

SRI LANKA DEVELOPMENT UPDATE

Creating opportunities and managing risks for sustained growth



November 2017

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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.

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This report can be downloaded at:

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Executive Summary



Sri Lanka has the opportunity to implement its Vision 2025 agenda to sustain growth, job creation and poverty reduction in the medium term, provided it shifts from a public investment, non-tradable sector-driven growth model to a more private investment, tradeable sector-led model. It can greatly benefit from its location close to the largest fast-growing economies in the world. This new growth model will open new opportunities for development, and will make Sri Lanka more resilient to many risks, but will also expose it to new ones, It is therefore important to manage them well to maximize the opportunities.

1. Recent Developments

Macroeconomic performance remained broadly satisfactory in the first half of 2017.

Despite significant challenges, Sri Lanka's economic performance remained broadly satisfactory in the first half of 2017. The corrective policy measures taken in the monetary and fiscal fronts have led to gradual stabilization. The construction sector's rapid recovery supported by a strong rebound in investment was partially able to mitigate the impact of inclement weather conditions on the real sector. External buffers strengthened thanks to foreign exchange purchases and improved capital flows. Inflation has risen since the second half of 2016 on account of drought and changes to the VAT Act.

Reform implementation was slower than expected.

Authorities pursued the economic reform agenda presented in the government policy statements, albeit at a slower pace, owing to the difficulties faced in a complex political environment and institutional constraints on policy implementation. Parliament passed a new Inland Revenue Law in September 2017, which marks a key milestone towards sustainable revenue-led fiscal consolidation. Although yet to be in full compliance, the efforts of the government led to restoration of the Generalized

System of Preferences Plus (GSP+) from the European Union in May 2017.¹ However, some other vital reforms were lagging; these included, implementing the One-Stop Shop for FDI, reforms to the investment climate² and trade, SOE reforms such as for Sri Lankan Airlines, meaningfully progressing on the debt management agenda and passing of the Audit Act.

Improvement in public finance continued; however, fiscal risks remain high.

Fiscal consolidation continued in the first four months of the year following the reduction of the fiscal deficit to 5.4 percent of GDP in 2016 from 7.6 percent in 2015. The VAT changes that came into effect in November 2016 will lead to a structural increase in tax revenues although the budget targets for 2017 are likely to be missed due to delay in implementation of the new Inland Revenue Act and higher than anticipated interest expenditure. Fiscal risks emanating from relatively high public debt to GDP ratio (79.3 percent, 2016) and treasury guarantees issued mainly for SOEs and state agencies (7.1 percent of GDP, 2016) remained high in the first five months of 2017 as well.

Economy suffered from continued natural disasters.

Floods and drought took a toll on real and external sectors. Despite important contributions from construction, financial services and trade sectors, growth decelerated to 3.9 percent, year-on-year, in the first half of 2017 due mainly to the contraction of the agriculture sector. On the external front, the benefit of low oil prices was offset by greater imports of food and petroleum³ due to the drought, while the impact on agricultural exports were masked by increased tea prices. Along with the changes in VAT, inclement weather exerted upward pressure on prices. However, relatively low international commodity prices helped maintain the inflation around mid-single digit. Despite drought related fiscal costs, the government has achieved a primary surplus in the first half of 2017.

Reserves increased on debt-creating flows, but organic growth is important.

Gross official reserves reached a 32-month high from relatively low levels thanks to proceeds from syndicated loans, fresh Eurobonds and central bank's purchases in the market although an expanded trade deficit and low FDIs presented a challenging landscape for reserve management. Nevertheless, supported by inflows to the government market, the monetary authority continued the purchasing of foreign exchange in the market in a bid to strengthen reserves. The Sri Lankan rupee depreciated by 2 percent, year-to-date, against the US dollar by end-August.

IMF, World Bank and other development partners supported reforms.

The key fiscal and monetary policy measures aimed at reinstating stability were supported by the IMF program.⁴ The reforms in the program are mainly focused on revenue led fiscal consolidation; transition to flexible inflation targeting; and reforms in SOE oversight and trade and competitiveness. The World Bank and Japan International Cooperation Agency provided support for reinforcing policy reforms to improve private sector competitiveness, transparency, public sector management,⁵ and fiscal sustainability while the Asian Development Bank provided support to strengthen the capital markets.

¹ Tariff-free access for most exports

² A Roadmap was presented, which now requires implementation.

³ As hydropower reservoirs ran dry

⁴ These included some important steps to increase government revenues and tighten the monetary policy.

⁵ The 2016 Development Policy Financing (DPF) Program Document is available online at:

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

2. Outlook, risks and policy priorities

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

The government's ambitious reform agenda aimed at improving competitiveness, governance and public financial management along with the IMF program focused on revenue-led fiscal consolidation adds to confidence. The central bank has shown that it stands ready to take appropriate action in the direction of stability. These factors have contributed to an improved outlook.

Growth is expected to reach 4.6 percent in 2017 and increase marginally over 5.0 percent beyond, driven by private consumption and investment. The impact of past high monetary growth along with the increase of VAT collection will increase inflation in 2017 although low international commodity prices will maintain some downward pressure.

The external sector is poised to benefit from the reinstatement of GSP+ preferential access to the European Union and growing tourism, although the drought could adversely impact exports and increase petroleum imports to cover a hydro power shortfall. The deceleration of the previously stable remittances flow will also be a strain on the external sector. Foreign capital inflows to government securities and FDI inflows will help closing the external financing needs with no Eurobond falling due in 2017. Nevertheless, external buffers are projected to improve, with emphasis placed on purchasing foreign exchange, maintaining a more market-determined exchange rate, and the sale or leasing of selected government assets, including Hambantota seaport.⁶

The fiscal deficit is projected to narrow to 5.1 percent of GDP for 2017 in line with its primary surplus target thanks to the impact of VAT changes in its first full year of implementation, and expenditure control. 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. Sustained primary surpluses would put debt on a decisive downward path, even with growth shocks.

The outlook is subject to domestic and external risks.

External risks include slower growth performance in key countries that generate foreign exchange inflows to Sri Lanka in terms of exports, tourism, remittances, FDI, and other capital flows. Tighter than expected global financial conditions could increase the cost of debt and could make it difficult to roll over the maturing Eurobonds from 2019. Faster than expected rises in commodity prices could increase pressure on the balance of payments and make domestic fuel and electricity price reforms more difficult.

On the fiscal and debt management front, risks include the delay in implementing revenue and liability management measures; and slower than expected improvement in tax administration. The increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal consolidation path, the trade balance and poverty reduction. Finally, the complex political environment could delay implementation of important structural reforms.

⁶ Forex purchases have been supported by capital inflows to the government securities market. In the past, monetary authority intervened in the market to stabilize the exchange rate at the expense of significantly large volumes of foreign exchange reserves. With the announced plan to move towards flexible inflation targeting, the exchange rate is expected to be given more flexibility, in the future.

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

Sri Lanka faces a number of challenges to sustain future economic growth, create more and better jobs and reduce poverty; and thus, must be addressed through determined reforms. These challenges can be addressed through four sets of priority reforms:

1. staying on the fiscal consolidation path and creating fiscal space for health, education, social protection and other public investments
2. improving the economy's competitiveness and promoting trade and FDI to facilitate a shift in the growth model driven more by private investment and exports;
3. making progress on and completing the already started governance reforms such as Right to Information, the National Audit Law and the Public Finance Law; and
4. reducing vulnerability and risks in the economy: (a) dealing proactively with the Eurobonds maturing from 2019 by increasing the flexibility in the Appropriation Act to manage liabilities actively; (b) improving the debt management function with requisite institutional, legal and strategy frameworks to manage the costs and risks of domestic and external debt portfolios; (c) mitigating the impact on the poor by replacing untargeted effective subsidies to the non-poor by targeted spending; and (d) enhancing the country's resilience and disaster preparedness to deal with frequent natural disasters more pro-actively

These key challenges are inter-linked and require a comprehensive and coordinated approach. Although, domestic political considerations and institutional constraints on policy implementation make it challenging, a strong political will and support of the bureaucracy could help advance the reform agenda. Steps are needed to ensure the support of private sector, civil society and other stakeholders through improved communications on costs and benefits of its Vision 2025 agenda.

3. Special focus

Managing risks is important for sustainability.

The new growth model will open new opportunities for development. It will make Sri Lanka more resilient to many risks, but will expose it to new ones, while increasingly frequent natural disasters also demand more preparedness. It is important to manage risks well at different levels of society—households, firms, the public sector and the macroeconomy. Therefore, the Special Focus Section of this edition of the Sri Lanka Development Update is devoted to a discussion on integrated risk management using the framework presented in the World Development Report, 2014.

Box 1: Sri Lanka: country context

Sri Lanka is a Lower Middle-Income country with a GDP per capita of USD 3,835 (2016) and a total population of 21.2 million people. Following 30 years of civil war that ended in 2009, Sri Lanka's economy grew at an average 6.2 percent during the period of 2010-2016, reflecting a peace dividend and a determined policy thrust towards reconstruction and growth; although there were some signs of a slowdown in the last three years (Figure 1). The economy is transitioning from a predominantly rural-based economy towards a more urbanized economy oriented around manufacturing and services.

The country has made significant progress in its socio-economic and human development indicators. Social indicators rank among the highest in South Asia and compare favorably with those in middle-income countries. Economic growth has translated into shared prosperity with the national poverty headcount ratio declining from 15.3 percent in 2006/07 to 4.1 percent in 2016. Extreme poverty is rare and concentrated in some geographical pockets; however, a relatively large share of the population subsists on slightly more than the extreme poverty line. The country has comfortably surpassed most of the MDG targets set for 2015 and was ranked 73rd in the Human Development Index in 2015.

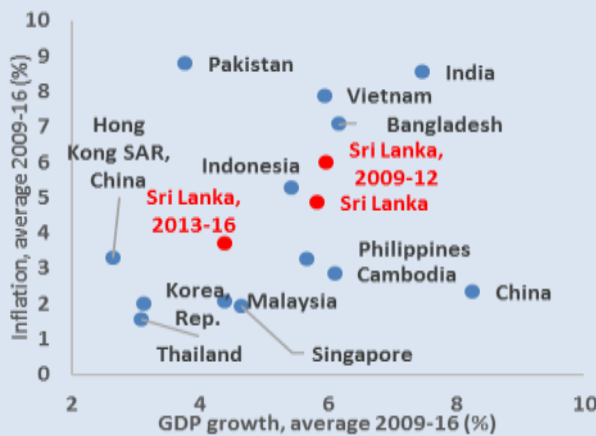
The economy's weak competitiveness is an issue to address. Restrictive trade policies over the past decade have created a strong anti-export bias, which has been reflected in a dramatic decline in trade. While growth in Sri Lanka has been strong over the past few years, it has been inward-oriented and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

Low revenues as a share of GDP has been a structural issue that adversely impacts fiscal position. The major causes are the low number of number of tax payers (less than 7 percent of the labor force and formal establishments pay income tax), reductions in statutory rates without commensurate efforts to expand the tax base, inefficiencies in administration and numerous exemptions. Low revenues combined with largely non-discretionary expenditure in salary bill, transfers, and interest payments has constrained critical development spending and squeezed expenditure on health, education and social protection, which is low compared to peer (Figure 2).

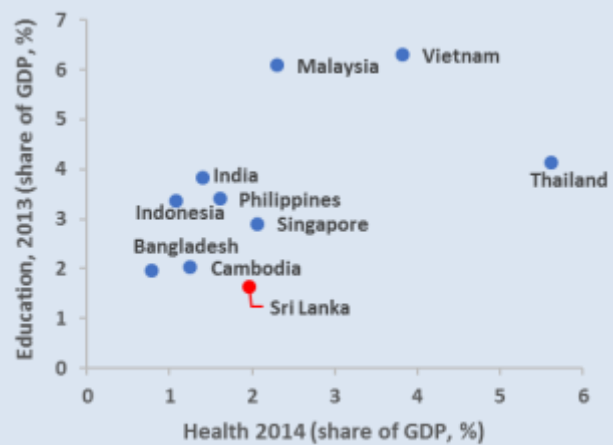
Sri Lanka has a 3-year Extended Fund Facility (EFF) program with the IMF, which is primarily focused on increasing revenues. The program calls for fiscal consolidation, transition to flexible inflation targeting, and reforms in public financial management, state enterprises and trade and competitiveness. The IMF announced that it had reached staff-level agreement with the government on completing the third review of the EFF.

The government that came to power in 2015 envisions promoting a globally competitive, export-led economy with an emphasis on inclusion. It has indicated keenness to undertake reforms in the areas of public finance, competitiveness, governance and education sectors. Recently, the government presented Vision 2025, a policy document encompassing key structural reforms to address the above challenges (Box 4).

**Figure 1: Sri Lanka compared to peer countries:
Growth and inflation**
(Percent annual change)



**Figure 2: Sri Lanka compared to peer countries:
Education and health**
(Percent of GDP)



Source: World Development Indicators

A. Recent Developments



Growth performance of first half 2017 was affected by inclement weather

Floods and drought affected growth.

Floods in the month of May in the South and the West; as well as continued drought in some parts of the country reduced the economic growth of the first half of 2017 to 3.9 percent.⁷ Adverse weather turned the agriculture sector's contribution to growth into a negative 0.2 percentage points in the first half, for the second consecutive year, while impacting related industry and service sectors. In contrast, the construction sector's contribution to growth remained at 1.0 percentage point continuing the strong rebound in 2016. This was mainly due to the resumption of a few large-scale infrastructure projects and increased private construction activities. Although, significant contributions also came from financial services and trade, these were not sufficient to fully compensate for the dampened performance of other industry and service sectors affected by unfavorable weather conditions, leading to a lower growth rate (Figure 3).

Capital formation was the key contributor to growth.

