Country Report

Sri Lanka

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The Economist Intelligence Unit

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"0 or 0.0" means nil or negligible;"n/a" means not available; "-" means not applicable

Sri Lanka

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Briefing sheet

Editor: **Sarthak Gupta**
Forecast Closing Date: **December 17, 2018**

Political and economic outlook

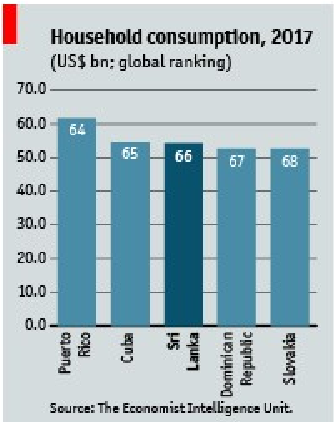
- The Economist Intelligence Unit expects early elections to be called in late 2019 and forecasts that the Sri Lanka Podujana Peramuna will win the largest number of seats. In the election run-up, the government will remain weak and the political scene unstable.
- Social unrest, caused by religious and ethnic tensions, will continue to pose a threat to political stability during the 2019-23 forecast period. Periodic bouts of violence against property and people are likely, but we expect the authorities to restore control quickly.
- The budget deficit will average the equivalent of 5.3% of GDP in 2019. We expect the fiscal deficit to widen from 2020 onwards, owing to the conclusion of the IMF programme in 2019 and also because a populist government is likely to be in office by then.
- We forecast that the annual rate of real GDP growth will average 4.7% in 2019-23. Exports will grow more strongly during the second half of the forecast period and will be supported by increased demand from major markets such as the US and the EU.
- We expect the Sri Lanka rupee to average SLRs182:US$1 in 2019, compared with an estimated SLRs162.4:US$1 in 2018. After stabilising briefly in 2020-21, the rupee will again start to depreciate against the dollar from 2022 onwards, because of rate rises in the US.
- Despite strong remittance inflows and tourism receipts, the current-account deficit will remain wide, owing to the country's high import needs, relating to fuel and textile inputs. We forecast a current-account deficit equivalent to 3.4% of GDP on average in 2019-23.

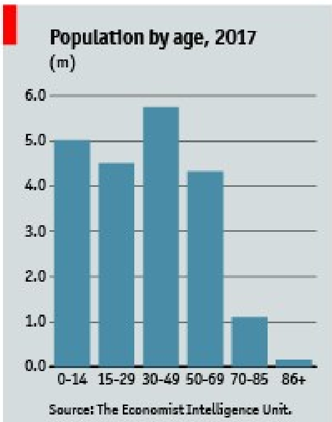
Key indicators

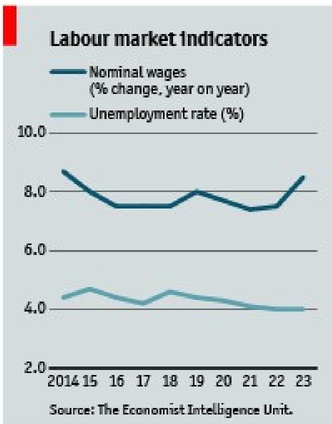
	2018[a]	2019[b]	2020[b]	2021[b]	2022[b]	2023[b]
Real GDP growth (%)	3.8	4.1	4.1	4.8	5.2	5.3
Consumer price inflation (av; %)	4.4	5.6	4.6	5.0	5.3	4.9
Government balance (% of GDP)	-5.3	-5.3	-5.5	-5.6	-5.6	-5.5
Current-account balance (% of GDP)	-3.6	-3.4	-3.3	-3.4	-3.5	-3.4
Money-market rate (av; %)	8.3	9.6	8.7	8.0	8.2	8.7
Unemployment rate (%)[c]	4.6	4.4	4.3	4.1	4.0	4.0
Exchange rate SLRs:US$ (av)	162.4	182.0	179.5	177.0	181.6	185.3

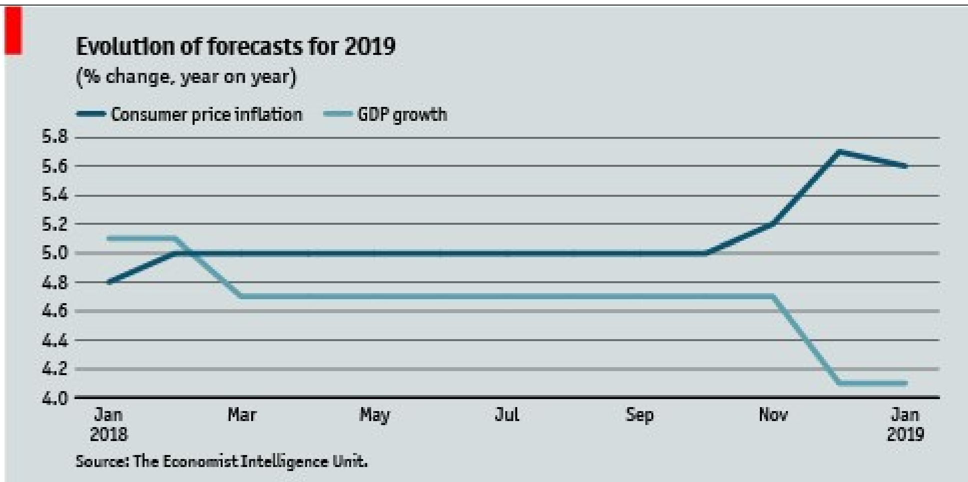
[a] Economist Intelligence Unit estimates. [b] Economist Intelligence Unit forecasts. [c] National estimates.

Market opportunities









Key changes since November 29th

- We have revised down our inflation forecast for 2019 in view of softening global oil prices. We now expect consumer prices to increase by 5.6% in 2019, compared with our previous forecast of 5.7%. Producer prices will rise by 6.8%, compared with 7% previously.
- We have revised our external sector forecast as we now expect oil prices to decline in 2019, which will have a moderating impact on import growth. We now expect a current-account deficit equivalent to 3.4% of GDP in 2019; our previous forecast was 3.7%.

The month ahead

- **December 28th—Monetary policy review:** The decision on interest rates will be important in gauging the Central Bank of Sri Lanka's reaction to the recent political crisis. The bank tightened rates in mid-November in response to increased volatility in the currency and financial markets.
- **December 2018/January 2019—National accounts (2018, Q3):** The data will be important to gauge the pace of economic recovery after lacklustre growth in 2017. Growth in the second quarter of 2018 averaged 3.7% year on year, a slight pick-up from 3.3% in the first quarter.

Major risks to our forecast

Scenarios, Q4 2018	Probability	Impact	Intensity
Domestic infrastructure fails to cope with severe weather disasters	High	High	16
Restrictions on foreign-exchange transactions are imposed	High	High	16
Interest rates rise sharply	Moderate	High	12
Job churn increases	Moderate	High	12
Sri Lanka faces a balance-of-payments crisis	Moderate	High	12

Note. Scenarios and scores are taken from our Risk Briefing product. Risk scenarios are potential developments that might substantially change the business operating environment over the coming two years. Risk intensity is a product of probability and impact, on a 25-point scale.
Source: The Economist Intelligence Unit.

Outlook for 2019-23

Political stability

The Economist Intelligence Unit expects the political scene to remain extremely volatile in the initial part of the 2019-23 forecast period. On December 17th Ranil Wickremesinghe was reinstated as prime minister, ending a political crisis of almost two months' duration. The country was plunged into turmoil in late October when the president, Maithripala Sirisena, announced the dismissal of Mr Wickremesinghe, appointing Mahinda Rajapaksa (who served as president in 2005-15) in his place. This broke the almost four-year alliance between Mr Wickremesinghe's United National Party (UNP) and Mr Sirisena's Sri Lanka Freedom Party (SLFP). After the Sirisena-Rajapaksa camp had failed to garner sufficient support to secure a parliamentary majority, Mr Sirisena dissolved parliament in early November and called a snap election for January 2019. On December 13th the Supreme Court reversed the president's order on constitutional grounds. We expect a Wickremesinghe-led government to be reinstated, but the SLFP will not be a part of it.

These events reflected the souring of relations between Mr Sirisena and Mr Wickremesinghe, who had been partners in the ruling coalition from January 2015 to October 2018. We believe that, although the political crisis has ended, the remainder of the government's term will be marked by ongoing risks to political stability. Tensions between the executive and legislature will persist and impede government effectiveness in 2019. Furthermore, the inability of different levels of governments to work together, owing to stark ideological divisions, will hurt political stability. The local governments are dominated by the Rajapaksa-led Sri Lanka Podujana Peramuna (SLPP, Sri Lanka People's Front), whereas parliament is dominated by the Wickremesinghe-led UNP. A UNP-led administration is likely to be fragile, relying on the support of minority parties outside the government, and would have little chance of holding on until the end of its term. We expect the government to collapse by late 2019, owing to its weak parliamentary position and ongoing political squabbling, prompting early elections. We forecast that an SLPP-led administration will come to office after the elections, which will bring much needed stability to Sri Lanka's political environment.

