Sri Lanka

Growth rebounded last year from a slowdown in 2012, and the current account deficit narrowed substantially. As inflation eased, the central bank relaxed monetary policy. The outlook is for sustained rapid growth leveraging easy private access to credit and the government's continued drive to expand infrastructure. An improving external environment will lift trade, but the current account deficit will expand on higher imports. Fiscal consolidation will focus on revenue enhancement.

Economic performance

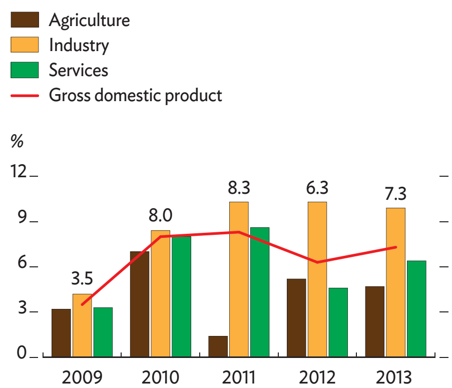
GDP growth rebounded to 7.3% in 2013 (Figure 3.21.1). The recovery reflected domestic demand strengthening and a pickup in exports and tourism. Faster growth in wholesale and retail trade, hotels and restaurants, transport, banking, insurance, and real estate lifted performance in the large service sector to 6.4% from 4.6% a year earlier, providing the impetus for the rebound. Industry grew by 9.9%, slightly less than a year earlier, as slower growth in mining and quarrying and in construction offset a pickup in manufacturing and utilities. Favorable weather helped maintain agriculture growth at a relatively favorable 4.7%.

Inflation trended downward in 2013, averaging 6.9% for the year. Food inflation was at about 12% during the first quarter, as drought late in 2012 had disrupted domestic food supplies, but then dropped markedly to 0.9% in February 2014 (Figure 3.21.2). Nonfood inflation also moved lower over the year but picked up to 7.1% in January 2014 on large increases in communications and transport prices that month.

The 2013 fiscal deficit is estimated at 5.8% of GDP, in line with the target (Figure 3.21.3). The target was hit, despite unexpectedly weak revenues, by compressing current expenditure. Capital expenditure was largely maintained but was again slightly below the target of 6% of GDP. Revenue including grants is estimated at 13.8% of GDP, lower than both the budget and the 2012 performance. The shortfall in revenue partly reflected measures that curbed certain imports such as automobiles, which suppressed value-added tax (VAT) collections and import-related taxes.

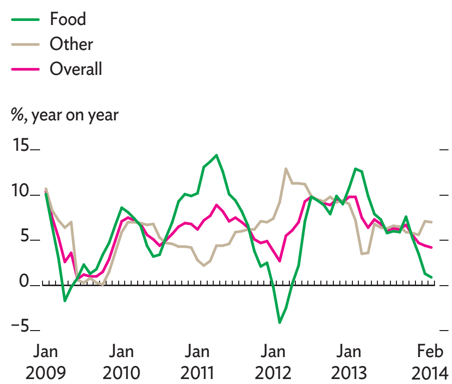
The ratio of government debt to GDP fell to 78.4% in September 2013 from 79.1% in 2012 (Figure 3.21.4). Debt composition is changing with the gradual move toward market and non-concessional instruments, with foreign investment in government securities, and with the rise in income as a middle-income country.

3.21.1 GDP growth by sector



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk/ (accessed 18 March 2014).
Click here for figure data

3.21.2 Inflation



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk (accessed 10 March 2014).
Click here for figure data

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

To address weak growth evident in 2012, the Central Bank of Sri Lanka relaxed its monetary stance for 2013, which was facilitated by a declining trend in inflation during the year. The bank began its relaxation in mid-December 2012 by cutting policy rates by 25 basis points and continued in May and October 2013 with rate reductions of 50 points in each adjustment (Figure 3.21.5). Commercial bank lending interest rates declined markedly during the year from 14.3% in January 2013 to 9.9% in December. However, credit to the private sector continued to decelerate, with year-on-year growth slowing to 7.5% in December 2013 from 17.6% at the end of 2012.

