Sri Lanka
State of the Economy Report 2011

Chapter 2
Economic Performance: Post-conflict Growth

by
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2. Economic Performance: Post-conflict Growth

2.1 Introduction

As anticipated, the Sri Lankan economy made a rapid recovery to post a GDP growth of 8 per cent in 2010 amidst a stable and benevolent macroeconomic environment characterized by a low inflation and interest rate regime. While the growth spurt in part reflected a recovery from a low base following the economic downturn of 2009, Sri Lanka's economic performance in 2010 holds up well in the light of global comparisons. The recovery in output and other macroeconomic fundamentals are comparable even to the better performing countries of the Asian region.

> *'Ensuring that Sri Lanka has the necessary macroeconomic policy space to respond appropriately to emerging risks to growth and stability is critical'*

The country's renewed economic vigour owes much to the perception of peace and stability in the aftermath of decades of socio-political conflict. Sri Lanka is also witnessing political stability in the presence of a strong incumbent government and a popular Executive. The combination of factors hold out a real opportunity for the country to embark on a sustained development drive that will deliver better standards of living and help cement social cohesion in the country.

A doubling of per capita GDP over the next few years is being envisaged. However, irrespective of whether Sri Lanka attains this goal or not, the details underlying such a growth momentum need to be given thought. Per capita income on its own can hide socio-economic disparities across and/or within regions, sectors and households. For instance, if the agrarian sector fails to keep pace with other more dynamic areas of economic activity in industries and services - or where surplus rural labour is unable to find alternative sources of gainful employment - aggregate growth alone will not deliver the promise of development to the country as a whole.

Sri Lanka's medium term development agenda as spelt out in the Mahinda Chinthana: Ediri Dakma (Vision for the Future) has taken cognizance of the need to achieve 'balanced growth', be it through rapid infrastructure development of rural and conflict-affected parts of the country or in promoting small and medium enterprises (SMEs) as a key source of livelihoods generation. The task before the government is to effectively implement its development programmes while keeping a watchful eye on the emerging economic shocks that can have a dampening effect on its programmes. In this respect, a keyword is 'stability' on the macroeconomic front - to be attained and retained, in order to allow the authorities the necessary leeway to respond appropriately to changing circumstances. As noted recently, rising food and oil prices in the world market once again pose a threat to the nascent global economic recovery. These developments will have inevitable consequences on Sri Lanka's own economic prospects in the near term. Thus, ensuring that the country has the necessary macroeconomic policy space to respond appropriately to emerging risks to growth and stability, is critical. Sri Lanka has made significant strides in this direction during 2009/10, but the risks must be recognized and appropriate policy adjustments made accordingly.

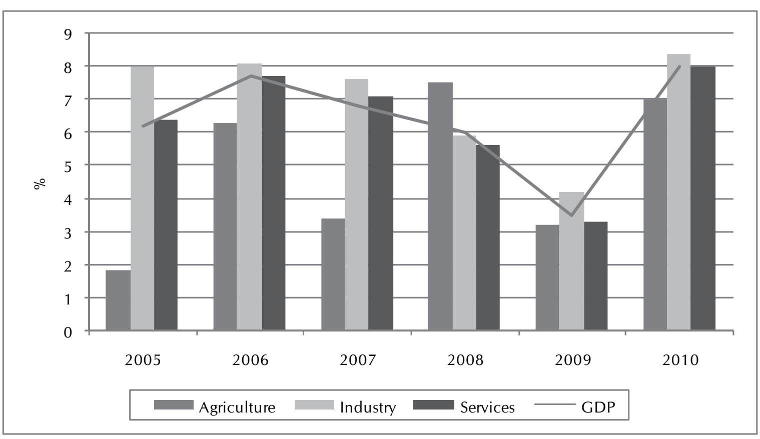
2.2 Output and Employment

Sri Lanka's economic recovery in 2010 was supported by broad-based output growth across all three sectors of economic activity. This is a positive outcome as skewed growth will have adverse outcomes in terms of broader socio-economic objectives, such as rapid delivery of income opportunities to the less well off. Higher growth was accompanied by a recovery in employment creation that saw Sri Lanka's rate of unemployment decline to 4.9 per cent by end 2010.

