Sri Lanka

Sri Lanka's economy experienced strong growth during the first half of the 1990s despite persistent macroeconomic imbalances, high inflation, and the armed conflict in the northeast of the country. However, with a major policy shift in the wake of national elections in 1994 and the escalation of the conflict in 1995, economic growth began to decelerate, accompanied by rising budgetary and external current account deficits. Although private saving has been increasing recently, the lack of progress in reducing the recurrent budget deficit has resulted in the absorption of a significant amount of this saving, the crowding out of investment, and an increasing reliance on foreign capital which is sensitive to economic and political conditions in the country.

A substantial reduction in the fiscal deficit is a crucial requirement if the Government is to be in a position, once hostilities cease, to meet the need for substantial rehabilitation expenditure while retaining macroeconomic stability.

Recent Trends and Prospects

Growth, Investment, and Employment. The economy grew by 5.6 percent in 1995, the same as in 1994, but substantially lower than the 6.9 percent recorded in 1993. The gradual deceleration in the rate of economic growth was the result of the resumption of hostilities, an increasing government budget deficit, and labor unrest. Nevertheless, the 1995 growth performance was impressive given these adverse factors and indicates the potential of the economy under more amenable conditions. Agricultural output grew by 2.3 percent in 1995, down from 3.3 percent in 1994. The lower growth rate is attributable to the spread of the civil war to farm areas in the northeast and the subsidy for wheat flour introduced in late 1994 which depressed prices of domestic substitutes such as rice. The industry sector, which accounts for about one third of total GDP, remained buoyant during 1995 with output in manufacturing growing by 9.1 percent in real terms, about the same rate as in the previous two years. The key to this growth performance is the private sector which expanded output by 12 percent and now accounts for almost 90 percent of industrial activity. The services sector, which accounts for about 50 percent of total GDP, grew by 5.4 percent in 1995 compared with 5.1 percent in 1994. Growth during 1995 was particularly strong in the import-export trade subsector, which expanded by 11 percent; energy expanded by 9.3 percent and financial services by 9.2 percent. However, tourism growth was lower in 1995 by about 2 percent as a result of the resumption of hostilities.

Acceleration in the investment rate is the main factor that contributed to Sri Lanka's strong growth performance during the 1990s. Gross domestic investment was 25.7 percent of GDP in 1995 compared with 21.4 percent in 1989. The rise in the investment rate is attributable primarily to government policies favoring private sector development and foreign investment. Nevertheless, uncertainty about the political situation, particularly among foreign investors, had a depressing impact on investment in 1995. In contrast to private investment growth, public investment has declined from 9.6 percent of GDP in 1991 to 7.6 in 1995 as a result of the Government's efforts to contain public expenditure. Government measures to deregulate the financial sector helped to raise the private savings rate from 13.4 percent of GDP in 1989 to over 19 percent in 1995. However, the domestic savings rate was lower, at only 15.9 percent of GDP in 1995, primarily because of government dissaving through the persistence of recurrent budget deficits. Domestic saving has been augmented by private transfers from abroad, which have been equivalent to about 4 percent of GDP recently. The domestic savings-investment gap has been rising steadily from 6.5 percent of GDP in 1990 to 9.8 percent of GDP in 1995 and reflects the country's increasing inability to generate sufficient saving to meet the investment needs of the economy. As a result, investment has been increasingly dependent on foreign saving that, in adverse conditions, could slow down or even decline.

Unemployment continues to be a major concern. While no official unemployment statistics exist, unemployment was estimated to be 13 percent of the labor force in 1995, an improvement over the 16.6 percent in 1992. However, if underemployment is taken into account, the unemployment rate rises to 35–40 percent. Growth in employment in Sri Lanka is still insufficient to absorb new entrants to the labor force or to have much effect on the numbers of unemployed or underemployed. Furthermore, significant imbalances continue to exist because of a mismatch between the skills acquired through the education system and the requirements of the labor market. There has been a relatively sluggish response of labor markets to the rapid expansion of economic activity because of structural rigidities, stemming, at least in part, from government regulations and hiring practices.

