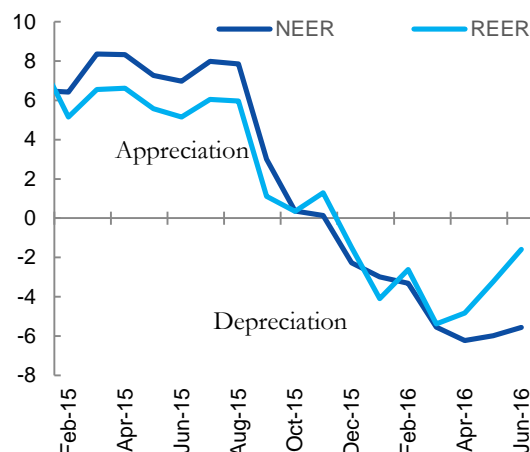
(Percentage point contribution)



Note: Months of imports computed using merchandise imports
Source: Central Bank of Sri Lanka and staff calculations

Figure 22: Movements in nominal and real effective exchange rates

(Percent year-on-year change, positive means appreciation)



Source: Central Bank of Sri Lanka

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

Listed equity market performance remained subdued.

Domestic policy uncertainty and changing patterns of global capital flows took a toll on the performance of the listed equity market, despite the present low interest environment. The benchmark All Share Price Index (ASI) of the Colombo Stock Exchange recorded a 5.5 percent year-on-year contraction in 2015 compared to a year-on-year return of 23.4 percent in 2014. Reflecting the reduced level of trading activity, the stock exchange turnover as a share of market capitalization³⁸ declined while the net foreign inflow turned an outflow during the same period. The Market Price-Earnings ratio (PER) remained at 18.0 times at end-December 2015. Continuing the lackluster performance, the ASI declined by another 5.5 percent as of end-April 2016, on a year-to-date basis.

The banking sector continued to be 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 2015. The gross non-performing loans ratio gradually improved to 3.2 percent in the 2015, down from 4.2 percent in 2014, thanks to measures taken to recover non-performing pawning advances that mainly arose prior to 2015.

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.

Sri Lanka has made encouraging progress in reducing

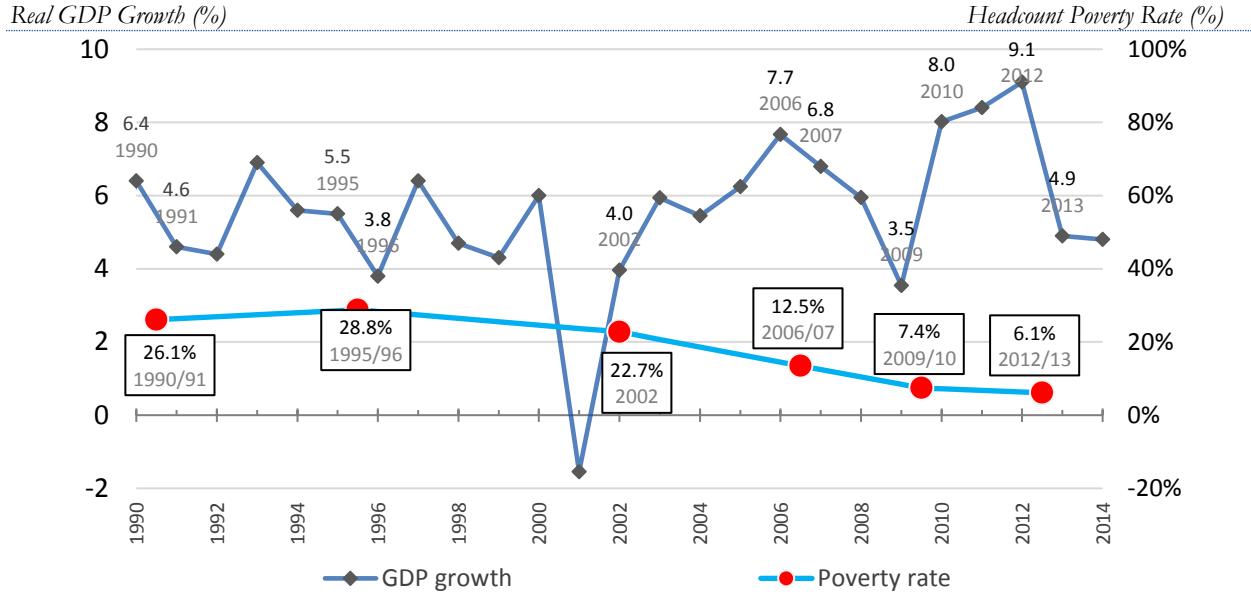
In part thanks to strong underlying growth, the poverty rate fell from 22.7 percent to 6.1 percent between 2002 and 2012/13 (excluding the formerly conflict areas of

³⁸ Declined from 12.3 in 2014 to 8.6 percent in 2015

poverty in recent years.

Northern and Eastern provinces).³⁹ The reduction has been particularly striking in the estate and rural sectors, where the poverty rate dropped from 30 percent to 10.9 percent and from 24.7 percent to 6.8 percent, respectively. Sri Lanka’s poverty is low by international standards. For cross-country comparisons, the World Bank currently uses an extreme poverty line of USD 1.90 per person per day (in 2011 PPP terms). By this measure, extreme poverty in Sri Lanka decreased from 8.3 percent in 2002 to less than 2 percent in 2012/13, and is lower than many of Sri Lanka’s neighbors, other post-conflict countries, and other comparable countries (Figure 23 and 24).

Figure 23: Poverty reduction and real GDP growth

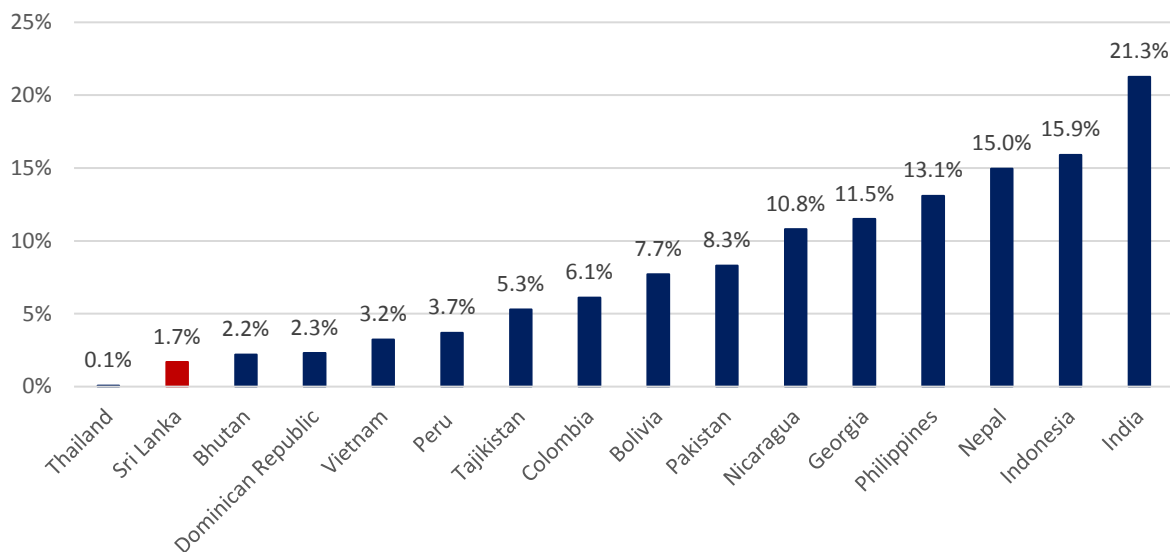


Source: Department of Census and Statistics and staff calculations

³⁹ Owing to the previous conflict, the North and East were not included in the 2002 household survey. When looking at only regions for which data was collected in both surveys, the decline in poverty was from 22.7 percent in 2002 to 6.1 percent in 2012/13.

