Sri Lanka

Growth stayed high in 2011 despite bad weather, which affected agriculture. A policy to keep the exchange rate stable in the face of credit-fueled strong domestic demand led to a growing trade deficit and loss of official reserves, while nonfood prices trended sharply higher. The authorities in response adopted in February 2012 more flexible exchange rate and monetary-tightening policies, and made steep power and fuel price adjustments. The outlook is for moderate but still strong growth.

Economic performance

The economy grew at 8.3% in 2011 as the country continued to absorb the benefits of the end of its long-running civil conflict in May 2009 (Figure 3.21.1). Industrial output (accounting for a little less than one-third of GDP) expanded by 9.6%. Within that, manufacturing grew by 8.1%, led by the export-oriented readymade garment industry. Construction and mining came in at double-digit growth, reflecting projects started since the conflict ended.

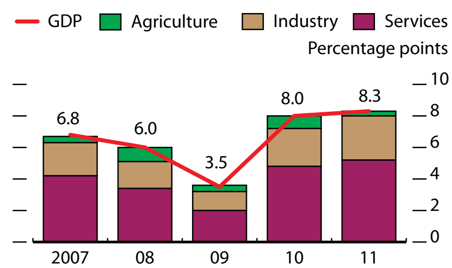
Services, the largest component of GDP (three-fifths), climbed by 8.8%. Hotel and restaurant activity was up by one-third, reflecting a 30.8% increase in tourist arrivals. Both transport and communications grew with the further integration of the northern and eastern provinces (former conflict areas) with the rest of the economy.

Agricultural output, however, was hit by adverse weather and heavy flooding in early 2011 and was down in the first half, but it picked up in the second to show annual growth of 2.5%.

Private consumption remained the main driver of economic expansion, fueled by remittances, greater demand from the northern and eastern provinces, and salary increases for civil servants and the defense forces. Investment activity also strengthened owing to implementation of major infrastructure development initiatives (especially in transport, energy, water, sanitation, and irrigation) and rising business investment, including international companies seeking a foothold in a fast-expanding economy. Private investment focused on tourism, telecommunications, manufacturing, and housing.

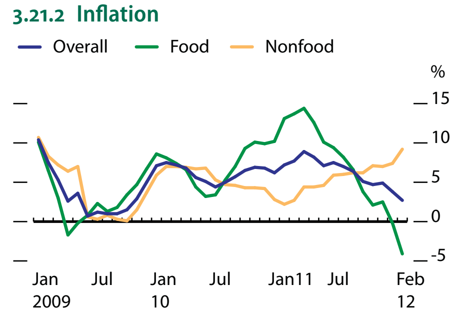
Overall inflation remained in single digits in 2011, averaging 6.7% and little changed from a year earlier (Figure 3.21.2). Food inflation, though, was volatile, reflecting flood damage, crop failures, and price pressure early in the year and, later, declining prices as production recovered. Nonfood inflation trended upward, due to strong demand and price increases for diesel, petrol, kerosene, liquefied petroleum gas, and bus fares late in 2011 and in February 2012, when it reached 9.2%. Fuel prices were suppressed during 2011 as international oil prices shot up by 41%

3.21.1 Contributions to growth (supply)



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2011 and Prospects for 2012.* http://www.cbsl.gov.lk; ADB estimates.

3.21.2 Inflation



Source: Department of Census and Statistics Sri Lanka. http://www.statistics.gov.lk (accessed 12 March 2012).

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

during 2010 and 2011. The government kept rises in petrol and diesel to 19% and 15%, respectively. Ceylon Petroleum Corporation lost a reported SLRs90 billion in 2011 (1.4% of GDP), mainly by selling oil to Ceylon Electricity Board below cost.

The central bank kept monetary policy rates low in 2011 to boost economic growth through rapidly expanding credit. Growth in credit to the private sector has accelerated rapidly since early 2010, fueling the pace of economic activity: year-on-year growth reached 34% in midyear and then plateaued (Figure 3.21.3). Construction, agriculture, and wholesale and retail trade have been prominent recipients. The central bank aimed at maintaining inflation at mid-single-digit level and signaled a tightening of policy by raising its repurchase and reverse repurchase rate by 50 basis points to 7.5% and 9.0%, respectively, in February 2012.

