

# SRI LANKA DEVELOPMENT UPDATE

## DEMOGRAPHIC CHANGE IN SRI LANKA



February 2019

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## Preface

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

The SLDU was prepared by a team consisting of Fernando Im and Kishan Abeygunawardana (Macroeconomics, Trade and Investment), with inputs from Anoma Kulathunga (Finance, Competitiveness and Innovation), Harsha Aturupane (Education), Thomas Walker (Social Protection and Labor), Mark Dorfman (Social Protection and Labor), Temel Taskin (Macroeconomics, Trade and Investment), Fabian Seiderer (Governance), Rafael Dominguez (IFC) and Juri Oka (Country Management Unit), with overall guidance from Idah Pswarayi-Riddihough (Country Director for Sri Lanka and Maldives), Valerie Layrol (Senior Operations Officer), Tatiana Nenova (Program Leader Equitable Growth, Finance and Institutions), and Manuela Francisco (Practice Manager Macroeconomics, Investment and Trade for the South Asia Region). Dilinika Peiris provided support on the dissemination of the report, and Sashikala Jeyaraj provided support on the report design and formatting of the report. The report was prepared based on published data available on or before January 15, 2019. Data sources included World Bank, International Monetary Fund, Central Bank of Sri Lanka, Ministry of Finance, Department of Census and Statistics, and press reports. For questions, please contact: [infosrilanka@worldbank.org](mailto:infosrilanka@worldbank.org)


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## Executive Summary



*Sri Lanka is facing a challenging macroeconomic landscape. The post-conflict high growth momentum has decelerated. A volatile global environment and structurally weak competitiveness continue to weaken growth and external sector performance. High interest costs mask limited fiscal improvement. While outlook remains stable conditional on political stability and reform implementation, the balance of risks is downward tilted. The country is vulnerable to global financial market conditions due to large refinancing requirements. Although some important reforms were carried out, the process has slowed down due to a challenging political environment.*

### 1. Recent Developments

#### **Recent macroeconomic performance has been mixed**

The year 2018 was a challenging year for Sri Lanka. Growth remained subdued, although there have been signs of a recovery in the first half from the impact of a series of natural calamities in the preceding two years. Inflation stabilized in the mid to low-single digit levels thanks to low food inflation, which compensated for currency depreciation and the fuel price pass-through. However, the deficit in the external current account widened amid a higher import bill, despite improved export performance. While the primary balance in fiscal accounts remained in surplus, the overall fiscal balance was high due to high interest expenditures, which continue to mask the overall fiscal improvement. The exchange rate came under heavy depreciation pressure, reflecting the effect of global financial market conditions, compounded by adverse domestic political developments. International reserves declined from their peak level in April, weakening the ability to deal with economic shocks amid large short-term external liabilities.

#### **Reform implementation is progressing although slower than expected**

The government progressed in its economic reform agenda, albeit at a slow pace, due to a complex political environment and institutional constraints on policy implementation. Nevertheless, a few important milestones were achieved in the last 12 months:

- The new Inland Revenue Law became effective in April 2018, which marks a key step towards sustainable revenue-led fiscal consolidation.
- The National Audit Bill, which strengthens the powers of the Auditor General building on the reforms of the 19<sup>th</sup> Amendment, was passed in July 2018.
- A cost-reflective fuel price formula introduced in May 2018 is expected to reduce fiscal risks from SOEs, particularly from Ceylon Petroleum Corporation.
- An Active Liability Management Act was enacted to deal with heightened external debt refinancing risks in 2019 and beyond.
- A new single web portal for investors called SWIFT was launched to facilitate investments, and a Trade Information Portal went live in July 2018 to provide import and export related information on regulations and processing steps.
- Various additional regulatory simplification in the business environment have been carried out such as the procedures for property registration and construction permits, resulting in a 10-notch jump in the Doing Business ranking of Sri Lanka.
- A new Public Finance Act drafted to strengthen management of public finances was sent to the Cabinet.
- The Secured Transactions Bill, which would help SME finance by allowing movable collateral to be used in banks when borrowing, was approved by the Cabinet.

It is important to consolidate on previous reforms to ensure maximum benefits. Future reforms that could potentially yield high development impact include: (i) further strengthening public finance management, (ii) implementing a medium-term debt management strategy through an independent debt office, (iii) rationalizing remaining para-tariffs with accompanying trade adjustments, (iv) accelerating SOE reforms including energy pricing and; (v) implementing a social registry to improve coverage and targeting of social safety nets.

**A political controversy heightened macroeconomic risks**

On October 26, 2018, Sri Lanka's President appointed a new Prime Minister and prorogued Parliament; that led to a political controversy. Although, the issues were resolved in mid-December, the uncertainty heightened economic challenges and resulted in a worsened perception of the country's risk profile. The country was downgraded by three rating agencies Fitch, Moody's, and S&P.

**Poverty reduction continued to be strong**

Poverty measured using the World Bank's international poverty line of \$3.20 per day (in 2011 PPP) for lower middle-income countries had declined from 15.4 percent in 2013 to 9.7 percent in 2016. The reduction in poverty was accompanied by a decrease in the number of districts with a high incidence of poverty. While the districts with the highest poverty headcount are in the Northern and Eastern provinces, the majority of the poor reside in other parts of the country. High levels of vulnerability and the multidimensional nature of risk factors continue to present significant challenges to the policy makers.

**IMF completed the fourth review of the program**

In June 2018, the International Monetary Fund (IMF) completed the fourth review of the Extended Fund Facility (EFF) program. A mission conducted in September made significant progress toward reaching a staff-level agreement with the government on the fifth review. However, in with the political uncertainty IMF was unable to conclude the discussions, which restarted in December 2018.

## 2. Outlook, risks and policy priorities

### **Sri Lanka is in a challenging macroeconomic position**

The global environment remains turbulent. Gradually tightening financial market conditions are exerting pressure, as Sri Lanka is preparing to rollover its maturing debt, which will be at a historical high between 2019-2023. Large refinancing requirements and exposure to foreign currency risk elevate Sri Lanka's vulnerability to exchange rate depreciation and rollover-related risks. Macroeconomic and political stability impact country risk and investor confidence, and commitment to implement reforms can mitigate some of these risks and help secure a more stable outlook. If successfully completed, the IMF program should help build confidence among investors and enhance economic resilience for the medium to long-term.

The economy is expected to rebound from a low base and move towards 4.0 percent in the medium-term, driven by domestic demand. Inflation will stabilize around mid-single digit level, although pass-through of currency depreciation and fuel prices would exert upward pressure. Primary surplus supported by the implementation of revenue measures will contribute to narrow the overall fiscal deficit to 4.7 percent of GDP by 2021. Continued fiscal consolidation, albeit slow, is projected to bring the public debt burden to a downward path at 79.2 percent of GDP by 2021. External current account deficit is projected around 2.4 percent of GDP between 2019-2021 as tourism receipts cushion sluggish remittance flows and high external interest payments. Foreign capital inflows to government securities and FDI inflows are expected to help closing the external financing. Reserve adequacy metrics will continue to be low as Sri Lanka raises funds mainly for refinancing Eurobonds.

### **Risk balance is tilted towards downside; the key one being the domestic political risk**

The challenging political environment has already slowed the reform agenda and remains the key risk to a favorable medium-term outlook. On the fiscal and debt management front, risks include the delay or reversals in implementing revenue measures, slower than expected improvement in tax administration, increases in non-discretionary spending, and delays in implementing the liability management operations. The increasing occurrence and impact of natural disasters could have an adverse impact on growth, the government budget, the external sector and poverty reduction.

External risks include disappointing growth in key countries that generate foreign exchange inflows to Sri Lanka: exports, tourism, remittances, FDI, and other financing flows. Tighter than expected global financial conditions would increase the cost of debt and make rolling over the maturing Eurobonds more difficult. Faster than expected rises in commodity prices would increase pressure on the balance of payments and could make further price reforms such as energy more difficult.

### **Tackling challenges through reforms is crucial for sustained and equitable growth**

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

1. staying on the fiscal consolidation path and creating fiscal space for health, education, social protection, public investments in infrastructure and others;
2. improving Sri Lanka's competitiveness and promoting trade and FDI to facilitate a shift in the growth model driven more by private investment and exports;
3. making progress on and completing the already started governance reforms such as Right to Information, the Audit Act and the Public Finance Act and SOE reforms; and
4. reducing vulnerability and risks in the economy: (a) managing refinancing risks of Eurobonds; (b) improving the debt management function with requisite institutional, legal and strategy frameworks; (c) mitigating the impact of reforms on the poor by replacing untargeted effective subsidies to the non-poor by

targeted spending; and (d) enhancing the country's resilience and disaster preparedness to deal with frequent natural disasters more pro-actively.

### 3. Special focus

#### Ageing population is expected to impact macroeconomic performance

The Special Focus section looks at the state of the demographic transition in Sri Lanka. Sri Lanka is undergoing a gradual aging process of its population, and compared to peers, it has reached an advanced stage of this demographic transition. These changes (household composition, size and age) are expected to have long-lasting implications for service delivery (health and education), pensions, employment, and public finances that should be taken into account on policy planning.

Because of this process, Sri Lanka's share of working-age population peaked in 2005 and it is expected to gradually decline over time. Despite falling fertility rates, the large gap in labor force participation rates between men and women has remained mostly unchanged.

Demographic factors are also expected to slow down growth in the medium-term. Closing the gender gap in labor force participation would buffer the impact coming through the reduction in the number of workers and could mitigate the impact of demographics on growth. Policies that foster women's entry to labor markets are important. Increases in education attainment can also lift productivity and participation rates of younger cohorts, in addition to labor reallocation towards more productive sectors that lead to productivity gains and hence higher growth.

#### Box 1: Sri Lanka: country context

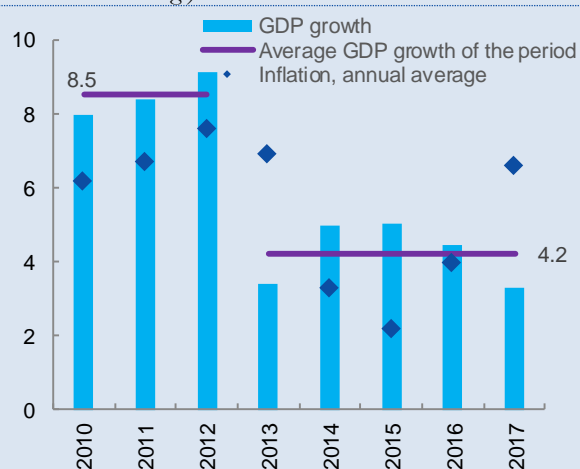
Sri Lanka is a lower middle-income country with a GDP per capita of USD 4,073 (2017) and a total population of 21.4 million people. Following 30 years of civil war that ended in 2009, Sri Lanka's economy grew at an average 5.8 percent during the period of 2010-2017, reflecting a peace dividend and a determined policy thrust towards reconstruction and growth; although there were some signs of a slowdown in the last few years. The economy is transitioning from a predominantly rural-based economy towards a more urbanized economy oriented around manufacturing and services.

The country has made significant progress in its socio-economic and human development indicators. Social indicators rank among the highest in South Asia and compare favorably with those in middle-income countries. Economic growth has translated into shared prosperity with the national poverty headcount ratio declining from 15.3 percent in 2006/07 to 4.1 percent in 2016. Extreme poverty is rare and concentrated in some geographical pockets; however, a relatively large share of the population subsists on slightly more than the poverty line. The country was ranked 76<sup>th</sup> in the Human Development Index in 2018.

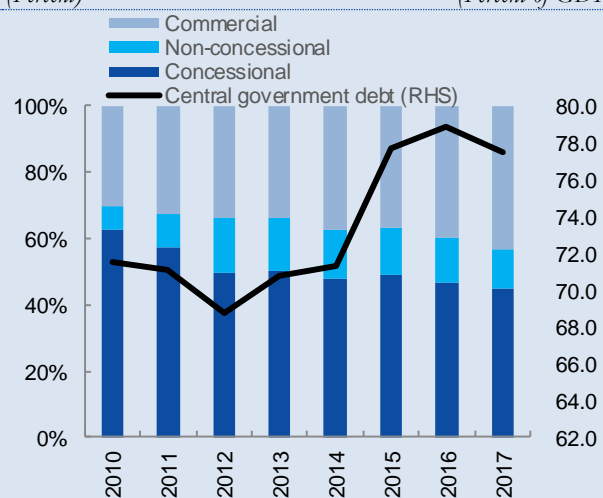
The economy's weak competitiveness is an issue to address. Restrictive trade policies over the past decade have created a strong anti-export bias, which has been reflected in a dramatic decline in trade. While growth in Sri Lanka has been strong over the past few years, it has been inward-oriented and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

Low revenues and high debt as a share of GDP are key macroeconomic concerns. The major causes of low revenues as a share of GDP are: the low number of tax payers (less than 7 percent of the labor force and formal establishments pay income tax); reductions in statutory rates without commensurate efforts to expand the tax base; and inefficiencies in administration and numerous exemptions. Low revenues combined with largely non-discretionary expenditure in salary bill, transfers, and interest payments have constrained critical development spending and squeezed expenditure on health, education and social protection, which is low compared to peers. The debt levels are high, and the overall debt portfolio also points to some important risks.

Sri Lanka has been on a 3-year Extended Fund Facility (EFF) program with the IMF since 2016, which is primarily focused on increasing revenues. The program calls for fiscal consolidation, transition to flexible inflation targeting, and reforms in the areas of public financial management, state enterprises and trade and competitiveness.

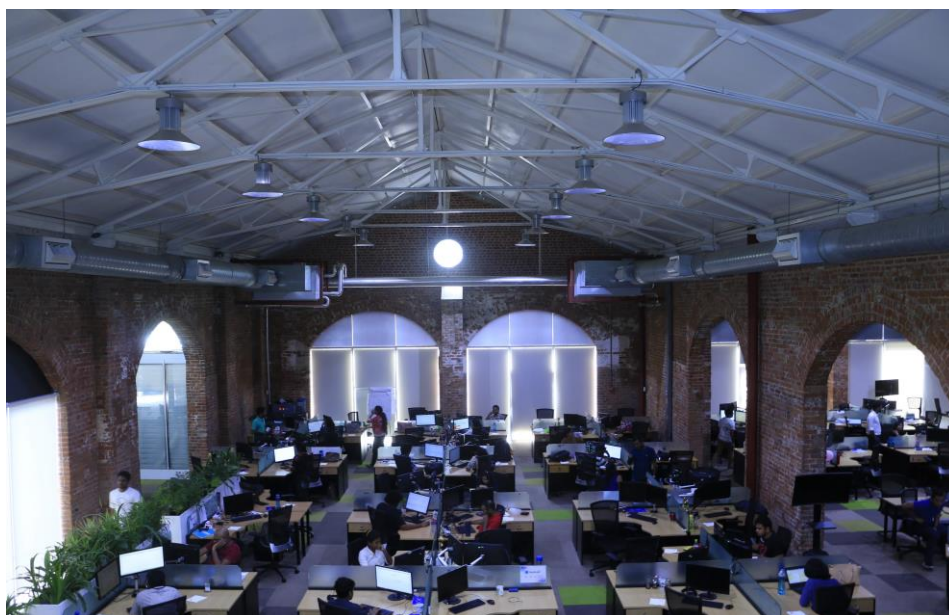
**Figure 1: Growth and inflation***(Percent annual change)*

Source: Department of Census and Statistics and staff calculations

**Figure 2: Change in external debt composition***(Percent)**(Percent of GDP)*

Source: Central Bank of Sri Lanka

## A. Recent Developments



### *Growth performance remains subdued.*

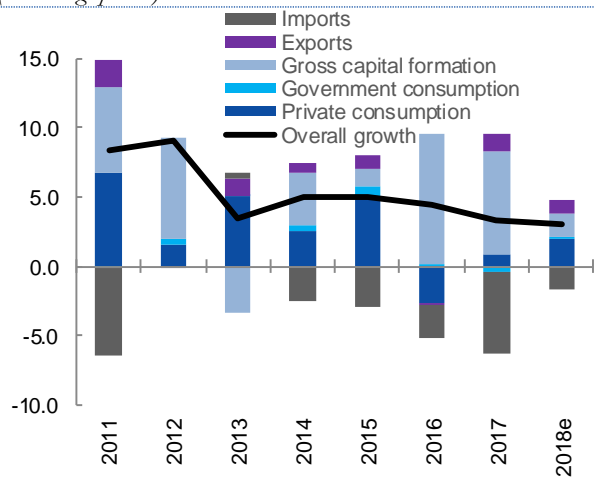
#### **Industry sector was a drag on growth from production side**

Growth for 2018 is expected to decline further to 3.1 percent, below the 3.3 percent recorded in the year 2017. Agriculture rebounded with a positive contribution to growth thanks to relatively benign weather - after a series of natural calamities in the preceding two years. A deceleration in construction and subdued performance of the mining and quarrying sub-sector lowered the overall growth of the industry sector. Services sector's expansion was not adequate to compensate for the drag from key industry sectors. As a result, overall growth performance remained weak. (Figure 3).

#### **Private consumption is expected to have driven growth from expenditure side**

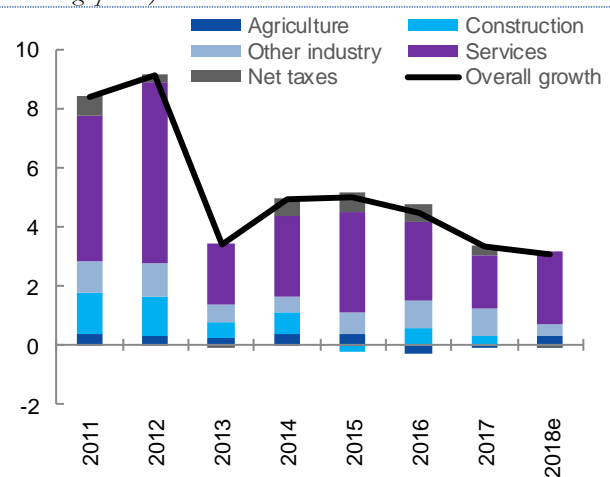
From the expenditure side, private consumption is expected to have driven the growth while government consumption remained muted with tight control over the wage bill and purchase of goods and services in 2018. Investment demand reflected by the contribution to growth from gross capital formation is estimated to be high thanks to some key projects driven by FDI progressing well. Exports contributed positively to growth with strong performance from garments and tourism. This was offset by increased imports in motor vehicles, petroleum products and gold, resulting in net exports contributing negatively to overall growth (Figure 4).

