Sri Lanka

Despite resurgence of the civil conflict, impact of the Asian tsunami, and doubling of oil prices since 2004, the economy grew at its fastest rate since 1978 last year. This strength was fueled by buoyant private activity and expansionary macroeconomic policies that have, though, accelerated inflation. Growth is forecast to moderate over the next 2 years, given the conflict, slow pace of structural reform, and need to cool the economy. Further out, if the fiscal consolidation and increased investment envisaged in the new 10-year development framework are achieved, growth is expected to pick up substantially.

Economic performance

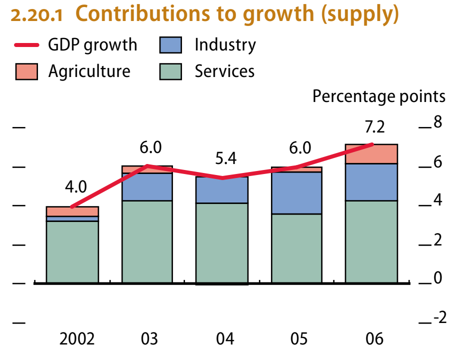
The impressive 7.2% growth in 2006 reflected continued strong performance of services of 7.7% and an unexpectedly high outturn in agriculture of 5.9% (Figure 2.20.1). (The peaceful west and south were responsible for most of the good news, since the two north and eastern provinces embroiled in the conflict contribute only about 9% of total GDP.) Aiding agriculture was fisheries' recovery from the December 2004 tsunami, as it surged by 55%. In fact, had agriculture continued its past 10-year trend of 1% growth, total GDP would have expanded by only 6.4%.

Aggregate domestic demand—buttressed by workers' remittances and rapid credit expansion—stayed high. The population continues to release its pent-up demand for consumer goods and services, especially mobile phones. Mobile and landline phone penetration has grown dramatically since 2003; as a result, mobile phone companies are thriving, with the major operators reporting revenue growth in the first half of 2006 of over 40%. These growth rates have induced many companies to reinvest their earnings to expand their networks, leading to an estimated doubling of total foreign direct investment inflows from $234 million to $480 million in 2006. Port services, cargo storage, and warehousing as well as other trade-related services also continued to boom, in line with growing international trade.

Tourism, in contrast, failed to do well in 2006 (Figure 2.20.2), with profit margins falling by up to 50% as hoteliers dropped prices to attract tourists. The subsector had picked up strongly after the signing of the cease-fire agreement between the Government and the Liberation Tigers of Tamil Eelam (LTTE) in 2002. However, it suffered in the aftermath of the tsunami and more recently has been hit by blanket travel warnings from key European markets following the sharp escalation of hostilities between the Government and the LTTE. Tourism industry sources put occupancy rates at 30–50% in January 2007, down from the 90% usually seen at that time of year. While tourism accounts for little more than 2% of GDP, the impact on employment, with about 120,000 directly and indirectly employed, is likely to have been significant.

Industry's performance was decidedly mixed. On the one hand, garments, which dominate the export and industrial base (contributing

2.20.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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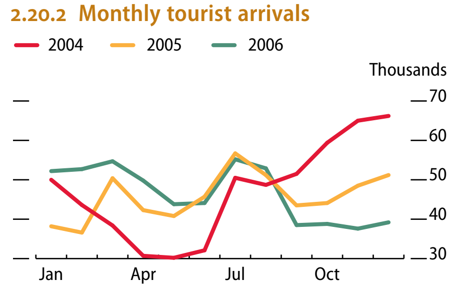
2.20.2 Monthly tourist arrivals



Source: Ministry of Finance, *Weekly Economic Position Report*, 2nd week, February 2007.

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about 40% of export earnings; Figure 2.20.3), continued to struggle following the end of the quota system on 1 January 2005, growing by little more than 5% in 2006. Structural weaknesses in garments, such as high staff turnover and levels of absenteeism, difficulties in attracting staff (over 30,000 vacancies left unfilled), problems with transport, high electricity prices, as well as the loss of price competitiveness vis-à-vis Bangladesh, People's Republic of China, and Viet Nam, caused in part by an appreciating real exchange rate, all added to the garment industry's woes. Small-scale manufacturing, too, was weak.

On the other hand, favorable weather conditions boosted hydropower generation, helping the utilities subsector expand by about 15%.