The budget deficit was narrowed in 2011 through a reduction of expenditure as a share of GDP, even as the proportion of government revenue in GDP fell. The deficit is estimated at 7.0% of GDP, improving from 2010's 8.0% (Figure 3.21.4). Total revenue increased by 12.3% in 2011 from a year earlier (tax receipts rose by 14.2%). Revenue as a share of GDP, however, fell by 0.5 percentage points to 14.3% in 2011, despite a 16.6% rise in nominal GDP and strong imports. The weaker performance seems largely due to tax holidays and incentives eroding the tax base. Total expenditure, which rose by 9.1%, moderated to 21.4% of GDP from 22.9% in 2010, reflecting government efforts to rationalize recurrent spending. Capital expenditure was maintained at 6.0% of GDP.

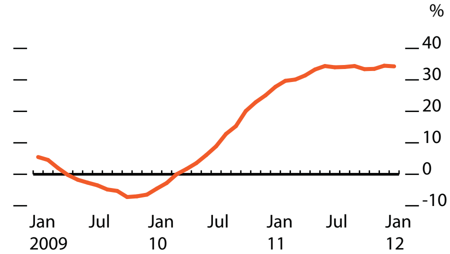
While exports expanded strongly, imports jumped because of higher oil prices and strong domestic demand, more than doubling the current account deficit to 7.3% of GDP in 2011 (Figure 3.21.5). Export earnings rose by about 22.4% to $10.5 billion, mainly owing to a 24.6% expansion in garment sales, a near 60% surge in rubber and rubber products, and strong prices for other agricultural products. Imports jumped by 50.4% to $20.2 billion, driven mainly by increases in imports of oil, intermediate goods for the garment industry and other raw materials, and capital goods. Export growth was weaker in the second half of 2011 than the first, while that of imports stayed high.

Improved workers' remittances and an increased surplus in the services account helped contain the current account deficit. Earnings from tourism shot up by 44% to $830 million, even though tourist arrivals, especially from Europe, slowed during the second half. Workers' remittances, up by 25.0%, remained the single largest foreign exchange earner, at $5.1 billion or 8.7% of GDP.

Foreign direct investment inflows exceeded the government target of $1 billion in 2011 as there was an influx of investments into the tourism, apparel, and information technology industries. Net inflows to the capital and financial accounts largely offset the current account deficit.

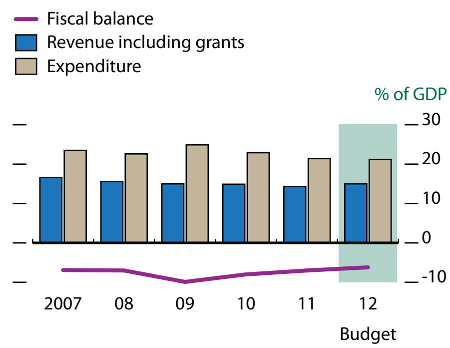
The central bank defended the foreign exchange rate (in a band around SLRs110/$1) against downward pressure from the current account deficit for most of 2011, although the government announced a 3% devaluation when presenting the 2012 budget in November 2011 (Figure 3.21.6). With strong demand pressures, gross official reserves fell continuously during the latter part of the year to $5.96 billion by end-December 2011, covering 3.5 months of imports (Figure 3.21.7).

3.21.3 Growth of private sector credit



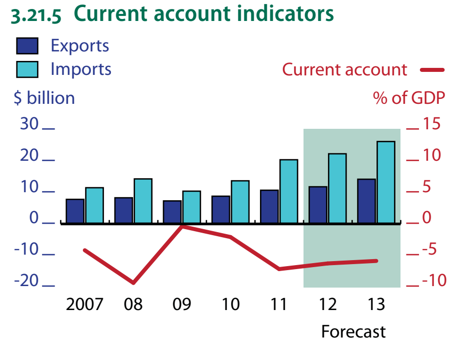
Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 12 March 2012).

