Sri Lanka
State of the Economy Report 2015

Chapter 2
Economic Performance

by
Dushni Weerakoon

2. Economic Performance

2.1 Introduction

The Sri Lankan economy is estimated to have grown by 7.4 per cent in 2014, in line with annual average growth registered since 2010.[1] GDP growth in 2015 was a marginal improvement on the 7.2 per cent recorded in the previous year, but below the 7.8 per cent target set for the year. Inclement weather conditions that had adverse impacts on agricultural output pulled overall growth down despite faster growth in industry, especially from construction.

Other macroeconomic indicators were benign with annual inflation down to 3.3 per cent, prime lending rates at a low 6 per cent and a near steady exchange rate. Sri Lanka's external current account deficit fell to 2.7 per cent of GDP from a peak of 7.8 per cent in 2011, helped by a higher earnings from tourism as the trade deficit continued to remain a high 11 per cent of GDP and remittances stagnated at 9 per cent of GDP.

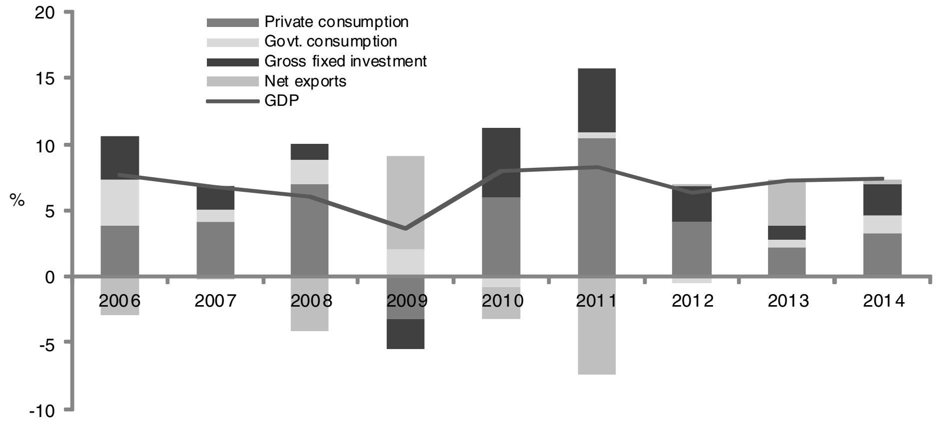
Amongst the positive economic numbers, a troubling sign of continued stress on macroeconomic stability is to be found on the fiscal front. The overall deficit was contained to 6 per cent of GDP, same as in 2013, but fell significantly short of the 5.2 per cent target. In the years that Sri Lanka's overall fiscal deficit continued to fall from a high 9.9 per cent of GDP in 2009, revenues have continued to shrink with tax revenue falling to an all-time low of 10.7 per cent in 2014. The fiscal numbers indicate the long-term fragility of sustaining Sri Lanka's debt-funded, and overwhelmingly infrastructure-investment driven, growth. Already in 2014, public investment was cut to 5 per cent of GDP from its peak of 6.8 per cent of GDP in 2009.

The overall economic outlook for 2014 was perceived to be sufficiently positive for the government to face early elections in 2015. In the event, the electoral defeat at presidential polls in January 2015 had little to do with economics and more to do with perceived problems on governance and corruption. In the first six months of the year, the economy continued to function in a near policy vacuum as political parties fought over constitutional and electoral reforms, well beyond the 100-day limit that was to end on 23 April 2015 with the dissolution of Parliament. In the interim, cracks are appearing in the Sri Lankan economy with fiscal policy consolidation under threat, pressure on the exchange rate and a moderation in GDP growth.

The Central Bank of Sri Lanka (CBSL) set a revised growth target of 7 per cent for 2015, the first time that the growth forecast has been revised downwards since 2011. Then, it was a deliberate policy decision to allow growth to slow in the wake of high growth (8.2 per cent) and signs of overheating. The decision to lower Sri Lanka's growth outlook for 2015 is for different reasons, primarily to allow for a political transition that could well impact on economic policy direction. The revised estimate set in April 2015 is beginning to look ambitious, with growth moderating to 6.4 per cent in the first quarter of 2015 and the country's policy deadlock continuing well beyond the 100-days and into the second half of the year.

[1] See Box 2.1 on preliminary revised GDP estimates released by the DCS after re-basing Sri Lanka's national accounts.

Figure 2.1
Growth Decomposition



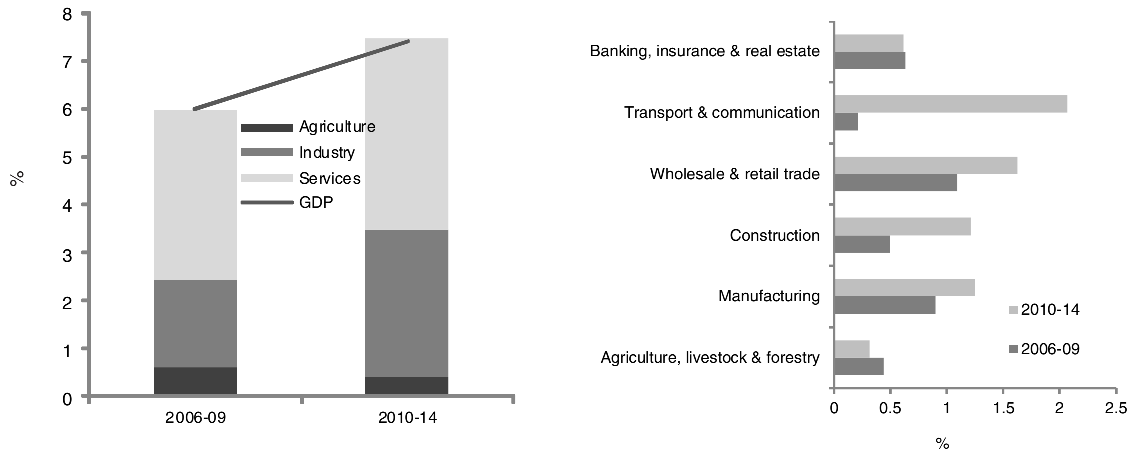
Source: CBSL, *Annual Report*, various years.