The economy is expected to grow at 5.2 percent in 1996 and 5.5 percent in 1997. Under normal weather conditions, agricultural output

Table 2.18 Major Economic Indicators: Sri Lanka

		1993	1994	1995	1996	1997
Gross Domestic Product[a]	% change	6.9	5.6	5.6	5.2	5.5
Agriculture	% change	4.9	3.3	2.4	2.3	2.7
Industry	% change	9.8	8.1	8.1	7.9	8.5
Services	% change	6.2	5.1	5.4	4.8	4.8
Gross Domestic Investment	% of GDP	23.6	26.3	25.7	24.9	25.2
Gross Domestic Saving	% of GDP	14.1	14.4	15.9	15.9	15.9
Inflation Rate	% change in CPI	11.7	8.4	7.7	9.6	9.7
Money Supply Growth	% change	23.5	19.6	13.5	17.0	17.0
Merchandise Exports	$ million	2,785.7	3,201.8	3,851.3	4,274.9	4,787.9
	% change	21.0	14.9	20.3	11.0	12.0
Merchandise Imports	$ million	3,527.8	4,072.5	4,830.0	5,457.9	6,222.0
	% change	17.0	15.4	18.6	13.0	14.0
Current Account Balance[b]	$ million	-543.0	-710.0	-1019.0	-1,090.0	-1,119.0
	% of GDP	-5.3	-7.9	-8.4	-7.9	-7.6
External Debt Outstanding	$ billion	6.8	7.8	7.6	8.4	9.2
Debt-Service Ratio	% of exports	10.1	9.9	10.0	10.5	11.0

[a] Based on constant 1982 factor cost.
[b] Excluding grants.

Sources: Data provided by the Government of Sri Lanka and the Central Bank of Sri Lanka; World Bank, *World Debt Tables 1996*, Vol.2 (Washington, DC, 1996); P.A. Nimal Siripala, "Asia Economic Outlook 1996–1997 Country Paper," paper prepared for the Asian Development Bank (mimeo, December 1995); International Monetary Fund, *International Financial Statistics* (Washington, DC, February 1996); and staff estimates.

could increase by 2–3 percent, primarily because of higher output of plantation and other high value-added crops. However, growth in rice production may decline because of the Government's policy to subsidize wheat flour (a substitute for rice), and the spread of the civil war to rice-producing areas such as the Mahaweli region. The industry sector is expected to continue to be the main engine of economic growth with output expanding by 7.9 percent in 1996 and 8.5 percent in 1997. As in the past several years, growth in the services sector should continue to follow closely that of the overall economy at about 5 percent in both 1996 and 1997. Energy, financial services, and the retail and wholesale trade subsectors should perform especially well, but tourism growth is likely to be adversely affected by the continuing hostilities.

Budget, Money, and Prices. The aim of fiscal policy in 1995 was to convert the budgetary current account from a deficit of 2.9 percent of GDP in 1994 to a small surplus, to reduce the overall budget deficit to 7.5 percent of GDP from 10 percent of GDP in 1994, and to reduce domestic borrowing to free up resources for use by the private sector. With the resumption of hostilities in April 1995, additional defense expenditure was necessary which the Government financed by increasing the Defense Levy from 3.5 percent to 4.5 percent. However, in subsequent months, there were further demands for defense expenditure as military activity intensified in the northeast. The fiscal situation deteriorated further with an increase in subsidy expenditure following a sharp rise in international wheat prices, and additional expenditure on public sector salaries and pensions. Thus, the overall budget deficit declined only marginally to 9.5 percent of GDP in 1995; however, while the current budget deficit also declined to 1.5 percent of GDP, the desired target of a small surplus was not achieved (Figure 2.23). Domestic borrowing to finance the budget deficit fell from 6.5 percent of GDP in 1994 to 5.3 percent in 1995, although this was still above the target of 3.4 percent of GDP.