3.21.4 Fiscal indicators



Sources: Central Bank of Sri Lanka. *Annual Report 2010*. http://www.cbsl.lk; Ministry of Finance and Planning and the Treasury of Sri Lanka. *Budget Speech 2012*. http://www.treasury.gov.lk

3.21.5 Current account indicators



Sources: Central Bank of Sri Lanka. *Recent Economic Developments Highlights of 2011 and Prospects for 2012*. http://www.cbsl.gov.lk; ADB estimates.

In February 2012, the central bank announced that it would limit its intervention in the foreign exchange market, moving toward greater market determination of the exchange rate. By end-March the rate reached SLRs129.6/$1, a 14% depreciation year on year.

Economic prospects

Although the economy is projected to maintain its strong performance of the last 2 years, growth prospects for 2012 are less favorable than in the past, and the pace of expansion will moderate. This easing is partly due to slower growth in industrial countries and attendant weaker growth in global demand and trade, and partly due to domestic factors: the rebound has largely run its course and with little slack in production capacity signs of overheating have emerged that will require tighter demand-management policies to forestall the buildup of serious economic imbalances.

Growth is expected to edge down to a still high 7.0% in 2012 as trends in investment, exports, tourism, remittances, and consumption remain broadly favorable; agriculture growth should be high, assuming normal weather. With the expected stronger performance of the global economy in 2013, growth is expected to recover to 8.0%, driven mainly by domestic and foreign investment.

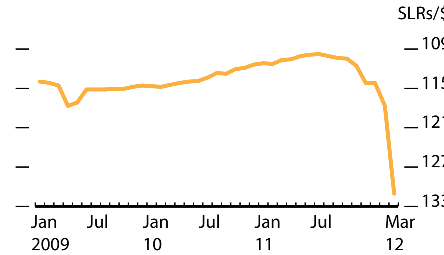
Fiscal policy will focus on further narrowing the budget deficit in 2012 to 6.2% of GDP. The budget plans most of this improvement to come from an 19.8% increase in revenue and grants, based on assumptions of rapid growth (8.5–9%) and inflation in mid-single digits. But with growth likely to be slower than this rate, it will be hard to reach the revenue target. Expenditure is slated to rise more slowly than revenue: planned economies in current spending should allow capital outlays to rise to 6.6% of GDP, in line with the target in the government's Development Policy Framework. The government plans to bring the deficit down to 5.8% in 2013, by improving income tax and value-added tax collection and further streamlining current expenditure.

The public debt ratio has been reduced over the last few years, although it was still very high at an estimated 78.9% of GDP at end-November 2011 (Figure 3.21.8). The impact of currency depreciation on external debt, additional budget borrowing, and slower growth is on course to worsen the debt-to-GDP ratio in 2012.

Monetary policy will focus on stabilizing inflation in mid-single digits and eliminating balance-of-payments pressures and loss of reserves. In moving toward this objective the central bank raised policy rates in early February 2012 and directed commercial banks to limit credit expansion to 18% during the year, alongside the moves to liberalize the exchange rate.

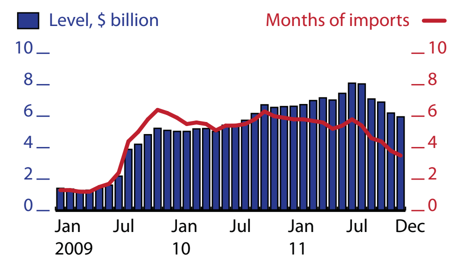
While the expected global slowdown and stable commodity prices in 2012 should curb external inflationary pressure, diesel and petrol prices were raised by 37% and 9%, respectively, and a surcharge (25–40%) was imposed on household electricity bills, all in February 2012. However, currency depreciation will also raise inflation through higher import prices. Inflation is forecast to be 8.0% in 2012 and fall marginally to 7.0% in 2013 owing to easing pressures from exchange rate depreciation and energy price adjustments a year earlier.