2.2 Realigning GDP Growth

The most telling feature of Sri Lanka's impressive GDP growth averaging a near 7.5 per cent per annum since 2010 is the weak contribution of net trade, in an economy driven by private consumption and public investment (Figure 2.1). From 2006 onwards, the country's development programme relied massively on an infrastructure drive, with public investment jumping to over 6 per cent of GDP from a more modest 4 per cent previously. Infrastructure projects were rolled out more strongly from 2010 after the conclusion of the war.

Not surprisingly, the infrastructure-led economic expansion is echoed in the breakdown of GDP growth. The contribution to growth from the industry sector increased markedly post-2010 as a result primarily of construction related activities (Figure 2.2). The services sector contribution also expanded post-2010, driven by transport and communication and retail trade. Indeed, the government has viewed

Figure 2.2
Sectoral Contribution to Growth



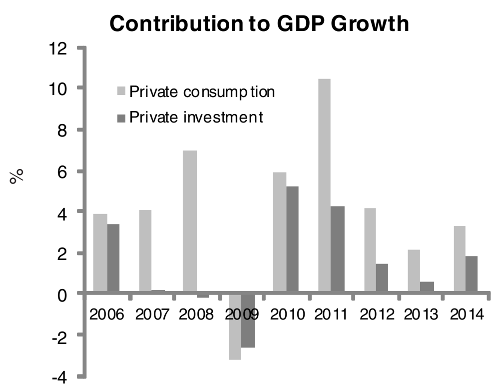
Source: CBSL, *Annual Report*, various years.

infrastructure as Sri Lanka's opportunity to unlock growth. Many of the big road infrastructure projects offering better internal connectivity do meet growing demand for public goods. At the same time, however, these and other high cost public infrastructure investments in ports, airports and such that have been powering the Sri Lankan economy cannot continue indefinitely without greater private sector investment in the economy.

Modest private investment, hovering around 23 per cent of GDP, is a continuing source of concern (Table 2.1 and Figure 2.3). Sri Lanka's narrow growth base and a more visible and heavy-handed state presence in these expanding economic sectors served to deter private investment from taking off. As previously noted, as a corollary, Sri Lanka's economic growth is led by consumption, accounting on average for 80-85 per cent of GDP. This is in contrast to many fast growing emerging market economies in Asia that raised their investment and boosted the supply of goods to the rest of the world at the cost of consumption in their own economies. In Sri Lanka, current levels of consumption are associated with over-extended government fiscal positions, high debt levels, and current account deficits.

In Sri Lanka, current levels of consumption are associated with over-extended government fiscal positions, high debt levels, and current account deficits.

Figure 2.3
Consumption, Investment and Savings



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

Table 2.1
Consumption, Investment and Savings

% of GDP	2012	2013	2014
Private consumption	69.6	66.9	65.4
Total consumption	83.1	80.0	78.9
Private investment	23.7	22.7	22.9
Total investment	30.6	29.5	29.7
Domestic savings	16.9	20.0	21.1
National savings	24.0	25.8	27.0

2.3 Public Finance Management

For many decades, the perilous state of Sri Lanka's public finances acted as a drag on economic growth and broader development objectives, hindering the delivery of efficient and effective public services. Fiscal deficits averaging 10 per cent of GDP was not uncommon, with knock-on effects on other critical areas of macroeconomic policy management, most notably in the conduct of monetary policy. The most visible manifestation of the resultant instability was high and volatile rates of inflation in the Sri Lankan economy, deterring private investments and savings. With rising fiscal imbalances, the country's indebtedness also rose - peaking most recently at 102 per cent of GDP in 2004 - narrowing the options for policy manoeuverability and limiting the ability to respond appropriately to domestic and external shocks.

Since 2009, however, when the deficit peaked at 9.9 per cent of GDP, Sri Lanka appears to have made significant headway in reversing fiscal fortunes with the deficit down to 6 per cent of GDP in 2014. The contraction has come with a better mix of fiscal retrenchment, focused on restraining current spending whilst accelerating capital investment. Over the same period, the public debt-to-GDP ratio has climbed down steadily from 86.2 per cent to 75.5 per cent (Table 2.2).

Despite these improvements in overall macroeconomic indicators, Sri Lanka's fiscal situation remains fragile. This stems largely from lack of progress on two fronts; rationalizing and streamlining government expenditure at all levels, and reversing Sri Lanka's deteriorating government revenue collection.

Current expenditures stand at well over 110 per cent of GDP and its composition - primarily made up of salaries and wages, interest payments on public debt, and transfers and subsidies - has hardly changed over time, underlining the lack of meaningful reform efforts in public finance management (Table 2.3). These relate especially to public sector reform initiatives and welfare measures. Sri Lanka has a large and growing cadre of public sector employees, estimated to account for 15.3 per cent of the total employed in 2014. In addition, Sri Lanka continues to implement a host of subsidies and transfers where issues of targeting and the effectiveness of outcomes in welfare programmes (e.g., Samurdhi) or subsidies (e.g., fertilizer) have been subject to considerable debate. In addition, public finances are heavily burdened by a non-contributory pension scheme, whilst at the same time leaving a large share of Sri Lanka's elderly and vulnerable population without adequate means of social protection. Without rationalizing current spending patterns, the country will be hard pressed

