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Sri Lanka's Growth Model: Progress and Vulnerabilities

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Introduction

Sri Lanka can be regarded as a development success, despite a recent history marked by nearly thirty years of conflict. There has indeed been a significant reduction in poverty and the country ranks 4th out of the 29 developing and emerging Asian countries in the Human Develop-ment Index (HDI). It has benefited from a robust and stable long-term growth rate (about 5.8% a year since 1990), which has gathered momentum with the return of peace. It was classified as a lower middle-income country (LMIC) back in 2010, thanks to the significant increase in per capita wealth to a higher level than in other South Asian countries. If it is to continue to pursue a dynamic development model in the longer term, Sri Lanka's economy will need to seize the opportunity to diversify towards more productive sectors with greater added value.

However, the country's macroeconomic fundamentals do show signs of weakness, which may jeopardize this progress in the medium term. Firstly, budget implementation is highly constrained by the low level of government revenues. This generates a structural budget deficit, which fuels the high level of public debt. Secondly, 2015 was a particularly difficult year for external balances due to the substantial outflows of capital which complicated the financing of the economy. Indeed, Sri Lanka has been badly affected by international instability and the redirection of capital from emerging countries to the USA, which has led to a depreciation in the national currency (Sri Lankan rupee – LKR) and a sharp decline in foreign exchange reserves.

Reducing these macroeconomic vulnerabilities – so that they do not hinder the sustainability of Sri Lanka's growth and development – is a major challenge for the Sri Lankan authorities. The country must deal simultaneously with several social issues related to the ageing of its population and challenges concerning its labour market, and the migration of a number of young graduates. It is essential to address these issues in order to consolidate the social cohesion of a country that is continuing its post-conflict reconstruction.

This study provides a cross-analysis of the social and macroeconomic challenges facing Sri Lanka and is based on five sections. The first section addresses the sociopolitical context. In the second section, the growth model of Sri Lanka's economy is analysed. The third section subsequently focuses on the issues of public finances. The fourth section is devoted to trends in the country's external balance and highlights recent tensions. Finally, the analysis is completed in the fifth and final section with a presentation of Sri Lanka's financial system.

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1/ A country in political transition showing signs of significant progress in poverty reduction

1.1. A country with an ongoing national reconciliation process

After gaining independence in 1948, Sri Lanka became a Commonwealth realm under the name of Ceylon. The British king was represented in the country by a Governor General until 1971. The following year, Ceylon took on the name of Sri Lanka and became an independent republic. In the new constitution approved in 1978, Sri Lanka adopted a presidential system. Since the early 1950s, the political landscape has been dominated by two political parties. Firstly, the Sri Lanka Freedom Party (SLFP) is the socialist party of the former president, Mahinda Rajapaksa, who was in power from 2005 to 2015, and the current President, Maithripala Sirisena. Secondly, the United National Party (UNP) is a centre-right party which was the main opposition party, but is currently taking part in the constitution of the Government of National Unity, with notably the position of Prime Minister. These two parties represent two opposing political movements of the Sinhalese majority ethnic group and have for many years been faced with the violent demands of the Tamil separatist group, Liberation Tigers of Tamil Eelam (LTTE).

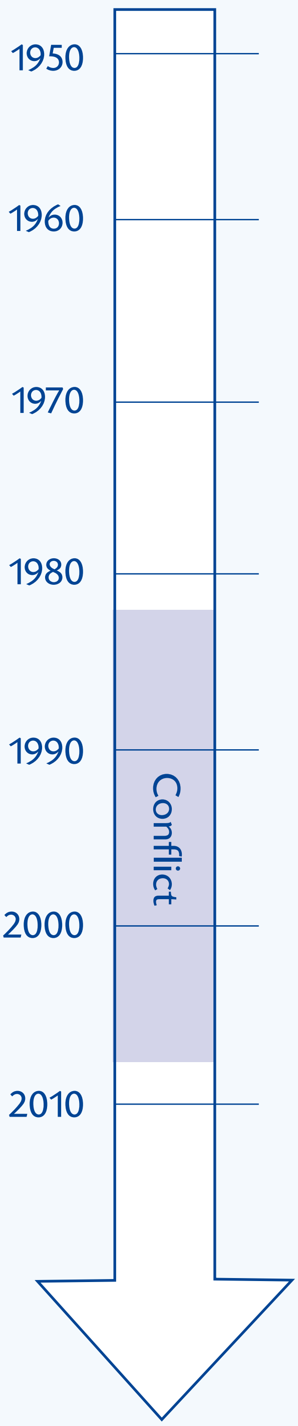
This country has a population of 20 million and is characterized by a great ethnic and religious diversity: 75% of the population is Sinhalese, against 15.4% Tamil (i.e. Indian and Sri Lankan), and the rest of the population includes several ethnic minorities: 9.2% are Moors, 0.2% Burghers and 0.2% Malays.[1] These ethnic disparities can be seen in the religious practice of Sri Lankans, as 70% of the population is Buddhist, 15% Hindu, 8% Christian and, finally, 7% Muslim. This fragmentation fuelled the internal conflicts which raged for 26 years starting in 1983 (see Box 1 below), during which the LTTE Tamil separatists demanded the creation of a separate State composed of the island's North and East provinces.

Mr. Mahinda Rajapakse, who was the country's leader in 2005, was re-elected for a second presidential mandate in 2010 at the end of the civil war. While his mandate was supposed to end in 2016, Mr. Rajapakse organized early presidential elections in January 2015. They resulted in the victory of the former Minister of Health, Mr. Maithripala Sirisena, who was an opponent of the outgoing President. Although he was the leader of the SLFP party, he stood as the common opposition candidate, leading his campaign on the theme of democratization and promising the position of Prime Minister to a representative of the UNP party if he was elected. Following the parliamentary elections and with no simple majority, UNP and SLFP formed a Government of National Unity, with Mr. Ranil Wickremesinghe (UNP) as Prime Minister. The members of the Government reached a *modus vivendi* over ministers staying in office for a minimum of two years in order to limit political instability.

A large number of reforms were implemented. Firstly, the 19th Amendment to the Constitution was passed in April 2015. Its aim was to reduce the President's executive power. This Amendment reinstated the Constitutional Council, once again limited the number of presidential terms to two, did away with the President's power to dissolve Parliament and, finally, extended the powers of the Prime Minister and Government. Certain restrictions on the freedom of the press were lifted and anti-corruption measures adopted. Furthermore, a constitutional reform process was engaged. In March 2016, public consultation was launched and a Constitutional Assembly set up in order to prepare a draft Constitution, which will be submitted to the people in a referendum in 2017. This constitutional reform comprises subjects which give rise to debate, such as the issue of the degree of decentralization that needs to be introduced in the country.

[1] Department of Census and Statistics, last census in 2012.

Box 1 *Chronology*



1948	Independence of Ceylon
1956	Adoption of an import-substitution industrialization policy
1958	Violent anti-Tamil demonstrations
1959	Assassination of Prime Minister Solomon Bandaranaike (SLFP)
1960	Sirimavo Bandaranaike (SLFP), his widow, becomes Prime Minister
1965	The opposition (UNP) wins the elections and Dudley Senanayake is appointed Prime Minister Start of a process to phase in a liberalization of the economy
1970	Sirimavo Bandaranaike (SLFP) returns to power
1972	Ceylon is renamed Sri Lanka, and the first Republican Constitution is promulgated
1976	Creation of the Liberation Tigers of Tamil Eelam (LTTE) movement
1977	Import-substitution industrialization policy abandoned
1978	Adoption of the Second Constitution of the Democratic Socialist Republic of Sri Lanka
1983	Start of the civil conflict
1987	Deployment of an Indian Peacekeeping Force in the North and East of Sri Lanka
1990	Withdrawal of Indian troops, escalation of violence
1991	Assassination of the Indian Prime Minister Rajiv Gandhi in the State of Tamil Nadu, India (suicide attack by a Tamil militant)
1993	Assassination of President Ranasinghe Premadasa (UNP), Tamil Tigers claim responsibility
1994	Chandrika Kumaratunga (SLFP) becomes President of the Republic
1998	Trade agreement signed between India and Sri Lanka
2005	Mahinda Rajapakse (SLFP) wins presidential elections
2006	Peace talks fail in Geneva
2009	End of civil war following the surrender of LTTE and the death of its longtime leader, Velupillai Prabhakaran
2010	Mahinda Rajapakse (SLFP) re-elected President of the Republic
2012	UN resolution urging Sri Lanka to prosecute war crimes committed during the conflict
2015	Early presidential elections resulting in the victory of Maithripala Sirisena

Source: Compiled by authors.

Seven years after the end of the conflict, the national reconciliation process is still in progress. In September 2015, the Office of the United Nations High Commissioner for Human Rights (OHCHR) released the findings of its investigation into the conflict between the Sri Lankan authorities and Tamil freedom fighters. The investigation revealed that violations of international humanitarian law and international human rights law had been committed by all parties to the conflict between 2002 and 2011. Several thousand people were reportedly killed during the conflict. In October 2015, the Government of President Sirisena took part in the adoption, at the UN, of an international resolution recognizing the existence of war crimes in Sri Lanka and paving the way for reparations for all victims and for national reconciliation. This resolution provides for the establishment of four judicial mechanisms: (i) a Commission for Truth, Justice, Reconciliation and Non-Recurrence; (ii) an Office of Missing Persons; (iii) an Office for Reparations; (iii) an independent special war crimes court, with international participation. Several decisions aiming to appease tensions between the Sinhalese Buddhist majority and the Tamil linguistic and religious minorities were made to this end in 2015. Announcements were made demonstrating the determination to ensure security, rebuild infrastructure in the northern part of the country, and conduct inclusive policies. Land which had been allocated for military bases in northern and eastern Sri Lanka was returned to civilians. Civil governors were appointed to replace army generals in the Northern and Eastern Provinces. Finally, certain prisoners, who had been detained under anti-terrorism provisions, were released.

1.2. A substantial reduction in poverty, but social challenges remain

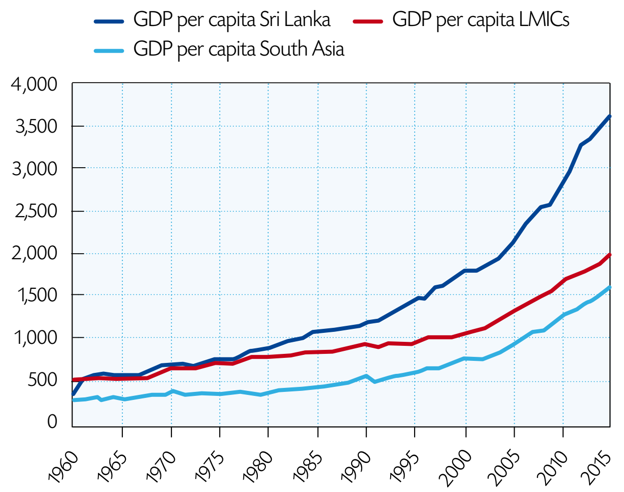
Sri Lanka stands out as a human development success, despite a history marked by war. Since the 1960s, the country has benefited from moderate but very stable growth levels, averaging +4%. This is despite the internal conflicts which, between 1983 and 1996, are estimated to have cost the equivalent of twice Sri Lanka's 1996 Gross Domestic Product (GDP) (Arunatilake *et al.*, 2001).[2] Overall, GDP per capita was multiplied tenfold between 1960 and 2015, against an average factor of 5.1 South Asian countries and 3.7 for LMICs (see Graph 1.1.).

