Sri Lanka

Policy measures in early 2012, including a tightened monetary stance and exchange rate flexibility, addressed emerging domestic and external imbalances. Weak external demand, drought, and floods slowed growth, but the balance of payments improved. Growth is expected to edge up, with some reduction in inflation and the current account deficit. High public debt means that sustaining rapid growth will require determined efforts to eliminate large losses in the energy sector and raise tax revenues to reduce budget deficits and borrowing.

Economic performance

Economic growth slowed in the second half of 2012 from a robust 7% in the first half to record annual expansion of 6.4% (Figure 3.21.1). This was the first time growth fell below 8% since the civil conflict ended, largely reflecting weak external demand, tight monetary conditions, and bad weather, as 15 of the country’s 25 districts suffered drought that affected agriculture and hydropower generation.

Economic performance was underpinned by a strong showing in industry, which provides 30% of GDP and is estimated to have grown by 10.3%, as in 2011. A doubling of growth in construction accounted for the resilient performance, as expansion moderated in mining and quarrying, manufacturing, electricity, gas, and water.

In the service sector, which is the largest component of GDP, contributing some 59% to GDP, growth slowed to 4.6% in 2012, well below 8.6% a year earlier. Marked slowdowns in key subsectors such as wholesale and retail trade and transport and communications reflected subdued international trade and the impact of policy measures implemented in early 2012 for macroeconomic stabilization.

Agriculture, which contributes some 11% to GDP, performed well in the first half of 2012, reaching double-digit growth of 10%. However, severe drought followed by floods during the second half brought growth for the year to 5.8%—still recording a substantial recovery from the weak, weather-affected performance in the previous year.

Inflation, measured by the year-on-year increase in the Colombo consumer price index, continued to remain in single digits during 2012, averaging 7.6% for the year (Figure 3.21.2). However, inflation rose to around 9% in the second half with pressure on nonfood prices coming from increases in government-administered prices for fuel and electricity in February 2012 and the depreciation of the Sri Lankan rupee. Food inflation also increased during the year as import duties were increased on selected food items and domestic food supplies were disrupted by drought and flooding.
The budget deficit is estimated to be 6.2% of GDP, exactly in line with the 2012 target (Figure 3.21.3). This was achieved, despite lower-than-expected revenues, by reducing budgeted current expenditure; capital expenditure was slightly lower than the targeted 6% of GDP. Revenue including grants is estimated to equal 14.2% of GDP, slightly lower than budgeted and less than in 2011. The shortfall was mainly due to lower value-added tax collections owing to slower growth.

The ratio of government debt to GDP rose to 82.6% in September 2012 from 78.5% at the end of 2011 owing to the impact of rupee depreciation on the value of foreign currency-denominated debt and increased borrowings, mainly through Treasury bills, to cover the budget deficit (Figure 3.21.4). Debt composition has changed with the gradual move toward more marketable instruments and foreign investment in government securities.

To counter external and internal imbalances that emerged during 2011, the central bank tightened monetary policy by raising policy rates in February and April 2012, and by imposing an 18% ceiling on licensed banks’ credit growth in February. Repurchase and reverse-repurchase rates were increased by 75 and 125 basis points in total from those of 2011 (Figure 3.21.5). Active liquidity management by the central bank continued absorbing excess rupee liquidity in the domestic money market to underpin the tightened monetary stance. With these measures, banks’ average lending rate on new loans rose by 300 basis points to just over 14%, and growth in credit to the private sector fell from about 35% in the first quarter to 17.6% by year-end. To address risks to growth, the central bank eased monetary policy in mid-December by reducing policy rates by 25 basis points and allowed the ceiling on credit growth to the private sector to expire at the end of 2012.

Exchange rate policy in 2012 moved toward greater flexibility by limiting central bank intervention in the foreign exchange market. The rupee quickly depreciated by about 15% against the dollar in the first half of the year, then slowly moved upward, appreciating by about 3% during the second half (Figure 3.21.6). Over 2012, the nominal and real effective exchange rates depreciated by about 11% and 6%, respectively.

Exports and imports both declined from the previous year after the second quarter, with exports contracting by 7.4% for the year and imports by 5.8%. Weak global demand and lower prices explained most of the drop in exports. Earnings from the island’s largest export, garments, fell by 2.3%, mainly owing to slack economic conditions in the US and the European Union (EU) and the loss in 2010 of the Generalized System of Preferences Plus facility previously offered by the EU, which continues to cause garment factories to close. Agricultural exports, including tea, contracted by 7.8% due to the drought and weaker prices.