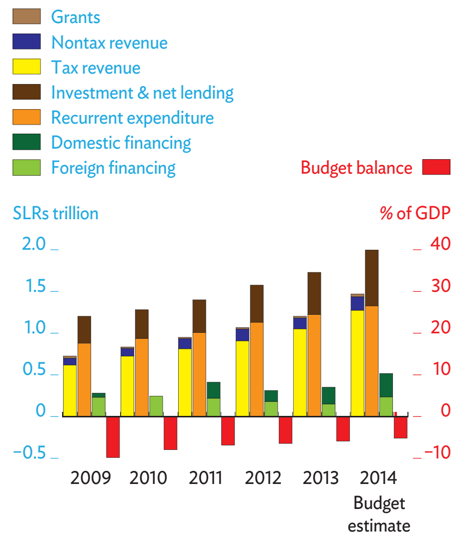
After the sharp depreciation of the Sri Lanka rupee in the early months of 2012, when the exchange rate was allowed to float, the currency has been broadly stable against the US dollar (Figure 3.21.6). Foreign investors' exit from emerging markets in mid-2013 had only a modest and temporary effect on the exchange rate. The rupee depreciated against the dollar by only 1.9% over 2013. The real effective exchange rate has risen markedly since April 2012, essentially moving back to the rate prevailing prior to the decision to let the currency float.

Exports and imports both posted positive growth only in the second half of 2013, following weakness a year earlier. Export earnings increased by 6.3% for the year to $10.4 billion, reflecting gradual recovery of demand in partner countries, with garment exports increasing by 13.0% and agricultural exports, mostly tea, advancing by 10.7%. Imports, on the other hand, declined by 6.2% during 2013 to $18.0 billion as a result of less demand for oil, policy measures adopted in 2012 to rationalize imports, and subdued commodity prices in international markets. Most of the fall was due to reduced imports of transport equipment by 32.7% and fuel by 14.7%. The trade deficit fell to 11.4% of GDP, a marked decline of 4.4 percentage points from 2012.

The tourism boom continued in 2013 with the number of visitors growing by 27% to reach 1.2 million and earnings expanding by 35% to $1.4 billion. Tourist arrivals from the People's Republic of China and the Russian Federation increased significantly, but Western Europe continued to be a large source of visitors. Workers' remittances expanded by 13% to $6.8 billion in 2013. The main factors boosting remittance inflows were increased labor migration under the professional and skilled category, the expansion of formal channels for remitting money, and the introduction of a swift web-based money-transfer system. These earnings held the current account deficit to an estimated $1.4 billion, which is an estimated 2.0% of GDP and a marked improvement on the 6.6% deficit seen a year earlier (Figure 3.21.7).

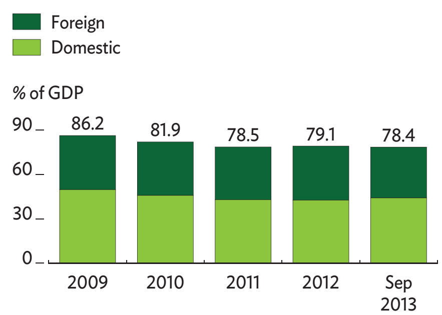
Portfolio investments recorded a net inflow of $269.9 million for the year, of which about half went into the Colombo Stock Exchange in the form of secondary market transactions. Foreigners' monthly net purchases on the exchange were broadly stable throughout the year. Foreign direct investment increased by 42% to $870.1 million in the first 9 months of 2013 from the corresponding period in 2012. Financial account net inflows brought the balance of payments surplus to an estimated $700 million. Consequently, Sri Lanka's gross official reserves increased to $7.2 billion in December 2013, equal to 4.5 months of imports (Figure 3.21.8).

3.21.3 Fiscal indicators



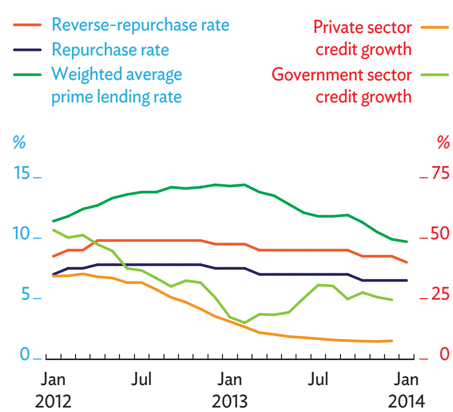
Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. 2013. *Budget Speech 2014.* http://www.treasury.gov.lk
Click here for figure data

