Sri Lanka

Chronic large budget deficits and reliance on short-term external borrowing in recent years made the economy vulnerable to a global financial crisis and recession. Heavy losses of foreign exchange reserves and a domestic downturn early in 2009 threatened an economic crisis and required a recovery program supported by financing from the International Monetary Fund. The end of the 30-year internal conflict in May, however, marked a major turning point, and an immediate revival of confidence coinciding with global economic improvement sparked an economic rebound. The outlook is positive, despite large budget deficits weighed down by reconstruction costs.

Economic performance

The economy grew by an estimated 3.5% in 2009 (Figure 3.21.1). Growth declined to 1.5% in the first quarter, but picked up rapidly after the second quarter supported by optimism over the end of 3 decades of civil war. With a revival of agriculture in Eastern province (which came under government control in 2008), the sector performed well in the first half before shrinking marginally due to drought in the third quarter.

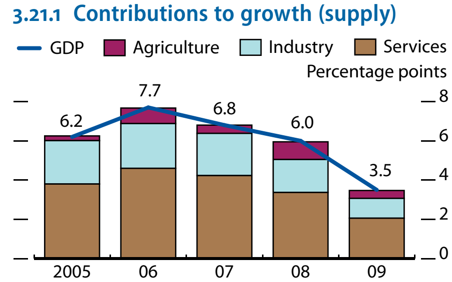
During the second half of 2009, services and manufacturing picked up sharply, driven by an upturn in domestic demand. External trade–related sectors stayed depressed throughout the year. Tourism saw a rebound after May.

Inflation had peaked at 28.2% in June 2008, driven by high global prices for food and fuel, but declines in these prices saw inflation subside to about 1% by mid-2009 (Figure 3.21.2). Prices picked up in the final quarter of the year on short supply of certain agricultural products including rice, vegetables, and coconuts, which have significant weights in the Colombo consumer price index. The annual average rate was 3.5%, down from 22.6% in 2008.

As inflation fell, the central bank eased monetary policy and cut the policy interest rates five times during the year. It also lowered the statutory reserve requirement. But despite the repeated rate cuts, commercial bank lending rates failed to come down significantly, especially in relation to indicative market rates, such as the 3-month Treasury bill rate (Figure 3.21.3). The government, in an attempt to speed up the process, directed the public sector commercial banks to bring down interest rates by 700 basis points (to 8%–12%) in October 2009.

Credit to the private sector remained in the doldrums throughout 2009, due to weak demand and banks' cautious approach to lending (Figure 3.21.4). Nonperforming loans increased, but the banking system as a whole remains well capitalized.

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*. http://www.cbsl.gov.lk; ADB estimates.

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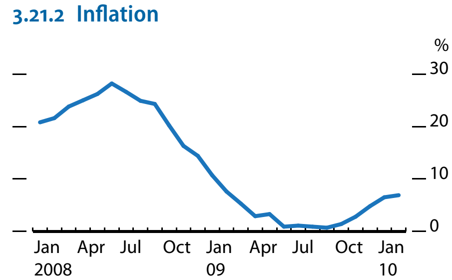
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 11 March 2010).

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This chapter was written by Nimali Hasitha Wickremasinghe of the Sri Lanka Resident Mission, ADB, Colombo.

Growth in broad money supply was subdued during the first half as the economy faltered, but accelerated in the second half, supported by a significant buildup of net foreign assets at both the central bank and commercial banks, and by an expansion of credit to the public sector. Broad money supply grew by about 19% in 2009 and was within the central bank's target.

An economic stimulus package was introduced in December 2008. It reduced prices of gasoline (petrol), diesel, kerosene, and liquefied petroleum gas; and brought in a subsidy for fertilizer for tea smallholders, and a subsidy for rubber manufacturers. In May 2009, Parliament passed a supplementary SLRs8 billion (about $70 million) package to support exporters. It included a reward scheme to grant a 5% incentive for exporters that maintained export earnings at levels similar to the year before, kept their current employment levels, and met specific domestic value-added criteria for various sectors.

