Sri Lanka

The resurgent conflict has not yet had an impact on growth, which has been driven by strong domestic demand and buoyant private sector activity, but global food and oil price increases, in combination with expansionary macroeconomic policies, have doubled inflation. Growth is forecast to decelerate over the next 2 years, as the global slowdown affects key export markets, and as the Government takes steps to cool the economy. Further out, achieving the 10-year development plan's goals depends crucially on the success of policies to improve productivity.

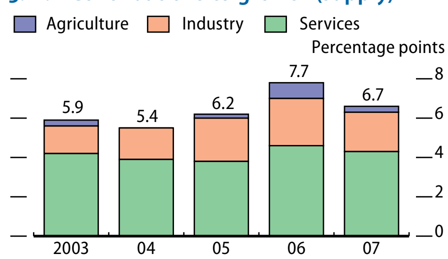
Economic performance

After expanding rapidly in 2006 the economy slowed in 2007, but still showed robust growth of an estimated 6.7%. Several important characteristics emerge from these 2 years, which were marked by a renewed, and escalating, civil conflict. First, the economy has proven more resilient than expected by most observers (both local and international). Second, post-tsunami reconstruction, rising credit expansion, and public sector investment continued to fuel growth in construction, which now accounts for almost 7.4% of GDP. Third, expansionary fiscal policies, largely negative real interest rates, and high remittances also substantially boosted aggregate demand.

On the supply side, services remained strong (especially telecommunications, finance, international port services, and logistics), contributing 64% of GDP growth in 2007 despite the conflict-related slowdown in tourism (Figure 3.21.1). While tourism contributes only 1–2% of GDP, the social costs of fewer tourists are high, as an estimated 300,000 jobs are linked to the industry. Agriculture fell back to its lackluster performance of the past, unable to sustain the post-tsunami recovery of 2006. The garment industry—the industrial mainstay—continued to weather difficult conditions. It grew by 7%, increasing exports to the European Union (EU) by 24%, taking advantage of the GSP Plus concessions granted in 2005, while its exports to the United States (US) decreased by 3.4%.

Soaring global prices for fuel and food and high government bank borrowing were the main causes of the doubling of inflation in the Sri Lanka Consumer Price Index (SLCPI), from 9.6% to 20.2% (Figure 3.21.2). Inflation was 5 percentage points higher than the targeted rate in the Monetary and Financial Policy Road Map published by the central bank in January 2007. The bank largely met its targets of reserve money and broad money growth by the end of the year, although there were sizable deviations during the course of it. As in 2006, monetary policy was conducted primarily through open-market operations, which

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka, *Annual Report*, various years; staff estimates.

Click here for figure data

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

pushed interest rates higher with the 91-day Treasury bill rate climbing by 7 percentage points over the year to 19%. To implement tightening, the central bank restricted access to the reverse repo window (for lending to commercial banks), but left its rate unchanged at 12.0%. Unlimited access to this window by some banks was a major factor fueling high credit growth in 2006. However, after interbank rates began to fluctuate, peaking at 40%, the central bank changed its policy in August. Access to the reverse repo window is now liberalized, though a penal rate ensures that its use is limited.

Higher interest rates reduced private sector credit growth from 24% to 20% year on year. However, the central bank cautioned in its Road Map that the success of its policies to bring down inflation would depend on government borrowing being kept within limits set by the central bank. During 2007, such borrowing varied substantially (Figure 3.21.3), complicating implementation of the Road Map.

Inflation in Sri Lanka is sensitive to public-sector credit expansion that causes an increase in the money supply. The continued heavy government borrowing from the banking system will exacerbate inflation pressure. The inflation impact of past modes of deficit financing is corroborated by the findings of the Government's think tank for economic policies, the Institute of Policy Studies of Sri Lanka, as well as the International Monetary Fund.

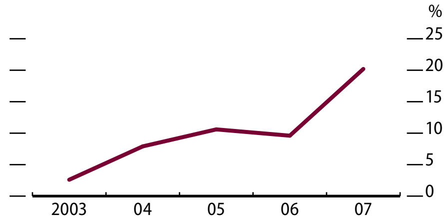
The sharp rise in inflation also reflects global food and fuel price increases, with their impact magnified by depreciation of the local currency against the US dollar for most of the year. Due to the global wheat shortage, wheat import prices rose by over 60% (in Sri Lanka rupee terms) in 2007. Reflecting both this and rises in other inputs (such as labor, transport, and marketing costs that are not solely supply driven), bread prices alone rose by almost 200%. The large share of food in the SLCPI (71.2%) is therefore a policy concern.

There were also substantial changes in government-administered fuel prices. Figure 3.21.4 shows the contribution to inflation of the food; transport; and housing, electricity, and fuel price subgroups in the new Colombo Consumer Price Index (CCPI-N), which shows that food was the prime source for the run-up in prices during the year. Inflation as measured by the CCPI-N, however, is slightly below that of SLCPI because of a lower weight for food.