The performance of imports reflected currency depreciation, some higher tariffs, and central bank measures to restrict credit growth. Except fuel, machinery, and building materials, imports of all other import subcategories fell from a year earlier. Imports of consumer goods contracted by 18% and of intermediate goods by 6%, while imports of investment goods rose by 5%. Fuel imports increased by 5% as thermal power generation stood in for hydropower output constrained by drought. Despite the fall in export earnings, the trade deficit narrowed by 4% to $9.3 billion.

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**Figure 3.21.3 Fiscal indicators**

[Graph showing budget balance, tax revenue, and recurrent expenditure over the years 2008 to 2013.]

**Figure 3.21.4 Government debt**

[Graph showing foreign and domestic debt as a percentage of GDP from 2007 to 2012.]

**Figure 3.21.5 Credit growth and interest rates**

[Graph showing reverse-repurchase rate, repurchase rate, weighted average prime lending rate, and private sector credit growth over time from January 2009 to February 2013.]
The post-conflict tourism boom continued in 2012, with the number of tourists visiting Sri Lanka surpassing 1 million in 2012 and earnings from tourism expanding by 25.1% to reach $1 billion. Workers’ remittances also expanded rapidly by 16.3% to $6 billion. Increased labor migration under the professional category and the expansion of formal channels for remitting money were the main factors boosting remittance inflows. These earnings held the current account deficit to an estimated $3.5 billion, about 5.8% of GDP, a marked improvement from 7.8% a year earlier (Figure 3.21.7).

Net foreign investments on the Colombo Stock Exchange increased to $305 million, and there was a significant increase in foreign purchases of government securities. Net inflows to the government in 2012 grew by 20.8%, in part reflecting the disbursement of foreign loans to finance major infrastructure development projects. Foreign direct investment of around $1 billion was, however, about the same as in 2011.

The proceeds of the fifth $1 billion sovereign bond issue and the final $415 million disbursement under the International Monetary Fund standby facility helped to buoy foreign exchange inflows. Gross official reserves increased by $0.9 billion to $6.9 billion, equivalent to 4.3 months of imports (Figure 3.21.8). In 2012, Fitch Ratings affirmed Sri Lanka’s stable sovereign rating, and Standard & Poor’s revised its foreign currency rating outlook from positive to stable.

### Economic prospects

Private consumption expenditure, which accounts for about 70% of GDP, will remain the main engine of economic expansion, fuelled by rising incomes and remittances from Sri Lankans abroad. Investments are expected to expand further in 2013, with higher growth in construction buoyed by large infrastructure projects. Slow recovery in the euro area, Sri Lanka’s largest export market, would continue to constrain growth potential somewhat. Exports will have to wait at least another year for a stronger recovery because weak external demand will continue in 2013. From the supply side, expansion is expected in services, led by hotels and other tourism-related businesses, along with growth in external and domestic trade. Agriculture is expected to improve with normal weather.

Economic growth will be subject to constraint from the balance of payments. Larger imports associated with high economic growth will worsen the trade deficit and—unless financed by exports, workers’ remittance, and capital inflow—depreciate the currency. Because of the need to address inflation, the monetary policy stance set at the end of 2012 is not expected to be relaxed, which will restrain economic growth. As such, GDP growth is expected to edge up to 6.8% in 2013 and then advance by 7.2% in 2014 on better external conditions.

