Sri Lanka

Despite the tsunami's devastating human cost, its economic impact was muted, and economic growth remained broadly on trend in 2005. Although talks between the Government and the Liberation Tigers of Tamil Eelam in February 2006 have improved the overall climate, the economy remains sensitive to the status of the cease-fire. Forecasts for the next 2 years assume, fundamentally, no outbreak of open hostilities, with the maintenance of "no war, no peace." In this case, economic growth should be respectable, driven by a resilient private sector. However, to sustain growth in the medium and long term, the infrastructure and human resource bases have to be upgraded markedly. As an example, only 2% of young people attend university, substantially lower than the South Asian average, and poor roads and expensive, intermittent power cost the private sector dear.

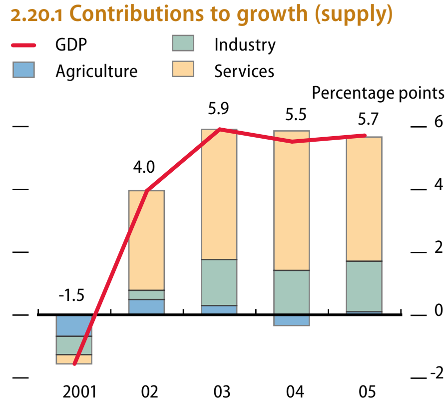
Economic performance

The human cost was awful, but the economic impact of the tsunami of 26 December 2004 on the country was not strong enough for economic growth to deviate significantly from its recent trend. Gross domestic product (GDP) grew at an estimated 5.7% in 2005. The sectors most badly hit, fisheries and tourism, continue to struggle. However, tourism accounts for only 1% of GDP and fisheries about 2%, and the industrial belt in the western part of the country was largely unhurt. According to official statistics, the number of tourists recovered relatively quickly in 2005 to about the same number as the year before, but this figure includes tsunami aid workers recorded in the tourism category. Foreign exchange earnings were affected by a combination of discounts, greater numbers of budget tourists on recently launched regional flights, and much lower arrivals from traditional European Union (EU) markets. Major hotel associations estimate their overall earnings to have fallen by 30–40%. The fisheries sector is slowly recovering, but output is still only half of the pre-tsunami level.

As in the previous 4 years, growth in 2005 was driven by that part of the services sector not related to tourism (import-related trade, mobile telephony, and financial services) (Figure 2.20.1). Subsequent to the 2001 drop in GDP (mainly resulting from an attack on Colombo airport) and the cease-fire agreement between the Liberation Tigers of Tamil Eelam and the Government that was signed in 2002, the economy recovered and expanded at a relatively strong pace. The sector contribution to growth after 2001 changed, as increased demand for services and imported consumer goods became a major force in the economic expansion. Domestic demand (Figure 2.20.2) in turn was fueled by flat, or negative, real interest rates (consumer loans increased by 40% in 2004 alone), and by a rapid expansion in inflows of workers' remittances.

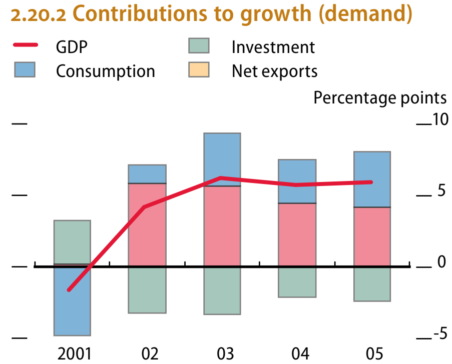
Manufacturing in textiles and clothing still dominates the industry

2.20.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 23 January 2006; staff estimates.

2.20.2 Contributions to growth (demand)



Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 23 January 2006; The Economist Intelligence Unit, *Country Forecast*, March 2006.

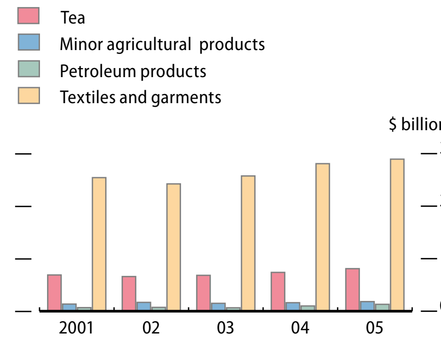
sector. Immediately after the 2001 crisis, textile and clothing exports and output fell; they have gradually recovered (Figure 2.20.3), but their contribution to growth is still below that before 2001. Significantly in 2005, the end of the quota system under the World Trade Organization agreements did not lead to multiple bankruptcies and closures, but export growth slowed sharply to 3.1% (down from 16.0% in 2004), and profit margins tightened. Although the textile and clothing industry is export oriented, most other manufacturing consists of agroprocessing (tobacco, alcohol, rice, etc.) and consequently its growth is closely linked to agricultural output. A good harvest in paddy, coconut, and rubber spurs related industries, which was the case in 2005. As part of its tsunami support to Sri Lanka, the EU offered the "GSP+," from July 2005, covering over 7,200 products. However, its stringent rules-of-origin requirements on domestic content, industrialists claim, have failed to provide many benefits to Sri Lankan clothing exports, which depend largely on imported yarn and fabric.

