Sri Lanka’s Macro-financial Developments, Issues and Challenges in Structural Transformation and Lessons from China’s Experience

P. Nandalal Weerasinghe

23th July 2021

Structure of the Presentation

- **Comparison between China and Sri Lanka**
- **Conclusions on Lessons to be Learnt from Chinese Experience**

Comparison between China and Sri Lanka

- To learn appropriate lessons for Sri Lanka from China, one needs to recognise significant differences between the two countries beyond macroeconomic management.
- China has the biggest domestic market in terms of population, domestic resource availability and very stable centrally planned administration which has made it easier to maintain consistent and predictable policies throughout the period.
- In contrast, Sri Lanka is a small island economy with a population of 21 million compared to the over one billion population in China.
- In addition, Sri Lanka has a long history of having democratically elected administrations changing power between right-wing liberal ideology versus left oriented socially oriented ideology

Real GDP growth

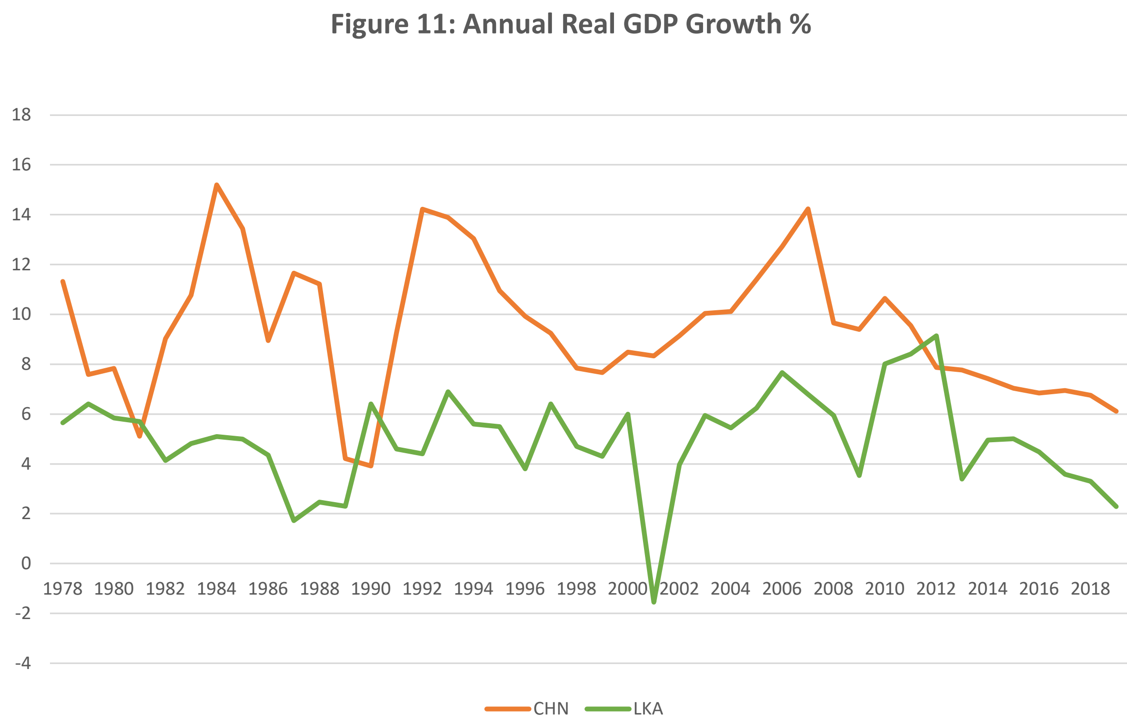
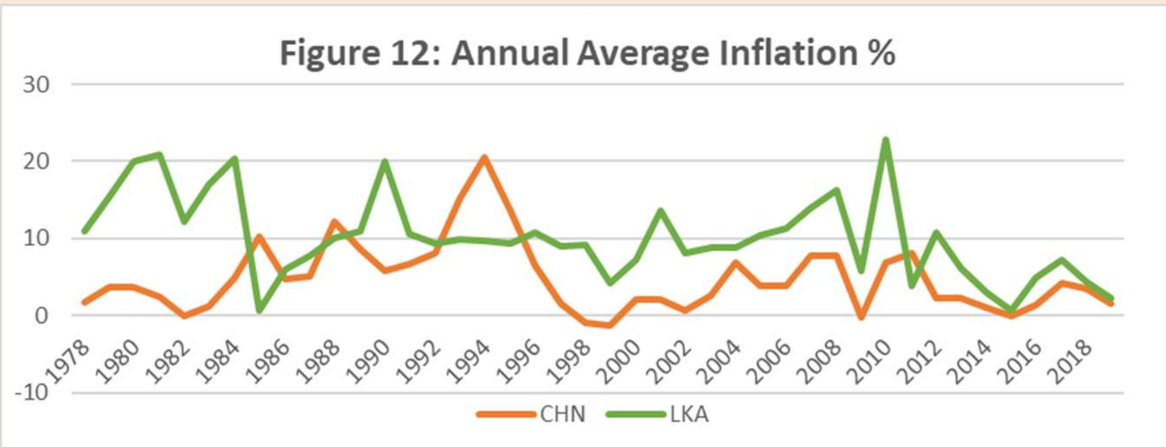