As expected, construction continued to grow, in part because of tsunami reconstruction, but also because of major housing developments in big cities, bolstered by a surge in property prices and demand for high-quality housing by Sri Lankan expatriates, and by returnees to the country.

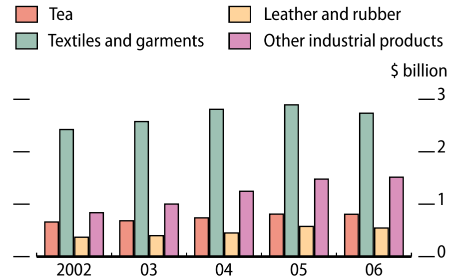
Government spending, up by 26% in 2006, imparted a strong stimulus to the economy but also drove up inflation. While the 2006 budget planned no borrowing from the banking sector, the Government ultimately borrowed 30 billion Sri Lanka rupees (SLRs), or about 1% of GDP. Fiscal consolidation has been a policy objective in recent years, though the Government has repeatedly announced that it would not cut expenditures to contain the deficit, focusing rather on improving revenue collection.

Preliminary data indicate that the 2006 budget deficit (including 0.8% of GDP for foreign-funded tsunami-related project expenditure) was 8.9% of GDP, essentially unchanged from the 2005 outturn and in line with official budget projections (Figure 2.20.4). Three elements contained the deficit: the Government lifted revenue collection substantially for the second year running (up 27.5%); it removed almost all fuel subsidies that had cost it SLRs26 billion, or about 1% of GDP, in 2005; and it offset an SLRs38 billion cost overrun on recurrent spending by means of reallocating funds previously earmarked for capital expenditures. The bulk of the revenue improvement stemmed from changes to income tax (raised tax rates and lowered taxable thresholds), improved value-added tax (VAT) collection, and increased import tariffs.

Recurrent spending rose by 22%, fueled mainly by larger defense expenditures (up by 27%); new recruits to the civil service (continued regularization of 40,000 trainees taken on earlier); additional home guards (35,000 recruits); a greater number of pensioners; and higher civil service wages (the second installment to bring the base salary to SLRs11,650) and cost-of-living allowances.

Looser fiscal policy and increased central bank financing of the budget deficit led to an escalation of demand pressures over the year. Inflation, which had subsided toward the end of 2005, reversed course and accelerated sharply after July 2006, peaking at 20.5% in January 2007 (Figure 2.20.5). This should be seen in the context of annual average inflation in 2006 of 13.6% (based on the Colombo consumer price index). While the one-time impact of rises in administered prices for fuel and electricity and in vegetable prices (due to supply shortages) were factors, the sustained large price upswing primarily reflects rapid increases in

2.20.3 Major exports



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007; Economist Intelligence Unit, *Sri Lanka Country Report*, February 2007.

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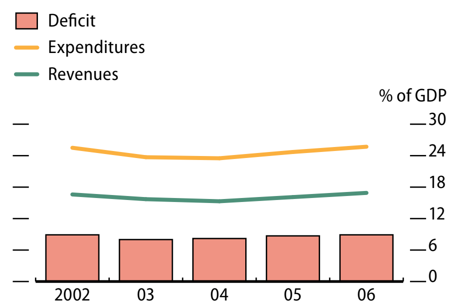
2.20.4 Fiscal indicators



Sources: Central Bank of Sri Lanka, avaliable: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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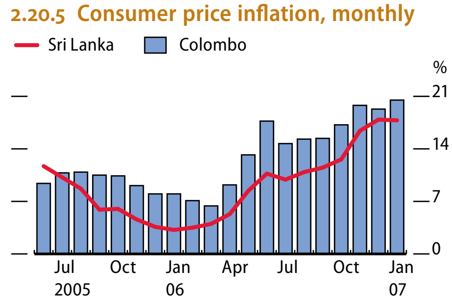
2.20.5 Consumer price inflation, monthly



Source: Department of Census and Statistics, available: http://www.statistics.gov.lk, downloaded 10 March 2007.

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money (Figure 2.20.6) and credit powered by low and at times negative real interest rates. Consumer credit jumped by 43% (October 2005–September 2006), and overall private sector credit leaped by 24% (both substantially above their respective 10-year averages of 25% and 15%); and credit to the government expanded by 20%.