Figure 24: Sri Lanka's extreme poverty rate is low relative to comparable countries

PPP \$1.90 headcount poverty rate (latest available, 2011 PPP)



Source: World Development Indicators

Underlying this poverty reduction, there are four salient and interrelated factors.

While it is difficult to identify the underlying causes of this poverty reduction, there are four salient and interrelated factors. They include (i) the economy's gradual structural transformation out of agriculture into more productive sectors, (ii) urbanization and agglomeration around key urban areas, (iii) rising international prices for food and tea that raised earnings in agriculture, and (iv) strong domestic aggregate demand that has boosted economic growth. Of these potential factors, a more rapid structural transformation and increased agglomeration have the most potential to sustain poverty reduction in the future. Growth in the agricultural sector during this period largely reflected rising prices and an expansion in arable land, neither of which are likely to be sustained. Domestic aggregate demand, meanwhile, has been led by the construction and transport sectors, spurred in part by public investment in the aftermath of the conflict (Box 1). These sectors, however, cannot be relied upon to produce sustained growth. This suggests that efforts to further improve living standards of the poor focus on promoting further structural transformation and urbanization.

Despite this recent progress, living standards remain low and pockets of severe poverty persist.

Around 40 percent of the population subsists on less than twice the poverty line, which was \$4.75 per capita per day in 2011 PPP terms, or 225 rupees per day. Furthermore, living standards of the near-poor – those above the national poverty line but below the 40th percentile -- are similar to those of the poor. Moreover, low-income households' ability to access basic services and public facilities has barely improved since 2002. The population in Northern and Eastern provinces is particularly disadvantaged in terms of consumption, labor market outcomes, educational attainment, and housing conditions. Finally, inequality increased sharply from 2009/10 to 2012/13.

Government spending on social assistance programs

Fiscal expenditure on social assistance programs is low and has declined, and therefore contributed little to poverty reduction. In the short run, more generous social assistance programs, as well as multi-sectoral interventions targeted to the remaining pockets of poverty, can help support the existing poor. In the longer term,

contributed little to poverty reduction.

adjustments to Sri Lanka's social protection system are necessary to address challenges related to a growing middle class and an aging population. Policies can also do more to speed the structural transformation out of rural and peri-urban agriculture into more productive work. Roughly 30 percent of the workforce, and about half of the working poor, toil in the agriculture sector. Many of the poor live in peri-urban areas – over half of the poor are estimated to live within 30 km of a main agglomeration area. Policies that help connect these workers to productive employment opportunities off the farm can contribute to sustainable poverty reduction. Revenue is also moderately regressive, with a large emphasis on indirect taxes.

Important knowledge gaps remain.

Important knowledge gaps remain, however, starting with the relative importance of the four potential factors described above in explaining the observed poverty reduction. Internal migration and more detailed information on access to infrastructure have yet to be thoroughly investigated. Nor does longitudinal data exist to examine how, or how frequently, households enter and exit poverty. Little is known about the underlying causes of the rise in labor demand – did workers' skills improve or was technology used more effectively? How much do labor regulations constrain further growth in wage employment? Bridging these knowledge gaps and documenting how public policies affect the poor can inform much-needed efforts to further improve their living standards.

Box 2. Sri Lanka Poverty Assessment

Poverty Assessments (PA) are a key instrument of the World Bank's country engagement strategy. They are designed to assess the extent and causes of poverty in a given country and to propose a strategy to ameliorate its effects. They review levels of and changes over time and across regions in poverty indicators, assesses the impacts of growth and public actions on poverty and inequality, and reviews the adequacy of a country's poverty monitoring and evaluation arrangements. PAs generally feed into country-owned processes to develop strategies to reduce poverty, help build in-country capacity, and support joint work and partnerships

Sri Lanka's Poverty Assessment is available at as a full report and as a brief:

Summary: <http://documents.worldbank.org/curated/en/2016/03/26066139/poverty-welfare-sri-lanka-recent-progress-remaining-challenges>

Full report: <http://documents.worldbank.org/curated/en/2016/02/25918944/sri-lanka-poverty-welfare-recent-progress-remaining-challenges>

B. Outlook, Risks and Policy Options



1. Outlook⁴⁰

A relatively favorable outlook is projected with reforms; downside risks are substantial.

Monetary tightening and enhanced currency flexibility since the last quarter of 2015 have contributed toward improving short-term stability. Meanwhile, the IMF program will add to the market confidence while helping reform the tax system to generate more revenues with a view to ensure fiscal sustainability. The government has undertaken to implement a medium-term reform agenda in line with the DPF that aims to improve competitiveness, governance and public financial management that would bring in long-term benefits. These developments have contributed to an improved outlook.

Growth is expected to continue with manageable inflation.

Growth is expected to remain unchanged in 2016 and grow marginally over 5.0 percent beyond, driven mainly by private consumption and postponed FDI in 2015 from the expenditure side and non-tradable sectors from the production side. The reduced drag from imports thanks to continued low commodity prices and recent policy measures to curb import growth would contribute to the increase in growth. The impact of past currency depreciation along with the increase of VAT rate is expected to lead inflation to rise in 2016. However, relatively low international commodity prices are expected to maintain downward pressure.

External current account is to widen after narrowing in 2016.

The current account is projected to reach its narrowest point in 2016 thanks to the slowdown of non-oil import expenditure and continued low commodity prices in a context of tighter monetary and fiscal policy. However, it is projected to gradually widen as the commodity prices rebound in the global markets during 2017-18. Remittances will be relatively weak due to the impact of the low oil prices on the Gulf economies. Exports are expected to grow slowly in line with growth in the United

⁴⁰ Table 1 on last page

States and European Union, while tourism receipts are expected to support the current account.

With increased forex flows, external buffers are to improve in 2016.

A pick up in FDI is projected with the political stability; and a boost received from the Colombo Port City⁴¹ and Western Province Megapolis projects. With forex inflows in IMF EEF, project loans, other multilateral borrowings and planned sovereign bonds, the official reserve cover to imports of goods and services is projected to increase above 4.6 months in the medium term. In the outer years, in the absence of faster growth in exports, 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.

