Sri Lanka
State of the Economy Report 2012

Chapter 2
Macroeconomic Performance

by
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2. Macroeconomic Performance

2.1 Introduction

Sri Lanka continued to build on its strong post-conflict growth performance, recording GDP growth of 8.3 per cent in 2011, maintaining the momentum generated by the government's infrastructure related development drive. Higher growth, however, was also accompanied by increasing signs of macroeconomic stress from the second half of 2011. This is not entirely unexpected. Greater recourse to foreign financing of government expenditure needs, as undertaken by Sri Lanka, limits options for policy manoeuvre. There is a trade-off between fiscal conditions and exchange rate management when currency movements impact debt ratios. Inflows of foreign capital, associated with higher volumes of borrowing, then spills over into the conduct of monetary and exchange rate policy management.

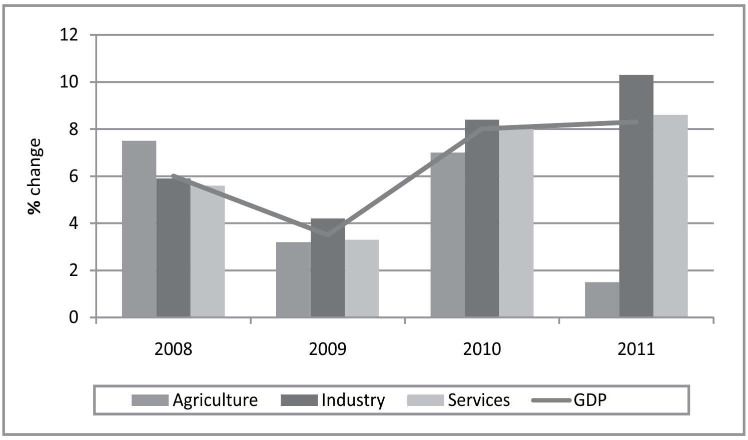
"It is often better to ensure an early trade-off between growth and stability as opposed to encouraging rampant growth and risk potential instability in the macroeconomic front"

These stresses were particularly evident in the Sri Lankan economy from the third quarter of 2011. Subsequent policy corrections, particularly with regards to exchange rate policy setting, have helped to avert a prolonged period of macroeconomic instability and a longer recovery in growth prospects. Nonetheless, it is a salutary lesson that the country must learn, following on from its foreign exchange crisis of 2009, that implementation of prudent macroeconomic policy is a must if Sri Lanka's long term growth and, hence, its socio-economic development objectives are to be met.

2.2 Output and Employment

GDP growth of 8.3 per cent in 2011, was driven by strong growth in industry and services sectors, accounting for approximately 29.3 per cent and 59.5 per cent respectively of total output. Agricultural output slumped sharply to record a growth of only 1.5 per cent on the back of adverse weather conditions experienced in the first quarter of 2011.

Figure 2.1
GDP Growth



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

Inclement weather in the form of severe floods in the first quarter of 2011 caused extensive crop damage -- as a result of direct crop damage as well as indirect impacts on yield -- in key agriculture products, particularly in paddy and other food crops. Paddy production contracted by 10 per cent in 2011, while many other field crops such as maize, green gram, kurakkan, etc., also saw a downturn in production.

The drag on agricultural output was compensated by improved performance in the industry sector, with much of the higher growth emanating from construction related activities, where growth accelerated to 14.2 per cent in 2011, from 9.3 per cent in the previous year. Other industry sectors such as mining and quarrying and utilities (electricity, water and gas) have also seen a fairly strong upturn in output. By contrast, manufacturing, the most critical sub-sector in industry, saw only a marginally higher rate of growth in 2011, with the manufacturing share of GDP continuing to stagnate at 17.3 per cent.