Continued modernization of revenue administration broadened the tax base with the opening of 79,000 new tax files in 2006 and 2007. Lowered tax thresholds and increases in some import duties also raised revenue collection. These moves, in combination with lower than expected expenditure, contributed to a further reduction of the fiscal deficit to an estimated 7.7% of GDP.

The Government continued to focus on expanding public investment as a share of GDP, in line with its 10-year development plan (Figure 3.21.5). In the past, when the Government had not been able to secure financing for all projects in its ambitious investment pipeline, this underspending was shifted in part to current spending, causing it to be higher than anticipated in the budget plan. Both primary and current fiscal deficits, after peaking in 2004, continued to contract as a result of strengthening revenues, but remain in negative territory, which means that the

3.21.2 Annual inflation



Sources: Department of Census and Statistics; staff estimates.

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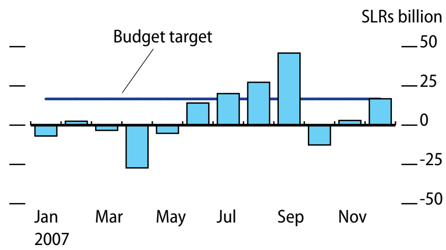
3.21.3 Cumulative new government borrowing from banking sector



Source: Central Bank of Sri Lanka, *Weekly Economic Indicators*, various issues.

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Government continues to borrow to fund part of current expenditures. Civil servants' salaries and pensions have grown as a share of GDP, while transfers and subsidies have fallen (Figure 3.21.6).

The costs of transfers and subsidies as a share of GDP have fallen since 2005, mainly the consequence of an end to fuel subsidies through the adoption of a formula for automatically adjusting domestic prices to import cost. However, wage costs have been increasing as a share of GDP, a result of an expanding civil service, upward salary and pension revisions, as well as an increase in the number of ministries (which now number 91). The average civil servant's salary, for example rose by 22% in 2006, more than twice the rate of inflation that year.

National defense spending (excluding civil security, internal administration, and law and justice) for 2007 is estimated at SLRs118 billion, taking up 15% of total government expenditure, or 2.6% of GDP. Yet this is still substantially lower than the level seen in 2000, when the Government was involved in an earlier major confrontation with the Liberation of Tigers of Tamil Eelam (LTTE).

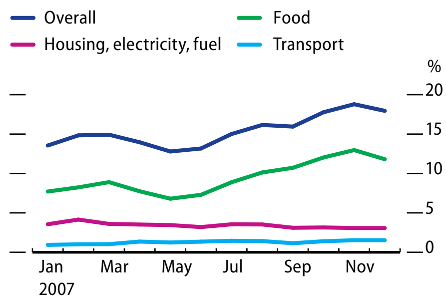
The trend of strong remittance growth since 2004 continued in 2007 to support the current account balance of payments. Remittances counterbalanced the continued high trade deficit, which fell slightly from the 2006 level, on account of lower import growth and a strong export performance (mainly garments). Notably, consumer imports fell by about 1%, reflecting the impact of higher duties and tariffs effective during the year (taxes on mid-range cars, for example, now are at 267% of the cost, insurance, freight value). For 2007, the current account balance-of-payments deficit amounted to 4.3% of GDP, compared with 5.3% in 2006.

The overall balance of payments, however, improved considerably in 2007, recording a surplus of $570 million. This was largely due to a $500 million sovereign bond issue. The government securities market was liberalized to allow foreign investors to participate (resulting in a net inflow of $470 million in 2007) and official foreign exchange reserves increased (Figure 3.21.7). The central bank continued to intervene in the foreign exchange market during the year to stabilize the Sri Lanka rupee; however, in sharp contrast to 2006, total net sales of foreign currencies amounted to only $5 million for all of 2007, compared to $453 million in 2006. In the first 2 months of 2008, net purchases of dollars by the central bank amounted to $360 million—a result of considerable foreign inflows driven by the sharp easing of monetary policy in the US.

Four years after starting preparations to obtain a sovereign credit rating, the Government made its first ever sovereign bond issue in September 2007. The issue was substantially oversubscribed, raising $500 million at 8.25%. The yield on the bond has implications for the private sector, as it will now be used as a benchmark in pricing private sector borrowing from abroad. The Government used the $500 million to retire its domestic debt held by the central bank. This lowered money supply growth and aided central bank monetary control, while bolstering foreign exchange reserves.