**Figure 3: Contributors to growth (expenditure side)**  
(Percentage points)



Source: Department of Census and Statistics and staff calculations

**Figure 4: Contributors to growth (production side)**  
(Percentage points)



Source: Department of Census and Statistics and staff calculations

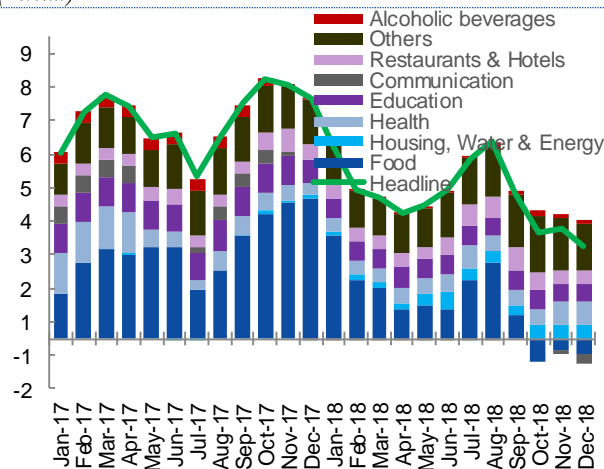
### *Annual average inflation has eased with improved agricultural output.*

**Inflation remains low** Year-on-year inflation measured by the Colombo Consumer Price Index (2013=100) was 2.8 percent in December 2018, which was substantially low compared to 7.1 percent in December 2017. This reduction was mainly driven by lower food prices compared to those in the drought-affected 2017. Lower food prices were also able to compensate for the inflationary impact of currency depreciation as well as the pass-through of high international fuel prices. Following the trend of year-on-year inflation, annual average inflation declined to 4.3 percent in 2018 compared to 6.6 percent in 2017. Core inflation (computed excluding food and energy prices) also decreased amid decelerating growth of monetary aggregates (Figure 5 and 6).

### **The national price index echoed the same trends**

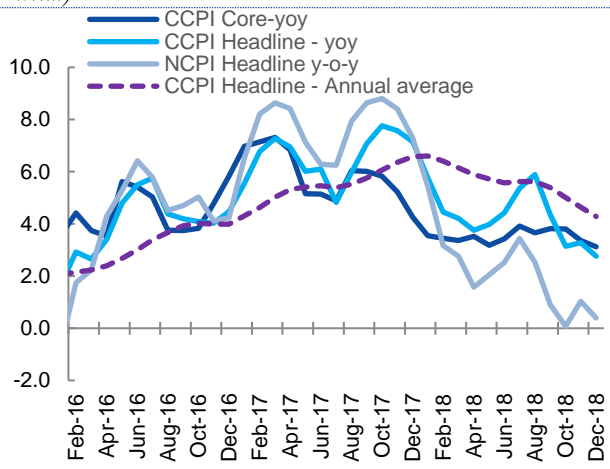
The National Consumer Price Index (NCPI, 2013=100) that reflects price movements of all provinces in the country based on the Household Income and Expenditure Survey (HIES) also reported a similar trend (Figure 6).

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



Source: Department of Census and Statistics and staff calculations

**Figure 6: Inflation movements**  
(Percent)



Source: Department of Census and Statistics and staff calculations

### *Monetary policy broadly remained tight.*

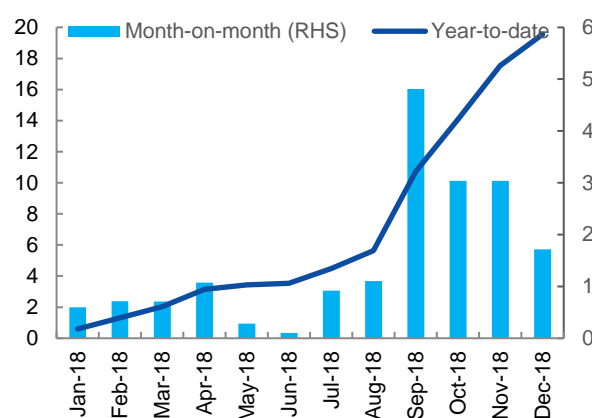
#### **The growth of monetary aggregates decelerated**

The Central Bank reduced the upper band of the policy rate corridor by 25 basis points in April 2018, citing the favorable inflation outlook and lower than expected real GDP growth. Despite the rate reduction, interest rates edged up and broadly remained high in the second half of 2018 as market liquidity indicated a persistent deficit. To release liquidity on a permanent basis, the Central Bank reduced the Statutory Reserve Ratio (SRR) applicable on all rupee deposits of commercial banks by 1.5 percentage points. At the same time, in order to maintain its neutral monetary policy stance, the Central Bank raised policy interest rates: Standing Deposit Facility Rate (SDFR) by 75 basis points to 8.0 percent and the Standing Lending Facility Rate (SLFR) by 50 basis points to 9.0 percent, thereby narrowing the policy rate corridor to 100 basis points. As a result of the relatively tight policy regime, the growth in monetary aggregates showed a gradual deceleration (Figure 8).

#### **Groundwork for inflation targeting continued**

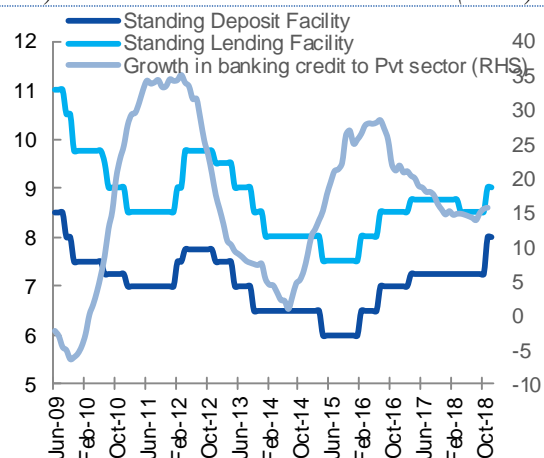
The Central Bank continued to work on the legal framework needed for a flexible inflation targeting regime. Implementation of such a framework will require the Central Bank's commitment to provide more flexibility for the exchange rate, which in return would help the country to improve its competitiveness and act as a first line of defense for external volatility. The Cabinet approval for the amendments to the existing Monetary Law Act to strengthen the CBSL's mandate, decision-making structures, autonomy, accountability, transparency, and instruments for implementing flexible inflation targeting has been a structural benchmark under the IMF program.

**Figure 7: Exchange rate depreciation (Sri Lanka)**  
(Percent)



Source: Central Bank of Sri Lanka, staff calculations.

**Figure 8: Policy rates and private credit growth**  
(Percent)



Source: Central Bank of Sri Lanka, staff calculations.

### *External sector was facing challenging times.*

#### **The current account deficit widened because of a higher import bill**

The deficit in the trade account widened as the growth in imports outpaced the growth in exports. Oil prices, which remained high in 2018, and increased imports of vehicles were the main causes behind the growth in imports bill. Industrial exports, textiles in particular, contributed to the growth in exports in the backdrop of reinstated Generalized System of Preference Plus (GSP+) from the European Union. However, subdued performance of agriculture both on volume and price was a drag on exports growth. Although earnings from tourism continued to grow fast, worker remittances remained almost flat.<sup>1</sup> Increased dividend and interest outflows also

<sup>1</sup> Tourism receipts grew by 12.5 percent, year-on-year, in the first 11 months of 2018 while remittances recorded a 0.9 percent decline during the same period.

exerted pressure on the current account. Reflecting these developments, the current account deficit is expected to have widened to 2.9 percent of GDP in 2018, up from 2.6 reported in 2017.

**Debt-creating flows dominated the financial account**

Although FDI is expected to have reached an all-time high at about USD 2.0 billion in 2018<sup>2</sup>, driven by proceeds coming from both the long lease of the Hambantota port and the Colombo Port City project; loan receipts and portfolio receipts continued to be the main sources of financing in the financial account. While the government securities market experienced significantly large outflows, issuance of sovereign bonds worth of USD 2.5 billion,<sup>3</sup> receipts of approximately USD 1.2 billion (estimate) in project loans and foreign currency term financing of USD 1.0 billion were the key inflows to the financial account in 2018.

**Currency came under depreciation pressure**

Tightening international financial market conditions, reflected in net capital outflows from the government securities market and the Colombo Stock Exchange exerted pressure on the Sri Lankan rupee. The repayment of a Eurobond by the National Savings Bank (a state deposit taking bank) and other debt repayments also contributed to elevated currency pressures. Despite the Central Bank's intervention in the foreign exchange market – mainly aimed at an orderly adjustment, the currency depreciated by 19.6 percent by end-December 2018 from a year earlier.<sup>4</sup> The nominal depreciation contributed to reversal in the real appreciation of the currency (Figure 7, 9 and 12).

**Government imposed restrictions on outflows**

With a view to minimizing the impact of currency depreciation, the government imposed temporary measures to control foreign exchange outflows. These include: (a) cash margin on letters of credit on imports - a 200 percent margin on vehicles other than buses, lorries and ambulances and a 100 percent margin on consumer durables such as refrigerators, air-conditioners, televisions, mobile devices and washing machines; (b) suspension of permits issued to parliamentarians and state officials to import vehicles at concessionary duty rates; (c) reduction of the Loan to Value Ratio (LTV) for Hybrid vehicles from 70:30 to 50:50; (d) suspension of vehicle imports for government entities; and (e) cutting the net open positions of commercial banks to increase dollar liquidity.

**Political controversy in the last quarter of 2018 affected external sector performance.**

Credit rating agencies (Fitch, S&P and Moody's) cut Sri Lanka's sovereign rating by one notch within a space of 15 days while the political turmoil was going on in the last quarter of 2018.<sup>5</sup> Sri Lanka's bonds spreads - measured in Emerging Market Bond Index – rose significantly in the last three months of 2018 (Figure 10).<sup>6</sup> Moreover, the LKR came under elevated depreciation pressures vis-à-vis emerging market economies during this period. In fact, Sri Lanka experienced limited currency pressures compared to its peers after the completion of the fourth review of the IMF program in June until the National Savings Bank repaid its Eurobond of USD 750 million in the month of September. However, while the emerging market currencies were recovering against the USD from late October to end December, the LKR

<sup>2</sup> Equivalent to 2.2 percent of GDP.

<sup>3</sup> Sri Lanka issued its twelfth sovereign bond worth USD 2.5 billion in two tranches of 1.25 each with maturities of 5-years (coupon at 5.75 percent) and 10-years (coupon at 6.75 percent) in April. The issuance rated 'B1', 'B+' and 'B+' by Moody's Investors Service, Standard and Poor's and Fitch attracted bids over USD 6.5 billion together. The proceeds of the issuance increased the country's foreign reserves to USD 9.9 billion, its highest level in the history.

<sup>4</sup> Between September and December 2018, the Central Bank sold USD 1.2 billion in the forex market in net terms.

<sup>5</sup> The downgraded sovereign rating, which now stands at B (stable) for Fitch and S&P, and B2 (stable) for Moody's is expected to increase borrowing cost and make refinancing more expensive when Sri Lanka approaches international markets in 2019.

<sup>6</sup> Although relatively weak liquidity condition generally makes Sri Lanka's ISBs vulnerable to swings in the yield rates, a substantial rise in the secondary market yields was seen just after the beginning of the crisis.

continued to depreciate, a possible reflection of the negative market sentiments. Approximately USD 500 million flew out of the government securities market and the Colombo Stock Exchange during the political controversy. The Central Bank's attempt to force an orderly adjustment of the exchange rate resulted in a deterioration of external buffers.

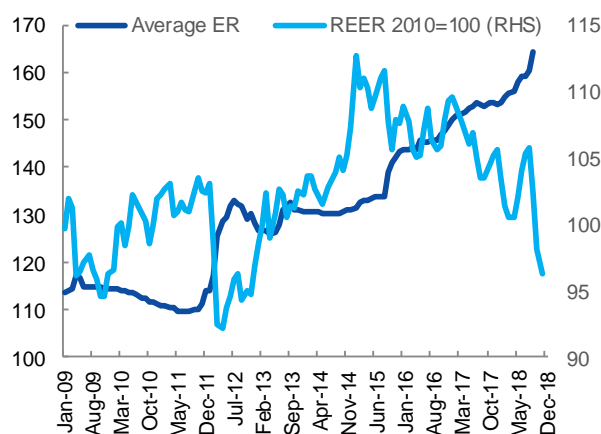
### Reserves remain low in relation to short-term liabilities

Keeping with the foreign exchange movements in capital outflows, debt repayment and market intervention, gross official reserves decreased to USD 6.9 billion in December from an all-time-high of USD 9.9 billion achieved in April 2018. Overall, reserve adequacy metrics remained relatively weak with a major share of reserves representing borrowed funds. Moreover, foreign exchange obligations for the 12 months starting from November 2018 are estimated at USD 6.6 billion (including two Eurobonds of USD 1.0 billion maturing in January 2019 and USD 500 million in April), reflecting substantial short-term debt service burden (Figure 11).<sup>7</sup>

### Government is preparing for large repayments

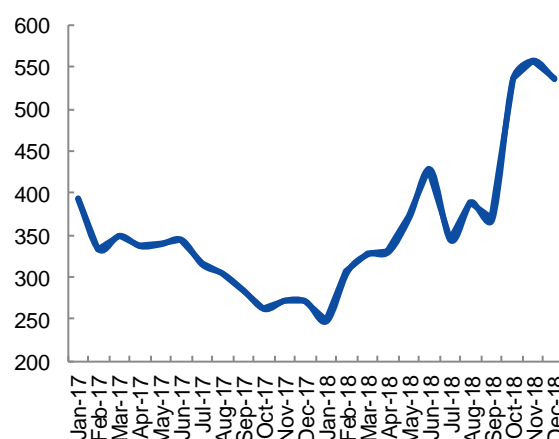
Government announced several measures to deal with historically high debt repayments falling in 2019. These include raising: (a) USD 2.0 billion from financial markets; (b) a SWAP facility for USD 400 million with the Reserve Bank of India, approved in January 2019— another SWAP of USD 1.0 billion was being negotiated; (c) an enhancement facility of USD 500 million agreed with the China Development Bank for February 2019; (d) USD 1.25 billion from/through state banks; and (e) USD 300 million from Bank of China with further negotiations to increase it to USD 1.0 billion. Most of the measures are expected to be implemented in the 1Q 2019, according to the government.

**Figure 9: Nominal Exchange Rate and Real Effective Exchange Rate**  
(2010=100) (LKR per USD)



Source: Central Bank of Sri Lanka, staff calculations.  
Note: Real Effective Exchange Rate relative to a basket of 24 currencies. Downward movement is nominal/real depreciation.

**Figure 10: EMBI spreads**  
(Basis points)



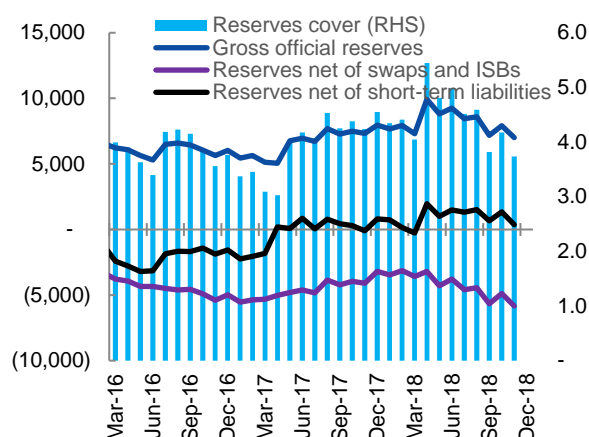
Source: Bank of International Settlement, Central Bank of Sri Lanka, staff calculations.

<sup>7</sup> USD 700 million of these liabilities represent swap arrangements with domestic banks.

**Figure 11: Reserve adequacy metrics**

(USD million)

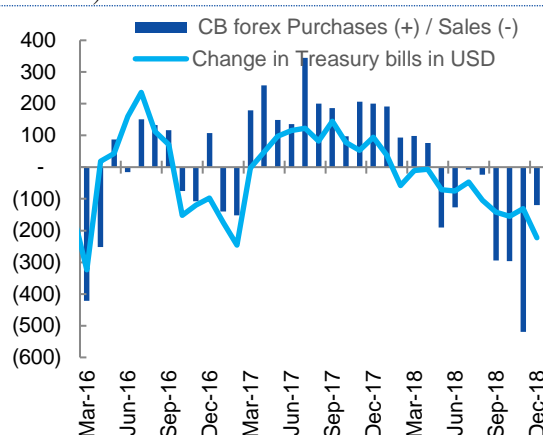
(Months of merchandise imports)



Source: Central Bank of Sri Lanka, staff calculations.

**Figure 12: Net foreign flows in the government securities market and the CBSL intervention**

(USD million)



Source: Central Bank of Sri Lanka, staff calculations.