From September 2006, the central bank took steps to reduce liquidity in the market by increasing its policy rates, bringing the repurchase (repo) rate to 9.625%, and reverse repo or lending rate to 11.5%, and the 91-day treasury bill rate to 12.7% by year-end (Figure 2.20.7). Since the start of this year, the central bank has restricted access to the reverse repo facility at times when the commercial banking system shows a liquidity surplus. Some commercial banks previously used this facility as their main source of credit expansion, taking advantage of the interest differential between the interbank market and (lower) policy rates. But on 30 January, the central bank acted to narrow the interest rate differential between market and policy rates.

Despite improvements in key debt indicators, the Government's debt policy has increased its exposure to foreign exchange rate fluctuations. While public debt rose in 2006 in absolute terms, it declined as a proportion of GDP because of the rapid expansion of *nominal* GDP, but it still remained quite high at about 92%. Since 2004, the Government has pursued a policy of taking on domestic short-term foreign-denominated debt to reduce interest rate costs and to retire more expensive local currency debt, increasing its exposure to foreign exchange risk.

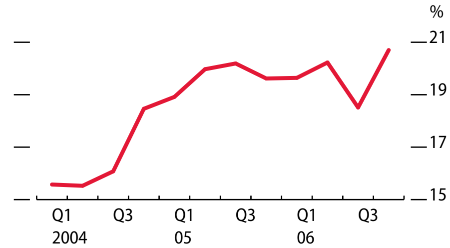
The stock of such debt increased by $520 million in 2006 to $1.65 billion at year-end, or 6% of GDP. Overall debt service (principal and interest) of the Government fell from 92% of total revenues in 2004 to 82% in 2006, but still amounted to 15.7% of GDP in 2006, edging up with the end of the tsunami-related debt moratorium in December 2006.

The balance of payments has weathered the oil price shock relatively well, even as the oil import bill (consonant with doubling oil prices) almost tripled in only 2 years to $2 billion in 2006. Nevertheless, strains are apparent, with the trade deficit remaining in double digits for the third year in a row, reaching 13% of GDP, a deficit not seen since 1994 (Figure 2.20.8). The current account deficit stabilized at 2.8% of GDP, substantially lower than projected in the Government's medium-term economic framework.

A major factor keeping the current account deficit largely in check and helping ease pressure on the balance of payments has been soaring workers' remittances, unexpectedly increasing by $400 million (or over 1% of GDP) to $2.3 billion in 2006: after the tsunami, they jumped by almost 30% a year (against 9% annual growth in the 5 years preceding the disaster).

An International Monetary Fund study finds that this jump is probably less a result of altruism than of high global oil prices, since they increased the chances of employment and higher wages for Sri Lankan migrants, over 85% of whom live in net oil-exporting countries. Even though foreign exchange reserves have been maintained at approximately $2.5 billion (Figure 2.20.9), last year's 15.7% expansion in imports reduced the import cover ratio to 2.6 months by year-end from 2.9 months at end-

2.20.6 Money supply (M2) growth



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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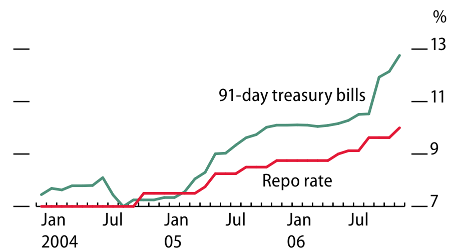
2.20.7 Interest rates



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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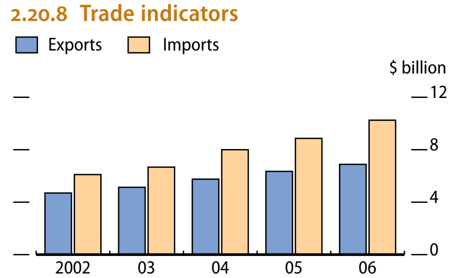
2.20.8 Trade indicators



Source: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 8 March 2007.

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2005. To safeguard reserves, the central bank imposed restrictions in late September 2006 on current payments, imposing deposit requirements of 50% on the import value of certain goods. The International Monetary Fund subsequently approved these restrictions as a temporary measure.