2.2.1 Output Growth

Even though the agriculture sector, for instance, accounts for less than 12 per cent of GDP, it continues to provide employment to nearly 33 per cent of the workforce. According to the HIES 2009/10 compiled by the DCS, the headcount poverty index is highest in the Eastern, Uva, and Sabaragamuwa Provinces.[1] Agriculture's share of GDP in these provinces at nearly 25 per cent is much higher than at the national level. A strong and sustained performance in the agriculture sector will, therefore, do much to ensure that the benefits of growth are more evenly distributed.

Figure 2.1
GDP and Sectoral Growth



Source: DCS and CBSL, *Annual Report*, various issues.

[1] The HIES 2009/10 did not cover Mannar, Mullaitivu and Kilinochchi districts in the Northern Province.

The strong recovery in agricultural output in 2010 is likely to face some disruption in 2011 with the adverse consequences of inclement weather conditions faced in late 2010/early 2011. In particular, paddy production is estimated to suffer losses as a result of not only destroyed crops, but also owing to the destruction of seeds. However, rising international commodity prices are expected to benefit Sri Lanka's plantation export crops. The overall net impact, however, is likely to ensure that agriculture sector performance will be less buoyant in 2011.

The industrial sector - accounting for 24.2 per cent of employment - recorded a strong rebound of 8.4 per cent growth in 2010, supported by manufacturing sector growth of 7.3 per cent and robust growth in construction of 9.3 per cent. Increased export demand as well as a recovery in domestic consumption helped industrial sector activity to resume after the modest output growth in 2009. The expansion in construction activities is set to continue with the heavy government expenditures on infrastructure related investments as well as the anticipated recovery in the housing and real estate sector.

The services sector has been the mainstay of Sri Lanka's economic growth over the last decade, accounting for nearly 60 per cent of GDP and 43 per cent of employment. Key service sector activities - in trade, leisure, communication and financial sectors - which suffered a downturn in 2009 saw an expansion of activities with the revival of demand in 2010. As Sri Lanka gears to promote itself as a hub for many services-related activities, it will require not only a supportive regulatory environment and infrastructure, but a skilled workforce that is able to meet the demands of an increasingly 'knowledge-driven' economy.

2.2.2 Consumption, Investment and Savings

Consumption expenditure as a percentage of GDP continued to remain relatively subdued, although private consumption had indicated a marginal recovery. The modest recovery is not surprising in view of the lagged effects of the financial sector volatility and economic downturn of 2008/09. Under such circum-

Table 2.1
Sectoral Performance

	Share of GDP (%)	Growth (%)			
	2010	2007	2008	2009	2010
Agriculture	11.9	3.4	7.5	3.2	7.0
Tea	1.1	-1.8	4.2	-8.4	13.1
Paddy	1.8	-6.2	23.1	-5.1	17.5
Industry	28.7	7.6	5.9	4.2	8.4
Manufacturing	17.3	6.4	4.9	3.3	7.3
Construction	6.7	9.0	7.8	5.6	9.3
Services	59.3	7.1	5.6	3.3	8.0
Wholesale and retail trade	23.2	6.1	4.7	-0.2	7.5
Hotels and restaurants	0.5	-2.3	-5.0	13.3	39.8
Transport and communication	13.9	10.5	8.1	6.3	11.9
Banking, insurance & real estate	8.9	8.7	6.6	5.7	7.5

Source: CBSL, *Annual Report*, various issues.

Table 2.2
Consumption, Investment and Savings

	2007	2008	2009	2010
Consumption	82.4	86.1	82.1	81.3
Private	67.2	70.0	64.4	65.8
Government	15.3	16.2	17.6	15.6
Investment	28.0	27.6	24.4	27.8
Private	22.6	21.1	17.9	21.6
Government	5.4	6.5	6.6	6.2
Domestic savings	17.6	13.9	18.0	18.7
National savings	23.3	17.8	23.7	24.7

Source: CBSL, *Annual Report*, various issues.

stances, firms and households are likely to save more and spend less. Indeed, Sri Lanka's domestic savings ratio has crept up from a low of 13.9 per cent in 2008 when the country witnessed a credit boom, to a ratio of 18.7 per cent in 2010.