***Managing fiscal risks is a key macroeconomic priority.*****Interest cost continues to be a strain on fiscal accounts.**

A primary surplus of 0.8 percent of GDP is expected for 2018, after recording a small primary surplus in 2017 that came as a first in decades. The improvement was due to a combination of increasing tax revenues and tight expenditure control. Tax revenue is expected to have increased to 13.2 percent of GDP<sup>8</sup> thanks to increased collection of motor vehicle excise tax amid a sharp rise in motor vehicle imports in the first half of 2018 and increased income tax collection thanks to the implementation of new Inland Revenue Act. Nevertheless, the reduction in duty rates on petrol, diesel and milk powder is expected to have caused a reduction in import duty. On the expenditure front, despite the increase in spending related to natural disasters, tight control is expected to have reduced non-interest current expenditures as a share of GDP.<sup>9</sup> A lower capital budget execution ratio resulted in a lower than budgeted public investment level.<sup>10</sup> These factors collectively contributed to the improvement of the primary balance. However, a sharp increase in interest expenditure<sup>11</sup> is expected to have partly masked this improvement as the overall deficit in 2018 is expected come out at 5.2 percent of GDP compared to 5.5 percent in the previous year (Figure 13 and 14).

**Fiscal risks remain high emanating from central government and SOE debt**

The central government debt to GDP ratio is expected to have increased to 83.0 percent by end-2018 due to the impact of currency depreciation and high real interest rates. Moreover, SOE debt (with or without guarantees from the Treasury), which is not included in the central government debt continues to remain high.<sup>12</sup> The debt guaranteed by the Treasury for SOEs highlights heightened risks as guarantees given to SOEs who do not have stable revenue streams have increased fast in recent years. While the implementation of cost-reflective pricing of fuel is an important step to reduce the debt burden, further reforms are needed to reduce fiscal risks of SOEs. (Figure 16, 19 and Box 2).

<sup>8</sup> A 0.6 percentage point increase over the previous year

<sup>9</sup> Non-interest current expenditures are expected to be reduced by 0.1 percentage points during the same period.

<sup>10</sup> Public investment is expected to remain flat.

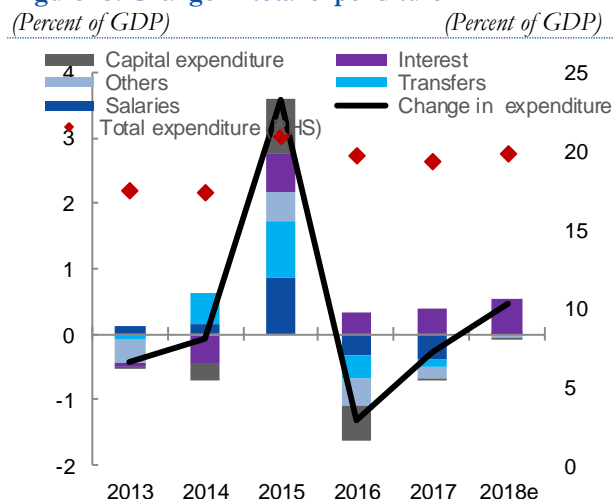
<sup>11</sup> As a share of GDP, interest rose from 5.1 percent in 2016 to of 5.5 percent in 2017 and is expected to have reached 6.0 percent of GDP in 2018.

<sup>12</sup> Debt of 06 large SOEs amounted to 7.1 percent of GDP by end 2017 and is expected to be around the same value for 2018 as well.

### Building on the new inland revenue law is important for continued fiscal improvement

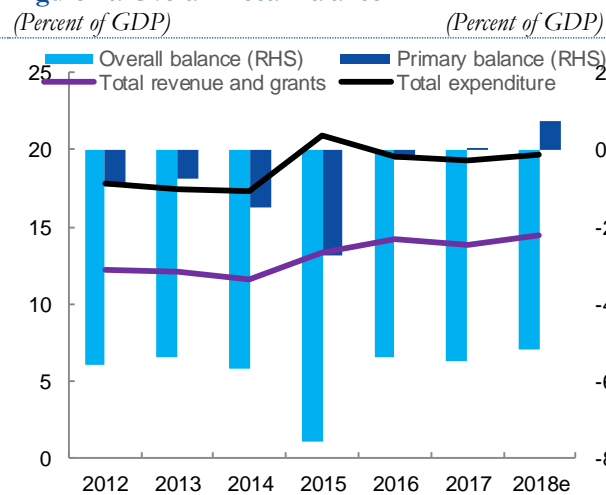
The new Inland Revenue Act that came into effect on April 1 of 2018 aims to broaden the tax base by removing excessive tax exemptions; rationalize corporate tax incentives through an investment-oriented regime; simplify the tax system; and strengthen powers of the tax administrator. If well implemented, the new law would serve as the foundation for sustained revenue-led fiscal consolidation over the medium-term. Proposed revisions to the law such as reducing rates, revising thresholds and introducing new exemptions could result in lower revenue collection and negatively impact policy consistency and intended simplicity of the system if not carefully evaluated.<sup>13</sup> Moreover, the law should now be supported by reform implementation to improve tax administration.

**Figure 13: Change in total expenditure**



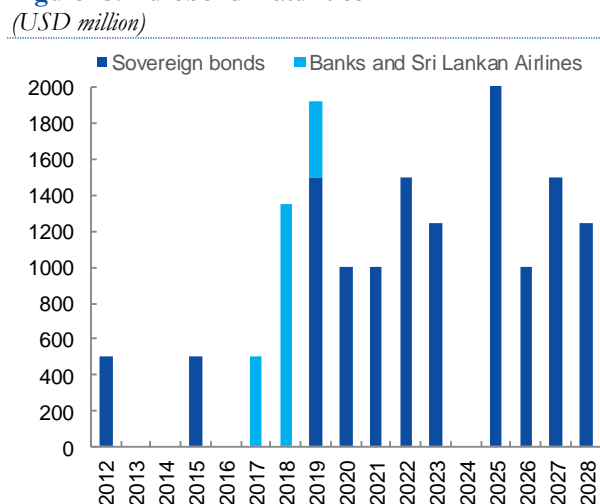
Source: Ministry of Finance, staff calculations

**Figure 14: Overall Fiscal Balance**



Source: Ministry of Finance, staff calculations

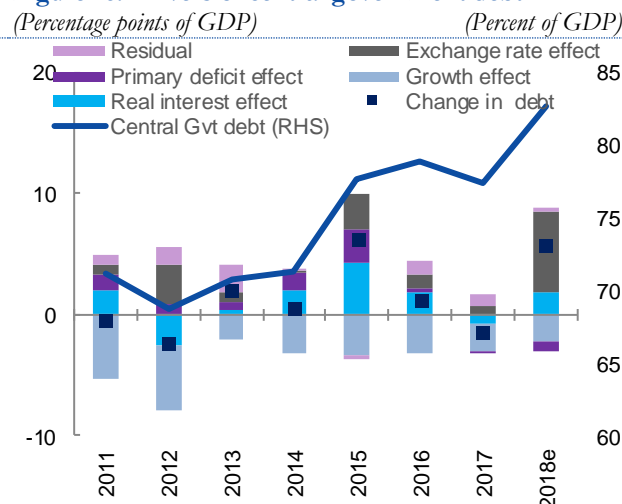
**Figure 15: Eurobond maturities**



Source: Ministry of Finance, annual reports staff calculations

Note: SLA is Sri Lankan Airlines

**Figure 16: Drivers of central government debt**



Source: Ministry of Finance, staff calculations

### Liability Management Act will provide some flexibility, but more

The Active Liability Management Act (ALMA) enacted in 2018 is intended to provide the legal framework for active liability management operations. The Act allows raising new debt of an amount up to 10 percent of the total outstanding debt beyond maturing debt within the year. The funds raised can be used to buy back debt maturing

<sup>13</sup> <https://www.news.lk/cabinet-decusions/item/23661-decisions-taken-by-the-cabinet-of-ministers-at-its-meeting-held-on-07-01-2019>  
<http://www.treasury.gov.lk/documents/10181/50545/23112018+E+Five+tax+exemption/5bcf77c4-5028-42ac-b4fb-b3ce8b5b1f0d?version=1.0>

## needs to be done to improve debt management

in future years. If operationalized quickly, liability management activities could help manage refinancing risks. An allocation of LKR 310 billion was approved in October 2018 for such operations. While enacting the ALMA is a key measure towards managing an immediate risk, many other important reforms are essential for improving the debt management function given the present risks in the debt portfolio (Figure 15 and Box 2).

### Box 2: Debt management

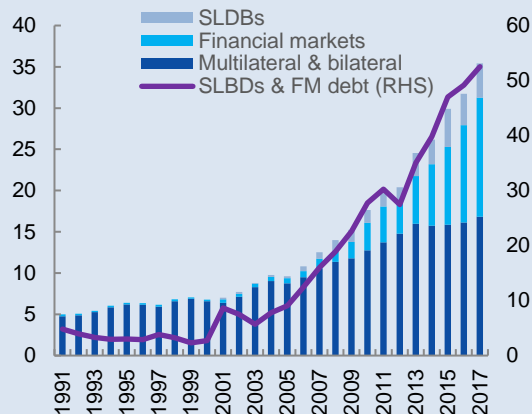
**Debt portfolio carries significant risks.** Sri Lanka's central government debt level (estimated at 83.0 percent of GDP, 2018) is high and the debt portfolio has deteriorated in several indicators in the recent past. The central governments' foreign-currency denominated external debt is estimated at 51.3 percent of its total debt, and the total debt service was estimated at 88 percent of revenue in 2018. Sri Lanka's gross financing needs are large relative to other emerging economies (IMF 2018).<sup>14</sup> Moreover, as the country approaches upper middle-income country status, it has been borrowing on more commercial terms with increased cost and risk. As a result, the interest rate risk on foreign currency debt has risen with the share of floating-rate debt in the total outstanding debt rising. The average time to maturity (ATM) has declined while average interest rates have increased. Moreover, adequacy of reserve cover of foreign currency commercial debt has deteriorated (Figure 20).

**The rise of foreign currency denominated commercial debt has been a key driver of the deterioration of portfolio.** International Sovereign Bonds (ISBs) issued outside the country and Sri Lanka Development Bonds (SLDBs) issued within the country – both denominated in US Dollars – have become key foreign currency mobilizing instruments. The significance of these financial market borrowings increased from 3 percent in 2000 to 53 percent in 2017 in the total foreign currency denominated debt. Sri Lanka issued ISBs every year except in 2008 and 2013, after raising its first ISB in 2007. These ISBs carry higher interest rates and lower maturities (5-10 years) compared to the terms offered by multilateral and bilateral sources. Similarly, the extensive use of SLDBs which have relatively low maturities such as 2-3 years contributed to a reduction in the ATM and an increase in average interest cost. With a significant proportion subject to floating rates, SLDBs adversely impact interest rate risk as well (Figure 17 and 18).

**Figure 17: Foreign currency denominated debt**

(USD billion)

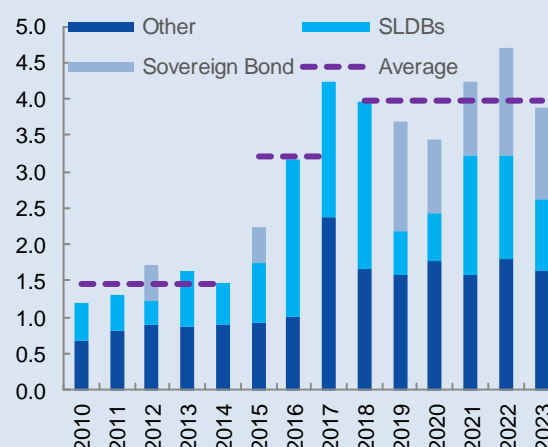
(Percent of total fx debt)



Source: Central Bank of Sri Lanka and staff estimates

**Figure 18: Foreign currency denominated repayments**

(USD billion)



Source: Central Bank of Sri Lanka and staff estimates

**Large repayments at a time of tight global financial conditions elevate the refinancing risks.** The country is expected to make its first-ever bullet repayment of USD 1.0 billion in January 2019 followed by another bullet repayment in April (USD 500 million) on Eurobonds. In total, maturities of bullet repayments on Eurobonds from 2019 to 2023 and from 2025 to 2028 alone amount to USD 12.15 billion. Given that large bullet repayments of more than USD 500 million are new to Sri Lanka, these repayments could expose the country to refinancing risk and could lead to higher spreads on Sri Lankan debt compared to benchmarks. Similarly, partial rollovers of the bonds would lead to loss of reserves and exchange rate pressures. Moreover, the foreign currency requirements are exacerbated by external repayments of project loans and foreign currency term-financing facilities, and domestic repayments of Sri Lanka Development Bonds, which are denominated in dollars.

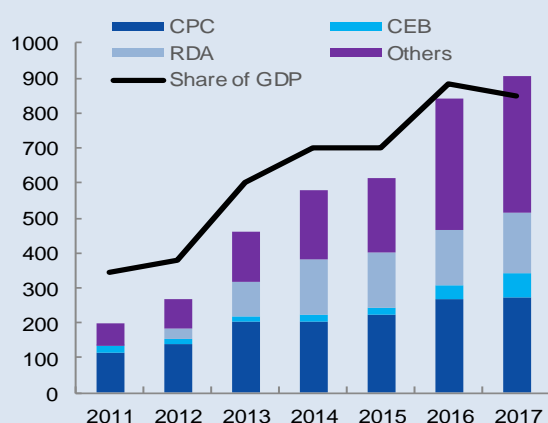
<sup>14</sup> <https://www.imf.org/en/Publications/CR/Issues/2018/06/19/Sri-Lanka-2018-Article-IV-Consultation-and-the-Fourth-Review-Under-the-Extended-Arrangement-45997>

**SOE debt is a key fiscal risk.** Based on available data, by end 2017, total debt of six large SOEs/entities<sup>15</sup> (excluding the financial institutions) was equivalent to 7.1 percent of GDP. While SOE financial institutions borrow both locally and overseas based on the strength of their respective balance sheets, non-financial SOEs receive financing predominantly from the domestic banking sector. To facilitate SOE borrowings, the Treasury issues guarantees and letters of comfort on a case-by-case basis. In the recent years, the treasury guaranteed debt rose fast, and remained high at 6.7 percent of GDP at end-2017. Moreover, the composition of guarantees has changed over time, with the share of guarantees given to commercially oriented state-owned business enterprises with revenue capacity declining from 90 percent in 2006 to 40 percent in 2017 while guarantees given to state establishments, primarily dependent on the state budget for expenditures have risen. Since the latter receive current and capital transfers to service this guaranteed debt, the government is effectively servicing this debt. On a similar note, letters of comfort issued by the Treasury have also increased in the past few years; as of end 2017, the total value of letters of comfort amounted to 0.7 percent of GDP (Figure 19).

**Figure 19: Trends in the guarantee composition**

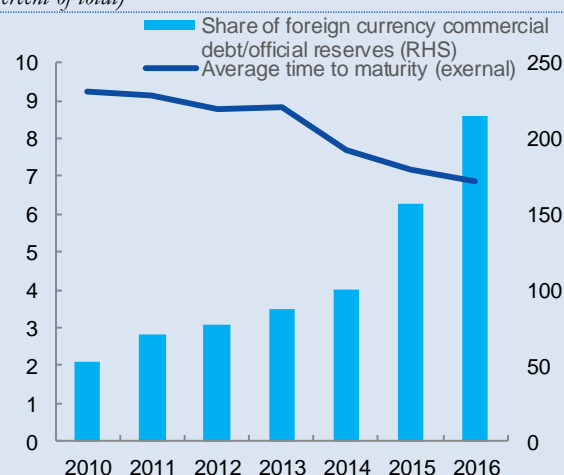
(LKR billion)

(Percent of GDP)



**Figure 20: External debt indicators**

(Percent of total)



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

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

**Sri Lanka's debt management has not evolved sufficiently for many decades to deal with emerging challenges.**

Costs and risks of the portfolio have been evolving along with market access, market development, use of new instruments and increased vulnerabilities in the global environment. However, the country's debt management function and structures have not kept pace with these new challenges. In general terms, the debt management lacks a holistic view, which covers all related functions from planning to risk management, in the absence of a dedicated unified institutional framework. Together, the fragmented institutional framework and lack of a comprehensive debt management strategy leads to important risks being not addressed. While limits on borrowing are determined by the annual Appropriation Act and the Liability Management Act, the decades-old legal framework falls short in providing a comprehensive framework for modern debt management. The Private Public Partnership (PPP) agenda may move the direct fiscal cost of investment to the private sector but may require the public sector to assume more fiscal risk, which will have implications on debt management. The context does not compare well with Sri Lanka's middle-income peers who have improved legal, institutional and operational frameworks along the lines of evolving costs and risks.

**The government has taken some important steps to deal with the refinancing risks; however, the progress of other key structural reforms on debt management has been slow.** To face the refinancing risks of maturing Eurobonds in 2019 and beyond, the government enacted the Active Liability Management Act and formulated a strategy. While these are important measures to mitigate a key risk of the portfolio, other reforms need to progress. An integrated risk management approach is needed for debt and contingent liabilities in relation to the central government, SOEs, PPPs and natural disasters. The establishment of a unified debt management office is an important step in this direction although it has experienced significant delays. A comprehensive Medium-Term Debt Strategy (MTDS) – covering both external and domestic debt – is needed to provide guidance to manage the costs and risks of the portfolio.

**In addition to managing costs and risks of the portfolio, improvements in debt management will help develop the domestic financial market and improve access to finance.** Managing liabilities actively will mitigate refinancing risks, contribute to improved investor perceptions and possible upgrading of credit ratings. Improved debt management

<sup>15</sup> Ceylon Petroleum Corporation, Ceylon Electricity Board, National Water Supply and Drainage Board, Sri Lankan Airlines, Sri Lanka Ports Authority and Road Development Authority.

will also lead to deeper, more liquid domestic debt markets that support private capital market development. Less fiscal pressure on financial markets will reduce market interest rates and thereby the cost of financing for households and firms. Together with the expected presentation of the Secured Transactions Registry Act, which will allow firms to pledge movable collateral for loans, this would support access to finance on reasonable terms for the struggling SME sector. Improvement in SOE governance may reduce fiscal pressures and improve service delivery.