Table 2.1
GDP Sectoral Output

	Share of GDP (%)	Rate of Change (%)	
	2011	2010	2011
Agriculture	11.2	7.0	1.5
Tea	1.0	13.8	-0.9
Paddy	1.5	17.5	-8.4
Other food crops	3.6	4.4	2.5
Industry	29.3	8.4	10.3
Manufacturing	17.3	7.3	7.9
Construction	7.1	9.3	14.2
Services	59.5	8.0	8.6
Wholesale and retail trade	23.6	7.5	10.3
Transport and communication	14.3	11.9	11.3
Banking, insurance and real estate	8.8	7.5	7.9
Government services	7.1	5.4	1.2

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

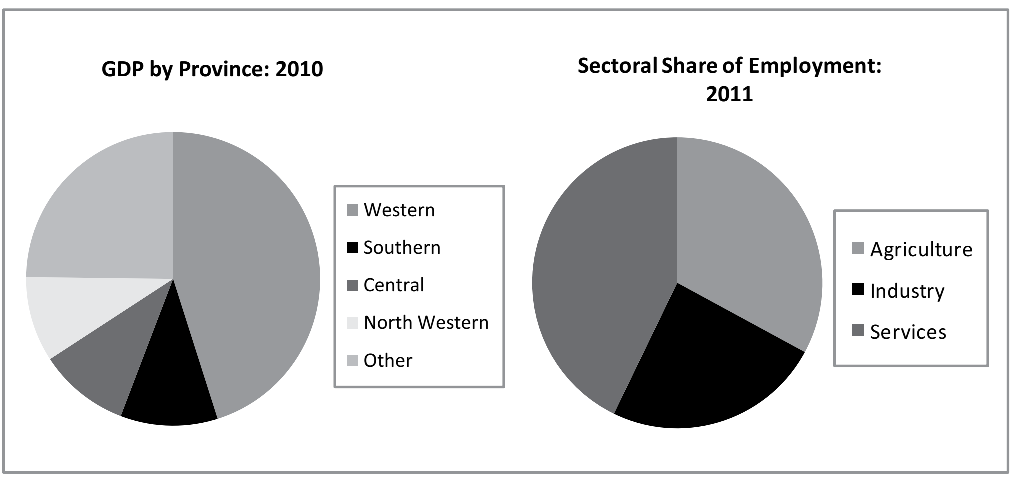
In the services sector, domestic demand and high trade volumes saw the wholesale and retail sector expand substantially by 10.3 per cent in 2011 relative to a growth rate of 7.5 per cent in the previous year. Financial services also saw an expansion, albeit at a lower rate of growth. By contrast, transport and communication services -- a key area that Sri Lanka is keen to develop as a regional hub – saw slower growth in 2011. The sharp drop in cargo handling is of particular concern given the significant capital investments being made in the ports and aviation sectors in the country.

Higher growth has been accompanied by a wider dispersion of economic activity across the country in recent years. The share of economic activity generated in the Western Province has declined over time from 50 per cent in 2006 to 45 per cent by 2010. This is in keeping with the government's stated policy objective of ensuring that regional disparities are bridged and the benefits of economic growth are more equitably distributed within the country.

The increased focus on the rural economy is also reflected in the sectoral share of employment across the country. Despite the sharp decline in agriculture's contribution to GDP, it remains the source of livelihood for the majority of those in the labour force. In 2011, the agriculture sector share of employment rose marginally to 32.9 per cent with the addition of 82,000 jobs. The industry and services sectors absorbed 48,000 and 60,000 jobs in 2011, with their share of employment being 24.3 per cent and 42.8 per cent, respectively.

Sri Lanka has continued to see a marked drop in its rate of unemployment in recent years. This trend persisted into 2011, with the rate of overall unemployment estimated at 4.2 per cent, although marked differences across provinces, gender, age, level of education, etc., still continue to persist. As the country

Figure 2.2
GDP by Province and Sectoral Share of Employment



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

Table 2.2
Labour Force Trends[a]

	2009	2010	2011
Labour force ('000 persons)	8,074	8,108	8,236
LFPR[b] (%)	48.7	48.1	48.2
Male	66.6	67.1	66.5
Female	32.8	31.2	31.8
Unemployment rate (%)	5.7	4.9	
By gender			
Male	4.3	3.5	2.7
Female	8.6	7.7	6.8
By age group			
15-19	20.9	20.3	15.4
20-29	15.4	13.8	12.4
By education level			
GCE (O/L)	8.5	6.9	5.2
GCE (A/L)	11.2	11.6	9.0

Notes: a: Date excludes Northern Province.
b: Labour Force Participation Rate.