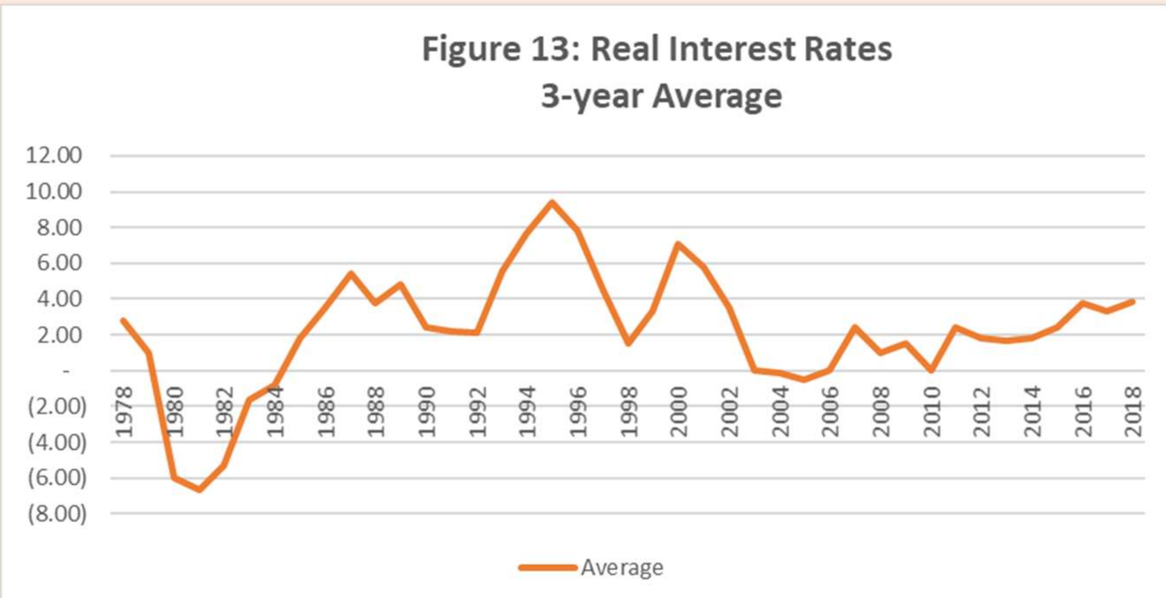
Table 2:Real GDP Growth Fluctuations 1978-2019	
Country	Volatility of Real GDP growth
BGD	0.20
CHN	0.18
IDN	0.79
IND	0.38
KOR	0.54
LKA	0 .30
MYS	0.49
PAK	0.30
PHL	0.25
SGP	0.54
THA	0.63

Inflation



- Both countries have used similar tools to maintain growth and inflation
- China has used tools proactively whereas Sri Lanka has used similar policies reactively

Real Interest Rates – Sri Lanka



- China has been able to maintain lower real interest rates than Sri Lanka
- Domestic savings are high and well above investment needs in China
- Sri Lanka has been running savings investment deficit with very low domestic savings

Exchange Rate Management

- Exchange rate management in both countries has evolved in a similar pattern.
- Both have moved gradually from fixed exchange rate regime to more flexible regime during the same period.
- China was able to pile up external reserves by pursuing export oriented and FDI promoting regime so that China was able to manage exchange rate in a more favorable manner
- Whereas Sri Lanka’s inward oriented growth promotion strategy required external borrowings to finance persistent current account deficits. This strategy led to regular cycles of balance of payment distresses and now face with unsustainable levels of external debt