More generally, social unrest rooted in religious and ethnic tensions will continue to threaten political stability in 2019-23. Violent protests and religiously motivated riots will remain a common feature of the political landscape. Nevertheless, we expect the authorities to be able quickly to restore basic law and order during such episodes, possibly through curfews and emergency rule. Both measures were applied in March 2018 after clashes between the majority Sinhalese Buddhist and minority Tamil Muslim communities.

Election watch

Although the next parliamentary elections are not due until mid-2020, we expect these to be brought forward to late 2019. Whenever they are held, we believe that the SLPP will win the largest number of seats and form a government. The SLPP's landslide victory in the February 2018 local elections illustrated its popularity and indicates strong anti-incumbency sentiment. The recent unconstitutional actions may have hurt the party's popularity with the electorate, but we do not expect this to have a significant impact; we continue to forecast an SLPP victory in the next elections.

Following the passage of the 19th amendment to the constitution in 2015, Mr Rajapaksa cannot run for the presidency, but the position of prime minister is open to him. We expect a close associate or relative of Mr Rajapaksa to win the presidential election, which is due by late 2019. Mr Sirisena had only a slim margin of victory over Mr Rajapaksa in 2015; public support has since swung sufficiently behind the SLPP to enable a candidate from the pro-Rajapaksa camp to be elected president.

International relations

The government's key foreign-policy challenge will be to balance its ties with China against those with India, while also ensuring that there is no marked deterioration in relations with Western partners. Increased financial and technical assistance from China, relating to a plethora of infrastructure projects under that country's Belt and Road Initiative, means that China will remain Sri Lanka's most important development partner in 2019-23. In December 2017 the government handed over operations at Hambantota port to a Chinese-led joint venture on a 99-year lease, in a deal designed to reduce Sri Lanka's debt to China. The Sri Lankan navy decided in July 2018 to move one of its bases to Hambantota, emphasising that the port remains under Sri Lanka's control militarily, despite China's operational control. Economic and diplomatic links with India will strengthen in the next five years, through increased co-operation in trade and investment. Furthermore, cultural ties will be supported through increased tourist arrivals from India.

The weaker role that human rights advocacy will play in US foreign policy under the presidency of Donald Trump will reduce the pressure on Sri Lanka's government to conduct a thorough investigation of abuses committed during the country's civil war (1983-2009). However, other Western powers, such as Canada and the EU, will continue to push for greater accountability. Although large parts of the Sinhalese-majority population will deeply resent such pressure, this is unlikely to have any repercussions for the island's economic relationship with Western countries.

Policy trends

The implementation of a 36-month financial assistance programme under the IMF's extended fund facility has led to some important reforms aimed at improving fiscal resilience. These include the passage of the Inland Revenue Act and the introduction of a new fuel-price mechanism. The IMF delayed a scheduled disbursement of funds in November owing to the political crisis. With the reinstatement of the Wickremesinghe government imminent, we expect the programme to resume as the IMF will be assured of continued progress on reform. The programme will end in mid-2019, but we expect progress on fiscal consolidation to continue in line with the Fund's recommendations, through the introduction of an automatic pricing formula for electricity and the restructuring of the ailing SriLankan Airlines.

As part of its "Vision 2025" agenda, the government led by Mr Wickremesinghe set out four intermediate goals to be reached by 2020: increasing GDP per head at market exchange rates to US$5,000 (from US$3,930 in 2016); creating one million jobs; raising foreign direct investment (FDI) to US$5bn per year; and almost doubling merchandise exports to US$20bn (from US$10.3bn in 2016). Political turbulence will impede the implementation of policies designed to support this agenda in the near future. We forecast that the country will fall well short of meeting the targets on exports, job creation and FDI, but it will come closer to reaching the goal on GDP per head.

Fiscal policy

The new Inland Revenue Act is expected to increase direct tax revenue through a simplification of the tax structure and a widening of the tax base. The introduction of a new fuel-pricing mechanism in May 2018 will also aid fiscal consolidation in 2019. Consequently, the budget deficit will narrow modestly in 2018-19, to the equivalent of 5.3% of GDP on average, from 5.5% of GDP in 2017. However, there is a risk of a spike in government spending in 2019 as we expect early elections; in this event, progress on fiscal consolidation may not be as marked. Once the IMF programme has ended, spending pressures will return, reversing the trend of a general steadying in the fiscal profile. Numerous infrastructure projects financed by international debt have been undertaken by the current administration and its predecessor, so debt-servicing expenditure will remain high during the forecast period. Moreover, we expect an SLPP-led government to come to power after elections in late 2019, with fiscal discipline weakening under that administration. The budget deficit is hence forecast to widen to the equivalent of 5.6% of GDP on an annual average basis in 2020-23.

Monetary policy

The Central Bank of Sri Lanka (CBSL) raised its policy rates in November 2018. The standing deposit facility rate was lifted by 75 basis points to 8%, and the standing lending facility rate was raised by 50 basis points to 9%. We expect the CBSL to maintain a modest tightening bias in 2019 to counter depreciatory pressure on the rupee as well as control price pressures. Upward movement in policy interest rates in 2019 will nonetheless be minimal, as this would increase the government's already substantial debt-servicing costs. In 2020 the CBSL will sanction interest-rate cuts with a view to bolstering economic activity; global trade growth will moderate in that year as the US experiences a business-cycle-induced slowdown. (The US is Sri Lanka's largest export market.) From late 2021 the CBSL will start to raise interest rates again as it becomes more confident about the economic outlook.

International assumptions

	2018	2019	2020	2021	2022	2023
Economic growth (%)						
US GDP	2.9	2.3	1.3	1.7	2.0	1.9
OECD GDP	2.3	2.0	1.5	1.8	1.9	1.9
World GDP	2.9	2.7	2.4	2.7	2.8	2.6
World trade	4.0	3.3	2.7	3.9	3.7	3.9
Inflation indicators (% unless otherwise indicated)						
US CPI	2.6	2.4	1.6	1.8	1.7	1.8
OECD CPI	2.5	2.6	2.1	2.0	2.0	2.1
Manufactures (measured in US$)	6.2	3.8	2.8	2.4	3.7	2.9
Oil (Brent; US$/b)	71.7	70.0	67.5	74.3	76.6	75.4
Non-oil commodities (measured in US$)	2.0	-0.1	3.6	1.5	1.5	0.6
Financial variables						
US$ 3-month commercial paper rate (av; %)	2.1	2.9	2.3	2.3	2.8	3.2
¥ 3-month money-market rate (av; %)	0.0	0.1	0.1	0.2	0.2	0.3
¥:US$ (av)	110.2	111.5	108.6	104.9	100.5	96.1
SLRs:US$ (av)	162.4	182.0	179.5	177.0	181.6	185.3

Economic growth

An unstable political environment will keep investor sentiment towards Sri Lanka negative in 2019. Subdued investment, along with a continued decline in government consumption, will preclude a strong economic recovery from devastating floods in 2017. Nevertheless, we expect economic activity to pick up slightly in 2019 on the back of continued growth in private consumption and a modest increase in demand for Sri Lankan exports, spurred by a weaker rupee. In 2020 an economic slowdown in the US will dent Sri Lanka's export growth. However, a rebound in government spending will help to maintain a rate of economic growth of over 4% in that year. The outlook will brighten again from 2021 as the US economy (and, by extension, the global economy) recovers, lifting Sri Lanka's export growth. This will spur the private sector to invest in new capacity. Additional free-trade agreements will also help Sri Lanka to boost its exports in the latter half of the forecast period.

Overall, we forecast that real GDP growth will average 4.7% per year in 2019-23. Structural constraints—such as a shortage of skilled labour, poor infrastructure and a low female labour-force participation rate—will preclude stronger growth. In factor-cost terms, the services sector will remain the key contributor to growth and will expand by an average of 4.9% per year in 2019-23. Agriculture's share of GDP will continue to fall throughout the forecast period.

