Creating opportunities and managing risks for sustained growth
Main takeaways

1. Macroeconomic performance continues to be broadly satisfactory, despite significant challenges incl. natural disasters.

2. New Inland Revenue Act, increased VAT collection, relatively high inflation and improved external reserves are key developments since the last update.

3. To increase and sustain growth, create jobs, and reduce poverty in the medium-term, Sri Lanka needs to move towards a more private-investment and tradable sector driven model.

4. Continued fiscal consolidation, improved competitiveness, enhanced accountability and governance are necessary ingredients.

5. Vision 2025 provides a strong platform for the new growth model.

6. To create new opportunities it is important to manage risks.
Global environment continues to be benign

- Global growth prospects have improved
- Commodity prices are still low though gradually increasing
- Global financial conditions are still benign
- GSP+ improves access to EU market

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Takeaway: best time to reform is now

World Bank Global Economic Prospects, June 2017; South Asia Focus, October 2017; Global Economic Prospects Preliminary estimates
Growth has decelerated and is still largely driven by non-tradable sectors

- Annual average growth decelerated from 7.3% (2009-12) to 4.4% (2013-16)
- Inward orientation is reflected in 70% of the total growth coming from 6 non-tradable sectors

Takeaway: need to change to more private investment-tradable sector growth model to sustain growth, jobs and poverty reduction
Zooming in on the last 6 months, natural disasters continue to be a drag on macroeconomy

- Construction (production side) and investment (expenditure side) drove growth, while agriculture-related output fell due to floods and droughts.
- Inflation rose due to demand pressures, supply disruptions and one-off impact of VAT changes.

**Takeaway:** growth performance could have been better without the impact of natural disasters
Natural disasters had widespread impact; poor were disproportionately affected

Good news: poverty rate fell in 2016 from 2012/13 and rise in inequality stopped

Floods and landslides in late May 2017
• Affected 15 of the 25 districts of Sri Lanka: significant loss of life (213) and property (LKR 70 billion)
• Total recovery needs are estimated at 1% of GDP

Drought in 2016 and 2017
• Affected 1,927,069 people across 17 districts
• Contraction of agriculture sector, food inflation: rice production for 2017 expected to be the lowest in the last 10 years (sufficient only for 7 months)
• Need for more food and petroleum imports

Takeaway: Disaster risk management should be an integral part of the growth model
Fiscal performance improved; however, significant risks remain

- **New Inland Revenue Act** is the key highlight that could lead to structural increase in revenues
- **Primary fiscal surplus** in 4 months of 2017 thanks to increased VAT revenue
- However, **overall fiscal deficit** probably higher than projected, as interest expenditure often underestimated
- **Public debt** is high at 79% of GDP, but likely to stabilize; **contingent liabilities** are a significant fiscal risk

Takeaway: fiscal & debt numbers moving in right direction, but important to manage quality of tax & spending, and composition/risks of debt & contingent liabilities
Why is fiscal consolidation important to manage debt-to-GDP?

Before 2012

- Primary fiscal deficits
- Exchange rate depreciation
- Growth
- Negative real interest rates

Decreasing debt-to-GDP

Increasing debt-to-GDP
Why is fiscal consolidation important to manage debt-to-GDP? Before 2012

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2013-16

Primary fiscal deficits

Exchange rate depreciation

Growth

Positive real interest rates

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2013-16

Primary fiscal deficits

Exchange rate depreciation

Decreasing debt-to-GDP

Growth
2017-20

Primary fiscal surpluses

Exchange rate depreciation

Growth

Positive real interest rates

Decreasing debt-to-GDP

Increasing debt-to-GDP
2017-20

- Primary fiscal surpluses
- Exchange rate depreciation
- Growth
- Positive real interest rates
- Decreasing debt-to-GDP
- Increasing debt-to-GDP
Takeaway: With a more market-determined exchange rate and increasingly commercial terms on borrowing, sustained growth and fiscal consolidation is necessary to manage public debt-to-GDP ratio.
External sector reported mixed messages

- **External trade balance** weakened due to increased petroleum and food imports while remittances shrunk (Middle East) and tourism slowed down (airport closure and dengue).
- **FDI** more than doubled in the first half of 2017 due to inflows (Port City)
- **Official reserves** increased with forex purchases and external borrowings.
- **External debt** related risks remain high.