3.21.6 Exchange rate



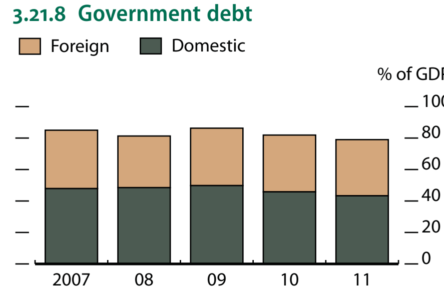
Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 26 March 2012).

3.21.7 Gross official reserves



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

3.21.8 Government debt



Note: 2011 data are up to end-November.

Source: Central Bank of Sri Lanka. http://www.cbsl.lk (accessed 12 March 2012).

Export growth is expected to fall to 11.0% in 2012, mainly owing to weaker demand, especially from Europe. Still, the trade gap is projected to stabilize, as import growth will also be much slower as higher interest rates, tighter credit, and a marked depreciation in the exchange rate are felt, especially for consumer goods. The current account deficit is projected to edge down to 6.4% of GDP in 2012, reflecting the more stable trade gap and continued large gains in remittance receipts. Growth in tourism-related inflows will take a hit but the sector will stay a major earner.

With stronger industrial-country growth and a pickup in trade in 2013, stronger export growth is projected to help narrow the current account deficit to 6.0% of GDP.

3.21.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.0	8.0
Inflation	8.0	7.0
Current account balance (share of GDP)	-6.4	-6.0

Source: ADB estimates.

Policy challenge—boosting private investment

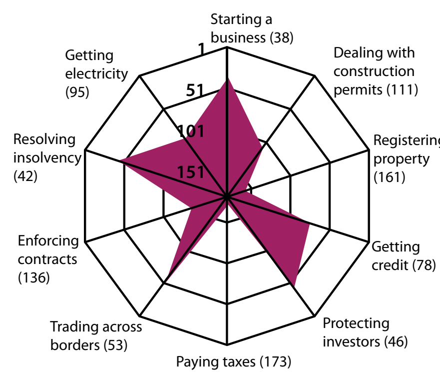
The government's Development Policy Framework for 2010–2016 aims to raise GDP growth to above 8% in the medium term and to nearly double per capita income from $2,400 to $4,200 at the end of the period. The government has therefore embarked on an ambitious plan to remove infrastructure bottlenecks. It has already undertaken significant investments in some sectors, especially among the major infrastructure development initiatives.

The government, as seen in the framework, would like to see a greater role for the private sector through increased investment by both domestic and foreign investors, as investment is key for increasing supply capacity and bolstering growth. The framework also seeks private investor participation (beyond the traditional areas of industry and commerce) in infrastructure. The framework projects private investment to rise from around 21% of GDP in 2011 to about 26–28% in the next few years.

Yet despite the improved political and economic environment, growth in private investment—domestic and foreign—is falling below planned levels. One reason is that the government has taken only a few steps to reduce red tape and improve the business climate, needed to create the conditions for ramping up private investment. Although Sri Lanka's position in the World Bank's *Doing Business* index has improved in 2012 to 89 (out of 183 countries) from 98 in 2011, some challenges still deter private investment (Figure 3.21.9), especially paying taxes.

Investor confidence is a key factor in attracting investment and this requires a predictable policy environment as articulated and reinforced through the legal, regulatory, and institutional framework. Thus the lack of such an environment for the private sector is a major obstacle to private sector development. Developing that framework will reduce uncertainties in the business environment and avoid unplanned actions that may send mixed signals to potential investors.

3.21.9 How Sri Lanka ranks on *Doing Business* indicators



Note: Numbers in parentheses show ranking out of 183 countries worldwide, 1 = best.

Source: The World Bank. Doing Business database. http://www.doingbusiness.org/data (accessed 20 March 2012).