Economic growth

%	2018[a]	2019[b]	2020[b]	2021[b]	2022[b]	2023[b]
GDP	3.8	4.1	4.1	4.8	5.2	5.3
Private consumption	6.2	6.0	5.8	5.4	5.6	5.7
Government consumption	-5.8	-3.0	4.5	5.3	5.5	5.4
Gross fixed investment	3.5	3.5	4.0	4.7	6.2	6.8
Exports of goods & services	1.2	4.0	2.9	5.5	6.2	6.2
Imports of goods & services	4.4	4.5	4.8	5.4	6.0	6.5
Domestic demand	4.6	4.3	4.5	4.9	5.3	5.5
Agriculture	3.8	3.4	3.3	3.5	3.4	3.4
Industry	2.3	2.9	4.0	4.8	5.7	5.8
Services	4.5	4.8	4.2	5.0	5.2	5.3

[a] Economist Intelligence Unit estimates. [b] Economist Intelligence Unit forecasts.

Inflation

We have adjusted our expectations for consumer price inflation in 2019, owing to a downward revision to our forecast for global oil prices. Despite this revision, consumer price pressures in 2019 will be higher than in 2018, mainly because of a weaker exchange rate, which will raise imported inflation. We expect consumer prices to rise by an average of 5.6% in 2019, compared with an estimated increase of 4.4% in 2018. Higher inflation in 2019 will also be underpinned by a low base of comparison: prices rose by 6.6% in 2017 as devastating floods caused a spiral in food price inflation, a significantly stronger increase than in 2018.

Consumer price inflation is expected to stabilise at around 5% per year on average in 2020-23, as the CBSL starts to prioritise inflation-targeting. However, there remains a risk that periodic adverse weather conditions or an unexpected increase in global oil prices could lead to stronger inflation in some years than we currently forecast. Fuel and food prices have the greatest weightings of the components of the Colombo Consumer Price Index—at 32% and 28.2%, respectively—on which we base our inflation forecasts.

Exchange rates

We expect the Sri Lanka rupee to weaken from an estimated average of SLRs162.4:US$1 in 2018 to SLRs182:US$1 in 2019. Mounting external pressures from the persistently wide current-account deficit, along with an unstable political situation, will underpin depreciation in the rupee in 2019. We expect the currency to stabilise briefly in 2020 as oil prices soften further and as the Federal Reserve (the US central bank) adopts an accommodative policy stance, relieving some of the pressure on emerging-market currencies. However, this stabilisation is likely to be short-lived and we expect the rupee to depreciate to an average of SLRs185.3:US$1 by 2023. We believe that the CBSL will gradually reduce its interventions in foreign-exchange markets, owing to an ongoing shift towards a more market-driven framework for exchange-rate management and the need to preserve scarce foreign-exchange reserves.

External sector

We have revised down our forecast for merchandise imports for 2019, owing to a downward revision in our global oil price forecast. We expect steady growth in merchandise exports, driven by continued demand for the country’s main export commodities—garments, tea and rubber products—albeit with a slight reduction in the pace of growth in 2020, owing to an economic slowdown in the US (Sri Lanka’s largest export market). Garment exports, which are Sri Lanka’s largest source of foreign-exchange earnings, will benefit in 2019-23 from the ongoing migration of export manufacturing away from China (the world’s largest garment exporter), which has been accelerated by the US imposition of goods tariffs on that country. However, an unstable political environment will exert a drag on tourism growth in 2019. The heightened political instability will also have a moderating effect on imports of capital goods such as machinery and transport equipment (Sri Lanka’s largest category of imports), owing to reduced investment. We therefore expect the current-account deficit to remain steady, averaging the equivalent of 3.4% of GDP annually in 2019-23. This still significant shortfall will be underpinned by Sri Lanka’s heavy reliance on imports for its fuel needs, as well as inputs for the textile industry and ongoing infrastructure projects. Remittance inflows and continued growth in tourism will, respectively, keep the secondary income and services accounts in surplus, offsetting a large part of the deficit on the merchandise trade account. We forecast the import cover provided by foreign-exchange reserves to average only 3.4 months in 2019-23, just above the IMF’s recommended three-month minimum for developing countries.

Forecast summary

Forecast summary

(% unless otherwise indicated)

	2018[a]	2019[b]	2020[b]	2021[b]	2022[b]	2023[b]
Real GDP growth	3.8	4.1	4.1	4.8	5.2	5.3
Gross industrial growth	2.3	2.9	4.0	4.8	5.7	5.8
Gross agricultural production growth	3.8	3.4	3.3	3.5	3.4	3.4
Unemployment rate (av)[c]	4.6	4.4	4.3	4.1	4.0	4.0
Consumer price inflation (av)	4.4	5.6	4.6	5.0	5.3	4.9
Consumer price inflation (end-period)	3.8	5.3	4.6	5.2	5.1	4.9
Lending interest rate (av;%)	11.6	12.5	11.5	11.1	11.2	11.6
Government balance (% of GDP)	-5.3	-5.3	-5.5	-5.6	-5.6	-5.5
Government balance, excl grants & privatisation (% of GDP)	-5.4	-5.3	-5.5	-5.6	-5.6	-5.5
Exports of goods fob (US$ bn)	11.9	12.5	12.9	13.7	14.5	15.5
Imports of goods fob (US$ bn)	22.7	23.6	24.8	26.4	28.1	30.1
Current-account balance (US$ bn)	-3.2	-2.9	-3.1	-3.6	-4.0	-4.3
Current-account balance (% of GDP)	-3.6	-3.4	-3.3	-3.4	-3.5	-3.4
External debt (end-period; US$ bn)	53.3	55.8	58.6	61.5	64.6	67.7
Exchange rate SLRs:US$ (av)	162.4	182.0	179.5	177.0	181.6	185.3
Exchange rate SLRs:US$ (end-period)	180.0	182.5	176.1	177.4	184.0	187.5
Exchange rate SLRs:¥100 (av)	147.5	163.2	165.3	168.8	180.7	192.8
Exchange rate SLRs:€ (av)	192.3	217.1	219.0	214.6	224.7	229.3

[a] Economist Intelligence Unit estimates. [b] Economist Intelligence Unit forecasts. [c] National estimates.

Data and charts

Annual data and forecast

	2014[a]	2015[a]	2016[a]	2017[a]	2018[b]	2019[c]	2020[c]
GDP							
Nominal GDP (US$ m)	79,355.7	80,604.1	81,787.4	87,357.2	88,833.4	87,199.7	96,273.0
Nominal GDP (SLRs bn)	10,361.2	10,950.6	11,906.8	13,317.3	14,429.8	15,872.2	17,281.8
Real GDP growth (%)	5.0	5.0	4.5	3.3	3.8	4.1	4.1
Expenditure on GDP (% real change)							
Private consumption	3.7	7.5	-3.9	1.3	6.2	6.0	5.8
Government consumption	6.0	10.2	2.3	-5.2	-5.8	-3.0	4.5
Gross fixed investment	-1.7	0.1	9.2	3.9	3.5	3.5	4.0
Exports of goods & services	4.3	4.7	-0.7	7.5	1.2	4.0	2.9
Imports of goods & services	9.6	10.6	7.9	19.3	4.4	4.5	4.8
Origin of GDP (% real change)							
Agriculture	4.6	4.7	-3.8	-0.8	3.8	3.4	3.3
Industry	4.7	2.2	5.8	4.6	2.3	2.9	4.0
Services	4.8	6.0	4.7	3.2	4.5	4.8	4.2
Population and income							
Population (m)	20.6	20.7	20.8[b]	20.9[b]	21.0	21.0	21.1
GDP per head (US$ at PPP)	11,300	11,942	12,583[b]	13,186[b]	13,807	14,589	15,525
Recorded unemployment (av; %)	4.4	4.7	4.4	4.2	4.6	4.4	4.3
Fiscal indicators (% of GDP)							
Central government revenue	11.6	13.3	14.2	13.8	13.4	13.3	13.8
Central government expenditure	17.3	20.9	19.6	19.3	18.7	18.6	19.2
Central government balance	-5.7	-7.6	-5.4	-5.5	-5.3	-5.3	-5.5
Public debt	71.3	77.7	78.8	77.4	79.4	80.1	81.8
Prices and financial indicators							
Exchange rate SLRs:US$ (end-period)	131.05	144.06	149.80	152.85	180.00	182.50	176.10
Exchange rate ¥:SLRs (end-period)	0.91	0.83	0.78	0.74	0.62	0.61	0.61
Consumer prices (end-period; %)	1.4	4.6	4.5	7.1	3.8	5.3	4.6
Stock of money M1 (% change)[d]	26.3	16.8	8.6	2.1	6.0	5.3	6.1
Stock of money M2 (% change)[d]	13.1	17.2	18.9	17.5	14.2	14.6	15.0
Lending interest rate (av; %)	7.8	7.0	10.5	11.6	11.6	12.5	11.5
Current account (US$ m)							
Trade balance	-8,287	-8,388	-8,873	-9,619	-10,877	-11,105	-11,888
Goods: exports fob	11,130	10,547	10,310	11,360	11,856	12,467	12,947
Goods: imports fob	-19,417	-18,935	-19,183	-20,980	-22,733	-23,573	-24,835
Services balance	1,880	2,325	2,879	3,338	3,835	4,135	4,756
Primary income balance	-1,808	-2,013	-2,202	-2,355	-2,627	-2,638	-2,643
Secondary income balance	6,227	6,193	6,453	6,327	6,509	6,687	6,626
Current-account balance	-1,988	-1,883	-1,743	-2,309	-3,159	-2,921	-3,149
External debt (US$ m)							
Debt stock	42,263	43,925	46,650	50,142	53,320	55,791	58,594
Debt service paid	6,360	3,412	3,154	4,086	4,806	5,027	5,322
Principal repayments	5,632	2,622	2,157	3,050	3,406	3,527	3,815
Interest	727	791	998	1,036	1,400	1,500	1,506
International reserves (US$ m)							
Total international reserves	8,209	7,303	6,019	7,959	8,435	8,320	8,680