There has been a sharp decline in the poverty rate, from 40% in 1990 to 14% in 2012, *i.e.* a much lower level than the average for LMICs and other countries in the subregion (see Table 1.1. below). According to a World Bank study (2016), 60% of the decline in poverty is due to the increase in labour income, mainly in the agriculture sector, 27% to non-labour income and, finally, 13% to the reduction in household sizes. The sharp increase in labour income between 2002 and 2012 is related to the following three main factors: (i) the gradual structural transformation, with an increase in industrialization – a sector where productivity and salaries are higher; (ii) growing urbanization, which has increased the spatial connectivity of people closer to employment centres; (iii) the increase in food and tea prices between 2006 and 2009 which, by increasing farmers' incomes, led to a rise in the minimum salary in the sector.

At the same time, significant progress has been made in education and health. Between 1990 and 2014, life expectancy at birth increased from 70 years to 74.8 years, and the secondary school enrolment rate for children has risen from 72% to virtually 100% today (see Table 1.1. below). These improvements have led to a high level of human development in Sri Lanka, which ranks it 73rd out of 188 countries worldwide, according to the United Nations HDI.

Graph 1.1.

Trend in GDP per capita (constant 2005 USD)

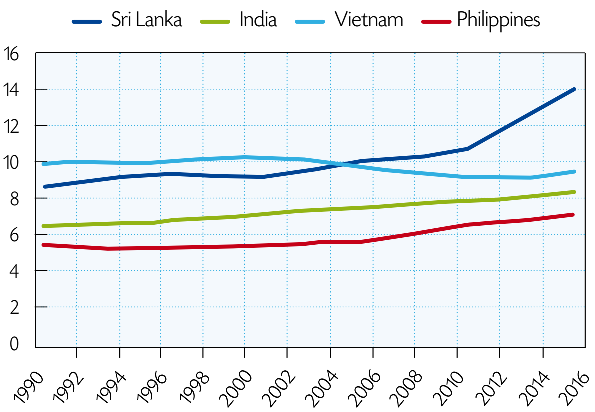


Source: World Bank.

[2] To our knowledge, there is not a more recent and more exhaustive estimate of the cost generated by 26 years of civil war. However, according to Athukorala and Jayasuriya (2012), the post-1996 cost, corresponding to the period when the armed conflict escalated, could be higher than the cost covering the period 1983-1996.

Graph 1.2.

Dependency ratio (population aged over 64 as a % of the working age population)



Source: World Bank.

However, despite this marked progress, there are still a number of challenges.

First challenge: income inequalities have risen over the recent period, and there are regional inequalities in the country, particularly to the detriment of the Northern regions, but also in the East.

Inequalities, as measured by the Gini coefficient, fell between 2002 and 2009, but have been rising again since the end of the conflict. These inequalities also relate to unequal access to health and education services. Some districts have benefitted from growth more than others. Consequently, although the poverty rate (national threshold) has fallen nationwide, it remains high in the less privileged provinces: in 2012, it stood at 28.8% in Mullaitivia in the North of the country and 19.4% in Batticaloa in the East, against a national average of 6.7%. Disparities between Tamils and Sinhalese, albeit moderate, remain and can be put down to differences in geographical location, age and level of education.[3]

Table 1.1. *Socioeconomic indicators of Sri Lanka – trend and international comparison*

	Sri Lanka					LMIC average	India	Indonesia	Philippines	Vietnam
Poverty and inequalities	1990	1995	2002	2009	2012	2012	Most recent year available			
Poverty rate (USD 2 PPP/day, as a % of population)	40.4	38.9	34.1	16.8	14.0	48.4	59.2	41.7	37.6	13.9
Poverty rate (national threshold, as a % of population)	26.1	28.8	22.7	8.9	6.7	N/A	21.9	11.3	25.2	13.5
Gini Index of income inequalities	32.4	35.4	40.7	36.2	38.6	N/A	33.6	38.1	43.0	38.7
Human development	1990	1995	2002	2011	2014	2014	2014			
Life expectancy at birth (years)	70.0	69.0	72.6	74.4	74.8	67.2	68.0	68.9	68.3	75.6
Secondary school enrolment rate (%)	71.9	76.5	85.4	99.1	99.7	66.6	68.9	82.5	88.4	N/A
HDI classification (rank)	76.0	97.0	96.0	97.0	73.0	N/A	130.0	110.0	115.0	116.0
Employment			2000		2015	2014	2014			
Participation rate (as a % of 15-64 year-olds)			60.6		53.8	64.4	56.5	69.9	67.1	82.5
Unemployment rate (%)			7.7		4.7	8.6	4.9	6.2	6.8	1.8
Youth unemployment rate (15-24 year-olds) (%)			23.6		19.7	16.9	10.7	21.8	15.7	6.0
Unemployment rate of higher education graduates			N/A		9.2	N/A	N/A	N/A	N/A	N/A

Sources: World Bank (WDI – World Development Indicators), UNDP – United Nations Development Programme (Human Development Report), AFD calculations.
PPP: Purchasing Power Parity; N/A: Data not available.

[3] See Newhouse *et al.* (2016).

Second challenge: social protection shows significant shortcomings, while the demographic transition should bring about an increase in social spending.

There are a large number of social protection programmes managed by various institutions, which hampers their effectiveness. According to IPS (Institute of Policy Studies of Sri Lanka), one of the main social assistance programmes (Samurdhi) has a poor performance in terms of targeting, as only 40% of households from the poorest decile benefit from it. The weakness of these programmes means that they contribute very little to poverty reduction. Indeed, in Sri Lanka, the contribution made by social protection programmes to the budgets of the lowest income households only stands at 6.6%,[4] while it stands at 20% in both Vietnam and the Philippines, for example. Furthermore, in recent years, there has clearly been a gradual disengagement of the State in terms of social protection expenditure, which is lower than in other countries in the region (approximately 3.1% of GDP in 2010/2011, according to the latest figures from ILO – International Labour Organization –, against 5.4% for the Asia Pacific region). In addition, migrant remittances also do not improve the financial situation of these households, as they are mainly received by the most affluent households (only 9% of the volume of transfers is received by the poorest quintile).

However, at the same time, the ongoing demographic changes will require an increase in social expenditure. Population growth is slowing,[5] which means that Sri Lanka's population is ageing. The dependency ratio, which compares the population aged 64 and over with the working age population (between 15 and 64), is high and rapidly increasing (see Graph 1.2. above). This ratio stands at 15% but, according to projections, could reach 30% by 2030. Elderly people traditionally benefit from the support of their family (only 30% of the over 60s receive a retirement pension and the pension system is restricted to civil servants and military personnel). However, due to the reduction in family sizes and longer lifespan, the viability of this system is called into question and requires the establishment of an adequate pension system (UNESCAP, 2015).

Third challenge: the unemployment rate for both youth and more educated people is relatively high, which prompts these populations to migrate.

In 2015, 54% of the 15-64 age bracket participated in the labour market, but this rate is slightly lower compared to the early 2000s (see Table 1.1. above). It is also much lower than in LMICs and in most of the countries in the region. Furthermore, the overall unemployment rate may be low (*i.e.* 4.7% in 2015), but it does mask the difficulties of young people, for which the unemployment rate stands at 19.7% at the same date. This specific characteristic of the labour market would appear to prompt young people to emigrate. In 2015, 263,000 people moved abroad for professional reasons (*i.e.* 3% of the country's labour force). Over 70% of them were young people under the age of 34. Similarly, there is a relatively high unemployment rate among higher education graduates (9.2%), which fosters the emigration of the skilled workforce. In 2015, migrations primarily concerned people with skilled jobs (31%) (CBSL, 2016). The main destination for Sri Lankan migrants is the Middle East: Saudi Arabia, the United Arab Emirates and Qatar together received 70% of Sri Lankan workers who settled abroad in 2015. The unemployment rate of qualified youth could be put down to the mismatch between training and the needs of the labour market (ILO, 2015; Asian Development Bank, 2016). In 2010, companies in the manufacturing sector stated that their third largest constraint for their operations was the inadequate training of the workforce. For example, only 20% of the population is fluent in English, and only 15% knows how to use a computer. Consequently, it would appear necessary to tailor training to the needs of the economy, in order to ensure that there is a more effective integration of young people into the national labour market.

[4] See The Atlas of Social Protection Indicators for Resilience and Equity, World Bank.

[5] Due to the increase in life expectancy and decline in fertility.

Fourth challenge: the urbanization rate in Sri Lanka is relatively low, whereas it is essential in fostering movements among labour force workers who have relatively unskilled jobs in rural areas and leave them for more skilled jobs in urban areas.

Ideally, for this to happen, the urbanization rate needs to be close to 40%, yet it only stands at 17% in Sri Lanka and remains below the average for LMICs and the rest of South Asia. According to the study conducted by Ellis and Roberts (2016), this low urbanization rate and its long-term stability are due to the following two main reasons: (i) Sri Lankan cities are unattractive to potential migrants, as the country has made significant progress in achieving spatial equity between rural areas and urban areas in terms of basic service provision; (ii) in Sri Lanka, the fact that official estimates of the urbanization rate are well below the estimates obtained by other means suggests that there is a substantial hidden urbanization. Large swathes of people live in areas which have all the characteristics of an urban area, but are officially classified as rural areas.

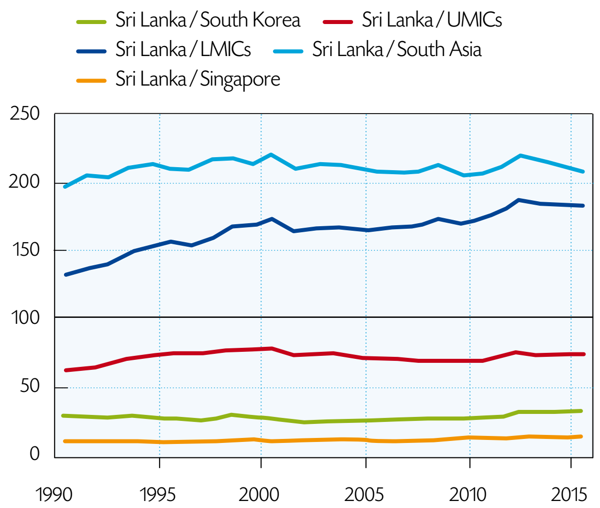
2 / The economy must be diversified to strengthen its growth dynamics

2.1. Growth path less dynamic than the Asian "tigers"

Sri Lanka has benefited from a robust and stable long-term growth rate (approximately +5.8% a year since 1990), which gathered pace once more with the return of peace (average of +6.2% since 2010). This improvement has allowed the country to maintain its level of GDP per capita well above the average recorded for all Southeast Asian countries and thereby be classified as a lower middle-income country (LMIC) back in 2010, with a higher GDP per capita than the average for this category (see Graph 2.1.).

Graph 2.1.