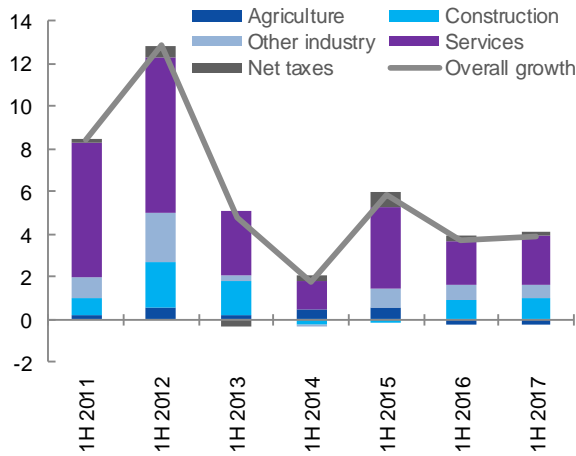
The contribution to growth from consumption remained low at 1.7 percentage points in the first half of 2017 with private consumption being subdued due to drought and VAT change while government consumption has also slowed down.⁸ Meanwhile, activity in construction and related sectors increased the contribution to growth from gross capital formation to 3.8 percentage points. Increased gross capital formation, especially in the construction sector, was reflected in the expenditure on imported investment goods such as machinery, equipment and building material, which led to a 2.6 percentage point negative contribution to growth from imports of goods and services. The contribution from exports in the first half of 2017 remained low with

⁷ However, this compared well with the natural-disaster-affected 3.7 percent recorded in the corresponding period of 2016.

⁸ When computed on a first-half contribution to growth basis

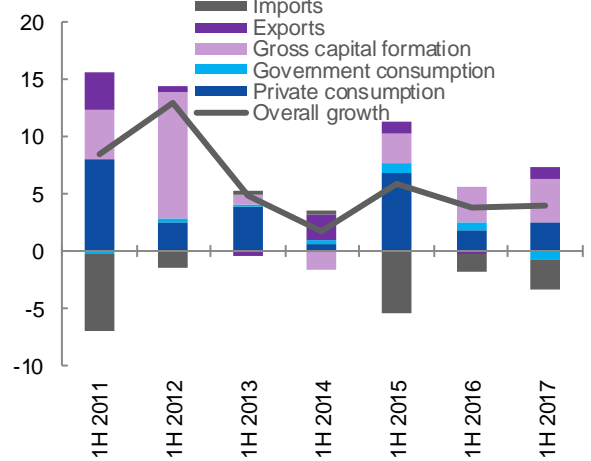
merchandise exports declining compared to the corresponding period in 2016. (Figure 4).

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



Source: Department of Census and Statistics and staff calculations

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



Source: Department of Census and Statistics and staff calculations

Annual average inflation has been on the rise since September 2016 due to inclement weather, VAT changes and demand pressures.

Inflation has risen from the second half of 2016.

A combination of factors including food inflation due to adverse weather, past currency depreciation and increased indirect taxes have contributed to a rise in inflation since the second half of 2016. Accordingly, year-on-year inflation measured by the widely-watched Colombo Consumer Price Index (2013=100) reached 7.1 percent in September 2017 from 4.2 percent recorded a year earlier. Annual average inflation followed suit, rising to 5.8 percent from 3.9 during the same period. In addition to food inflation, larger contributions to the rise in prices came from health,⁹ education, restaurant and hotel segments with the increase in the VAT rate. Reflecting demand pressures in the economy amid continued high monetary growth, core inflation, measured excluding fresh food and energy, moved up to 5.8 percent by September 2017, on an annual average basis (Figure 5 and 6).

The new national price index echoed the same trends.

The recently introduced National Consumer Price Index (NCPI, 2013=100) that reflects price movements of all provinces of the country based on the Household Income and Expenditure Survey (HIES) reported higher year-on-year inflation of 8.6 percent and an annual average inflation rate of 6.8 percent by September 2017.

⁹ The VAT net was broadened removing exemptions on selected private health-related items while the rate was increased to 15 percent (from 11 percent) in May 2016; the related legal process was completed in November 2016.

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

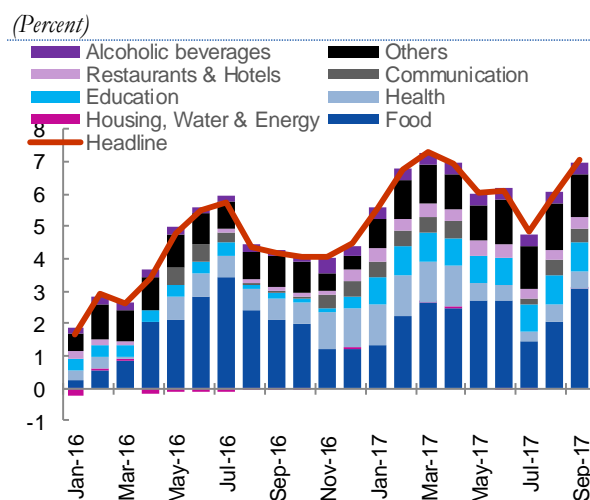
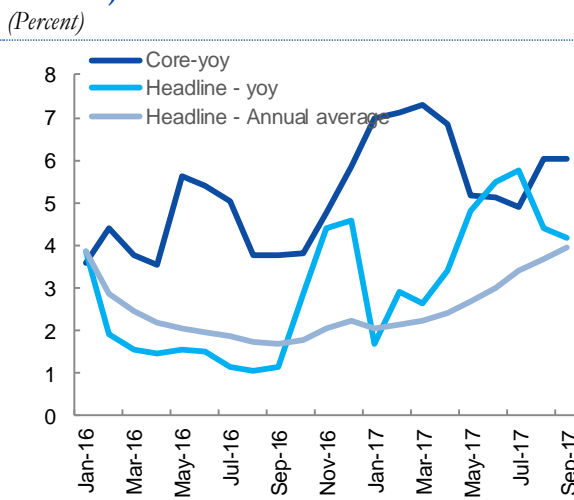


Figure 6: Headline versus core inflation (CCPI: 2013=100)



The new Inland Revenue Act is expected to pave the way for sustainable, revenue-led fiscal consolidation.

Parliament passed a new Inland Revenue Bill in September 2017.

The new Inland Revenue Act,¹⁰ which builds on international best practice, aims to broaden the tax base by removing excessive tax exemptions; rationalize corporate tax incentives toward an investment-oriented regime; simplify the tax system; and strengthen powers of the tax administrator. If well implemented, the new law would serve as the foundation for sustained fiscal consolidation over the medium term and provide resources for essential social services and productivity-improving public investments while making the budget more resilient to natural disasters.

Increase in VAT led to a primary surplus in the first four months of 2017.

VAT collection almost doubled in the first four months of 2017 thanks to changes effected in 2016. With improved collection of VAT and income taxes, the first four months' total tax collection increased by 25.6 percent, year-on-year, compared to the corresponding period of 2016.¹¹ Non-interest expenditures rose by 13.7 percent during the same period with improved execution of the public investment budget. The faster growth in revenues compared to non-interest expenditures, helped the government to report a primary surplus for this period. Continued improvement, particularly in the revenue front is expected to lead to a marginal primary surplus for the full year 2017 while a substantial increase in interest expenditure compared to the budget will mask the improvement of the overall fiscal deficit (Table 1).

2017 results follow the fiscal consolidation path of 2016; however, debt remains high.

Increased revenues and low execution of public investment contained the fiscal deficit for 2016 at the envisaged level of 5.4 percent of GDP as against a 7.6 percent in 2015 (Table 1, Figure 7). However, the central government debt remained high at 79.3 percent of GDP in 2016 (Figure 8)¹² while the debt profile also indicated significant exposure to a variety of risks as discussed in the Special Focus section (Figure 10).

¹⁰ Submission of the bill to the Parliament satisfied an important structural benchmark in the IMF-supported program as well

¹¹ Yet, the tax revenues remained 4.4 percent below the budgeted volume for the first four months of 2017.

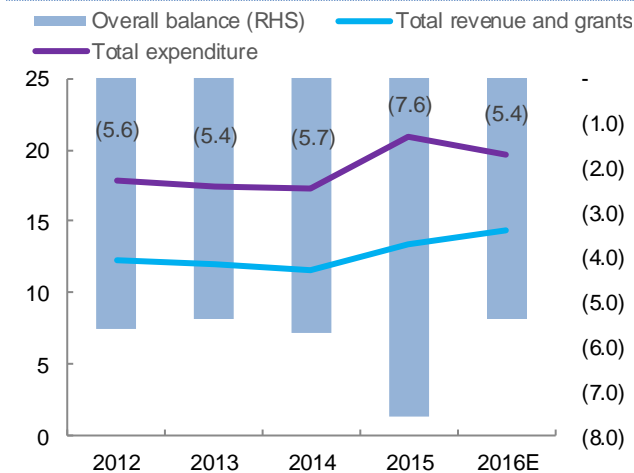
¹² Debt stock increased in 2016 due mainly to exchange rate depreciation and the real interest rate effect.

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 the debt profile and bringing the debt-to-GDP ratio back to a declining path.¹³

Guaranteed and non-guaranteed SOE debt is a source fiscal risk.

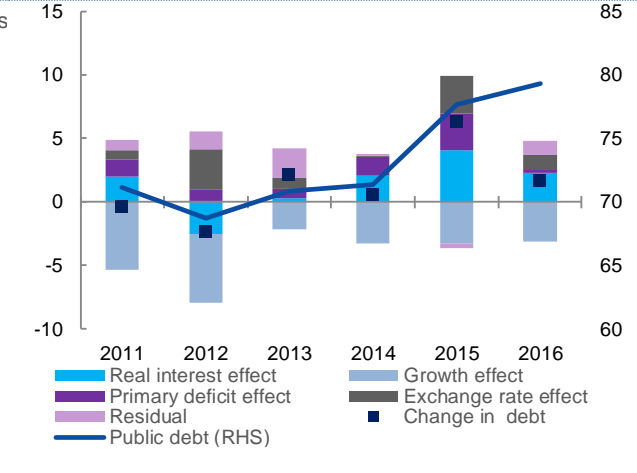
Some of the SOE debt, both foreign and domestic, is guaranteed by the Treasury. In the recent years, the treasury guaranteed debt rose fast, and remains high at 7.1 percent of GDP at end-2016.¹⁴ Moreover, the composition of guarantees has been changing over time, with the significance of guarantees given to commercially oriented state-owned business enterprises with revenue capacity, such as Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB), declining from 90 percent in 2006 to 36 percent in 2016 while guarantees given to state establishments, primarily dependent on the state budget for expenditures are on the rise (Figure 9).¹⁵ ¹⁶ Since the latter receive current and capital transfers to service this guaranteed debt, the government is effectively servicing this debt. Besides guarantees, there are other means of fiscal and quasi-fiscal support to SOEs, such as fiscal expenditure to cover operational losses, capital infusions, and lending by the state banks. Based on available data,¹⁷ by end 2015, total SOE debt excluding the financial institutions was estimated at over LKR 1.3 trillion or 12 percent of GDP.

Figure 7: Overall Fiscal Balance
(Percent of GDP)



Source: Ministry of Finance, staff calculations

Figure 8: Public Debt Drivers
(Percentage points of GDP)



Source: Ministry of Finance, staff calculations

¹³ Sri Lanka’s long-term foreign currency credit rating is B+ for Fitch and S&P, and B1 for Moody’s.
¹⁴ Issued treasury guarantees increased as a share of GDP from 5.6 percent in 2015 to 7.1 in 2016 while the used guarantees also moved up from 3.7 to 4.4 percent of GDP during the same period.
¹⁵ Among others, these include Road Development Authority, General Sir John Kotelawala Defence University and Urban Development Authority. These agencies have no significant sources of revenue and the debt repayment will likely come from the Treasury in the future.
¹⁶ It is important to formulate a Guarantee Policy to manage risks emanating from the guarantees. Currently, there is no written policy on guarantees.
¹⁷ Ministry of Finance and Central Bank of Sri Lanka annual reports, SOE annual reports.

Figure 9: Trends in the guarantee mix

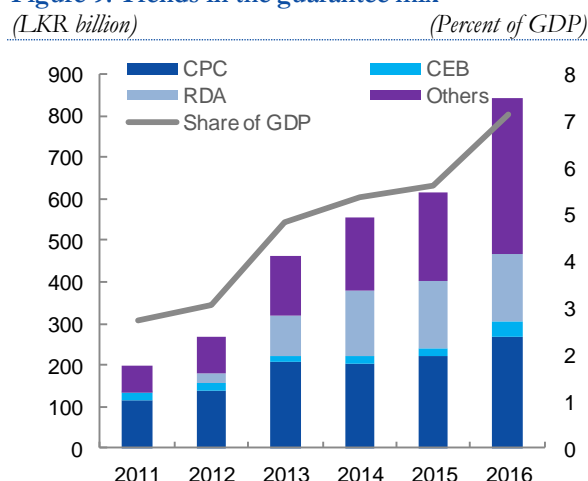
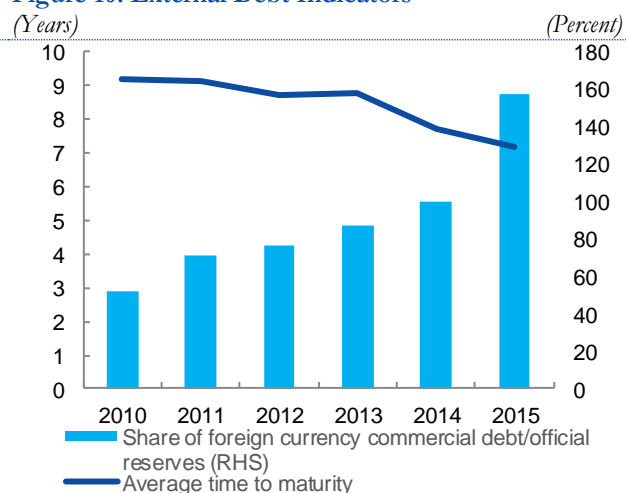


Figure 10: External Debt Indicators



Note: CEB – Ceylon Electricity Board, CPC – Ceylon Petroleum Corporation, RDA - Road Development Authority. RDA and other entities may not have stable revenue streams.