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

The fiscal deficit is projected at 5.7 percent of GDP for 2016 after considering the impact of key policy measures and related implementation delays. Although implementation will be challenging, reforms in line with the IMF program would help increase revenues while rationalizing expenditure. These measures will help the fiscal budget to return to primary surplus in 2018 and reduce the deficit to 3.5 of GDP by 2020 as articulated in the government policy statement presented to the Parliament. On public debt, a staff Debt Sustainability Analysis confirms the need of structural and credible revenue and expenditure measures to bring the debt burden on a downward path again. The fiscal discipline is even more important in an environment of rising domestic interest rates, tightening global financial conditions and a less welcoming climate for emerging markets. The baseline scenario that assumes no major current expenditure proposals while capital expenditure and net lending is maintained at 5.0 percent of GDP returns a deceleration path for public debt to reach 69.6 percent of GDP by 2020.

2. Risks

A further slowdown could adversely affect public debt.

If growth continues to be slow, a further fiscal adjustment might be needed to contain the debt level. Any fiscal slippages due to inadequate tax policy reform or decreased efficiency of collection, pressure to increase current expenditure or the realization of contingent liabilities could derail the debt sustainability. Such an eventuality could lead to loss of confidence reflected in reduced consumption and investment, and decelerating growth. SOE debt both guaranteed and non-guaranteed could pose a risk to the fiscal position.

Risks to the outlook from the global environment will be significant.

External shocks could come from a number of sources (see Box 3): a further slowdown in key export markets and source countries of remittances, tourism and investment; increases in global commodity prices; and tightening global financial conditions. Continued economic woes in European countries and in Russia could deteriorate export performance⁴² and impact tourism (about 1/3 of tourism arrivals are from this region). While it appears that remittances from Middle Eastern countries are relatively insensitive to global commodity price fluctuations, persistently low prices may eventually have a detrimental impact on remittances. The slowdown in

⁴¹ The USD 1.4 billion project (the single largest FDI project in Sri Lanka), which was halted by the new administration just after coming to power is expected to be allowed to recommence construction work in mid-2016.

⁴² Russia remained Sri Lanka's largest tea export destination even in 2015 with a 12 percent share while the Middle East generated 54 percent of the country's total remittances. The EU receives approximately 30 percent of the country's total exports.

China could affect tourism inflows.⁴³ Financial market problems in China could also affect official bilateral financing and financing through its development banks and FDI inflows, while indirectly it could lead to global volatility. Although the impact is yet to be estimated, the exit of United Kingdom from the European Union⁴⁴ can have implications on exports, FDI, remittances and tourism flows in the medium-term. Geopolitical tensions in oil producing countries could also spill over to other parts of the world through disruptions in production or transportation and reverse the commodity windfall. Finally, a further tightening of global financial conditions could worsen capital outflows as experienced in the past few months. As a result, the currency pressures could persist in the short to medium term and the debt roll-over could become expensive, especially once the Eurobonds are starting to mature from 2017. Besides increased refinancing risk, increases in global benchmark interest rates would directly affect the interest cost with the country's growing share of variable-interest rate debt.

Box 3. Global outlook

Global growth: continued weakness. Global growth this year is projected at 2.4 percent, unchanged from the disappointing pace of 2015, and 0.5 percentage point below January forecasts. Emerging market and developing economies (EMDEs) account for about half of this downward revision, in large part due to the significant downgrade to growth forecasts for commodity exporters, and amid heightened domestic uncertainties and a challenging external environment). Advanced economies are projected to expand by 1.7 percent this year, 0.5 percentage point slower than expected in January. Investment continues to be soft, and export prospects have worsened. Despite a boost from lower energy prices and improvements in labor markets, advanced-economy growth is expected to level off in 2016, rather than strengthen further as previously envisaged.

EMDEs: divergences. Growth disappointments have extended into 2016. Aggregate growth for EMDEs is projected at 3.5 percent for 2016, just above the post-crisis low reached in 2015. However, the overall forecast masks a marked difference between commodity exporters and importers. After stagnating last year, growth in commodity exporting EMDEs for 2016 is expected to be 0.4 percent—substantially below the 1.6 percent forecast in January, reflecting a significant downward revision in commodity price forecasts, weak global trade, volatile capital flows, and persistent domestic challenges. In contrast, growth projections for commodity importing EMDEs are little changed at 5.8 percent for 2016, and are expected to be broadly stable at that level through 2018. Policy buffers continue to erode in commodity exporting EMDEs, especially in oil exporting countries, reducing their ability to withstand further downside shocks.

LICs: commodity exporters struggling to adjust. Low-income country (LIC) growth slowed to 4.5 percent in 2015, the weakest pace since 2009. Although output is projected to pick up to 5.3 percent this year in this group, lower commodity prices and nagging security and political challenges have trimmed 0.9 of a percentage point from the previous forecast (Figure 1.D). While the difficult external environment confronting LICs will likely continue, growth is still expected to be supported by resilient investment growth and implementation of reforms.

Risks: tilted further to the downside. A sharper-than-expected deceleration in major emerging market economies, rising policy and political uncertainties, geopolitical risks and eroding confidence in policy effectiveness could set back global growth and trigger financial market turbulence, with particularly significant consequences for EMDEs. Rising private sector indebtedness has become a significant source of vulnerability in some EMDEs. Historically, countries with rapidly rising debt in the years leading up to a period of financial stress have experienced a more protracted slowdown in its aftermath.

Policy buffers: limited. Limited fiscal and monetary policy buffers in many countries is leaving the global economy less prepared to cope with these risks. The room for policy accommodation has increasingly diverged between commodity importers and exporters. Diminishing foreign reserves and fiscal buffers have already forced many commodity exporting EMDEs to tighten policy pro-cyclically. In commodity importing EMDEs, even though low

⁴³ China is Sri Lanka's second largest tourist source country with a share of 12 percent of the total arrivals.

⁴⁴ Sri Lanka receives 18 percent of its total garment export revenue, 9 percent of total tourist arrivals and 7 percent of total remittances from the UK. European Union is Sri Lanka's largest market for merchandise exports.

commodity prices have reduced fiscal and external vulnerabilities and inflation, the scope for expansionary fiscal policy remains limited because of weak starting positions. In advanced economies, actual and expected inflation are below targets. Large-scale unconventional monetary policy accommodation in advanced economies has to some extent bolstered demand, but may over time have diminishing returns and raise financial stability risks. Expansionary fiscal policy could support activity in a number of advanced economies in the event of an adverse shock.

Policy priority: focus on structural reforms. In an environment of weak growth, rising risks, and limited policy buffers, growth-sustaining structural policies are urgently needed. These measures would boost medium- and long-term growth, reduce vulnerabilities, and signal to investors that authorities are committed to reinforcing long-term prospects. If well targeted, they could also support short-term aggregate demand. Greater investment—in infrastructure, productivity enhancing technology, and human capital—could lay the foundation for stronger growth. Policies should aim to fill public infrastructure gaps, encourage foreign direct investment, strengthen human capital, foster diversification, and reduce trade barriers. However, countries with diminishing fiscal space may be limited in financing such investments. International cooperation efforts could include commitments to undertake expansionary fiscal policies if large downside risks materialize, to channel pooled global resources into infrastructure and human capital investment, and to strengthen global safety nets for the most fragile countries.

Source: World Bank Global Economic Prospects, June 2016

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)

Prospects blog: <http://blogs.worldbank.org/prospects/>

3. Policy options

The current economic reform process has to weigh policy trade-offs.