Both 2004 and 2005 saw a widening of the trade gap (Figure 2.20.4). Higher payments for oil alone accounted for about half of the overall growth in imports in 2005. Net current transfers increased by 28% in 2005, partly on account of private remittances that amounted to $2.0 billion, or almost 10% of GDP. However, these inflows could not offset the expanded trade deficit, and the current account deficit (Figure 2.20.5) continued to widen to 3.5% of GDP ($828 million). Unlike 2004, this deficit was more than covered by the large capital and financial account surplus: net capital transfers leaped fivefold to $370 million, almost exclusively because of post-tsunami reconstruction inflows, while concessional loans and foreign currency borrowing of the Government increased. Moreover, the Paris Club debt moratorium for 2005, a part of the tsunami assistance effort, saved principal and interest payments of $264 million. The resulting overall surplus pushed up central bank official reserves by $600 million to nearly $2.5 billion, reversing a 2004 decline (Figure 2.20.6). As a result of improved exchange market conditions, the Sri Lanka rupee (SLR) appreciated by 2.4% against the dollar.

Average annual inflation, as measured by the Colombo consumer price index, picked up sharply in 2004 and 2005, in a period when rising global oil prices were only partly passed through. A steep rise in money supply fueled by low real interest rates was a major factor (Figure 2.20.7). However, pressures from a substantial civil service salary increase, poor harvest-related food shortages of paddy, and higher prices for imported consumer goods, especially sugar, were also important (since the Colombo consumer price index is heavily weighted toward food and beverages). In response, the central bank raised policy interest rates five times in 2005, which slowed inflation appreciably by the beginning of this year, but failed to slow growth in monetary aggregates.

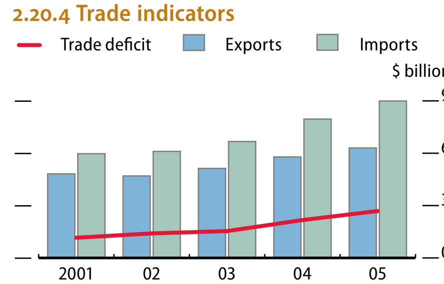
In 2005, administered gasoline and diesel prices at the pump were increased by 33% and 67%, respectively. This move, combined with exemptions for diesel from value-added tax after August 2005, eliminated subsidies on gasoline, but kept diesel and kerosene subsidized by SLRs6 and SLRs26 per liter, respectively. The administered price system for petroleum products meant continuous high subsidy costs, which amounted to about SLRs20 billion in 2005. With the country's high

2.20.3 Major exports



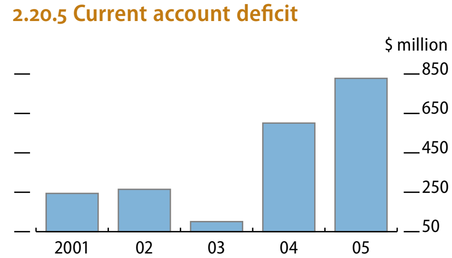
Source: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org.

2.20.4 Trade indicators



Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 25 January 2006; staff estimates.

2.20.5 Current account deficit

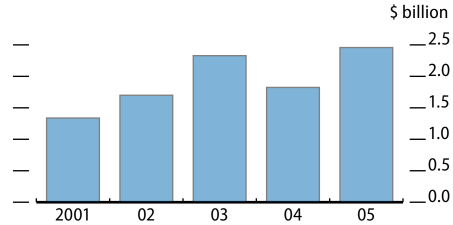


Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 25 January 2006; staff estimates.

dependence on diesel generators for power supply, the cost of electricity subsidies also escalated. These are borne almost entirely as operational losses by the state-owned power utility, Ceylon Electricity Board, and amounted to about SLRs20 billion, or nearly 1% of GDP, bringing the total costs of fuel subsidies carried by the public sector to about 2% of GDP in 2005.