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

Source: Central Bank of Sri Lanka

Table 1: Budget and fiscal outcomes for the first four months of 2017 compared to 2016

(LKR millions)

	Actual	Actual
	2016 January-April	2017 January-April
Revenue	472,689	589,019
Tax revenue, of which	441,211	554,294
Income tax	64,857	84,475
VAT	79,793	152,371
Excise taxes	148,458	155,697
Non-tax revenue	31,478	34,725
Expenditure	706,133	822,840
Recurrent	559,697	626,049
Salaries	188,604	197,518
Interest payments	196,676	243,499
Other	174,417	185,032
Public investments	151,978	201,012
Primary balance	-36,768	9,678
Overall balance	-233,444	-233,171
Net financing	233,444	233,171
Foreign financing	-17,058	14,342
Domestic financing	250,502	218,829

Source: Ministry of Finance, staff calculations

Mixed external sector performance, but recent purchases led to improvement of external buffers.**Trade performance weakened in the first half of 2017.**

The trade deficit expanded by 13.4 percent to USD 4.8 billion in the first half of 2017 compared to the corresponding period of 2016. The benefit of low oil prices was offset by greater imports of food and petroleum due to the drought, while the impact on agricultural exports was masked by increased tea prices. Although growth in tourism flows¹⁸ continued to ease external pressures, weakening worker remittances and an elevated trade deficit led to more than doubling of the current account deficit in the first half of 2017 from a year earlier.¹⁹

Debt-creating flows dominated the financial account.

The external current account deficit was mainly financed by debt creating flows. Although FDI substantially increased from a low base, loan receipts and portfolio receipts continued to be the main sources of financing the deficit in the first half of 2017. While the government securities market started attracting inflows after a period of outflows, issuance of sovereign bonds worth of USD 1.5 billion,²⁰ receipts of USD 1.1 billion in project loans and syndicated loans of USD 450 million²¹ were the key inflows to the financial account. The Sri Lankan rupee depreciated by only 2 percent, year-to-date, against the US dollar by end-August, much less than other emerging market currencies thanks to these significantly large inflows (Table 2, Figure 13)).

After bottoming out in April 2017, reserves recovered.

Gross official reserves increased to USD 7.7 billion or approximately 4.5 months of merchandise imports by end-August 2017 (up from USD 6.0 billion recorded in December 2016), the highest level recorded in 32 months. The central bank continued to strengthen reserves through purchases in the forex market from the month of March²² while proceeds from debt issuances helped to increase reserves. However, foreign exchange obligations for the 12 months starting from August 2017 are estimated at USD 6.9 billion, implying that official reserves net of short-term liabilities are low. About USD 1.9 billion or 1/4 of these liabilities represent swap arrangements with domestic banks (which issued medium-term international bonds), some of which will be maturing in 2018. The central bank has already indicated that it plans to settle some of the swaps, which were rolled over in the past.²³ Moreover, the government expects that the foreign inflows related to the setting up of the Hambantota port lease would further shore up reserves in the coming months (Figure 11, 12 and 14).

¹⁸ Growth in tourism receipts decelerated to 4.8 percent, year-on-year, in the first half of 2017 compared to double-digit growth rates experienced in the past few years, reportedly due to the limited access provided by the country's main airport through to April on account of renovation activities and a Dengue breakout that kept tourists away.

¹⁹ During the period, remittances shrank on a year-on-year basis for the first time in more than eight years, indicating the potential impact of continued low oil prices in the Middle East. This region generates over 50 percent of Sri Lanka's remittances.

²⁰ Sri Lanka issued its eleventh sovereign bond worth USD 1.5 billion (10-year) in May 2017. The coupon rate of 6.20 percent reflected a spread of 380 bps over the US Treasury rate for a 10-year security, which compares well with a 540-bps spread recorded in the previous issuance in July 2016. The issuance rated 'B1', 'B+' and 'B+' by Moody's Investors Service, Standard and Poor's and Fitch attracted bids over USD 11 billion achieving an oversubscription ratio of over 7 times (compared to an oversubscription ratio of 3 times in the previous issuance), spread across 500 participating accounts.

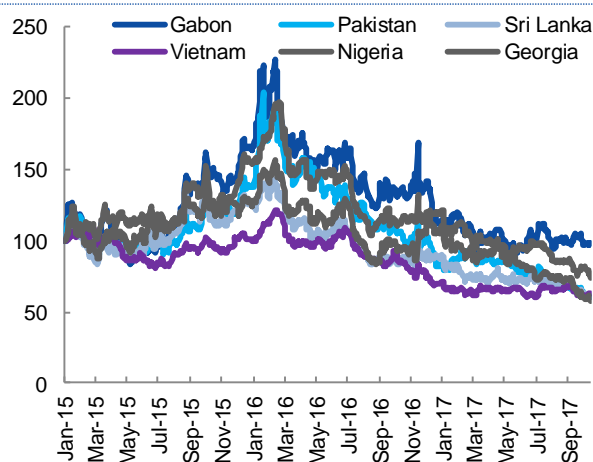
²¹ A further USD 550 million was raised in the month of August 2017.

²² These purchases were supported by capital inflows to the government securities market.

²³ Some of the underlying Eurobonds are expected to mature in the coming year: e.g. National Savings Bank USD 750 million, Bank of Ceylon USD 500 million, DFCC Bank USD 100 million.

Figure 11: Movements of bond spreads over US Treasury, (Jan 2015 = 100)

(Basis points)

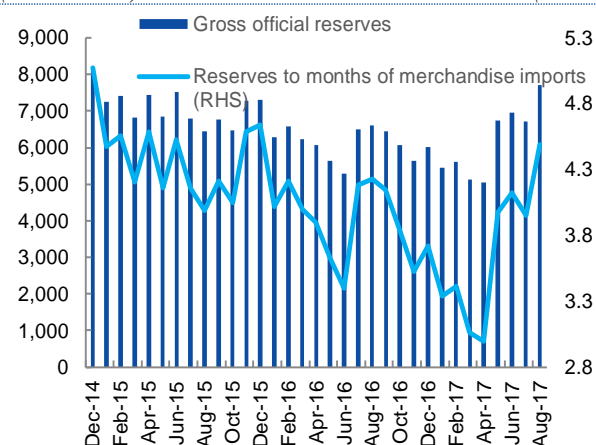


Note: comparison with countries with close ratings
Source: EMBIG, staff calculations

Figure 12: Gross Official Reserves

(USD Million)

(Months)

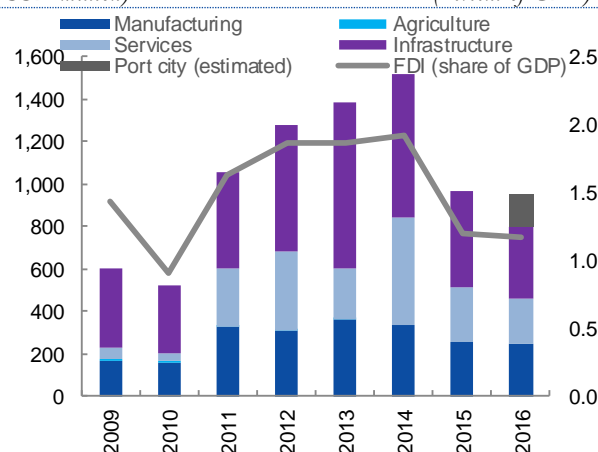


Source: Central Bank of Sri Lanka, staff calculations

Figure 13: FDI composition

(USD million)

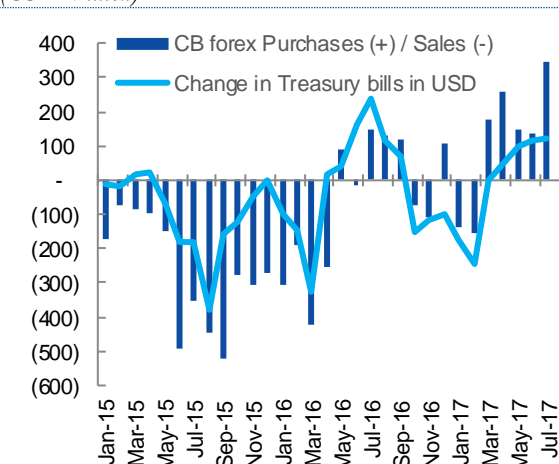
(Percent of GDP)



Source: Central Bank of Sri Lanka, staff calculations

Figure 14: Treasury bond/bills inflows and outflows

(USD Million)



Source: Central Bank of Sri Lanka, staff calculations

Monetary policy was tightened to curb rapid credit growth and rising core inflation.

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

The tightening policy cycle, which commenced in 2016 amid high growth in monetary aggregates continued in the first half of 2017 as well. As a precautionary measure against the buildup of inflationary expectations, the central bank increased policy rates by 25 basis points in the month of March. Nevertheless, the growth of monetary aggregates remained high although some early signs of deceleration have been observed since April 2017.²⁴ The central bank has indicated that it stands ready to further tighten the monetary policy if inflationary pressures build up on excess demand. In order to use inflation as the clear nominal anchor,²⁵ the central bank has already commenced ground work to move into a flexible inflation targeting regime.

²⁴ The growth of credit to the private sector from banks decelerated to 18.0 percent in July, on a year-on-year basis, from 21.9 percent reported in December 2016.

²⁵ The Roadmap 2017 defines a target of 4 to 6 percent of the National Consumer Price Index (NCPI), http://www.cbsl.gov.lk/pics_n_docs/02_prs/docs/press/press_20170103e9.pdf

Implementation of such a framework would essentially require honoring the central bank's commitment to provide more flexibility for the exchange rate, which in return would help the country to improve its competitiveness and act as a first line of defense for external volatilities (Figure 16).

Table 2: Balance of Payments in the first half of 2017
(USD millions)

	Jan-June 2016	Jan-June 2017
Current account balance	(644)	(1,480)
Goods trade balance	(4,191)	(4,753)
Exports	5,130	5,398
o/w Textiles	2,515	2,384
Imports	9,321	10,151
o/w Petroleum	1,178	1,625
Services trade balance	1,314	1,407
Receipts	3,493	3,646
o/w Tourism	1,654	1,734
Payments	2,179	2,239
Primary income (net)	(971)	(1,038)
Secondary income (net)	3,204	2,904
o/w Remittances	3,613	3,355
Key capital flows		
FDI	55	472
Portfolio Investment	(622)	1,036
General Government	(578)	1,335
Other Investment	(198)	1,058
Loans	740	1,314
General Government	98	516
Gross official reserves	5,292	6,954

Source: Central Bank of Sri Lanka and staff calculations

Banking sector remained broadly stable while listed equity returns showed a gradual recovery.

The banking sector continued to remain stable.

The banking sector remained well capitalized and adequately liquid. The regulatory Capital Adequacy Ratio (CAR) requirement under Basel II was maintained well above the required level of 10 percent and the Statutory Liquid Asset Ratio was also maintained well above the minimum statutory requirement of 20 percent during the first half of 2017. The expansion of the loan book was supported by the growth in deposits in a high interest environment. Faster growth in lending rates compared to deposit rates led to increased net interest income resulting in improved Return on Assets (ROA) and Return on Equity (ROE) for the banking sector. The Non-Performing Loan (NPL) ratio remained low thanks to fast credit growth and aggressive credit recovery. However, the NPL ratio might come under upward pressure in the coming months when the pace of credit growth decelerates following the last two years of rapid credit growth, a trend observed in the past. Moreover, increasing leverage, shown by the strong increase in credit relative to the size of the sector, such as in construction, tourism and financial business, warrants attention

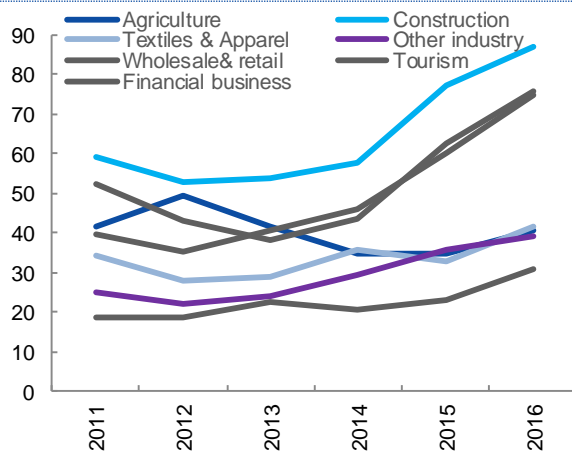
(Figure 15). Although the sector remains well-capitalized, implementation of Basel III will require the banks to strive hard to increase the capital base.

Listed equity indicators improved buoyed by foreign activity.

Following negative returns in two consecutive years, listed equity returns showed early signs of a recovery. The benchmark All Share Price Index (ASPI) moved up by 3.4 percent by September on a year-to-date basis. Foreign purchases increased 45-fold in the first nine months of 2017 from a low base in 2016, to report the second largest volume of foreign inflows to the Colombo Stock Exchange in history. While attractive valuations (reflected in low Price-Earnings ratios) in a relatively stable macroeconomic environment was a key driver, the MSCI’s upgrading of Pakistan to the Emerging Market category also led to capital inflows to some frontier markets such as Sri Lanka when investors rebalanced exposures.

Figure 15: Credit Leverage

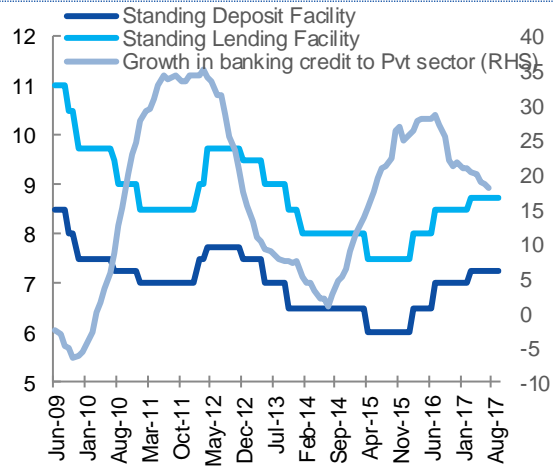
(Sector Credit as a share of Sector Value Addition - Percent)



Source: Central Bank of Sri Lanka, staff calculations

Figure 16: Policy tightening and private credit

(Y-o-Y Growth Percent) (Y-o-Y Growth Percent)



Source: Central Bank of Sri Lanka, staff calculations

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

Extreme poverty is low in Sri Lanka and fell further between 2012/13 and 2016.