The nominal exchange rate has increasingly come under pressure and has depreciated substantially, especially vis-à-vis the euro and the British pound, even despite initial central bank intervention to defend the currency. Tsunami-related foreign inflows, which in 2005 led to real and nominal currency appreciation, are now moving out of the country to fund capital imports for reconstruction. These outflows, in combination with higher external debt service and oil import bills, all contributed to the substantial drop in the nominal exchange rate. The real effective exchange rate however, is trending upward because of accelerating domestic inflation (Figure 2.20.10).

Since the Government took office in November 2005, structural reform has been limited. Although the private sector accounts for over 85% of GDP, the Government owns institutions that manage about 60% of all financial assets as well as all public utilities and some smaller enterprises. In key policy statements, it has announced that it would seek alternatives to privatization for bringing greater efficiency into the state-owned sector.

Restructuring, rather than privatization, of the People's Bank, which accounts for about 20% of financial assets in the country, has made some progress. One major reform was the removal of fuel subsidies in 2006, relieving a heavy drain on the budget and moving Ceypetco, the state oil and petroleum company, to operate more on a commercial basis. However, the market for retail fuel and lubricants was liberalized in September 2006 without the regulator, the Public Utility Commission, yet receiving authority to regulate applicable retail prices, safeguard consumers' interests, and ensure fair competition.

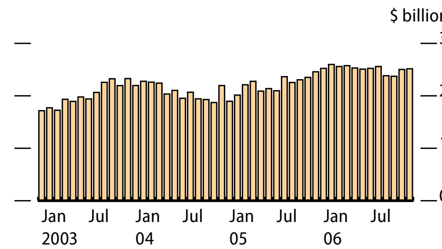
Strong opposition by labor unions has been one of the major factors holding back reforms. The long-awaited unbundling of the Ceylon Electricity Board, in the planning stage since 1997, has been put on hold. The Government is now seeking to manage the utility more efficiently by other means, and to bring more transparency into rate setting and procurement.

The power sector remains a major troublespot for the economy because its least-cost generation plans have not been implemented for the last 20 years. This has pushed electricity tariffs to among the highest in the region, despite the fact that the sector does not charge cost-recovery tariffs, leading to daily losses of SLRs50 million and an accumulation of large debts. Operational problems are exacerbated by rising power demand and high capacity utilization in the transmission and distribution system. Many lines and transformers are becoming overloaded and this will result in rising maintenance costs, deteriorating performance, and higher technical losses.

Economic prospects

Growth prospects have become, if anything, more complex: opportunities for, and risks to, economic growth have risen since last year. Factors that could potentially lay the foundation for strong economic growth

2.20.9 Gross official reserves



Source: Central Bak of Sri Lanka, available: http://www.cbsl.lk, downloaded 14 March 2007.

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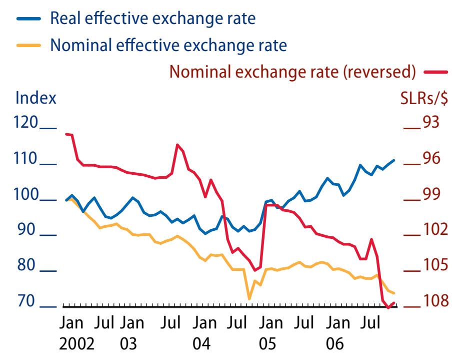
2.20.10 Exchange rates



Source: CEIC Data Company Ltd., downloaded 12 March 2007.

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and that show a marked departure from previous approaches are, first, a powerful president whose first term will end in 2011, and who has now also succeeded in forging a parliamentary majority with crossovers of Members of Parliament from the typically more private sector-oriented United National Party. This could make implementing legislative changes easier than before, and could also be the beginning of a "southern consensus," the lack of which has been partially blamed for the slow resolution of the ethnic conflict in the country. Second, public investment is considerably higher.

Factors that have increased the risks are the falling import cover in terms of foreign exchange reserves, accelerating inflation, and the rapid buildup of domestic dollar-denominated, short-term, commercial debt, now amounting to 6% of GDP. Despite the fact that the private sector continues to be resilient, these developments are a concern, and need to be addressed through policy actions to reduce the fiscal deficit (and hence the need to borrow commercially), and to gradually tighten monetary policy so as to control inflation. There is also the risk of prolonged power cuts in 2007, a result of the delay in commissioning a new power plant, unless the government quickly introduces contingency plans.