Weak revenue performance and expenditure pressures pushed the 2009 budget deficit to 10.2% of GDP (excluding grants) according to the government's provisional estimates (Figure 3.21.5), substantially exceeding the planned deficit target under an International Monetary Fund (IMF) $2.6 billion standby arrangement of July 2009. Due to the slowdown in external trade and domestic economic activity, total revenue in 2009 was SLRs702 billion, well below target; and at 14.6% of GDP, revenue performance was marginally worse than a year earlier.

Expenditure increased to 24.7% of GDP in 2009 (a rise of 2.1 percentage points), accounting for the bulk of the deficit's increase from a year earlier. Expenditure pressures came from larger national security spending, provision of basic needs for internally displaced persons, greater public investment, and double-digit increases in wages and pensions and in interest payments.

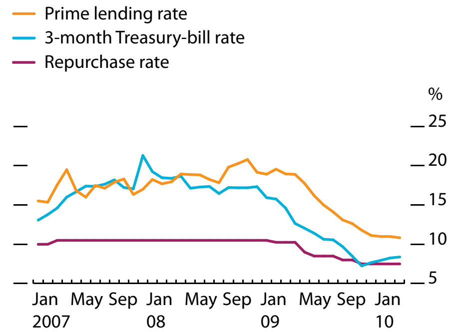
Total government debt increased by 16% in 2009 and the debt-to-GDP ratio rose from 82% to 86%. While this ratio had decreased in recent years through 2008, the structure of the debt became less favorable, with the mix shifting from concessional external borrowing to higher-cost domestic and nonconcessional external borrowing. This has increased rollover risk, while the rise in dollar-denominated domestic debt has added to the exchange rate risk.

The central objective of the IMF standby program is to reduce the fiscal deficit to a sustainable 5.0% of GDP by 2011. The government is expected to introduce reforms to broaden the tax base and reduce tax exemptions in the 2010 budget, which should assist in moving toward this target.

One of the most difficult targets of the fiscal reform effort under the standby arrangement is hitting breakeven in operations at the two loss-making state utilities, the Ceylon Electricity Board and the Ceylon Petroleum Corporation.

As an initial step, the government established an independent regulator for the power sector in March 2009. It is also moving toward lower-cost electricity generation and has appointed a Joint Review Mechanism Committee to monitor the operations of the two enterprises and to recommend improvements. In July 2009, the government raised retail prices of gasoline and diesel by 5%–10%,

3.21.3 Interest rates



Source: Central Bank of Sri Lanka. http://www.cbsl.gov.lk (accessed 12 March 2010).

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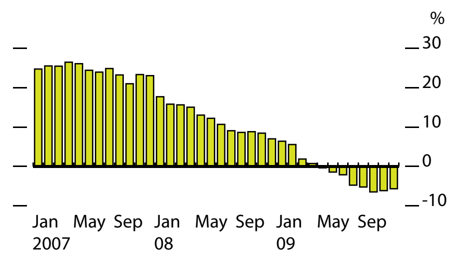
3.21.4 Private credit growth



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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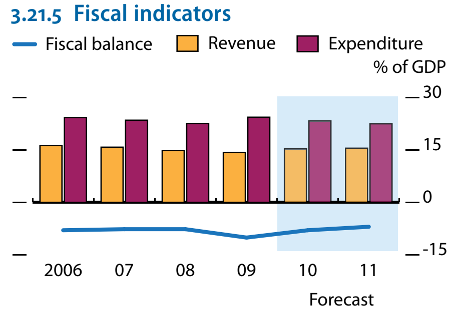
3.21.5 Fiscal indicators



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*. http://www.cbsl.gov.lk; Ministry of Finance and Planning. 2010. *Pre-Election Budgetary Position Report*. http://www.treasury.gov.lk; ADB estimates.

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moving toward full pass-through of increases in international oil prices. However, it cut gasoline prices by 11% in December 2009, prior to the presidential election in late January.