**Takeaway:** to strengthen external account, important to strengthen exports and FDI by implementing investment climate, trade and FDI reform agendas, use GSP+ as window of opportunity
Monetary policy remained tight and financial sector remained stable

- Banking sector’s capital adequacy, liquidity ratios, non-performing loans are stable, but credit growth in certain sectors needs to be monitored
- High monetary growth showed signs of deceleration in response to tight policy

Takeaway: monetary policy improved, but continued close monitoring of credit quality required
Sri Lanka’s macro outlook continues to be steady

Outlook remains steady, thanks to a strengthened global outlook, revenue-led fiscal consolidation program and pro-active monetary policy – reform implementation is necessary.

| **Growth** | • Expected to reach 4.6 percent in 2017 and grow marginally over 5.0 percent beyond, driven by private consumption and investment. |
| **Inflation** | • Will increase for the full year 2017 due to one-off impact of VAT and stabilize, low but gradually increasing international commodity prices and base-effect will maintain downward pressure |
| **Fiscal deficit** | • Will narrow to 5.1% of GDP for 2017, although the budgeted fiscal target of 4.6% is likely to be missed  |
| | • Revenue-led fiscal consolidation will continue with improving primary fiscal balances |
| **Public debt** | • Projected to stabilize at 79% of GDP and gradually fall, supported by primary fiscal surplus and growth |
| **External sector** | • Will benefit from tourism, and GSP+ in the second half of 2017 and 2018; however, imports of food and petroleum will mask the improvement |
| | • FDI and debt flows to close the financing gap |
| **Reserves** | • Expected to improve with forex purchases, a more market-determined exchange rate, monetary policy and divestment/lease out of some government assets |
Substantial downside risks could weigh on outlook

**Internal risks:**
- Delay in implementing revenue and debt management reforms
- Natural disasters
- Delays in structural reforms in a complex political environment

**External risks:**
- Disappointing growth performance in key countries
- Tightening global financial conditions
- Faster than expected rises in commodity prices
Policy priorities

Stay on fiscal consolidation
- Implementation of new IR Act
- Improve tax administration
- VAT reforms
- Align spending to priorities

More private investment and export led model
- Trade policy & facilitation
- FDI attraction
- Innovation & business environment
- Institutional capacity and coordination
- Communication, trade adjustment package

Governance & Accountability
- Implementation of Right to Information
- PFM reforms
- SOE reforms
- Audit function

Manage risks (Special focus section)

Macro economy stability
- Debt sustainability
- Fiscal space for health, education, social protection, disaster management and other public investment
- Prepare for ageing

A competitive economy
- Sustained growth towards UMIC status
- More and better jobs
- Poverty reduction

Public sector effectiveness
- Improved service delivery
- Improved citizens engagement and public trust

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Vision 2025 envisions a new growth model: a knowledge-based, highly competitive, social market economy focused on inclusion.

Targets for 2020
- Become a rich country by 2025

By 2020
- Per capita income of USD 5,000
- One million new jobs
- FDI USD 5 billion p.a.
- Exports USD 20 billion p.a.

Key challenges
- Less competitive, Inward-oriented, non-tradable driven growth model
- Weak public finances
- Strong anti-export bias
- Weaknesses in SOEs
- Low female labor force participation

Areas of focus
- Growth framework
- Macroeconomic framework
- Factor market reforms
- Governance and accountability
- Social safety nets
- Sustainable development
- Technology
Special focus on creating opportunities and managing risks for sustained growth
Special focus on creating opportunities and managing risks for sustained growth

- New growth model will create many opportunities to make Sri Lanka more resilient to risks, but it will also expose them to new ones.
- Risks need to be managed well to maximize opportunities.
- Risks impact different levels of society: households, firms, public sector and the macroeconomy.
- An integrated approach to risk management is recommended (WDR, 2014) to deal with risks.
- Potential key sources of risks include:
  - Fiscal policy reforms (VAT and energy price reforms)
  - Trade policy reforms
  - Public debt and contingent liabilities
  - Natural disasters
## 1. Managing risks in fiscal reforms