The underlying assumptions of the following projections are: the conflict will not escalate further; the LTTE will not succeed in destroying key economic infrastructure; and 2007 will see gradual monetary tightening and a determined effort to slow inflation (as the central bank at least partially succeeds in implementing its ambitious financial and monetary policies for the year). In this it will need to be supported by the Government and the newly established National Economic Council.

The outlook for 2007–2008 is for growth of 6.1% and 6.0%, respectively (Figure 2.20.11), which is somewhat below government forecasts. It assumes that tighter fiscal and monetary policies gradually curtail aggregate demand by 2008, and that the conflict will continue to curtail tourism growth. In addition, agriculture will expand much less quickly than in 2006, in line with long-term trends, as its post-tsunami recovery is largely completed. However, except for the lackluster performance of tourism, the private sector will once again prove to be resilient, and services will remain the engine of growth. Finance, trade-related services, telecommunications, and information technology (IT) will perform robustly, buoyed by continued consumer demand and public sector expansion.

Assuming a gradual deceleration in inflation to 9% by 2008 (as the impact of tighter policy is felt with a time lag of up to 2 years), industry consolidation, and facilities upgrading, the garment sector is projected to regain some of its competitiveness by 2008, just when the People's Republic of China moves out of restraints imposed by the European Union and United States. The Government expects a breakthrough in the negotiations with the European Union on lowering the threshold of country-of-origin requirements under the "GSP Plus" scheme from 50% to 35% this year. However, hopes to conclude a free trade agreement with the United States are unlikely to be realized.

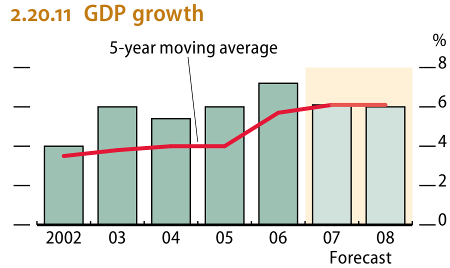
The government-projected deficit of 9.2% of GDP for 2007, including fully foreign funded projects, is likely to be met. A gradual reduction of spending as fiscal policies slowly tighten will bring the deficit—including

2.20.1 Selected economic indicators

	2007	2008
GDP growth	6.1	6.0
Inflation	10.0	9.0
Current account balance (% of GDP)	-2.5	-2.4

Source: Staff estimates.

2.20.11 GDP growth



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 12 December 2006; staff estimates.

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fully foreign funded investment projects—to 7.7% of GDP in 2008. However, the expenditure composition is likely to change, with recurrent expenditure (such as defense, subsidies, and wages and pensions) likely to surpass budgeted estimates. The implementation of key cost-cutting exercises outlined in the budget speech, such as cutting SLRs16 billion by avoiding duplication of expenditure, would have to be tackled quickly to show results.

Revenue collection, though, is projected once again to increase substantially, despite the growing complexity of the tax regime that introduces more exemptions: higher CIF mark-up values on imports, the cascading nature of the tax regime, falling tax thresholds, and tax implementation changes that would convert VAT to a quasi-withholding tax (whereby one third of VAT payments to government contractors are withheld), will all help boost revenue collection.

The first steps taken in January 2007 to rein in growth of monetary aggregates suggest that the central bank is determined to fight inflation more aggressively than last year. Its financial and monetary policy plans of January 2007 indicate its intention to reduce growth of broad money supply to 13.2% by December 2007 (relative to estimated actual levels of 12 months earlier), a sharp drop from the 17.8% growth seen in 2006.

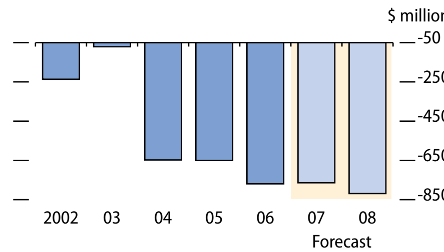
Achieving the central bank target depends crucially on the volume of government net domestic borrowing, which has to keep in line with the budget target of SLRs156 billion (out of which commercial bank borrowing should not exceed SLRs16.7 billion).

Given the Government's expenditure plans, and past delays in firming up foreign financing, it is not yet clear whether the central bank will succeed in controlling expansion of the money supply (and thereby inflationary pressure). Neither is it clear whether moves to control prices of 11 essential consumer items for 3 months from 1 March 2007, are temporary, or whether these measures will remain more permanent.

