Sri Lanka

Despite the prolonged ethnic strife, Sri Lanka's economic fundamentals continue to improve, although the regional currency crisis may have some indirect impact on future prospects. Foreign direct investment increased in 1997 and contributed to a balance-of-payments surplus of more than $400 million.

RECENT TRENDS AND PROSPECTS

GDP growth accelerated to 6.3 percent in 1997, a significant increase from the 3.8 percent growth in 1996. This was primarily due to recovery in the agriculture sector, which grew by 5.4 percent in 1997 as fair weather resulted in good crops. Manufacturing remained the most dynamic sector in 1997, growing at around 9 percent, stimulated by buoyant demand for Sri Lanka's manufactured exports such as garments and rubber goods. Growth in the services sector was also robust, particularly in the communications, banking and finance, and tourism-related sectors. Despite continuing civil conflict, tourist arrivals recovered strongly from the 1996 slump, increasing by more than 20 percent.

Investment was about 26 percent of GDP and domestic savings ran at 17 percent in 1997, slightly up on 1996. Increased business confidence and a decline in interest rates translated into higher private domestic investment. The reduction of the budget deficit and the use of privatization proceeds to retire public debt also stimulated private investment by reducing public sector claims on available financial resources. Local investors and a high demand for plantation sector shares dominated activity on the Colombo Stock Exchange. Foreign investors continued to remain cautious because of the turbulent situation in Asia.

Unemployment declined to about 10 percent of the labor force, a moderate fall from the 1996 figure. Real wages continued to decline in industry, commerce, and services in 1997, but remained substantially unchanged in agriculture. To correct distortions in relative salaries, the government raised civil service wages and allowances by an average of 12 percent in 1997, with a further 15 percent increase planned for 1998.

The 1997 budget was designed to continue fiscal consolidation and achieved the target of limiting the budget deficit to 4.9 percent of GDP. Government revenues were up nearly 15 percent in nominal terms, reflecting increased tax collection from improved corporate profits, and government expenditures did not increase significantly. The recent decline in wheat prices resulted in savings on subsidies. The privatization of 35 percent of Sri Lanka Telecom was finalized in A ugust 1997, and yielded $225 million to the government, a large share of which the government used to retire Treasury bills. This reduced government debt and the interest payment burden. The sale of government-held convertible debentures for the National Development Bank raised an additional $73 million, further easing public budget constraints. Over time, the fall in interest rates and the partial shift in government borrowing from short-term to medium-term debt should have a positive impact on the budget's interest component.

Monetary policy was eased considerably in 1997, with broad money growing by 14.7 percent, and the statutory reserve ratio was lowered in two steps. Combined with greater fiscal discipline, these measures helped reduce interest rates considerably. The yield on one-year Treasury bills fell to 10 percent in 1997 from 17 percent in 1996, and the prime lending rate declined from 18 to 12 percent. Given the relatively long duration of deposits, deposit rates did not fall by as much, creating temporary pressure on bank intermediation spreads and profitability.

The inflation rate declined from 16 percent in 1996 to 9.6 percent in 1997. Annual average inflation was on a declining trend since the start of the year because of improved supplies of rice, vegetables, coconut, and other food crops and the lower cost of money as a result of declining interest rates.

Imports grew by 7 percent in 1997 in dollar terms, while exports increased by approximately 13 percent. Investment and intermediate goods led the recovery of imports, followed by consumer products. Industrial exports, particularly clothing, leather, and rubber products, led export growth. Agricultural exports also rose because of favorable tea and coconut prices, and a modest expansion in volume. In the first ten months of 1997 tourist arrivals were 22 percent higher than in 1996 and tourist earnings were 29 percent higher, resulting in an improved services account. Overseas remittances increased by 9 percent and the current account deficit fell to 2.1 percent of GDP in 1997, down 3 percentage points from 1996.

The capital account balance was positive in 1997, reflecting a 27 percent increase in long-term foreign aid inflows and more than $550 million of foreign investment. Large-scale privatization of Sri Lanka Telecom and the National Development Bank contributed to these inflows. The balance of payments closed with a $400 million surplus at the end of 1997, increasing reserves to approximately five months worth of imports. The exchange rate depreciated by nearly 7 percent in nominal terms during 1997, with the depreciation rate accelerating in the last two months of the year. In real terms, the exchange rate remained relatively unchanged.