With domestic savings of 18.7 per cent of GDP, Sri Lanka continued to grapple with a savings-investment gap of over 9 per cent of GDP. While private transfers helped to bridge the gap partially, the need to push for higher volumes of FDI - from a current level of 0.9 per cent of GDP in 2010 - is clear.

Much of Sri Lanka's growth momentum in recent years has been coming from increased volumes of public investment. Clearly, in times of a dip in private investment, public investment plays an important role in keeping the economy buoyant. However, as private investment picks up, the challenges to ensure macroeconomic stability will be felt more keenly. Indeed, the weak private sector investment response in part explains why Sri Lanka was able to maintain a relatively modest inflationary environment in 2010 despite high growth and a fiscal deficit of 7.9 per cent of GDP.

2.2.3 Labour Force and Employment

Sri Lanka's labour market seems to have done well over the years, recording a persistent reduction in the rate of unemployment. According to the Labour Force Survey (LFS) data compiled by the DCS, this decrease is reflected across both males and females. It is also encouraging that the decline is sharper for youth in the 20-24 age group, and for females with more than an Advance-Level education - two groups that have had historically high unemployment rates.[2] Part of the improvement in the unemployment rate in Sri Lanka can be attributed to foreign employment, others being demographic changes and higher participation in education.[3] Following a slight reversal in the unemployment rate in 2009 in the wake of the economic downturn, the unemployment rate has once again come down to 4.9 per cent in 2010.

The unemployment rate alone does not provide a full picture of the labour market conditions of an economy. This is because the unemployment rate might hide the fact that workers are underemployed or doing unproductive work. Hence, usually along with unemployment rates, other indicators are examined to assess labour market performance. The employment-to-population ratio for Sri Lanka has remained around 45 from 2003 onwards, indicating that the ability of the economy to create jobs has stagnated over the years. The proportion of workers participating in the labour market - the labour force participation rate - also had remained just below 50 per cent over the

Table 2.3
Demographic and Labour Force Trends[a]

	2007	2008	2009	2010
Population ('000 persons)	20,010	20,217	20,450	20,653
Labour force ('000 persons)	7,489	8,082	8,074	8,108
LFPR[b] (%)	49.8	50.2	49.2	48.6
Male	67.8	67.9	66.7	67.3
Female	33.4	34.3	33.7	32.1
Unemployment rate (%)	6.0	5.2	5.7	4.9
By gender				
Male	4.3	3.6	4.3	3.5
Female	9.0	8.0	8.2	7.5
By age group				
15-19	21.6	20.6	21.2	21.1
20-29	15.0	13.2	15.1	13.7
By education level				
GCE (O/L)	8.2	7.4	8.1	6.9
GCE (A/L)	11.8	9.9	10.8	11.3

Note: a: Date excludes Northern and Eastern Provinces; b: LFPR = Labour Force Participation Rate.
Source: CBSL, *Annual Report*, various issues.

same period. According to the LFS data, over 60 per cent of the employed were working in the informal sector. These included 83 per cent of those in the agricultural sector, and around a half (49 per cent) of those in the non-agriculture sector.[4]

A large proportion of Sri Lanka's workforce being in informal sector employment also means that they are subject to a higher degree of income insecurity, are likely to receive limited opportunities for skills training and are also exposed to other forms of vulnerability. Indeed, informal sector workers are less likely to be covered by social safety nets which raise their vulnerability in times of acute crises.

2.3 Fiscal Policy Developments

Sri Lanka has seen an improvement in its fiscal policy stance in 2010. The fiscal deficit was reduced to a more manageable 7.9 per cent of GDP in 2010 as opposed to the 9.9 per cent recorded in 2009. The deficit was reduced primarily by a cut in expenditures, predominantly through a cut in current expenditures. This is the preferred course as opposed to a cut in budgeted capital expenditure given its adverse implications to support Sri Lanka's long term growth objectives. Fiscal consolidation efforts have also been encouraging in view of the efforts being made to address weaknesses in revenue generation as well. The key focus is to raise government revenues through tax reforms based on the recommendations of the Presidential Commission on Taxation. The benefits of tax reforms in raising revenue are expected to be seen more sharply in 2011.