The Government has identified the decades-long neglect of infrastructure investment as a key obstacle to economic growth and countrywide development. Since it came to power, it has embarked

3.21.4 Inflation contributors



Source: Department of Census and Statistics.
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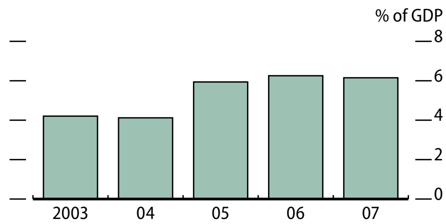
3.21.5 Public investment



Source: Central Bank of Sri Lanka, *Weekly Economic Indicators*, various issues.
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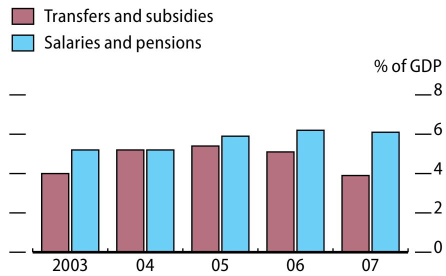
on implementing an ambitious infrastructure program to ensure the benefits of growth reach down to the poorer households and regions. Major investment projects that were embroiled in controversy over the last 20 years have taken off. Perhaps most important is a major coal-fired power-generating plant where construction started in 2007. Other projects where the Government is close to reaching financial closure include a major irrigation project (financed by the Islamic Republic of Iran), and another coal power plant (financed by India).

The Government in 2008 is expected to eliminate the large electricity subsidy. In early February this year, the Ceylon Electricity Board (CEB), invited public comments on a proposed substantial revision of the tariff structure, coupled with a large increase in the average price that is charged. The new tariff would eliminate the past subsidy element for wealthier households and set rates to provide a significant cross subsidy from these high-user households to the poorest 1 million households. The new tariff schedule increases the average weighted tariff by about 30%, ending CEB's quasi-fiscal losses. At present costs, the unrevised tariff rates would result in a subsidy ultimately costing the Government about SLRs25 billion, or 0.7% of GDP, for the year. Reflecting past losses, CEB's short-term debt amounts to SLRs60 billion, or 1.8% of GDP.

The Government, for the second year, largely maintained its policy of not providing retail fuel subsidies. It is the only country in South Asia to have done so, saving the Government the equivalent of approximately 0.7% of GDP annually since 2006. However, global price changes are quickly catching up with domestic price adjustments. Despite the latest hike in January 2008, gasoline prices are only partially cross subsidizing kerosene prices to make it SLRs14, and diesel SLRs11 per liter cheaper than it would be according to the formula that has been used to set retail prices (Figure 3.21.8), leading to renewed losses at the Ceylon Petroleum Corporation.

3.21.6 Government spending



Sources: Central Bank of Sri Lanka, *Annual Report 2006*; staff estimates.

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Economic prospects

The anticipated economic slowdown in both the EU and US and the escalating conflict at home add to the downside risks to economic growth in 2008–2009. The more protracted the military campaign against the LTTE, the higher its negative impact on economic growth, as it would strain government finances (unless public investment is cut), lead to more crowding out of private sector investment, and further increase inflation pressure.

The following forecasts rest on five major assumptions. First, the intensity of the conflict (and thereby defense spending) will not be substantially above levels experienced at the time of writing (March 2008), and any disruption to economic life in the south and Colombo caused by LTTE attacks will be relatively short-lived. Second, the slowdown in the US will continue to dent garment exports to that destination. Third, oil prices will rise to an annual average of about $85 per barrel and then $95 per barrel over the forecast years. Fourth, foreign investors will continue to invest in government securities denominated in the Sri Lanka rupee, and remittance growth will not slow. Fifth, the central bank will continue to gradually tighten monetary policy to rein

3.21.1 Selected economic indicators

	2008	2009
GDP growth	6.0	6.0
Inflation	16.2	14.0
Current account balance (% of GDP)	-4.3	-4.2

Source: Staff estimates.

in private sector credit growth while bank financing of the budget deficit moves within Road Map limits.

On the basis of these assumptions, economic growth is forecast at 6% for 2008 and 2009, higher than the average trend of 4.0% (1997–2007), but lower than in 2007 alone. Growth will be held back by a slowdown in private sector investment as investors are currently hesitant; a weaker performance of the crucial garment industry because of the projected global deceleration in growth; higher oil prices; and the conflict.

Inflation will stay relatively high in 2008, and taper off slightly in 2009, for three reasons: high inflation expectations (which will lead to significant pressures to increase wages in the government sector with a likely knock-on effect for private sector wages); robust aggregate demand (sustained by high government expenditure and private remittances); and continued upward adjustments of fuel and electricity tariffs.