The current account deficit in 2007 will narrow slightly to $764 million (or 2.5% of GDP; Figure 2.20.12), due to substantially lower import growth following a projected stabilization of oil prices at about $57 a barrel. Export performance will stay muted, despite several expected positive developments for the garment sector. Concessional financing, tsunami-related grants (largely phased out by 2008), and commercial borrowing appear sufficient to finance this deficit. However, should oil prices be as high on average as in 2006 (about $65 per barrel), the current account deficit would increase sharply by 1.2% of GDP ($320 million) to 3.7% of GDP.

In the long term, the significantly higher public investment planned by the Government will increase economic growth. Three major investment projects, some in the pipeline for 20 years, are now finally going ahead: the Kerawalapitya Combined Cycle Power Plant ($310 million), the Norrachchalai coal power plant ($510 million), and the extension and development of the Colombo Port ($300 million, with total project costs including planned private sector investment for the terminals eventually estimated at $1.2 billion). These investments are crucial to safeguard economic growth, act as a catalyst to private sector investment, and expand the country's role as a logistics hub.

2.20.12 Current account balance



Sources: Central Bank of Sri Lanka, available: http://www.cbsl.lk, downloaded 7 March 2007; staff estimates.

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Development challenges

The country's civil conflict is undoubtedly the main long-term challenge to development, shaving off an estimated 2% of GDP growth each year. Civil conflicts of such complexity can take decades, if not generations, to resolve. However, despite the opportunity costs of the conflict, the economy has grown at an annual average of 4.6% since the conflict started in 1983, and is a testimony to its resilience.

The current policy focus of the Government is on infrastructure development to improve electricity supply and roads. This is crucially important, but would need to go hand in hand with preparing the ground for higher productivity gains. To achieve this—and at the same time increase income equality—Sri Lanka needs a well-educated labor force and better access by the underprivileged to high-quality education (Box 2.20.1).

2.20.1 Education

Literacy indicators are high, and do not point to an immediate crisis. However, representatives of those segments that can propel the country on to a higher growth path (e.g., IT and high-value manufacturing) have repeatedly stated that they suffer from a shortage of suitably skilled labor.

Spending on private tuition among all families, including the poorest, has shot up, pointing to deficiencies in the quality of public education. In turn, sustained high economic growth has to create jobs attractive enough to retain highly skilled people who are usually among the most mobile and too often leave the country. The country reportedly has one of the highest "brain drain" ratios in the world. (This may reinforce the lack of skilled staff, identified by entrepreneurs as slowing growth in business outsourcing and IT development.)

In addition to the need to improve the skills of its students, the school and education system seems to increasingly fail the poorest. School leavers who, due to poor conditions in rural schools, often fail one or more of their O levels, stand little chance of being employed in the private sector; with very high pressure emanating from their families that hope to have at least their offspring move away from the agriculture sector, the public service (clerical jobs) or the army is often the only source of employment.

In addition, the lack of mathematical skills precludes even those who go to university from studying a non-arts degree, thereby again relegating them to arts subjects for which employers usually pay less well. The quality of schooling is highly skewed between rural and urban regions and educational outcomes between the provinces differ sharply (box table).

The quality of English language teaching and the lack of English language proficiency are other serious obstacles to social mobility. Overall, the poor see few chances of upward mobility, due to the lack of good education and—according to anecdotal evidence—a social and political network. As a result, their children drop out more often, and intergenerational education mobility is low internationally.

In contrast to Sri Lanka's earlier impressive record, education's share of GDP and expenditure started decreasing in the 1970s and is now equivalent to about 2.5% of GDP—lower than in most comparable countries.

The Government now sees education as a priority, embarking in 2006 on a reform program that includes improving English at all levels and that introduces English as a medium of instruction in state schools. This 5-year program should show some results within a few years. It is hoped that it will be able to address some of the needs of a modernizing society, of the knowledge economy, and of the poor.

Provincial education outcomes

	Percentage of students achieving mastery of:		
Province	their first language (Sinhalese or Tamil)	mathematics	the English language
Western	51	52	20
Central	34	33	8
Southern	43	44	13
North-Eastern	23	25	5
North-Western	42	43	9
North-Central	36	41	8
Uva	34	35	8
Sabaragamuva	40	43	10
Sri Lanka	37	38	10

Source: World Bank, *Treasures of the Education System*, 2004.