Despite the overall positive fiscal outcomes in 2010, Sri Lanka has still to be watchful on fiscal policy trends, particularly in relation to the financing of deficits and implications for public debt management. Essentially, the

[2] Arunatilake, N., and P. Jayawardena, 2010, "Labour Market Trends and Outcomes in Sri Lanka" in R. Gunatilaka, M. Mayer and M. Vodopivec (eds.), *The Challenges of Youth Employment in Sri Lanka*, World Bank, Washington, D. C.

[3] *Ibid.*

[4] Weerakoon, D., and N. Arunatilake, 2011, a report on "Macroeconomic Policy for Full and Productive Employment and Decent Work for All: Sri Lanka Country Study", International Labour Organization, Geneva.

Table 2.4
Government Revenue and Expenditure

% of GDP	2007	2008	2009	2010	2011[a]
Fiscal deficit	-7.7	-7.0	-9.9	-7.9	-6.8
Revenue and grants	15.8	15.6	15.0	14.9	15.6
Tax revenue	14.2	13.3	12.8	13.0	13.6
Expenditure and net lending	23.5	22.6	24.9	22.9	22.4
Recurrent	17.4	16.9	18.2	16.7	16.1
Public investment	6.4	6.0	6.8	6.4	6.5
Deficit financing (domestic)	3.6	7.1	5.1	3.6	4.6
Deficit financing (foreign)	3.7	-0.1	4.8	4.4	2.3
Government debt	85.0	81.4	86.2	81.9	80.0

Note: a: Estimates.
Source: CBSL, *Annual Report*, various issues.

country has been resorting to borrowings to finance higher volumes of infrastructure investments. In principle, governments can justify such borrowing on the grounds that infrastructure investment holds the potential to raise a country's medium to long term growth prospects, enabling higher volumes of revenue to be generated that will allow debt obligations to be met comfortably. The key to such a strategy of course is that investment decisions are taken after a careful assessment of the returns on such investments - i.e., to use debt financing only for projects that generate returns higher than the interest to be paid on related debt.

In recent years, foreign sources have appeared as the dominant means of deficit financing. In 2010, foreign financing of the fiscal deficit amounted to 4.4 per cent of GDP, of which 3.5 consisted of loans and another 0.9 per cent of GDP consisted of foreign capital inflows into government Treasury bills and bonds. The government's preference to limit its recourse to domestic borrowing is aimed to encourage private sector investment in the economy. Under normal economic conditions, heavy domestic borrowing for fiscal financing purposes can crowd out private investment and put upward pressure on interest rates. Higher interest rates in turn would stifle GDP growth prospects.

Foreign currency denominated debt carries well-known additional risks, especially in relation to the exchange rate. In the presence of a growing foreign currency denominated debt portfolio, a depreciating currency leads to a growing public debt-to-GDP ratio. Conversely, an appreciating currency can lead to a lowering of the ratio, as Sri Lanka has witnessed to some extent in recent years. However, a real appreciation of the exchange rate can lead to a deterioration in the current account, whereby any gains on fiscal indicators becomes a temporary phenomenon. That is, in order to restore external sustainability, a country may have to undertake a real devaluation that once again leads to a sudden jump in the public debt-to-GDP ratio. Indeed, the trade-off between fiscal conditions (debt) and exchange rate management can constrict a country's macroeconomic policy space considerably.

The desirability or otherwise of external debt accumulation also depends critically on its composition. Here, Sri Lanka's increasing reliance on costlier non-concessional forms of foreign borrowing in recent years is very clear. Although the country's overall foreign debt-to-GDP ratio has not changed much as previously observed, the composition of foreign debt has changed sharply. For instance, the share of non-concessional and commercial borrowing in Sri Lanka's total outstanding foreign debt has increased notably from 7.3 per cent in 2006 to 37.5 per cent in 2010.

The growing reliance on costlier sources of foreign finance has important implications for Sri Lanka's foreign debt servicing obligations. As evident from Figure 2.3, the country's overall foreign debt service ratio - i.e., the ratio of interest and amortization on foreign debt to earnings from the export of goods and services - has been rising steadily in recent years. In 2009, the ratio rose sharply to 19 per cent as a result of the shrinking of earnings from exports, but has recovered to an extent in 2010 to stand at 15.2 per cent.