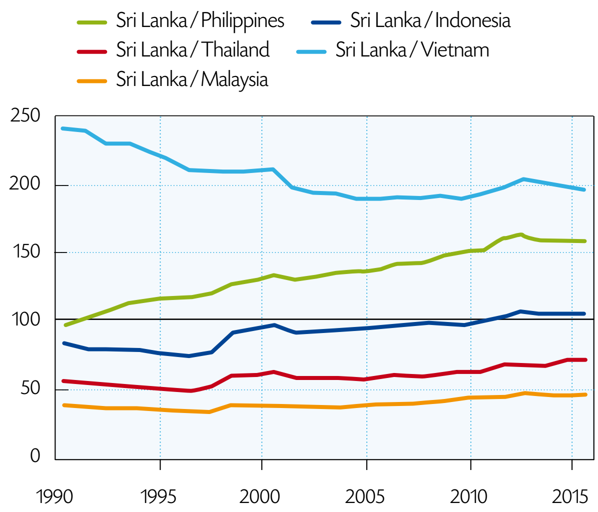
Comparison of Sri Lanka's GDP per capita (PPP) (% of GDP per capita, PPP of comparison countries)



Sources: World Bank (WDI), AFD calculations.

Graph 2.2.

Comparison of GDP per capita (PPP) of Sri Lanka and the "tiger cubs" (% of GDP per capita, PPP of comparison countries)



Sources: World Bank (WDI), AFD calculations

While these are positive and encouraging trends, the situation in Sri Lanka nevertheless remains well below the situation in upper middle-income countries (UMICs), and the country is finding it difficult to initiate a process to converge towards the latter category of country.[6] Sri Lanka has not managed to follow the same path as certain Asian countries which are now emerging or advanced, such as South Korea, Singapore or Malaysia, whereas their respective levels of per capita income were similar at the time of independence, i.e. in the 1950s (Athukorala and Jayasuriya, 2012). The country's growth path has suffered from 30 years of civil war and the occurrence of natural disasters (see Box 2 below). Consequently, in 2016, Sri Lanka's GDP per capita represented 43% of that of Malaysia, 32% of South Korea and, finally, less than 14% of Singapore

[6] There is income convergence when the curves move towards 100, i.e. when GDPs per capita in PPP are identical.

(see Graph 2.1. above). Several studies (Bruton, 1992; Abeyratne, 2008; Attygalle, 2012) have shown that Sri Lanka and Malaysia did, however, have a number of points in common at the time of their independence: two former British colonies, similar surface areas and resource endowments, an export sector specialized in plantation crops and mining, alongside subsistence farming based on a handful of food crops. However, Malaysia's growth path has experienced much stronger dynamics than Sri Lanka's. These dynamics have also allowed Malaysia to overcome potential multi-ethnic conflicts which might have emerged in a society that is 62% Malay (majority ethnic group), 25% Malay of Chinese descent and 10% Malay of Indian descent.

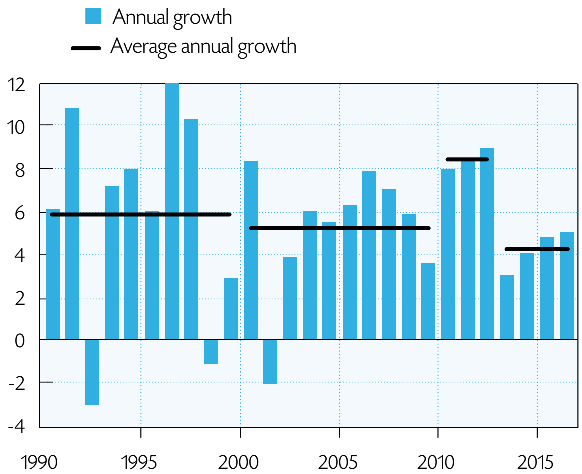
While Sri Lanka has been left behind by the "Asian Tigers", its dynamics are now more comparable to the "Tiger Cub" group,[7] particularly the dynamics of the Philippines, Indonesia and Thailand (see Graph 2.2. above). The question which now arises is of the economic policies that need to be conducted to ensure this pace of growth is sustainable in the long term, thereby allowing the UMIC category to be achieved. Indeed, few of the countries that reached the rank of middle-income country (MIC) many years ago have managed to continue their development in order to achieve the high-income category and have been stuck, to a certain extent, in a "middle-income trap". They are stuck in this trap as a result of a slowdown in productivity growth, as the initial gains from sectoral redistribution and technological catch-up have already been achieved. It is also because they have become less competitive due to the wage increase in the economy. According to Eichengreen et al. (2013), this kind of slowdown in growth tends to occur during two periods: when countries reach a level of GDP per capita[8] of around USD 10,000-USD 11,000 and a level around USD 15,000-USD 16,000. As Sri Lanka's GDP per capita did indeed reach USD 11,000 in purchasing power parity (PPP) at the end of 2015, the country will need to ensure that it implements economic policies that are conducive to productivity growth (support for investment, research and development, increase in the qualifications of the labour force.), in order to avoid the risk of falling into this trap and seeing a slowdown in its growth rate.

2.2. Growth bolstered by robust household consumption

Since the end of the 2000s, economic growth has mainly been shored up by the upturn in household consumption. The country also went through a period of economic overheating starting in 2010, before returning to normal in 2013: real GDP growth rose from an annual average of +5.2% between 2000 and 2009 to +8.2% on average between 2010 and 2012 (see Graph 2.3. below). The opening of the East and North Provinces at the end of the conflict was one of the reasons behind this increase in momentum. However, the sharp rise in household consumption was only reached through a rapid increase in imports, which widened the current account deficit (from -0.5% in 2009 to -7.8% of GDP in 2011), and created macroeconomic imbalances. Sri Lanka's economy subsequently went through a normalization phase, which resulted in the combination of a tightening in monetary policy and a more restrictive fiscal policy. These corrections had an impact on real GDP growth, which saw a marked slowdown in 2013 at +3%, before levelling off at around +5% in 2014, 2015 and 2016, *i.e.* close to its potential growth level estimated at +5.5%.

Graph 2.3.

Real GDP growth rate

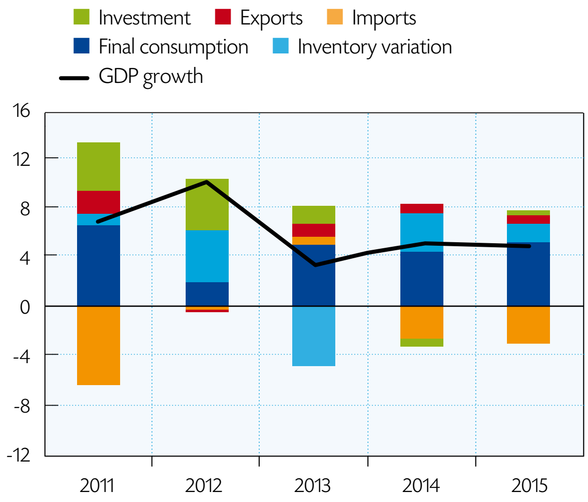


Sources: World Economic Outlook (WEO), Department of Census and Statistics (Sri Lanka).

[7] This category includes Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
[8] In 2005 purchasing power parity (PPP).

Graph 2.4.

Contributions of the different factors of demand to real GDP growth (in growth points)

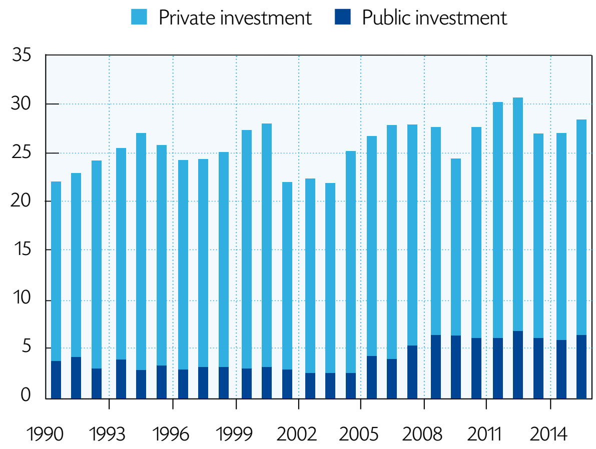


Source: Department of Census and Statistics (Sri Lanka).

The dynamism of public investment, which is partly due to what can be called "peace dividends" and the post-tsunami reconstruction needs in 2004,[9] is another source of economic growth: in order to rebuild the country, significant investments have been made in major public infrastructure (roads, ports, airports), which has contributed to GDP growth (see Graph 2.4. above). Back in 2005, a 10-year economic recovery plan, called Mahinda Chintana, was launched for 2005-2014. It was geared towards infrastructure and aimed to attract foreign investment, while strengthening the integration of the North and East Provinces, which had been badly affected by the civil war, into the rest of the island. There has been a substantial increase in public investment, from an average of 3% of GDP for 2000-2005 to an average of 6% of GDP since then (see Graph 2.5. below). This investment expenditure has broadly supported the development of the construction, transport, but also trade, sectors. It has largely been financed by external borrowing and has allowed the country to reach a substantial overall investment rate (28.4% of GDP at the end of 2015). However, two factors point to a future slowdown in the investment rate. Firstly, the constraints on the authorities in terms of fiscal space (see Section 3 below) suggest they may experience difficulties in achieving their objectives of increasing the public investment rate from 6.5% to 7.5% of GDP by 2020, which they have set out in the new 5-year national development plan (2016-2020).

Graph 2.5.

Public and private investments (as a % of GDP)



Source: Central Bank of Sri Lanka (CBSL).

In addition, there was a slight slowdown in private investment in 2014 and 2015 (see Graph 2.4. above). Over the long term, private investment has risen by taking advantage of the increased availability of national savings (the latter rose from 15% of GDP in the mid-1970s to 26% of GDP in 2015). In the future, the private savings rate could, however, decline due to the ongoing demographic changes, which bring about a rapidly increasing old-age dependency ratio vis-à-vis the working population (Hevia and Loayza, 2013).

2.3. The economy needs to diversify in order to increase its competitiveness

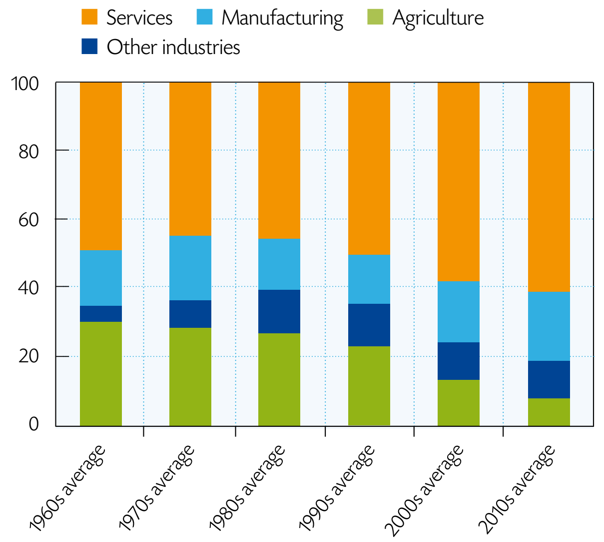
The country's development path has gone hand in hand with a transformation of its production structure (see Graph 2.6. below). The agriculture sector, which accounted for 31% of GDP in the 1960s, has declined to 8.7% of current GDP. At the same time, industry has developed (from 21 to 31% of GDP) based on the following two sectors: tea processing and the

[9] The country was severely affected by the tsunami in late December 2004, which resulted in the death of 35,000 people, 500,000 people being displaced and extensive physical destruction on the east and south coasts. The reconstruction cost totals 7% of GDP.

garment industry. The economy has also accelerated the expansion of its service sector in recent years, with services now accounting for the largest share of GDP (60.4%), in sectors as diverse as wholesale and retail trade, banking services, business process outsourcing servicess[10] and tourism. The latter has been booming since the end of the conflict.