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<th>Reform</th>
<th><em>VAT and energy price reforms</em> to increase revenue and reduce fiscal risks</th>
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| Opportunity | • *Simpler and more predictable tax system* for firms  
• Increased fiscal space for *education, health, other public investment; social protection*  
• *Macro stability* with low inflation good for households, firms and the economy as a whole |
| How | • *Remove VAT exemptions* (Often top-60% consumes 90%)  
• Introduce *cost-reflective fuel and energy pricing* (Top-30% consumes 70% of fuel) |
| Risk | • Increased cost of living leading to vulnerable households falling into *poverty*  
• Implications on firm competitiveness |
| Manage risks | • Couple the reform with *targeted fiscal expenditure* (cash transfers, focused public investment, education and health); on VAT 25% needs to be transferred to compensate  
• The better the targeting, the larger the net fiscal gain |
2. Managing risks in trade reforms

Reform
- Further liberalization of trade: Low and **declining export-to-GDP** and concentration on a few export products/markets could lead to slower growth and a less competitive economy creating fewer jobs.

Opportunity
- More and **better jobs** in some sectors, more **productive firms** and **new markets**
- More **export oriented FDI**
- Increased **tax revenue** due to increased activity, in the medium-term
- **Strengthened external position** in the medium to long-term

How
- **Phase out tariffs, rationalize duties**
- Bilateral agreements
- Trade facilitation
- FDI attraction and retention

Risk
- Impact not uniform
- Shifts in **relative prices of inputs and outputs** faced by households and firms
- **Revenue loss** from reduced tariffs, offset by increasing revenue of remaining duties
- Weakened BoP in the short-run

Manage risks
- Strengthen **social safety nets**
- Improve **business environment**
- Implement **trade adjustment programs**
### 3. Managing risks from public debt and contingent liabilities

| Challenge                                                                 |
|                                                                          |
| • **High public debt, deterioration of debt profile** and increased cost and risk of debt, fiscal risks from **guaranteed and non-guaranteed SOE debt** (12% of GDP estimated) |
| • **Bunching** of Eurobond repayments from 2019                        |
| • Structural challenges in **debt management**                          |

| Opportunity                                                               |
|                                                                          |
| • **Reduced cost or risk** of debt portfolio                              |
| • **Fiscal and macroeconomic stability**                                  |
| • Lower interest costs and improved **access to finance** for SMEs and households |
| • **Domestic market development**                                          |
| • **Reduced fiscal risks** from SOEs                                      |

| How                                                                      |
|                                                                          |
| • **Update legal framework** and expedite **unified debt management office** |
| • **Medium Term Debt Management Strategy** to guide borrowing decisions and help develop more liquid domestic debt market |
| • **Active Liability Management** to reduce refinancing risks             |
| • Formulate a **guarantee policy** to manage contingent liabilities       |
| • **SOE reforms** to improve performance and reduce fiscal risks          |
4. Managing risks from natural disasters and impacts of climate change

<table>
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<tr>
<th>Challenge</th>
<th>Opportunity</th>
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| • Increased frequency, severity and economic impact of natural disasters  
  • Disproportionate impact on poor households  
  • Slow response and lack of readily available data | • Households less at risk from harm, loss of life, houses and jobs, food insecurity  
  • Fewer business interruptions  
  • Fewer fiscal shocks  
  • More stable macroeconomy |

**How**

Better preparedness

Physical resilience:
- Identify current and future climate and disaster risks
- Disaster and climate-resilient investment
- Improve disaster preparedness and physical response

Financial resilience:
- National disaster risk financing strategy
- Fast-disbursement mechanism of post-disaster operations
- National recovery plan for floods and landslides
- Catastrophic risk insurance for public assets
Summarizing

• There can be new opportunities for Sri Lanka, if risks are managed well

• Risk management needs to happen at all levels:
  • Small shocks: households, firms and budget can cope
  • If shock exceeds ability of households and firms to cope: special role for government
  • Sometimes even public sector and macroeconomy cannot cope: role for international community and financial markets

• Strengthen capacity to analyze risks and design and implement mitigation mechanisms; special role for budget

• Need to communicate better about the risks and opportunities as well as pragmatic mitigation measures

Takeaway:
• Anticipate
• Mitigate
• Communicate
Full report at: www.worldbank.org/sldu

Previous editions:
• June 2017: Unleashing Sri Lanka’s trade potential
• October 2016: Structural challenges identified in the Systematic Country Diagnostic

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