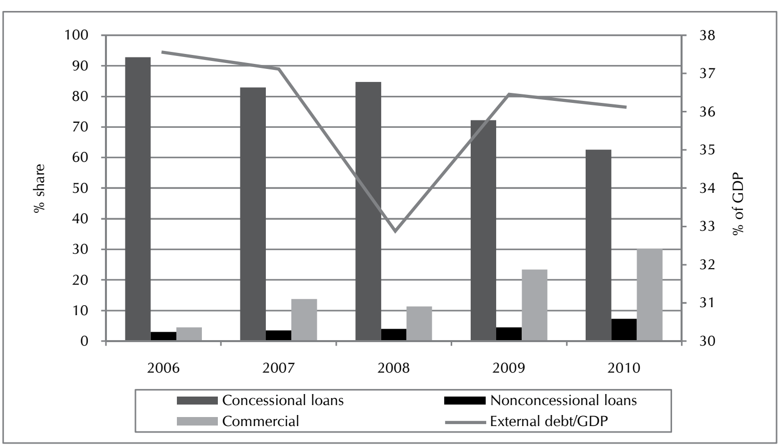
As previously noted, the return on investments financed by debt matters. Much of Sri Lanka's public investment is being channelled to infrastructure such as roads, ports, airports, etc., where such investments may not generate the necessary foreign earnings flows to service the debt in the short to medium term. The most prudent course of course is to ensure that foreign currency denominated debt is confined as much as possible to projects that can, either directly or indirectly, generate the foreign exchange needed to service the debt. This becomes all the more imperative given the fact that despite Sri Lanka witnessing an increase in earnings from the export of goods and services in absolute terms, the ratio of such earnings to GDP has been on the decline (Figure 2.3). It suggests that the higher GDP growth momentum that Sri Lanka has observed in recent years is not being driven by an export-push, but rather by other factors such as higher volumes of government infrastructure investment, etc. which can have considerable multiplier effects on economic activity.

The increased recourse to foreign financing of the fiscal deficit clearly has other spillover effects on macroeconomic management, not least its impact on monetary policy management and exchange rate performance.

2.4 Monetary Policy Developments

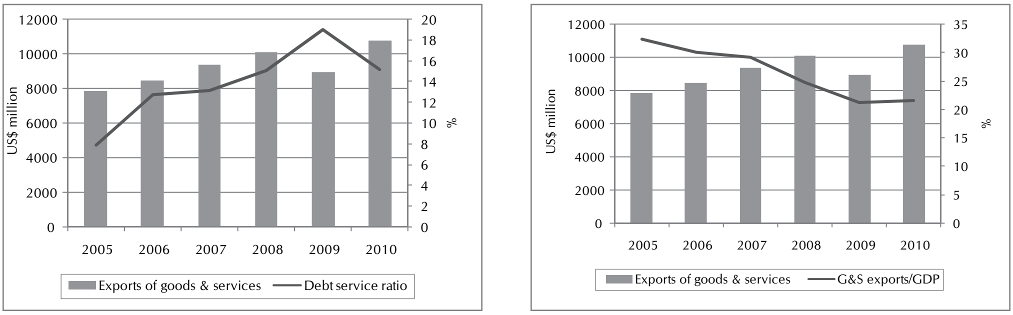
The relatively slow recovery in private investment in 2010 was reflected in weak demand for credit by the private sector for much of the year, despite the improvements to the

Figure 2.2
Emerging External Debt Profile



Source: CBSL, *Annual Report*, various issues.

Figure 2.3
External Debt Dynamics

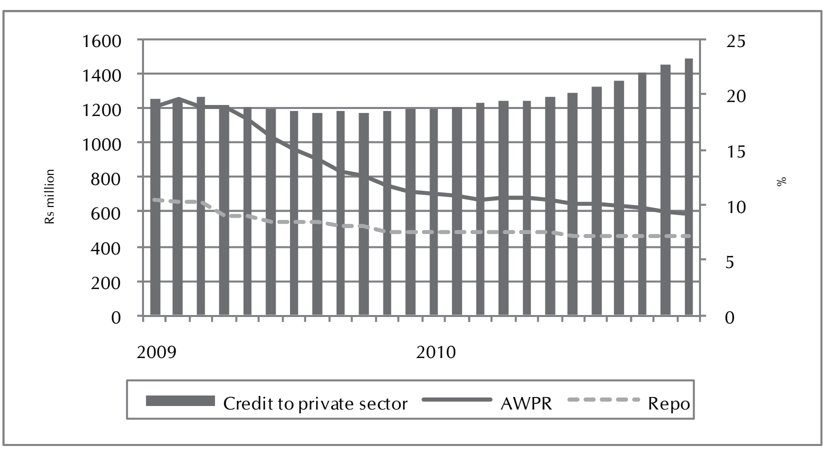


Source: CBSL, *Annual Report*, various issues.