Projections indicate that the economy will continue to grow at a rate of between 5 and 6 percent in both 1998 and 1999. In the absence of

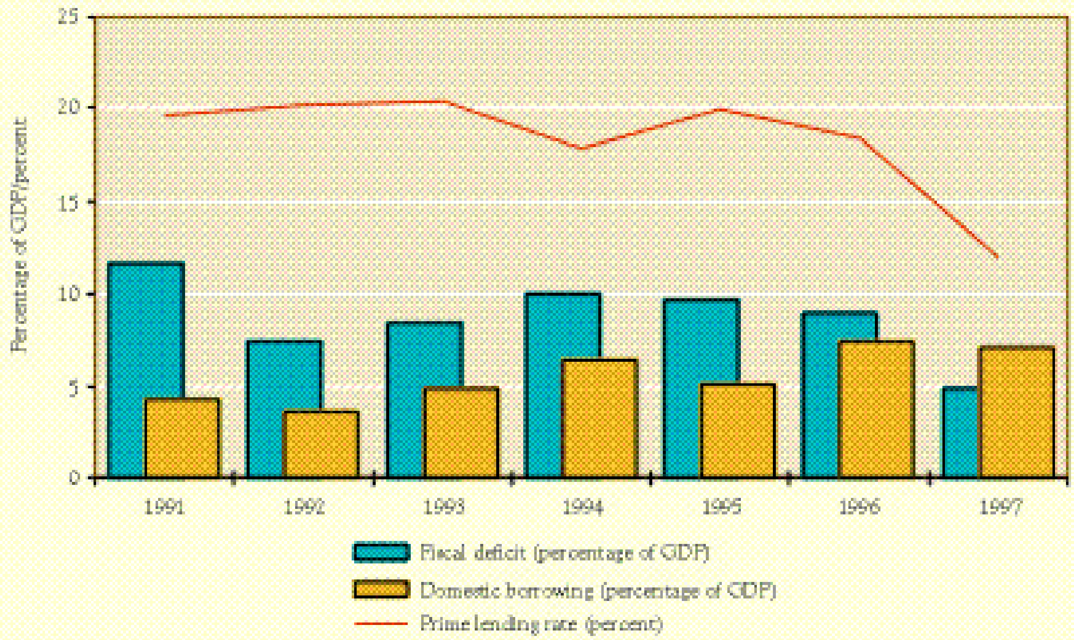
Table 2.16 Major Economic Indicators: Sri Lanka, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product growth[a]	5.5	3.8	6.3	5.6	6.0
Gross domestic investment/GDP	25.7	24.2	25.8	26.7	27.6
Gross domestic saving/GDP	15.3	15.5	16.5	17.5	18.0
Inflation rate (consumer price index)	7.7	15.9	9.6	10.0	9.0
Money supply (M2) growth	19.2	10.8	14.7	14.0	13.0
Fiscal balance/GDP	-9.6	-8.9	-4.9	-5.7	-4.0
Merchandise exports growth	18.7	7.9	13.0	9.0	10.0
Merchandise imports growth[b]	11.6	2.5	7.0	10.0	9.0
Current account balance/GDP[c]	-6.3	-5.3	-2.1	-4.2	-4.0
Debt-service/exports	11.6	12.9	11.4	11.2	11.0

[a] At constant 1982 factor cost.
[b] Cost, insurance, freight.
[c] Excluding official transfers.

Sources: Central Bank of Sri Lanka (1997); Siripala (1997); Ministry of Finance and Planning (1997); and staff estimates.

Figure 2.12 Fiscal Deficit, Domestic Borrowing, and Interest Rates: Sri Lanka, 1991-1997



Sources: Central Bank of Sri Lanka (1997) and Siripala (1997).

adverse weather conditions, expectations are that the agriculture sector will grow 3 percent per year in both years. Tea is likely to perform well in the next two years, with stable or growing output and prices, while rubber prices are likely to recover moderately. The industry sector is forecast to grow by around 8 percent in 1998 and 1999. Stronger price competition by Southeast Asian countries in Sri Lanka's export markets and a possible reduction in foreign investment flows will partially offset the positive impact of the incentives included in the 1998 budget. The services sector is anticipated to grow by more than 5 percent in 1998 and 1999, reflecting increased tourism, greater activity in the retail and wholesale sector, and growth in the banking and finance subsectors.