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

aims for higher growth, labour market constraints – skills gaps as well as issues of labour productivity -- will be key factors in whether or not Sri Lanka is able to sustain high growth over the longer term. In addition, emerging labour market trends in Sri Lanka hold significant implications for any policy approach adopted in regard to promotion of foreign employment, particularly in the context of current initiatives to encourage more skilled migrants to seek temporary employment overseas.

2.3 Consumption, Savings and Investment

The relatively sharp upturn in consumption expenditure in 2011, particularly of private consumption – rising to 69.8 per cent of GDP compared to 65.2 per cent of GDP in 2010 – is indicative of the demand-driven nature of economic performance in 2011. Indeed, higher consumption spending saw Sri Lanka's domestic savings ratio plummet sharply to 15.4 per cent of GDP in 2011 from 19.3 per cent recorded in 2010. Clearly, Sri Lanka's

Table 2.3
Consumption, Investment and Savings

(% of GDP)	2009	2010	2011
Consumption	82.1	80.7	84.6
Private	64.4	65.2	69.8
Government	17.6	15.6	14.8
Investment	24.4	27.6	29.9
Private	17.9	21.4	23.7
Government	6.6	6.2	6.3
Domestic savings	17.9	19.3	15.4
National savings	23.7	25.4	22.1

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

low domestic savings ratio, despite gains made in raising per capita income, is a cause of concern as low savings limits domestic resource mobilization for investment purposes.

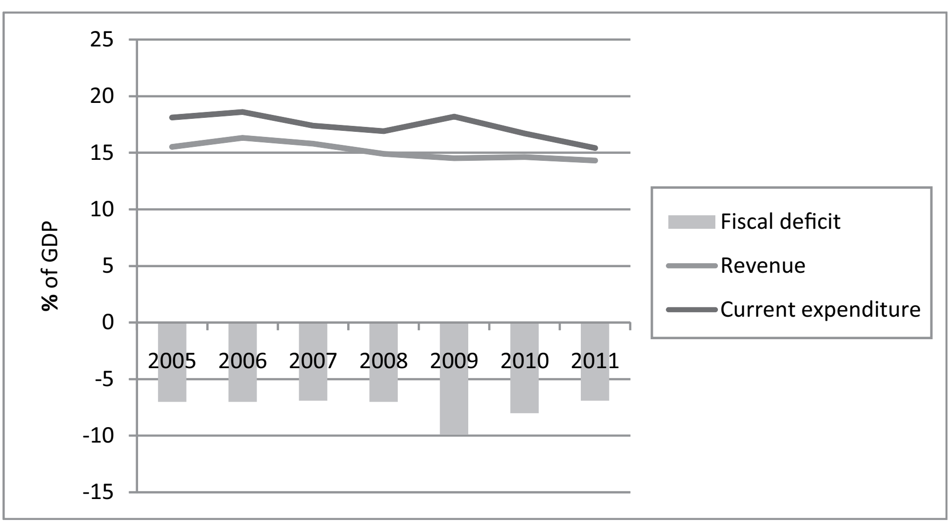
Moreover, as a matter of setting macroeconomic policy, Sri Lanka should make attempts to encourage saving over consumption, particularly in order to ensure that future consumption relative to current consumption is not penalized, as a rapidly ageing population finds itself without adequate retirement incomes. The country needs to not only focus on policy decisions around pensions funding and retirement savings, but also on ensuring an environment that encourages savings. Low interest rates, designed to encourage private investment, can also discourage savings. Here, maintaining a real return on savings is important so that there is no transfer of wealth from savers to borrowers.