country's medium term economic outlook since the end of the conflict in May 2009. Private sector credit growth remained sluggish, despite attempts to ease monetary policy from early 2009 through downward adjustments to policy rates as well as other directives to commercial banks. Credit growth to the private sector picked up in the latter part of 2010 to record a growth of 25 per cent by year end as compared to a contraction of 5.8 per cent in 2009.

The initial weak recovery in demand for credit by the private sector is perhaps best explained by the over-leveraging of households and firms preceding the economic downturn. Sri Lanka witnessed a credit boom during 2006-07 that was abruptly curtailed with a sharp tightening of monetary policy as the rate of annual inflation peaked at over 22 per cent in 2008. Consequently, the gross non-performing loan (NPL) ratio of the banking sector rose from 5.2 per cent in 2007 to 8.5 per cent in 2009. Thus, Sri Lanka's experience of hesitant private sector investment growth suggests that both supply and demand factors played a role. Despite the signs of an early economic recovery, over-leveraged

Figure 2.4
Demand for Credit



Note: AWPR = Average Weighted Prime Lending Rate.
Source: CBSL, *Monthly Economic Indicators*, various issues.

households and firms may have been less willing to borrow, while banks too may have been less willing to revert to a lending spree. Thus, despite high volumes of excess liquidity in the market - as high as Rs. 120-130 billion by the beginning of 2011 - there was muted inflationary pressures as demand for credit remained low, while the exchange rate movements minimized import-related price pressures. Indeed, Sri Lanka saw a moderate inflationary environment for much of 2010, with inflation beginning to rise only towards the last quarter of 2010, largely as a result of rising food prices in the country (Figure 2.5). A standard monetary policy response to such short term supply shocks is ineffective. Other options such as the removal of taxes and tariffs on food commodities were used to keep prices down, notwithstanding possible adverse impacts on fiscal operations via lost revenues. There is, however, a risk that if demands for wage increases on the back of rising food and fuel prices are accommodated, supply-side induced inflationary pressures can be absorbed into general price increases.

The threat of rising inflationary pressures in the Sri Lankan economy is growing. In April 2011, the Central Bank of Sri Lanka (CBSL) opted to raise the Statutory Reserve Requirement (SRR) on commercial banks by 1 percentage point rather than raise interest rates and set back the recovery in credit growth to the private sector. The SRR works through quantity rather than price and can be effective if there is no significant variation in levels of liquidity between institutions - i.e., forcing credit rationing in those institutions operating at the margins. However, with the government anticipating further inflows of foreign capital in 2011, the risks of igniting 'demand-pull' inflation in the economy continues to remain high.

2.5 External Sector Developments

Sri Lanka saw a significant recovery in earnings from exports of merchandise goods, remittances and tourist receipts in 2010 on the back of a much improved global economic environment. Earnings from merchandise exports grew by 17 per cent, remittances by 24 per cent, and tourism earnings by 65 per cent. Thus, despite import expenditure growing at a much faster pace of 32 per cent relative to export earnings, the country was able to maintain a manageable current account deficit of 2.9 per cent of GDP in 2010.

Notwithstanding the improved earnings via current account flows, the bulk of foreign currency inflows were generated through the capital account of the balance of payments (BOP). Here, the recovery of FDI inflows remained muted while non-equity flows remained high. This included the issue of a US$ 1 billion Sovereign bond in October 2010.