Despite the recent macroeconomic challenges, extreme poverty remains low, as the \$1.90 (PPP 2011) poverty rate fell half a percentage point, from 2.4 to 1.9 percent between 2009/10 and 2012/13. The real per capita consumption of the bottom 40 percent increased 2.2 percent annually between 2006/07 and 2012/13, and improved living standards were reflected in rising asset ownership, declining shares of food consumption, and a rise in reported household per capita income among the poor. Preliminary results from the Department of Census and Statistics’ Household Income and Expenditure Survey (HIES) conducted in 2016 show a further decline in the national poverty rate, which is equivalent to about \$2.50 in 2011 Purchasing Power Parity terms, from 6.7 percent in 2012/13 to 4.1 percent in 2016.

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

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

Box 2: Getting to Work: Unlocking Women's Potential in Sri Lanka's Labor Force

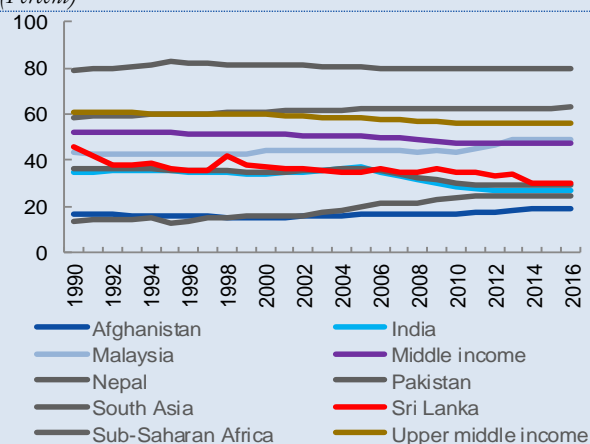
Sri Lanka has shown remarkable persistence in low female labor force participation (FLFP) rates over the past three decades. Even as the economy expanded, FLFP declined from 41 percent in 2010 to 36 percent in 2016. This trend stands in contrast to the country's achievements in human development outcomes that favor women, such as high levels of female education and low total fertility rates, as well as its status as a middle-income country.

A forthcoming World Bank report, *Getting to Work: Unlocking Women's Potential in Sri Lanka's Labor Force*, finds that women's experience in Sri Lanka's labor market remains characterized by: (1) low LFP; (2) high unemployment, especially for women under age 30; and (3) persistent wage disparities between the sexes, though these are shrinking over time. The report's analysis supports three hypotheses to explain gender gaps in labor market outcomes.

Household roles and responsibilities, which fall disproportionately on women: Marriage continues to penalize women's participation in labor markets, though less so than before 2010. As of 2015, marriage lowers odds of FLFP by 4.4 percentage points, while boosting men's odds by 11 percentage points. Having young children is associated with even lower odds of FLFP, lower chances of becoming a paid employee, and lower earnings compared to these odds before 2010—and compared to men's odds. Social norms against women's mobility outside the home, especially for commuting, exacerbate the gender gap in LFP.

Figure 17: FLFP comparison

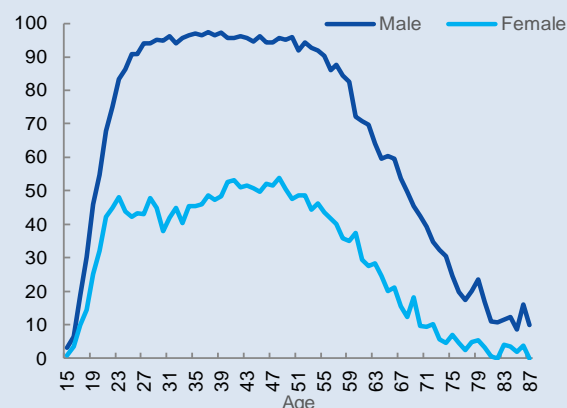
(Percent)



Note: Population age 15+. Data from the Northern Region was not included. The 2009 weight factor was adjusted by the staff projection of total population from Census 2012.
Source: LFS 2009, 2015 and staff calculations

Figure 18: FLFP by age and gender, 2015

(Percent)



Note: Some ILO data may predate the 2016 LFS data.
Source: World Bank datacenter, modeled ILO estimates

A human capital mismatch, whereby women are not acquiring the proper skills demanded by job markets:

Since the end of civil conflict, women at all levels of educational attainment are even more challenged than men in securing high-skill and higher-paying jobs. Qualitative research reveals women's preference for humanities and arts in their educational training, rather than in technical skills that better match with private sector jobs in growth industries. These educational and occupational choices are also strongly influenced by what girls and their parents consider to be gender appropriate—e.g., women with the highest educational attainments (university level or higher) still queue for a limited number of public sector jobs—which, unlike the private sector, uniformly offer regular working hours, maternity leave, and other women-friendly benefits—and thus contribute to elevated rates of female youth unemployment. Multivariate analysis confirms that in spite of women's advancements (even exceeding those of men, as with years of education), endowments are not sufficient to close gender gaps in LFP and wages.

Gender discrimination in job search, hiring and promotion processes: Discrimination appears to determine large shares of gender gaps in LFP and earnings, though to a diminishing degree over time, especially since 2009. Primary research confirms that employers actively discriminate by gender to a much smaller degree than employees suspect. Yet, stubborn occupational segregation across industries suggests that this may not be the case for promotions—especially into high-skill and management jobs, in which men continue to dominate. Raw gender wage gaps are shrinking, but the portion of these gaps that is determined by gender discrimination—rather than endowments—is increasing over time and is especially pronounced in the public sector.

The report recommends four priority areas for addressing the multiple supply- and demand-side factors to promote women's entry into and continued employment in the labor market. This is essential for preparing for an aging population and to achieving the country's growth and equity goals.

- Reduce barriers to women's participation in paid work, particularly (a) lack of child care services, and (b) socio-physical constraints on women's mobility, which undermines their ability to travel to work.
- Strengthen girls' early orientation to career development and to acquiring the types of education and skills (e.g., STEM courses) that prepare them for labor markets.
- Improve the job orientation of education providers; and expand provision of job matching services and TVET that respond to employers' needs.
- Ensure gender equity in labor legislation and non-discriminatory workplace environments, which includes zero tolerance for sexual harassment in—and traveling to—the workplace and provision of safe transportation for women; undertake affirmative action and ethical branding initiatives to expand women's share of employment and firm ownership in emerging sectors.

Source: Getting to Work: Unlocking Women's Potential in Sri Lanka's Labor Force, World Bank Washington D.C (forthcoming).

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

Moderate poverty remains high. While numbers for 2016 are not yet available, in 2012/13, nearly 15 percent of the population, and a quarter of the Estate sector, lived on less than \$3.10 per day. Furthermore, pockets of poverty persist in the North, East, Estate Sector and Moneragala district where equality of opportunities in terms of access to services and linkages to the labor market are weaker. In 2016, poverty rates according to the national line were highest in the Northeast Districts of Kilinochchi (18.2 percent), Mullaitivu (12.7 percent), Batticaloa (11.3 percent), and Trincomalee (10 percent), as compared with 4.1 percent for all of Sri Lanka. Spending on social assistance declined in real terms between 2004 and 2014, and suffers from inefficient targeting. An increase in social assistance spending since 2014 may have helped stabilize inequality, which remained flat between 2012/13 and 2016. However, other challenges remain, including high rates of malnutrition, low rates of female labor force participation (Box 2), and a rapidly aging population.²⁶

Recent frequent natural disasters led to significant economic, fiscal and social impact.

Floods and landslides in late May 2017 affected 15 of the 25 districts of Sri Lanka. In two days (25-26 May) the precipitation rose to 600mm, provoking flash floods and landslides, and resulted in 213 deaths, 88,000 partially or fully damaged houses, over 100,000 displaced people, and economic damages and losses of about LKR 70 billion. The most affected sectors in terms of costs are housing, agriculture, transport and industry & commerce. The total recovery needs are estimated at LKR 116 billion. The sectors that require major amounts of financial resources are housing, transport, water and sanitation and agriculture.²⁷

The ongoing drought in 2016 and 2017 has affected 1,927,069 people across 17 districts, according to the Disaster Management Centre. During this Maha season 612,224 hectares of paddy were cultivated of which 50,615 hectares were damaged due to the drought. The Department of Agriculture estimates that, due to the floods in May and ongoing drought impacting the primary and secondary harvests of 2017, rice production for 2017 is expected to be the lowest paddy production in the last 10 years. The production forecast for 2017 will be sufficient for just over 7 months of

²⁶ "Sri Lanka - Poverty and welfare : Recent progress and remaining challenges", World Bank, January 2016, <http://documents.worldbank.org/curated/en/2016/02/25918944/sri-lanka-poverty-welfare-recent-progress-remaining-challenges>

²⁷ Rapid – Post Disaster Needs Assessment Floods and Landslides May 2017

household consumption which may lead to widespread food insecurity.^{28,29} The drought also led to decreased exports of agricultural exports, mainly tea, and increased imports of petroleum, as hydropower reservoirs ran dry.

As shown in Figure 3 and 5, the disasters have led to a contraction in the agricultural sector and exports of agricultural products and increase in food inflation, and triggered an increase in imports of oil and other relief. In addition, it has diverted fiscal spending in the form of relief. In the four months of 2017 the government has reportedly incurred LKR 1,397 million for the provision of disaster relief: LKR 163 million for supply of drinking water, LKR 500 million for the payment of the premium of the National Disaster Insurance Scheme benefitting the National Insurance Trust Fund (NITF) and LKR 734 million for the payment of compensation and housing construction for those affected by the 2016 landslides.³⁰

The disasters also significant affected areas with vulnerable populations.

The 2017 floods and landslides disasters and the 2016/17 drought also stand out in terms of their effect on the poor. In each case, approximately 12 percent of those affected were poor, nearly twice the national average of 6.7 percent. In the case of the landslides, this is because the 11 affected Divisional Secretary (DS) Divisions tend to be poorer than the national average. Those affected by the floods overall were also disproportionately poor, with an estimated poverty rate of 8.7 percent (Table 3). This demonstrates the importance social protection measures to mitigate the impacts of drought floods, particularly landslides, on the poor.

Table 3: Impact of recent disasters on poverty

Disaster	Number of DS Divisions affected	Measure of effect	Estimated poverty rate of affected persons (percent)	Estimated poverty rate of affected DS Divisions (percent)
2016 Floods	256	Affected persons	6.1	7.4
		Persons in safety centers	7.9	7.4
2017 Drought	163	Affected persons	11.7	8.7
2017 Floods	86	Affected persons	8.7	6.3
		Of which 11 Affected by landslide	11.6	11.3

Notes: Estimated poverty rate of affected persons is the weighted average of the DS Division poverty estimates, with the weights equal to the share of persons affected by the disaster in each DS Division. The estimated poverty rates of the affected DS Division are the weighted average of the DS Division estimates, with the weights equal to the share of the population residing in each DS Division.

Source: Staff calculations based on disaster reports from Disaster Management Centre and 2011 DS Division poverty estimates produced by World Bank and Department of Census and Statistics.

Summary of key macroeconomic developments

- Construction sector rebound partially compensated the impact of weather on growth performance
- Inflationary pressures remained high due to drought, VAT changes and demand pressures
- External trade balance weakened due to increased petroleum and food imports
- Official reserves improved markedly with forex purchases and external borrowings
- Primary surplus expected thanks to VAT changes; however, high interest costs to mask the improvement of fiscal deficit
- Public debt remains high; the debt portfolio indicates some significant risks
- Preliminary data shows poverty has fallen further between 2012/13 and 2016

²⁸ Joint Assessment of Drought Impact on Food Security and Livelihoods. 15 March 2017

²⁹ Office of the UN Resident Coordinator Drought Update No. 2, Sri Lanka | 19 September 2017

³⁰ Mid-Year Fiscal Position Report, 2017, Ministry of Finance, June 30, 2017.

B. Outlook, Risks and Policy Priorities



1. Outlook³¹

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

The government is progressing on an ambitious reform agenda, albeit at a slower pace than expected, aimed at improving competitiveness, governance and public financial management that would bring in long-term benefits. Continuation of reforms along with the IMF program will add to confidence while helping to reform the tax system to pursue revenue-led fiscal consolidation. The central bank stands ready to take appropriate action in the direction of stability. This is supported by a strengthening global growth outlook, including in some countries important to Sri Lanka (Box 3). These factors have contributed to an improved outlook.

Growth is expected to pick up with manageable inflation.

Growth is expected to reach 4.6 percent in 2017 and increase marginally over 5.0 percent beyond, driven by private consumption and investment growth. Although short to medium term growth will continue to be driven by non-tradable sectors, successful implementation of reforms should help the country to rely on productive tradable sectors in the long run. Inflation will stabilize around mid-single digit level towards the end of 2017 thanks to the base-effect and relatively low international commodity prices. In the medium term, the announced shift by the central bank to flexible inflation targeting will keep inflation in the single digits, while the exchange rate is left to adjust to market forces.

Fiscal consolidation will put the debt

Supported by a small primary balance, the overall fiscal deficit is expected to fall to 5.1 percent of GDP for 2017 thanks mainly to the implementation of revenue measures. In 2017, the VAT reforms, in its first year of implementation, will drive

³¹ Table 1 on last page

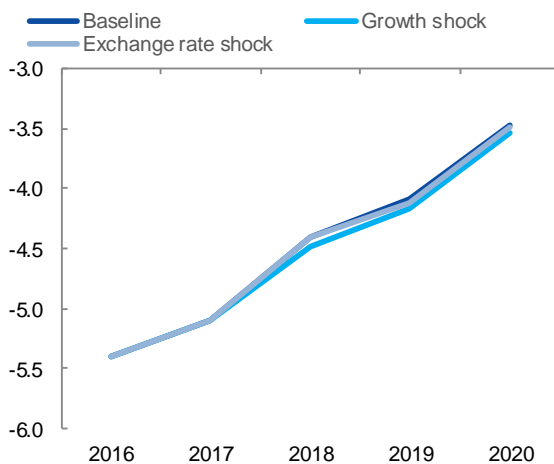
back on a declining path.

fiscal consolidation. In outer years, implementation of the new Inland Revenue Act, further reforms to the VAT law and improvements in tax administration are expected to expand revenues. On the expenditure side, staff projects that the increased fiscal space will primarily benefit public investment, assuming no major additional recurrent expenditure commitments. Under this baseline, the fiscal deficit is expected to narrow to 3.5 of GDP by 2020.