3.21.4 Government debt



Source: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* http://www.cbsl.lk
Click here for figure data

3.21.5 Credit growth and interest rates



Source: Central Bank of Sri Lanka. *Weekly Economic Indicators.* http://www.cbsl.lk (accessed 18 March 2014).
Click here for figure data

Economic prospects

An improving external environment, higher investments, and a recovery in domestic consumption will sustain a rapid pace of GDP growth in the next 2 years. The recent relaxation in monetary policy will allow more lending to the private sector and provide an impetus for expansion. Sri Lanka's post-conflict growth has been buoyed by construction, which has increased its share of GDP from 6.6% in 2009 to 8.1% in 2012, and by transport and telecommunications, its share up from 12.8% to 14.3% in the same period. The government's focus on infrastructure and post-conflict reconstruction and development has supported this expansion and will continue to drive growth in the medium term. The expansion in tourism and related construction has been noteworthy and is reflected in hotel and restaurant expansion, though modest scale limits the contribution to growth. As tourist numbers continue to rise rapidly and large hotel projects in the pipeline open their doors, economic growth and foreign exchange earnings from tourism will continue to be buoyant over the next several years.

On the demand side, the investment ratio improved from 28% in 2010 to 31% in 2013. This gradual gain reflects the government's infrastructure drive and the expansion in construction. Monetary policy relaxation will start to take effect on private sector credit around mid-2014 and continue in 2015, facilitating private investment. Moreover, foreign direct investment is expected to continue to expand as the economy strengthens and the investment climate improves. Exports, having recovered since mid-2013, will continue to expand. With these factors pushing up income, private consumption will pick up after slowing in 2013 and contribute significantly to higher growth. Growth is thus expected to accelerate to 7.5% in 2014 and maintain that rate in 2015.

While high inflation has been a problem in the past, it has been contained below 10% since 2009. Inflation is expected to remain in the middle single digits in 2014 and 2015. Broadly stable international fuel and food prices will help to keep inflation in check over the next 2 years, assuming normal weather. While high inflation in the past has been attributed to government's borrowing from banks, among other things, improved fiscal discipline and a falling fiscal deficit have eased such inflationary pressures in recent years.

As the pace of economic growth picks up, the central bank will use monetary policy to keep inflation acceptable. In January 2014 the bank compressed the policy rate corridor, now renamed the standing rate corridor, to reduce variability in the transmission of its policy intentions, and then continued with monetary easing. The standing lending facility rate (the upper band) was cut by 50 basis points to 8.0%, narrowing the corridor to 150 basis points from 200. Credit to the private sector, which decelerated throughout 2013, will expand in 2014 by 16%, according to central bank projections. However, broad money is expected to grow at a slower pace as credit demand from the public sector declines. Average inflation in 2014 is expected to fall to 5.0% from 6.9% in 2013, then accelerate slightly to 6.0% in 2015.

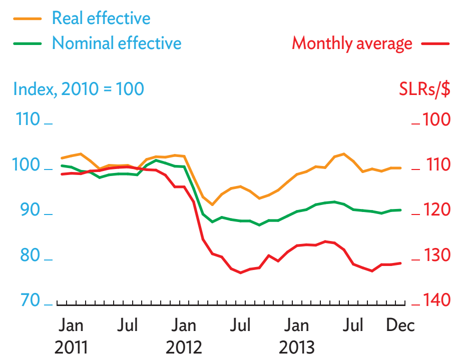
The fiscal deficit steadily shrank to 5.8% of GDP in 2013 from a peak of 9.9% in 2009. The government has deployed both revenue measures

3.21.1 Selected economic indicators (%)

	2014	2015
GDP growth	7.5	7.5
Inflation	5.0	6.0
Current account balance (share of GDP)	–2.6	–3.5

Source: ADB estimates.