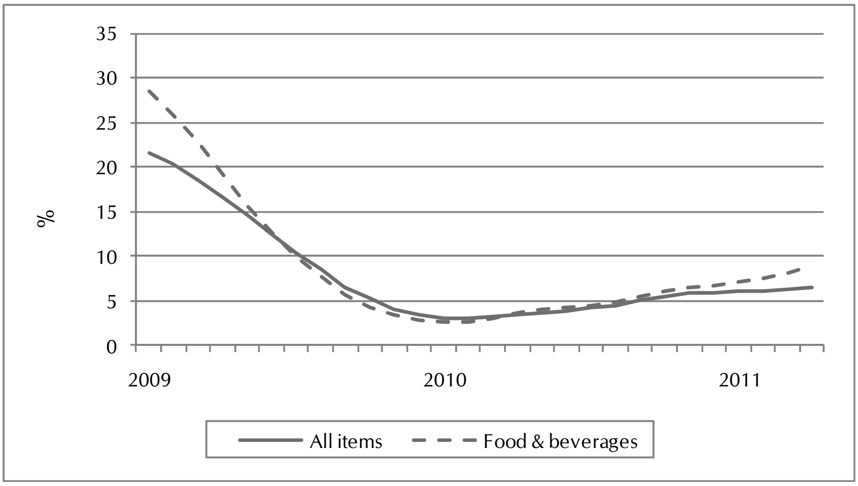
Foreign capital inflows cause upward pressure to be applied on the exchange rate. An appreciation of the real exchange rate in

Table 2.5
Select Monetary and Financial Indicators

% change	2007	2008	2009	2010
Reserve money	10.2	1.5	13.1	18.8
Broad money (M_{2b})	16.6	8.5	18.6	15.8
Credit to private sector	19.3	7.0	-5.8	25.1
Gross NPL ratio of banking sector	5.2	6.3	8.5	5.3
Rate of inflation	15.8	22.6	3.4	5.9

Source: CBSL, *Annual Report*, various issues.

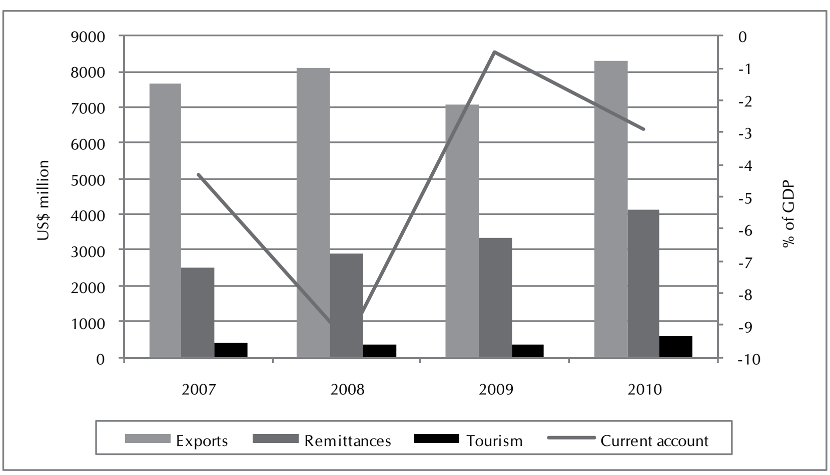
Figure 2.5
Inflation Trends



Source: CBSL, *Monthly Economic Indicators*, various issues.

turn, hurts the competitiveness of domestic exports in international markets. To prevent the currency from appreciating too much, monetary authorities can intervene in foreign exchange markets and mop up foreign capital inflows. This, however, also has the effect of raising the monetary base in the country which can hold inflationary consequences. In 2010, despite intervention by the CBSL, the rupee appreciated by 3 per cent in nominal terms against the US dollar. Of greater concern was the sharper real appreciation of the exchange rate by 5.3 per cent over the same period. As Sri Lanka prepares to float another Sovereign bond of US$ 1 billion in 2011, the continued inflows of foreign capital will require prudent management of monetary policy to ensure that excess rupee liquidity does not spill-over into rising inflationary pressures. Any hesi-

Figure 2.6
Exports, Remittances and Tourism



Source: CBSL, *Annual Report*, various issues.

tance to raise interest rates for fear of squeezing growth will generate macroeconomic instability. In the circumstances, the trade-off between stability and growth needs to be carefully assessed. Sustainable high growth in the long term can only come with a stable macroeconomic environment.