2.4 Fiscal Policy Developments

Government budgetary management over the years has also failed to contribute to the country's efforts to raise savings. Persistent fiscal deficits signal that the government is drawing on resources of other sectors in the economy. Over more recent years however, Sri Lanka has made progress in key fiscal balances in keeping with the country's commitments under the IMF SBA arrived at in July 2009. The overall deficit has seen a marked reduction from 9.9 per cent of GDP in 2009 to 6.9 per cent of GDP in 2011 and is expected to be contained further to 6.2 per cent of GDP in 2012. Fiscal consolidation has been accompanied by a consistent decline in Sri Lanka's government debt to GDP ratio from 86.2 per cent in 2009 to 78.5 per cent in 2011.

The turnaround has come about despite a sustained public investment drive with public investment as a percentage of GDP maintained at an average of 6.5 per cent of GDP over the period 2009-11. This is in contrast to earlier efforts where fiscal targets have often been met, simply, by cutting back on allocated expenditure on capital investment. Thus, the decline in current expenditures from 18.2 to 15.4 per cent of GDP between 2009 and 2011 is the most promising aspect of Sri Lanka's recent fiscal consolidation efforts.

Figure 2.3
Key Fiscal Trends



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

Table 2.4
Current Expenditures

(% of GDP)	2009	2010	2011	2012
Expenditure on goods and services	7.9	6.9	6.6	6.7
Salaries and wages	5.6	5.4	4.9	4.9
Interest payments	6.4	6.3	5.5	4.9
Foreign	0.7	1.0	1.1	0.6
Domestic	5.7	5.3	4.4	4.3
Transfers and subsidies	3.9	3.5	3.3	3.1
Households and other sectors	3.1	2.8	2.6	2.5
Samurdhi	0.2	0.2	0.1	0.2
Pensions	1.8	1.6	1.5	1.5
Fertilizer	0.6	0.5	0.5	0.4
Other	0.6	0.5	0.5	0.4

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

Salaries and wages of public sector employees account for one-third of government revenues. A relatively low inflationary environment that dampened demand for public sector wage increases, and an estimated 6 per cent reduction in the overall number of public sector employees between 2009 and 2011,[1] has allowed the government some flexibility to restrain recurrent spending on wages and salaries. Meeting interest payments on debt that take up another one-third of government revenue has also been helped since mid-2009 by a sharp reduction in domestic interest rates as well as by a relatively stable rate of exchange in regard to external debt service obligations.

However, significant weaknesses in financial management of SOEs continue, exerting pressure on public finances. Operational losses by SOEs not only dent government tax revenue enhancement efforts, but they are also a source of high government borrowing from the banking sector that crowd out private sector investment. If Sri Lanka is to prevent continuous hemorrhage of scarce domestic resources through growing financial losses incurred by SOEs, reforming of operational management of state enterprises has to be a priority item on the government's agenda for long term fiscal sustainability.

Such action is all the more necessary in view of continuing revenue deficits and attempts

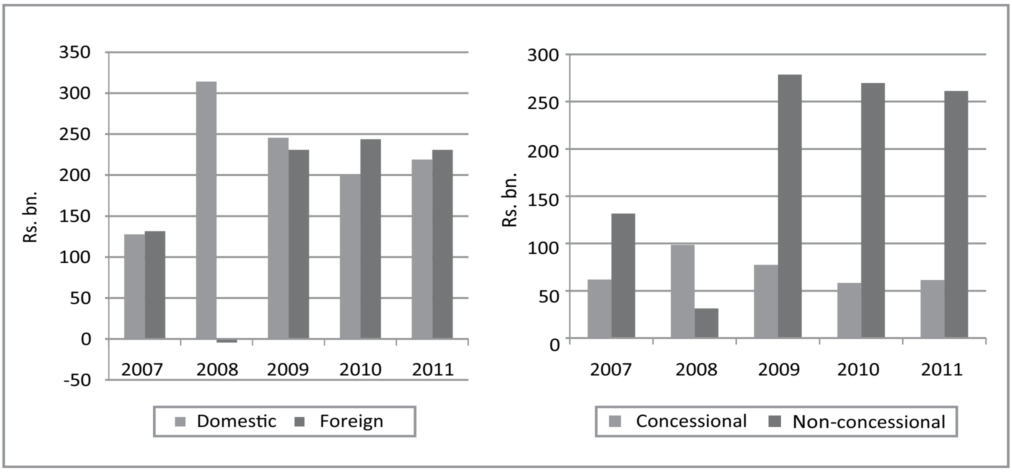
Table 2.5
Operational Losses/Profits of Select SOEs