Table 2.2
Select Fiscal Indicators

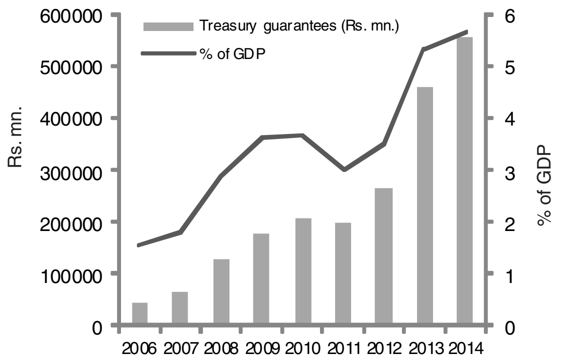
	2012	2013	2014
Total revenue	13.9	13.1	12.2
Tax revenue	12.0	11.6	10.7
Total expenditure	20.5	19.2	18.3
Recurrent	14.9	13.9	13.5
Public investment	5.9	5.5	5.0
Fiscal deficit	6.5	5.9	6.0
Public debt	79.2	78.3	75.5

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

Table 2.3
Select Expenditure Shares

	2006	2010	2014
% of current exp. (%)			
Salaries and wages	32.0	32.0	33.3
Interest payments	27.4	37.6	33.0
Subsidies & transfers	26.3	20.9	21.3
% of GDP			
Education exp.	2.7	1.9	1.9
Health exp.	2.0	1.3	1.4

Figure 2.4
Treasury Contingent Liabilities



Source: CBSL, *Annual Report*, various years; and Ministry of Finance, *Annual Report*, various years.

to focus on areas such as education and health, where spending as a share of GDP has declined.

There has also been no progress in halting losses incurred by state-owned enterprises (SOEs) in Sri Lanka. Since 2005, there has been a clear policy reversal with further privatization efforts ruled out in favour of 'restructuring' SOEs. However, SOEs continue to makes huge losses, especially the larger corporations such as the Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC) and Sri Lankan Airlines (Table 2.4).

Sri Lanka's Fiscal Management Responsibility Act of 2003 capped direct borrowing by state entities with Treasury guarantees - treated as a contingent liability - to 4.5 per cent of GDP. This was subsequently amended in the Budget 2013 and raised to 7 per cent. The move to encourage state enterprises to resort to direct borrowing is mooted on the grounds that government guarantees will ensure better terms and conditions, and enable the government to ensure that they fulfill prudential requirements if they wish to obtain such guarantees. However, there are significant downside risks in view of the poor financial performance of most SOEs. It is likely that on their own balance sheet and financial rating, without the unfettered support of government

Table 2.4
Operating Losses of Select SOEs

Rs. billion	2012	2013	2014
CEB	-62.1	24.6	-11.7
CPC	-89.6	-7.9	1.7
SriLankan Airlines	-27.0	-28.6	-29.0

guarantees, many would not be able to raise the volumes of funding needed. In addition, the risks multiply when such funding is obtained from other state-entities such as state-owned financial institutions. As seen in Figure 2.4 contingent liabilities have increased sharply from 1.6 per cent of GDP in 2006 to 5.7 per cent of GDP in 2014 heightening systemic risks for overall fiscal stability.

If performance of public finance management on the expenditure front has been mixed, fiscal performance on the revenue front has clearly failed. Revenue as a share of GDP has declined persistently despite rising per capita income. A part of the reason for low tax revenue generation is perhaps to do with the changing structure of the Sri Lankan economy, where many of the country's large services sector tends to be informal and cash-based. Unless tax administrative structures are efficient and effective, collection of tax revenues becomes harder.

The inability to reverse a weakening revenue base comes despite a number of recommendations to address tax administration and policy issues as per the Presidential Taxation Commission report of 2010. The implementation of reforms at best has been ad hoc and incomplete.

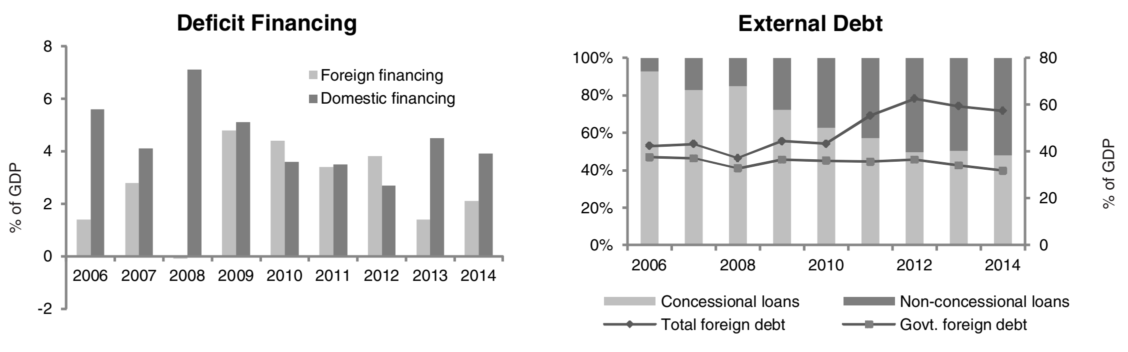
Rising expenditures and declining revenues have seen Sri Lanka rely increasingly on foreign borrowing for budgetary support. Where domestic borrowing implies a higher interest rate as the government competes with firms for limited investment funds, the effect is muted when a country accesses foreign capital, because the budget deficit can be financed from abroad.

2.3.1 Deficit Financing and External Debt

Sri Lanka obtained a sovereign credit rating in December 2005 with the express purpose of tapping international financial markets. Between 2007 and 2014, the country issued seven sovereign bonds to the tune of US$ 5.5 billion. This was accompanied by an incremental opening up of the government securities market to foreign investors. The threshold limit of 5 per cent of Treasury bonds outstanding introduced in 2006 was relaxed to 10 per cent in 2007. In 2008, Sri Lanka opened its Treasury bill market to foreign investors with a threshold limit of 10 per cent. In December 2011, the threshold limit was further expanded to 12.5 per cent of outstanding Treasury bills and Treasury bonds stock. Sri Lanka also tapped bilateral loans, particularly from the Export-Import (EXIM) Bank of China to fund large infrastructure projects including roads and transportation, power and energy, and ports.