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***Financial sector remained broadly stable; however, important challenges are ahead.***

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**Financial sector reported a mix bag**

The banking sector remained adequately capitalized and liquid. The regulatory Capital Adequacy Ratio (CAR) requirement under Basel II was maintained well above the required level of 10 percent and the Statutory Liquid Asset Ratio was also maintained well above the minimum statutory requirement of 20 percent. However, the asset quality saw an impairment with the NPL ratio rising gradually, as the credit growth decelerates - responding to a relatively a tight monetary policy. Profitability indicators also marginally deteriorated due to moderate economic growth and rising NPLs. Although the sector remains well-capitalized, implementation of Basel III will require the banks to strive hard to increase the capital base as required by the Central Bank. Moreover, increasing leverage, shown by the strong increase in credit relative to the size of the sector, such as in construction, tourism and financial business, warrants attention. In the Non-Bank Financial Sector, similar to the trend observed in the banking sector, headline indicators such as capital and liquidity of the remained at satisfactory levels while asset quality and profits witnessed a deterioration. This sector requires consolidation with certain finance companies undergoing financial difficulties.

**Listed equity market declined**

Listed equity indices of the Colombo Stock Exchange (CSE) declined in the second half of 2018 after showing a modest uptick in the first half. For the year 2018, the benchmark All Share Price Index (ASI) declined by 5.0 percent, reflecting adverse macroeconomic sentiments amid capital outflows from emerging markets and the domestic political turmoil in the last quarter. Low market capitalization (around 20 percent of GDP) and liquidity levels highlight the need to develop the domestic capital market to supplement the domestic capital formation process.

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***Despite the fast poverty reduction, there remain areas with significant poverty.***

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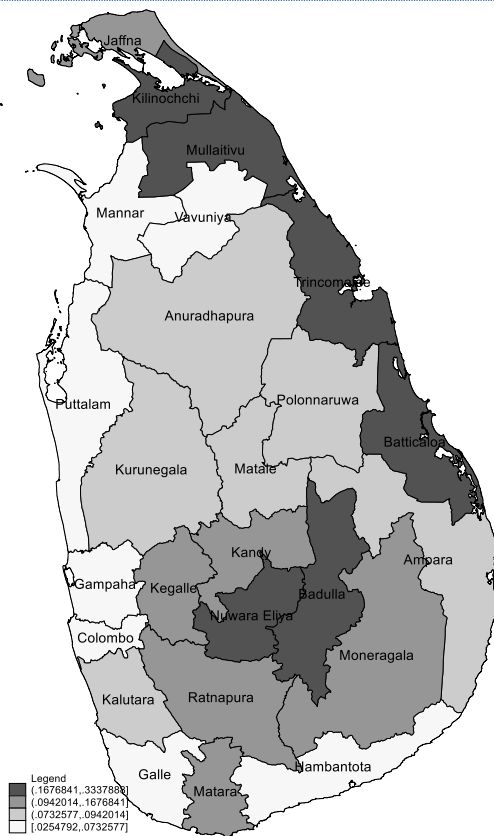
**Poverty in Sri Lanka continued to decline in line with strong economic growth**

Poverty measured using the World Bank's international poverty line of \$3.20 per day (in 2011 PPP) for lower middle-income countries had declined from 15.4 percent in 2013 to 9.7 percent in 2016. The reduction in poverty was accompanied by a decrease in the number of districts with a high incidence of poverty. As of 2016, only two districts in these provinces had poverty rates near or above 30 percent as compared to five districts in 2012. The expansion of the Samurdhi program in 2015 had a positive impact in some districts in the Northern and Eastern provinces that saw large declines in poverty. Better targeting of social assistance could have resulted in even larger gains. Since then, the pace of poverty reduction is projected to have slowed down somewhat following floods and a prolonged drought which brought down the GDP growth rate.

**Geographic patterns of poverty reflect different development challenges**

While the districts with the highest poverty headcount are in the Northern and Eastern provinces, most of the poor reside in other parts of the country; for example, Ratnapura, Kandy and Badulla have the largest number of poor, accounting for more than a quarter of the poor population combined. The maps in Figure 21 and 22 compare the poverty rates and the distribution of the poor by district. Similarly, while the poverty rate in the estate sector is high, the estate poor account for only 10 percent of all poor with an overwhelming majority residing in rural areas. This pattern reflects that regions are facing different development challenges around human capital, basic services, the availability of jobs and access to markets.

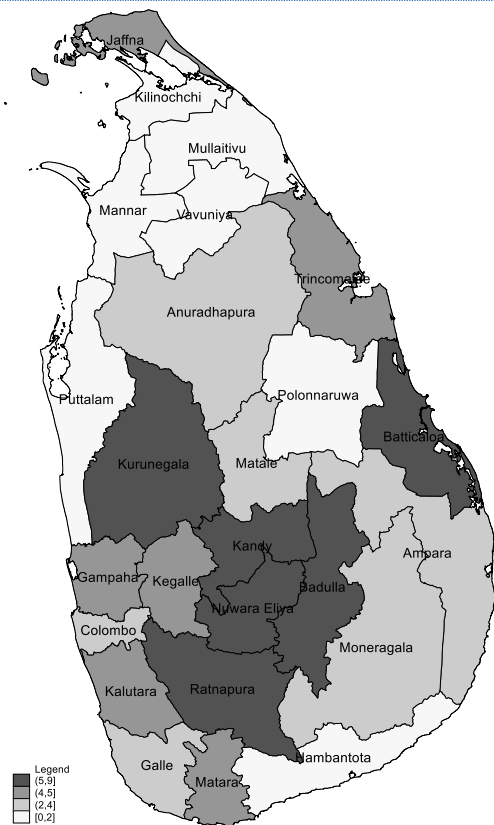
Figure 21: Poverty rates by districts



Source: Staff calculation using HIES 2016

Note: Poverty is defined using the \$3.20 international poverty line in 2011 PPP.

Figure 22: Distribution of poor by district



Source: Staff calculation using HIES 2016

Note: Poverty is defined using the \$3.20 international poverty line in 2011 PPP.

### High levels of vulnerability and the multidimensional nature of risk factors present large challenges

The national poverty rate is low and not sufficient to capture the various social inclusion problems in Sri Lanka.<sup>16</sup> There is a high level of vulnerability in the population: a simple simulation exercise that varies the poverty threshold by 20, 30 and 50 percent increases the \$3.20 per day international poverty rate from 9.7 percent to 17.4, 21.9 and 30.4 percent, respectively. This indicates that a large number of people remain just a small shock away from falling back into poverty. The risk factors for vulnerability are diverse: productivity and earnings remain low in the estate sector where poverty is still acutely high. Demographics are an important risk factor as a large share of the rapidly aging population does not have a formal pension to support themselves. The frequency and intensity of weather shocks have become increasingly important in recent years, with direct welfare losses and implications for food prices. Economic development is still lagging in the Northern and Eastern provinces where female headed households constitute a particularly vulnerable group subject to cultural norms, insecurity, and difficulty accessing economic opportunities.

### Informality remains a salient feature of the labor market

As of 2015, 61.3 percent of Sri Lankan workers were employed informally, and 71 percent of all private sector jobs were of an informal nature. Well-paying formal private sector jobs that are covered by labor regulations remain far too scarce. High levels of informality contribute to forgone tax revenues and have implications for productivity and social protection. Tackling informality requires a deeper understanding of the heterogeneous nature of informal jobs: of the informally employed, about half is accounted for by own account workers (30.9 percent), followed by informal employees working in informal (10.2 percent) and formal (9

<sup>16</sup> Sri Lanka's national poverty line was estimated back in 2002 and is too low to provide a meaningful minimum subsistence level of consumption. It now represents the oldest poverty line in the region.

percent) firms, unpaid family workers (8.4 percent) most of whom work in agriculture, employers working in their own informal firms (1.9 percent) and a small yet vulnerable number of domestic workers (1 percent). Given widespread informality and the lack of good jobs, formalization efforts will take time to materialize. The causes of informality are complex and reform strategies need to tackle all relevant areas to make formality a more attractive option. This would require reforms to increase labor market flexibility, measures to enhance labor productivity, and lifting regulatory and tax burden. Compliance policies will need to consider the precarious nature of informal activities if they are not to unduly increase unemployment and poverty.

### Box 3: Human Capital Project – World Bank

**Human capital is critical for economic development in the twenty-first century.** Human capital, which contains the knowledge, skills, and health accumulated by people over their lives, is the key driver of economic growth in countries. Technological advances are enabling machines to take over jobs based on routine cognitive or manual skills. Economic development now requires higher-order cognitive skills. Modern production processes rely increasingly on human capital and technology. In this context, countries need to focus policy attention on the rapid development of their human capital as a high priority.

**Education and health outcomes are central to human capital development.** Education makes a vital contribution to earnings, and growth. Good health too makes an important contribution to growth, as healthy individuals are more productive. Education and health play complementary roles in generating a variety of social benefits. Educated individuals, especially women, take better care of the health and nutrition of their children and family members. Good nutrition in utero and in early childhood are closely associated with higher levels of cognitive performance later. Sound health in childhood also improves school attendance and learning.

**Due to the importance of human capital for development, the World Bank has launched the Human Capital Project (HCP), through which the Human Capital Index (HCI) was introduced in October 2018.** The HCI is a metric designed to measure a country's human capital based on internationally comparable information. The index anticipates the expected path, from birth into adulthood, of an infant born today. It tracks the level of human capital that a child can expect to accumulate, given the risks to health and education in a country at the time of the child's birth. The HCI consists of three components: (a) the proportion of children that survive from birth to school age (age five); (b) the expected years of quality-adjusted education, which combines information on the quantity and quality of schooling; and (c) two general measures of health and nutrition: child stunting rates and adult survival rates. The HCI provides countries the ability to understand their human capital and to map a path for its future development.

**Sri Lanka has an overall score of 58 percent in the Human Capital Index.** This means that children born in Sri Lanka today will be only 58 percent as productive in adulthood compared to their full potential. Children born in the top performing HCI countries can expect to achieve considerably higher levels of human capital. For instance, a child born today in Singapore can expect to achieve 88 percent of her potential, a child born today in Japan and South Korea 84 percent, and a child born today in Hong Kong China 82 percent. Overall, Sri Lanka ranks 74th place out of the 157 countries included in the HCI. It is the best performing country in South Asia. However, it lags below most East Asian countries.

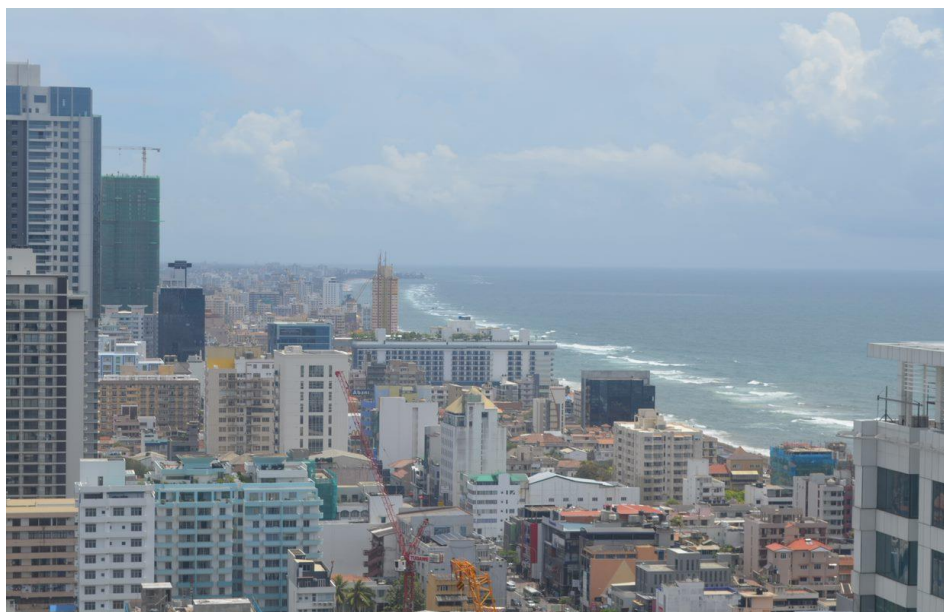
**Sri Lanka performs well in some parts of the HCI but less well in others.** Sri Lanka does well on the probability of children surviving to age five, with 99 percent of children reaching this age. Sri Lanka also does well in the expected number of years of schooling, with an average of 13 years. The probability of adults surviving to the age of 60 years is also high, at 87 percent. However, Sri Lanka does less well on learning outcomes and stunting rates. Learning outcomes are less than the average for middle-income countries. The stunting rate, too, at 17 percent is higher than the rate expected for a country at Sri Lanka's level of development.

Overall, strengthening human capital, especially as the demographic transition proceeds, is both an urgent need to improve productivity and growth, and to address health and nutrition needs of an aging population.

### Summary of key macroeconomic developments

- Economic growth remained subdued on weak industry performance and political turmoil in the last quarter
- Inflation was low on low food inflation despite currency depreciation and high oil-prices
- External trade balance weakened as growth in imports outpaced growth in exports
- Official reserves hit a record high in April 2018 before declining due to capital outflows, debt repayment, currency defence and other payment obligations
- Interest bill continues to mask fiscal improvements
- Public debt remains high; the debt portfolio indicates some significant risks; passing of the Active Liability Management Law is a key step towards managing refinancing risks
- Poverty fell further between 2012/13 and 2016

## B. Outlook and Risks



### 1. Outlook<sup>17</sup>

**Growth is expected to pick up with manageable inflation**

Growth is expected to rebound from a low base and continue to gradually reach 4.0 percent in the medium-term, driven by domestic demand as in the past. Inflation will stabilize around mid-single digit level, although the pass-through of oil prices and currency depreciation may exert some upward pressure. In the medium-term, the announced shift by the central bank to flexible inflation targeting will keep inflation in the single digits, while the exchange rate is left to adjust to market forces.

**Fiscal consolidation will improve overall fiscal balances**

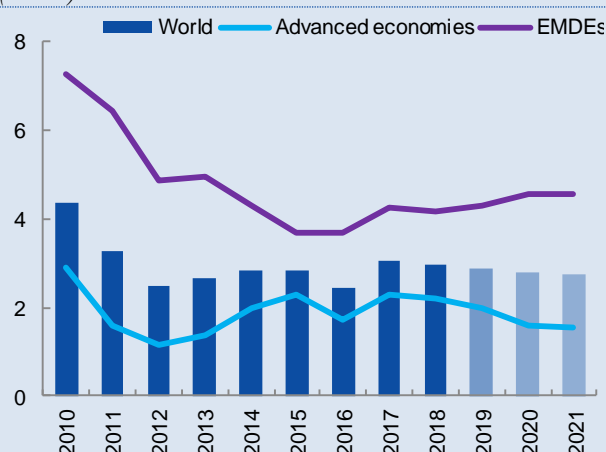
If implemented, the new Inland Revenue Act, further reforms to the VAT law and to the Excise law and improvements in tax and excise administration are expected to expand revenues. Primary surpluses supported by the implementation of these revenue measures will reduce the overall fiscal deficit. On the expenditure side, staff projects that the increased fiscal space will primarily benefit public investment, assuming no major additional recurrent expenditure commitments. Under this baseline scenario, the fiscal deficit is expected to narrow to 4.7 percent of GDP by 2021, missing the government's original target of 3.5 percent of GDP manifested in the reform program.

#### Box 4: Global economic context

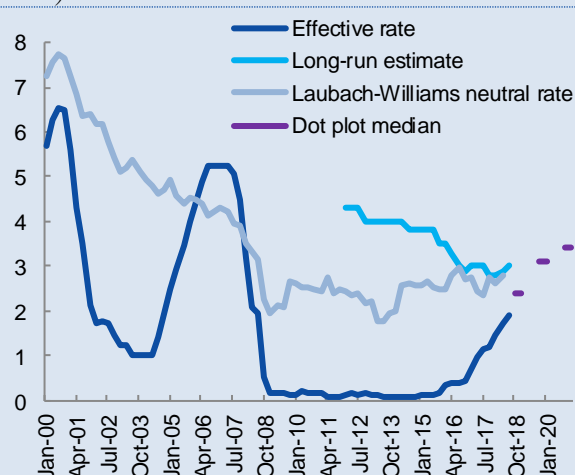
**Growth and prices:** Global growth has softened but remains robust despite signs of moderation in trade and manufacturing activity. Global growth is projected to reach 3.1 percent in 2018, and edge down to 2.9 percent by 2020, as global slack dissipates, trade and investment soften, and financing conditions tighten. Global growth projections are above estimates of potential, suggesting that capacity constraints will become more binding and inflation will continue to rise during the forecast horizon. Growth in advanced economies is expected to decelerate towards potential with normalizing monetary policies and fading effects of fiscal stimulus. Among emerging market and developing economies, while the growth in commodity exporters has recovered amid higher commodity prices, growth in commodity importers remains robust as investment strengthens.

<sup>17</sup> Table 1 on last page

**Figure 23: Global Growth**  
(Percent)



**Figure 24: U.S. federal funds rate**  
(Percent)



Source: Bloomberg, Haver Analytics, World Bank.

Notes: A. Shaded areas indicate forecasts. Data for 2018 are estimates. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights.

B. The effective rate is the mid-range of the federal funds target rates. The long-run estimate is the federal funds rate that would be expected to prevail in the absence of shocks to the economy, as assessed by members of the Federal Open Market Committee. The neutral rate is the nominal short-term interest rate consistent with the economy operating at its full potential once transitory shocks have abated, and is estimated according to Holston, Laubach, and Williams (2016). Shaded area indicates forecasts. Last observation is 2018Q2 for the neutral rate and 2018Q3 for the effective rate and long-run estimate.

**Financial markets:** Following a prolonged period of stable and favorable global financing conditions, prospects of a faster withdrawal of monetary policy accommodation in advanced economies have led to rising global borrowing costs since the start of 2018. The increase in US long-term yields, together with fears of escalating trade tensions between the US and China, and rising geopolitical risk contributed to bouts of volatility in global markets. Investor appetite for EMDE debt remains strong but capital inflows to EMDEs are likely to moderate as global financial conditions tighten. However, as long as the EMDE growth outlook continues to improve and financial commodity markets do not experience significant disruptions, capital flows should remain generally robust.