[a] Actual. [b] Economist Intelligence Unit estimates. [c] Economist Intelligence Unit forecasts. [d] Based on Central Bank of Sri Lanka data.
Source: IMF, International Financial Statistics.

Quarterly data

	2016 4 Qtr	2017 1 Qtr	2 Qtr	3 Qtr	4 Qtr	2018 1 Qtr	2 Qtr	3 Qtr
Central government finance (SLRs m)								
Revenue	513,526	436,655	440,922	453,019	508,966	n/a	n/a	n/a
Expenditure	647,881	636,322	573,848	679,794	683,092	n/a	n/a	n/a
Balance	-134,355	-199,667	-132,926	-226,775	-174,126	n/a	n/a	n/a
Output								
GDP at constant 2010 prices (SLRs bn)	2,542.1	2,155.2	2,183.1	2,362.7	2,632.2	2,230.0	2,264.4	n/a
Wages and prices								
Wages, agricultural (Dec 1978=100)[a]	4,735.8	4,736.3	4,736.6	4,736.8	4,737.1	4,737.2	4,736.8	n/a
Consumer prices (2013=100)	113.5	116.4	118.5	119.3	122.0	122.0	123.3	125.5
Consumer prices (% change, year on year)	4.2	6.5	6.3	6.0	7.5	4.8	4.1	5.2
Producer prices (Q4, 2013=100)	112.9	119.5	125.8	125.6	130.1	130.9	135.0	132.3
Producer prices (% change, year on year)	6.4	15.3	20.0	17.5	15.3	9.5	7.4	5.3
Financial indicators								
Exchange rate SLRs:US$ (av)	147.84	150.78	152.31	153.25	153.45	154.80	157.70	161.37
Exchange rate SLRs:US$ (end-period)	149.80	151.74	153.51	153.10	152.85	155.97	158.26	169.24
Repurchase rate (end-period; %)	7.0	7.3	7.3	7.3	7.3	7.3	7.3	7.3
Reverse repurchase rate (end-period; %)	8.5	8.6	8.8	8.8	8.8	8.8	8.5	8.5
Average weighted prime lending rate (end-period; %)	11.7	11.6	11.8	11.4	11.3	11.1	11.2	11.7
3-month Treasury-bill rate (end-period; %)	8.7	9.6	9.6	8.7	7.7	8.2	8.3	8.6
M1 (end-period; SLRs bn)[b]	776.6	782.0	753.9	754.6	793.3	841.2	804.5	809.0
M1 (% change, year on year)	8.6	7.2	6.8	3.5	2.1	7.6	6.7	n/a
M2 (end-period; SLRs bn)[b]	4,823.6	5,096.2	5,281.4	5,503.1	5,665.3	5,995.5	6,120.8	6,284.5
M2 (% change, year on year)	18.9	21.2	22.5	20.9	17.5	17.6	15.9	n/a
Colombo Stock Exchange All Share Price Index (average; 1985=100)	6,373.3	6,111.9	6,595.1	6,527.4	6,476.6	6,501.8	6,425.2	6,080.0
Sectoral trends								
Exports, tea ('000 tonnes)	66.0	68.4	70.3	77.1	73.2	68.9	68.7	n/a
Exports, rubber ('000 tonnes)	5.7	7.7	3.2	3.3	3.0	5.0	3.1	n/a
Tourist arrivals ('000)	542.4	605.0	405.5	541.5	564.5	707.9	456.7	567.3
Foreign trade (SLRs bn)								
Exports fob	373.2	418.4	399.5	463.9	450.7	462.7	432.6	510.7
Tea	47.2	52.7	57.8	63.0	59.9	57.0	56.8	58.7
Imports cif	779.4	796.0	741.7	783.8	877.1	924.3	862.6	873.0
Trade balance	-406.2	-377.6	-342.2	-319.9	-426.4	-461.6	-430.1	-362.3
Foreign payments (US$ m)								
Merchandise trade balance	-2,748	-2,505	-2,246	-2,088	-2,780	n/a	n/a	n/a
Services balance	772	956	580	889	914	n/a	n/a	n/a
Primary income balance	-708	-558	-439	-540	-817	n/a	n/a	n/a
Net transfer payments	1,675	1,703	1,473	1,557	1,594	n/a	n/a	n/a
Current-account balance	-1,009	-404	-633	-182	-1,090	n/a	n/a	n/a
Reserves excl gold (end-period)	5,189	4,228	6,069	6,358	7,031	6,425	8,467	n/a

[a] Nominal rates. [b] Central Bank of Sri Lanka.

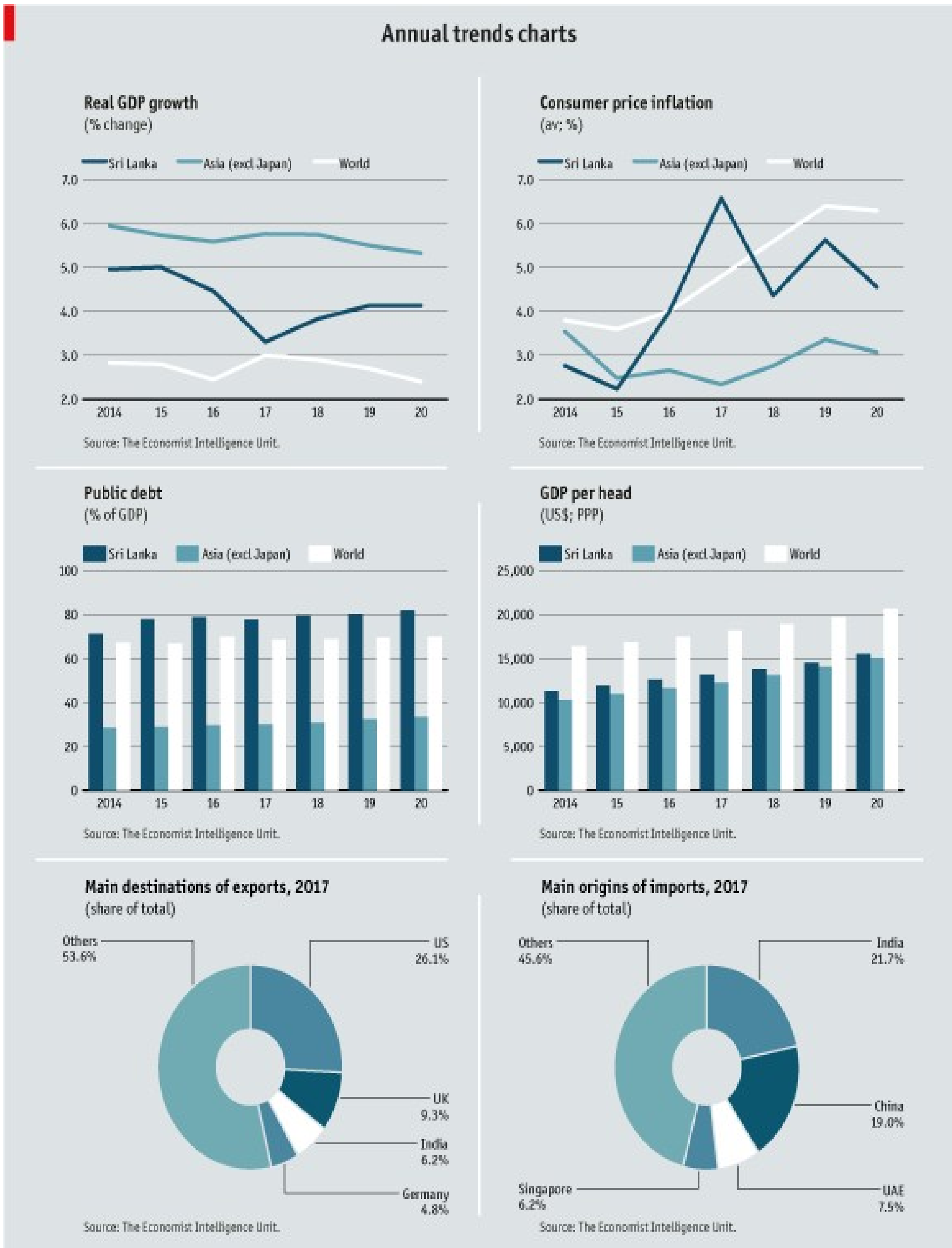
Sources: Central Bank of Sri Lanka, Bulletin; IMF, International Financial Statistics.