Graph 2.6.

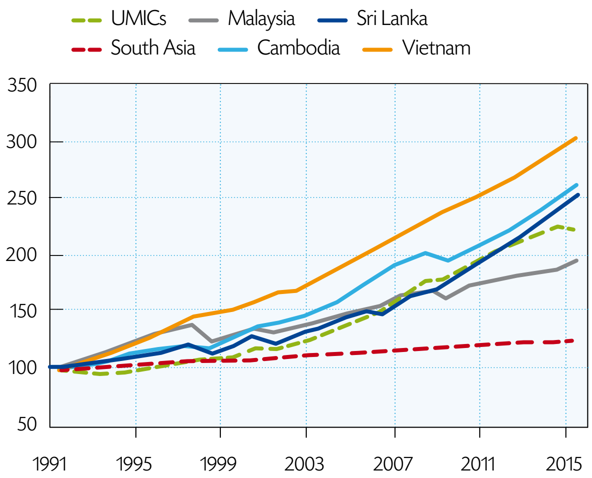
Sectoral structure of GDP (as a % of GDP)



Source: World Bank (WDI).

Graph 2.7.

Labour productivity measured by GDP per employee (constant PPP USD, base 100 in 1991)



Source: World Bank (WDI).

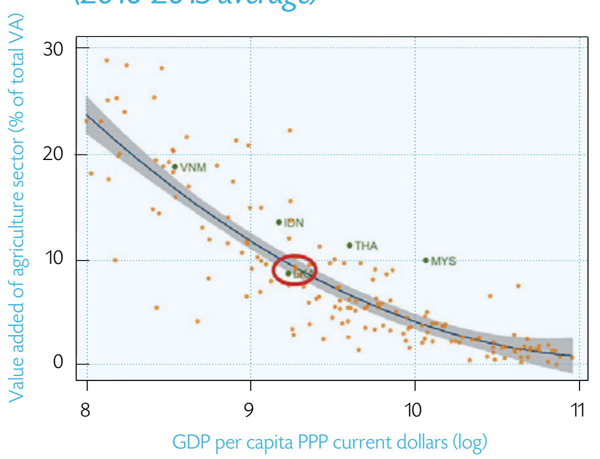
Productivity gains are increasing, in line with the results achieved by its Asian neighbours (see Graph 2.7.). Sri Lanka's productivity growth rate has been higher than the average in South Asian countries and, in recent years, has even benefited from an upturn which has allowed it to exceed the rate of Malaysia and the average of the UMICs. There is, however, still room for progress, as some countries have higher productivity growth rates over the same period (Cambodia and Vietnam, for example). Sri Lanka's agriculture sector, in particular, shows signs of low productivity, meaning that significant gains could be made in the sector. As shown by Graphs 2.8. and 2.9., while the share of the agriculture sector in GDP is in line with international standards, in view of Sri Lanka's level of development, the share of employment for the agriculture sector is much higher than might be expected. This indicates that there is most certainly a low productivity in this sector.

The activities in which the country has been specialized for many years suffer from problems of competitiveness and are subject to strong international competition. The country indeed faces competition from several low-income countries where the wage cost is lower (Hausmann, 2016). This is the case for tea (accounting for 12% of exports in value) and textile products (for example, ladies underwear, which accounts for 5% of exports).

[10] Business process outsourcing comprises activities such as call centres, external billing services, accounting, marketing, technical support and after-sales services.

Graph 2.8.

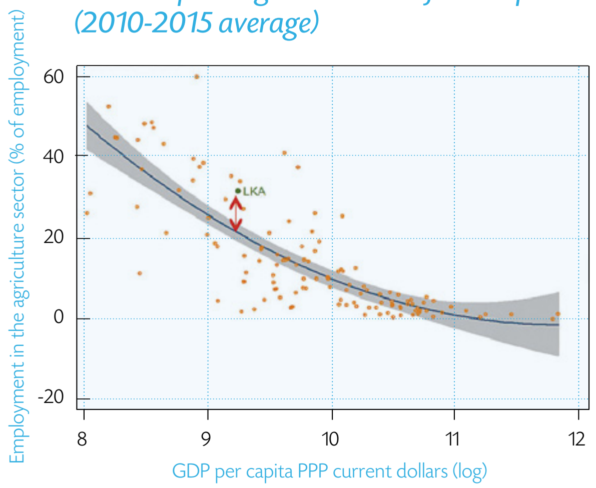
Share of agriculture sector in GDP depending on the level of development (2010-2015 average)



Sources: World Bank (WDI), AFD calculations.

Graph 2.9.

Share of employment in the agriculture sector depending on the level of development (2010-2015 average)



Sources: World Bank (WDI), AFD calculations.

The country has potential to develop its comparative advantages towards new areas with higher added value (logistics, tourism and outsourced business services). Three main business areas can be identified. Firstly, port and logistics activities benefit from Sri Lanka's strategic geographical location in a dynamic subregion and along a major trade route. Large-scale investments have already been made in order to seize this opportunity to develop port activities and act as a regional transport hub (particularly between China and India and the rest of the world). One investment concerns the extension of the Port of Colombo, which has increased the country's deep-sea capacity. Secondly, tourism has been experiencing strong growth since 2010 (+18% of tourist arrivals in 2015, after +20% in 2014) and can develop further. There are, in particular, margins for tourism development in the East and North regions, which still receive few visitors. Furthermore, setting up training geared to this sector will be an advantage, as it currently suffers from a shortage of skilled labour. Thirdly, the country is starting to become a popular destination for outsourced business services and financial services due to the development of skills in the fields of information technologies and accounting. In addition, Forth City (Colombo) is an emerging financial centre governed by British common law in order to facilitate the establishment of international companies.

However, two issues need to be addressed in order to develop these new sectors. Firstly, it is essential to increase the efficiency of the higher education system in order to meet the specific needs for skilled labour in these sectors. It is becoming possible for these segments, which tend to be more complex and require more skilled jobs, to remain competitive, while paying higher salaries. Expanding these new activities can also provide a way for the country to stem the emigration of qualified Sri Lankan workers to Western countries and the Middle East and, consequently, avoid exposure to the negative effects of a large-scale brain drain in the medium or long term.

Secondly, the complexity of Sri Lanka's business environment hampers the expansion of both domestic and foreign private investment, which is necessary for the development of new segments. According to the 2017 Doing Business index, Sri Lanka only ranks 110th out of 190 countries in terms of the ease of doing business, meaning it is at a lower level than several of its neighbouring countries,[11] and is in a relatively poor position for the aspects related to the registration of property rights, fiscal procedures and the performance of contracts. The low level of annual net inflows of foreign direct investment (FDI), which have remained below the level of 2% of GDP since 2000, can partly be put down to the existence of restrictive rules. Yet these flows could have the knock-on and dissemination effect for international standards which is often attributed to them.

[11] Malaysia ranks 23rd in the world, Thailand 46th, Indonesia 91st, the Philippines 99th and, finally, India 130th (meaning India is behind Sri Lanka).

Box 2 *Climate and Energy issues*

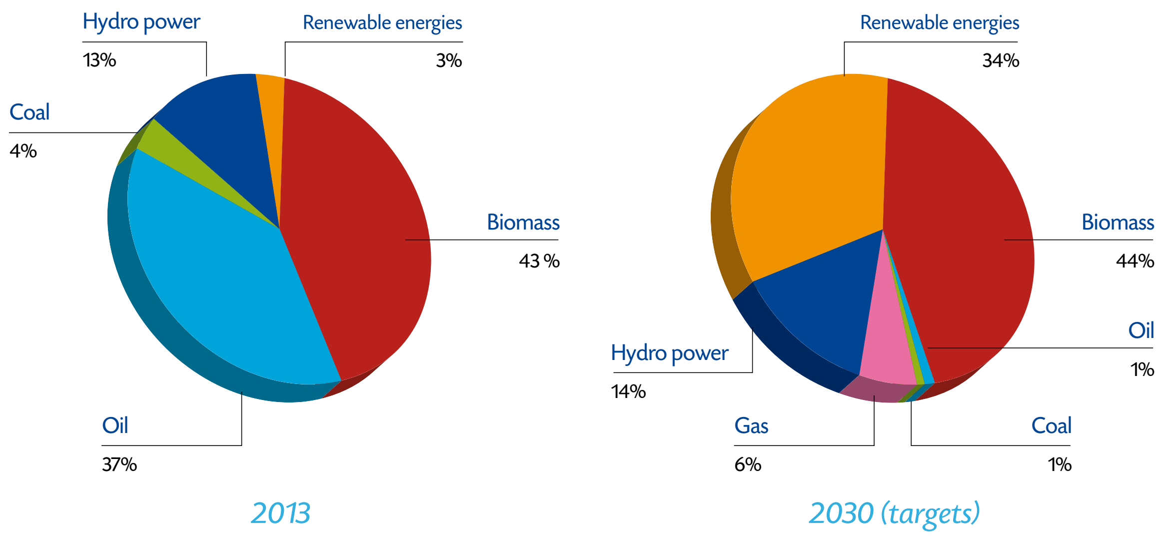
The country is highly vulnerable to climate change. With its 1,585 km of coastline, the island of Sri Lanka is highly exposed to rising sea levels and the increase in the frequency of cyclones and tsunamis. The harmful consequences of climate change which have been identified are as follows (Punyawardena, 2015):

- Soil salinization and degradation, as well as sea water incrustation in groundwater leading to irrigation problems;
- Increase in rainfall variations (more extreme events) exposing the agriculture sector to floods and drought;
- Increase in the average temperature leading to an evaporation of water reservoirs, whereas water resources are the country's third main source of energy.

The energy mix is highly dependent on the outside world. 43% of energy comes from biomass, 37% from oil, 13% from water resources, 4% from coal and, finally, 3% from renewable energies (see Graph 2.10.). Consequently, Sri Lanka is currently highly dependent on the outside world for its power generation, as 44% of its energy needs are covered by imported crude and refined oil and coal (Rodrigo, 2015). In the 2015-2025 energy sector development plan, there is an ambitious zero target for the share of oil-fired generation, by replacing it with an increase in renewable energy generation by 2030 (see Graph 2.10.). The renewable energy generation would mainly come from wind energy and, secondarily, from solar and biomass energy.

Graph 2.10

Sri Lanka's power generation mix in 2013 and for 2030 (targets)



Source: Ministry of Power and Energy (2014), Sri Lanka.