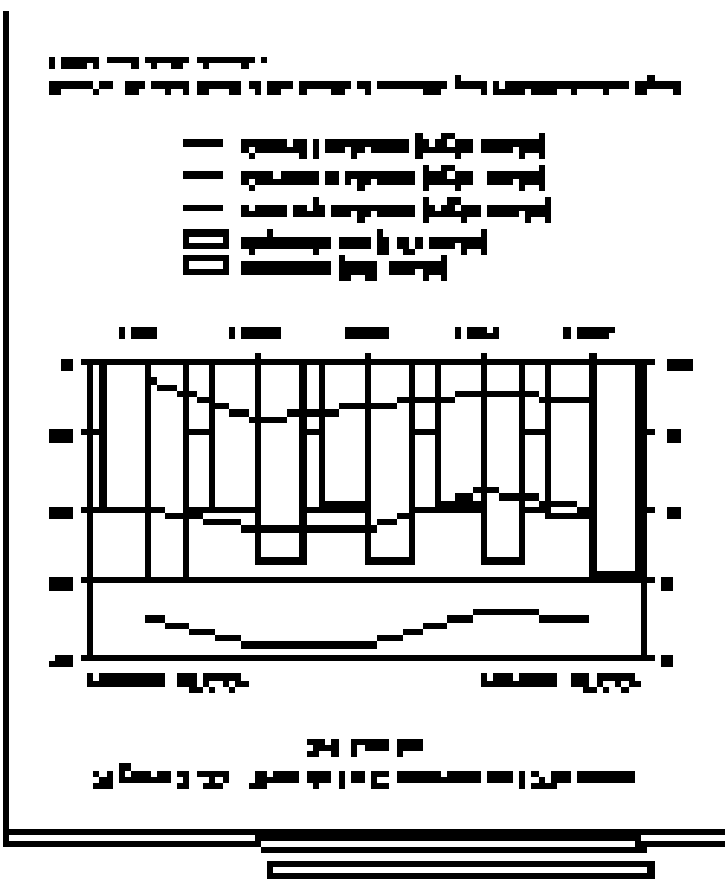
Monetary policy was tight during 1995 with broad money supply (M2) expanding at a rate of 13.5 percent during the year, significantly slower than the 19.6 percent recorded in 1994. Net foreign assets increased by 2.2 percent, while net domestic assets rose by over 15 percent. Credit to the private sector from the banking system rose 22.6 percent. Credit to the public sector decreased by 15.2 percent as more of the budget deficit was financed by captive sources such as government-controlled pension and insurance funds. The statutory reserve ratio of 15 percent for rupee deposit liabilities and 5 percent for foreign currency deposited abroad was maintained at the same level as in 1994. Meanwhile, the market-determined Treasury bill interest rate rose from 13.4 percent in January 1995 to 17.5 percent in December 1995 because of the large budget deficit and expectations of rising inflation.

Inflation, as measured by the Colombo Consumer Price Index (CCPI), fell marginally in 1995 to 7.7 percent from 8.4 percent in 1994. Prices of a large number of consumer items such as fish, vegetables, rice, wheat flour, and coconut registered declines in 1995 because of improved supply conditions. Lower import duties and taxes and lower prices of several commodities administered by the Government that have a significant representation in the CCPI also contributed to the fall in the recorded inflation rate. However, excluding the impact of these administered prices, it is estimated that the core inflation rate was in the 12–14 percent range.

The Government's medium-term developmental objective is to stabilize the economy by correcting long-standing fiscal imbalances; however, the Government recognizes that this is not feasible as long as the peace and order issue remains unresolved. Even if peace were to be achieved in the short term, new expenditure on rehabilitation and restoration of normalcy to the northeast of the country will compel the Government to keep security-related outlays at current levels. Moreover, the Government is committed to continuing the subsidization of several commodities for welfare purposes. The potential for raising revenue from additional taxes is limited since Sri Lanka's revenue/GDP ratio is already high by developing country standards, and the proceeds from the privatization program will most likely be moderate. As a result, it is expected that the fiscal position of the Government will improve only marginally over the next two years. The overall budget deficit is expected to fall only to 9 percent of GDP in 1996 and 8.5 percent of GDP in 1997.

The maintenance of a tight monetary policy is essential to slow down the growth of money supply and to prevent inflation from accelerating. Monetary policy needs to be less accommodating, particularly in relation to the public sector. However, the Central Bank has only limited autonomy and the credit demands of the public sector will undoubtedly be met. Furthermore, there is little scope for reducing money supply growth through higher interest rates as this would have a significant negative impact on private sector investment. Therefore, growth in broad money supply over the next two years is expected to be slightly higher than in 1995, at 17 percent per annum.

Given that the Government will continue to keep the prices of key commodities under its administration low over the short term, the official inflation rate is expected to rise slightly from current levels to 9–10 percent in 1996 and 1997. However, the core inflation rate (estimated by excluding the prices of items administered by the Government) will most likely be higher in the 12–15 percent range. This is consistent with the expected real GDP growth rate and the growth in money supply.



External Trade and Payments. Exports surged in 1995, growing by 20.3 percent to $3.9 billion. This growth was led by garment exports which expanded by 16 percent and accounted for about half of total exports. In contrast, the increase in earnings from agricultural exports was a modest 6 percent, largely owing to depressed prices of tea and coconut products. At the same time, imports grew by 18.6 percent to $4.8 billion. Intermediate goods accounted for half of the import bill, investment goods for 28 percent, and consumer goods for the balance. Almost one half of intermediate goods imports were textiles, mostly imported for the apparel industry. The rapid increase in exports together with a moderation in import growth resulted in a trade deficit of about $1 billion in 1995 compared with $0.9 billion in 1994.