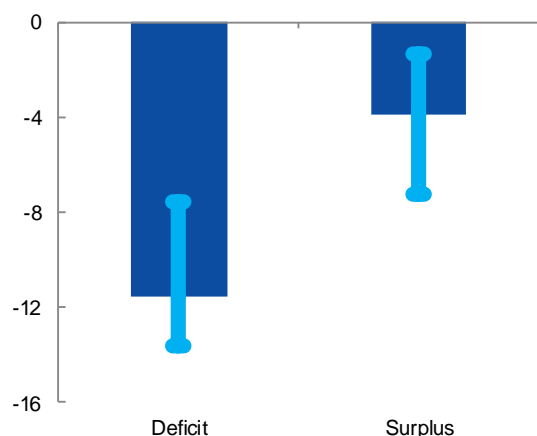
**Risks:** Risks to the outlook remain tilted to the downside. The risk of escalation of trade restrictions is particularly acute as it could derail the recovery in global trade and impact confidence and investment worldwide. The risk of disorderly tightening of global financing conditions has also heightened reflecting a possible reassessment of inflation risks amid shifting monetary and fiscal policy stances in advanced economies. Such developments could have severe consequences for more indebted EMDEs. The possibility of intensifying geopolitical tensions and heightened conflicts in some regions are among the other risks to the EMDE outlook. A further rise in oil prices might amplify external vulnerabilities in some oil-importing EMDEs while it would support oil exporters.

**Factors affecting EMDE growth prospects:** EMDEs need to rebuild monetary and fiscal buffers and restore the scope of policy support against negative external shocks such as rising global interest rates. Aside from the possible deterioration of debt dynamics as a result of monetary policy normalization in advanced economies and bouts of financial market volatility, EMDEs face various structural challenges to boost long-term prospects. These include the need to intensify economic diversification in commodity exporters, boost skills and adaptability to confront technological change, and promote regional trade integration.

**South Asia:** South Asia is once again the fastest-growing region in the world, due to the pickup in growth in India after the second half of 2017. The region is expected to remain the fastest growing region with growth forecasted to reach 6.9 percent in 2018 and stabilize around 7 percent over the medium term. Despite more favorable international conditions, domestic demand will remain the main driver of growth with private consumption and investment expected to offset the moderating public expenditures stemming from tighter fiscal policy. While escalating trade protectionism and tightening global financial conditions do pose risks to South Asia, the main risks for the region are related to the possibility of domestic policy slippages, such as weakening fiscal policies or setbacks in areas of reforms.

**Figure 25: Currency movements since April 2018, by current account balance exc. FDI**

(Percent)

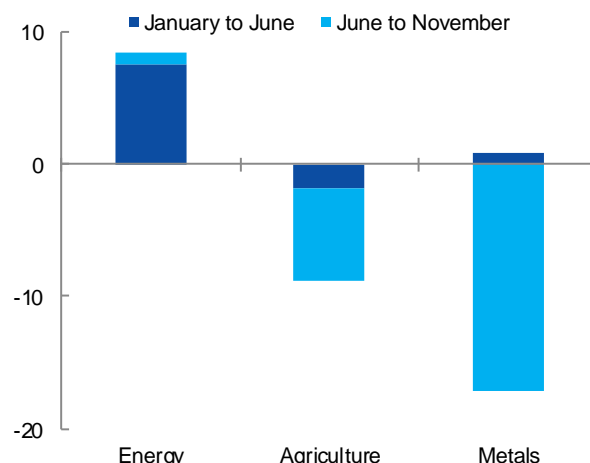


Source: Bloomberg, World Bank.

Notes: Figure shows the median of cumulative changes in exchange rates since January 1, 2018. Orange lines indicate interquartile ranges.

**Figure 26: Change in commodity prices, 2018**

(Change, Index points)

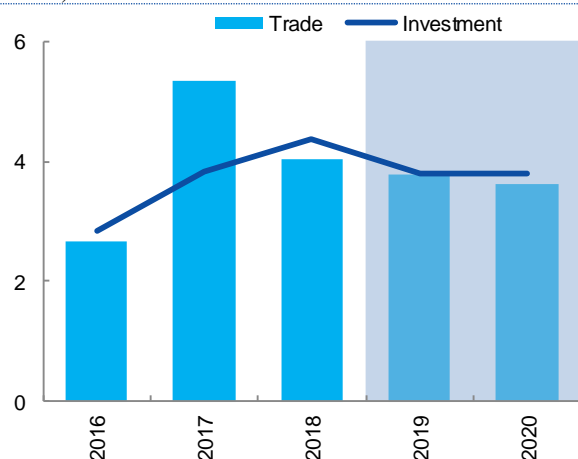


Source: Bloomberg

Notes: Figure shows cumulative change over January 1 to June 14 and June 14 to November 7. June 15 indicates the date on which the United States announced tariffs on \$34 billion of Chinese goods.

**Figure 27: Global Trade and investment growth, volumes**

(Percent)



Sources: Bloomberg, Haver Analytics, World Bank.

Note: Shaded area indicates forecasts. Aggregate growth rates calculated using constant 2010 U.S. dollar GDP weights. Trade measured as the average of export and import volumes.

A. FDI = foreign direct investment. Figure shows the median of cumulative changes in exchange rates since April 15, 2018. Orange lines indicate interquartile ranges. Last observation is November 7, 2018.

B. Cumulative change for periods January 1 to June 14 and June 15 to November 7. June 15 indicates the date on which the United States announced tariffs on \$34 billion of Chinese goods.

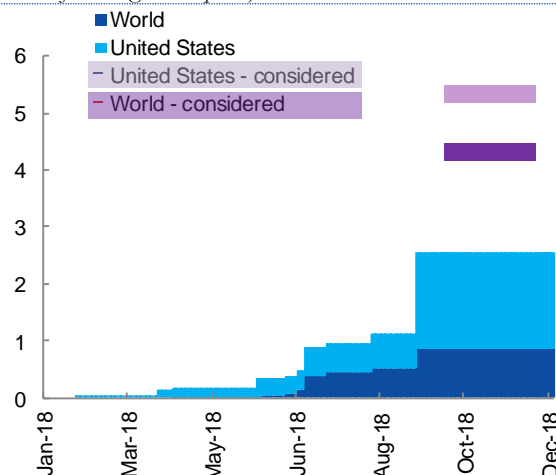
C. Trade measured as the average of export and import volumes.

D. Import tariffs implemented in the United States and the rest of the world in 2018, as well as those under consideration, as a percent of global goods imports. Tariffs considered exclude car imports from Canada and Mexico and are as of November 7, 2018.

E. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa. Figure shows the total new bond issuance from January to September for each year. Last observation is September 2018.

**Figure 28: Imports affected by new tariffs**

(Percent of world goods imports)



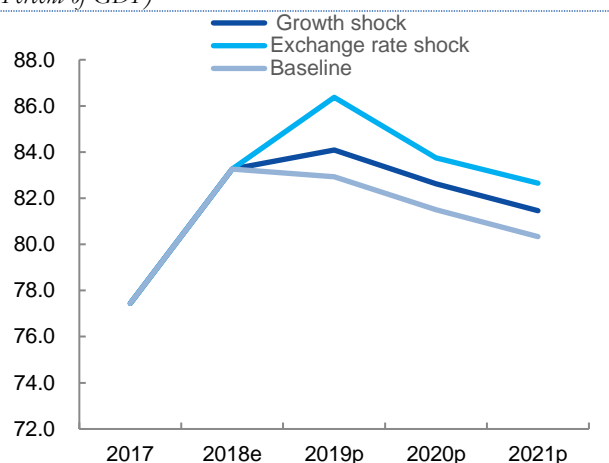
Source: Peterson Institute for International Economics

Note: Figure shows import tariffs implemented in the United States and the rest of the world in 2018, as well as those under consideration, as a percent of global goods imports. Tariffs considered exclude car imports from Canada and Mexico and are as of September 27, 2018.

### Risks to debt sustainability remain high

If continued, Sri Lanka's fiscal consolidation efforts will gradually bring the public debt burden to a downward path. Under the baseline scenario, central government debt-to-GDP ratio is projected to come down to 79.2 percent of GDP by 2021. Fiscal discipline is even more important in an environment of high domestic interest rates and gradual tightening of global financial conditions amid currency depreciation. However, the reduction of debt will be adversely impacted by shocks. A negative shock to the growth rate or exchange rate would widen the fiscal deficit and would mainly affect the path of central government debt (Figure 29). In addition, there is a risk that guarantees, and other contingent liabilities will be called.

**Figure 29: Central government debt**  
(Percent of GDP)



Source: Staff projections.

Note: Shocks considered were: (a) 20 percent currency depreciation for 2019 and; (b) a reduction of real GDP growth rate to 2 percent in 2019.

### External buffers will be weak as refinancing remains the focus

The country will continue to benefit from tourism growth and the EU's GSP+ in the medium-term. However, rising external interest payments will result in a sizeable current account deficit in the medium-term. In 2019 and beyond, significantly large debt creating flows will be required to close the external financing gap when the impact of one-off FDIs wanes off. With the focus placed on refinancing, external buffers are expected to remain relatively weak. Gross official reserves are projected to hover around 3.4 months of imports of goods and services between 2019-2021. In the medium-term, enhancing competitiveness and attracting more non-debt creating flows will become even more important to manage external financing pressures.

## 2. Risks

### Risk balance is tilted towards downside; the key one being the domestic political risk

The challenging domestic political environment is the key risk to a favorable medium-term outlook. On the fiscal and debt management front, risks include the delay in implementing revenue measures, slower than expected improvement in tax administration, increases in non-discretionary spending, and delays in implementing the Liability Management Act. The increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal budget, the external sector and poverty reduction.

External risks include disappointing growth in key countries that generate foreign exchange inflows to Sri Lanka: exports, tourism, remittances, FDI, and other financing flows. Tighter than expected global financial conditions would increase the cost of debt and make rolling over the maturing Eurobonds more difficult. Faster than expected rises in commodity prices would increase pressure on the balance of payments and could make further price reforms more difficult.

**Summary of outlook**

- Growth expected to rebound thanks to domestic demand
- Inflation will stabilize around single mid-digit levels
- Fiscal consolidation will continue towards a deficit of 4.7 percent of GDP in the medium-term
- Albeit slowly, debt is likely to stabilize and start to fall, but is sensitive to growth, fiscal and exchange rate shocks
- Reserves adequacy metrics will remain weak given large refinancing requirements

## C. Special Focus: Demographic Change in Sri Lanka



*This Special Focus section looks at the state of the demographic transition in Sri Lanka and discusses its impact on growth and potential mitigating factors, including reducing the gender gap in female labor force participation.*

### Key messages

- Sri Lanka is undergoing a gradual aging process of its population, and compared to peers, it has reached an advanced stage of this demographic transition. The population pyramid is already beginning to show signs of aging.
- Sri Lanka's share of working-age population peaked in 2005 and it is expected to gradually decline over time. In addition, the shrinking labor supply is expected to slow down growth in the medium-term. The dependency ratio (the ratio of youth and elderly to the working-age population) was 51 percent in 2015. About one-fourth of the population were under 15 years old, whereas under one-tenth were 65 years or older. By 2050, it is projected that the proportion elderly (23 percent) to surpass that of the youth (17 percent).
- Such changes in the structure of the pyramid will translate in a slower growth rate of its population and a shrinking labor supply. In addition, demographic changes are expected to have long-lasting implications for service delivery (health and education), pensions, employment, and public finances that should be taken into account on policy planning.
- Several factors can mitigate the impact of demographic factors on growth and labor markets. Sri Lanka's labor force participation rate has remained relatively unchanged over the past 20 years and is low compared to other developing countries. This can be partly explained by the large gap in labor force participation rates between men and women.
- Closing the gender gap in labor force participation would buffer the impact coming through the reduction in the number of workers and could mitigate the impact of demographics on growth. Policies that foster women's entry to labor markets are important.
- Increases in education attainment can also lift productivity and participation rates of younger cohorts, in addition to labor reallocation towards more productive sectors that lead to productivity gains and hence higher growth.

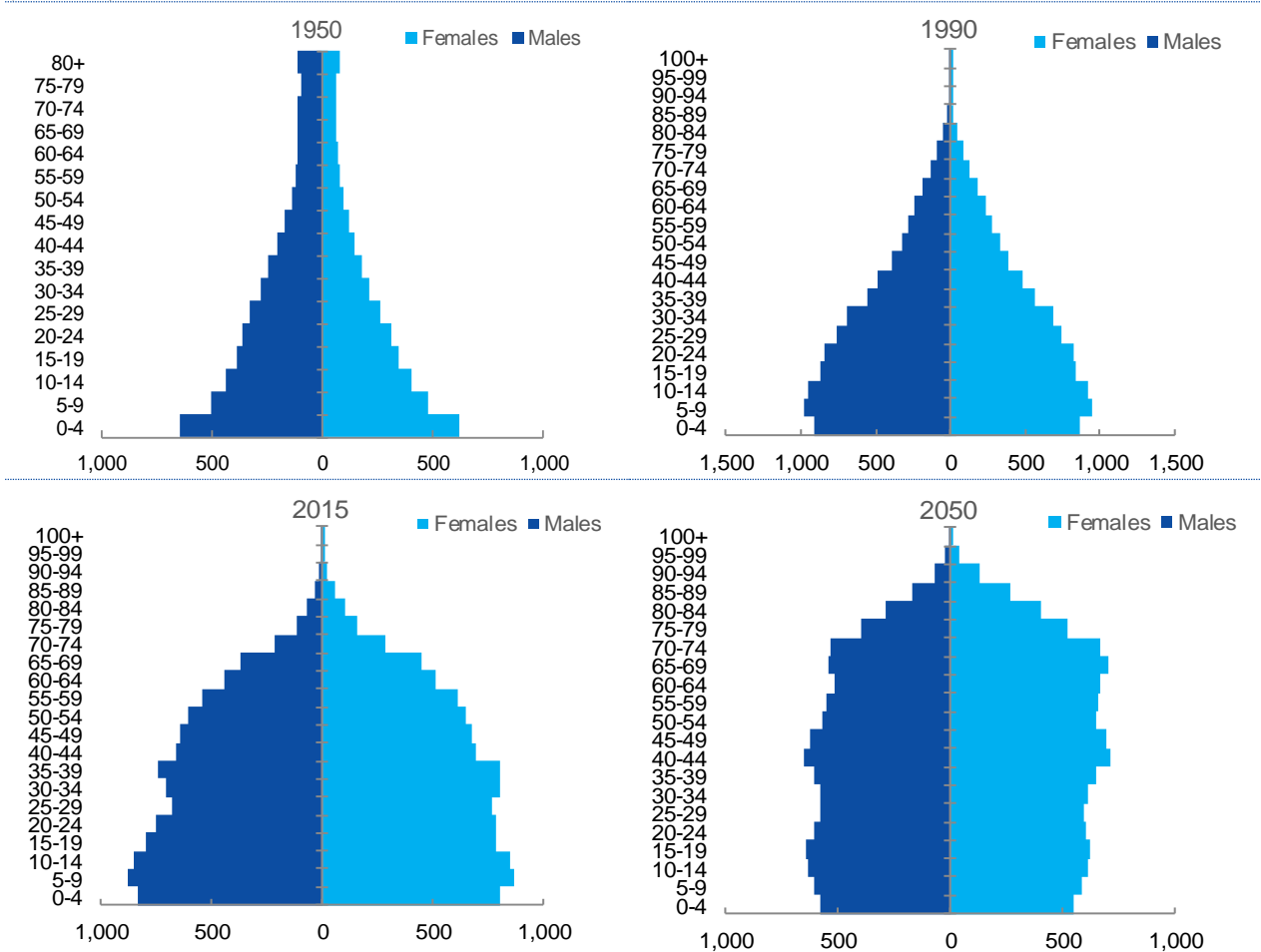
## 1. Demographic trends in Sri Lanka

**Sri Lanka is undergoing a gradual aging process of its population**

Many countries around the world are undergoing a gradual aging process of their populations. Falling fertility rates and rising life expectancies are resulting in fewer children and more elderly. These secular trends are expected to continue over the next few decades, with important implications for economic development, efficacy of institutions and the social contract, the macroeconomy and fiscal accounts.

The population of Sri Lanka is not immune to these secular trends. Sri Lanka reached the advanced stage of this demographic transition relatively early compared to regional peers. The impact of this on age structure shaped a population pyramid that is already beginning to show signs of aging. By 1990, the population pyramid was beginning to lose its triangular shape. Its base, representing the young cohorts of the population, was already shrinking. This trend became more apparent in 2015, with both the body where the middle-aged population (or working-age population) and the elderly were already gaining significant mass. By 2050, it is expected that this process will translate into a further narrowing of the base and an evening out of the relative weight of the different age brackets, which will result in the pyramid taking a more rectangular shape. The number of elderly is expected to catch up and then exceed the number of young children (Figure 30).