 Fiscal policy will focus on further consolidation and the challenge of narrowing the budget deficit. The government projects a budget deficit of 5.8% of GDP in 2013, down from 6.2% estimated for 2012. The narrowing of the deficit is attributable to an expected 18.9% increase in tax revenue and grants, against a 15.9% increase in government expenditure. Expenditure as a share of GDP will be 20.5%, essentially unchanged from 2012. The ratio of current expenditure to capital expenditure will
fall as the government increases public investments to a planned 6.1% of GDP, in line with its Mahinda Chintana development policy framework. The planned expansion of revenue to 14.7% of GDP is to come mainly through higher collection of value-added tax and improved efficiency in tax collection, supported by higher economic growth and a better external trade performance. Increasing revenue is difficult. Revenue has been declining as a share of GDP, even in years with high economic growth (Figure 3.21.9). To decisively reverse this trend, tax efficiency would need to improve substantially and the tax base to widen. Average inflation in 2013 is expected to be 7.5%, little improved from a year earlier, despite the base effect from the energy price adjustments in 2012 disappearing in the second quarter of 2013, expected declines in global commodity and oil prices, and expected exchange rate stabilization at current levels. Gas prices were adjusted upward by 2% and diesel by 5% in the last week of February 2013. Further price increases are required to address the current operating losses of the Ceylon Electricity Board (CEB), and to pay down debts to banks that funded previous years’ losses. The estimated loss was about Rs89 billion (equal to 1.2% of GDP) for Ceylon Petroleum and Rs65 billion (0.9%) for the CEB. An increase in the national minimum wage is a risk that could top up inflationary pressures. Monetary policy will therefore need to remain tight to limit second-round effects and anchor inflation expectations in 2013. External demand is expected to recover gradually in 2013. Merchandise exports are projected to grow at a slow 4% in 2013 and 5% in 2014. Meanwhile, worker’s remittances will continue to expand rapidly. Services exports are expected to be boosted by growing tourism, the further development of business process outsourcing, and higher income from trade and shipping services partly derived from the opening of new port facilities. Revenues from these items will allow imports to expand by 6% in 2013 and 10% in 2014 without widening the current account deficit as a share of GDP (Figure 3.21.10). Normal weather would increase the share of hydropower generation and contain the oil bill. The current account deficit is thus expected to be 5.0% of GDP in 2013 and 4.5% in 2014, both improvements on the estimated 5.8% in 2012. It is assumed that the current account deficit will continue to be financed by capital inflows.

**Policy challenge—developing the power sector**

Sri Lanka achieved remarkable progress in developing its power sector. The national electrification ratio grew from 29% in 1990 to an estimated 94% in 2012. Power supply is stable, and power cuts are very limited. The cost of electricity supply is, however, high. Moreover, tariffs do not reflect full costs or adjust according to an automatic mechanism. The average cost of electricity generation is currently around SLR$21.0 per kilowatt-hour while the average selling price is SLR$16.4. The CEB’s estimated loss of SLR$65 billion in 2012 occurred even with fuel supplied by Ceylon Petroleum at less than full cost. The CEB relies on bank loans to cover its operating costs. In January 2013 the regulator for the sector, the Public Utilities Commission, began preparing an assessment of the CEB’s costs toward revising electricity tariffs based on a formula.
The share of thermal power increased from 6% in 1995 to 60% during 2008–2012, as demand growth was met by oil-fired generation (Figure 3.21.11). The growing reliance on oil-fired plants, higher oil prices, and the delayed construction of new hydropower plants have significantly pushed up the cost of generation. The option now available for generating large base loads is traditional coal-fired plants, which are under development (Table 3.21.2). At present, unconventional renewable energy sources cannot contribute significantly because of their intermittent nature and other technical constraints. Another option Sri Lanka has to strengthen its energy security is to diversify into other forms of traditional generation and to build a cross-border connection with India, which is being planned.

Disparities still exist in electrification across the provinces. As demand grows, particularly in the former conflict areas, the transmission network must be continuously improved. The challenge is to obtain financial support to implement crucial transmission links.

The government’s 10-year development framework, prepared in 2006, envisions the sustainable development of energy resources, access extended to the entire population, and reliable service delivery at a competitive price through commercially viable institutions subjected to independent regulation.

### 3.21.2 Long-term power generation expansion plan, 2011–2018

<table>
<thead>
<tr>
<th>Year</th>
<th>Renewable additions (using hydro)</th>
<th>Thermal additions (using coal and furnace oil)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>Puttalam coal (stage 1) (315 MW)</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>Upper Kotmale (150 MW)</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>Chunnakam furnace oil (24 MW)</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>Puttalam coal (stages 2 &amp; 3, 2 × 315 MW)</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>Uma Oya (120 MW)</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>Gin Ganga (49 MW)</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>Broadlands (35 MW)</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>Moragolla (30 MW)</td>
<td></td>
</tr>
</tbody>
</table>

MW = megawatt.

Sources: Ceylon Electricity Board. *Long-Term Transmission Development Plan 2011; ADB estimates.*