The government policy statements have indicated the appetite to implement much needed reforms in the areas of fiscal operations, competitiveness and governance. These reforms, if successfully implemented while paying attention to the related policy trade-offs could uplift the country into the Upper Middle Income status in the medium term. Although a turbulent external environment and domestic political considerations makes it challenging, a strong political will and the support of the bureaucracy should help advancing the reform agenda. Steps are needed to ensure the support of private sector and the civil society.

Adherence to the planned fiscal consolidation is important for a number of areas.

Raising more revenue while controlling current expenditure is needed to reduce the fiscal deficit and bring public debt to a sustainable path. It will also help 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. 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 comprehensive debt management strategy is important.

The government's decision to establish a unified Debt Management Unit (DMU) to manage the public debt portfolio is important as concessional international funding is drying up as the country has graduated to the middle income level. A proactive debt management strategy can provide guidance to the DMU to consider trade-off

to manage costs and risks of the portfolio.

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. Pro-active liability management to buy back part of the 2019 Eurobond is important to reduce medium-term external refinancing risks. 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.

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, while the increased fiscal space could be used for investment in public health and education provision and infrastructure.

Simplification of the tax system and strengthening of the tax administration and improve investment climate.

The new Inland Revenue Act, to be enacted for early 2017 with IMF support, and further reforms are expected to widen the tax base, make the current tax system simpler and more stable, and make administration more efficient. The Government committed to move away from blanket tax holidays and other tax concessions as investment incentives and offer investment-related incentives targeting long-term investors and priority sectors that will contribute to a transformation of Sri Lanka into an upper-middle income country, by connecting Sri Lanka into global value chains and production networks and by bringing in new technology and best practices. While removing tax exemptions and special tax rates will make some firms worse off, a more efficient tax system, strengthened tax administration and an improved business climate will benefit all firms.

Tax reforms could enable a new trade policy more conducive to exporting.

The current tax system is overly reliant on a myriad of trade-related taxes and para-tariffs (special levies on imports and exports), which has, at least in part, led to inward orientation and weakening of competitiveness.. Tax reforms leading to an increase in tax collection and more efficient administration will create the fiscal space to gradually remove the para-tariffs, and support implementation of a new trade policy that will be more conducive to exporting.

Structural reforms on competitiveness could help the transformation envisioned.

In order to enhance private sector competitiveness the Government has announced a long-term reform agenda aimed at strengthening the ability of Sri Lankan enterprises to compete in the international markets. The key reforms include setting up an institutional framework to guide reforms and enhance interagency coordination, streamlining trade-related regulation in line with good international practices; facilitating FDI; and eliminating well-identified deficiencies in the legal framework. As a first step, the Government has set up an Agency for Development and an Agency for International Trade to develop a new FDI attraction strategy and trade policy.

Governance reforms will support fiscal sustainability and

A Constitutional Amendment to 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

overall competitiveness.

comprehensive Public Financial Management Act will provide clarity on roles and responsibilities in the management of public assets. A 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.

Box 4. Support to improve competitiveness, transparency and fiscal sustainability

The World Bank is supporting the government in its efforts to modernize the economy. A Development Policy Financing (DPF) operation, for an amount of USD 100 million, was approved in July 2016 to provide budget financing and to support the following reforms (1) eliminate obstacles to private sector competitiveness, (2) enhance transparency and public sector management and (3) improve fiscal sustainability. Section D discusses the World Bank Group's country strategy and ongoing support to Sri Lanka. This operation was closely coordinated with JICA, which provided an additional USD 100 million budget loan supporting the same policy reforms.

The Program Document is available online at:

<http://www.worldbank.org/en/news/loans-credits/2016/08/01/sri-lanka-dpf>

Box 5. Fiscal policy options in South Asia

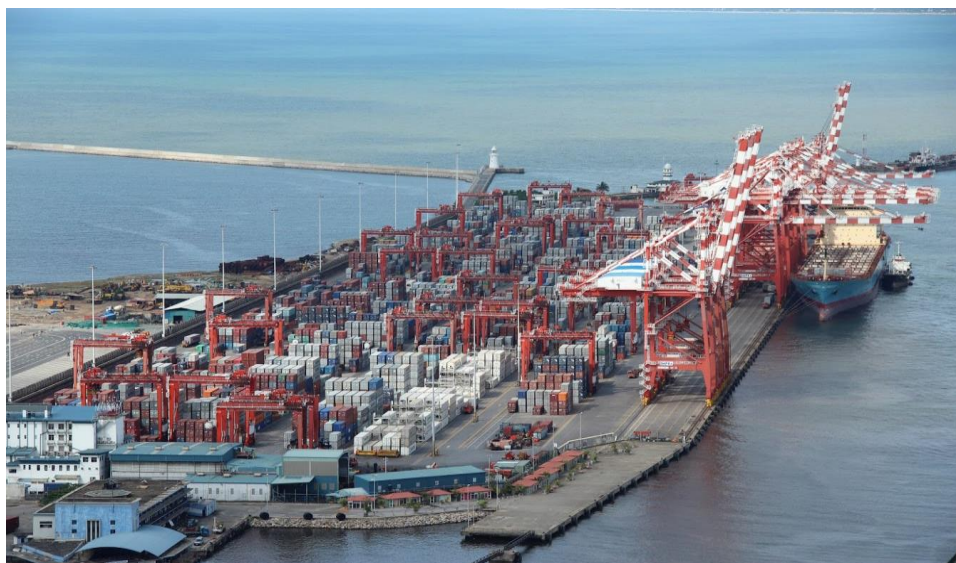
As the global economy slows down, and some of the tailwinds that had helped South Asia rebound start fading, the overall fiscal policy stance at the national level may warrant reconsideration.

A recent World Bank publication looks at fiscal policy options to find a balanced path towards fiscal consolidation in the four largest South Asian economies: Bangladesh, India, Pakistan and Sri Lanka. The quality of fiscal consolidation will affect these economies and societies in a number of ways: (1) the pace at which they address their expenditure and revenue will have a large impact on economic stability; (2) the extent to which expenditure supports capital accumulation will matter for economic growth; (3) taxes, subsidies and spending on basic services will affect equity; and (4) reducing implicit energy subsidies and introducing explicit carbon taxation will have implications for environmental sustainability. The report shows, the window with strong tailwinds may be closing and reforms will be more difficult to introduce later on.

The full report is available online at:

<http://www.worldbank.org/en/news/press-release/2016/04/09/south-asia-fastest-growing-region-world-vigilant-fading-tailwinds>

C. Challenges



Special Focus: Structural challenges identified in the Systematic Country Diagnostic

Systematic Country Diagnostic provides a platform to identify development challenges.

The World Bank Group launched a Systematic Country Diagnostic (SCD) for Sri Lanka in February 2016. The objective was to identify the most critical constraints and opportunities facing Sri Lanka in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. The SCD is an objective, evidence-based, candid assessment of the main challenges facing the country, without limitation to the areas where the WBG is currently engaged. The SCD and the subsequent Country Partnership Framework, which guides the WBG program, are part of a new approach to working with country partners.