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

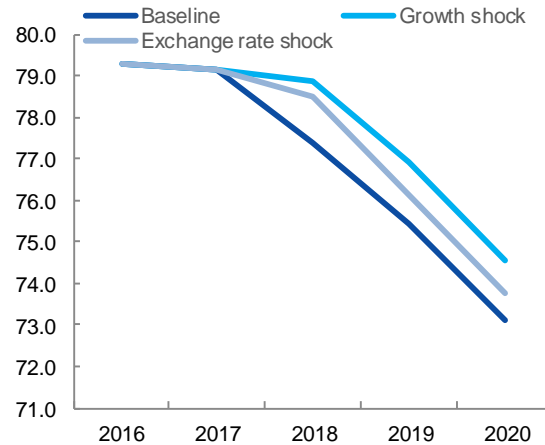
Continued fiscal consolidation is projected to bring the public debt burden to a downward path again in 2017 with a marginal decline in public debt-to-GDP ratio, ending a 5-year consecutive rise. Fiscal discipline is even more important in an environment of high domestic interest rates, an expected gradual tightening of global financial conditions and an expected gradual depreciation of the exchange rate, as the central bank moves to inflation targeting. Under the baseline scenario, this would bring the debt-to-GDP ratio to 73 percent of GDP by 2020. However, this is subject to shocks. A shock to the growth rate or exchange rate would widen the fiscal deficit (Figure 19) and would mainly affect the path of public debt (Figure 20).³² In addition, there is a risk that guarantees and other contingent liabilities will be called.

Figure 19: Fiscal balance – overall deficit
(Percent of GDP)



Source: Staff projections

Figure 20: Public Debt
(Percent of GDP)



Source: Staff projections

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

With healthy growth in the US and Euro Area and a recovery in a few key Middle Eastern countries (see Box 3), the external environment for Sri Lanka has improved, which would be favorable for exports and further tourism growth. This may compensate the lingering impact of the 2016/2017 drought manifested through a decline in exports and increase in petroleum imports. In outer years, while Sri Lanka will continue to benefit from tourism growth and the benefits of the EU's GSP+, recovering global commodity prices and external interest payments will lead to a widening deficit. These projections do not yet take into account the impact of intended structural reforms and the expected signing of trade agreements, which could provide an uptick to exports.

With emphasis on market forex

Inflows to the government and FDI inflows will help close the external financing needs with no Eurobond falling due in 2017. A pick up in FDI is projected with the

³² Shocks considered were: (a) 10 percent currency depreciation for 2018 and; (b) a reduction of real GDP growth rate to 3 percent in 2018.

purchases, external buffers are to improve in 2017.

boost received from the Hambantota Port lease and the Colombo Port City project and other earmarked large investment projects. External buffers are projected to improve, with emphasis placed on purchasing foreign exchange, maintaining a more market-determined exchange rate, using monetary policy and the sale of selected government assets. Supported by forex disbursements under the IMF EFF, project loans, other multilateral borrowings and sovereign bonds, the official reserve coverage of imports of goods and services is projected to increase above 4.0 months by 2018. In the outer years, unless export and FDI growth accelerates, more external borrowing will be needed when large repayments are due in Eurobonds. Emphasis, therefore, is needed on improving non-debt creating forex flows in the financial account.

2. Risks

The outlook is subject to a number of risks.

The immediate risk is tighter than expected global financial conditions that would increase the cost of debt and make it difficult to roll over the maturing Eurobonds from 2019. Other external risks include disappointing growth performance in key countries that generate foreign exchange inflows to Sri Lanka in terms of exports, tourism, remittances, FDI, and other financing flows. Faster than expected rises in commodity prices would increase pressure on the balance of payments and make domestic fuel and electricity price reforms more difficult.

Domestically, on the fiscal and debt management front, risks include the delay in implementing revenue and liability management measures; and slower than expected improvement in tax administration. The increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal consolidation path, the trade balance and poverty reduction. Finally, the complex political environment could delay implementation of important structural reforms.

The Special Focus section contains a discussion on risks and opportunities at various levels of society.

Box 3: South Asia economic context

Growth and prices: Global growth is firming, contributing to an improvement in confidence. A recovery in industrial activity has coincided with a pick-up in global trade, after two years of marked weakness. In emerging market and developing economies (EMDEs), obstacles to growth among commodity exporters are gradually diminishing, while activity among commodity importers remains generally robust. As a result, global growth is expected to reach 2.9 percent in 2017 and 2018, up from a post-crisis low of 2.4 percent in 2016 despite substantial policy uncertainty (Table 3.1). **Commodity prices** have continued to recover moderately, although prospects for increased U.S. shale oil production are weighing on the outlook for oil prices.

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

Risks: Substantial risks cloud this outlook, despite the possibility of fiscal stimulus in some major advanced economies, particularly the United States. Escalating trade restrictions could derail a fragile recovery in trade and undo gains from past liberalization efforts. A further increase in policy uncertainty from already high levels could dampen confidence

and investment and trigger financial market stress, after a period of unusually low financial market volatility. Market reassessment of advanced-economy monetary policy, or disorderly exchange rate developments, could contribute to swings in EMDE asset prices and capital flows, potentially amplified by vulnerabilities in some countries. Over the longer term, persistent weaknesses in productivity and investment growth would erode potential growth.

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

South Asia: South Asia is no longer the fastest-growing region in the world, due to gradual deceleration in India after the first quarter in 2016. Nevertheless, the region is expected to grow by 6.7 percent in 2017, reach 6.9 percent in 2018 and stabilize around 7 percent over the medium term. Robust growth prospects rest on the expectation that domestic consumption will remain strong, private sector investment will regain momentum, and exports will recover.

Table 4: Growth prospects for key partners of Sri Lanka

	2015	2016	2017	2018	2019	Key financial flows to Sri Lanka
	Actual	Estimates	Projections			
World	2.7	2.4	2.7	2.9	2.9	
United States	2.1	1.7	1.9	1.8	1.7	Textiles, Portfolio Flows
United Kingdom	2.2	1.8	1.7	1.5	1.5	Textiles, Tourism, FDI
Euro Area	2	1.8	1.7	1.5	1.5	Textiles, Tourism, Portfolio Flows
China	6.9	6.7	6.5	6.3	6.3	Tourism, FDI, Official Financing
India	8.6	7.1	7	7.3	7.4	Tourism, Remittances
Saudi Arabia	4.1	1.4	0.6	2	2.1	Remittances
Russia	-2.8	-0.2	1.3	1.4	1.4	Tea
United Arab Emirate:	3.8	2.3	2	2.5	3.2	Remittances
Japan	1.1	1	1.5	1	0.6	Official Financing

Source: World Bank Global Economic Prospects, June 2017; South Asia Focus, October 2017; and Global Economic Prospects Preliminary estimates

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>

South Asia Economic Focus is published in April and October each year. The latest report and regional outlooks can be found at: <https://openknowledge.worldbank.org/handle/10986/11978>

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

3. Challenges and policy priorities

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

Sri Lanka faces a number of challenges to sustain future economic growth, create more and better jobs and reduce poverty; and thus must be addressed through determined reforms. These key challenges are inter-linked and require a comprehensive and coordinated approach. Although domestic political considerations and institutional constraints on policy implementation make it challenging, a strong political will and the support of the bureaucracy could help with advancing the reform agenda. Steps need to be taken to ensure the support of the private sector, civil society and other stakeholders through improved communications on costs and benefits of the reform agenda (see Box 4 Vision 2025).

Box 4: Sri Lanka's Vision 2025 document

The government announced its vision – “Vision 2025” - to make Sri Lanka a rich country by 2025. While recognizing the structural and inter-linked challenges that Sri Lanka is facing, the Vision 2025 aspires to transform Sri Lanka into the hub of the Indian Ocean, with a knowledge-based, highly competitive, social market economy focused on inclusion. It sets intermediate targets for the next three years to lay the foundation to become a rich country by 2025. These include raising per capita income to USD 5,000 per year, creating one million new jobs, increasing FDI to USD 5 billion per year, and doubling exports to USD 20 billion per year.

Key challenges

The document recognizes the important constraints to growth.

- It suggests that growth in recent years has primarily been through inward-oriented economic activities driven by government infrastructure spending based on heavy commercial borrowing. Persistent fiscal deficits and external current account deficits have resulted in poor investor confidence and low levels of foreign direct investment (FDI) and private domestic investment. Much of private investment, both local and foreign, has gone into real estate and related sectors as well as uncompetitive import substitutes.
- The documents attributes strong anti-export bias in the economy to the often-uncompetitive exchange rates alongside high effective protection rates. It argues that the country's exports are still concentrated on a few, mainly low technology products and that investment policies have failed to attract transformational, knowledge-based investments.
- The Vision 2025 contends that public finances have been a constraint on growth. A steady decline in government revenue generation has resulted in debt accumulation, particularly concentrated on non-concessional foreign borrowing. It suggests that high levels of public debt hamper growth through increased uncertainty, over-taxation, predominance of indirect over direct taxation, diverting resources from social and infrastructure development, crowding out of private investment and weakening resilience to shocks.
- It recognizes the fragile financial standing and the poor quality of public service delivery of state-owned enterprises (SOEs) as additional constraints to productivity and growth.
- According to the document, growth is also hampered by regulatory barriers constraining both foreign and local private investment. Critical constraints are the dearth of land for commercial and other productive purposes; the skill profile of the current workforce not being aligned with the needs of a globally-integrated economy; archaic labor laws and inefficiencies in the labor market that hinder female labor force participation; rigid border taxation laws which hamper trade facilitation, inadequate infrastructure in terms of access, quality and pricing of energy, transport and telecommunication; and access to finance, especially for SME sector.

Reforms

In order to achieve set targets, the Vision 2025 outlines the key following areas for reform.

Strengthening growth framework	Land, labor and capital markets	Economic and social infrastructure
<ul style="list-style-type: none"> • Private sector development • Investment facilitation • Doing Business • PPPs • Trade policy and related reforms: Para-tariffs, FTAs • SMEs • Logistics • Tourism 	<ul style="list-style-type: none"> • Dynamic land market • Land policy, scientific land management • Increase female labor force participation • Labor productivity • Migrations • Address informality • Colombo International Finance Centre • Capital market reforms 	<ul style="list-style-type: none"> • Access and quality of education • Vocational training • Youth empowerment • Skill development • Non-communicable Disease Management • Improved health facilities • Excise taxation policy • Economic corridors • Water, housing and transport

<p>Agriculture and sustainable development</p> <ul style="list-style-type: none"> • Efficiency in agricultural markets • Agriculture/plantation modernisation • Smallholders in exports • Livestock and fisheries • A new development bank • Financial inclusion • Disaster management • Green initiatives • Waste management • Power generation, clean energy, pricing formula 	<p>Macroeconomic framework</p> <ul style="list-style-type: none"> • Revenue-led fiscal consolidation • Direct-indirect tax mix • Efficient incentives • Financial planning and commitment control • Liability management • Expenditure management and Public Investment Program • Price stability and flexible inflation targeting • Market-determined exchange rate • SOE restructuring 	<p>Legislations</p> <ul style="list-style-type: none"> • Inland Revenue • Foreign Exchange • State Land Bank • Anti Dumping • State Commercial Enterprises • Ports and Airports • Ruhunu Economic Development Corporation • Lands (Special Provisions) • Sustainable Development • Liability management • National Debt Office
<p>Governance and accountability</p> <ul style="list-style-type: none"> • Policies of good governance • Reconciliation • Right to Information • People's participation in development 	<p>Social safety nets</p> <ul style="list-style-type: none"> • Contributory pension for all • Targeting for Samurdhi • Access for differently-abled citizens • Efficient, integrated social protection 	<p>Technology and digitization</p> <ul style="list-style-type: none"> • Private investments in technology • ICT initiatives • Intellectual property • Mobile payments and electronic transactions

The document is available at https://news.lk/images/pdf/2017/sep/Vision_2025_English_final.pdf.

1. *Stay on the fiscal consolidation path*

Staying on the fiscal consolidation path is a key priority.

Raising more revenue while controlling current expenditure is needed to reduce the fiscal deficit and bring public debt to a sustainable path. Following the success in 2016, emphasis is needed on raising tax revenues structurally without relying too much on non-tax revenues driven by SOEs. Continued fiscal consolidation will help the country prepare for additional public spending on expanding pension coverage and 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 are expected to gradually become tighter, and free up credit for the private sector in the domestic market. A reduced fiscal deficit, a reduced debt level and more predictability in the markets will also reduce the burden on the central bank to provide temporary financing, which gives it more operational independence to pursue an appropriate monetary and exchange rate policy for the country.

Implementing the new Inland Revenue Act is a good start.

The new Inland Revenue Act should be followed up by further reforms to widen the tax base, make the current tax system simpler and more stable, and make administration more efficient. The incentives structure in the new law, which relies on investment allowances is expected to promote investment and job creation instead of offering fiscally expensive tax holidays, exemptions and special rates. Although there is room for improvement through sector targeting, investment allowance based incentives could be helpful for simplification and reduce leakages while preserving competitiveness. Improving the VAT Act and its administration will be a key step in the direction of revenue-led fiscal consolidation, going forward.

2. *Change to more private investment, tradable sector-led growth model*

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

While Sri Lanka has grown rapidly in the past, the non-tradable drivers of such growth are unlikely to remain adequate for inclusive and sustainable growth in the coming decade.^{33 34} Given the context of continued weak external liquidity, foreign exchange generated through tradeable sectors is even more important for Sri Lanka. In order to benefit from an export-led growth model, which is necessarily based on trade, it is important that Sri Lanka strengthens its competitiveness in order to promote trade and FDI, leverage its locational advantage of geographical proximity to the global powerhouses, establish the necessary conditions for a thriving knowledge economy, integrate productive local companies in global value chains, and attain higher value addition in the manufacturing sector. This reform process will be key for Sri Lanka's sustained economic prosperity (Figure 18).