Financial Reforms, Financial Deepening and Financial Stability

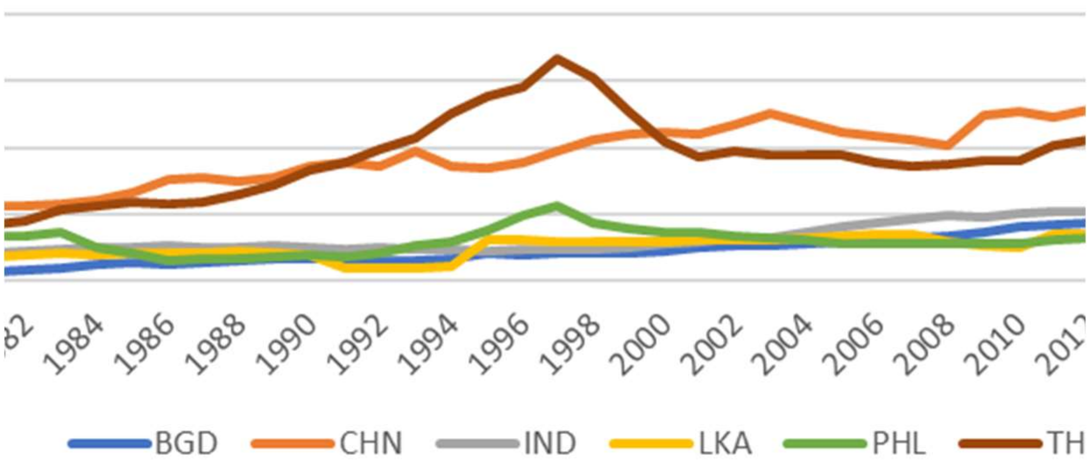
- China has developed the domestic financial system at a rapid pace by implementing a strong set of reforms within a relatively short period while maintaining financial stability.

- Development and reestablishment of capital markets began even later in the early 1990s with opening of stock exchanges, in the early-1990s. Now China has a multi-tier capital market which is playing an important role in financial intermediation, particularly in the reform of state-owned enterprises and the growth of the private sector.

- In comparison, Sri Lanka has a longer history of a well-established banking system, stock exchange and regulatory institutions. Despite this, financial deepening and financial sophistication remain much lower than what China has achieved in a relatively short period of time.

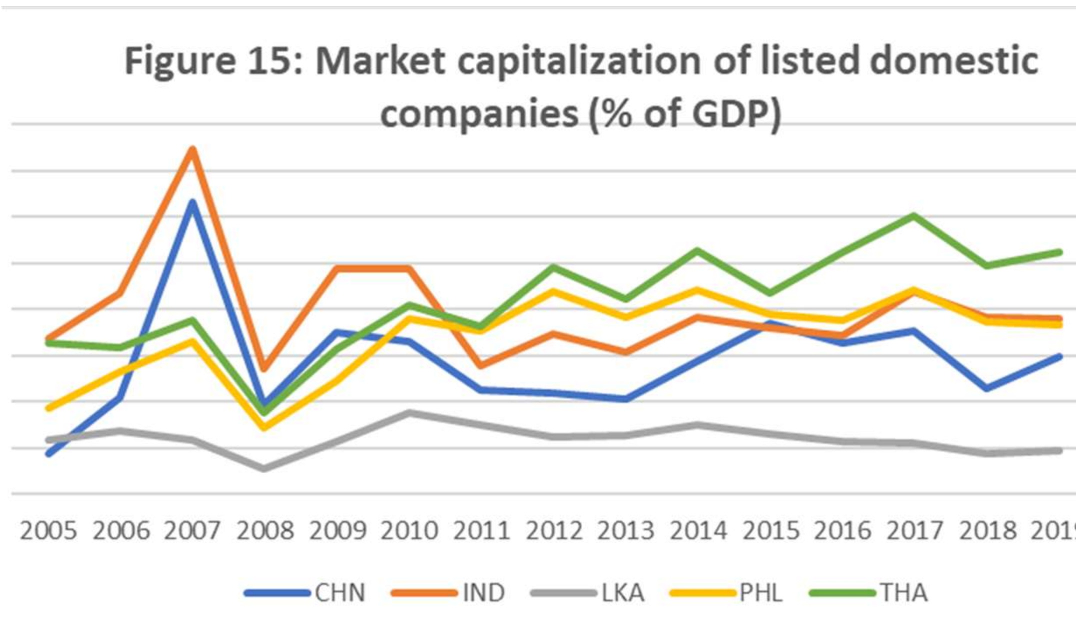
Financial Deepening through Banking Sector