The key development challenges identified in the Sri Lankan context are:

1. The fiscal challenge
2. Promoting more and better jobs for the bottom 40 percent
3. Inward versus outward orientation of the economy
4. The relationship between the public sector and private sector
5. Social Inclusion Challenges

a. The fiscal challenge

Low and declining revenues critically impact Sri Lanka's fiscal position.

Sri Lanka now has one of the lowest tax revenue-to-GDP ratios in the world, reflecting a decline from 24.2 percent in 1978 to 10.7 percent in 2014. The major causes of this decline are the low increase in the number of tax payers, reductions in statutory rates without commensurate efforts to expand the tax base, inefficiencies in administration and numerous exemptions. In particular, since the introduction of a VAT in 2002, successive changes in the tax regime have led to over 500 types of

exemptions for a wide variety of goods. There are also over 40 broad types of exemptions on corporate and personal income tax depending on the source of income and the type of taxpayer. Administration is complicated by lack of coordination among entities collecting revenue as well as the Board of Investment, which provides incentives. No tax expenditure analysis is conducted before or after the introduction of incentives.

Low tax revenues combined with largely non-discretionary expenditure has constrained critical development spending.

Sri Lanka's overall revenues and expenditures are among the lowest in the region. Fiscal consolidation and relative prioritization of public investment in capital infrastructure following the conflict have squeezed expenditure on other public goods, including health, education and social protection, which are currently below levels in other regional and emerging market comparators. Fiscal consolidation combined with declining revenues has made the budget rigid, leaving little fiscal space for the government to maneuver. Difficult-to-reduce items such as public service remuneration, transfers, and interest payments have accounted for 60 percent of expenditure in recent years. Moreover, wage pressures have been rising due to a 57 percent increase in the numbers of public servants in the past ten years that has yielded a situation where they account for 13 percent of the labor force, comparable to OECD levels (average of 15 percent in 2011). At the same time, increases in recurrent expenditures in early 2015, particularly a raise in allowances to public servants, is to be financed by one-time taxes, leaving very little room to maneuver. A strong commitment to fiscal consolidation in the face of these pressures has led to Sri Lanka having extremely low levels of public spending on education, health, and social protection as a percentage of GDP. Going forward continued commitment to fiscal consolidation is needed to ensure macroeconomic stability, but this will require long-term improvements in revenues.

b. Promoting more and better jobs for the bottom 40 percent

Sri Lanka has a number of advantages that can contribute to inclusive growth.

Given its relatively small domestic market, Sri Lanka will need to look outward to fulfill its ambitions to become a prosperous and competitive middle income country. As such, the country has important strengths such as overall strong human capital and a reliable infrastructure base, particularly when compared to other South Asian countries. Sri Lanka also enjoys an enviable location in a fast growing region along a major trade route, opening opportunities to serve as a regional trading hub. Moreover, Sri Lanka's boasts unique natural assets, with a temperate climate, diverse topography, and unique historical assets, giving it a strong basis for tourism. At the same time, the country has a track record of developing globally competitive companies, particularly in niches of the apparel and IT sectors.

Sri Lanka has to look for the right policy balance.

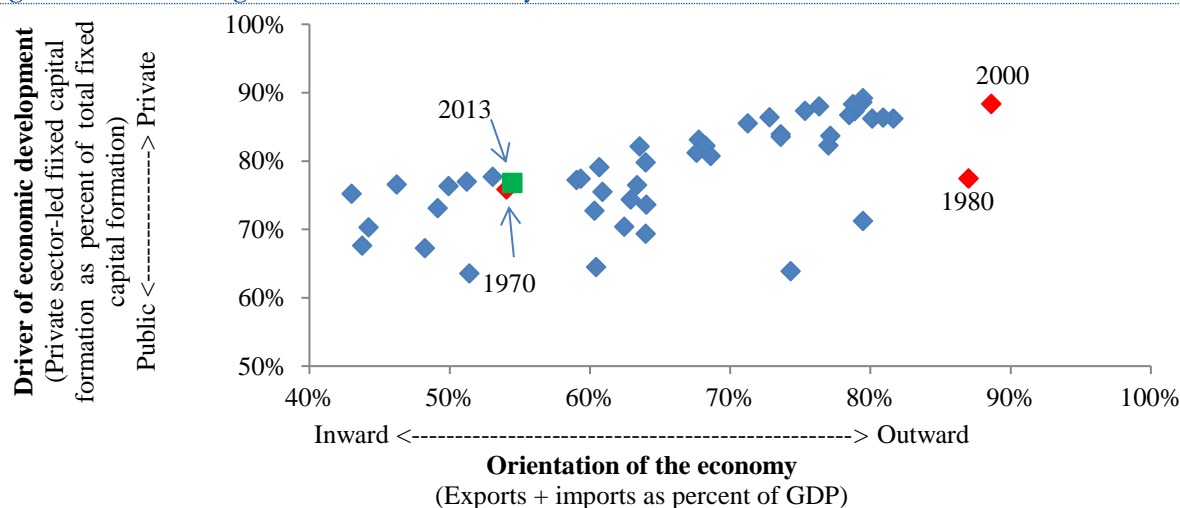
For Sri Lanka to capitalize on its advantages it will need to find an effective balance along two axes: (i) inward vs. outward orientation of the economy and (ii) the respective roles of the public and private sectors (Figure 1.1). The country's world market share has fallen to levels last seen in the 1980s, with a steady decline in commodity exports and an export basket that has remained largely unchanged in a context of rising production costs and weakening demand due to slow growth in some of its main markets (Europe and the Middle East). At the same time, the economy has shifted towards a public-sector led model, as public investment to rebuild following the end of conflict was responsible for much of the large growth in construction as well as transport over the last decade.

Increasing inward orientation is an issue to address.

c. Inward versus Outward Orientation of the Economy

While Sri Lanka's industrial policy has been broadly market-oriented since liberalization in the 1970s, the degree of outward orientation has wavered in the past decade. Two earlier rounds of economic liberalization introduced a series of reforms towards deregulating the economy, accompanied by a strong focus on export orientation and FDI promotion. The last decade has seen a noticeable shift towards protectionism. The introduction of para-tariffs has effectively doubled the protection rates, making the present import regime one of the most complex and protectionist in the world. Moreover the 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 lead to an anti-export bias, since producers have strong incentive to sell goods domestically even though their domestic costs are higher than their opportunity costs through trade. 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. Incentives are structured to expand production of import-competing crops (rice, maize) and discourage the production of exportables through 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. Revenues from cesses were supposed to be then invested in research and development for the corresponding sectors to encourage value addition, yet this has not been implemented.

Figure 25: Rebalancing the focus of the economy



Source: World Development Indicators

Foreign direct investment has been disappointing despite numerous fiscal incentives.

Foreign direct investment (FDI) remains below 2 percent of GDP five years after the end of armed conflict. Moreover, FDI inflows to Sri Lanka have been 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. Although conclusive data is not available, the benefits from incentives in terms of attraction and retention of productivity-enhancing FDI may not outweigh the costs involved in fiscal losses and potential disruption of market dynamics (through, inter alia, the creation of an unlevelled playing field). Global experience suggests that the most important ways to ensure both domestic and foreign investment include measures to improve the enabling environment, including through

a skilled workforce and adequate innovation policies that form the basis of a competitive economy.