(Rs. bn)	2009	2010	2011
Ceylon Petroleum Corporation	-26.2	-27.0	-94.0
Ceylon Electricity Board	-11.0	4.8	-25.5
SriLankan Airlines	-12.2	-6.3	-19.1
Department of Posts	-2.5	-3.0	-4.6
Sri Lanka Railways	-4.8	-3.2	-4.1
Sri Lanka Transport Board	-5.2	-8.4	-3.8

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

[1] See CBSL, *Annual Report 2011*.

Figure 2.4
Trends in Deficit Financing



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

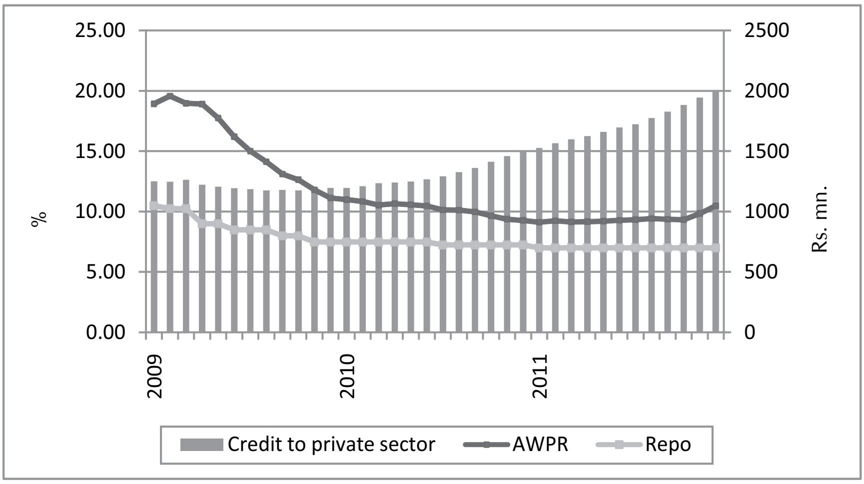
to improve revenue collection via a host of reforms recommended by a Presidential Commission on Taxation in 2010. Despite GDP growth in excess of 8 per cent over the last two years, tax revenue as a percentage of GDP declined to 12.4 per cent in 2011 from 12.9 per cent in 2010. Sri Lanka's revenue to GDP ratio of 14.3 per cent is a well below average performance for a country that has attained lower middle income status whereby the ratio should be in the region of 20 per cent. Recommendations of the Presidential Commission on Taxation -- to rationalize the tax system, broaden the tax base and improve administrative oversight on tax collection -- should be implemented in a systematic fashion if Sri Lanka is to see a continuous improvement in its tax revenue-to-GDP ratio over the medium term.

Better domestic resource mobilization is vital for fiscal consolidation. Sri Lanka has been relying on a mix of domestic and foreign finance to bridge its fiscal deficit. Historically, such foreign financing has been by way of grants and concessional assistance. Increasingly, however, the country has turned to non-concessional sources of funding as the major component of foreign financing of its fiscal deficit. Even as the transition away from grants can be expected as countries like Sri Lanka graduate to middle income status, a swift accumulation of costlier external debt to bridge fiscal financing needs can make the country more vulnerable to external shocks and constrain macroeconomic policy space. A tighter policy environment in which to manoeuvre, calls for prudent macroeconomic management -- a coordinated approach to both fiscal and monetary policies, as well as exchange rate management. In the absence of this, macroeconomic stability can begin to unravel and hinder the country's long term growth prospects.