Figure 14: Credit to Private Sector % of GDP



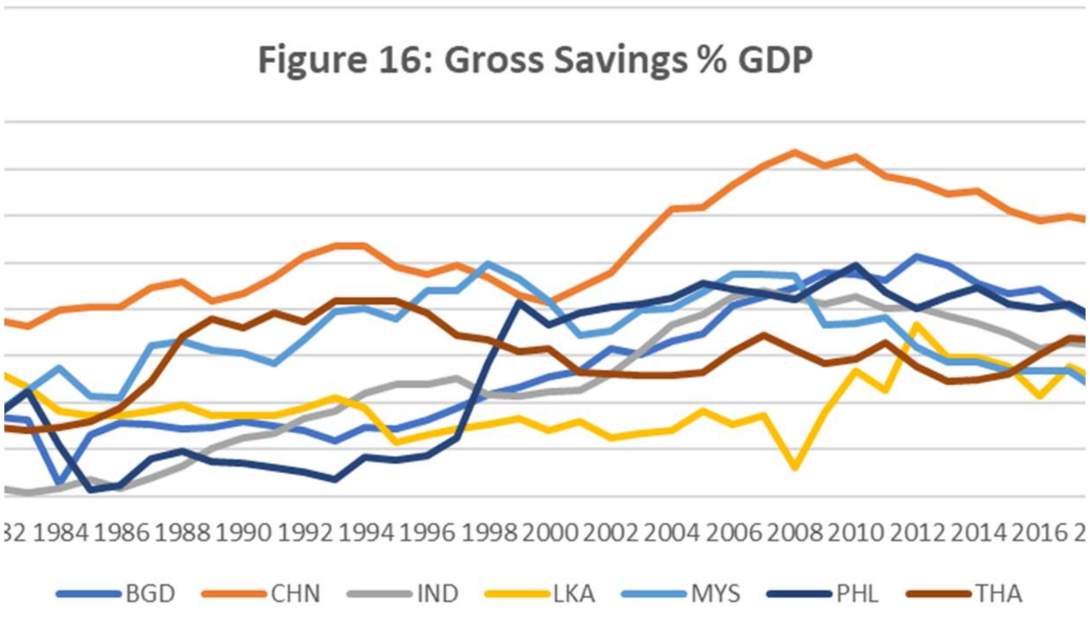
- Reforms has improved the financial intermediation process and funded the high GDP growth achieved by China.
- In contrast the contribution by the Sri Lankan banking sector in funding GDP growth has been much lower.

Role of equity market in financial deepening



- Both countries had similar levels of market capitalization in 2005
- China has made a significant progress whereas Sri Lanka's level remain stagnant well below peer markets in the region

Gross Savings



- China has become one of the best gross domestic saving economies compared to all regional peers.
- Sri Lanka's position remains one of the lowest despite it was only second to China, in 1982.
- By 2019 the two countries had moved in opposite directions.

Capital Account Liberalization

- Both countries have followed a similar gradual and cautious approach in liberalizing the capital account
- China has moved in the direction of liberalization steadily and consistently
- Sri Lanka has moved in both directions from time to time to deal with recurring balance of payment issues and now maintain a very tight controls on capital out flows.
- Such unpredictable policy directions has deterred attracting long term capital inflows to Sri Lanka.

China’s Exchange Rate Regimes and External Reserves

- China has managed exchange rate favoring export led growth leading to persistent current account surpluses thereby piling of external reserve buffers.

- With large built-up reserves, China can now maintain exchange rate as they wish.

Lessons to be Learnt from Chinese Experience

- Even after opening the Sri Lankan economy to a more market-oriented approach from 1978, the development strategy has been switching between export oriented outward looking policies and inward oriented policies favouring non-tradable sectors or an attempted mix of these two ideologies.

- Such changes make macroeconomic policies highly unpredictable, making it difficult to formulate medium to long term investment decisions with certainty. This is one of the reasons why Sri Lanka has never been able to achieve a high ratio of gross investment or the high level of FDI required for long-term sustainable growth.

Lessons to be Learnt from Chinese Experience

- As a result of pursuing export-oriented development strategy, China became a key manufacturing base for global production and a key centre for global supply chains.
- China has built up a massive buffer in terms of external reserves enabling China to maintain a stable exchange rate regime.
- Sri Lanka has never been able to build up sufficient buffers in external reserves compared to its external financing needs, compelling the authorities to seek assistance from the IMF on a regular basis.
- Sri Lanka can learn several lessons from China's experience on how to fast track reforms in the financial sector to make the financial intermediary process much more efficient and improve financial deepening within a relatively short period.

Lessons to be Learnt from Chinese Experience

- Another major lesson Sri Lankan authorities can learn from the Chinese experience is to become more proactive in using macroeconomic tools to prevent potential distress in growth and stability of the economy instead of being compelled to use such tools reactively.
- The major source of Sri Lanka's macroeconomic imbalances has been successive governments running persistently high fiscal deficits causing external current account deficits, leading to repeated cycles of balance of payments distress.
- Such twin deficits have led to public debt sustainability issues, in particular external debt sustainability.

Thank You