The quality of general education lags behind higher middle-income countries and firms have difficulty accessing the skills.

Although human development indicators are ahead of regional peers, the quality of education, as measured by periodic internationally comparable tests, lags behind that of higher middle-income countries, particularly in language and numeracy skills. Sri Lanka also lacks the kind of vocational and technical skills in its workforce which are increasingly in demand, reflecting constraints on the quality and relevance of higher education and research. For instance, over 75 percent of employers expect a high-skilled worker to know English and have computer skills, however, only 20 percent of Sri Lankans are fluent in English and only 15 percent can use computers. The mismatch between the skills being demanded and the education of the workforce is also reflected in declining returns to education. More generally, there are poor linkages between what the private sector needs in order to innovate and research and development institutions that could meet these needs. This is particularly acute in agriculture where there is limited distribution of new technologies which are critical for modern farming.

d. The Relationship between the Public Sector and Private Sector

The government's performance as regulator and facilitator of the economy has improved, though there remain significant shortcomings.

Given fiscal constraints, sustained growth will need to be driven by the private sector which in turn calls for government regulation conducive to business. Among areas of regulation, systems for registration of property rights and land-use regimes which introduce limitations and lead to fragmentation of land parcels are an important constraint to businesses. Land ownership issues are the most common reason cited by informal firms for not registering. Moreover, the predictability of state regulation with regard to property rights has proven to be an issue, with particular harm caused by the 'Revival of Underperforming Enterprises and Underutilized Assets Act', which expropriated 37 enterprises, in sectors like hotels, mixed property development and sugar industries. Licenses and permits are also an obstacle, particularly in the Northern Province. Finally policy induced barriers consisting of regulatory and institutional bottlenecks account for nearly 70 percent of the total time spent on exporting or importing goods.

Labor market regulations constrain the growth of employment.

Although labor market regulations aim to provide job security to formal sector workers, since these represent only about 15 percent of the workforce, they have resulted in creating a deep divide between formal and informal workers. Sri Lanka's Termination of Employment of Workmen Act (TEWA) requires that firms with 15 or more employees justify layoffs and provide generous severance pay to displaced workers, with smaller firms being exempted. These severance payments are expensive relative to regional and middle income peers. Finally, the legal framework prevents women from taking up night work or part-time work in the growing service sector while the laws governing maternity benefits make employers bear the entire cost, potentially deterring employers from hiring women.

Regulatory compliance leads to informality, which in turn undermines competition.

Most business establishments in Sri Lanka are small and hence do not benefit from economies of scale. Moreover, side-by-side operations of informal and formal firms in a market lead to unfair practices and market inefficiencies. Unfair competition from informal players is viewed as the single most important obstacle to the growth and competitiveness of established firms. At the same time informal firms generally have no access to financial services, government contracts, and essential licenses and permits.

SMEs face multiple constraints, particularly access to finance and technology.

Financing issues are driven by weaknesses of the firms to put forward bankable projects as well as failures in SME banking which relies on asset-based financing with little flexibility to provide project-based finance. SMEs also find it difficult to access technology to upgrade their businesses. Reducing the cost of operating a business is arguably the most effective way to reduce informality, reduce uncompetitive practices, and by extension create an environment more conducive to investment in productivity enhancing activities.

Proliferation of small firms and informal employment have consequences on shared prosperity.

Most of the increase in non-agricultural employment between 2002 and 2012 was among self-employed non-farm workers. Moreover, the decline in agricultural employment coincided with an increase in workers employed in establishments with no regular employees. By 2012, 74 percent of unskilled workers (those with less than a primary education) had only temporary or casual wage employment, up from 70 percent in 2006, suggesting that these workers are increasingly working under precarious conditions. Wages of temporary workers are on average 33 percent lower than wages of permanent workers; one-third of which cannot be explained by differences in the job or individual characteristics, suggesting that workers would choose more stable reliable jobs if they could.

State participation in the economy has implications on competitiveness.

Beyond carrying out regulatory functions, the state itself is a major participant in the market through its large SOE sector and large public service, which in turn has impacted competitiveness in a number of sectors and labor market dynamics. SOEs have a significant market share in many sectors, including areas where there isn't a strong apparent rationale for public intervention, such as where there are natural monopolies or free/easy rider issues. This is most striking in the finance sector, where major SOEs make up about close to half of the market. In addition, the state plays an outsized role as an employer. There is strong demand for public sector jobs as public sector workers enjoy the advantages of formal employment and other benefits such as a pension. Moreover, the evidence suggests that there is a salary premium for public sector workers and that this premium has grown between 2006 and 2012. Workers, particularly educated women, are queuing for public sector employment.

A high degree of interconnectedness between the state and some segments of the private sector motivates intervention by the government.

The variation in tax and customs incentives reflects government policy but also contains specific benefits for specific sectors, many of which have a limited number of major actors. In addition, there are several high profile cases of movement of senior officials between public and private sectors as there is no developed framework for handling conflict of interest to separate public sector work from private sector interests. Given that there are frequent instances of state regulatory help to a given sector it follows that private sector entities would seek to maintain or expand privileges, reinforcing the level of regulatory intervention into the economy. These circumstances also suggest that many private sector entities would have to adjust considerably were Sri Lanka to open its markets more. Combined with broader expectation of public sector employment, a reduction of the state's role or an attempt to "level the playing field" in some sectors will encounter resistance from vested interests.

e. Social inclusion challenges

The highest numbers of people living in poverty and the bottom 40 percent are located

Urbanization in Sri Lanka has been a strong driver of growth and that trend will continue. Streamlining urban management structures and improving their capacity to ensure they have the administrative powers to deliver functional urban services and conduct integrated, strategic planning (including land use planning and transport planning) will provide local authorities with the opportunity to respond to both

within multi-city agglomeration areas.

present and future needs. Improved connectivity across the country will further assist in raising the economic potential located outside the Kandy-Colombo-Galle agglomeration, as well as improving growth drivers within those districts.

The poor in more isolated regions of the country represent a different challenge.

There are high rates of poverty in the Northern and Eastern Provinces, the center where the estate sector (plantation-based agriculture) is concentrated, and Moneragala in the southeast. Poverty rates are highest in portions of the Northern and Eastern provinces, which were at the center of the conflict. The high poverty headcount rates in these regions are associated with weak links to the labor market, particularly among the youth and among educated women. Persons with physical disabilities and psychological problems due to conflict, in particular ex-combatants and widows, are particularly vulnerable to exclusion.

Poverty in consumption has dropped among estate workers, but non-monetary measures of poverty and vulnerability to falling back into poverty remain high.

Estate workers continue to be largely dependent on the estate's management for their basic needs, particularly housing. While poverty in the estate sector fell markedly in the past decade, poverty rates continue to be higher compared to both urban and rural sectors, pointing to continued vulnerability. This is, particularly evident when looking at health and nutrition indicators. Estates have the highest maternal mortality rates in the country, and both estate women as well as children suffer from high rates of malnutrition that are double national averages. Estate sector households are less likely to have drinking water, sanitary facilities or electricity within their households. Moreover, access to services and the quality of services in the estates is comparatively low. Poor outcomes in education impede the ability of the estate population to participate in Sri Lankan society. The youth are increasingly leaving the estate sector but they face difficulties in accessing salaried employment when competing with other youth. Women tend to be employed for the lowest-paying unskilled tasks that require intense labor such as tea plucking or rubber tapping. Despite being income earners, there is substantial anecdotal evidence that estate women's wages are often collected by their husbands or fathers who in turn often spend it on alcohol. Alcoholism and associated abuse of women is much higher in the estate sector.