2.5 Monetary Policy

Whilst improvements in overall fiscal policy trends, particularly in containing the fiscal deficit, contributed towards allowing a moderate inflationary environment to persist, monetary policy management has not been without problems. With the end of the conflict in May 2009 and increased reliance on government foreign borrowing to finance development expenditures, the CBSL intervened in the foreign exchange market to prevent an undue appreciation of the Sri Lankan rupee. The resulting build-up of reserves saw an ex-

Figure 2.5
Credit Growth and Interest Rates



Notes: a: AWPR = Average Weighted Prime Lending Rate.
Repo = Repurchase Rate.

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

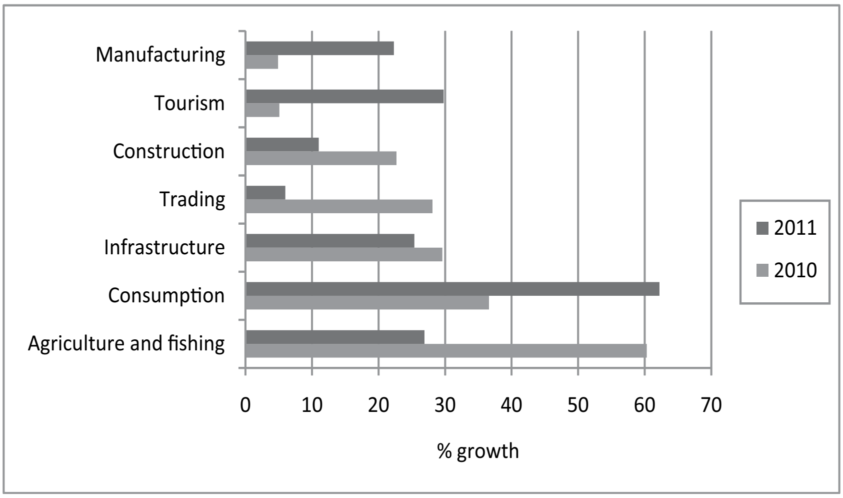
pansion of the monetary base, with significant volumes of excess liquidity in the financial market. Credit growth to the private sector which was slow to expand initially as Sri Lanka's long-drawn conflict ended precipitately, began to gather momentum from mid-2010, and accelerated during 2011. Indeed, as credit growth to the private sector picked up sharply, financial sector developments shifted swiftly from an environment of excess liquidity in the first quarter of 2011 to an environment of tight liquidity by the third quarter of 2011. Despite credit growth to the private sector averaging 34.5 per cent in 2011, relative to 25 per cent growth in 2010, policy rates remained unchanged throughout 2011.

A rapid credit expansion can have broader implications for medium term financial sector stability as experienced by Sri Lanka in 2008/09. The loan-to-deposit ratio of the banking sector has climbed steadily from 71 per cent in 2009 to 85 per cent by end 2011. Sector-wise credit exposure in 2011 indicates the high growth in consumption lending, a segment that is particularly vulnerable to a general economic slowdown when it comes to servicing debt obligations.

Whilst keeping policy rates unchanged, the CBSL was also simultaneously attempting to hold the currency steady for much of 2011. The initial pressure on the rupee to appreciate in the face of foreign capital inflow began to reverse from mid-2011 as Sri Lanka's current account position on the BOP began to weaken significantly. Access to cheap credit and an overvalued exchange rate were pulling in imports and widening the country's trade balance sharply. Thus, even as import expenditure expanded and the currency began to come under pressure, the CBSL adopted a policy stance of reverse intervention of selling dollars to ensure that the rupee remained within a pre-determined band.

[2] See IPS, *Sri Lanka: State of the Economy 2010*, IPS, Colombo.