Monthly data

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exchange rate SLRs:US$ (av)												
2016	143.94	143.93	143.96	143.90	145.65	145.28	145.41	145.60	145.78	146.87	147.77	148.88
2017	150.09	150.82	151.43	151.76	152.33	152.83	153.67	153.19	152.90	153.53	153.66	153.15
2018	153.80	154.86	155.73	156.14	157.90	159.07	159.34	160.35	164.42	171.22	176.85	n/a
Exchange rate SLRs:US$ (end-period)												
2016	143.92	144.35	143.90	143.90	145.75	145.25	145.75	145.62	146.72	147.11	147.95	149.80
2017	150.24	151.25	151.74	151.90	152.50	153.51	153.73	152.84	153.10	153.59	153.77	152.85
2018	153.77	154.87	155.97	157.65	158.09	158.26	159.71	161.47	169.24	174.38	179.67	n/a
M1 (% change, year on year)												
2016	13.1	17.4	15.2	13.5	11.3	12.1	11.6	9.9	10.4	9.4	7.6	8.6
2017	7.3	6.3	7.2	6.9	5.7	6.8	7.2	6.3	3.5	2.1	4.3	2.1
2018	4.1	3.5	7.6	6.2	6.6	6.7	3.0	4.3	7.2	n/a	n/a	n/a
M2 (% change, year on year)												
2016	18.6	19.1	18.4	18.1	16.5	17.2	17.7	17.2	19.1	19.1	18.7	18.9
2017	18.6	19.1	21.2	21.3	22.9	22.5	22.1	22.3	20.9	19.8	18.5	17.5
2018	17.9	17.7	17.6	17.4	16.0	15.9	14.8	15.1	14.2	n/a	n/a	n/a
Average weighted deposit rate (end-period; %)												
2016	6.3	6.3	6.4	6.6	6.7	6.9	7.1	7.3	7.6	7.8	8.0	8.2
2017	8.4	8.7	8.8	8.9	9.0	9.1	9.2	9.2	9.3	9.2	9.2	9.1
2018	9.1	9.1	9.0	9.0	8.9	8.9	8.6	8.7	8.7	8.7	8.8	n/a
Average weighted prime lending rate (end-period; %)												
2016	7.8	8.3	8.8	9.6	10.1	10.5	10.9	11.8	12.3	12.3	12.0	11.7
2017	11.5	11.6	11.6	11.7	11.7	11.8	11.9	11.7	11.4	11.3	11.4	11.3
2018	11.3	11.3	11.1	11.3	11.3	11.2	11.4	11.6	11.7	12.4	12.1	n/a
Reverse repurchase rate (end-period; %)												
2016	7.5	7.7	8.0	8.0	8.0	8.0	8.0	8.5	8.5	8.5	8.5	8.5
2017	8.5	8.5	8.6	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8
2018	8.8	8.8	8.8	8.5	8.5	8.5	8.5	8.5	8.5	8.5	8.8	n/a
Colombo Stock Exchange All Share Price Index (average; 1985=100)												
2016	6,499	6,294	6,032	6,323	6,615	6,453	6,375	6,541	6,496	6,489	6,346	6,276
2017	6,161	6,130	6,053	6,388	6,673	6,693	6,709	6,461	6,404	6,570	6,495	6,358
2018	6,462	6,550	6,498	6,494	6,475	6,302	6,133	6,091	6,009	5,834	5,987	n/a
Consumer prices (av; % change, year on year)												
2016	1.7	2.9	2.6	3.4	4.8	5.5	5.8	4.4	4.2	4.1	4.0	4.5
2017	5.5	6.8	7.3	6.9	6.0	6.1	4.8	6.0	7.1	7.8	7.6	7.1
2018	5.8	4.5	4.2	3.8	4.0	4.4	5.4	5.9	4.3	3.1	3.3	n/a
Wholesale prices (av; % change, year on year)												
2016	-3.4	2.5	-0.5	-0.3	-0.9	1.4	0.6	0.7	1.1	5.0	6.7	7.6
2017	13.6	13.5	18.9	20.3	20.2	19.5	16.3	17.8	18.3	16.8	14.8	14.3
2018	9.8	8.1	10.7	7.9	7.3	7.0	7.7	6.0	2.2	n/a	n/a	n/a
Foreign-exchange reserves excl gold (US$ m)												
2016	5,497	5,692	5,335	5,155	4,779	4,350	5,525	5,659	5,506	5,143	4,795	5,189
2017	4,596	4,739	4,228	4,141	5,855	6,069	5,803	6,759	6,358	6,588	6,418	7,031
2018	6,710	6,977	6,425	9,094	7,976	8,467	7,648	7,816	n/a	n/a	n/a	n/a

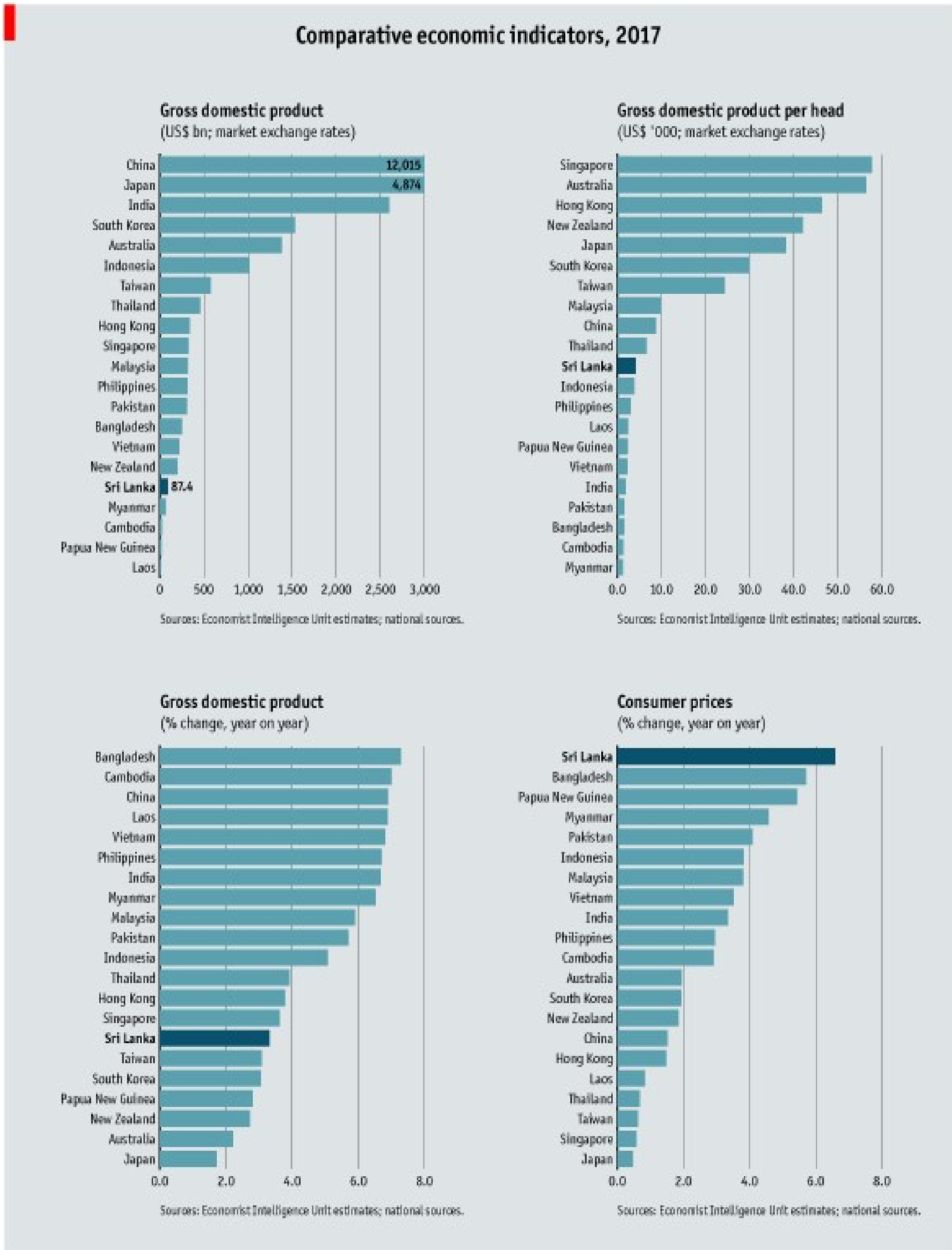
Sources: IMF, International Financial Statistics; Haver Analytics.

