Sri Lanka

The economy bounced back strongly in 2010, reflecting post–civil war optimism and the global recovery. The outlook, too, is positive for healthy growth provided the fiscal consolidation process meets targets and the burgeoning inflation pressures are addressed. The medium term presents a need to greatly lift private investment, if the country is to reap the full rewards of the peace dividend.

Economic performance

The economy rebounded in 2010, with GDP growth estimated at 7.6%, after 3.5% in 2009 (Figure 3.21.1). Continued benefits from the end of the long-running civil conflict in 2009, such as improved business and tourist confidence plus more land available to agriculture, as well as the global return to growth, underpinned the strong performance. The overall optimism was reflected in the stock market's doubling.

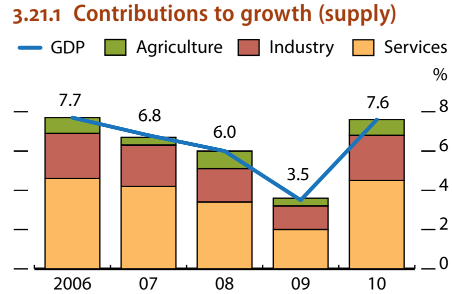
With the revival of paddy and fisheries production in the former conflict areas of Northern and Eastern provinces, agriculture grew at 6.5% in 2010. Good weather and fertilizer support by the government helped. With the improved domestic business climate, the upturn in domestic and external demand, and gradually improving infrastructure, industry grew by 8.0%.

Services, which account for nearly 60% of GDP, recorded growth of 7.6%. This was mainly due to the expansion of wholesale and retail trade, revival in tourism—which contributed to robust performance in hotels and restaurants—and the impressive performance of the banking, insurance, and real estate subsector. Tourist arrivals leaped by 46% to 654,477 in 2010, the highest number on record.

Annual average inflation as measured by the Colombo Consumer Price Index reached 5.9% in 2010, up from a 25-year low of 3.4% in 2009. Import duty reductions and subsidies that maintained stable fuel prices partly reined in rising global commodity prices' impact on domestic inflation. Nevertheless, overall inflation increased steadily from midyear to reach 7.8% in February 2011, with the rise due to escalating food prices that were 13% higher than a year earlier (Figure 3.21.2). Core inflation was on a downward trend throughout 2010 that continued in the first 2 months of 2011.

Commercial banks' average weighted prime lending rate continued to decline gradually in 2010 to 9.3% by year-end (Figure 3.21.3). The central bank reduced the reverse repurchase rate, the main policy rate, twice (and again in January 2011 to 8.5%). As interest rates edged down, growth in credit to the private sector came back strongly after 2009's shrinkage,

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.gov.lk; ADB estimates.

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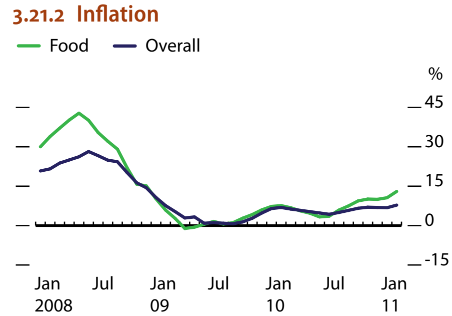
3.21.2 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 2 March 2011).

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

reflecting commercial banks' improved lending appetites. Credit to the private sector increased by 25.1%, and broad money by 15.8%.

Per plan, the government tightened the budget deficit to 8.0% in 2010 from 9.9% in 2009 (Figure 3.21.4). It took minor steps to expand the revenue base, preferring to focus on simplifying the tax system, including reducing customs duty bands from five to four, removing the import duty surcharge, revising taxes relating to imports of motor vehicles and selected electronic items, and revising cess rates. Domestic revenue as a share of GDP at 14.6% was only marginally above 2009's. Grants added 0.4% of GDP to budget revenue.

The deficit narrowed therefore through current expenditure being cut by 1.5 percentage points as a share of GDP. All major categories of current expenditure saw a reduction as a share of GDP, including salaries and wages, interest payments, and transfers and subsidies. As a share of GDP, public investment was lower than in 2009, at 6.5%. Total expenditure was 23% of GDP in 2010.