Treasury contingent liabilities have increased sharply from 1.6 per cent of GDP in 2006 to 5.7 per cent of GDP in 2014 heightening systemic risks for overall fiscal stability.

Figure 2.5
Deficit Financing and Government External Debt



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

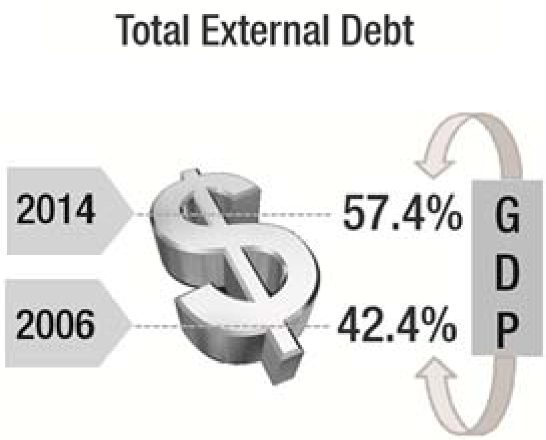
Regulations governing foreign borrowing by Sri Lanka's private sector have also been eased to encourage private firms and commercial banks to tap foreign sources for funding.[2] In addition, two development banks (DFCC and NDB) were given special dispensation to raise foreign loans without having to bear the related exchange rate swap costs. These sources provide the government with an indirect source of foreign borrowing through on-lending activities of the financial institutions. In effect, however, such borrowing amount to proxy borrowing by the government, with added risks of multiple parties exposing their balance sheets to international capital markets.

Thus, Sri Lanka has increasingly come to rely on foreign financing to bridge its fiscal deficit (Figure 2.5). This has brought about two significant changes to the country's external debt profile. In the first instance, while total government external debt has remained relatively flat, the country's total external debt-to-GDP ratio has risen sharply (Figure 2.5). A part of this debt is non-sovereign backed debt incurred by private corporates and banks relying on corporate balance sheets, and is not under the purview of the government.

A second notable feature is that even though the government external debt-to-GDP ratio has declined, the composition of that debt has changed dramatically with the shift to more costly non-concessional and commercial sources of borrowing. Where these accounted for just 7 per cent of total outstanding government external debt in 2006, by 2012 it had come to account for more than 50 per cent. Thus, Sri Lanka's external debt servicing obligations are set to rise significantly in the foreseeable future as a result of high cost external borrowing.

In principle, governments can justify borrowing for capital investment on the grounds that better infrastructure 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. It must also be kept in mind that capital investments with high operational and maintenance costs generate additional fiscal burdens down the road.

Thus, the return on investments financed by debt matters, particularly when it is foreign denominated debt. 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 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, whilst all possible efforts are made to mobilize domestic resources.



[2] The Budget 2013 proposals permit LCBs and corporate entities to borrow up to US$ 50 million and US$ 10 million, respectively, each year for three years without the approval from the Department of Exchange Control.

Clearly, the means through which the fiscal deficit is financed today has implications on debt management and economic stability in the medium to longer term. The direction of overall trends on the fiscal policy front in conjunction with other key indicators suggests strongly that significant changes are required. High cost external debt is being accumulated while government revenues continue to decline; higher GDP growth through externally debt financed public investment spending is not coming via an export surge, requiring debt to be rolled over continually. Cost-effective debt rollover hinges on two critical factors - i.e., prevailing domestic macroeconomic stability and global financial conditions. If either or both of these are unattractive, costs of rolling over external debt can rise substantially.

2.4 Monetary Policy and Exchange Rate Misalignment

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, when countries resort to external borrowing, the trade-off between fiscal conditions (debt) and exchange rate management can constrict macroeconomic policy space considerably.

Inflows of foreign capital associated with higher volumes of borrowing then spills over into the conduct of a monetary and exchange rate policy management. Sri Lanka has witnessed the above

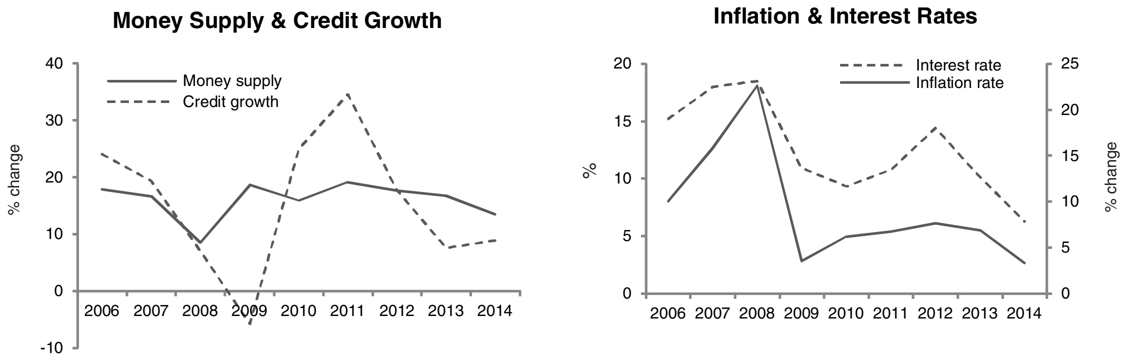
When countries resort to external borrowing, the trade-off between fiscal conditions (debt) and exchange rate management can constrict macroeconomic policy space considerably.

tensions in coordinating macroeconomic policy, the failure of which brought about significant instability.