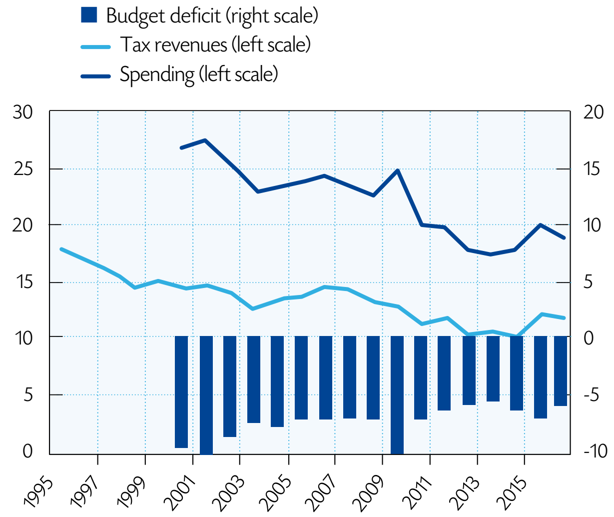
3 / Insufficient and declining public revenue generates structural imbalances in public finance

3.1. Structural budget deficit

Budget implementation is severely restricted by the low level of government revenues. Sri Lanka faces serious difficulties in raising tax revenues, which are low in view of the country's level of development (11% of GDP on average over the last three years) and have been declining since the mid-1990s (see Graph 3.1.). This poor performance is due to the weak tax base, collection difficulties, and the excessive number of exemptions, which complicate and are a burden on the system: for example, over 500 everyday consumer goods are exempt from value added tax (VAT). Initial tax reforms aiming to increase revenues were undertaken in 2016, driven by the negotiation of a financing programme with the IMF, which required a reduction in the budget deficit. The introduction of a tax on capital gains and the increase in VAT from 11 to 15% were the first stage in curbing the decline in tax revenues.

Graph 3.1.

Revenues, spending and government deficit (as a % of GDP)



Source: Ministry of Finance (Sri Lanka).

Interest costs are a burden on public spending (23% of spending) and limit the resources available for social and investment spending (see Table 3.1. below). Interest on debt accounts for 4.5% of GDP and remains an irreducible short and medium-term expenditure, although the Government does ensure that its bond issues on the international market are rationalized. It also gives priority to recourse to the abundant financing from international donors at more concessional rates. The public sector wage bill is high and places a burden on spending, as over a million people work in the public sector (accounting for approximately 13% of the working population). Due to these budget constraints, public investment has been on a downward trend since 2011, and has fallen from 5.7% to 4.3% of estimated 2016 GDP. After having mainly focused on heavy infrastructure, investment should, nevertheless, be directed more towards the health and education sectors, which have been put to one side in recent years. Similarly, current social spending (Samurdhi transfer programme, for example) is constrained by the low level of revenues and it will it will need to be adjusted upwards due to the apparent ageing of the population.

All in all, and throughout the past 15 years, the budget deficit has been high (-7.4% of GDP on average), which has increased the country's debt (see Graph 3.1. opposite). While the deficit had been declining since 2011, a number of fiscal slippages occurred in 2015, an election year where the budget deficit reached -6.9% of GDP. Under the EFF (Extended Fund Facility) programme, signed with the International Monetary Fund (IMF) in June 2016, the new Sri Lankan Government pledged to gradually bring this deficit down to 3.5% of GDP by 2020. However, significant efforts to increase revenues will need to go hand in hand with achieving this objective in order to avoid a further crowding out effect on public investment and social spending, which guarantee social cohesion.

Table 3.1. *Sri Lanka's budget implementation (as a % of GDP)*

	2011	2012	2013	2014	2015	2016 (estimations)
Budgetary revenues	13.6	12.2	12.0	11.5	13.1	13.1
Tax revenues	11.7	10.4	10.5	10.1	12.1	11.9
– *incl. direct taxes*	*2.2*	*2.0*	*2.1*	*1.9*	*2.3*	*1.9*
– *VAT*	*3.1*	*2.6*	*2.6*	*2.6*	*2.0*	*2.6*
Non-tax revenues	1.7	1.6	1.4	1.4	0.9	1.1
Grants	0.2	0.2	0.2	0.1	0.1	0.1
Expenditure	19.9	17.8	17.4	17.2	19.9	18.9
Current expenditure	14.2	13.0	12.6	12.7	15.2	14.5
– *incl. defence expenditure*	*2.2*	*1.7*	*1.7*	*1.8*	*2.0*	*n/d*
Salaries	*4.4*	*4.0*	*4.1*	*4.2*	*5.0*	*4.8*
Goods and services	*1.8*	*1.6*	*1.2*	*1.6*	*2.0*	*1.1*
Grants and transfers	*3.0*	*2.7*	*2.6*	*2.7*	*3.5*	*3.5*
Interest paid	*4.9*	*4.7*	*4.6*	*4.2*	*4.7*	*5.0*
Capital expenditure and net loans	5.7	4.9	4.8	4.5	4.7	4.3
Primary balance (excl. interest and grants)	-1.5	-1.1	-1.0	-1.6	-2.2	-0.8
Overall balance	**-6.2**	**-5.6**	**-5.4**	**-5.7**	**-6.9**	**-5.7**

Sources: Ministry of Finance (Sri Lanka) and IMF for the 2016 forecasts.
n/d: Data not determined.

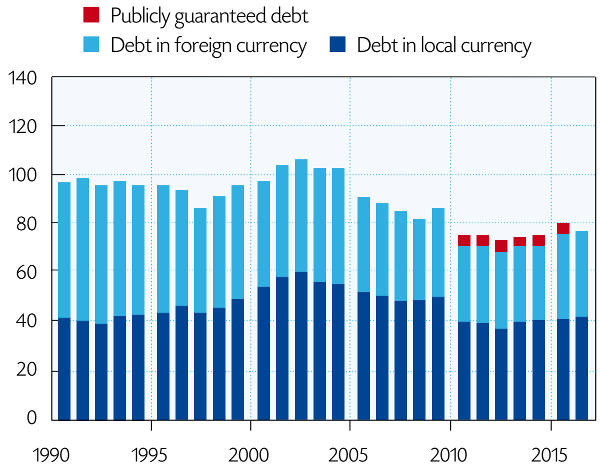
3.2. High level of debt

There is a high level of public debt and, following a decline of over 30 GDP points in the 2000s, it is once again on an upward trend (see Graph 3.2. below), and reached 76% of GDP at the end of 2015. Debt has risen by almost 5 GDP points compared to the end of 2014, under the combined effect of the substantial budget deficit and the depreciation of the national currency (Sri Lankan rupee), which has led to an "automatic" increase in debt of 3 GDP points. In 2016, debt continued to rise, as the two international bond issues for a total amount of USD 1.5bn represent an additional debt of 1.8% of GDP. The Government aims to reduce its debt gradually to 55% of GDP by 2020. To achieve this, it anticipates an annual GDP growth of 6.5% and budgetary consolidation.

The trend for contingent liabilities is another point which needs monitoring. Firstly, debt which explicitly benefits from a State guarantee stood at 3.4% of GDP at the end of 2015, bringing Sri Lanka's public debt to 79.5% of GDP. Secondly, the debt of certain loss-making State-owned companies is also a contingent liability for the State. The financial obligations related to State-owned companies were estimated by the IMF at 11% of GDP at the end of 2015. The Government has launched a reform of State-owned companies, in order to mitigate the losses which place a burden on budget implementation and to limit these contingent liabilities (see Box 3 below).

Graph 3.2.

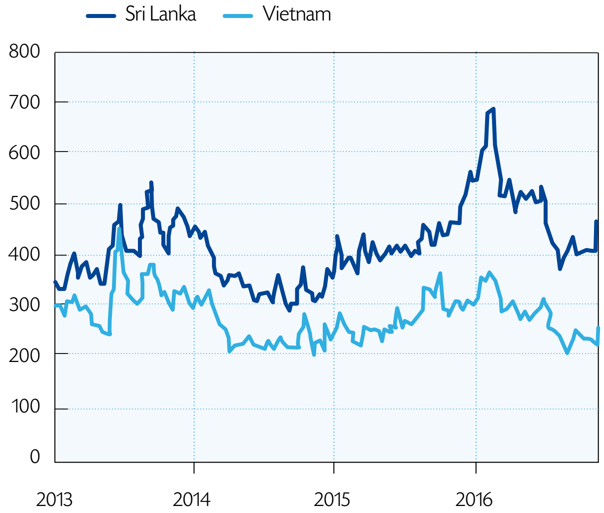
Public debt: Trend and composition (as a % of GDP)



Source: Central Bank of Sri Lanka (CBSL).

Graph 3.3.

Diversified EMBIG [12] spread



Source: J.P. Morgan.

The debt structure is relatively favourable, and it will mainly denominated in local currency and the portion in foreign currency is mainly contracted at concessional rates (see Table 3.2. below). The existence of a domestic debt market has allowed Sri Lanka to mainly borrow in local currency (accounting for 58% of the debt). However, as half of this debt reaches maturity over the next three years, the authorities are trying to gradually extend the maturity of the new loans raised in order to reduce the refinancing risk. The share of non-residents on the domestic debt market is rising, but there is a regulatory limit of 12% of debt in order to avoid destabilizing the market in the event of volatility in these funds. Non-resident investors mainly focus on Sri Lanka Development Bonds (SLDB), which are securities issued on the domestic market but denominated in US dollars.[13] This financial instrument, which was set up in 2002, has maturities ranging from one to four years and its outstanding amount reached 6% of GDP at the end of 2015.

External public debt benefits from concessional financing conditions – 20% – and has a long maturity (59% of the debt only reaches maturity at between 10 and 30 years). External debt subscribed from multilateral and bilateral donors has mainly concerned the infrastructure sector. Roads and bridges account for a third of loans allocated by donors, followed by the water and sanitation sector.[14] The two 10-year Eurobond issues conducted in 2015 (USD 650m and USD 1.5bn) benefited from reasonable exit rates, at 6.25% and 6.85%, respectively. However, the financing conditions for Sri Lanka's economy on the international market tightened in early 2016, during the period of tension on the balance of payments, with a peak spread reaching almost 700 basis points in February 2016 (see Graph 3.3. above). There was a return to normal following the credit agreement concluded with the IMF in June 2016. Thanks to the more favourable exit rates, two sovereign bond issues in USD were conducted in July 2016 for a total amount of USD 1.5bn, at the rate of 6.8% for the 10-year issue and 5.75% for the 5-year issue. In order to diversify external debt, in May 2016, the Sri Lankan authorities requested authorization from the Chinese Central Bank to issue Panda Bonds, 5-year Treasury Bonds denominated in renminbis (RMB), the Chinese currency, which may be subscribed by Chinese investors and will benefit from a lower rate than securities in USD.

[12] The J.P. Morgan Emerging Market Bond Index Global.
[13] SLDBs may only be subscribed by non-residents or residents with income in USD.
[14] Source: Economic Service of the French Embassy in Sri Lanka (2016).

Table 3.2. *Composition of government debt at the end of 2015*

	% of GDP	% of total debt
External debt	31.7	41.7
Concessional	15.5	20.3
Bilateral	8.0	11.0
Japan	3.0	4.0
China	1.0	1.0
Multilateral	7.0	9.0
IDA [15]	3.0	4.0
AsDB [16]	4.0	5.0
Non-concessional	16.2	21.3
Domestic debt	44.3	58.3
Long-term debt	36.2	47.6
Treasury Bonds	30.0	39.0
Sri Lanka Development Bonds	6.0	8.0
Loans in Sri Lankan rupee (LKR)	0.2	0.3
Short-term debt	8.2	10.7
Treasury Bonds	6.0	8.0
Central Bank advances	1.0	2.0

Source: Central Bank of Sri Lanka (CBSL).