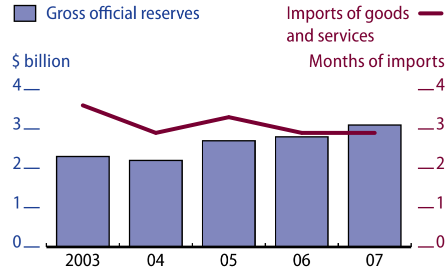
Managing inflation and the rising cost of living entails a difficult trade-off between short-term options to bring down the cost of living (such as controlling food prices) and medium-term policies (reducing inflationary deficit financing) to rein in inflation. A $10 per barrel increase in the price of diesel (free on board) would increase the price of this politically most sensitive fuel by SLRs8 a liter. A full pass-through—while necessary to contain the fiscal deficit—involves considerable political costs. Conversely, government efforts to bring down the cost of living by forgoing taxes and duties on key foodstuffs and fuel, if continued, will also ultimately add to inflation pressure by increasing the budget deficit.

Continued tightening of monetary policy will restrict the growth of private sector credit, but is unlikely to reduce inflation pressure unless it dovetails with fiscal policies that reduce bank borrowing to the levels outlined in the Road Map.

The budget for 2008 envisages a reduction in the overall deficit to 7.3% of GDP. Government current expenditures are unchanged in real terms from a year earlier, while capital spending is to be substantially increased. A buoyant revenue forecast, underpinned by new tax measures, provides the resources to cover the increase and slightly reduce deficit financing in relation to GDP, relative to the 2007 estimated outcome. While there has been a material increase in revenue collection over the last 5 years, achieving the planned modest fiscal consolidation will be difficult. Problematic assumptions include maintaining discipline on current expenditures when measures to provide relief to the public from high inflation are proposed, the burden of any escalation in the conflict, and the risk that economic growth and global commodity price assumptions are over-optimistic. Containing the fiscal deficit as outlined in the 10-year development program are, however, crucial measures given the recent expansion of commercial foreign-denominated borrowing.

The balance of payments will continue to be strained by the costs of oil imports in the current account and a bunching of foreign debt repayments in the capital account. A slowdown of consumer and intermediate goods imports, in conjunction with an expected moderate expansion in exports and continued strong growth in remittances, should keep the current account deficit to 4.3% of GDP in 2008. A modest reduction of the deficit might be achieved in 2009 as global demand improves and as garment export growth picks up.

3.21.7 Gross official reserves



Sources: Central Bank of Sri Lanka, *Annual Report*, various issues; staff estimates.

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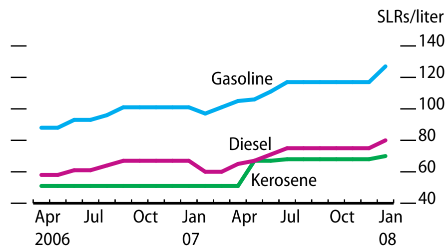
3.21.8 Fuel price adjustments



Source: Ceylon Petroleum Corporation.

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Development challenges

It is unlikely that Sri Lanka will experience a protracted period of very low growth, despite the conflict. At the same time, it is entering a difficult phase in its economic development, that of improving its low-middle-income country status. A recent World Bank study shows that middle-income countries have to adopt different policies if they are to prosper, as their incomes have consistently risen less fast than either their poorer, or richer, peers. Middle-income countries cannot compete anymore on price and cheap labor; at the same time they do not yet have the capacity to attract key talent and be at the forefront of innovation and rapid technological change.

How well equipped is Sri Lanka to compete? On the one hand, it has a remarkably sophisticated private sector (its garment sector, for example, is very successful in a high-value market niche, and its business process outsourcing industry conducts market research for international banks). On the other hand, its education system still presents serious obstacles, which a "brain drain" might make more difficult to resolve.

A recent survey of the biggest 20 listed companies by stock market capitalization and of key companies in the information technology and banking industries shows that, in many sectors, the trend of qualified, skilled people emigrating is increasing, with the pace of migration generally accelerating in 2007.

It is difficult to clearly differentiate between "push" and "pull" migration factors. The reasons for leaving include a slowdown in recruitment by key companies and better job opportunities elsewhere (such as rapidly expanding financial and tourism centers in the Middle East, especially Dubai); the pursuit of higher education abroad; and a general feeling that the situation in the country may not improve in the medium term. Those with skills (among the 20 companies) migrate because they are offered considerably better-paid jobs abroad, among other things enabling them to provide an international education for their children.

The category where the "brain drain" is sharpest is information technology, accounting, finance, banking, and the travel and tourism industry. The last group particularly is hard hit, losing both low-skilled staff (such as waiters and cooks) and managers. Many companies report that they find it increasingly difficult to recruit qualified staff, and that replacements are not on a par with the person who left (though this is in part due to internal wage policy constraints, as companies cannot substantially increase wages offered to new outsiders).

This trend of losing skilled people is worrying but has not reached a crisis point. However, it would need to be reversed or at least halted to enable Sri Lanka to maintain its middle-income status, and move up the income ladder.