Inflows of capital typically prompt central banks to intervene in the foreign exchange market. This may be to avoid volatility in exchange rate movements, and to prevent an undue appreciation that hurts export competitiveness. In 2010, for example, as capital inflows were mopped up in order to target the exchange rate, the build-up of foreign exchange reserves saw the domestic monetary base expand (Figure 2.6). An expansion in the monetary base without a corresponding increase in production holds potential inflationary consequences.

To compound matters, the CBSL used both regulatory tools and moral suasion to persuade banks to lower interest rates from mid-2010 in order to boost Sri Lanka's immediate post-war economic recovery. A sharp increase in credit growth,

Figure 2.6
Monetary Indicators

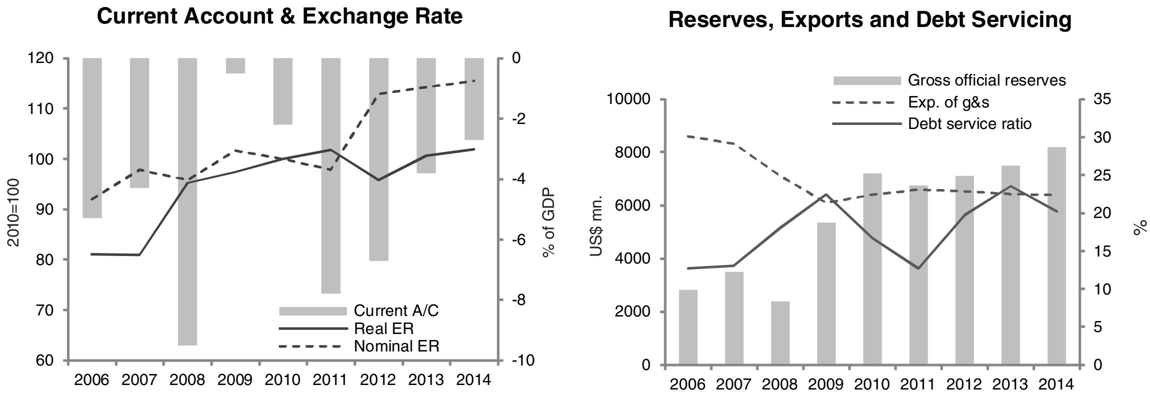


Source: CBSL, *Annual Report*, various years.

particularly in sectors such as consumption, began to fuel inflation and precipitated the imposition of a mandatory ceiling on commercial bank credit growth in January 2012.

Cheap credit stimulated an import surge that was to be even more damaging. As the trade deficit expanded and the current account deficit increased to 7.8 per cent of GDP in 2011, the CBSL opted to draw down official reserves in defence of the currency at a pre-determined 'fixed' rate. By February 2012, the country was teetering on a balance of payments crisis, exactly three years to the date that it last approached the IMF for a bailout package after a similar untenable defence of the currency. A BOP crisis was averted only after a series of policy reversals in March 2012, the most important of which was a sharp devaluation of the rupee.

Figure 2.7
External Sector Indicators



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

The relatively inflexible exchange rate policy stance is hurting exports - the very sector that needs to generate foreign exchange earnings if Sri Lanka is to service its growing external debt comfortably. Instead, capital inflows have distorted the exchange rate artificially - where a real appreciation is occurring against the fundamentals of a weak external current account position - leading to an appreciating real effective exchange rate (REER) and hurting export competitiveness.

Thus, Sri Lanka is more exposed today to external shocks as its external debt and related indicators such as the external debt service ratio rises (Figure 2.7). Where a sizeable volume of official foreign reserves might have provided comfort as a buffer, the fact that the bulk of reserves is also made up of foreign borrowings is a downside. The purchase of government debt by non-residents and purchase of international reserves by governments are both pro-cyclical. During good times with lower default risk, governments may be tempted to borrow more. In the event of any shock to the economy, governments will be forced to cut down on borrowing and use available reserves to smooth out consumption. These conditions can result in a collapse of both the purchase of government debt by foreign investors, as well as the ability of governments to raise foreign borrowings, leading to external crises.

Having restored exchange rate stability after a devaluation of over 17 per cent in the first half of 2012, the CBSL turned its attention to aggressively ease monetary policy once more from end- 2012. The measures adopted include cuts to policy rates, slashing of Statutory Reserve Requirement (SRR) of Licensed Commercial Banks (LCBs), reductions to penal rates of interest charged on all loans and advances by LCBs, etc. However, as evident from Figure 2.6, despite the steady drop in interest rates, credit growth to the private sector remained stubbornly low.

The reasons for the overdue credit pick-up are perhaps partly explained by the doubling of credit growth to the private sector during 2009-12. It is not surprising that the credit overload of the past takes time to work its way through the economy, deterring fresh uptake in the interim. A second reason is perhaps related to Sri Lanka's recent growth pattern, dominated by non-tradable services sectors and other industry sectors such as construction and utilities. Many of these also have large state involvement. Booming sectors where businesses can plug-in investments is more limited than the overall high GDP growth numbers would suggest, as highlighted in the past by high credit uptake for consumption. Thus, Sri Lanka's most recent episode of monetary easing to stimulate growth, underscores

Capital inflows have distorted the exchange rate artificially - where a real appreciation is occurring against the fundamentals of a weak external current account position - leading to an appreciating real effective exchange rate (REER) and hurting export competitiveness.

the reality that such a policy stance helps only if the economy is constrained by the money supply, and is failing to follow growth in economic efficiency and value added.

2.5 Economic Performance 2015 and Outlook

The electoral outcome of January 2015 signalled a change of course for the Sri Lankan economy on several fronts. The most immediate was a slowdown of some of the infrastructure development initiatives of the previous regime, the implementation of electoral pledges through a revised budget for 2015, and enunciating a new economic policy direction for the country.