The debt presents risks of unsustainability, particularly if the substantial government deficit were to continue and growth faltered. The Debt Sustainability Analysis (DSA) conducted by the IMF (June 2016) shows that the sustainability of the debt is at high risk. The level of debt, as well as the financing needs, would embark on paths of rapid increases in several of the shock scenarios analysed. It is worth pointing out that, despite the country's high level of debt, the EFF (Extended Fund Facility) agreement signed with the IMF in June 2016 does not set out conditions restricting future non-concessional borrowing by the country. However, conditions have been imposed concerning budget implementation with deficit reduction targets which actually have an incidence on the rhythm at which debt progresses, a rhythm and would slow it down.

The country has, however, never defaulted on the repayment of its debt maturities and may have recourse to financing on concessional terms from the various donors. Sri Lanka is currently benefiting from donors' willingness to finance the country on concessional terms (AsDB and the World Bank aim to double their respective commitments to Sri Lanka by 2020). However, owing to the increase in Sri Lanka's revenues, the decision as to whether to maintain its eligibility for the concessional financing of the International Development Association (IDA) is under discussion. The country has made a request to maintain its eligibility for this category, at least until 2020, in order not to penalize its growth model and to be able to meet its debt obligations.

[15] International Development Association (World Bank Group).
[16] Asian Development Bank

Box 3 *Reform of State-owned companies*

55 out of the 245 Sri Lankan State-owned companies, which are of a commercial nature, have been identified as being strategically important, as they play a key role in the country's economy and are classified as State-Owned Business Enterprises (SOBE). They operate in a number of sectors: energy (Ceylon Electricity Board, Ceylon Petroleum Corporation), water (National Water Supply and Drainage Board), ports (Sri Lanka Ports Authority), aviation (Sri Lankan Airlines, formerly Air Lanka), construction, banking, etc.

The activity of these 55 State-owned companies accounts for 12% of GDP (including 5% of GDP for energy and 3% for banking and finance) and their total assets 71% of GDP. In 2015, 39 of them made profits (a total of LKR 121bn, *i.e.* 1% of GDP), while the other 16 companies suffered losses (for a total amount of LKR 57bn), in particular Ceylon Petroleum Corporation and Sri Lankan Airlines.

All of these companies have autonomy for their financing and have recourse to borrowing from banks, or turn to international markets. Their debt is estimated at 11% of GDP and mainly comes from Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lanka Ports Authority and Sri Lankan Airlines.

The Sri Lankan authorities have decided to restructure loss-making State-owned companies in order to limit their burden on public finances. This reform of State-owned companies is set out in the agreement signed with the IMF in June 2016, and in which the following associated target requirements have been determined:

- Implementation of a strategy to privatize the national airline company Sri Lankan Airlines;
- Introduction of pricing mechanisms to cover the costs of energy and water production and the provision of other public services;
- Streamlining of recruitments and implementation of measures to improve productivity;
- Reflection on how to improve the efficiency of companies *via* public-private partnership (PPP) mechanisms.

Source: Ministry of Finance of Sri Lanka (2016).

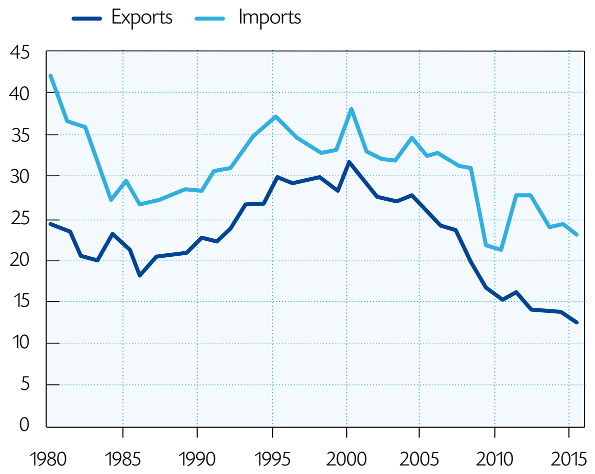
4 / External imbalances subject to significant tensions

4.1. Poor export performance adversely affects current account balance

The gains in terms of opening up trade following the economic liberalization in 1977 have been totally reversed over the past 15 years. Consequently, following a peak at 70% reached in 2000, the trade openness rate[17] fell continuously and returned to 36% in 2015 (see Graph 4.1.). This trend can mainly be put down to the increase in the effective customs protection rates since the early 2000s, which are estimated to have almost doubled between 2004 and 2009 (Athukorala and Jayasuriya, 2012), and to a deterioration in the performance of the export sector.

Graph 4.1.

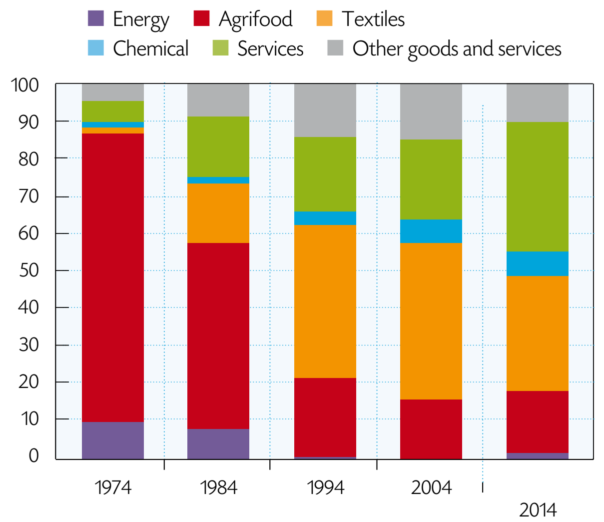
Exports and imports of goods (as a % of GDP)



Source: World Bank (WDI).

Graph 4.2.

Composition of exports of goods and services (as a %)



Source: CEPII[18] "Country Profiles".

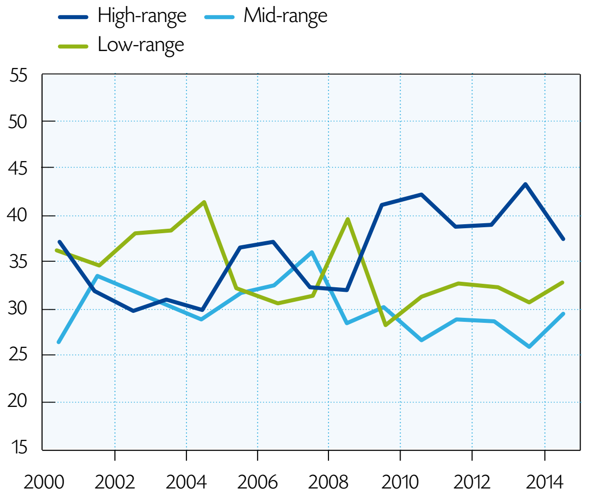
The composition of exports has completely changed since the 1970s and now has a higher level of diversification (see Graph 4.2.). While in the 1970s and 1980s exports mainly concerned agrifood products, the exports of these products were overtaken by textile exports starting in the 1990s. Among agricultural products, tea is the main product exported and accounts for 55% of revenues. Sri Lanka is the world's leading exporter of this product, but is subject to strong competition from countries with lower wage costs (Kenya and India in particular), which erodes its global market share. In the textile segment, the country is exposed to intense competition from its Asian neighbours, particularly its South Asian neighbours, which are also specialized in this niche. Sri Lanka is seeking to diversify its production apparatus with products with a higher added value and technology content. Since 2010, a slight move upmarket has been taking place, with high-end products now accounting for 38% of exports of manufactured goods, against about 30% in the early 2000s (see Graph 4.3. below).

[17] The trade openness rate is measured as the ratio of the sum of exports and imports to GDP.
[18] Centre for Prospective Studies and International Information, Prime Minister's Office (France).

The lack of diversification in terms of destination has been identified as one of the reasons for the weakness of exports (IPS, 2015). Sri Lanka's two main export markets are in the USA and Europe (see Table 4.1. below). In 2010, the European Union (EU) withdrew Sri Lanka from the list of countries benefiting from the GSP+ [19] (customs exemptions to enter the European market), due to non-compliance with human rights by the Sri Lankan State. This withdrawal of the customs exemption has heavily penalized its exports to the European market. In June 2016, the Sri Lankan authorities made a new request to the EU in order to be reinstated in the mechanism allocating exemptions from customs duties for its clothes exports. If the EU rules favourably in 2017, the mechanism could come into force at the end of 2017. In terms of tea, the main export markets are in the Middle East, where the complicated geopolitical system and economic system slow down demand from this region. For all its products, it should be noted that the country still exports little to its two main regional neighbours (China and India). Discussions are ongoing to extend the 1998 Indo-Sri Lanka Free Trade Agreement on goods to services and investments. This Economic and Technological Cooperation Agreement (ETCA) (under negotiation) has come up against some serious stumbling blocks, but could be signed in the course of 2017. Discussions have also been initiated with China for the signing of a trade agreement. China ranks 13th among Sri Lanka's export destinations.

Graph 4.3.

Share of the different ranges in exports of manufactured goods (as a %)



Source: CEPII "Country Profiles".

Table 4.1. *Share in the exports of the main partners (as a %)*

Exports	2004	Exports	2014
USA	32.5	USA	22.4
UK	13.8	UK	10.1
India	6.4	India	6.1
Germany	5.2	Germany	5.3
Belgium	5.1	Italy	4.7
Japan	3.3	France	3.4
Italy	2.9	Russia	2.8
Russia	2.4	Belgium	2.8
France	2.3	United Arab Emirates	2.4
Netherlands	1.9	Japan	2.3
United Arab Emirates	1.8	Switzerland	2.0
Singapore	1.5	Canada	1.9
Maldives	1.4	China	1.8

Source: CEPII "Country Profiles".

[19] Generalised Scheme of Preferences Plus.

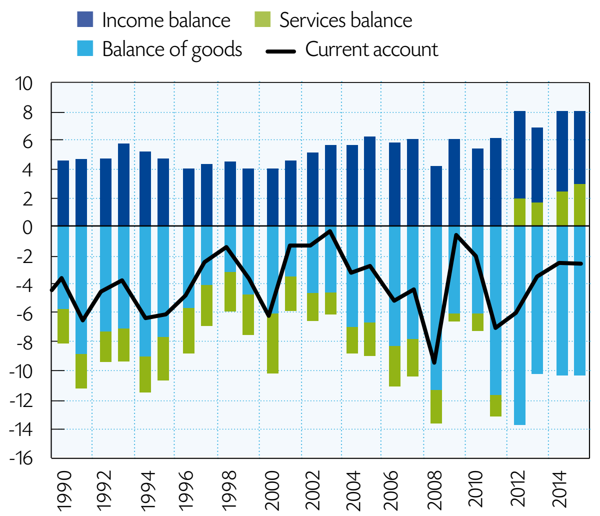
The trade balance for goods is structurally in deficit (average of -11% of GDP over the past five years), under the combined effect of the weak export performance and large share of consumption which is imported (particularly cars). The trade deficit has widened over the past ten years, from 7% of GDP in 2005 to 10% in 2015.

Since 2012, there has been a surplus on the services balance as a result of the take-off in tourism revenues due to the end of the internal conflict. There is also a surplus on the income balance, thanks to the high level of migrant remittances (7.6% of GDP in 2015).

The country's current account deficit has remained below 5% of GDP in recent years thanks to tourism and migrant remittances (see Graph 4.4.). Since 2014, the current deficit has even fallen to -3% of GDP. The country now needs to transform the favourable economic factors of the last two years into structural factors (diversification of exports, moving upmarket) in order to confirm this downward trend for the current deficit.