Figure 2.6
Sector-wise Lending



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

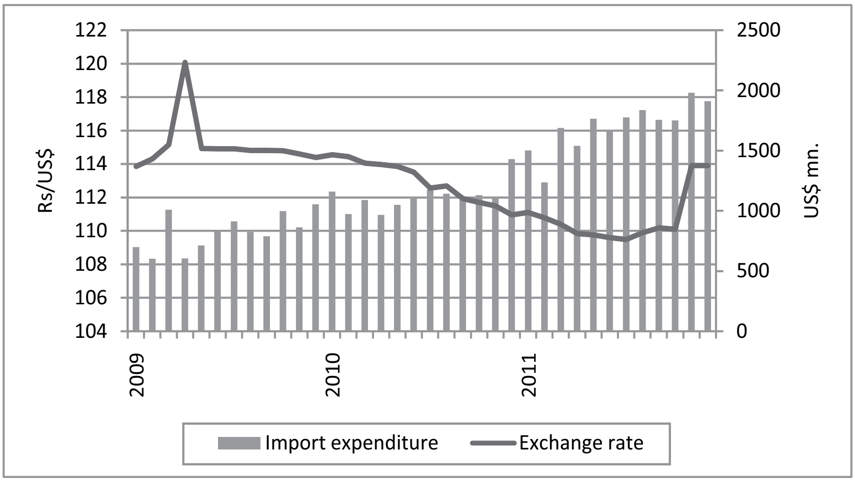
Clearly, such a policy stance holds inherent threats to macroeconomic stability, particularly so in the face of a weak global economic environment that can have a significant drag on a country's foreign exchange reserves. Despite the CBSL stance, the Budget 2012 presented in November 2011, sought a change of policy with regards to exchange rate management in announcing a nominal depreciation of 3 per cent against the US dollar.

Tight liquidity conditions in the domestic financial sector saw upward pressure on interest rates, particularly in the fourth quarter of 2011. The CBSL, however, held off from adjusting policy rates until February 2012, whereby an upward adjustment of 50 basis points was effected. Additional measures to curb credit growth to the private sector were also announced in February 2012, where the CBSL slapped a mandatory ceiling on commercial bank credit growth for 2012 of 18 per cent and 23 per cent if the balance 5 per cent comes from foreign sources.

A redeeming feature of Sri Lanka's monetary policy management has been that inflationary pressures have remained moderate with annual average inflation rising marginally from 6.2 per cent in 2010 to 6.7 per cent in 2011. Much of the inflationary pressure emanated from rising food prices following inclement weather in the first quarter of 2011, and adjustments to fuel prices in April 2011. Despite high credit growth, the inflationary consequences were mitigated to an extent by the fact that much of the credit growth is likely to have been channeled to higher import expenditures, dampening pressure on domestic output. In addition, an overvalued exchange rate also helped to curb import-related price inflation.

Rising inflationary pressures will be of some concern in 2012. Adjustments to administered prices and a depreciating rupee will be driving inflationary pressure. While front loading in the credit growth ceiling imposed on commercial banks will see credit growth remain high for the first half of 2012, it is likely to ease thereafter, especially if export growth is hampered by a weakening global economy.