Policy recommendations to improve trade and business environment and FDI:

- Trade policy: (1) adopt trade policy with a gradual but firm liberalization schedule, allowing time for adjustment to avoid a sudden shock to fiscal revenue and the balance of payments; and (2) make progress on bilateral trade agreements while carefully evaluating the costs and benefits to Sri Lanka, with a particular focus on non-tariff barriers and Mutual Recognition Agreements. The Special Focus Section discusses managing risks of carrying out para-tariff reforms with a view to improve trade.
- Trade facilitation: (1) adopt a systematic and effective risk management system, the absence of which imposes a huge burden in terms of time and cost, adversely impacting competitiveness; and (2) create a single trade information portal, which will help meet the informational needs of businesses.
- Innovation: improve the innovation landscape in Sri Lanka especially for SMEs and start-ups.
- FDI attraction: (1) enhance effectiveness of the Board of Investment as a 'one-stop shop' for foreign investors; (2) strengthen BOI's investment

³³ Real GDP expanded by 40.5 percent from 2010 to 2016 with the top six sectors contributing to 70.0 percent of the total growth all being non-tradables: construction, transport, other personal services, financial services, wholesale and retail trade, and real estate. Agriculture that employs around 28 percent of the total labor force contributed to only 4.1 percent of growth while all other manufacturing/service sectors collectively accounted for 25.9 percent of growth.

³⁴ In general, shifting resources into tradable sectors, led by manufacturing, is desirable for emerging markets because productivity gains are higher in tradable sectors than in non-tradable sectors. (World Bank (2013), 'Island of Prosperity? Ideas for Accelerating Inclusive Economic Growth in Sri Lanka', Washington, DC.) In Sri Lanka, the share of manufacturing output, which was 18.7 percent in 2000, rose to 19.5 percent in 2005, and declined to 16.3 percent by 2016 due to faster growth in the services sector.

attraction capabilities by adopting modern tools and techniques in sector targeting, investor outreach, and investor facilitation; (3) strengthen investment retention capacity through ‘after sales services’ for existing investors; and (4) address regulatory barriers to FDI in backbone sectors to promote exports.

- Ensure coherence and coordination between investment policy and trade policy with a clear indication of future policy direction.
- Conduct awareness campaigns and adopt an effective communication strategy to dispel concerns regarding preferential trade agreements.
- Enhance institutional capacity of GoSL to address the shortcomings in the investment climate undermining the competitiveness of the private sector.
- Formulate a legal framework and policies to help firms and workers adjust to the impact of trade policy reforms and allow them to seize new opportunities.

3. Improve governance and accountability

Governance reforms will support fiscal sustainability and overall competitiveness.

It is important that the government takes steps to implement the Right to Information Act in full, the passing of which reflected a landmark improvement to transparency and governance. The Constitutional Amendment to strengthen the supreme audit institution was a key first step; however, this needs to be followed by the Audit Bill, providing for greater administrative and financial independence. The current work on drafting a comprehensive Public Finance Act will provide clarity on roles and responsibilities in the management of public assets and improve budget credibility. A legal framework for SOEs, strengthened audit function as well as improved public financial management and oversight of public enterprises could improve fiscal performance as well as public sector effectiveness, including for public enterprises.

4. Manage risks and create opportunities

Managing risks is important for sustainability.

The new growth model will open new opportunities for development. It will make Sri Lanka more resilient to many risks, but will expose it to new ones. Increasingly frequent natural disasters also demand more preparedness. It is important to manage risks well at different levels of society—households, firms, the public sector and the macroeconomy. Therefore, the Special Focus Section of this edition of the Sri Lanka Development Update is devoted to a discussion on integrated risk management using the framework presented in the World Development Report, 2014.

Summary of outlook

- Growth expected to be affected by disaster, but return to 5 percent in medium term
- Inflation will increase in 2017 due to one-off impact of VAT and stabilize with continued low commodity prices
- Fiscal consolidation will continue towards a deficit of 3.5 percent of GDP in the medium-term, despite 2017 government budget deficit target of 4.6 percent of GDP is likely to be missed.
- Debt is likely to stabilize and start to fall, but sensitive to growth, fiscal and exchange rate shocks
- External sector will benefit from tourism and GSP+ from the second half of 2017; however, expenditure on food and petroleum could mask the improvement
- Reserves will improve, with forex purchases, a more market-determined exchange rate, monetary policy and divestment/lease out of some government assets

C. Special Focus: Creating opportunities and managing risks for sustained growth



To sustain growth, job creation and poverty reduction, Sri Lanka needs to change its growth model, and manage risks.

Risk management can be a powerful instrument for development, by reducing the impact of adverse events and presenting new opportunities

To implement its Vision 2025 agenda (Box 4) to sustain growth, job creation and poverty reduction, Sri Lanka needs to change its growth model. This new growth model will open up more opportunities for development for different levels of society—households, firms, the public sector and the macroeconomy. It will make them more resilient to certain risks, but will also expose it to new ones. It is therefore important to manage them well to maximize the opportunities.

The 2014 World Development Report³⁵ argues that risk management can be a powerful instrument for development—not only by building people’s resilience and thus reducing the effects of adverse events but also by allowing them to take advantage of opportunities for improvement.

It offers five key insights on the process of risk management:

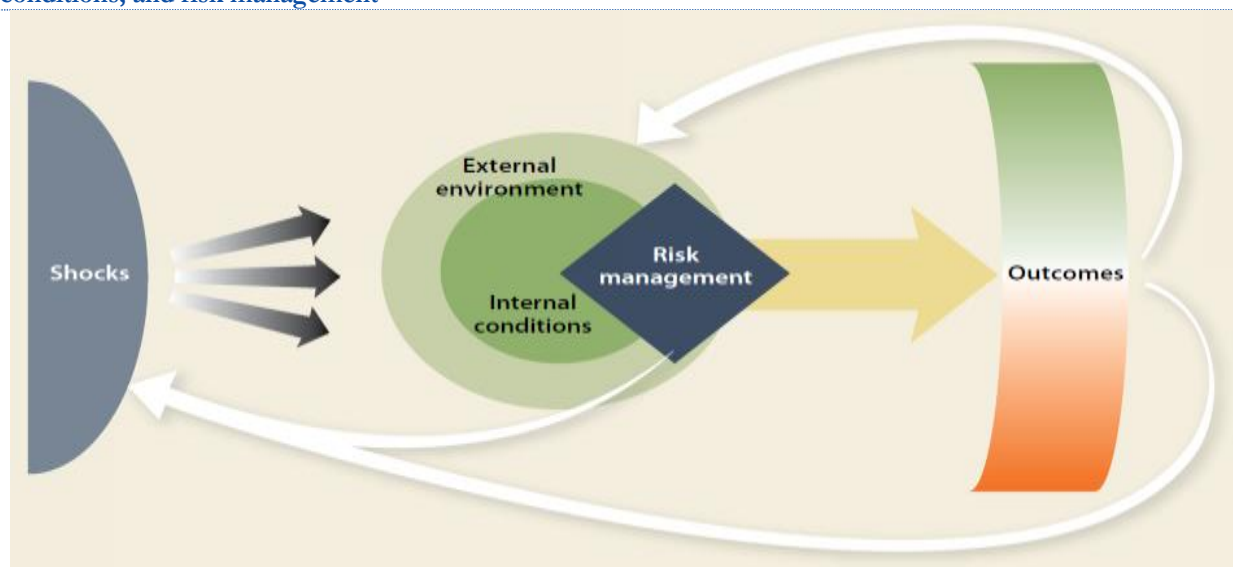
1. Taking on risks is necessary to pursue opportunities for development. The risk of inaction may well be the worst option of all.
2. To confront risk successfully, it is essential to shift from unplanned and ad-hoc responses when crises occur to proactive, systematic, and integrated risk management.
3. Identifying risks is not enough: the trade-offs and obstacles to risk management must also be identified, prioritized, and addressed through private and public action.

³⁵ *World Development Report: Risk and Opportunity, Managing Risk for Development*, World Bank Group, 2014, <http://www.worldbank.org/wdr2014>.

4. For risks beyond the means of individuals to handle alone, risk management requires shared action and responsibility at different levels of society, from the household to the international community.
5. Governments have a critical role in managing systemic risks, providing an enabling environment for shared action and responsibility, and channeling direct support to vulnerable people.

The WDR analyzes how various levels of society can manage risks, cope with the impact of shocks and create new opportunities.

Figure 21: The risk chain: The nature and extent of outcomes depend on shocks, exposure, internal conditions, and risk management



Note: The feedback arrows in the risk chain diagram represent the potential for the outcomes of past shocks to affect exposure and internal conditions, as well as the propensity for future shocks. Similarly, the effectiveness of people's risk management can significantly affect the nature of and propensity for future shocks.

Source: WDR 2014 team

Integrated risk management is critically important in ensuring sustainable development.

This section will apply the WDR 2014 framework to Sri Lanka and address the question of how households, firms, public policy and international community can benefit from opportunities if risks are managed well for Sri Lanka.

It will focus on four sources of risks that can have implications on different levels of society: households, firms, the public sector and the macroeconomy. The definition of risk depends on the level of society affected: certain reforms that are necessary from a macroeconomic perspective (public sector and macroeconomy) can be perceived as a source of risk at the microeconomic level (households and firms). See Table 5:

1. Fiscal policy reforms (VAT and energy price reforms)
2. Trade policy reforms
3. Public debt and contingent liabilities
4. Natural disasters and climate change

Table 5: Impact of sources of risk to levels of society

	Households	Firms	Public sector	Macroeconomy
1. Fiscal policy reforms (VAT, fuel price reforms)	Price shock	Price shock	Revenue, recapitalization, targeted expenditure	Inflation
2. Trade policy reforms	Income, employment, relative prices	Demand, relative prices for inputs and outputs	Shock to tariff/para-tariff revenue, trade adjustment package	Trade balance, structural change to economy
3. Risks of public debt and contingent liabilities	Cost of borrowing	Access to finance	Shocks to interest expenditure, level of debt	Risk to capital flows
4. Risks of natural disasters	Income, employment, cost of basic goods, health, damage, food security	Damage, lost opportunity, cost of inputs, infrastructure, value chain interruptions	Reduced import tariffs, reduced tax revenues, increased expenditure on relief and reconstruction	Increased imports, decreased exports

Source: World Bank

Managing these risks well would lead to new opportunities for households, firms and strengthen the public sector and macroeconomy.

Not managing the risks could lead to a slowdown in reform momentum, slowdown in growth and deterioration in the external position, increased vulnerability to shocks for households, and less favorable views of investors and financial markets.

However, if managed well it is expected that these reforms could lead to new opportunities, such as better jobs, more business opportunities, a healthier society, better infrastructure and quality of life and a more stable macroeconomic environment.

This points to a clear agenda to strengthen the capacity to analyze risks, and design and implement risk mitigation mechanisms. The public sector and especially the budget plays a special role in its ability to mitigate risks. There is also a need to communicate reforms well, be open about the risks and opportunities and make credible announcements how the risks can be mitigated.

1. Fiscal reforms

To support the fiscal consolidation, it is important to broaden the Value Added Tax (VAT) base.

Since its introduction, the performance of VAT as a share of GDP has fallen sharply, with collection falling from 5.7 to 2.0 over the 2005-2015 period, caused to a large extent by the widening set of exempted goods, services and programs, reaching close to 400 by 2017, thus narrowing the tax base. Many of the exemptions on final consumption goods are effectively subsidies to the non-poor, since they account for most of the consumption of these items. Those exemptions therefore increase inequality. Since VAT is in principle not a burden on firms in the value chain, the existence of VAT exemptions on intermediate goods is the result of individual firms lobbying for exemptions. However, the aggregate impact of the exemptions offset these individual benefits to some extent. This backdrop warrants a discussion to revisit VAT exemptions with a view to widen the tax base and support revenue-led fiscal consolidation.

These reforms are expected to create opportunities for the public sector, while improving the business environment through a simpler tax system.

The elimination of some of the VAT exemptions and broadening of the VAT net will directly strengthen the fiscal balance. While the increase in the VAT rate and removal of exemptions may increase the price level, there are many expected benefits that would offset this effect: (1) a simpler and more predictable VAT system is better for business and job creation; (2) improved macroeconomic and fiscal stability will allow more stable inflation, which improves the business and investment climate and is generally good for the poor; (3) increased fiscal space for investment in physical and human capital to improve productivity and sustain growth with an aging population.

However, the removal of VAT exemptions will raise the cost of living, raising the risk for some households to fall into poverty.

The increase in prices driven by the removal of VAT exemptions will affect all households but the extent of the policy's impact will be determined by a household's position in the income distribution. Higher prices will have a negative impact on poverty and inequality, with households living close to the poverty line facing a heightened risk of being pushed into poverty. If VAT exemptions are removed for items consumed predominantly by non-poor, the increase in poverty is likely to be modest and the increase in inequality even more so. Indeed, for many exemptions the top 60 percent of society account for 75 percent of spending, compared to the bottom 40 percent, which makes them effectively subsidies benefitting the non-poor.

To manage this risk, the government needs to carefully choose VAT exemptions for removal and use targeted fiscal expenditures to mitigate the impact on the poor.

To maximize the fiscal benefits and minimize the risk of increasing poverty, it is important to focus on removing exemptions on goods that (1) account for large amounts of foregone tax revenue (i.e., a high tax expenditure); (2) are effective subsidies to the non-poor (the non-poor account for most of the spending), and (3) are not important in the bottom 40 percent's household. Preliminary estimates show that by abolishing VAT exemptions predominantly consumed by the non-poor and replaced by reasonably well-targeted fiscal spending, for every 100 rupees recovered from abolishing the exemption, only about 25 rupees need to be devoted to spending targeted to the poor to mitigate the impact. The better the targeting of the spending to the poor, the lower the spending needed, and the larger the net fiscal revenue increase.

Employing timely and targeted fiscal measures to mitigate the impact on the poor is critical as these households often lack the resources and preparedness to cope with adverse shocks in a sustainable and effective way, while the targeting will maximize the positive net fiscal impact.

The most natural way to channel the funds would be through targeted cash transfers, such as Samurdhi. However, since Samurdhi benefits reach many non-poor, this system needs to be reformed first. In the meantime, the additional fiscal resources can also be used in other ways to reach the poor, for example, through improvements in public health and education provision (which are highly progressive in nature), or public investment projects in DS divisions with high poverty rates.

Adopting such measures to mitigate the impact of these risks and communicating them to the public at the onset of these reforms will go a long way towards gaining public support and ensuring that the policy reforms are accepted and successful while also minimizing or even offsetting the adverse outcomes that are unavoidable in the short run.