The overall fiscal deficit widened to 8.7% of GDP in 2005, including the tsunami-associated expenditure of 1.4% of GDP that was largely financed by grants. However, this figure understates the deficit somewhat as it excludes subsidies financed by public sector corporations (i.e., quasi-fiscal expenditures), mainly at Ceylon Electricity Board, where short-term debt and payment arrears have risen to SLRs50 billion. The deficit widened in spite of cuts in capital expenditure, which, to the detriment of long-term development, has historically borne the brunt of fiscal adjustment. The debt moratorium, grants, official development assistance, and substantial domestic borrowing on commercial terms of $1.1 billion helped finance the deficit in 2005.

2.20.6 Gross international reserves



Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Sp.%20Stat.pdf, downloaded 24 January 2006; staff estimates.

Economic outlook

Sri Lanka is facing a difficult environment both in terms of political developments and macroeconomic management. A complex political and social structure, combined with civil strife and a strong commitment to a welfare state, has made it difficult for many successive governments to push through unpopular but necessary decisions for structural change. The election manifesto of the current Government included some departures from the past, but the extent and manner in which they will be implemented remains to be seen. Structural reforms may proceed in a diluted form or in some cases may even be reversed. Agreement on reforms may prove difficult and time-consuming: although the executive presidency is strong, the president's alliance spans a wide range of groupings with markedly different political agendas.

2.20.1 Selected economic indicators

	2006	2007
GDP growth	5.3	5.2
Inflation	9.0	8.0
Current account balance (% of GDP)	-3.7	-2.7

Source: Staff estimates.

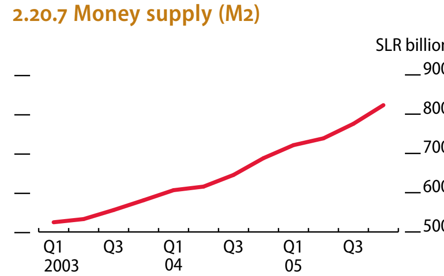
Prospects for 2006 and 2007

The forecasts for the next 2 years assume no outbreak of open hostilities and the maintenance of "no war, no peace." They also assume that financial policies are geared to stabilization objectives.

GDP growth is forecast at 5.3% in 2006 and 5.2% in 2007 (Figure 2.20.8). This would be a respectable performance and in line with Sri Lanka's long-term trend. The private sector will continue to drive economic growth, especially in textile and clothing manufacturing and in services. The private sector is versatile, can survive in a difficult environment, and its corporate companies are highly diversified. Although the current business climate might not be very conducive for foreign or for other new investors, established companies and conglomerates have easy access to financial markets—in fact, competition for their business is high—and these companies are able to operate and invest in an uncertain political environment. This resilience is evidenced in the buoyant performance of the Colombo stock market (Figure 2.20.9).

Inflation is projected to remain quite high at 9.0% in 2006 and 8.0% in 2007. A further reduction in the subsidies of kerosene and diesel, as

2.20.7 Money supply (M2)



Source: Datastream, downloaded 8 March 2006.

announced in the 2006 budget, coupled with long-delayed adjustments to electricity tariffs (made in two steps of 8% in January this year and 12% set for later in the year) will have a substantial impact on inflation as the changes are implemented and fully passed through via production costs to consumers. Additional, substantial increases in civil service salaries announced in the budget (to be spread out over 2 years) as well as the budget's increases in indirect taxes will add to price pressures.

It is not yet clear how the Government plans to keep a rein on growth in credit and monetary aggregates. In key policy statements, it has announced plans for banks to reserve a substantial share of their loan portfolio for agriculture, to set up specialized agricultural and development banks, and to provide subsidized credit to small and medium enterprises. The Government recognizes the importance of adopting a financial framework that buttresses macroeconomic stability and continues to attract donor support.

The current account deficit is projected to remain high, peaking in 2006 at 3.7% of GDP and moderating in 2007 to 2.7%, as most large-scale post-tsunami construction work, predominantly roads, is just now starting. This work, with high import content and financed mainly through aid, should be largely completed by 2008. Oil prices are expected to remain high but stable. Exports are projected to grow at about 8% annually, a slightly slower rate than in recent years as the clothing industry continues to consolidate, and smaller, less efficient producers close down or are absorbed. Prospective inflows of tsunami-linked aid, development assistance, foreign direct investment (FDI), and government borrowing that is not official development assistance appear sufficient to fully finance current account deficits of this size, though their adequacy is contingent on implementation of appropriate policies over the period and maintenance at least of the "no war, no peace" assumption.