**Figure 30: Population pyramids**  
(Thousands)

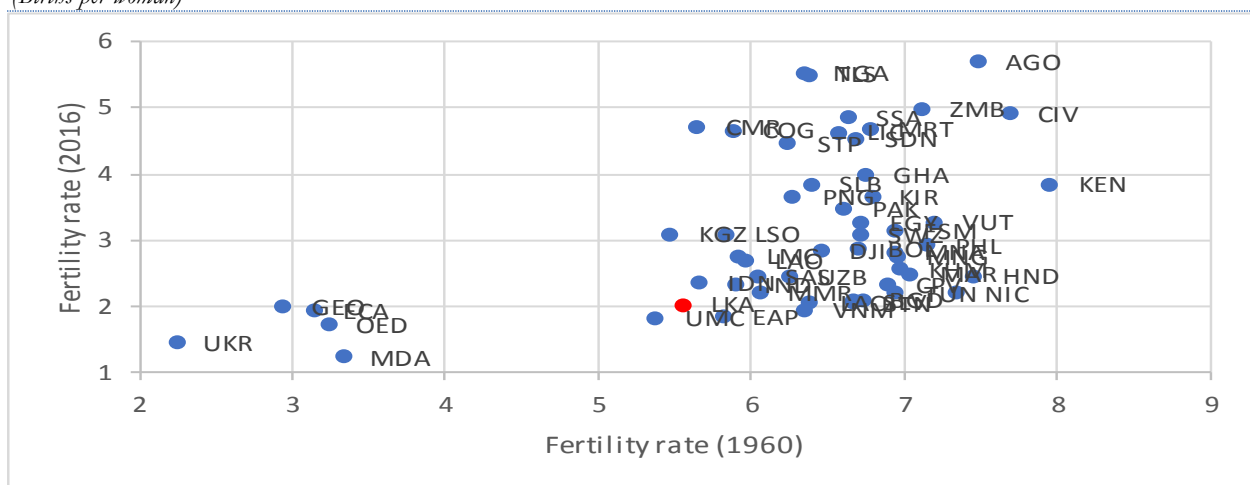


Source: Staff calculations based on World Population Prospects: The 2017 Revision, United Nations

**Sri Lanka reached the advanced stage of this demographic transition, helped by low fertility rates and rising life expectancy relative to peers**

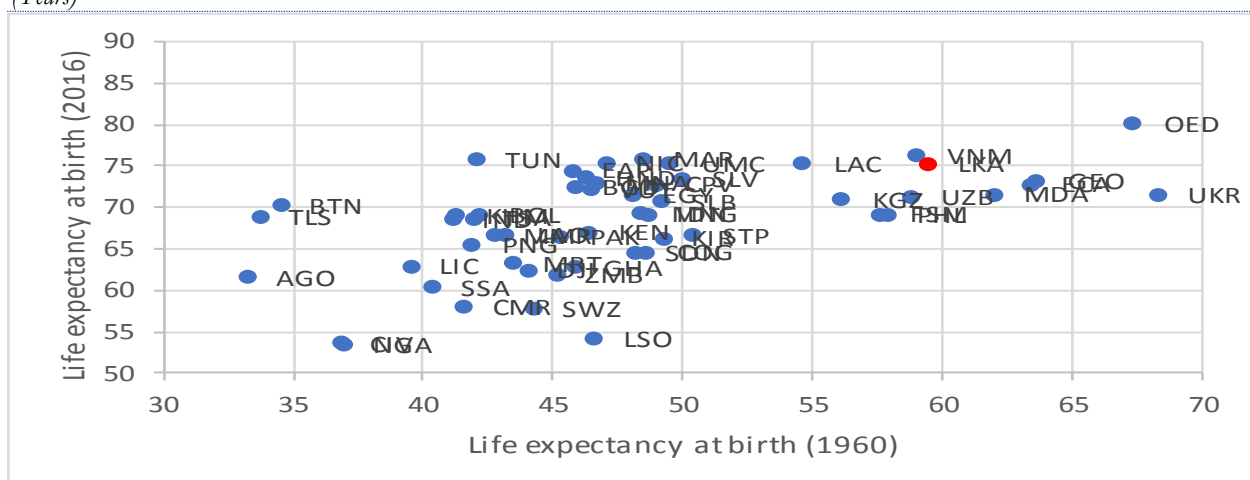
Two factors are at play here. One, prolonged periods of low fertility, contributing to narrowing the base and placing a cap on the growth of the next generations. In 1960, Sri Lanka's fertility rate, at 5.5 births per woman, was much lower than other low and lower middle-income countries (Figure 31). By 2016, Sri Lanka's fertility rate has fallen to 2.0 births per woman, bringing it closer to upper middle-income countries (1.8) and OECD countries (1.7). In comparison, the fertility rate for low and lower middle-income countries stood at 4.6 and 2.8 births per woman. Two, lower mortality rates and rising life expectancy of the population over time, resulted in an increasing mass of population at the top of the pyramid. Life expectancy at birth in Sri Lanka was already high in relation to peers in the 1960s. At over 75 years in 2016, Sri Lanka's life expectancy is at par with upper middle-income countries, with just Morocco, Nicaragua, Tunisia and Vietnam standing above Sri Lanka among other lower middle-income countries.

**Figure 31: Fertility rate**  
(Births per woman)



Source: World Development Indicators

**Figure 32: Life expectancy at birth**  
(Years)



Source: World Development Indicators

Changing demographics can have a direct impact on growth through changes in working-age population shares and dependency ratios (labor supply effect), and, under certain conditions, to outcomes in savings and investment. In addition,

demographic changes (household composition and size, age) are expected to have long-lasting implications for service delivery (health and education), pensions, employment, and public finances. Box 5 discusses implications of aging in social protection and pensions.

#### Box 5: Aging and Old Age Protection

**Sri Lanka is undergoing profound demographic change with an aging labor force and limited savings and institutional support mechanisms to protect its rapidly expanding elderly population.** Savings, pensions and long-term care to support its growing elderly population are inadequate both in terms of their adequacy and coverage.

**The Public Servants Pension Scheme (PSPS)** provides a relatively generous defined-benefit pension for Government employees with an estimated replacement rate of 83-88 percent but the costs of the scheme are projected to increase in the coming years from the current cost of about 1.4 percent of GDP thereby making it increasingly difficult for the authorities to afford the benefit promises over the long-term. There are also technical weaknesses in the benefit formula that pose risks and inequities for workers and retirees. For example, there is no formula for automatic benefit adjustments during retirement, so the purchasing power of benefits can be eroded because of ad-hoc adjustments. Moreover, benefits are computed based on workers' final year's salaries which makes the value of pensions sensitive to promotions and wage adjustments prior to retirement. Moreover, civil servants in Sri Lanka face heavy reductions in their pensions (preservation losses) if they move to the private sector during their careers thereby creating strong incentives to stay in the public sector and forgo private sector jobs.

**The EPF is an employer-based defined-contribution savings scheme for formal private sector workers, covering about a third of the labor force.** The EPF has relatively good coverage among the formal sector, but it plays a limited role in financing retirement for most workers. It provides a relatively small benefit, at too young an age to support an adequate retirement as Sri Lankans expect to live to an age of 80 at age 55. Retiring members received a lump sum averaging about Rs. 579,000 in 2016, which is equivalent to about 1.4 times the average annual per capita income of employed household members. Since the payment is made as a lump sum on retirement, workers must invest and manage the funds personally if they wish to take an annuity. Anecdotally, many retirees exhaust the full balance within a few years. Even if taken as an annuity, the average payout would only yield an income of about Rs. 2,650 per month (below the poverty line) over a 23-year life expectancy at the retirement age of 55 for men and Rs. 2,130 per month for women, who are allowed to retire at 50 and have longer life expectancy.

**The Government also sponsors a number of informal sector schemes; however, these are poorly aligned to the variability and uncertainty of informal workers' incomes.** The schemes provide a small defined benefit at retirement, but such benefit is not linked with individual salaries and work histories and are periodically adjusted. Moreover, the benefits are not indexed. This creates considerable uncertainty for contributing workers and therefore weak incentives to participate. Finally, these schemes are predicated upon the mistaken assumption that workers will spend the bulk of their working lives in the same sector or working informally when for many this tends not to be the case.

**The non-contributory social pension scheme, Elderly Benefit, provides modest support to the poorest elders (over 70) but there is a long waiting list of eligible applicants.** Around 400,000 people receive the Rs. 2,000 per month from the government, but another 100,000 approximately are eligible and excluded due to budget constraints. The benefit is also very modest - about half of the poverty line - so may be insufficient to sustain the livelihoods of many poor elderly.

**There are also formidable challenges to improve the various aspects of delivery systems that will prove essential to broadening worker coverage.** In the modern economy, workers change jobs frequently and move between sectors. At present, the administrative systems are not equipped to handle this, as a result of which many EPF beneficiaries have multiple accounts in their name. Establishment of a unique and deduplicated identification system based on biometric verification and an interoperable platform could be the foundation not only for material improvements in pension savings but also improve the efficiency and integration of retirement savings programs.

**Although the country has a relatively robust health care system, this system has yet to be adapted to the needs of its aging population such as the need for treatment of non-communicable diseases and provision of long-term care for elderly patients.** Sri Lanka's provision of elder care including home-based care and institutional care appears to be insufficient to address the materially growing demand for such care stemming from demographic pressures. There also needs to be better coordination between health and social services at the local level. The government could do more to encourage investment and innovation in elder care, not only among large firms, but also

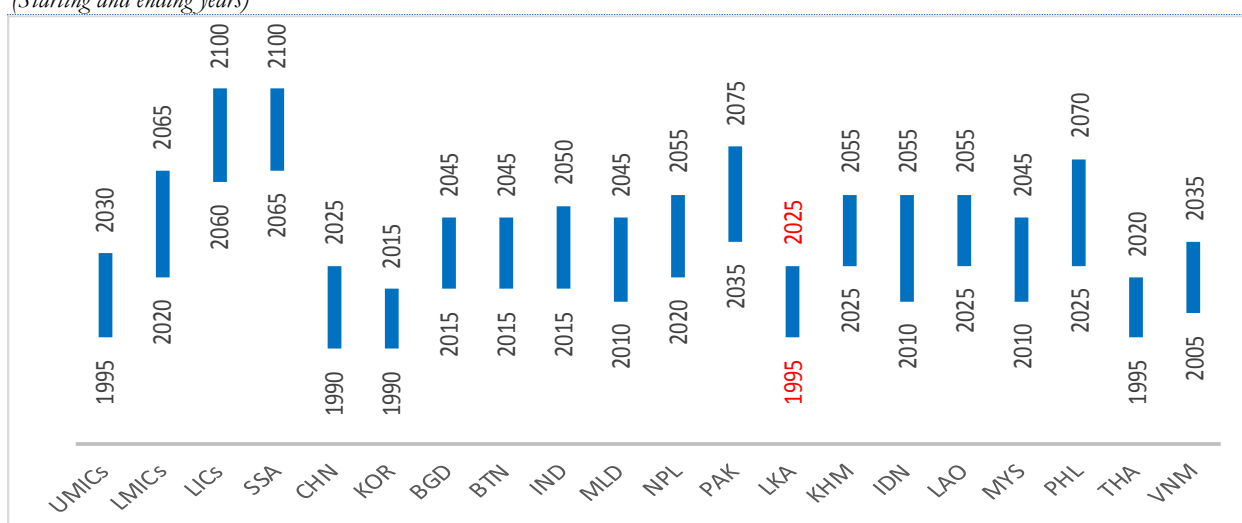
among small entrepreneurs at the local level. This would create jobs, improve quality of life of the elders, reduce the rate of hospitalization among the elderly, and support family members who care for the elderly.

**Formulating a strategy to improve old age income and poverty protection will require a multi-year program of policy reforms and institutional strengthening.** Such a program could include measures to improve the equity and sustainability of the public-sector pension scheme, extension of voluntary pensions savings opportunities in the EPF to informal workers without labor contracts, and strengthening of the Elderly Benefit through improved targeting and adjustments in the amount and age for eligibility. The government could also act as a steward in the elder care sector, improving the supply of affordable and high-quality services for the elderly. Finally, investment in better identification and delivery systems would help to broaden coverage and efficiency of savings and insurance mechanisms to protect the elderly.

### Sri Lanka's demographic window opened in 1995 and it is expected to close by 2025

Because of some of the factors outlined above –i.e. reaching relatively low fertility rates and high life expectancy—, Sri Lanka's demographic window opened in 1995 and it is expected to close by 2025 (Figure 33). The United Nations<sup>18</sup> defines this window as opened when the proportion of the youth in the total population falls below 30 percent and the proportion of the elderly is below 15 percent. Intuitively, as a country's young bulge reaches working age, a country enters a demographic window of opportunity. An expanding working-age population (defined as those persons between ages 15 and 64) generates a labor supply effect that, under certain conditions, can propel economic growth and lift income levels higher.<sup>19</sup>

**Figure 33: Demographic window**  
(Starting and ending years)



Source: Staff calculations based on World Population Prospects: The 2017 Revision, United Nations

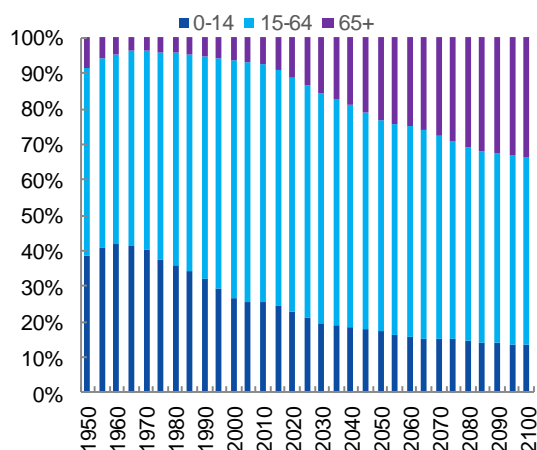
### Sri Lanka's share of working-age population peaked in 2005 and it is expected to gradually decline over time

Sri Lanka's window appears more comparable to upper middle-income countries and other more advanced countries such as China, Thailand and South Korea. Between 1950 and 2005, growth of the working-age population outpaced total population growth. Total population expanded steadily at 1.5 percent (annual exponential growth rate), growing from about 8 million in 1950 to 20.7 million in 2015, more than doubling in 65 years. By comparison, the working-age population expanded by more than three-fold (9.5 million persons). Sri Lanka's share of working-age population peaked in 2005 at 68 percent and it is expected to gradually decline, as its old dependency ratio increases over time (Figure 34 and 35).

<sup>18</sup> United Nations (2004): "World Population to 2300," Department of Economic and Social Affairs, Population Division.

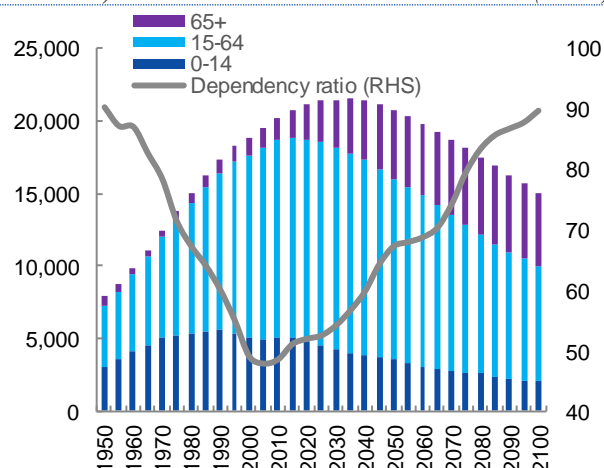
<sup>19</sup> See, for instance, Bloom et al (2003) and Mason and Lee (2007, 2012).

**Figure 34: Youth, working age population and elderly**  
(Percent of total)



Source: Staff calculations based on World Population Prospects: The 2017 Revision, United Nations

**Figure 35: Population groups and dependency ratios**  
(In thousands) (Percent)



Source: Staff calculations based on World Population Prospects: The 2017 Revision, United Nations

In 2015, the dependency ratio (the ratio of youth and elderly to the working-age population) was 51 percent. About one-fourth of the population were under 15 years old, whereas under one-tenth were 65 years or older. By 2050, it is projected that the proportion elderly (23 percent) to surpass that of the youth (17 percent). Such changes in the structure of the pyramid will translate in a slower growth rate of its population and a shrinking share of the working-age population. According to the United Nations Population Division forecasts, Sri Lanka's population is projected to peak around 2035, and to decline thereafter. The next section discusses some of the implications of demographic changes in growth.

## 2. Demographic change and growth

**Over the past two decades, Sri Lanka's economy expanded at a rapid pace**

Over the past two decades, Sri Lanka's economy expanded at a rapid pace. Between 1996 and 2015, GDP grew on average at 5.4 percent per year. Similarly, in per capita terms, the economy expanded on average at about 4.7 percent per year. Put it differently, GDP per capita more than doubled between those years.

**Demographic factors are starting to have a larger impact on GDP growth**

To understand the evolution of GDP per capita growth, we decompose GDP per capita in three components: GDP per worker, the share of working-age population, and the employment rate. In other words, changes in GDP per capita can be expressed as the sum of changes in GDP per worker (a proxy for labor productivity), the share of persons able to work, and share of persons employed to those who are able to work. Changes in the share of the working-age population could be interpreted as the demographic change component.<sup>20</sup>

Between 1996 and 2015, economic growth has largely been driven by gains in labor productivity, and to a lesser extent, by increases in the employment rate. Labor productivity, measured by output per worker, contributed about 94.4 percentage points to the increase in GDP per capita, whereas increases in the employment rate added another 8.4 percentage points and demographic factors subtracted about 2.8 percentage points. It is also important to note that there are indications suggesting that the demographic component, measured by changes in the share of the working-

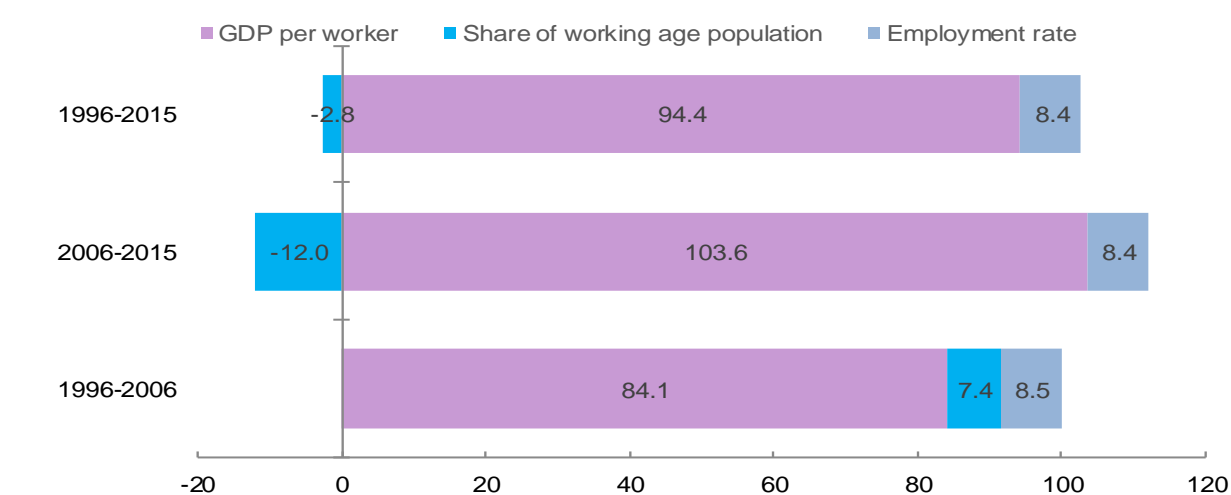
<sup>20</sup> This can be stated as  $\frac{GDP}{N} = \frac{GDP}{E} \times \frac{WAP}{N} \times \frac{E}{WAP}$ , where N is total population, E is the number of workers or people employed, WAP is the number of working-age population.

age population, is beginning to be a drag on economic growth. By dividing into two subperiods (1996-2006 and 2006-2015), we observe that lately demographic factors are starting to have a larger impact on GDP growth.