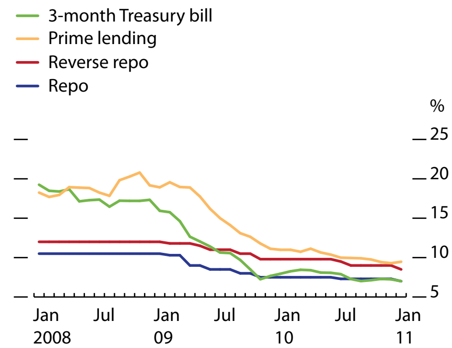
The ratio of government debt to GDP fell to an estimated 84% at end-2010 from 86% a year earlier but the total stock of government debt increased by 11%. While the debt ratio has fallen in recent years, the structure of debt has adversely changed, as the mix shifted from concessional external borrowing to higher-cost domestic and nonconcessional external borrowing. By August 2010, the share of concessional debt had declined to 68% from 72.2% at end-2009. In September 2010, the government issued its third international sovereign bond offering of $1 billion, after issues in 2007 and 2009. This issue was oversubscribed six times, with a yield substantially lower than the two previous issues.

After a 12.7% fall in 2009, exports recovered to expand by 17.3% in 2010. Industrial exports accounted for 74% of export earnings (of which more than half came from textiles and clothing) and agricultural exports 25%. Exports to major regions increased even though the European Union withdrew concessions under its Generalized System of Preferences Plus in August 2010. As the economy recovered in 2010 there was a marked increase in imports (about 32%), though this upsurge in large part reflected higher global prices, especially of oil. The steeper rise in imports than exports pushed out the trade deficit to 10.5% of GDP, from 7.5% a year earlier.

The strong resurgence in tourism as well as freight- and port-related activities brought an upturn in the services sector surplus. Growth momentum in remittances continued, reaching 24%. These items helped to counterbalance the large trade deficit to hold the current account deficit to 3.8% of GDP (Figure 3.21.5). Supported by healthy capital flows, the balance of payments recorded an estimated overall surplus of about 1.8% of GDP in 2010. Foreign direct investment strengthened sharply, to an estimated $500 million from $384 million in 2009, though at only about 1% of GDP it is very low for an economy of Sri Lanka's size and development level.

Investor sentiment was strengthened by the simultaneous approval of the third and fourth tranches of the International Monetary Fund (IMF) stand-by arrangement in June, and the fifth tranche in September, 2010. Both Standard and Poor's and Moody's raised the country's outlook to

3.21.3 Interest rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 February 2011).

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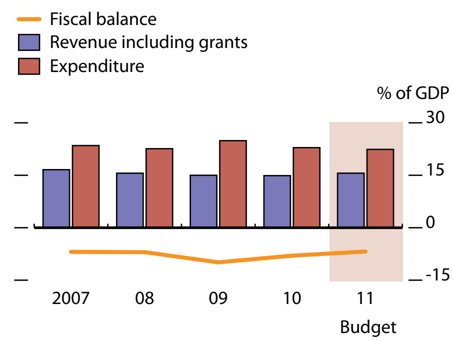
3.21.4 Fiscal indicators



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. *Budget Speech 2011*. http://www.treasury.gov.lk

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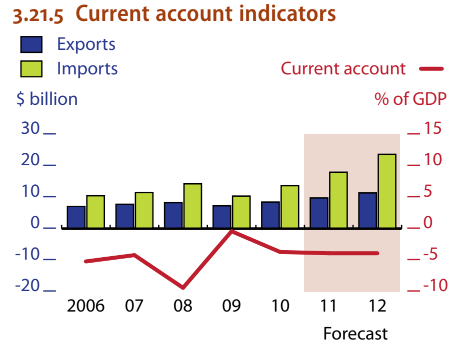
3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2010 and Prospects for 2011*. http://www.cbsl.gov.lk; ADB estimates.

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stable, and Fitch to positive. Supported by the success of the bond issue and the release of IMF funding tranches, gross official reserves reached $6.6 billion, covering 5.9 months of imports (Figure 3.21.6).

The Sri Lanka rupee climbed gradually against the US dollar by about 3% to reach SLRs111.1 by end-2010 (Figure 3.21.7). The real effective rate appreciated by about 5% because of higher inflation than in trade partners. The central bank intervened to buy foreign currency, though this move created excess rupee liquidity in the economy, leading to inflation concerns.

Economic prospects

After last year's rebound, the economy is expected to show continued high growth of 8.0% in 2011, supported by some strengthening in external demand, and maintain growth at that level in 2012. Sustaining such performance will require fiscal consolidation, state enterprise and finance sector reforms, as well as flexible exchange rate management.

Services and industry will lead growth in 2011; agriculture is likely to be hampered by heavy rains and consequent flooding that affected several provinces in January–February 2011. Continued and planned infrastructure- and tourism-related building will support construction growth, while services, especially hotels and restaurants, will perform well, catering to the likely prolongation of the tourist boom.

Rising global food and oil prices and a shortfall in domestic supply of agricultural produce due to the flooding will stoke inflation, but only up to around 8%. In January 2011, the government reduced customs duty on gasoline from SLRs15 a liter to SLRs5 to avoid passing through global price rises. As with similar tariff-lowering steps on some imported food items, the fiscal implications are unclear. A recent hike in electricity prices will also contribute to upward price pressures this year.