The estate sector faces structural challenges that will likely impact the population going forward.

Wages have risen by over 10 times since privatization in 1992 - due in part to the strong collective bargaining power of estate workers, linked to a powerful political party representing them. At the same time, Sri Lankan tea producers are facing increasing competition from Kenyan and Indian producers which have lower costs of production and higher productivity. As a result, the future welfare of estate communities is at risk due to narrowing surpluses enjoyed by Regional Plantation Companies and a socio-economic structure that may not be tenable in the long term.

Beyond the locational concentration of the population, inclusion across ethnic and religious groups is critical.

Although partially correlated to spatial disparities, poverty outcomes across ethnicity and religion illustrate a second important challenge for social inclusion. Differences in poverty outcomes across ethnic groups are related to employment and other opportunities. This is the case even when the North and East are excluded. As more youth migrate across the country in search of jobs, equal opportunities will be critical. Sri Lankan Tamils and Sri Lankan Moors have relatively high levels of poverty; however, empirical analysis finds that most of the difference in monetary poverty is related to inequality of opportunities. For a range of indicators, the most recent household survey shows that Sri Lankan Tamil households have lower access to basic services, including drinking water within their premises, the availability of a pipe borne line nearby their house, a toilet within their unit, or access to electricity. Similarly, educational attainment is lower for the ethnic minority workforce, and rates of ownership of land are also uneven among the country's ethnic communities. In terms

of labor market opportunities, labor force participation is low and unemployment is high for Sri Lankan Tamils and Moors. However, when focusing outside of the post-conflict regions, both Sri Lankan and Indian Tamils have higher labor force participation and employment rates relative to their Sinhalese counterparts. This suggests that different rates of participation are mostly determined by differences in employment opportunities. The conflict-affected areas face the additional challenge of integrating displaced persons: while over 700,000 have returned, they face multiple challenges in securing land rights, accessing shelter and infrastructure and developing livelihoods.

Gender inclusion is critical, particularly as it relates to the labor market.

Women made up 53 percent of the working age population in 2012, but only 34 percent of the employed population. Women are less likely to participate in the labor market, but when they decide to look for work, they are more likely to be unemployed. Social norms related to women's role in the household and especially as related to childcare responsibilities restrict women's opportunity to participate in the labor market. However, beyond social norms, gender wage gaps and occupational segregation dissuade and constrain women from participating in the labor force. At the same time, the formal legal framework for labor prevents women from taking up night work or part-time work in the growing service sector and the laws governing maternity benefits make employers bear the entire cost, potentially deterring employers from hiring women.

f. Sustainability challenges

Sustainability of development will involve keeping momentum towards reconciliation and successful completion of institutional reforms.

Achieving a lasting settlement of conflict that ensures peace and security for Sri Lankans is the *sine qua non* condition for progress. While circumstances are unique to every country and conflict is not imminent, global experience suggests that Sri Lanka is 'at risk' given its past history of internal conflict. Achieving lasting reconciliation and addressing issues which led to grievances that in turn fueled conflict in the past will be critical. Sri Lanka has taken notable steps along this path, including following up on extensive recommendations by its Lessons Learned and Reconciliation Commission. Important measures have occurred in recent months, including the appointment of a civilian as Governor in the north and beginning to return some land occupied by the military after the conflict ended. This momentum will need to be sustained. The second area involves following through on major institutional reforms now taking place to achieve a lasting political settlement around a government that is more transparent and accountable.

Other risks to sustainability are associated with economic stability in the context of an uncertain external environment and environmental issues.

External risks include a chronic current account deficit and relatively low reserve adequacy metrics; a gradual but steady decline in goods exports; an already high external debt burden and a rising cost for external financing as Sri Lanka must now borrow on commercial terms; and disappointing levels of foreign direct investment. While the current account deficit has decreased in recent years, in part thanks to slow increases in remittances and tourism, it remains financed largely by debt-creating inflows. At the same time, Central Bank foreign exchange reserves are at the lower end of what is considered adequate by standard metrics. Moreover, Sri Lanka is in the midst of its demographic transition, and is projected to age fast in the next few decades. As the elderly typically run down their savings and require additional public spending in the form of pensions, social protection and healthcare, their increasing share in the population means that national savings will fall even further. Finally, preserving Sri Lanka's natural asset base and managing environmental impact as the country continues its structural transformation, including urbanization, will be critical to sustaining progress on the twin goals. Sri Lanka will continue to face environmental

risks due to natural disasters as well as the long term impacts of climate change which by one accounting will result in reductions of 1.2 percent of GDP per year by 2050.

g. Conclusions and priorities

Sri Lanka's drivers of past progress are not sustainable.

Solid economic growth, strong poverty reduction, overcoming internal conflict, effecting a remarkable democratic transition in recent months, and overall strong human development outcomes are a track record that would make any country proud. However, the country's inward looking growth model based on non-tradable sectors and domestic demand amplified by public investment cannot be expected to lead to sustained inclusive growth going forward.

The SCD points to fiscal, competitiveness, and inclusion challenges as well as cross-cutting governance and sustainability challenges as priorities areas of focus for sustaining progress.

The fiscal challenge is due above all to poor revenue collection, compounded by inefficiencies in public expenditures that result in rigidity and underinvestment in human capital. The competitiveness challenge is a mix of several areas where Sri Lanka is behind comparator countries, most notably in fostering adequate skills in the labor force, but also in other areas such as FDI attraction, investment climate, and promotion of innovation. The inclusion challenge is both spatial in the urban areas and remote 'pockets of poverty' as well as cross cutting across ethnic, gender, and age differences in Sri Lanka's population. Governance is a challenge in all areas, but is particularly manifested in regulatory constraints and an outsized public sector. Finally, there are important sustainability risks including the need to maintain peace and security, carry through with governance reforms, address longer term economic challenges of an aging population, and balance imperatives to grow with stewardship of Sri Lanka's natural assets as a basis for lasting prosperity and quality of life.

Addressing the constraints and sustainability risks diagnosed in the SCD will require effective leadership.

Consultations conducted while preparing this diagnostic showed that many of the identified constraints were known, at least on an intuitive level. Indeed, with regard to several constraints, reforms or government intervention has been initiated to address problems such as equality of opportunity in underserved areas or improving Sri Lankans' skill sets. The present government has articulated further plans to address other constraints outlined in this diagnostic. Yet there also remain interests that support the status quo, whether they are specific tax exemptions or limitations on the number of slots available in higher education institutions. Sri Lanka is presently at a crossroads in its economic growth model and its governance framework that will provide for an effective state to facilitate growth and ensure social inclusion. Effective leadership will be needed to steer it forward on a path that will continue its strong progress in ending poverty and promoting shared prosperity.

Box 6. The Systematic Country Diagnostic: A New World Bank Group Tool for Country Engagement.