**These factors are expected to continue to keep slowing down growth in the medium-term**

Demographic change contributed about 7.4 percent to GDP per capita growth between 1996 and 2006. However, demographics subtracted 12 percent from growth between 2006 and 2015, as population growth outpaced working-age population growth (Figure 36). Demographics are expected to keep slowing down growth in the medium-term as the aging process gains pace and the share of working-age population continues to shrink.

**Figure 36: Drivers of GDP per capita growth: 1996-2015**



Source: Staff calculations based on LFS and WDI

### 3. Demographic change and jobs

**Sri Lanka's labor force participation rate has remained relatively unchanged over the last 20 years and is low compared to other developing countries**

This section analyzes the recent evolution of labor force participation and labor productivity. The analysis will explore these variables along three key dimensions (age, gender, and education) using the labor force surveys conducted by the Department of Census and Statistics (1996-2015). Since 1995, Sri Lanka's labor supply expanded significantly. Between 1995 and 2015, the UN World Population Prospects indicates that the working-age population expanded by more than 1.9 million persons. During the last 20 years, the labor force participation rate—the number of persons that work or are looking to work relative to the working-age population ages 15-64—has remained relatively unchanged, at about 59.4 percent in 1996 and 58.4 percent in 2015. Figure 37 indicates that labor force participation in Sri Lanka, relative to other developing economies, is low.

Country	Value
JOR	41.4
DZA	45.1
IRN	46.6
MDA	47.1
SDN	47.4
ISR	48.9
MRT	50.1
EGY	51.2
LTU	51.5
MAR	52.3
GAB	53.7
NEA	54.9
IND	56.2
TUR	56.5
BIH	56.7
PAK	56.7
SWZ	56.7
LKA	57.9
MVE	58.2
BGD	58.4
ZAF	58.7
SUR	60.7
GNQ	61.4
GUY	61.4
TUN	62.1
FIN	62.4
MNG	63.3
NAM	64.1
GTM	64.3
PHL	64.7
MEX	64.8
ALB	65.2
KGZ	65.2
SLV	65.3
ROU	65.3
KEN	65.9
CRI	65.9
ARM	66.1
UKR	66.4
VUN	67.5
LSO	68.1
MYN	68.2
IDN	68.4
MDV	68.6
TKM	69.0
BTN	69.1
BGR	69.1
UZB	69.2
BOL	69.3
BLZ	69.4
NIC	69.4
PRK	69.8
PNG	70.8
COM	70.8
ECU	71.0
AZE	71.2
JAM	71.2
GUY	72.9
GAB	72.9
BWA	74.1
RUS	74.3
COL	74.9
THA	75.5
ZMB	75.5
CHN	76.0
CHL	77.1
GHA	77.1
KAZ	78.1
AGO	78.1
PER	79.5
LAO	81.4
VNM	83.2
KHM	86.5

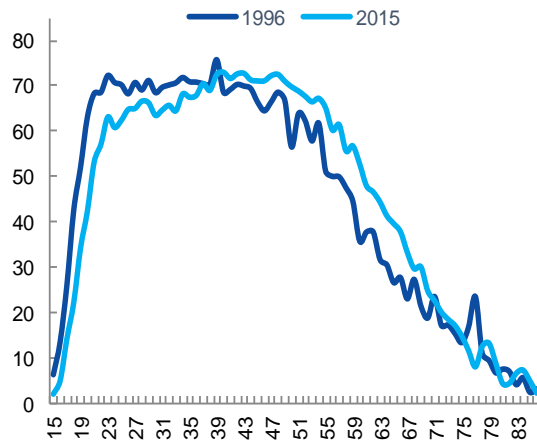
A rightward shift in the labor force participation curve is observed due to increases in entry and retirement ages

The large gap in labor force participation rates between men and women has remained

There is a large gap in labor force participation rates between men and women across the age spectrum. Only 40 percent of working-age women were either working (employed) or looking for a job (unemployed). In contrast, 80 percent of working-age men were in the labor force (ages 15-64). As fertility rates fall, and higher numbers of women enter into the labor market, an upward shift of the labor force participation curve is also expected. However, little or no change is shown in the female labor force participation curve from 1996 and 2015. Female labor force participation in Sri Lanka barely moved between those years. This seems at odds with the behavior observed in other countries (see Box 6).

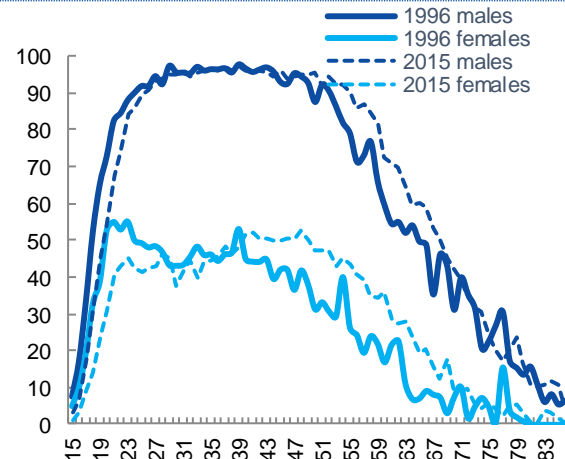
February 2019

**Figure 38: Labor force participation rate by single-year age**  
(Percent)



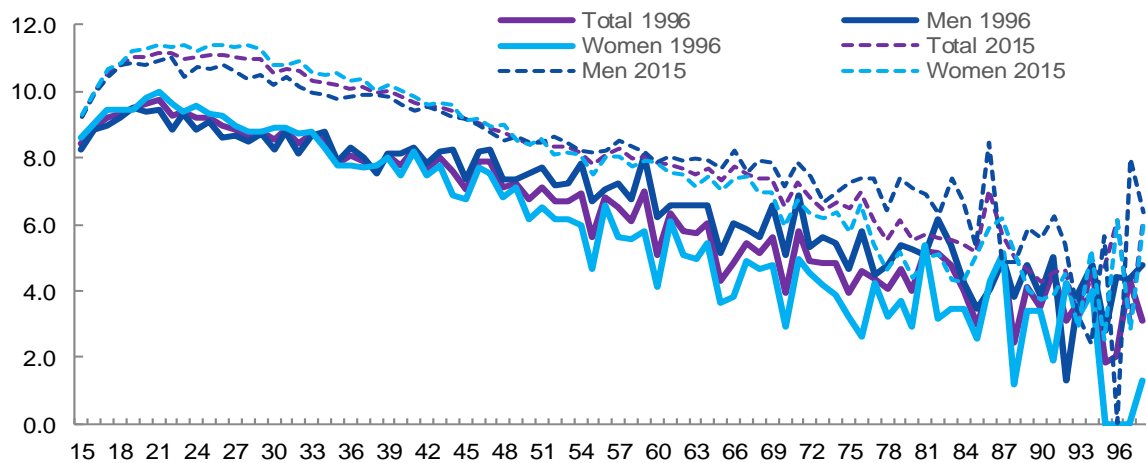
Source: Staff calculations based on the LFS

**Figure 39: Labor force participation rate by single-year age: gender**  
(Percent)



Source: Staff calculations based on the LFS

**Figure 40: Years of education by single-year age group**  
(Years of education)

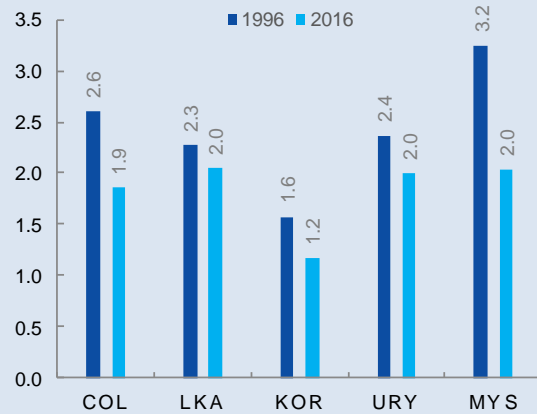


Source: Staff calculations based on the LFS

#### Box 6: Evolution of labor force participation in Colombia, Malaysia, Korea, and Uruguay

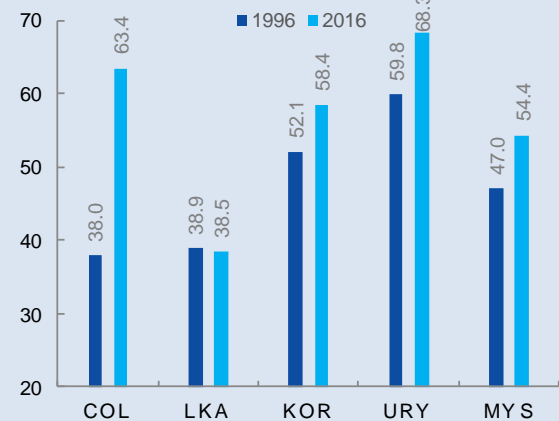
Between 1996 and 2016, the fertility rate fell from 2.3 to 2.0 births per women. However, these changes did not translate into higher number of women entering the labor markets. Female labor force participation in Sri Lanka remained relatively constant over the last two decades. This contrasts sharply with the evolution of female labor force participation in other countries. Figure 41 shows the changes in fertility rates in Colombia, Korea, Malaysia, Sri Lanka and Uruguay. All these countries experienced, to some extent, falling fertility rates between 1996 and 2016. Figure 42 indicates that only Sri Lanka, among the countries considered, did not experienced an upward movement in female labor force participation.

**Figure 41: Fertility Rates**  
(Birth per woman)



Source: World Development Indicators

**Figure 42: Female Labor force participation**  
(Percent)

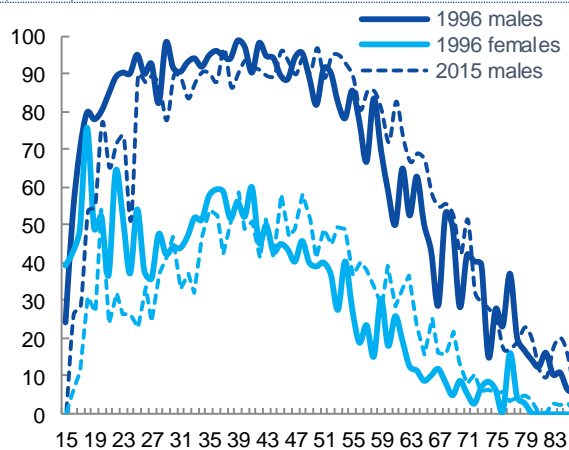


Source: World Development Indicators

**The gap between male and female participation rates was small for educated women**

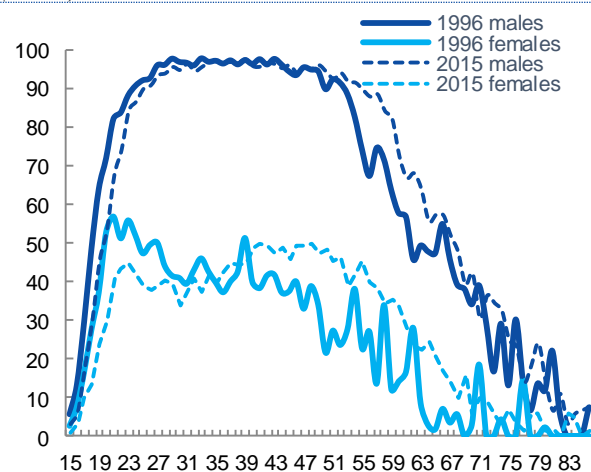
Disaggregating by education levels reveals some heterogeneity in female participation rates (Figures 43-45). Between 1996 and 2015, the gap between male and female participation rates was small for educated women with some degree of post-secondary education relative to those with only primary or secondary education, consistent with the potentially higher opportunity cost of not working for those with higher educational attainment.

**Figure 43: Labor force participation rate by single-year age group: primary or less**  
(Percent)



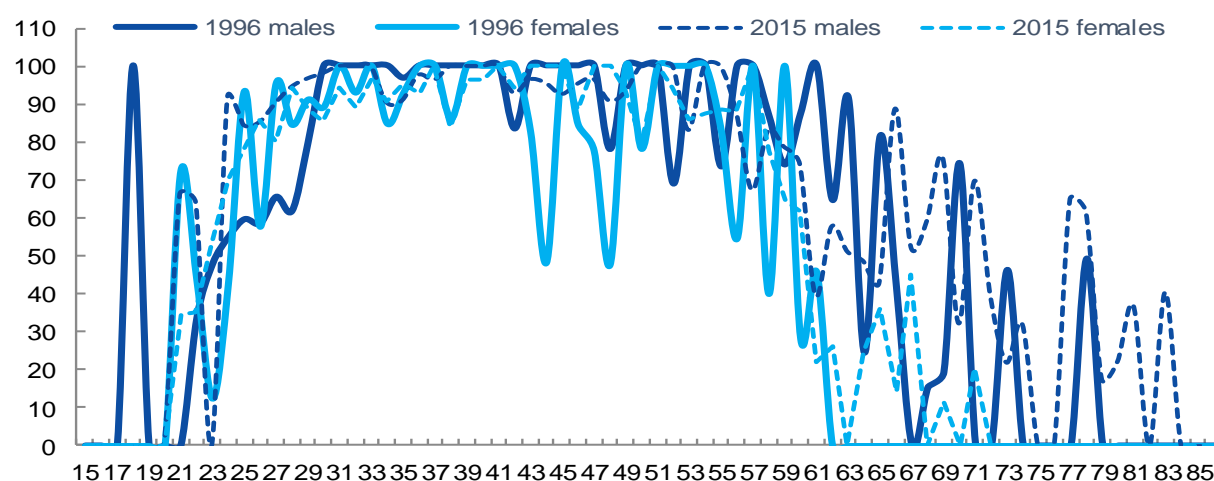
Source: Staff calculations based on the LFS

**Figure 44: Labor force participation rate by single-year age group: secondary**  
(Percent)



Source: Staff calculations based on the LFS

**Figure 45: Labor force participation rate by single-year age group: post-secondary**  
(Percent)



Source: Staff calculations based on the LFS

#### 4. Demographic change, female participation rates and growth

**Changes in the demographic structure are expected to have significant effects on labor market and growth**

Changes in the demographic structure of the Sri Lankan population are expected to have significant effects on the labor market. Factors directly linked to demographics such as population aging, the number of children, age of childbearing and fertility rates, together with other factors indirectly linked to demographics and associated with cultural norms and social behavior such as women's labor participation and education attainment—delaying entry in labor markets—are expected to impact people's choices in the labor market.

**All else equal, Sri Lanka's economic growth will decay due to demographic changes**

As discussed, relative to other countries in the region, Sri Lanka did undergo an early start of its demographic transition. Its population is older, because of high life expectancy and low fertility rates compared to countries in the same income bracket. All else equal, demographic factors are expected to drag economic growth and generate economic challenges for the working population supporting a gradually increasing share of the elderly. The dependency ratio—the ratio of potentially dependent population, i.e. youth and elderly, to potentially working-age population, i.e. 15-64—is projected to grow significantly from 51.2 percent in 2015 to 67.4 percent in 2050, driven by the increase in the number of the elderly. All else equal, Sri Lanka's economic growth will decay as the result of demographic changes.

**Increasing female labor force participation could mitigate the impact of demographic factors on growth**

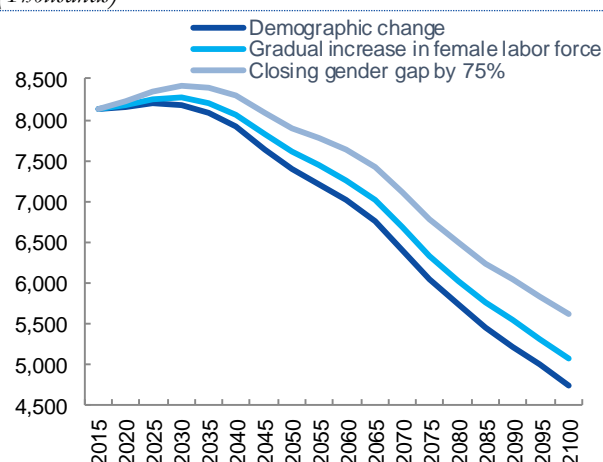
Female labor force participation depends on several factors, including traditional/culturally driven gender-division of labor, childbearing, domestic chores, availability of child and elder care centers, labor conditions and legislation, access to education, divorce rates, salary and pay gap, and safe transportation, among others. Several of these factors may limit or constrain female labor force participation on the supply side.<sup>22</sup> This section analyzes three simple scenarios to evaluate the impact of an aging population structure on economic growth in the decades to come. The first scenario solely considers the impact of demographic forces. The second and third scenarios evaluate the effect of changes in female labor force participation.

<sup>22</sup> This section centered mainly on the impact of demographic changes on some key labor market indicators. The analysis of the demand side of the labor market has been left out and it is beyond the scope of analysis of this section.