That any new government would revisit Sri Lanka's ambitious publicly funded infrastructure projects to assess their economic viability and funding is to be expected. Some key initiatives, such as the Colombo Port City Expansion project undertaken by China, were suspended as a result. There was also, however, a more general slowdown in infrastructure spending as fresh fiscal estimates were worked out. The budget presented in end January 2015 delivered on many of the pre-election promises such as a reduction in fuel prices and an increase in public sector salaries and pension payments, whilst attempting to introduce new revenue generating measures by way of one-off taxes on private businesses, imposition of a 'mansion tax' on housing, etc., to meet additional expenditure commitments.

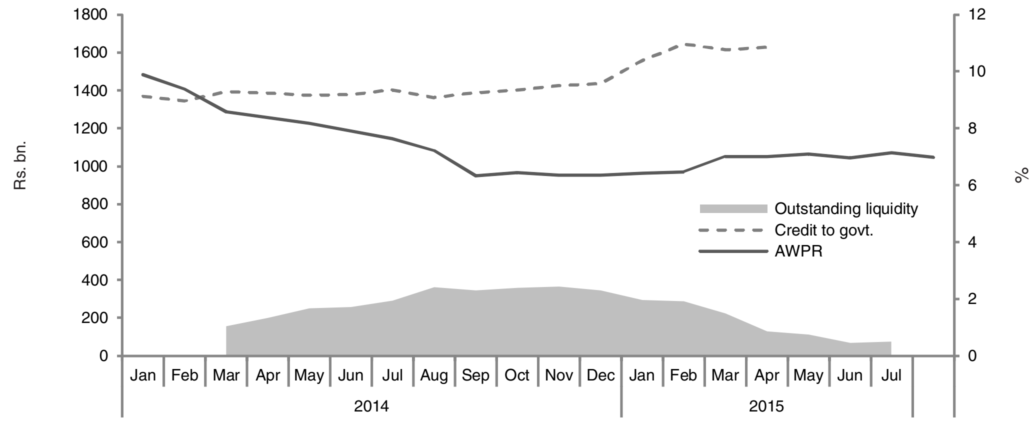
Fiscal policy management has run into difficulties as proposed new revenue measures failed to be placed before Parliament after the defeat of a government move in April 2015 to raise Treasury bill borrowing limits. With current expenditures rising, capital spending has borne the brunt of cuts (Table 2.5). Financing of the deficit has also changed in the interim, with net domestic financing of Rs. 444 billion during January-June 2015 exceeding the Rs. 341 billion total net domestic financing for the entire year in 2014. As the government tapped the domestic market for funds, net credit to the government expanded, outstanding liquidity shrank and interest rates began to nudge upwards (Figure 2.8). The impact on interest rates was partly subdued owing to the low demand for credit by the private sector in view of anticipated Parliamentary elections and associated uncertainties.

Table 2.5
Fiscal Outcomes (Jan-June 2015)

	Budget Estimates (% of GDP)			Fiscal Outcomes (Rs. bn.)	
	2014	2015[a]	2015[b]	Jan-Jun 2014	Jan-Jun 2015
Revenue	12.2	14.6	14.1	536	605
Current exp.	13.5	13.5	14.2	637	769
Public investment	5.0	6.2	4.6	278	223
Overall deficit	6.0	4.6	4.4	371	401
Financing					
Foreign	2.1	2.2	2.2	129	-41
Domestic	3.9	2.4	2.2	242	444

Notes: a: Estimates presented in Oct. 2014; b: Revised estimates presented in Jan. 2015.
Source: CBSL, *Annual Report*, various years; Ministry of Finance.

Figure 2.8
Net Credit to Government, Outstanding Liquidity and Interest Rates



Source: CBSL, "Weekly Economic Indicators", various issues.

The government was forced to tap domestic financing not only because of the failure to implement new revenue measures, but also as a result of slowdowns and delays in accessing foreign financing. The rolling back of the infrastructure push meant that the inflow of funds by way of long-term loans declined quite sharply in the first five months of 2015 (Table 2.6). In addition, the country experienced some delay in issuing an announced Sovereign bond placement. This finally materialized in end May 2015 for US$ 650 million at a yield rate of 6.125 per cent with a 10 year maturity, slightly above the last 10 year Sovereign bond yield rate of 5.875 obtained in July 2012.

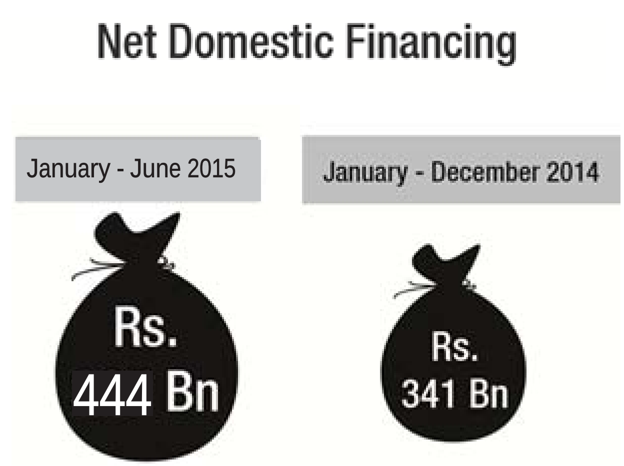


Table 2.6
Foreign Inflows (January-June)

Inflows to govt. (US$ mn.)	2014	2015	External Current Account (US$ mn.)	2014	2015
Treasury bills & bonds	941.9	547.4	Trade balance	-3,535.2	-4,085.8
Sovereign bonds	1,500.0	650.0	Remittances	3,360.0	3,432.7
Long-term loans	1,002.2	490.8	Tourism	1,157.9	1,321.4

Source: CBSL, "External Sector Performance", various issues.