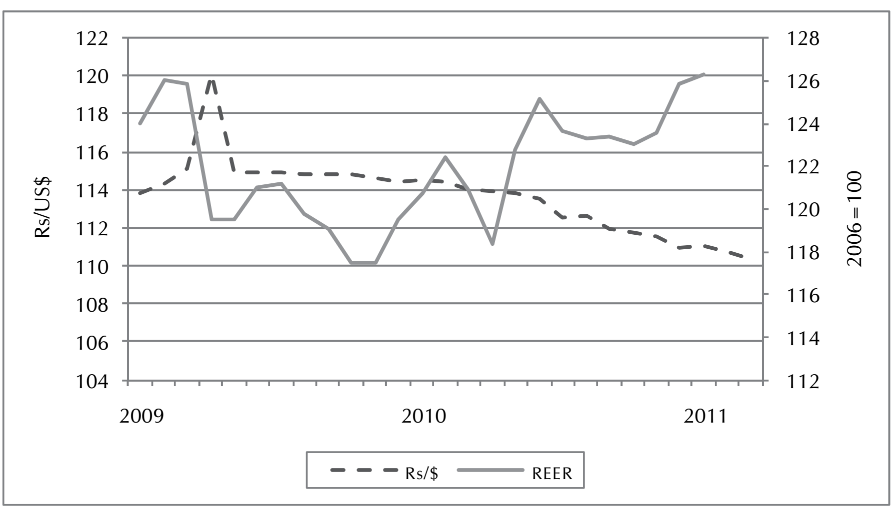
There are emerging threats to the Sri Lankan economy arising from external shocks, primarily in the form of rising food and fuel prices from the latter part of 2010. However, Sri Lanka appears comfortably positioned to deal with external exigencies in the near term with healthy official reserves of US$ 6.6 billion at end 2010, sufficient for 5.9 months of imports. Sri Lanka's accumulation of reserves, however, is not the result of surpluses in the current account of its BOP, but rather the result largely of foreign investments in Treasury bills and bonds, government foreign borrowing, etc. Thus, the country's medium term exposure to external shocks cannot be discounted. Indeed, a weakening of macroeconomic fundamentals could lead to a swift outflow of funds in government debt instruments. Additionally, Sri Lanka remains sensitive to any adverse changes in its sovereign rating that will stymie efforts to raise funds from international capital markets at competitive rates of interest.

2.6 Conclusion

Sri Lanka has experienced a sharp and broad based recovery in economic growth in 2010, accompanied by a stable macroeconomic environment. The country has thus set itself a strong foundation from which to build on what has already been achieved in a relatively short time span of two years following the end of a three decade long debilitating armed conflict. While the near term outlook promises higher growth to achieve the government's development objectives, there are also areas of concern with regards to the evolving macroeconomic environment that cannot be ignored.

Critical amongst these is the growing reliance on costlier forms of foreign borrowing

Figure 2.7
Trends in Nominal and Real Exchange Rate Movements



Source: CBSL, *Monthly Economic Indicators*, various issues.

to finance government capital spending. If Sri Lanka is to continue down this path, a prudent course is to ensure that such borrowings will over time generate foreign currency earnings - directly or indirectly - to meet debt service obligations. The most satisfactory outcome would for Sri Lanka to bridge its savings-investment gap via non-debt sources of finance such as FDI. Here, Sri Lanka's performance has been desultory, with FDI inflows stagnating at 0.9 per cent of GDP in 2010 despite the rather more impressive recovery recorded in all other sectors - viz., export earnings, tourism receipts, remittance inflows, etc.

The failure to generate more dynamism in attracting FDI inflows has been blamed variously on prevailing institutional and regulatory weaknesses. Sri Lanka is attempting to attract FDI in a highly competitive environment, particularly in the neighbouring Asian region. In 2011, the country is likely to see a much better outcome, owing largely to anticipated inflows into the country's real estate and leisure sectors. But it is FDI inflows into skilled manufacturing and service sectors activities that are most likely to boost productivity in the country. Transfers of knowledge and skills that often accompany such FDI inflows are as important as the actual financial flows. Sri Lanka has made the first important breakthrough to attract such investments in future by bringing to an end the unattractive political and security environment for foreign investors that dogged the country through its decades of conflict. It remains for the country to take the next important steps of ensuring predictability and consistency in policy, and strengthening the policies, regulations and institutions that will encourage investors to act on the opportunities available.