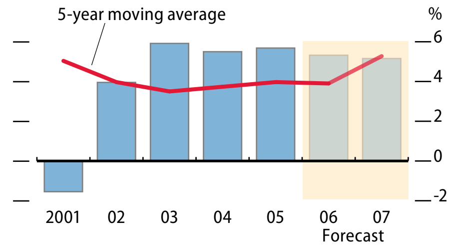
Overall, the Government plans to raise significant funds internationally, now that Sri Lanka has a sovereign credit rating (since late 2005). Achieving the overall budget deficit target (9.1% of GDP) in 2006 (Figure 2.20.10) will be difficult for the Government, because it has to resume external debt-servicing payments that were suspended for 1 year as Paris Club tsunami assistance, and because key development partners have announced that they envisage new direct budget support to the Government only if policies significantly advance economic reform.

Medium-term outlook

Medium-term prospects hinge on government plans to foster economic growth by significantly raising FDI as well as public and private domestic investment. The authorities' planned policy instruments range from international bond issues to substantial additional tax benefits to those companies investing outside Colombo and the western province—the "300 factories" program to boost economic activity in the less-developed provinces (poverty rates in the north and east are substantially higher than the national average of 22%). Growth in the past was driven largely by consumption, but private investment and privatization, mainly coming through FDI (Figure 2.20.11), played a growing role over time.

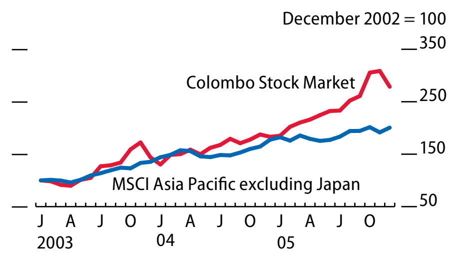
No large infrastructure improvements have been made for at least 20 years, resulting in bottlenecks that are a heavy drag on the economy.

2.20.8 GDP growth



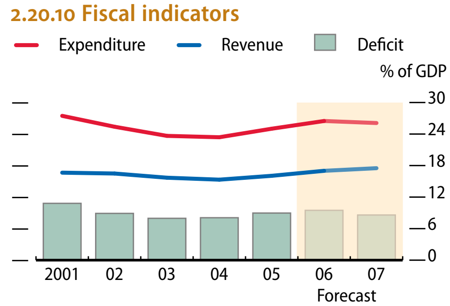
Sources: Central Bank of Sri Lanka, available http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 23 January 2006; staff estimates.

2.20.9 Stock market indexes



Source: Datastream, downloaded 7 March 2006.

2.20.10 Fiscal indicators



Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 25 January 2006; staff estimates.

Rebuilding the infrastructure is key to rapid development in the medium term. For example, poor roads in Sri Lanka have been associated with 44% lower total factor productivity, and lack of access to the power grid with a 35% reduction, relative to firms with access to good roads and to power supply.

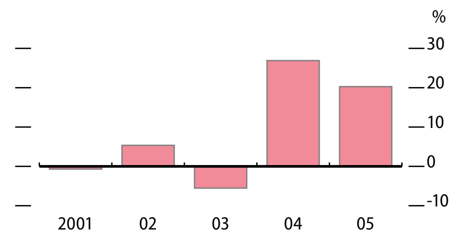
The question arises as to which sectors will continue to drive growth: agriculture (especially nonplantation activities) receives subsidies, mainly for fertilizer, but crucial—and long-term—investments in agricultural research and infrastructure, which frequently have the largest impact on productivity and poverty reduction, have been neglected. Over the last 5 years, labor productivity has fallen by a cumulative 10% in agriculture and 3% in services, but has risen by 1% in manufacturing. Agriculture's weak performance is a cause for concern and is unlikely to be reversed without decisive policy shifts. Earlier studies have already identified the main issues: lack of agricultural research, weak development and extension services, inconsistent tariff policy, land-use restrictions, lack of infrastructure, and fragmentation of land holdings.

The country's software industry is still in its infancy, employing only about 5,000 people with exports estimated at a mere 1.5% of foreign exchange receipts. The industry is hobbled by a serious shortage of skilled computer staff, a problem that retards the country's development generally in an era when technology is transforming all productive activity. To improve the skills of students is a long-term undertaking, and the Government is slowly embarking on the arduous task of educational reform. Only 2% of the relevant age cohort attend university, versus 8% in South Asia and 30–40% in developed countries overall. This is because of an acute lack of university places: only 14,000 students out of the 113,000 who pass A-level exams each year secure a place. Clearly, this very low base will make it increasingly difficult for Sri Lanka to improve productivity and move away from being a low-skills, low-wage economy.