Annual trends charts



Monthly trends charts

Comparative economic indicators



Basic data

Land area

65,610 sq km

Population

20.8m (2016; UN)

Main towns

Population in ’000 (2016; Department of Census and Statistics estimates)

Colombo (capital): 2,395

Gampaha: 2,372

Kurunegala: 1,676

Kandy: 1,434

Kalutara: 1,261

Ratnapura: 1,140

Climate

Tropical

Weather in Colombo

Hottest month, May, 26-31°C (average daily minimum and maximum); coldest month, December, 22-29°C; driest month, February, 69 mm average rainfall; wettest month, May, 371 mm average rainfall

Languages

Sinhalese, Tamil, English

Measures

The metric system is now predominant

Currency

Sri Lanka rupee (SLRs); SLRs1 = 100 cents. Average exchange rate in 2017: SLRs152.4:US$1

Time

5 hours 30 minutes ahead of GMT

Fiscal year

January-December

Public holidays

January 15th (Tamil Thai Pongal Day); January 20th (Duruthu Poya Day); February 4th (National Day); February 19th (Navam Poya Day); March 4th (Mahasivarathri Day); March 20th (Madin Poya Day); April 14th (Sinhalese and Tamil New Year); April 19th (Good Friday/Bak Poya Day); May 1st (May Day); May 18th (Vesak Poya celebration); June 5th (Eid al-Fitr); June 16th (Poson Poya Day); July 16th (Adhi Esala Poya Day); August 12th (Eid al-Adha); August 14th (Nikini Poya Day); September 13th (Binara Poya Day); October 13th (Vap Poya Day); October 27th (Deepawali); November 12th (Il Poya Day); December 11th (Unduvap Poya Day); December 25th (Christmas Day)

Political structure

Official name

Democratic Socialist Republic of Sri Lanka

Form of state

Executive presidency based on the French model

The executive

The president is head of state, with executive powers. According to the 19th amendment to the constitution, passed in April 2015, the president is elected for a five-year term by universal suffrage, and may dissolve parliament only after four and a half years have passed since the start of the first session of the current parliament. The president may serve a maximum of two five-year terms

National legislature

Unicameral legislature; the 225 members are directly elected for five years (changed from six years prior to the 19th amendment to the constitution), using a system of modified proportional representation

Local government

Under the 13th amendment to the constitution, passed in 1987, extensive powers are required to be devolved to nine directly elected provincial councils with a view to meeting Tamil demands for greater autonomy; however, the amendment has not yet been fully implemented. The United People's Freedom Alliance (UPFA) has majorities in all the provincial councils except the Northern provincial council

National elections

A presidential election was held in January 2015 and a parliamentary election in August 2015. The next presidential election is scheduled for late 2019 and the next parliamentary election in 2020

National government

Maithripala Sirisena was elected president in January 2015, defeating Mahinda Rajapaksa of the Sri Lanka Freedom Party (SLFP, the main component of the UPFA), who had ruled since 2005. Following the August 2015 parliamentary election, the United National Party (UNP) formed a so-called national unity government with the SLFP. The alliance broke up in October 2018, owing to differences between the coalition parties. The parliamentary composition below reflects the situation before the October political crisis

Main political organisations

In government: UNP; UPFA (including the SLFP); Tamil National Alliance (TNA); Janatha Vimukthi Peramuna (JVP); Sri Lanka Muslim Congress (SLMC); Eelam People's Democratic Party (EPDC). The Sri Lanka Podujana Peramuna (SLPP, Sri Lanka People's Front) was formed in 2016 by disenchanted UPFA members loyal to Mr Rajapaksa

Main members of the government

President, minister of defence: Maithripala Sirisena (SLFP)

Prime minister, minister of policy planning, economic affairs & child, youth & cultural affairs: Ranil Wickremesinghe (UNP)

Key ministers

Disaster management: Ranjith Siyambalapitiya (SLFP)

Education: Akila Viraj Kariyawasam (UNP)

Finance: Mangala Samaraweera (UNP)

Foreign affairs: Tilak Marapana (UNP)

Home affairs: Vajira Abeywardena (UNP)

Industry & commerce: Rishad Bathiudeen (UNP)

Irrigation & water resources: Vijith Vijayamuni Zoysa (SLFP)

Justice: Wijayadasa Rajapakshe (UNP)

Labour & trade union relations: Malik Samarawickrama (UNP)

Ports & shipping: Mahinda Samarasinghe (SLFP)

Power & renewable energy: Ranjith Siyambalapitiya (SLFP)

Central bank governor

Indrajit Coomaraswamy

Recent analysis

Generated on January 7th 2019

The following articles were published on our website in the period between our previous forecast and this one, and serve here as a review of the developments that shaped our outlook.

Politics

Forecast updates

Ruling declares dissolution of parliament unconstitutional

December 14, 2018: Political stability

Event

On December 13th the Supreme Court delivered a verdict overturning the decision of the president, Maithripala Sirisena, in November to dissolve parliament and hold snap elections in January 2019.

Analysis

The development is in line with The Economist Intelligence Unit's expectations. The country has been in a political crisis since late October, when Mr Sirisena dismissed the then prime minister, Ranil Wickremesinghe, amid growing personal and ideological differences. Mr Sirisena later dissolved parliament and called for fresh elections when his preferred candidate for the premiership, Mahinda Rajapaksa, failed to win sufficient parliamentary support. On December 12th parliament passed a confidence motion in favour of Mr Wickremesinghe; we believe that Mr Sirisena will now have no choice but to reappoint him as prime minister. However, an administration led by Mr Wickremesinghe and his United National Party is likely to be fragile. It would need to rely on the support of minority parties outside the government, a dependence that would be, at best, likely to last only until the next presidential election, which is due in late 2019.

Going forward, the government's weak position in parliament, together with ongoing tensions between the president and Mr Wickremesinghe, will continue to pose significant risks to political stability. We have already revised down our real GDP forecasts for 2019 in view of the recent political developments. We expect real GDP to grow by 4.1% in 2019, compared with an estimated 3.8% in 2018.

Impact on the forecast

The latest development is in line with our forecast. We continue to expect a Wickremesinghe-led government to be reinstated in the coming few weeks. Risks to political stability will remain high throughout 2019.

President reinstates sacked prime minister

December 19, 2018: Political stability

Event

On December 16th the president, Maithripala Sirisena, reinstated Ranil Wickremesinghe as prime minister. He had dismissed Mr Wickremesinghe from his position on October 26th on account of ideological differences.

Analysis

The prime minister's reinstatement follows two months of political turmoil. After dispensing with Mr Wickremesinghe, the president dissolved parliament and called for fresh elections when his preferred candidate for the prime ministership, Mahinda Rajapaksa, failed to win sufficient parliamentary support. However, on December 13th the Supreme Court overturned the president's decision to dissolve parliament; following this, he was left with no choice but to reinstate Mr Wickremesinghe and, by extension, his government.

The parliamentary majority of Mr Wickremesinghe's government was bolstered on December 18th by the defection to it of three members of Mr Sirisena's Sri Lanka Freedom Party. Mr Wickremesinghe's reappointment provides only temporary stability, however. His coalition's dependence on smaller groups, such as the Tamil National Alliance, for support in parliament will impair the government's effectiveness. However, we do not expect the government to complete its term. It is likely to collapse by late 2019, owing to its weak parliamentary position and ongoing political squabbling. This would prompt early elections, in which we expect the Sri Lanka Podujana Peramuna (Sri Lanka People's Front) to secure the largest number of seats.

Impact on the forecast

This development is in line with our expectations. We do not expect the Wickremesinghe government to last its full term. No change to our outlook is required.