Graph 4.4.

Breakdown of the current account (as a % of GDP)



Source: IMF (BOPS – Balance of Payments Statistics).

4.2. Significant need for external financing

In 2015, despite the improvement in its current account, Sri Lanka experienced substantial pressure on its external financing due to capital outflows. The country suffered from significant outflows of portfolio investment as a result of international instability and the rise in interest rates in the USA. In 2015, foreign investors consequently conducted some USD 2bn of gross sales of public securities on Sri Lanka's domestic market (Treasury bills and bonds). During the first five months of 2016, this trend continued with USD 442m of net outflows on this public securities market. The situation only reversed in the 2nd half of 2016, thanks to renewed investor confidence.

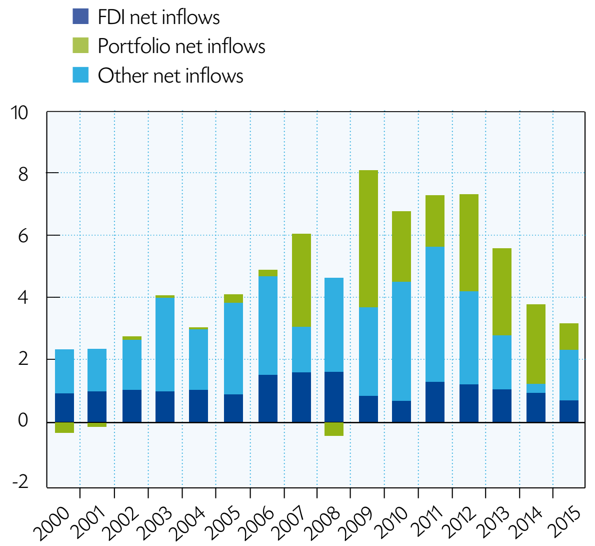
These tensions have already emerged in the past, showing the country's fragility in terms of external balances. Indeed, it should be noted that Sri Lanka came close to a balance of payments crisis in 2009, which was narrowly avoided thanks to the USD 2.6bn two-year Stand-By Arrangement (SBA) signed with the IMF. Foreign reserves in months of imports of goods and services had fallen to 1.2 months in March 2009. This IMF programme was a short-term crisis management instrument aiming to rebuild reserves and restore market confidence: an SBA agreement which did not set out requirements in terms of structural reforms, unlike the EFF agreement signed with the IMF in June 2016.

Debt-generating flows are the country's main source of external financing, given that foreign direct investments (FDI) are low (see Graph 4.5. below). Since 2000, annual net FDI inflows have remained below 2% of GDP. This weakness of FDI is partly due to strict rules which hinder investment by foreigners. They include: (i) the ban on foreigners owning land; (ii) the high minimum investment amount (USD 250,000). The authorities now wish to relax these rules in order to make it easier to do business in Sri Lanka and thereby attract more FDI. The bulk of external financing consequently comes from long-term borrowing contracted by the State with bilateral and multilateral donors on concessional terms, or *via* bond issues on the international market (two issues in 2014, two more in 2015 and another two in 2016).

Furthermore, portfolio inflows, which are more volatile and potentially destabilizing, have been rising since 2009 and account for an average 2.5% of GDP, *i.e.* more than FDI. This trend is due to the increasing recourse of the banking sector to external borrowing and the growing participation of non-residents in the domestic public debt market (this participation does, however, only account for 12.5% of Treasury bonds and public bonds).

Graph 4.5.

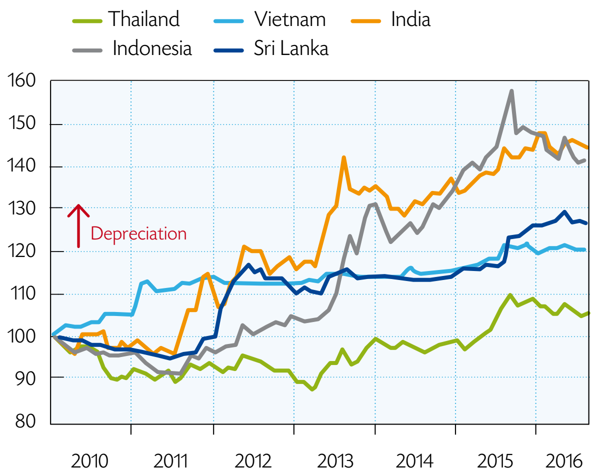
External financing (as a % of GDP)



Source: Central Bank of Sri Lanka (CBSL).

Graph 4.6.

Exchange rate vis-à-vis the USD (base 100 in 2010)



Sources: IMF, Central Bank of Sri Lanka (CBSL).

The capital outflows led to a deterioration in the financial account, which resulted in a fall in reserves and a depreciation of the national currency. The Central Bank initially sought to maintain a soft peg with the dollar (USD) by drawing on its foreign exchange reserves, but subsequently let its currency fluctuate freely from September 2015 onwards. This resulted in an immediate 5% depreciation of the currency against the dollar. In September 2016, the currency had depreciated by a total of 10% compared to January 2015, reaching a 10-year low. This is despite the fact that the Sri Lankan rupee (LKR) is still one of the Asian currencies to have depreciated the least (see Graph 4.6.). The Central Bank increased its key interest rates by 50 basis points twice, in February and July 2016, in order to mitigate the net capital outflows and the depreciation of the currency.

4.3. Tensions on liquidity

In 2015 and 2016, substantial pressures appeared on foreign currency liquidity, despite the foreign currency swap agreement signed with India. Both the capital outflows and strategy to support the currency ended up placing a burden on reserves, which fell to USD 7.3bn at the end of December 2015, then to USD 5.3bn at the end of June 2016, *i.e.* close to the level of 3 months of imports (see Graph 4.7. below). Similarly, at the end of 2015, reserves only covered 87% of the short-term external debt. The Sri Lankan Government initially contracted foreign currency swaps with the Reserve Bank of India (RBI), India's Central Bank, in order to reconstitute the reserves and meet the high maturities for the foreign currency debt amortization. Consequently, in April 2015, Sri Lanka benefited from a USD 400m allocation from the RBI facility for member countries of the South Asian Association for Regional Cooperation (SAARC), then in July 2015, from an additional USD 1.1bn foreign currency swap. Following the repayment of the previous swaps in early March 2016, the Central Bank of India authorized a new special USD 700m swap with a 3-month maturity.

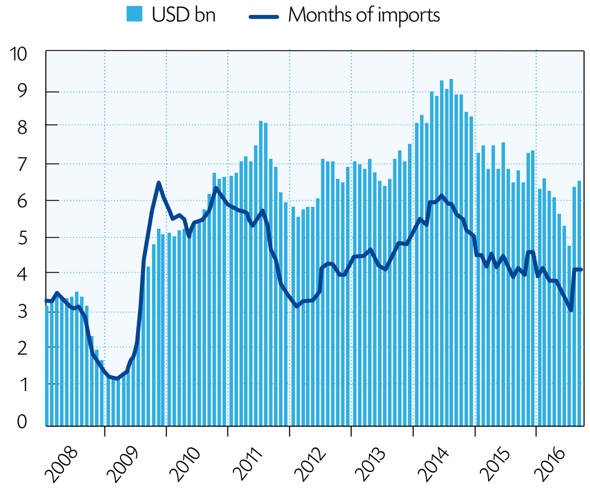
The Sri Lankan authorities requested financial support from the IMF in order to restore investor confidence and rebuild reserves. A 3-year Extended Fund Facility (EFF) for USD 1.5bn was allocated to Sri Lanka by the IMF in June 2016. The objectives of the IMF programme are as follows: (i) generate a structural increase in tax revenues; (ii) reverse the downward trend in foreign exchange reserves; (iii) reduce public debt and the risk of debt unsustainability; (iv) improve the financial situation of State-owned companies. Half-yearly IMF reviews will be conducted in the country: IMF disbursements will be conditional on the achievement of quantitative targets to reduce the primary deficit and increase reserves. The first USD 165m disbursement made by the IMF strengthened reserves slightly. In addition to the IMF programme, the World Bank and Asian Development Bank (AsDB) have pledged to contribute USD 650m to the financing needs of the economy for 2016-2018.

Foreign currency liquidity does, however, remain fragile and the authorities need to monitor the trend in foreign exchange reserves in relation to the path of external debt.

External debt is high and places a burden on the country's creditworthiness, but does benefit from a favourable structure (see Table 4.2.). It mainly has long and medium-term maturities (corresponding to 83% of the debt), which limits the refinancing risk. However, while the external debt mainly remains public, private sector external debt is rising and currently accounts for 40% of external debt (against 30% in 2012).

Graph 4.7.

Foreign exchange reserves



Sources: IMF, Central Bank of Sri Lanka (CBSL).

Table 4.2. *Composition of external debt (as a % GDP)*

	2012	2015
External debt		
Long-term	44.8	45.8
Government	31.5	30.3
Central Bank	4.8	2.9
Banking sector	1.8	4.2
Other sectors	4.1	5.1
Inter-company loans	2.6	3.3
Short-term	9.4	9.3
Government	0.8	0.0
Central Bank	0.3	0.6
Banking sector	5.4	7.1
Other sectors	2.8	1.6
Foreign exchange reserves (% of short-term external debt)	*99.7*	*86.8*

Source: Central Bank of Sri Lanka (CBSL).

The country's overall net external situation is negative – 52% of GDP –, as the stock of financial assets held by Sri Lanka in the rest of the world is well below its stock of financial liabilities. It has, however, remained stable over the last four years.

5 / The banking sector is correctly regulated but rapid credit growth must be monitored

5.1. Strong acceleration in credit dynamics

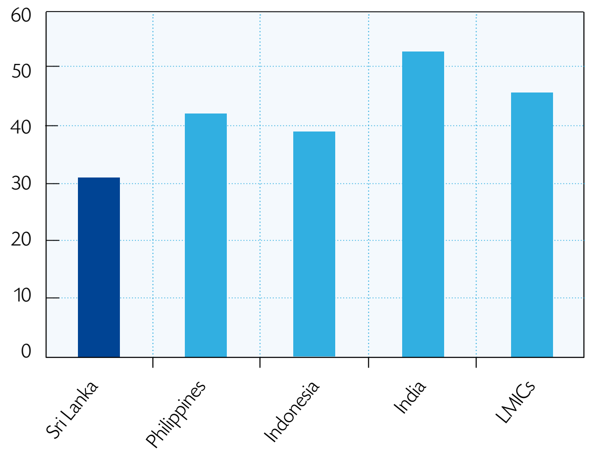
The country's financial sector is dominated by banks, which account for 69% of financial assets. Sri Lanka's banking sector is relatively concentrated and small, with 25 commercial credit institutions (12 of which are banks with foreign capital) and seven specialized banks (which include regional development banks). The total assets of the banking system account for 85% of GDP. The State is predominant, as the country's three largest banks (The Bank of Ceylon, People's Bank, National Savings Bank) are State-owned and account for almost 50% of banking assets, which leaves a narrow market for the other 29 credit institutions. The development of the financial sector has led to the creation of 53 non-banking financial institutions (NBFI) (employee contingency funds, insurance companies, financial and leasing companies). There appears to be a very high level of financial inclusion, as the rate of adults with a bank account stands at 83%, *i.e.* a rate well above the average in South Asia and closer to the level of OECD (Organisation for Economic Co-operation and Development) countries.