Reforms to the fuel and electricity prices above cost-recovery

The government is also planning reforms to the fuel and energy pricing regime moving from a system of administered prices to allowing the state-owned utilities to charge prices above cost-recovery levels. This will allow these firms to be financially

levels are expected to present similar opportunities and challenges.

sustainable and reduce the fiscal risk to the government, which manifests itself through repeated recapitalizations of the utilities, clearing intra-SOE arrears and exposure of state-owned banks to the SOEs, while it may also improve their transparency and quality of service.

Since the non-poor are the largest consumers of fuel and electricity (the top 30 percent of society consumes 70 percent of fuel, well ahead of direct and indirect consumption of fuel by the bottom 40 percent through the use of public transport), the administered fuel prices are an effective subsidy to the non-poor funded indirectly by fiscal resources.

The reforms will, therefore, pose similar risks and opportunities for vulnerable households, as VAT reforms. As with the VAT reform, fuel and electricity reforms should go hand in hand with strengthening safety net and targeted expenditure to mitigate the impact on the poor, while preserving fiscal resources.

The opportunities would be a stronger public balance sheet through reduced fiscal risk and a better pass-through of global commodity prices to users, which could facilitate a shift to alternative fuel sources and lead to a more stable balance of payments, as the volume of fuel imports would fall if global prices rise.

2. Trade policy reforms

Sri Lanka's trade share of GDP has shrunk since 2000, leading to a risky status quo due to the concentration on a few export products and export markets.

Having recognized the significance of open, competitive economic policies that can boost economic growth, job creation and poverty reduction—particularly in the small open economy context—Sri Lanka pioneered trade liberalization among South Asian countries in the 1970s. However, policy reversals since the mid-2000s have led to a regression back to the trade restrictiveness of the 1970s, marked by the introduction of para-tariffs, such as the export and import cess and the Ports and Aviation Levy (PAL) (see Box 5). This has created a strong anti-export bias, which has been reflected in the dramatic decline in the trade-to-GDP ratio (from 89 percent in 2000 to 48 percent in 2016) and an unchanged composition of exports. As a result of an inward-oriented growth model, Sri Lanka suffers from a structurally weak external position, and is vulnerable to shocks in a few key export markets (textiles, tea and rubber) and a few destinations (European Union and the United States).

The internal conditions and external environment mean that a gradual but firm liberalization schedule is needed.

While being mindful of the impact on fiscal revenue and balance of payments, the tariff reform needs to incorporate a gradual but firm liberalization schedule, allowing time for adjustment, with a fixed phase-out schedule. Para-tariffs are non-transparent in nature and their ad-hoc imposition as an easy “go-to” for revenue generation takes away predictability, which is critical for production and investment decisions. It is clear, therefore, that they need to be consolidated, reduced in magnitude, and eventually eliminated. Similarly, export taxes on agricultural commodities need to be revisited as the rationale behind them is no longer clear. International experience suggests that many countries, transitioned to upper middle income level, have gone through similar processes (Box 5).

Trade reforms and tariff liberalization will create new opportunities in the

Trade reforms will increase Sri Lanka's openness to trade, with an expected positive impact on GDP, exports and imports and possibly a lowering of the price level that consumers face. The opportunities arising from trade reforms will present themselves at all levels in the medium to long-term. The economy will be able to generate more

medium to long-term.

and better jobs for households; firms are expected to become more productive and will be able to enter new markets and seize new opportunities, increased economic activity along with tax reforms will support tax revenue; and the external position of Sri Lanka is likely to strengthen in the medium to long term, while a more diversified basket of goods and export markets will make the macroeconomy more resilient. Policy simulations suggest that the expected increase in economic activity and trade, with remaining duties in place and other ongoing tax revenue reforms will offset the possible revenue losses from reducing the tariff and para-tariff rates.

However, impact of reforms is not uniform, some sectors will face difficulties in the short-run.

Since trade policy reforms affect relative prices in the economy, firms in almost any economic sector, even protected ones, would be affected, through changes in input and/or output prices. Some firms and sectors will grow while others may struggle to survive, unless they become more productive. While the opening up of the economy is expected to lead to more investment, more product choice, and new and better paid jobs, households would be affected through changes in the real wage (compared to the price of their consumption basket), changes in prices, and employment. The reduction in duties and para-tariffs would also lead to lower tax revenue from those sources for the public sector.

Managing the downside risk through mitigating the short-term negative impacts on households and firms is essential.

It is expected that the overall benefits, in term of GDP growth, net job creation, quality of new jobs and the price level will outweigh the costs and that such costs can be managed through public policy. The impact on households can be mitigated through a strengthened and well-targeted social safety net, retraining programs and transferable pension arrangements. Improving the business environment, including improving trade facilitation, will make it easier for firms and workers to benefit from growing sectors.

While the public sector would reduce its reliance on revenue from duties and para-tariffs, the net impact will be dampened by the impact of increased trade on the remaining duties. Economy-wide, the impact of opening up may lead to an initial increase in imports before exports start to increase, causing the trade balance to temporarily worsen before it improves. For this reason, the time to start to reform is now, given strengthened foreign exchange reserves and commodity prices projected to rise gradually.

Early public communication is key to gain public support for this agenda, since those who benefit often have a less powerful and uniform voice than those who lose out.

Box 5: The Complexity of Sri Lanka's Tariff Structure and Reform Possibilities

The government of Sri Lanka has recently adopted the New Trade Policy³⁶ with “an overarching objective to improve domestic productive capacity and trade performance, revitalize the nation's integration in global and regional markets, raise the living standards of the people and accelerate the nation's long-term economic growth rate”. A central piece of the implementation of this strategy is to simplify and reduce the burden of protective import taxes. Indeed, Sri Lanka's import tax structure has become a complex web of tariffs and para-tariffs that have been revised frequently during the last decade. The revisions have been ad hoc, inconsistent, and have followed different directions. The number and complexity of the taxes on imports impair the development of competitive firms, industries, and exports.

³⁶ <http://modsit.gov.lk/images/New-Trade-Policy.pdf>

Ports and Airports Development Levy (PAL) and Cess are two prominent para-tariffs. As of October 2017, besides Customs Duties (CDs) which have rates of 0 percent, 15 percent, and 30 percent,³⁷ there are two taxes that apply exclusively to imports (“para-tariffs”): (i) PAL with rates of 0, 2.5 and 7.5 percent; and (ii) import cess, which has ad-valorem, specific and mixed rates that range from 1 percent to 465 percent.³⁸ In addition, three other taxes are charged on both imports and domestic production (VAT, NBT and Excise) and one composite tax (Special Commodity Levy) is charged in lieu of all other taxes for a small number of mainly agricultural commodities.

Para-tariffs add significantly to overall protection of domestic production. While PAL applies to most tariff lines (84 percent of the total) with uniform and low rates, the import cess applies to 28 percent of tariff lines with significantly higher rates (59 percent of tariff lines under cess pay a cess rate above 10 percent). The cess is also imposed non-uniformly between sectors with more than half of tariff lines in sectors like footwear, vegetables, textiles, plastics, and foodstuff, paying import cess. On the other hand, less than 10 percent of tariff lines in sectors like machinery, chemicals, and transportation pay import cess. Because the import cess generally falls on items paying non-zero customs duties, the level of protection afforded by the combination of tariffs and para-tariffs can become very high. Thus, average protection implied by the cess tends to be higher for sectors like foodstuff, footwear, glass, vegetables, etc. (Figure 1).

Revenues generated by para-tariffs are relatively low, making tariff rationalization manageable from a revenue standpoint.

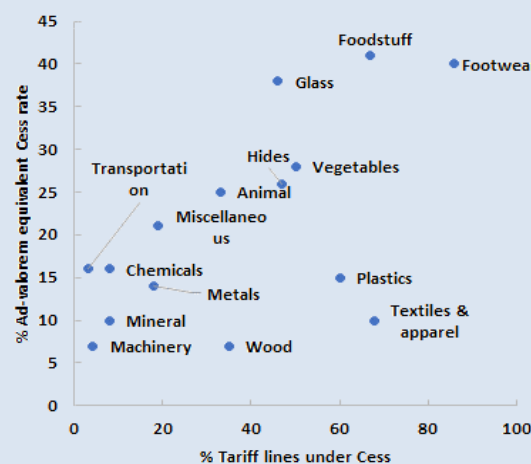
In 2016, the two most prominent para-tariffs, Cess and PAL, represented less than 10 percent of total government revenue. The largest share of revenue from imports arises from domestic taxes such as Excise, VAT, and NBT applied to imports. These taxes, along with the SCL, generated more than 28 percent of total tax revenue in 2016. Finally, the government forgoes considerable revenues through the provision of many exemptions to several of the seven taxes applied on imports for different purposes. Thus, from a revenue point of view, there is considerable room to rationalize the very pervasive and complex para-tariff regime.

The complexity of para-tariffs also means that there is much scope for relatively painless rationalization. For example, there are many tariff lines where revenue collections are very low or negligible. There are a very large number of tariff lines where the import cess is specific (as in Rs/unit), and could be converted to ad-valorem. The overall duty structure is also very dispersed, and a serious effort could be made to reduce this variation.

A broader reform of all tariffs and para-tariffs also needs to begin, as announced in the New Trade Policy. Such reforms are expected to have a positive impact on the economy as a whole, with the gains in GDP, exports, and imports, as well as a lowering of the price level for consumers outweighing the impact on those sectors that are less competitive and face a risk of shrinking.

The process is manageable, and a part of the transition to upper middle income levels. For example, Thailand reduced its average tariffs from 40.4 percent in 1991 to 8.2 percent in 2014; Malaysia from 13.6 to 3.4 percent between 1991 and 2014. Both countries are in the upper middle income ranks. Sri Lanka’s average tariffs (including para-tariffs), by contrast, rose from 13.4 to 21.9 percent between 2004 and 2016.

Figure 22: Cess prevalence and implied average protection in different sectors



Source: Customs data, staff calculations

³⁷ Specific or mixed custom duty rates apply to 262 tariff lines (3.8 percent of total).

³⁸ The import cess is only applied on 1,937 tariff lines (TLs). The ad-valorem rates apply to 598 TLs and range from 1 percent to 70 percent; specific rates apply to 522 TLs and range from LKR 4/kg to LKR 6,000/kg; mixed rates apply to 817 TLs and range from 8 percent or LKR 25/kg (whichever higher) to 35 percent or LKR 2,000/kg (whichever higher). The ad-valorem equivalents of specific and mixed rates usually exceed 10 percent and can reach up to 350 percent.

3. Public debt and contingent liabilities

Sri Lanka's public debt is high and shows significant risks.

At 79.3 percent of GDP, Sri Lanka's public debt is high compared to its regional peers. Moreover, the debt portfolio has deteriorated in several indicators; especially, in relation to external debt. The country's transition towards Upper Middle-Income status has led to more commercial borrowing terms and increased the cost and risk. The non-concessional and commercial component of the government foreign debt rose from 1 percent in 2000 to 53 percent in 2016. The interest rate risks on foreign currency debt has risen, while average interest rates also increased. The average time to maturity has shortened, and reserve adequacy in relation to share of the foreign-currency commercial debt component has deteriorated. Given the bunching in external Eurobond repayments, external debt service could become a matter of concern starting from 2019 (Box 6). Guaranteed and non-guaranteed SOE debt amounted to about LKR 1.3 trillion or 12 percent of GDP, presenting additional fiscal risk.

Compounded by structural challenges in debt management

The fragmented institutional framework and lack of a comprehensive debt management strategy leaves the public sector exposed to a debt portfolio with high cost and risk in the domestic market as well. The decades-old legal framework falls short in providing a comprehensive framework for modern debt management.³⁹ The Private Public Partnership (PPP) agenda may move the direct fiscal cost of investment to the private sector, but may require the public sector to assume more fiscal risk.

Improvement in debt management will help develop the domestic financial market, and improve access to finance.

Reforms in debt management and SOEs are crucial for macroeconomic stability. Improved debt management may reduce the interest cost or risks of government debt and support fiscal consolidation while reducing fiscal risks. Managing liabilities actively will mitigate refinancing risks, contribute to improved investor perceptions and possible upgrading of credit rating (Box 6). Improved debt management will also lead to deeper, more liquid domestic debt markets that support private capital market development. Less fiscal pressures on financial markets will reduce market interest rates and thereby the cost of funding for households and firms. Together with the expected presentation of the Secured Transactions Registry Act, which will allow firms to pledge movable collateral for loans, this would support access to finance on reasonable terms for the struggling SME sector. Improvement in SOE governance may reduce fiscal pressures and improve service delivery.

³⁹ A well-defined legal framework for debt management includes the following: clear authorization for the Executive branch to borrow and issue guarantees on behalf of the government, definition of long-term debt management objectives to guide the debt management office, definition of the purposes of borrowing (including to finance budget deficit and cash needs, to refinance and prefinance outstanding debt, to honor guarantees, to fulfil requirements by the central bank to issue Treasury bills), requirement of the Executive branch to develop a debt management strategy in line with objectives to guide borrowing decisions; and requirement to report annually on the implementation of the strategy to Parliament (World Bank, Debt Management Performance Assessment tool, <http://www.worldbank.org/en/topic/debt/brief/dempa-2015>).

However, urgent action is needed to manage the downside risks of public debt and contingent liabilities

Fiscal risks emanating from the debt portfolio and SOE-related liabilities highlight the need to carry out reforms. In this context, the government has initiated steps to set up a unified Debt Management Office (DMO) to manage the debt portfolio, but progress has been slow. In order to enhance performance and reduce the fiscal risk of SOEs, the government already has signed Statements of Corporate Intent with five key SOEs and is planning to sign a few more. Although these are important steps in the right direction, more needs to be done to manage the risks and reap the benefits of improved performance.