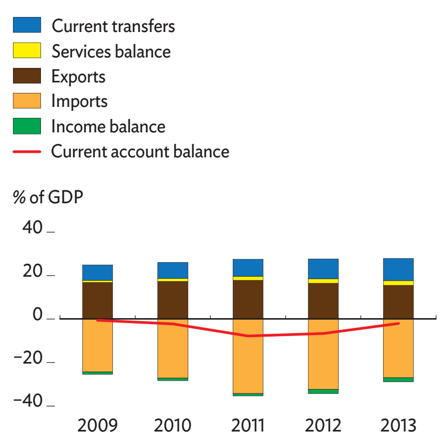
3.21.6 Exchange rates



Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 18 March 2014).

Click here for figure data

3.21.7 Current account components



Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012*; Central Bank Press Release. http://www.cbsl.lk; ADB estimates.

Click here for figure data

and expenditure reduction to narrow the deficit. However, the revenue ratio—tax collections as a percentage of GDP—has not picked up as expected, so deficit reduction has been achieved mainly by rationalizing expenditure. The government expects the deficit to narrow further over the medium term. The 2014 budget estimates the deficit at 5.2%, with a higher revenue ratio and expansive 16% growth in expenditure. Better economic performance and more imports will catalyze higher revenue collection in 2014 and 2015, but continued policy action is also needed, together with improved revenue administration, to achieve a higher revenue ratio. Some measures are being introduced through the 2014 budget to broaden the revenue base, such as expanding the nation building tax to the financial sector and lowering the VAT threshold for retail and wholesale trade. The nation building tax is an indirect tax that has been levied since 2009 to help finance the rehabilitation of conflict damage; it is passed on in the price of goods or services sold.

One risk to achieving the targeted revenue ratio is that the measures to expand the revenue base may take effect more slowly than anticipated. If revenue collection is lower than anticipated, the capital budget will be hard pressed to meet its target of 6%–7% of GDP, as expenditure rationalization is already substantial in the 2014 budget and 2015 projections.

Exports are expected to strengthen with better economic performance in the European Union and the US, Sri Lanka's main export destinations. After declining in 2013, imports will pick up in 2014 as domestic demand normalizes. However, policy measures taken to limit food imports to support local production will affect imports in the medium term. Measures that helped improve remittances will continue to bolster such inflows in 2014 and 2015. The current account deficit is projected to widen from an estimated 2.0% in 2013 to 2.6% in 2014 and 3.5% in the following year (Figure 3.21.9).

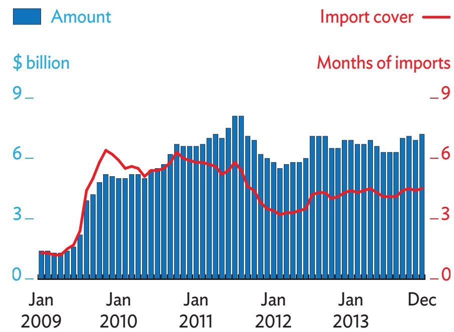
Policy challenge—boosting fiscal revenues

Sri Lanka has been focusing on fiscal consolidation and taking many steps in recent years to improve revenue collection. However, the revenue ratio excluding grants remains low, at 13.6% of GDP in 2013 (Figure 3.21.10). In fact, it has fallen over the past few years, underperforming its target each year. As the government continues its fiscal consolidation, reversing the revenue ratio's declining trend is critical.

The main cause for the erosion of the revenue ratio has been the VAT, which accounts for 25% of tax revenue. VAT revenue has declined from 5.8% of GDP in 2004 to 2.7% of GDP in 2012 (Figure 3.21.11).

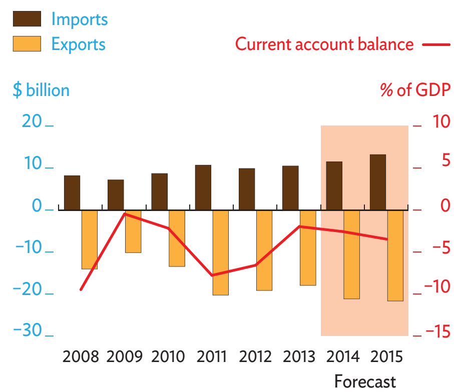
The VAT was introduced in 2002, replacing the goods and services tax with rates of 0%, 10%, and 20%. There are many exemptions: food such as rice, wheat, tea, and domestically produced sugar; machinery, including that for agriculture and construction; and other items such as crude oil, diesel, kerosene, liquefied petroleum gas, electricity, and public transportation. The VAT Act has been amended many times since 2002, mainly to improve collection. However, VAT collection has relentlessly declined, affected by exemptions, the unification of the rate at 12% in 2011, and the poor performance of imports since 2009.