The traditional bulwarks of export earnings—clothing and tea—will have to negotiate recently erected hurdles. The post-quota era means that the health of the former sector now depends not only on reducing production costs, but also on improving many factors beyond the control of the private sector, ranging from establishing more flexible labor laws, to increasing the reliability of power supply and road transport. The latter sector will need to be able to meet new EU standards (the destination for 10% of tea exports) with the deadline for certification now postponed to June 2006; industry insiders think that other countries will subsequently impose similar quality control measures.

In terms of risks to the outlook, the situation of the civil conflict is the main one. Anecdotal evidence already suggests that some firms have postponed expansion plans. There is a considerable risk that hostilities could resume at a high level of intensity that might, in the worst case, lead to a full-scale conflict, although the talks in Geneva in February, and the agreement to continue the dialogue in April, offer grounds for some optimism. In the worst-case scenario, investment and economic growth would be stunted and the country would again suffer from a brain drain—a familiar spiral that would be difficult to arrest. Moreover, renewed conflict would see the north and east hit by the double jeopardy of slower or halted tsunami reconstruction (about 60% of the damage

2.20.11 Foreign direct investment growth



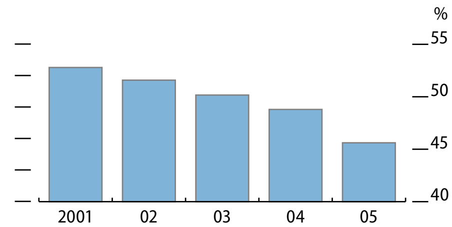
Sources: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org/Stat.%20Appendix-04.pdf, downloaded 23 January 2006; staff estimates.

and 55% of the deaths occurred in this area) and difficulties in providing assistance to over 320,000 people still displaced.

In addition to conflict-associated risks, the Government has to grapple with substantial macroeconomic issues—increasing exposure to commercial foreign borrowing, a high public debt (105% of GDP), a large fiscal deficit, substantial quasi-fiscal liabilities, and fairly high inflation. Clearly, the Government's room for maneuver is limited. Moreover, its new borrowing plans might possibly be diverted from its investment requirements, with adverse long-term consequences.

A very sharp escalation in post-tsunami construction costs is another area of concern and could hamper reconstruction efforts. The cost of one bag of cement had risen by 60% to SLRs500 by November 2005 from its pre-tsunami price. Major tsunami reconstruction projects are just starting, yet it is estimated that the cost of construction of 1 km of a provincial road is now two thirds higher than before December 2004.

2.20.12 Textiles and clothing (share of export earnings)



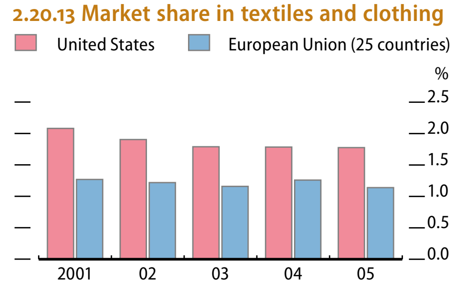
Source: Central Bank of Sri Lanka, available: http://www.centralbanklanka.org.

Textiles and clothing

The textiles and clothing industry is still the country's largest foreign exchange earner, accounting for 46% of export earnings (Figure 2.20.12). It employs over 200,000 people directly and about another 400,000 indirectly. Of nearly 750 factories in the industry, 80 are estimated to generate over 80% of its exports. Preliminary data suggest that 15 small and medium companies closed in 2005 with a loss of 3,000 jobs, but there is no conclusive evidence that this was caused by the loss of quota access and increased competition. The industry weathered 2005 relatively well, helped by concessional access (linked to high labor standards for the EU) and GSP+ access (associated with the tsunami). Preliminary statistics for 2005 indicate that textile exports to the EU and US have declined, but clothing exports have improved slightly, such that market shares have been roughly constant in both markets (Figure 2.20.13). However, most insiders expect competition to sharpen in the coming years since buyers appear to have limited their shift to the PRC for now, because the EU and the US imposed quotas on that country's exports of some items early this year. So far, Sri Lanka has been able to compete on its high labor standards (which are quite good) rather than high labor productivity (which is not).

The next few years will be decisive in how the textile industry fares. Most clothing factories are already in special export processing zones, and the Government has given the industry additional tax and customs incentives, ranging from green channel access to exempting all exports and marketing services from value-added tax. Needless to say, the domestic clothing industry's future also hangs on how well the PRC and India fare in reducing costs, improving efficiency, and finding market niches.

2.20.13 Market share in textiles and clothing



Sources: US Census Bureau, available: http://www.census.gov/foreign-trade/statistics/product/enduse/imports/C5420.html;Eurostat; available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1090,30070682,1090_30298591&_dad=portal&_schema=PORTAL, downloaded 13 February 2006.