Falling global demand and prices hit both exports and imports heavily. The largest factor in the 12.9% export drop was a 15.4% decline in industrial products, due mainly to lower exports of textiles and garments, food, beverages and tobacco, machinery, and equipment. The even larger import fall of 29.4% reflected lower demand across all categories.

Remittances held up well, growing by about 14%. The shrinking trade deficit and growth in remittances took the current account into surplus at about 0.3% of GDP in 2009 (Figure 3.21.6).

Tourist arrivals, which fell heavily during the first 5 months, recovered strongly over the rest of the year. Although they grew by only 2.1% for the whole year, it was the largest gain since 2004. The outlook for the industry is for marked upturn in the coming years.

Gross official reserves rebounded from a low of $1.3 billion (only 1.2 months of imports) in early 2009 (Figure 3.21.7) to $5.1 billion by end-December 2009 (6.2 months of imports). This gain was underpinned by $1.2 billion from sales of government short-term securities and by IMF disbursements. The central bank intervened in the foreign exchange market in this period to prevent a substantial appreciation of the Sri Lanka rupee.

The authorities made several policy changes at the beginning of 2010 with the intention of gradually relaxing restrictions on capital account transactions. The changes include allowing Sri Lankans to open accounts with banks abroad and to invest in foreign company shares; and permitting foreigners on tour to open domestic currency accounts in Sri Lanka and to invest in local corporate bonds.

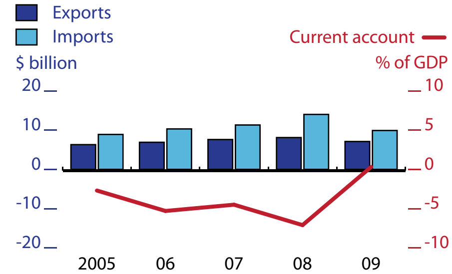
Economic prospects

The ending of the military conflict in May last year is likely to boost growth and development in the coming years. Investor confidence in Sri Lanka's markets has already shown signs of improvement, as evidenced by a sharp runup in the stock market (Figure 3.21.8) and the country's standing in global capital markets. Substantial government investment in social and economic infrastructure will still be needed, though.

With growth picking up in the second half of 2009, the economy is poised to recover in 2010. The sectors that performed poorly in 2009 were mainly industries and services related to the external sector, such as textiles and garments, import and export trade, and cargo handling. With the global economy in recovery mode and with higher domestic and foreign investment, growth momentum is likely to strengthen and reach 6.0% in 2010 and 7.0% in 2011. These projections assume that the tax reforms and fiscal consolidation will achieve fiscal deficit targets, sustaining investor confidence.

The authorities aim to control inflation through monetary targets, while ensuring adequate credit to the private sector. The central bank plans the growth of both reserve money and broad money supply to accelerate by 14.5% in 2010. Given international price pressures, inflation is expected to remain at around 6.5% in 2010.

3.21.6 Current account indicators



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*; *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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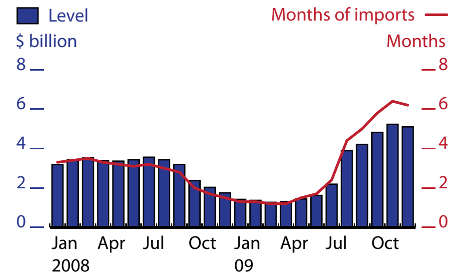
3.21.7 Gross official reserves and import cover



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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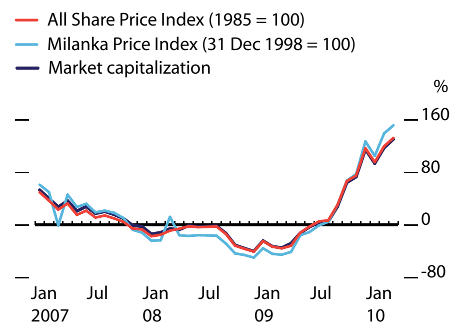
3.21.8 Stock market growth



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk

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3.21.1 Selected economic indicators (%)

	2010	2011
GDP growth	6.0	7.0
Inflation	6.5	8.0
Current account balance (share of GDP)	-2.0	-3.0

Source: ADB estimates.