In the first half of 2015, there has been a significant slowdown of foreign capital inflows overall, as well as a deterioration in the trade deficit (Table 2.6). Inflows from foreign investment in Treasury bills and bonds and long-term loans to the government declined sharply. The trade deficit in the first half of 2015 weakened by over 15 per cent; the more serious is the slow contraction in export earnings of 0.6 per cent over the same period. Earnings from worker remittances have also slowed to a low 2.2 per cent in the first half of 2015 compared to 10.5 per cent growth in the first half of 2014. Thus, Sri Lanka's current account is also under pressure.

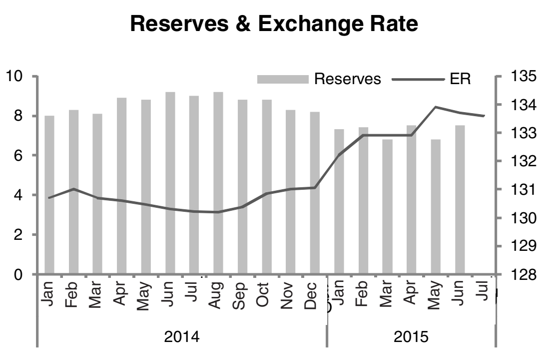
External sector developments have had an inevitable impact on the exchange rate. However, the currency has been allowed to depreciate by only around 2 per cent, with CBSL intervention in the foreign exchange market through a drawdown of official reserves. By March 2015, reserves were recorded at US$ 6.8 billion, sufficient for 4.2 months of imports, relative to holdings of US$ 8.2 billion at end 2014 (5.1 months of imports). In addition to supporting the currency, reserves were also used for immediate foreign debt settlements. Official reserves were augmented with a US$ 400 million swap arrangement with the Reserve Bank of India (RBI) in April 2015, a Sovereign bond issue in May 2015 and a further swap agreement with RBI for US$ 1.1 billion in July 2015. At end June 2015, official reserves stood at US$ 7.5 billion, sufficient for 4.5 months of imports.

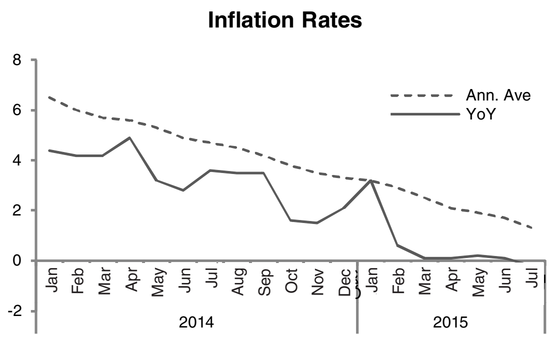
In contrast to higher domestic borrowing by the government, upward pressure on interest rates and depreciating pressure on the exchange rate, Sri Lanka's consumer price inflation captured by the Colombo Consumer Price Index (CCPI) has been on a sharp downward trend, with the annual inflation rate edging to a low 1.3 per cent by July 2015 (Figure 2.9). However, Sri Lanka's low inflationary environment is unlikely to persist if the current subdued economic activity reverses in the fourth quarter of 2015 pursuant to a stronger political outlook following Parliamentary elections.

In the first half of 2015, the lack of a clear policy direction on the economic front is taking a toll on Sri Lanka's economic growth prospects for 2015. First quarter 2015 GDP estimates suggest that economic growth slowed to 6.4 per cent relative to a growth rate of 7.6 per cent in the first quarter of 2014. The sharp deceleration in construction sector growth was to be expected; what appears to be a more general slowdown in productive economic sectors such as manufacturing, and transport and communications is, however, of concern.

Sri Lanka's growth outlook for 2015 is thus set to moderate. At the same time, the Department of Census and Statistics (DCS) has undertaken a re-basing of national account estimates that is likely to re-set the country's medium to long-term growth projections once the revised methodology is finalized (Box 2.1).

Figure 2.9
Movements in Exchange and Inflation Rates





Source: CBSL, "External Sector Performance" and "Monetary Policy Review", various issues.

Box 2.1
Re-basing Sri Lanka's GDP

Sri Lanka's Department of Census and Statistics has undertaken a re-basing of its national account estimates. The most current approximations are based on 2002 production and consumption patterns. Over time, this one-year snapshot of the economy becomes less accurate and can lead to overestimation of traditionally dominant sectors such as agriculture and underestimation of newer sectors, especially those in the services sectors. The IMF statistical division recommends a change of base year every fifth year. Sri Lanka has not done so since 2002 suggesting that the previous GDP framework underestimated economic activity. The re-basing uses 2010 as the new base year, and includes expanded coverage of economic activities through information collected by various censuses. This, together with other changes such as the adoption of the 2008 System of National Accounts, re-classification of economic activities as per the International Standard of Industry Classification (ISIC), etc., will also mean changes in the sectoral composition of GDP. In total, the old and new national accounts will not be comparable.

While data challenges remain in any attempt to compile national accounts, additional complexities exist to accurately estimate the size of Sri Lanka's significant informal economy. Notwithstanding such weaknesses, a regular re-basing exercise is extremely useful to provide a clearer picture of an economy's size and structure and allow a better planning of longer term growth and development options.

Absolute GDP Estimates

	GDP at Market Prices (Rs. mn.)		GDP at Constant Prices (Rs.mn.)
	2002 Base	2010 Base	2010 Base
2010	5,604,104	6,413,668	6,413,668
2011	6,543,258	7,219,106	6,952,720
2012	7,578,555	8,732,463	7,588,517
2013	8,674,228	9,592,125	7,846,202
2014	9,742,240	10,291,581	8,195,979

Source: DCS.