Under its new approach to working with its country partners, the World Bank Group (WBG) requires the preparation of a Systematic Country Diagnostic (SCD) to precede the development of Country Partnership Frameworks (CPF) that guides programming. The objective of an SCD is to identify the most critical constraints and opportunities facing a country in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. The SCD is expected to produce an objective, evidence-based, candid assessment of the main challenges facing the country, without limitation to the areas where the WBG is currently engaged.

The Sri Lanka SCD report and video and CPF are available online at:

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

CPF: <https://openknowledge.worldbank.org/handle/10986/24682>

D. World Bank Group Assistance



The World Bank Group is committed to support Sri Lanka's transition to a middle-income country.

In the Country Partnership Strategy (CPS) for FY13–16, the World Bank Group supported Sri Lanka to address long-term strategic and structural development challenges as it transitioned to middle-income country (MIC) status. The CPS FY13–16 focused on: (i) facilitating sustained private and public investment; (ii) supporting structural shifts in the economy; and (iii) improving living standards and social inclusion. The World Bank 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.

A CPS Progress Report prepared in FY 14 reviewed the country program.

A CPS Progress Report prepared in FY 14 provided an opportunity to review the country program and refocused the activities in line with the government's evolving development needs and agenda. The Progress Report proposed the inclusion of a fourth strategic area of engagement, namely increasing resilience to disasters and climate change, deemed central to Sri Lanka's development agenda and poverty reduction efforts. As the country shifted from reconstruction to addressing the challenges of development on a middle income trajectory greater emphasis was placed on facilitating and creating the enabling environment for increased foreign and domestic investment. Continued pockets of poverty also highlighted the need for renewed efforts to better target the poor.

The recently concluded Systematic Country Diagnostic helped identifying critical challenges.

The Systematic Country Diagnostic prepared in 2015 identified critical constraints and opportunities that Sri Lanka faced in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. The SCD concluded that the challenges of i) 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) longer term sustainability (especially of the environment, political stability, and an aging population) were priority areas. Governance was identified as a cross-cutting challenge.

The SCD anchors the new CPF.

The Country Partnership Framework (2017- 2020) for the World Bank Group is anchored in the analysis of the SCD and consists of three major pillars. Interventions under pillar one will seek to improve macroeconomic stability and competitiveness, pillar two will tackle the promotion of inclusion and opportunities, while pillar three will seek to enhance resilience and management of natural assets. The IFC will give priority to sustainable infrastructure (through PPP's), financial inclusion, and access to input/output markets, products, services and jobs. MIGA will where possible support foreign investment projects, across sectors.

The current active World Bank portfolio in Sri Lanka is healthy.

The current active World Bank portfolio comprises 14 projects (12 IDA and 2 IBRD operations) with a total net commitment value of US\$1.8 billion. Urban and rural development accounts for 27 percent of the overall portfolio followed by water (17 percent) and resilience to climate and disaster risk (14 percent). The education sector (14 percent) and health sector (11 percent) also continue to be core sectors that bank interventions focus on. This fiscal year (FY17), the lending program is expected to include five new projects, supporting competitiveness, financial sector modernization, social safety nets, higher education and renewable energy development. Trust funds have continued to play an important role in implementing the World Bank Group's CPF in Sri Lanka, supporting both analytical work and technical assistance, as well as providing stand-alone or co-financing for projects. The portfolio currently comprises five recipient-executed trust funds with a total net commitment value of approximately \$54 million. Thirteen advisory and analytical service products across ten sectors will also feature in the Bank portfolio this fiscal year. The World Bank Group's program of support to Sri Lanka continues to benefit from close coordination and collaboration with development partners.

IFC has invested over USD 1 billion in Sri Lanka supporting the World Bank Groups' CPS goals.

As of June 2015, International Finance Corporation (IFC) has invested over USD 1 billion in Sri Lanka. IFC's activities in Sri Lanka are supporting the World Bank Groups' CPS goals. By working closely with the private sector, the government, and the World Bank, IFC focuses on facilitating inclusive growth. The focus remains on priority sectors that enhance productivity, support better job creation, build global competitiveness and contribute to sustainable development. IFC looks to work on improving financial and social inclusion including gender, health and education; logistics and infrastructure to facilitate Sri Lanka building itself as a hub for the region.

IFC is taking steps to increase the committed investment portfolio

As of June 30, 2015, IFC's total committed investment portfolio stood at over USD 230 million. IFC's advisory projects are helping to boost access to finance and insurance, build business skills for entrepreneurs, develop supply chains, and promote the growth of tourism. IFC's advisory program currently operates 6 portfolio projects with a combined portfolio value of USD 5.86 million.

MIGA stands ready to strengthen the WBG's work.

Sri Lanka is an important country for MIGA, given MIGA's global focus on supporting high development impact investments into IDA countries and fragile and conflict-affected situations. MIGA stands ready to participate in productive projects across sectors in the country, and will seek to partner closely with the World Bank and IFC in all potential transactions, so as to ensure full collaboration.

Key Economic Indicators

Macroeconomic Indicators	Actual		Projections		
	2014	2015	2016	2017	2018
Real sector					
GDP, (current, LKR billion)	10,448	11,183	12,232	13,419	14,757
GDP per capita, (current, US\$)	3,853	3,971	3,998	4,230	4,489
Real GDP growth (%)	4.9	4.8	4.8	5.0	5.1
CCPI inflation (%)	3.3	0.9	4.0	4.5	4.7
Percent of GDP, unless otherwise indicated					
External sector					
External sector					
Exports of goods	13.9	12.8	12.4	12.3	12.2
Imports of goods	24.3	23.0	21.2	21.7	21.8
Trade balance	-10.4	-10.2	-8.8	-9.4	-9.6
Tourism receipts	3.0	3.6	4.0	4.2	4.3
Remittances	8.8	8.5	8.6	8.4	8.1
External Current Account	-2.5	-2.4	-0.6	-1.4	-2.1
FDI inflows	1.0	0.8	0.8	1.6	1.8
Official reserves (USD billion)	8.2	7.3	7.5	8.9	9.7
Official reserves (months of imports of goods and services)	4.3	3.8	4.1	4.5	4.6
Exchange rate (end period, LKR/USD)	131.1	144.1			
Fiscal accounts					
Fiscal accounts					
Total revenue and grants	11.5	13.1	12.8	13.7	14.0
Tax revenue	10.1	12.1	11.6	12.6	12.8
Total expenditure	17.2	20.5	18.5	18.4	18.4
Current expenditure	12.7	15.2	14.4	14.0	13.9
Capital and net lending	4.5	5.3	4.1	4.4	4.5
Primary Balance	-1.5	-2.9	-1.0	-0.1	0.4
Overall fiscal balance	-5.7	-7.4	-5.7	-4.7	-4.4
Public debt	70.7	76.0	76.1	74.9	73.4
Treasury guarantees	5.3	5.3			
Monetary/financial sector					
Standing deposit facility rate (% per annum)	6.5	6.0			
Standing lending facility rate (% per annum)	8	7.5			
Private sector credit growth (M2b, %)	8.8	25.1	7.2	11.4	13.3

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 8).

² Includes currency, demand deposits, time and savings deposits held by the public commercial banks