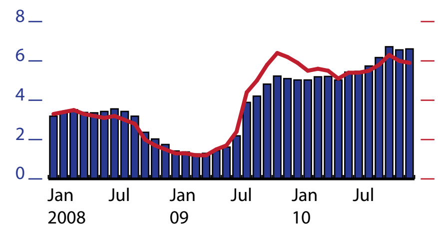
In a surprise move, the central bank cut policy rates in January even though inflation was on an upward trend, reasoning that the prevailing economic conditions provided the space for monetary relaxation to facilitate greater private investment without creating inflation pressures. With the economy now on a higher growth trajectory and inflation pressures rising, however, monetary tightening may well be needed later in the year.

The budget deficit is expected to come down to 6.8% of GDP from 8.0% in 2010, split equally between a 0.6% increase in revenue and a 0.6% cut in expenditure. Revenue buoyancy is likely, stemming from budget measures to simplify the tax system and move from tax concessions as the principal tool for attracting investment to increased economic activity.

Expenditure is forecast to rise moderately in nominal terms as the government is looking to cap public investments at around the 2010 level of 6%–7% of GDP. A sharp one-third increase in private investment is seen driving growth higher.

The budgeted fiscal consolidation is prudent, but meeting its target will require further measures as the costs of the humanitarian and reconstruction expenses related to the flooding in 2011 and the reduction in customs duty on gasoline were not provided for in the budget adopted in 2010.

3.21.6 Gross official reserves



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

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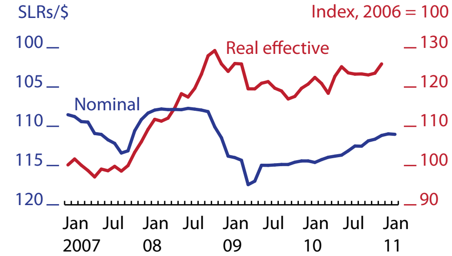
3.21.7 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 2 March 2011).

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3.21.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.0
Inflation	8.0	7.5
Current account balance (share of GDP)	-4.0	-4.0

Source: ADB estimates.

The government expects to move to a 5% of GDP deficit target in 2012. To achieve this it would be necessary to look closely at closing loopholes in the tax system and to improve efficiency in tax collection, together with further steps to broaden the tax base. Moreover, with infrastructure development a compelling priority, expenditure rationalization would have to focus rigorously on recurrent expenditure.

Export performance will depend on the recovery in Sri Lanka's major markets and is likely to grow by, say, 16% in 2011 and 2012. Rising global prices, especially of food items and petroleum, as well as high domestic demand, are expected to push up imports by around one-third in 2011 and 2012. Higher remittances and net services receipts are expected to hold the current account deficit to some 4% in both years.

FDI is projected to increase, supported by policy measures reinforced in the 2011 budget, including streamlining the role of the Board of Investment and ensuring that incentives to unproductive investments are canceled. The government wants FDI to hit about 3% of GDP this decade. The reserve position is likely to remain strong, supported by capital flows and the IMF program.

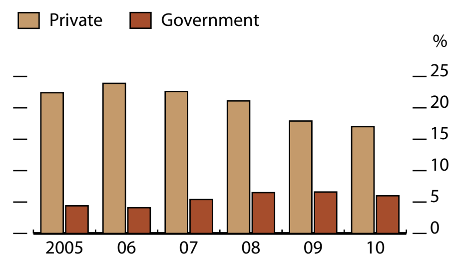
Development challenges

Investment is too low to achieve national development goals, and private investment in particular needs to be scaled up substantially (Figure 3.21.8). But several areas need to improve to secure an investment climate conducive to large-scale private investments. The 10-year development plan, the Mahinda Chintana, emphasizes the need to improve the business environment more widely. The World Bank's *Doing Business 2011* report ranks Sri Lanka at 102 out of 183 economies, suggesting the need to eliminate red tape. It also includes strengthening institutions, building human resources capacity, and simplifying procedures.

The finance sector requires development, as part of the thrust toward macro stability and hence greater investment. Improvements are needed in the legal framework for financial services and commercial transactions, and more generally in strengthening and enforcing prudential norms. The challenge for Sri Lanka will be enforcing different institutional and regulatory policy reforms in ways that are effective but without excessive bureaucracy.

It is also important to encourage both competition and consolidation in various parts of the finance sector to achieve efficiency and economies of scale. The capital markets are underdeveloped. Developing the corporate bond market is important to diversify funding sources in order to reduce reliance on banks and the equity market.

3.21.8 Fixed investment



Sources: Central Bank of Sri Lanka. *Annual Report 2009*. http://www.cbsl.lk; ADB estimates.

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