FDI inflows declined slightly to $156 million in 1995 from $158 million in 1994 because of uncertainties created by labor unrest and the escalation of the civil war, as well as by the suspension – pending review – of the privatization program following the change of government. The net inflow of private long-term debt capital also declined, falling sharply to $18 million in 1995 from $278 million in 1994. However, net official capital inflows rose to $323 million in 1995 from $294 million in the previous year, reflecting better utilization of foreign aid. Of total disbursements during the year, 41 percent consisted of project loans from Japan, 23 percent as assistance from the World Bank, and 16 percent from ADB.

Sri Lanka's external debt declined by 2.7 percent to an estimated $7.6 billion or about 59 percent of GDP at the end of 1995. Debt-service payments as a ratio of exports of goods and services, at 10 percent in 1995, were slightly higher than in 1994, but still a relatively low ratio because of the concessional nature of the debt.

Export growth in 1996 is not expected to be as strong as in 1995; it will be led by industrial exports. Garments will continue to be the major export item, although other industrial products such as leather, rubber and wood products, paper, and ceramics will increase as a proportion of the total. Agricultural exports are also expected to increase, but to a lesser degree because prices of agricultural commodities are not expected to rise in the short term. Assuming that the Government's exchange rate policy maintains the real effective exchange rate at current levels, total exports in dollar terms should increase by 11 percent in 1996 and 12 percent in 1997 compared with 20 percent growth achieved in 1995.

Imports should accelerate slightly in the short term as the investment rate begins to recover and more capital goods are imported. Imports of consumer and intermediate goods should also increase because of lower import taxes and the Government's continued subsidization of commodities such as wheat, diesel, kerosene, and fertilizer. Consequently, total imports are expected to grow by 13 percent in 1996 and 14 percent in 1997. Slower export growth combined with stronger import expansion will cause the trade deficit to widen to $1.2 billion in 1996 and $1.4 billion in 1997. The current account deficit should remain in the 7.5–8 percent of GDP range aided by increases in remittances from overseas workers.

Progress toward the achievement of peace in Sri Lanka will, to a great extent, determine the level of FDI that the country will receive. As the conflict subsides, a resurgence in investment can be expected. Investors from Korea and other countries that have a long-term perspective have demonstrated continuing interest in investing in Sri Lanka.

External debt outstanding is projected to increase by 10 percent in 1996 to $8.4 billion, and 9 percent in 1997 to $9.2 billion. The debt-service ratio should rise moderately to 10.5 percent in 1996 and 11 percent in 1997 as the proportion of interest payments associated with financing defense spending at commercial rates begins to rise.

Policy and Development Issues

Although the main, longer-term developmental concern in Sri Lanka is the reduction of poverty and unemployment, the concern of paramount importance in the short term is the cessation of hostilities, which have not only been costly in human terms but have also led to excessive government expenditure, high budget and external account deficits, inflation, and the erosion of investor confidence. These factors indicate that economic growth at current rates is not sustainable over the medium term, that the underlying macroeconomic situation in the country is rather fragile, and that the Government's efforts to address the issues of poverty and unemployment could be seriously compromised. Therefore, the Government's immediate priority should be to make the fiscal adjustments needed to secure a substantial reduction in the budget deficit even though high levels of defense expenditure may still be required. Measures that should be considered include the reduction or elimination of subsidies, particularly for commodities that are imported, and a reduction in the size of the public services sector. Steps to improve the effectiveness and efficiency of public health and education programs should also be considered.

It is generally accepted that, even if peace were forthcoming in the near future, additional expenditure would be necessary for the rehabilitation and restoration of normalcy in the northeast. Therefore, it is particularly important to begin the process of fiscal consolidation early; otherwise, the peace dividend that is expected with the end of hostilities will in all likelihood not be forthcoming.

To revive domestic and foreign investor confidence in the economy, the Government needs to reinforce its commitment to the process of economic liberalization and the market orientation of the economy. Steps should be taken to create an environment that fosters private sector development through deregulation, particularly in the provision of infrastructure services such as power generation, transport, and telecommunications.

The labor market in Sri Lanka needs special attention. It is segmented, and wages and working conditions are determined by government regulation and strong union pressure and do not reflect the level of unemployment in the country. Policy reforms are needed to ensure that workers looking for new jobs are given adequate support, and that employers have the flexibility to adjust to changing market conditions. Labor market flexibility could make a significant contribution toward promoting economic growth and employment.