3.21.8 Gross official reserves



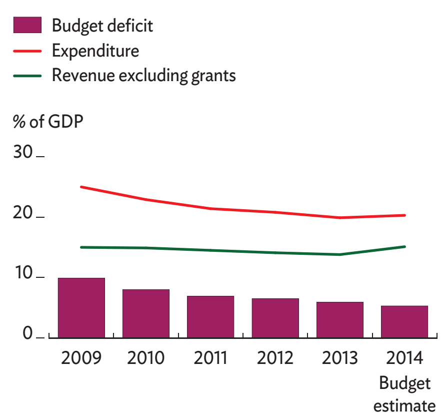
Source: Central Bank of Sri Lanka. *Weekly Economic Indicators.* http://www.cbsl.gov.lk (accessed 18 March 2014).
Click here for figure data

3.21.9 Current account indicators



Note: 2013 values are estimates.
Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* Central Bank Press Release. http://www.cbsl.lk; ADB estimates.
Click here for figure data

3.21.10 Government finance



Sources: Central Bank of Sri Lanka. 2013. *Annual Report 2012.* http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. 2013. *Budget Speech 2014.* http://www.treasury.gov.lk
Click here for figure data

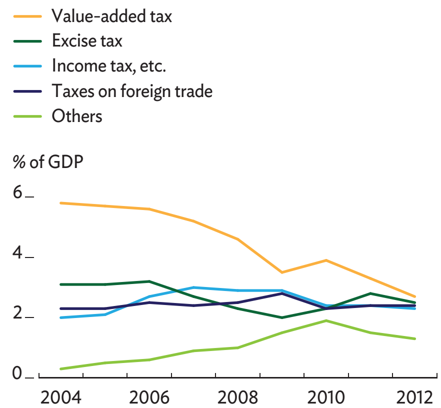
In the context of faster growth reached in the post-conflict years and increased income per capita, the low revenue ratio implies that revenue generation has not kept pace with the rising capacity of the population to pay. Average tax buoyancy—how well revenue mobilization tracks GDP growth—has hovered for the past 5 years at 0.78, which is significantly below unity. This indicates that tax collection has been unresponsive to the pace of economic expansion.

A study released in 2013 by the International Monetary Fund entitled *Understanding Countries' Tax Effort* estimates Sri Lanka's tax capacity at 21.9% of GDP, one of the lowest in South Asia. This suggests that strengthening institutions and improving administration can increase tax capacity. With regard to efforts at fiscal consolidation, so far the reduction in the deficit has come about mainly by rationalizing expenditure. However, improving the revenue ratio is key to reining in the fiscal deficit to a sustainable level and ensuring that public investment is not curtailed. As interest payments are a large drain on Sri Lanka's budget, higher revenue collection will contribute to lowering the borrowing requirement and future borrowing costs to the government.

The government recognizes the importance of improving the revenue ratio and has set up a tax reform committee. The committee submitted reform recommendations in 2009 that began to be introduced through the 2010 budget. The major tax reform in 2011 reduced rates as it sought to broaden the tax base. Many rationalization measures were introduced, including simplifying the economic service charge (a tax withholding system) and lowering the tax slabs of the personal income tax. In 2013, the government expanded the VAT base by bringing in the retail trade, which had been exempt. The 2014 budget introduced further measures to expand coverage and lower the threshold for certain taxes, such as expanding the nation building tax to the financial sector and lowering the VAT threshold for the retail and wholesale trades.

The government has brought the Board of Investment under the Inland Revenue Act in an effort to limit exemptions and tax holidays provided to new companies that apply for incentives. Many existing concessions are ending in the near future, which will broaden the tax base. The government expects the reforms introduced in recent years to contribute to a higher revenue ratio in 2014. It is currently implementing in the Inland Revenue Department the new revenue administration information system to make revenue collection more efficient.

3.21.11 GDP share of tax revenue



Source: Central Bank of Sri Lanka. *Economic Statistics 2013.* http://www.cbsl.lk
Click here for figure data