The DCS' statistical exercise has produced revised nominal and real GDP estimates for Sri Lanka for the period 2010-14. At the aggregate level, the re-basing exercise suggests that share of agriculture in GDP is smaller and that of industry is larger than previously estimated, and that the Sri Lankan economy continues to be a services sector dominated one. This is not surprising in view of expanded activities involving sectors such as telecom, information technology, etc., that is better captured with fresh sources of data.

The re-basing also shows that the absolute size of the Sri Lankan economy in 2010 was larger by over 14 per cent than previously estimated. Nominal GDP re-basing produces cosmetic changes, with some changes in key indicators; for example, Sri Lanka's per capita GDP has risen to US$ 3,795 in 2014 from the previously estimated US$ 3,625 as a result of the re-basing. At the same time, the increase has not been sufficiently large to significantly impact fiscal deficit-to-GDP or public debt-to-GDP ratios, and as such, holds limited broader economic consequences.

GDP Growth Estimates

	GDP Growth (%)			Price Change (%)	
	2002 Base	2010 Base	CCPI	Old GDP Deflator	New GDP Deflator
2011	8.2	8.4	6.7	7.9	3.8
2012	6.3	9.1	7.6	8.9	10.8
2013	7.2	3.4	6.9	6.7	6.2
2014	7.4	4.5	3.3	5.1	2.7

Source: DCS.

The new estimates matter if GDP growth rates are an important consideration for governments. Slower real growth after a re-basing exercise is a fairly common and accepted occurrence as witnessed in many of the African countries that have done similar exercises. This is because with economic growth, changes in relative prices are to be expected; in effect, re-basing of real GDP means adopting a new set of reference prices to value output in each year. If there has been fairly strong economic growth and relative prices have changed, then almost certainly the first year will have a higher measured real GDP when national accounts are re-based. With a higher initial level of GDP, the growth rate can turn out to be smaller.

What is puzzling in Sri Lanka's re-based real GDP growth is that even as output moves to a higher base in 2010, significantly high growth rates are recorded for 2011-12, followed by a sharp decline; indeed, growth appears to have shrunk from 9.1 per cent to 3.4 per cent year-on-year during 2012/13. Thus, Sri Lanka's real GDP growth after re-basing – measured by reference to the prices and structure of the economy in 2010 – appears to have grown at sharply varying rates in subsequent years.

The DCS has devised a GDP implicit price deflator with a revised base year of 2010 – with weights assigned to capture price changes and derive constant value added. The new GDP deflator shows significant volatility against not only the old GDP deflator, but also against the consumer price index, CCPI. Clearly, the data and methodology employed in re-basing Sri Lanka's GDP estimates need further study and clarification, but going forward, what the preliminary data seem to suggest is that the country is set to experience a slower rate of economic growth because of the revision, and resultant larger GDP base.

2.6 Conclusion

Just as today's policy focus on taxation, spending, deficits, and debt affect current economic growth, they will also have an equally, if not more important bearing on economic growth and stability in the long-term. Sri Lanka's unabated practice of competitive populism ensures that political parties routinely discount the economic costs of electoral promises and handouts. The fiscal costs, and the related broader consequences on macroeconomic stability, are ignored.

With two closely contested elections in one year – seven months apart – the impact of such profligacy can be high. Sri Lanka's fiscal situation is already straining under additional expenditure commitments undertaken following presidential elections in January 2015. Similarly, in parliamentary polls, election handouts are being offered as inducements such as cost of living allowances to the public sector workers, payments to school leavers, public sector jobs for unemployed youth, etc. Even as the full cost of such electoral pledges are realized, leading to further weakening of fiscal consolidation efforts, Sri Lanka will be called on to implement some tough economic reforms for long-term macroeconomic stability and sustainable growth.

The most pressing of these relate to tax and SOE reforms. Sri Lanka has to focus on reversing declining government revenues as a matter of urgency. Recommendations to rationalize and streamline tariffs, broaden the tax base and improve administrative capacity of agencies involved in revenue collection have already been studied and proposed by the Presidential Taxation Commission in its 2010 report. So far, the recommendations have been implemented and applied in an ad hoc manner, and may need to be revisited once again in view of the considerable time that has lapsed since the report was finalized and submitted.

Similarly, Sri Lanka's loss making SOEs need to be restructured and better managed as a key priority. Governments will fight shy of outright privatization of SOEs in the face of considerable popular and political opposition. The opposition stems in part from past mishandling of privatization initiatives that have often been tainted by allegations of corruption, and/or proven by the judiciary to have by-passed laid down procedures and therefore nullified. Better management of SOEs need not necessarily go down the route of privatization; the options are many through a spectrum of ownership structures that can bring the public and private sectors together.

Sri Lanka's unabated practice of 'competitive populism' ensures that political parties routinely discount the economic costs of electoral promises and handouts.

Aside from these two critical areas, there are other outstanding public finance related issues that need policy attention. These include rationalizing Sri Lanka's many transfer and subsidy schemes, reforming the existing non-funded public sector pension system, improving debt management, etc. It is only from a thorough review that Sri Lanka can reconsider how it taxes and spends in order to support long-term development objectives. Fiscal and monetary expansion is not interchangeable; stronger public finances will allow fiscal and monetary policy to play independent roles to provide an economic stimulus as and when needed.

A strong fiscal foundation can also have an important bearing on a successful broader structural reform effort. Sri Lanka has a long to-do list of reforms which has been around for years without making much headway. Fiscal consolidation will help compensate potential losers of a reform initiative; by the same token, it is more difficult to implement structural reforms at the same time as tightening fiscal budgets. Sri Lanka is already faced with the likely prospect of slower economic growth and narrower fiscal space in the near term; fiscal reforms should start early before the situation becomes sufficiently fraught to make reforms unavoidable.