Economy

Forecast updates

Price pressures remain weak

December 7, 2018: Inflation

Event

According to data released by the Department of Census and Statistics, consumer prices as measured by the Colombo Consumer Price Index (CCPI) rose by 3.3% year on year in November.

Analysis

The headline annual rate of inflation picked up slightly in November, compared with October, when the rate touched multi-year lows. Nevertheless, the pace of growth in consumer prices remained weak, owing to a decline in food prices compared with the year-earlier period. Food price inflation accelerated sharply in the latter half of 2017 in the wake of floods that destroyed agricultural output. Food accounts for 28.2% of the consumer price basket in Sri Lanka.

We expect price pressures to remain muted at least until January 2019 as the agricultural sector continues to recover from the 2017 floods. Thereafter, consumer price inflation is expected to pick up gradually, reflecting the impact of high global oil prices and the lagged effect of a sustained drop in the value of the Sri Lanka rupee. We expect the currency to average SLRs181.2:US$1 in 2019, compared with an estimated SLRs162.2:US$1 in 2018.

Impact on the forecast

The latest data are in line with our expectations and do not warrant any change to our forecasts. We continue to expect consumer prices to rise by an average of 5.2% in 2019, compared with an estimated increase of 4.4% in 2018.

Tourist arrivals increase despite political crisis

December 11, 2018: External sector

Event

According to data released by the Sri Lanka Tourism Development Authority, tourist arrivals in November increased by 16.8% year on year to 195,582.

Analysis

The main reason for the strong growth in tourist arrivals—despite the ongoing political turmoil in the country—is the dramatic upsurge in arrivals from the UK (Sri Lanka's third-largest source market for tourism in 2017). Arrivals from the UK increased by 61.1% year on year to 21,971 in November; the country was the second-largest source of tourists that month. The cause of this strong rise in UK visitors is likely to have been the cricket Test matches between Sri Lanka and England in November. India remained the largest source of tourists, with 39,137 arrivals. The weakness of the Sri Lanka rupee against the Indian rupee is likely to have supported growth in tourism numbers from India.

We expect tourism to be hit hard in December 2018 and the first few months of 2019 as Sri Lanka's political crisis has raised security concerns among tourists. According to a report by Reuters, an international news agency, many hotels have reported significant number of cancellations in bookings after news of the crisis came to the fore. Additionally, several countries—including the US, Canada, Australia, the UK and a number of other European states—have issued travel advisories warning their citizens to keep away from political demonstrations and meetings in Sri Lanka.

The crisis has lasted for almost one and a half months now, with no solution in sight. We therefore expect the tourism sector to experience a significant slowdown over the next few months. Tourism is a key sector for Sri Lanka and is its third-largest source of foreign-exchange earnings, after garment exports and remittances.

Impact on the forecast

Our forecast already takes into account a slowdown in tourism owing to an unstable political situation. We continue to forecast that services exports will grow by around 5.7% in 2019, compared with estimated growth of 9.2% in 2018.

Growth momentum slows in Q3

December 20, 2018: Economic growth

Event

According to data from the Department of Census and Statistics, real GDP grew by 2.9% year on year in the third quarter of 2018. This is the slowest pace of growth since the second quarter of 2016.

Analysis

Real GDP growth moderated in the third quarter, from 3.7% in the second quarter. The main reason for the slowdown in the third quarter was subdued growth in the industrial sector; this stemmed from depressed domestic demand, which had weakened against a backdrop of relatively rapid consumer price inflation. Consumer prices increased by 5.2% year on year on average in July-September, compared with a rise of 4.1% in April-June. The slowdown in the industrial sector was further exacerbated by the unstable political situation, which is likely to have weighed on business sentiment.

The agricultural sector, in contrast, continued to show signs of recovery and grew by 3.3% year on year in the July-September quarter, although the pace of growth was slower than in the first half of the year. Agricultural output had expanded rapidly in the first two quarters of 2018, partly owing to a low base of comparison in the year-earlier period, as output was damaged by a series of natural disasters in the early part of 2017. The agricultural sector accounts for just 8% of total nominal GDP, but for almost one-third of total employment. The services sector continued to be the main driver of economic activity, although growth momentum also slowed in July-September from its April-June outturn.

The latest national accounts data are weaker than we had expected. Consequently, we will be making downward adjustments to our economic growth estimate for 2018 and for our forecasts for 2019-23. In 2019 we expect economic prospects to remain bleak as heightened political instability continues to weigh down sentiment and hence activity in the industrial and services sectors. The agricultural sector will continue its broad-based recovery, helped by a pick-up in rice cultivation.

Impact on the forecast

We will revise down our forecast for economic growth in 2019 owing to weaker than expected growth in the third quarter of 2018. Currently, we forecast that the economy will expand by 4.1% in 2019.

Analysis

Economic gloom to continue in 2019

December 21, 2018

Following a political crisis that lasted for almost two months, the Sri Lankan economy will face a plethora of challenges in 2019. The Economist Intelligence Unit expects economic growth to remain subdued in 2019 as a tense political climate exerts a drag on investment. An already weak economic climate will be further exacerbated by tight monetary policy. However, a slight uptick in government spending is likely to provide some support to growth. Overall, Sri Lanka's economic prospects will continue to be weighed down by heightened instability in the political environment.

Economic recovery after devastating floods in 2017 has not been as marked as we had expected it to be. According to the latest data from the Department of Census and Statistics, the economy expanded by just 2.9% in the third quarter of 2018, the slowest pace of growth since the second quarter of 2016. Growth in the year ahead will be very much determined by the political situation in the country. On December 13th the Supreme Court overturned a presidential order issued in November to dissolve parliament and call for fresh elections. The verdict ended a political crisis that had lasted for almost two months and had left the country with virtually no government.

The immediate crisis ended with the recent reinstatement of Ranil Wickremesinghe as prime minister. However, we believe that the political squabbling and jostling for power has made investors even more apprehensive about Sri Lanka than they were before. Moreover, we expect some populist measures to be declared by the reinstated government, undermining its economic reform agenda.

Growth to remain subdued in 2019

This departure from the government's previously ambitious economic reform programme will encourage businesses, both local and foreign, to take a wait-and-see approach towards investing in the country. Furthermore, tensions between the executive and the legislature will make investors nervous about policy stability. We expect investment to expand by just 3.5% in 2019, unchanged from its estimated level of growth in 2018, an unusually weak year.

The Sri Lanka rupee was already among the worst-performing currencies in Asia before the recent political instability. The crisis exacerbated this trend as the currency fell sharply against the US dollar during the past two months, signalling growing concerns in the financial markets. We expect the rupee to average SLRs182:US$1 in 2019, compared with an estimated average of SLRs162.5:US$1 in 2018. The weakening exchange rate will serve to push up consumer price inflation in 2019.

Higher inflation is likely to erode purchasing power, dampening household spending over the next year. Furthermore, it has already resulted in a tightening of monetary policy. The Central Bank of Sri Lanka raised its policy rates in November, lifting the standing deposit facility rate by 75 basis points to 8% and the standing lending facility rate by 50 basis points to 9%. These rate increases, and the marginal additional tightening that we expect in the next few months, will serve as a further headwind to investment growth in 2019.

Spending pressures will return

The new administration has a weaker parliamentary position than the coalition government that was in place until late October. Mr Wickremesinghe's United National Party (UNP) has lost much of its popularity since it won the largest number of votes in the 2015 parliamentary elections. This was reflected in the results of the February 2018 local elections, in which the UNP lost heavily to the Sri Lanka Podujana Peramuna (Sri Lanka People's Front). We therefore expect that the new government will be under pressure to include populist spending measures in the budget for 2019. It had been due to be presented in November, but this was delayed by the political crisis. It is now expected to be tabled in parliament in late January 2019. In addition, revenue collection is likely to be weaker in 2019 than we had expected. The political crisis has delayed the implementation of several approved revenue measures.

In light of this, it will be hard for the government to adhere to the fiscal consolidation plan that it is committed to under its IMF extended fund facility (EFF) programme. Nevertheless, the government will be careful not to deviate too much from the IMF's recommendations to cut spending, as it will be wary of the financial instability that would be caused by any suspension of the EFF. We thus expect the fiscal consolidation process to slow, or even freeze, in 2019, but we do not expect the budget deficit to widen as a share of GDP from the estimated level of 5.3% in 2018.

Political instability will undermine economic prospects

In the World Bank report *Doing Business 2019*, published in November 2018, Sri Lanka jumped an impressive 11 places to 100th out of 190 countries. However, the improvements in the regulatory environment that are embodied in this advance have been largely overshadowed by the recent political crisis. Although the recent Supreme Court verdict has drawn a line under the immediate crisis, political instability seems likely to persist in 2019, as Mr Wickremesinghe's position remains weak. It will be challenging for the government to balance its economic and political goals next year. Against this background, many potential investors will wait on the sidelines until the next elections, when the country's policy direction will become clearer. This will preclude a significant pick-up in economic activity, even though the pace of fiscal consolidation is set to slow.

