What to expect in 2016 for Sri Lanka's economy?

Sri Lanka's economy in 2015 was overshadowed by the developments on the political front. By the time political stability seemed to have reached an even footing in early September, the economy came into the lime light with a depreciation of the LKR against the USD. While Sri Lanka may have reached some degree of political certainty at least in the short-term, economic uncertainty still lingers on.

2015 in short

The year started with a slide in reserves mainly to accommodate the redemption of the sovereign dollar bond issued in 2009. The delay in going to the international capital market saw a surge in domestic borrowing mainly through Treasury bonds. A surprise rate cut by the Central Bank of Sri Lanka in April supported domestic borrowing at lower cost. Meanwhile a surge in imports driven by consumer goods applied pressure on the trade account with subdued level of export growth. Remittances which has historically grown over 5% every year, has only so far grown 1.8% when compared to 2014. The key inflation indicator went into deflation territory albeit briefly (July- September) but is expected to edge up to mid-single digit levels by December with a weaker rupee impacting the cost of living mainly through imported foods.

Sri Lanka Economy in 2016: Key Themes to watch out for

- **Policy Dilemma**

The impact on interest rates and LKR will be determined by two factors. The policy direction that the CBSL would want to pursue in particular for interest rates; the longer that interest rates are held at present levels, the more it will drive the economy through imports and consumption leading to further pressure on the Balance of Payments. If rates do not adjust, then the LKR will be under significant depreciatory pressure. If the monetary policy is adjusted to reflect a higher interest rate regime then we could see some degree of stability in the LKR. The CBSL will also be mindful not to stoke a private sector credit bubble similar to what was seen in 2011/12 which required tightening monetary policy that led to two years of subdued credit growth in the economy.

The other key factor is how global markets play out in 2016 especially with expectations of higher interest rates in the U.S. which is a key benchmark for lot of Sri Lanka's debt instruments. If many of the emerging markets see depreciation similar to 2015, then the LKR could require a similar adjustment to be competitive.

- I**nflation risk back on the table**

Global food prices are rising after being subdued in recent years and this is expected to have a significant impact on countries like Sri Lanka which have a high percentage of food in their inflation basket(CCPI 2006/07 has 41%). Other supply side issues such as the impact from the much discussed "El-Nino" weather condition could add to the pressure on prices globally. The more the rupee depreciates, inflation will see the pass through impacts of it. This reason alone could be a cause of concern for the CBSL in raising policy rates.

- **Rebalancing in the economy to more investment driven**

The Medium term economic policy laid out by the Prime Minister which was complimented to a large part by the Budget will need to see concrete action in 2016. Though the political realties may hinder the full implementation of certain proposals, the need of the hour will be to encourage investment through Foreign Direct Investments and Public Private Partnerships to drive investment growth in the island without a continued heavy reliance on commercial debt. In turn, we could see a favorable shift to a balance between a consumption and investment economy given that the high levels of consumption in 2015 is unsustainable moving forward given our debt levels.

- **Reforms crucial in 2016 to avoid a repeat of debt cycle in 2018/19**

2016 reforms are crucial in providing the Government with a return on investment to face headwinds and repayments from 2018 onwards. Current data shows there is about $4 billion in debt and loan repayments between April 2018 to April 2019 (this calculation includes maturing sovereign, quasi-sovereign and SLDB bonds in addition to IMF repayments as well). This indicates the bunching up of debt similar to 2015 could occur in 2018/19 if steps are not taken next year to redirect the economy from it.

- **Lack of Fiscal consolidation leaves country's credit rating vulnerable**

Sri Lanka requires a sovereign rating by an international rating agency every time it looks to tap international capital market to raise dollar bonds. Most economic commenters including the IMF, had been looking at the Budget 2016 to see feasible revenue initiatives and move to reduce the budget deficit. However, the budget provides rather optimistic revenue growth targets with lack of steps to reduce the deficit and address the growing debt levels. Post the budget, Fitch Ratings has commended the reforms initiatives but has stated that there is lack of fiscal consolidation in the medium term while Moody's has issued a report which says fiscal targets for 2016 is credit negative. Hence, a key risk for Sri Lanka in 2016 is either a negative ratings outlook or a ratings downgrade.

- **Exports could perform better in 2016 with a competitive rupee and GSP+**

Exports growth in 2015 has been rather muted, affected by a seafood export ban to the EU, decline in garments exports to the EU compared to recent years, benign demand conditions and an uncompetitive LKR for most part of the year. With expectations for the removal of this ban and regaining of the GSP+ status by at least the second half of 2016, exports could become a key driver of the economy and ease BoP pressure.

- **Rate rising environment in the U.S.**

Whether it will be December of 2015 or in the first half next year, the U.S. Federal Reserve is set to increase their benchmark rates from near zero levels which they have maintained since December 2008. Though expectations are now poised for a rate rise, uncertainty still lies with the pace at which policy raised will be increased. A faster than expected pace could be negative for emerging and frontier markets like Sri Lanka in particular if hot money flows out of these markets back to safe heavens like the U.S. Sri Lanka which has already seen a Rs.153 billion decline in foreign holdings of local government securities from January to November of this year would be sensitive to further declines, if emerging markets see further outflows.

Overall 2016 will continue to be a challenging year for Sri Lanka's economy with many different headwinds expected. If a stable footing for the economy is achieved in the near-term it augurs well for the medium to long-term when the fruits of the reform agenda could come into play.

Shiran is a Senior Economic Analyst at Frontier Research. He can be reached on shiran@frontiergroup.info or on twitter on @ShiranFdo