However, the banking sector does not sufficiently finance the economy. Credit to the private sector only stands at 30% of GDP, *i.e.* a level well below other countries in the subregion and at the average level in LMICs (see Graph 5.1. below). This weakness in credit allocations to the private sector is partly due to the difficulties experienced by borrowers in finding collateral to guarantee their loans, as well as to lengthy and difficult legal procedures for dispute resolution in the event of default.

Loans secured against gold assets developed significantly starting in 2010, in order to address the guarantee constraints, but have declined due to the fall in gold prices. In 2012, 17% of bank loans, mainly loans for consumption, agriculture and small businesses, were collateralized through the pawning of borrowers' gold assets. The fall in gold prices prompted banks to gradually withdraw from this mechanism (a sort of pawn-broking system), which has become very risky. At the end of 2015, collateralized loans consequently accounted for only 3% of banking sector loans.

Graph 5.1.

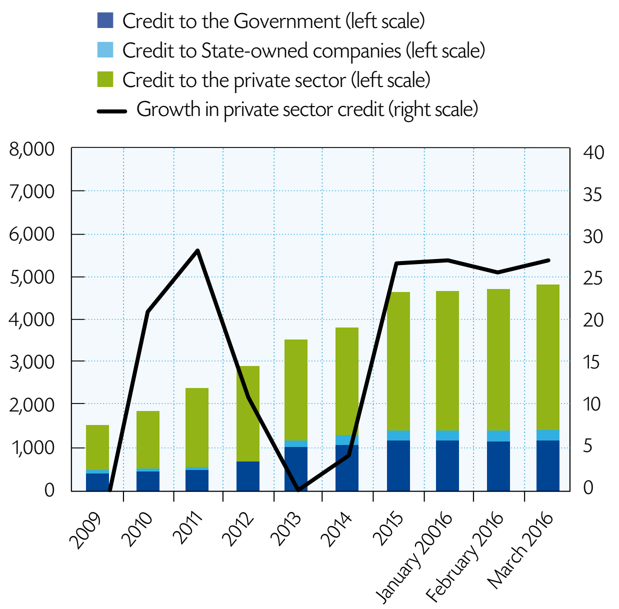
Credit allocated to the private sector (as a % of GDP, in 2015)



Source: World Bank (WDI).

Graph 5.2.

Credit composition (in LKR bn) and growth of credit to the private sector in real terms (as a %)



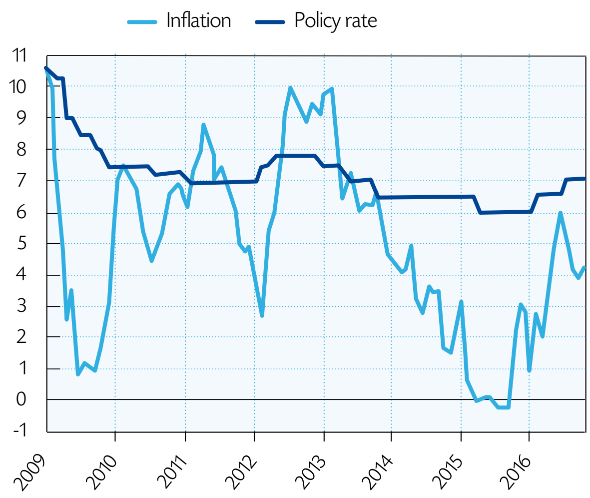
Source: Central Bank of Sri Lanka (CBSL).

Since 2009, the country has already experienced two credit booms (see Graph 5.2.). In 2010, during the post-conflict economic overheating, there was a sharp increase in the credit to private sector/GDP ratio, although it started from a relatively low level at nearly 27% of GDP. This generated a credit expansion in 2010 (+26% in real terms between 2010 and 2011). Credit to the private sector soared in 2015 (+24% in real terms over the year), after having increased at a very moderate level in 2013 and 2014, due to the tightening of the monetary policy. The low rates (see Graph 5.3. below) and substantial liquidity in rupees (LKR) helped the banking sector allocate credit, mainly in the real estate and consumer sectors. Consumer credit led to many imports, in particular for the purchase of vehicles, which had an impact on the country's external balances. A real estate bubble started to form on asset prices, with real estate prices practically doubling in the space of two years. A number of investors turned to real estate due to the low level of interest rates and the decline in the stock market.

The current credit boom needs to be monitored, but the country is not, for the time being, showing warning signs associated with the credit expansions which led to certain financial crises, such as the East Asian crisis in 1997. These credit expansions may be a sign of healthy financial development, seen during the development phases of a country. However, a number of other credit booms have been a sign of banking intermediation bubbles, leading to financial crises (Schularick and Taylor, 2012). The IMF study (2004) shows that damaging credit expansions are usually booms which last over a long period of time, in a context of a real exchange rate appreciation, an asset price bubble, and rapid growth in investment associated with capital inflows. All these symptoms are not currently to be found in the case of Sri Lanka. However, the risks associated with strong credit growth highlight the importance of prudent banking regulations and vigilant monitoring in order to ensure that a credit boom does not lead to excessive weaknesses.

Graph 5.3.

Trend in key interest rates and inflation rates (%)



Source: Central Bank of Sri Lanka (CBSL).

As this type of credit boom can carry increased macrofinancial risks, the Central Bank of Sri Lanka (CBSL) has implemented several measures to limit credit growth and guarantee financial stability. In February 2016, the decision was taken to raise monetary policy rates by 50 basis points and increase the reserve requirement ratio to be constituted with the Central Bank from 6% to 7.5%. The credit growth target for 2016 stands at +15%. However, during the first quarter of 2016, growth did maintain a high rate (+26%). A new 50 basis point increase was decided in July 2016, with the Central Bank's key rate reaching 7%. Furthermore, in December 2015, restrictions were imposed on credit for the purchase of imported vehicles (introduction of a ceiling, with credit not allowed to finance more than 70% of the value of the vehicle), in order to limit the rapid increase in the exposure of the banking sector to loans financing the purchase of vehicles.

The exposure of the banking sector *vis-à-vis* the Sri Lankan Government is increasing and has reached a substantial level (13% of GDP) (see Graph 5.2. above). At the end of 2015, the credit portfolio of the banking sector for the public sector stood at 30% (public securities and credit to State-owned companies). This trend needs to be monitored as it makes the banking system sensitive to a sovereign debt default.

5.2. Satisfactory regulation

The profitability and solvency of the banking sector are by and large satisfactory (see Table 5.1.). Banks are highly profitable, with an average return on assets of around 2% and an average return on equity of 23%, *i.e.* higher than in the group of comparison countries (such as India, Indonesia and the Philippines). The sector has a high capital adequacy ratio (16%) and satisfactory liquidity, with a liquid assets/total assets ratio higher than the generally accepted norm of 20%, and the credit/deposits ratio (between 82 and 87% for the period analysed) lower than the norm (100%). Asset quality is improving, with a decline in non-performing loans and a better provisioning rate (albeit limited at 62%, meaning that the provisioning policy is still relatively weak). In addition, despite the increasing recourse of banks to external sources of financing (foreign currency borrowings account for 61% of borrowings), the foreign exchange risk remains limited, with a net open currency position (*i.e.* liabilities less assets in foreign currency) at under 1.5% of the regulatory capital for banks in the country.

Table 5.1. *Asset ratios of Sri Lanka's banking sector (in %)*

	2011	2012	2013	2014	2015	Comparison group average*
Regulatory capital on risk-weighted assets	16.0	15.0	16.3	16.7	16.0	16.2
Profitability						
Average return on assets	2.4	2.4	1.9	2.0	1.9	1.6
Average return on equity	28.3	28.6	22.5	23.8	23.1	14.9
Asset quality						
Bad debts out of total credit – Non-performing loans out of total loans	3.8	3.6	5.6	4.2	3.2	2.9
Provisioning rate	57.1	54.5	40.4	50.7	62.3	58.1
Liquidity						
Credit/deposits ratio	84.7	86.9	82.2	83.1	87.3	88.2
Liquid assets/total assets	32.4	31.3	37.7	39.5	33.5	N/A

* *Average India, Indonesia, the Philippines for 2015.*
N/A: Data not available
Sources: Central Bank of Sri Lanka (CBSL), IMF.

The banking sector appears to be well supervised and the implementation of the Basel III international standards by 2018 is well on track. Banking supervision is exercised by the Central Bank (CBSL), which has been conducting regular macro stress tests and publishing annual reports on the stability of the financial sector since 2004. In April 2015, the Basel III regulations concerning liquidity coverage ratios were adopted by commercial banks, and the ongoing implementation of the capital regulations coincides with the international agenda. There is a regulatory limit on foreign currency borrowing by banks (maximum of 15% of the capital) and their rights to open foreign exchange positions are capped.

Conclusion

Sri Lanka can be regarded as a success in terms of human development, thanks to the sharp decline in poverty and its social progress. In order to maintain and consolidate this social progress, it is necessary to ensure that the pace of economic growth is sustainable. However, the international environment is becoming increasingly competitive for several of the country's traditional export products. It is therefore up to Sri Lanka to support the emergence of new more high-end business sectors that generate productivity gains and skilled jobs, while taking advantage of the dynamism of its geographical environment.

Reducing macroeconomic imbalances, while ensuring the growth of the economy, is a major challenge for the Sri Lankan authorities. One of the main measures is the reform of the tax system, in order to make the tax collection base as broad as possible and limit the scale of the budget deficit. An increased availability of revenues would allow public and social protection spending to be financed. This spending is necessary in order to address the many social challenges facing the country, particularly in terms of national reconstruction and reconciliation.

Finally, the country's medium-term challenge is to increase the number of skilled jobs created in order to limit the departure abroad of qualified young Sri Lankan workers and thereby, in the long term, avoid being subject to the detrimental effects of this brain drain.

Acronyms and abbreviations

AsDB	Asian Development Bank
BOPS	Balance of Payments Statistics (IMF)
CBSL	Central Bank of Sri Lanka
CEPII	Centre for Prospective Studies and International Information, Prime Minister's Office (France)
DSA	Debt Sustainability Analysis
EFF	Extended Fund Facility (IMF)
EMBIG	The J.P. Morgan Emerging Market Bond Index Global
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GSP+	Generalised Scheme of Preferences Plus (European Union)
HDI	Human Development Index
IDA	International Development Association (World Bank Group)
ILO	International Labour Organization (UN)
IMF	International Monetary Fund
IPS	Institute of Policy Studies (Sri Lanka)
LKR	Sri Lankan rupee
LMIC	Lower middle-income country (World Bank)
LTTE	Liberation Tigers of Tamil Eelam
MIC	Middle-income country
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
PPP	Public-private partnership
RBI	Reserve Bank of India (Indian Central Bank)
RMB	Yuan renminbi (Chinese currency)
SAARC	South Asian Association for Regional Cooperation
SBA	Stand-By Arrangement (IMF)
SLDB	Sri Lanka Development Bond
SLFP	Sri Lanka Freedom Party
SOBE	State-Owned Business Enterprises
UMIC	Upper middle-income country (World Bank)
UN	United Nations
UNDP	United Nations Development Programme
UNP	United National Party
USD	United States dollar
VAT	Value Added Tax
WDI	World Development Indicators (World Bank)
WEO	World Economic Outlook

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