Looking for low-cost labour

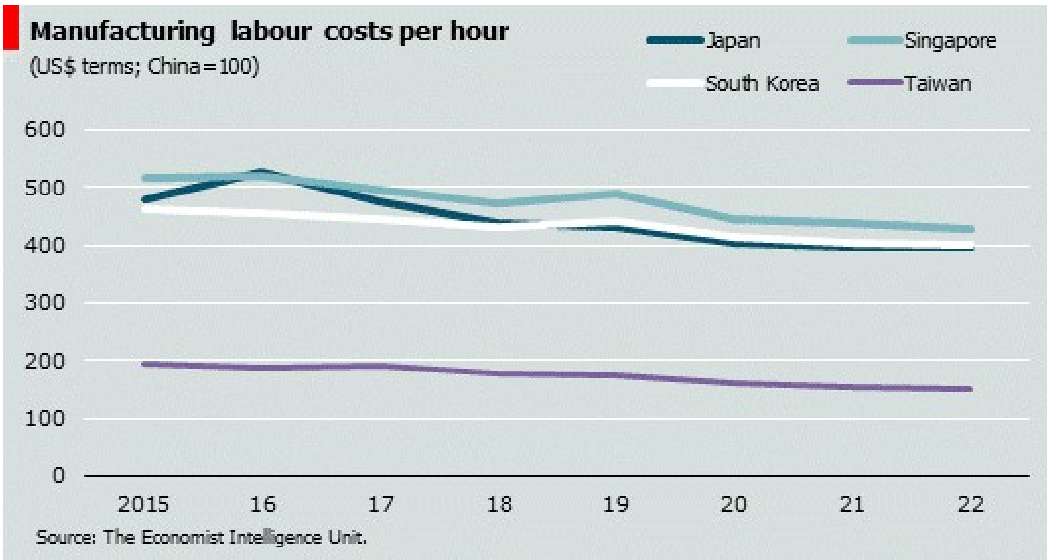
December 27, 2018

Although the US-China trade war has paused following the G20 summit in Argentina in November, we expect trade hostilities between the two nations to begin escalating again in 2019. The growing friction between the US and China has forced firms that manufacture for export in Asia to consider potential alternative manufacturing sites. The changes in relative labour costs within the region in recent years could serve to give some economies a comparative advantage in this race.

Our recent whitepaper on the potential winners and losers within Asia from the US-China trade war approached the question from a perspective of sectoral advantage and overall business environments. (Like the paper, this article will focus on Asian markets, although other economies, such as Mexico, could also benefit from the shift in export manufacturing from China.) However, it is worth addressing the question of labour costs in particular more closely, as the last few years have seen some notable developments that have shifted labour costs within the region. If export manufacturing does begin to move from China in a significant way, as we expect it gradually will, these labour cost advantages could have a significant impact on where firms chose to relocate.

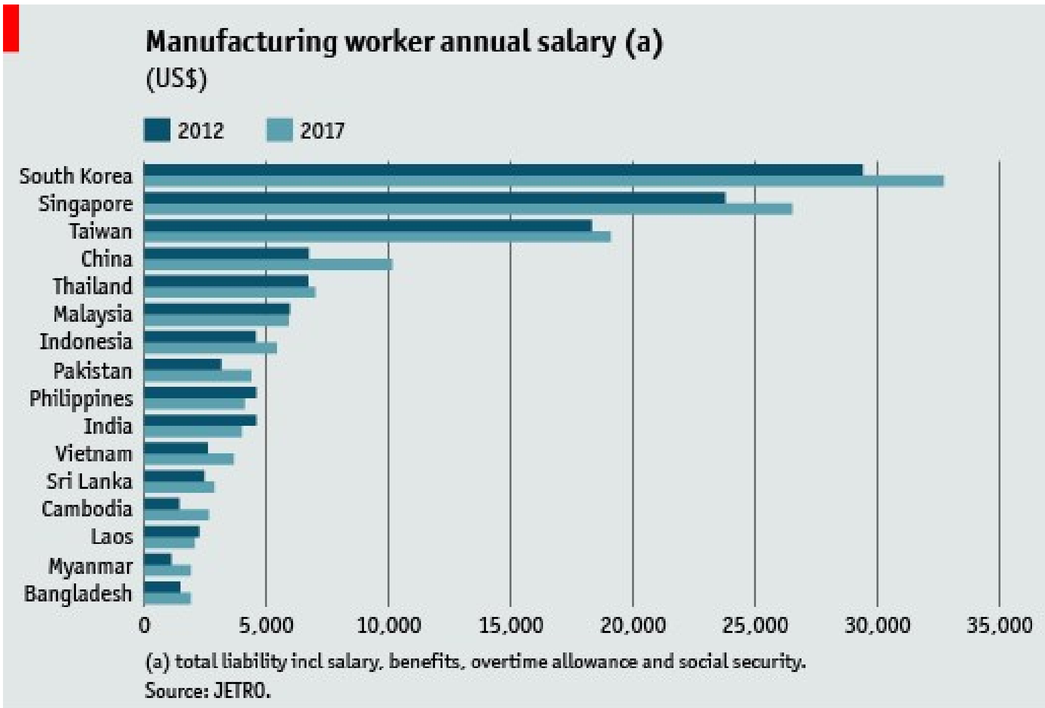
The first thing to note is that the process of relocating low-cost export manufacturing out of China is already relatively advanced. Much of the low value-added work for shoe manufacturing, for example, is now done in locations such as Vietnam, rather than in southern China, as used to be the case several years ago. China is not yet a high labour-cost environment, but it sits in a clear category above most emerging Asian nations when it comes to labour costs.

Looking at the relatively high-wage economies in Asia, it is fairly clear that most manufacturers who currently produce in China would suffer something of a price shock if they tried to recruit similar manufacturing staff in Japan, South Korea or Singapore. This is, of course, partly reflective of the fact that automation and a focus on higher-value-added work mean that manufacturing workers in these countries are much more skilled and productive. However, it also means that there is little chance of many firms that manufacture in China moving to these economies: the difference in operating environments is simply too large.



It is notable that manufacturing wages in Taiwan are significantly lower than in most other economies in Asia with a comparable level of education, technology and development. Although labour costs are still much higher than in China, there may be an area of overlap where firms producing at the higher end of the value spectrum in China might find it cost-effective to move production to Taiwan.

There are, of course, complications. Other costs in Taiwan (such as power and land) tend to be comparatively high. Relocating to Taiwan is also likely to be easier for foreign companies than for Chinese ones, which could face suspicion from both the Chinese government and the island's own authorities. Nevertheless, the positioning of Taiwan on the labour price spectrum indicates that the trade war could have some positive effects nudging production towards the island. These may go at least some way towards mitigating the obvious negative effects that US-China trade tensions will have for Taiwan's export manufacturers, whose supply chains rely heavily on China-based production.



On the lower end of the pay spectrum, the picture is complicated by the fact that it is difficult to obtain good data on labour costs in most poor emerging markets. Within Asia, Thailand and Malaysia are among the more expensive low-cost labour production bases, although at present they still have lower labour costs than China does. The pricing of their labour points to a higher level of education and skills than in many other emerging markets in the region. This suggests that manufacturers looking to relocate from China may be more able to find pools of talent in these markets comparable to those that they were accustomed to in China. This could, as our earlier research suggested, put Thailand and Malaysia in a good position to benefit from the fallout of the trade war.

The relative cost advantages of the most low-cost labour markets are hard to distinguish owing to the poor quality of the data. Our own data suggest that Asia's cheapest manufacturing labour is to be found in Indonesia. However, data from the Japan External Trade Organisation (JETRO) indicate that—at least for those Japanese firms that responded to JETRO's enquiries—labour costs were even lower in several other economies, including Vietnam, India and Bangladesh. JETRO's figures also highlight the fact that labour costs in Cambodia have surged in recent years, which may eventually serve to put that country at a disadvantage relative to even cheaper countries like Myanmar and Bangladesh, which are competitors in the vital garment export manufacturing sector.

Overall, however, all of these countries are likely to benefit from the continued migration of low-cost production from China, a process that will be accelerated by the trade war. The differences among them in terms of labour costs are fairly marginal. Instead, the winners in this competition for low-end export manufacturing production are likely to be those locations that can provide the necessary infrastructure and land to support the sort of large-scale production that helps to keep costs down.