The World Bank recommends that the government:

- Continue the already started work on establishing the unified DMO and strengthen the legal framework for debt management, which currently has some gaps.
- Formulate and implement a comprehensive Medium-term Debt Management Strategy (MTDS): A proactive debt management strategy can provide guidance to the DMO on how to consider trade-off between the costs and risks of available domestic and external borrowing options, while enhancing transparency and predictability in the domestic financial market that will contribute to capital market development.
- Active Liability Management (ALM): ALM operations could mitigate the refinancing risks emanating from the bunching of Eurobond maturities, and could help domestic bond market development. Changes to the budget's legal framework are needed to allow ALM operations (Box 6).
- Formulate a guarantee policy: A well-designed guarantee policy could ensure that guarantees are going to priority sectors while helping manage fiscal risks. Key elements would be an independent credit risk assessment, charging a risk-adjusted guarantee paid into a guarantee fund, and close monitoring of the beneficiary and the project throughout the lifetime of a project and a consolidated presentation of debt and contingent liabilities. This is even more important given the government's vision to promote PPPs as an important vehicle for large projects.
- Strengthen capacity for modern debt management: Staff capacity in modern debt management techniques and toolkits is critically important. Among others, these include formulation and implementation of an MTDS and an annual borrowing plan, carrying out a Debt Sustainability Analysis (DSA), and ability to evaluate various debt instruments and options for a prospective Upper Middle Income Country.
- Manage fiscal risks from SOEs through implementing performance agreements and monitoring mechanisms, establishing a centralized state ownership institution to improve the effectiveness of public enterprises oversight and reduce fiscal risks, and enhancing the capacity of public enterprise boards to improve operational and financial performance.

Box 6: Active liability management could potentially reduce costs and risks for Sri Lanka's debt.

Sri Lanka faces external sovereign bond maturities starting from 2019 to 2023 and from 2025 to 2027 (USD 9.65 billion). The situation is exacerbated by maturing bonds of commercial banks and Sri Lankan Airlines during the period from 2017 to 2019 (approximately USD 1.8 billion).

Large bullet repayments of over USD 1.0 billion are new to Sri Lanka. Such payments could expose the country to refinancing risk and the investors could become wary of the country's external liquidity leading to higher spreads. Similarly, partial roll overs due to challenging environments (created by large repayments) could lead to loss of reserves and exchange rate pressures. These factors could adversely influence macroeconomic stability.

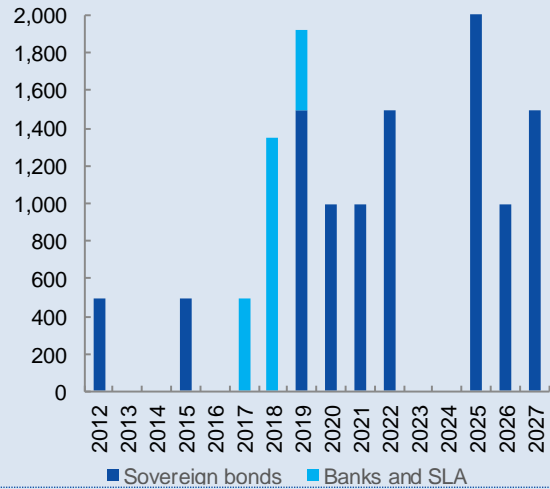
One important way to manage debt portfolio is Active Liability Management (ALM). ALM refers to taking actions beyond the regular calendar of debt issuance and servicing in a particular fiscal year; and is aimed at executing the goals of the debt management strategy through instruments such as occasional buy-backs of both external and domestic debt before its maturity, switching (buy-backs and re-issuance) of bonds, and building cash buffers for future redemptions. The government, for example, could decide to buy back one of the 2019 sovereign bonds (there are two bonds maturing in 2019: USD 500 and USD 1,000) now and issue a bond, maturing in 2024 – a year in which there is no sovereign bond maturing. The benefits of ALM include (a) mitigating the bunching risk by improving the maturity profile; (b) lowering costs; and (c) reducing refinancing risks. It could simultaneously help improve the sovereign credit rating. However, ALM could create some fiscal costs related to buy-backs and higher interest rates due to extension of maturities.

Similar to external debt, domestic debt in Treasury bonds and bills can be managed actively to improve the debt profile and market liquidity. Building cash buffers, buy-backs and switches could help debt management by lowering the cost and risks of the debt portfolio and by focusing on a limited number of benchmark maturities, which would (a) provide liquidity for primary and secondary market trading; (b) establish a stable and credible yield curve; and (c) help with the development of private debt markets. Moreover, buy-backs could be used to capitalize on market interest rate movements.

Timing is important in ALM. Financial market considerations suggest that such a buy back should be expedited as (a) Sri Lanka's bonds spreads have come down in the past few months due mainly to the confidence in the IMF program; (b) Tighter than anticipated global financial markets could increase the interest rate for new bonds issued; and (c) active debt management would signal the investors that Sri Lanka is addressing refinancing risks prior to large redemptions that could potentially have implications on macroeconomic stability.

In order to facilitate ALM, the present legal framework on budgetary operations need changes. The annual Appropriation Act currently only gives the space to service the debt maturing in the budget, and does not allow explicitly for the building up of cash buffers and early retirement of debt maturing beyond the budget year. Simple changes to the provisions of the Act would provide sufficient flexibility for liability management for debt maturing in future years, while still providing an anchor for fiscal consolidation.

Figure 23: Eurobond and SOE bond maturities
(USD million)



Source: Central bank of Sri Lanka, respective annual reports of SOEs

4. Natural disasters and climate change

Sri Lanka is vulnerable to recurring natural disasters.

On average over the long term, annual losses for housing, infrastructure, agriculture, and relief from natural disasters are estimated at LKR 50 billion (or around USD 327 million), with the highest annual expected losses from floods (LKR 32 billion), cyclones or high winds (LKR 11 billion), droughts (LKR 5.2 billion) and landslides (LKR 1.8 billion). This is equivalent to 0.4 percent of GDP or 2.1 percent of government expenditure.⁴⁰

The execution of the budget is continuously knocked off track due to the impact of natural disasters, which seem to have increased in frequency, severity and economic impact. Evidence of disasters can be seen everywhere in the macroeconomic data: the contraction in the agriculture sector in GDP data, the increase in food price inflation, the decline in revenue due to temporary removal of duties on essential goods, reallocated fiscal expenditure, increased imports of essential goods, increased imports of oil (due to the 2016/17 drought's impact on hydro power) and reduced exports due to damage and losses in the productive sectors.

Due to the increased sophistication of the Sri Lankan economy, the damage caused by the 2016 and 2017 floods and landslides was more than twice as high in US dollar terms than the worst flood disasters between 1992 and 2011.

Better disaster risk management will create significant benefits at all levels of society.

Better disaster preparedness and faster response to disaster will have benefits for all levels of society. There would be less physical damage from disasters and economic losses through opportunity costs (such as lost harvests, interruption of production, alternative uses of public assets such as using schools for shelter). Households will be safer from disasters and the resulting harm and loss of life, loss of jobs, houses and food insecurity. Firms will face fewer interruptions in production. Public infrastructure will be easier to maintain at a higher quality. The public sector would benefit as it will be less subject to revenue and expenditure shocks and fiscal risks, and the macroeconomy will be more stable.

To manage the risk of disasters Sri Lanka needs to improve its physical and financial resilience to natural disasters

It is important for Sri Lanka to increase its physical resilience (to reduce impact of disasters) and financial resilience (to deal with the impact when the disaster happens).

To improve physical resilience, the World Bank is supporting the government's Climate Resilience Improvement Project (CRIP)⁴¹ and recommends that the government

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

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

⁴⁰ "Fiscal Disaster Risk Assessment and Risk Financing Options: Sri Lanka", World Bank, January 2016. <https://openknowledge.worldbank.org/handle/10986/24689>

⁴¹ <http://crip.lk/>

Short term

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

Medium to long term

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

There exists a huge, untapped potential for corporate sector interventions into disaster risk reduction to enhance national resilience in Sri Lanka. However, there is no Corporate Social Responsibility (CSR) policy in Sri Lanka or appropriate policy guidelines on required interventions in disaster risk reduction under a CSR, which would give direction to the corporate sector in Sri Lanka. Such a CSR policy has the potential to make a significant contribution to enhancing national resilience.

D. World Bank Group Assistance



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

The World Bank Group has been supporting Sri Lanka's development for close to six decades. Sri Lanka is in many ways a development success story, and yet faces a number of critical challenges as it pursues its goal of becoming an upper middle-income country. The Systematic Country Diagnostic (SCD)⁴² carried out in 2015 identifies critical constraints and opportunities that Sri Lanka faces in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. They include: (i) achieving fiscal sustainability; (ii) enhancing competitiveness and promoting more and better jobs for the bottom 40 percent; (iii) providing for social inclusion for disadvantaged segments of the population; and (iv) attaining longer term sustainability, especially of the environment, political stability, and an aging population). In addition, strengthening governance is a cross-cutting challenge. The SCD anchors the World Bank Group Country Partnership Framework (CPF) for FY2017–20.⁴³

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

Under the CPF, the World Bank Group will contribute to Sri Lanka's transition to a more competitive, inclusive, and resilient upper-middle income country. Main areas of support include macro-fiscal stability and competitiveness; promoting inclusion and opportunities for all; and seizing green growth opportunities, improving environmental management, and enhancing adaptation and mitigation potential. Sri Lanka has graduated from IDA and is receiving IDA transition financing during IDA 18 (FY2018–20). IFC gives priority to sustainable infrastructure (through PPP's), financial inclusion, and access to input/output markets, products, services and jobs. MIGA is ready to provide guarantees where possible to support foreign investment projects across sectors.

⁴² The SCD report and video are available online at:

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

⁴³ The CPF is available at: CPF: <https://openknowledge.worldbank.org/handle/10986/24682>

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

Current active World Bank portfolio comprises 16 projects with a total net commitment value of USD 1.98 billion (14 IDA, 1 IBRD, and 1 IBRD-IDA blend). The World Bank has provided a mix of financing – investment project, development policy, and program-for-results – to meet the development needs of Sri Lanka. The first development policy financing was approved in July 2016 and focuses on policy reforms to strengthen the country's trade and competitiveness. It is co-financed by JICA, and complements IMF's Extended Fund Facility. The first program-for-results financing was approved in May 2017 to support the government's program to improve higher education. Urban and rural development sectors account for the largest share of the portfolio both in terms of number of projects (28 percent) and total commitment (38 percent). The second largest sector of engagement is education (22 percent of total number of projects, and 16 percent of total net commitment), followed by water (11 percent of total number of projects, 15 percent of total net commitment). In addition to lending, the World Bank is carrying out analytical work and technical assistance across various sectors, funded both through trust funds and own budget. The World Bank has extended its support in close coordination and collaboration with development partners, including through co-financing of projects and leveraging private sector resources where opportunities arise.

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

IFC's activities in Sri Lanka are supporting the World Bank Group's CPF goals. By working closely with the private sector, the government, and the World Bank, IFC focuses on facilitating inclusive growth by crowding in private sector finance. IFC in Sri Lanka addresses key development gaps by focusing on financial and social inclusion, infrastructure, productivity, and sustainability. To foster inclusion, IFC is working on increasing access to finance, especially to SMEs and women, and seeking opportunities to help expand quality healthcare, affordable housing, and training and education for skills development. IFC launched a "Women in Work" program to demonstrate that corporate performance can improve by closing gaps between men and women in the private sector. IFC's support for sustainable infrastructure aims to improve electricity service, complete critical last mile infrastructure, and revamp logistics and services infrastructure. In sustainability, IFC will promote renewable solutions, narrow the green/affordable housing gap and support climate change adaptation and resource efficiency applications. IFC is also targeting sectors with significant job creation impacts especially agribusiness, tourism, and pharmaceuticals.

IFC is taking steps to increase the committed investment portfolio.

As of June 30, 2017, IFC's total committed investment portfolio stood at about USD 334 million. In addition, IFC has an advisory program comprising 12 portfolio projects with a combined portfolio value of USD 12.5 million. IFC's advisory projects are helping boost access to finance and insurance, build business skills for entrepreneurs, improve economic empowerment of women, develop supply chains, and promote the growth of tourism.

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

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

Key Economic Indicators

Macroeconomic Indicators	Actual		Projections	
	2015	2016	2017	2018
Real sector				
GDP, (current, LKR billion)	10,952	11,839	12,999	14,353
GDP per capita, (current, US\$)	3,843	3,835	3,934	4,097
Real GDP growth (%)	4.8	4.4	4.6	5.0
CCPI inflation (%)	0.9	4.0	5.2	5.2
Percent of GDP, unless otherwise indicated				
External sector				
Trade balance	-10.4	-11.2	-11.1	-11.0
Exports of goods	13.1	12.7	12.9	13.1
Imports of goods	23.5	23.9	24.0	24.1
Tourism receipts	3.7	4.3	4.6	4.8
Remittances	8.7	8.9	8.6	8.5
External Current Account	-2.3	-2.4	-2.4	-2.5
FDI inflows	0.8	0.8	1.7	1.7
Official reserves (USD billion)	7.3	6.0	7.8	8.6
Official reserves (months of imports of goods and services)	3.8	3.1	3.8	4.0
Exchange rate (end period, LKR/USD)	144.1	149.8
Fiscal accounts				
Total revenue and grants	13.3	14.3	14.6	15.2
Tax revenue	12.4	12.4	13.1	13.6
Total expenditure	20.9	19.7	19.7	19.6
Current expenditure	15.5	14.8	15.0	14.6
Capital and net lending	5.4	4.9	4.7	5.0
Primary Balance	-2.8	-0.2	0.5	1.1
Overall fiscal balance ¹	-7.6	-5.4	-5.1	-4.4
Public debt ²	77.6	79.3	79.2	77.4
Treasury guarantees (granted)	5.6	7.1
Monetary/financial sector				
Standing deposit facility rate (% per annum)	6.0	7.0
Standing lending facility rate (% per annum)	7.5	8.5
Private sector credit growth (M2b ³ , %)	25.1	21.9	16.9	15.9

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

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

² Public debt number excludes: debt contracted by SOEs and state agencies with or without a Treasury guarantee, and Treasury bonds amounting to LKR 78,447 million issued to settle dues to CPC in January 2012 and LKR 13,125 million issued to capitalize Sri Lankan Airlines in March 2013 (as reported by the CBSL), and the overdraft facility at two state banks of LKR 159 billion at end-2016, down from LKR 193 billion at end-2015 (Minister of Finance annual report 2016).

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

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