In February 2010, the European Commission withdrew preferential tariffs under the Generalized System of Preferences Plus (GSP Plus) to Sri Lanka's exports on account of weak implementation of human rights conventions. The suspension will take effect in August. The two sides, however, are working on measures that could allow for the preference to be reinstated. The garment sector, which receives about 7% in tariff concessions under the scheme, will be the most affected by the loss of concessions.

External trade is expected to continue gathering momentum as the global economy recovers. At about 5.0% growth, exports will be below potential in 2010 owing to the impending withdrawal of GSP Plus concessions (as well as only a modest improvement in demand for garments).

Imports will advance from their current low base, growing by about 20.0%, reflecting a marked increase in domestic demand and higher oil prices. The trade deficit will widen significantly, but continued improvement in workers' remittances should hold the current account to a deficit of 2.0% of GDP in 2010 (Figure 3.21.9). It is likely to reach 3.0% of GDP in 2011.

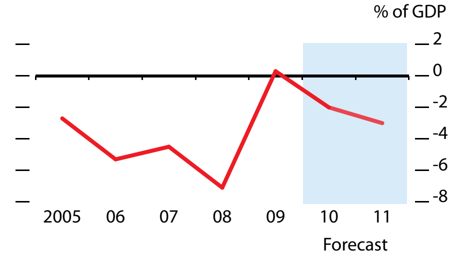
External capital inflows have improved since May and are likely to strengthen further in the forecast period. Sri Lanka floated a $500 million, 5-year international sovereign bond issue in October 2009, and the offer was oversubscribed, receiving $6.8 billion and reflecting the increased international confidence in the economy. Moreover, during the second half of 2009, rating agencies raised Sri Lanka's outlook to "stable" from "'negative."

Budget expenditure is projected to come down to 23.3% of GDP in 2010 and reach 22.5% in 2011 (Figure 3.21.5 above). Since the 2009 targets were not achieved and some of the additional expenditure items such as humanitarian assistance to Northern province (the locus of the conflict) and expenses relating to stimulus measures introduced in 2009 will spill over to 2010, greater adjustment than this would likely be difficult.

As the economy picks up, revenue collection should improve. However, revenue-enhancement measures that were expected to be implemented in 2010 under the IMF program have been delayed due to the scheduling of the parliamentary election in April and the consequent postponement of the 2010 budget. The latest government estimates envisage revenue to be 15% of GDP this year. A Presidential Tax Commission, set up in 2009, is expected to recommend measures to broaden the tax base. With these recommendations implemented, revenue could reach 15.5% of GDP in 2011.

The government aims to bring down the fiscal deficit to 8.0% this year. In 2011, the deficit should come down to 7.0%, if revenue and expenditure adjustments are made. How the government will actually address fiscal issues this year and beyond will become clear only once the budget is approved by Parliament (likely by midyear).

3.21.9 Current account balance



Sources: Central Bank of Sri Lanka. 2008. *Annual Report*; *Weekly Economic Indicators*. Various issues. http://www.cbsl.gov.lk; ADB estimates.

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3.21.1 Development challenges

The 2010–2012 development plan for Northern province aims to spend SLRs295 billion (about $2.7 billion). While it gives no estimate on how much donors will fund, the government likely needs to raise a significant amount from them. GDP growth of the province is expected to average 13% during the 3 years.

There are manifold challenges in reviving the economy of Northern province (and to a lesser extent, Eastern province). A substantial infrastructure gap with the rest of the country has opened during 30 years of destruction and virtually no investment. The investment that the two provinces need to bridge this gap is enormous.

Yet developing the former conflict regions and normalizing living conditions are key factors in establishing lasting peace and placing Sri Lanka on a higher growth path. Consequently, there is no alternative but to make this investment.