- Scenario I – Demographic transition: Labor force participation rates by five-year age group<sup>23</sup> derived from the 2015 labor force surveys are embedded into the UN population projections to reflect changes in the age-structure of the population.
- Scenario II – Gradual increase in female labor force participation rates: An increase in female labor force participation of 0.5 percentage points for younger cohorts and 0.25 percentage points for middle-age cohorts every five years is considered under this scenario. The scenario also reflects the changes in the age-structure of the population.
- Scenario III – Closing the gender gap by 75 percent: This scenario assumes that female labor force participation rates increase over time and they reach 75 percent of the male labor force participation rates by 2100. This is calculated by five-year age brackets.

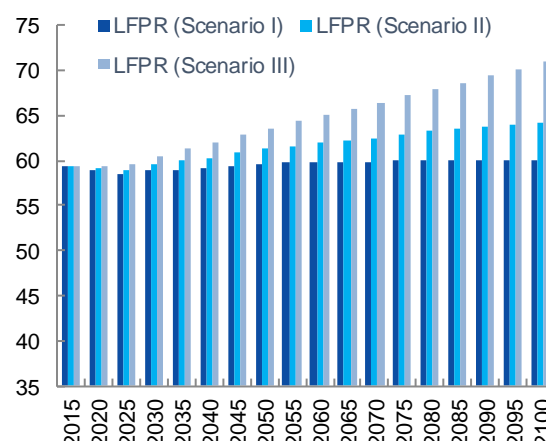
Total population is forecast to peak in 2035 at about 21.5 million persons, and to decline afterwards. The potential working-age population is projected to peak earlier in 2025 at 14 million persons and to decline thereafter. Under the demographic scenario, the labor force (ages 15-64) falls from about 8.1 million persons in 2015 to 7.4 million in 2050. Labor force participation rates remain around 59.5 percent.

**Figure 46: Demographics and labor force (15-64)**  
(Thousands)



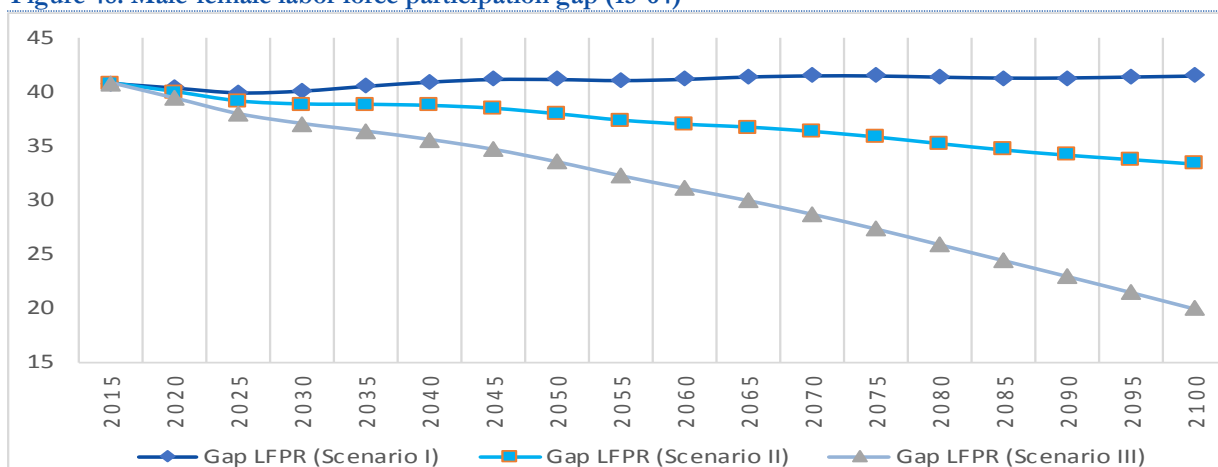
Source: Staff calculations

**Figure 47: Labor force participation rates (15-64)**  
(Percent)



Source: Staff calculations

**Figure 48: Male-female labor force participation gap (15-64)**



Source: Staff calculations

<sup>23</sup> In this section, labor force participation is computed using five-year age groups (i.e. 15-19, 20-24, and so on). This is due to the available population projections.

Under the gradual increase in female participation scenario, the total labor force falls to 7.6 million by 2050. Male participation rates by five-year age brackets are assumed to remain at 2015 levels. Female labor force is projected to decline marginally by 26,000 persons. To put it in perspective, female labor supply (ages 15-64) is expected to decline over the same period by 627,000 persons. Under this scenario, female labor force participation is expected to gradually rise from 39.7 percent to 43.2 percent by 2050.

**Even after factoring in increases in female participation rates, a decline in labor force should be expected**

Under the last scenario, the gender gap by five-year age brackets is assumed to narrow by 75 percent in 2100. This implies a much faster increase in female labor force participation rates compared to scenario II. Under this scenario, female labor force is expected to increase by 263,000 persons between 2015 and 2050 and female participation rates are expected to increase from 39.7 to 47.6 percent. Total participation rate will increase from 59.3 in 2015 to 63.6 percent in 2050. Overall, Figures 46-48 suggest that even after factoring in increases in female participation rates, a decline in the labor force should be expected.

We perform some back of the envelope calculations to determine the impact on GDP per capita growth of each of the scenarios presented above (Table 1). We disaggregate GDP per capita into GDP per worker, the share of employed to labor force (assumed constant in this exercise) and the share of labor force to total population.<sup>24</sup>

**Table 1: Impact on GDP per capita growth**

	2020	2025	2030	2035	2040	2045	2050
Scenario I	-0.27	-0.17	-0.13	-0.26	-0.36	-0.46	-0.28
Scenario II	-0.20	-0.10	-0.05	-0.18	-0.27	-0.38	-0.20
Scenario III	-0.10	0.01	0.05	-0.06	-0.16	-0.28	-0.10

Source: Staff calculations

**Closing the gender gap would buffer the impact coming through the reduction in the number of workers**

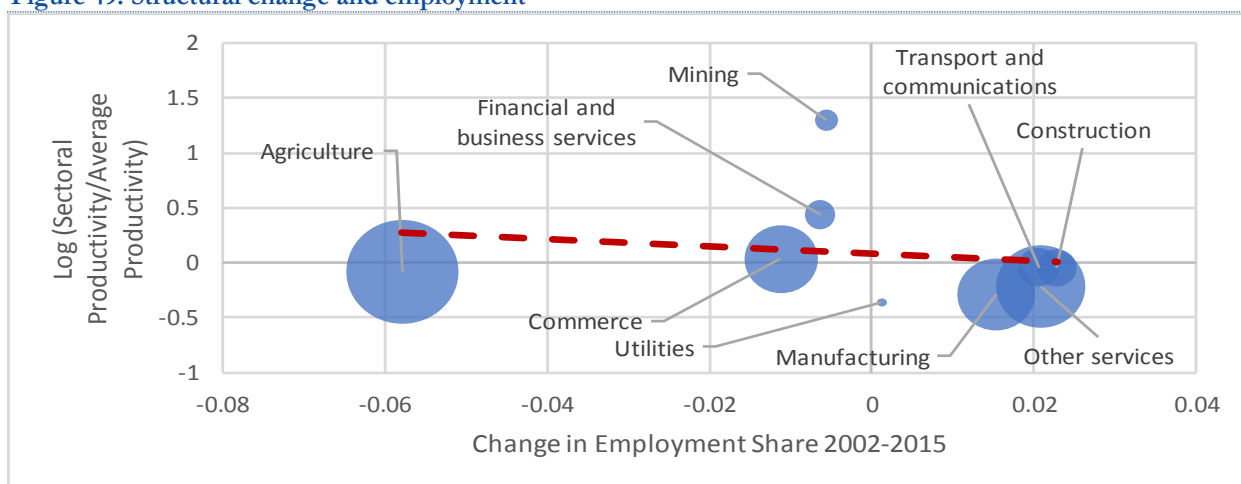
Table 1 shows the drag on annual growth rate (compound annual growth rates) associated with the shrinking labor force. Under the demographic scenario, GDP per capita growth could have an important slowdown effect due to population aging. Without any other offsetting factor, it would also lead to a significant fall in the labor force over time. Increases in female labor force participation are expected to counter—to some extent—the impact of ongoing demographic changes. Closing the gender gap in terms of labor force participation would buffer the impact coming through the reduction in the number of workers. Results in Table 1 also suggest that other factors are required to sustain long-term growth.

**Increases in education attainment can also lift productivity and participation rates of younger cohorts**

These other factors have not been directly incorporated in the analysis presented above. For instance, participation rates are closely related to education decisions and the return to education. The opportunity cost of an additional year of education is reflected in postponement of entry to the labor market and forgone income. As discussed, female participation rates for people with post-secondary education was significantly higher than those with lower levels of educational attainment. Higher levels of educational attainment are also likely to be accompanied by increases in labor productivity and labor income. Increases in education attainment and number of years of education could also help lift productivity levels and participation rates of younger cohorts. In addition, behavioral changes as life expectancy increases are likely to increase participation rates of the elderly as well, particularly in an environment in which only a few are entitled to old age pensions and retirement savings are low.

<sup>24</sup> This can be expressed as  $\frac{GDP}{N} = \frac{GDP}{E} \times \frac{E}{LF} \times \frac{LF}{N}$ . GDP per capita changes are the sum of changes in GDP per worker (labor productivity), the ratio of employment to labor force, and the ratio of number of persons in the labor force to total population.

Figure 49: Structural change and employment



Source: Staff calculations

**Labor reallocation towards more productive sectors could also lead to productivity gains and hence higher growth**

The distribution of employment in Sri Lanka remains heavily tilted towards agriculture. Employment in the agriculture sector accounted for about 28.7 percent of total employment in 2015 (down from 34.5 percent in 2002), followed by other services (23.3 percent), manufacturing (18 percent) and commerce (13.5 percent). Figure 50 compares the movements in employment measured by employment shares (the size of the bubble being the employment shares in the initial year) to relative sector labor productivity. The overall picture is that changes in employment across sectors between 2002 and 2015 have been in sectors with labor productivity below that of the average productivity. Labor reallocation towards more productive sectors could also lead to labor productivity gains.

**Policies that foster women's entry into the labor market could be important**

Public policies that foster women's entry into the labor market could be relevant. This includes improving the supply of child care and elder care services, safe transport, and flexible work arrangements for women. Policies that could also lead to a change in the composition of the labor supply towards a more educated and skilled workforce could also help reverse the slowdown in growth. While Sri Lanka was able to provide high and equitable access to primary and secondary education, the country has ample room for improvements in terms of tertiary education level. Gross enrollment rate in higher education is lower than what its GDP per capita would suggest, more comparable to the average in low income countries and lower than in middle-income countries. Major efforts to enhance the quality and relevance of education at different stages would be needed (World Bank, 2017).<sup>25</sup> In addition, an aging population structure generates a new set of challenges in terms of education policy, health care systems and old age income that would require significant rethinking in current public policies and financing options. Planning and provisioning for such changes would be a good starting point in the process.<sup>26</sup>

<sup>25</sup> Dunder, H., B. Millot, M. Riboud, M. Shojjo, H. Aturupane, S. Goyal, and D. Raju (2017): "Sri Lanka Education Sector Assessment: Achievements, Challenges, and Policy Options," Directions in Development, World Bank.

<sup>26</sup> The analysis presented in this focus section does not cover the demand side of the labor market and is beyond the scope of analysis presented here.

## D. World Bank Group Assistance



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

The World Bank Group has been supporting Sri Lanka's development for close to six decades. Sri Lanka is in many ways a development success story, and yet faces a number of critical challenges as it pursues its goal of becoming an upper middle-income country. The Systematic Country Diagnostic (SCD)<sup>27</sup> carried out in 2015 identifies critical constraints and opportunities that Sri Lanka faces in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. They include: (i) achieving fiscal sustainability; (ii) enhancing competitiveness and promoting more and better jobs for the bottom 40 percent; (iii) providing for social inclusion for disadvantaged segments of the population; and (iv) attaining longer term sustainability, especially of the environment, political stability, and an aging population). In addition, strengthening governance is a cross-cutting challenge. The SCD anchors the World Bank Group Country Partnership Framework (CPF) for FY2017–20.<sup>28</sup>

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

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

**The World Bank portfolio covers a range of areas to**

Current active World Bank portfolio (as of 31<sup>st</sup> May 2018) comprises 15 projects with a total net commitment value of USD 1.82 billion (13 IDA, 1 IBRD, and 1 IBRD-IDA blend). The World Bank's financing to Sri Lanka has mainly been for investment

<sup>27</sup> The SCD report and video are available online at:

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

<sup>28</sup> The CPF is available at: CPF: <https://openknowledge.worldbank.org/handle/10986/24682>

**support Sri Lanka's transition**

projects. It is financing one program-for-results project, approved in May 2017, to support the government's program to improve higher education. The sustainable development cluster (consisting of urban operations, climate resilience, agriculture, environment and water sectors) accounts for the largest share of the portfolio with 7 operations and 56% of the financing. The WB provides significant financing support for urban development (23 percent of the total commitment), and climate resilience (8 percent of total commitment). The human development cluster (i.e. education, health and social protection) also has 7 operations and represents 40 percent of total commitments. The education sector alone consists of 5 operations and represents nearly 25 percent of the portfolio. In addition to lending, the World Bank is carrying out analytical work and technical assistance across various sectors, funded through both trust funds and own budget. The World Bank has extended its support in close coordination and collaboration with development partners, including through co-financing projects and leveraging private sector resources where opportunities arise.

**IFC is addressing the key development gaps**

In line with the CPF, IFC's strategy in Sri Lanka is aimed at promoting better, efficient and sustainable growth. It focuses on the country's biggest development gaps, especially in: inclusion; infrastructure and productivity; and sustainability. To foster inclusion, IFC is working on increasing access to finance, especially to MSMEs, smallholder farmers, and women. IFC is also working on gender inclusion such as the "Women in Work" program which aims to improve women's participation in private sector economic activities from board representation to corporate employment and supply chains. IFC's support for infrastructure aims to improve electricity provision, generation mix and efficiency. IFC is also focused on critical last mile infrastructure including in logistics and value chain services. In sustainability, IFC is working on renewable solutions, narrowing the green/affordable housing gap, supporting climate change mitigation and adaptation measures, and improving resource efficiency. IFC is also targeting sectors with significant job creation impacts especially agribusiness and tourism.

**The IFC portfolio is expanding**

As of April 30, 2018, IFC's total committed investment portfolio stood at about USD 349 million. In addition, IFC has an advisory program comprising 12 portfolio projects with a combined portfolio value of USD 13.4 million. IFC's advisory projects are helping to boost access to finance especially for SMEs and women, and strengthening business skills and supply chains particularly in tourism sector. IFC is also enabling the government in the development of sustainable infrastructure such as water and solar.

**MIGA stands ready to support FDI, in projects aligned with the CPF and the WBG's goals**

MIGA is open to supporting foreign investment in projects with positive development impacts, consistent with the CPF and the World Bank Group's goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. Through its political risk guarantee products, MIGA stands ready to support foreign investors, including in partnership with the World Bank and IFC.

## Key Economic Indicators

Macroeconomic Indicators	Actual	Estimates	Projections		
	2017	2018	2019	2020	2021
<b>Real sector</b>					
GDP, (current, LKR billion)	13,317	14,484	16,044	17,501	19,011
Real GDP growth (%)	3.3	3.1	3.5	3.6	3.7
CCPI inflation (year-on-year, %)	6.6	4.3	5.0	5.0	5.0
USD billion, unless otherwise indicated					
<b>External sector</b>					
Exports of goods	11.4	11.8	12.1	12.4	12.7
Imports of goods	21.0	22.0	21.9	22.4	22.9
Trade balance	(9.6)	(10.1)	(9.7)	(9.9)	(10.2)
Tourism receipts	3.9	4.3	4.6	4.9	5.1
Remittances	7.2	7.2	7.3	7.5	7.7
External Current Account	(2.3)	(2.5)	(2.0)	(2.1)	(2.3)
External Current Account (share of GDP, percent)	(2.6)	(2.9)	(2.4)	(2.4)	(2.5)
FDI inflows	1.4	2.0	1.2	1.0	1.1
Official reserves	8.0	6.9	7.3	7.6	8.0
Official reserves (months of imports of goods and services)	3.8	3.1	3.3	3.4	3.5
Exchange rate (end period, LKR/USD)	152.9	182.9			
Percent of GDP, unless otherwise indicated					
<b>Fiscal accounts</b>					
Total revenue and grants	13.8	14.5	14.6	14.6	14.7
Tax revenue	12.5	13.2	13.3	13.3	13.3
Total expenditure	19.3	19.7	19.4	19.4	19.3
Current expenditure	14.5	14.9	14.6	14.6	14.5
Capital and net lending	4.8	4.8	4.8	4.8	4.8
Primary Balance	0.0	0.8	1.0	1.1	1.3
Overall fiscal balance	-5.5	-5.2	-4.8	-4.8	-4.7
Central government debt <sup>1</sup>	77.4	83.0	81.4	80.2	79.2
<b>Monetary/financial sector</b>					
Standing deposit facility rate (December, % per annum)	7.25	8.00			
Standing lending facility rate (December, % per annum)	8.00	9.00			
Private sector credit growth (M2b <sup>2</sup> , year-on-year, %)	14.7	15.7	14.8	15.2	14.5

Notes: <sup>1</sup> Central government debt number excludes: debt contracted by SOEs and state agencies with or without a Treasury guarantee, overdrafts at the state banks of LKR 150 billion (2017), and restructuring bonds amounting to LKR 102.5 billion issued to settle dues from SOEs to CPC (LKR 53.9 billion), to recapitalize Sri Lankan Airlines (LKR 11.7 billion), National Water Supply and Drainage Board (LKR 13.0 billion) and CPC (LKR 23.9 billion) (Central Bank of Sri Lanka annual report 2017).

<sup>2</sup> Includes currency, demand deposits, time and savings deposits held by the public with commercial banks

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