Savings and investment patterns will depend on the general health of the economy, on the government's ability to reduce the budget deficit, on the continuation of privatization, and on success in containing the impact of the Asian currency turmoil on Sri Lanka. Gross domestic investment is projected to increase to about 27 percent of GDP in 1998 and 28 percent in 1999. Private sector investment, stimulated by a decline in interest rates, is expected to expand and support growth. As the public sector's financing requirements decrease, a reorientation of the private sector's savings should take place from traditional saving deposits and investment in government securities to other financial instruments.

The 1998 budget envisions a deficit reduction to 6.5 percent of GDP in 1998 and 4 percent by 2000. The improvement in government accounts in 1998 is to be achieved through lower real current expenditures and an expansion in capital expenditures, matched by increased revenues. The revenues from privatization in 1998 are projected to be $125 million, or one third of those in 1997. Defense expenditure remains as a potentially destabilizing component in the budget, although the government has asserted that it will not exceed defense targets.

Also included in the 1998 budget are a number of investment promotion measures to which the business community has reacted favorably. These measures include accelerated depreciation and investment tax credits, duty exemptions for imports of advanced technology machinery and equipment, and extended tax holidays for investment and employment creation in backward areas. The budget also introduced a goods and services tax that will replace the business turnover tax.

The government will have to manage monetary policy prudently to accommodate growth without fueling inflation. Inflation in 1998 and 1999 should remain at, or slightly above, the 1997 rate of 9.6 percent. Interest rates will be influenced by the extent of fiscal consolidation and the strength of economic growth and monetary expansion.

Exports and imports are expected to grow by some 9 to 10 percent in 1998 and 1999. Improved agricultural exports will reflect increased export demand and higher prices. Manufactured exports will face stronger competition from some Asian countries whose exchange rates have depreciated sharply. Duty exemptions granted in the 1998 budget will sustain import growth. Services receipts are expected to increase as the tourist industry recovers and economic activity strengthens generally, and the current account deficit will remain at some 4 percent of GDP. Private capital inflows are likely to moderate, particularly in 1998, as the international climate becomes more cautious and economic adjustment takes place in some economies that have been traditional sources of foreign direct investment.

POLICY AND DEVELOPMENT ISSUES

Maintaining fiscal discipline remains a critical economic policy issue. The public deficit (as a percentage of GDP) has declined for three consecutive years, and the authorities have set targets to continue on this path. The use of privatization revenues to retire public debt sent an important signal to markets. The government should define its rationale for a second wave of privatization clearly, and should continue to pursue the privatization and/or commercialization of public enterprises with attention to the development of an appropriate regulatory framework. Structural measures on pensions, on the size and efficiency of the civil service, and on other relevant expenditure and revenue items will continue to be needed to achieve the government's target of a budget deficit equivalent to 4 percent of GDP by 2000.

Reducing the deficit and the government's financing requirements would also have beneficial effects on the financial market. The immediate impact would be lower interest rates, which would reduce the crowding out private sector investment has experienced and generate a virtuous cycle of lower budget outlays for public debt service and still lower deficits. This would permit lengthening the maturity of government debt, which would free the government from frequent renewal of short-term debt and would provide useful benchmarks for developing the long-term debt market, which is currently extremely thin. This should be accompanied by other interventions to strengthen governance in the financial sector, such as improved accountability by and performance of the two state-owned commercial banks and more stringent prudential regulations and banking supervision.

The status of the ongoing civil conflict is a key determinant of the country's long-term development prospects. Successful conclusion of the conflict would increase investor confidence, reduce the drain of defense expenditures on the budget, free resources for investment and economic growth, and lead to a resurgence in tourist arrivals. This would lead to an upward revision of the growth outlook and offer the potential for sustained growth.