Figure 2.7
Exchange Rate Trends

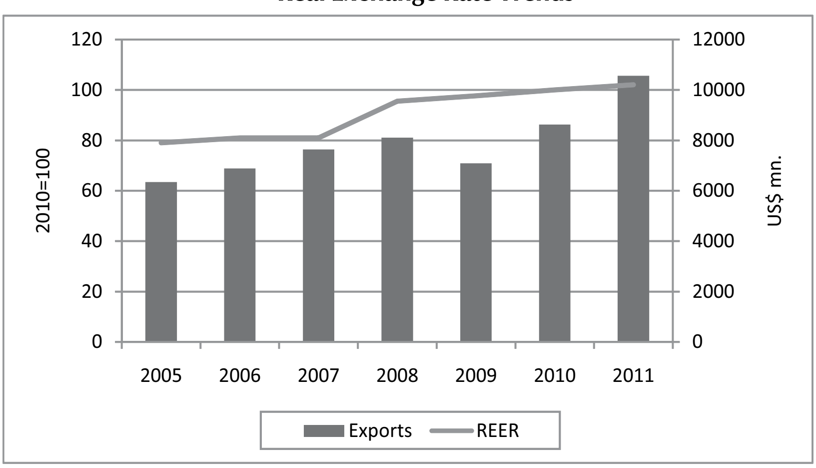


Source: CBSL, *Monthly Economic Indicators*, various issues.

2.6 Balance of Payments

The performance of Sri Lanka's export earnings from both goods and services is going to be a critical lynchpin to the country's long term growth objectives. Not surprisingly, the reversal in exchange rate policy management introduced in the Budget 2012 was presented as a necessary adjustment to support the export sector to compete in an increasingly volatile and weak global economic environment. Despite a healthy 8 per cent GDP growth rate achieved in Sri Lanka's immediate post-conflict phase of development, the contribution of exports to drive growth has been poor. The country's exports-to-GDP ratio has declined persistently from 26 per cent in 2005 to 17.8 per cent in 2011. Whilst this points to structural constraints to export growth, a steady appreciation of the real effective exchange rate (REER) of 26 per cent from 2007-2011 would not have helped the export sector to retain price competitiveness in international markets.

Figure 2.8
Real Exchange Rate Trends



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

Table 2.6
External Current Account Developments

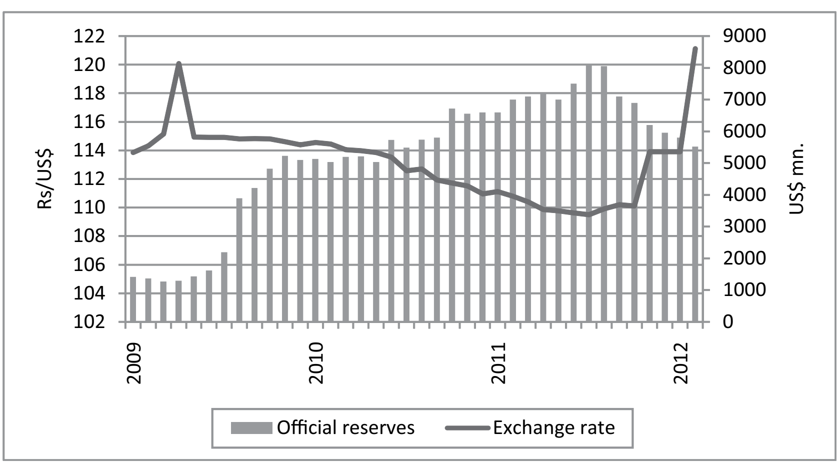
	2009	2010	2011
Trade balance (US$ mn.)	-3122	-4825	-9710
Remittances (US$ mn.)	3330	4116	5145
Tourism (US$ mn.)	350	576	830
Current account (% of GDP)	-0.5	-2.2	-7.8

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

With import expenditure growth (51 per cent) far outstripping export earnings growth (22 per cent) in 2011, even healthy earnings from remittances and tourism could not help to bridge Sri Lanka's ballooning current account deficit of 7.8 per cent of GDP. As mentioned previously, even as the current account was weakening and exerting pressure on the exchange rate, the CBSL resorted to selling dollars in the foreign exchange market in an attempt to prop up the currency.

Sri Lanka's gross official reserves built up since the end of the conflict and SBA with the IMF peaked at US$ 8 billion (sufficient for 5.7 months of imports) in July 2011 on the back of the country's fourth US dollar benchmark offering in the global bond markets since 2007. Indeed, the bond issue followed an upgrade of Sri Lanka's long-term foreign and local currency issuer ratings to "BB-" from "B" with the outlook on both listed as "stable" by Fitch Ratings. Similarly, Moody's Investors Service lifted the outlook on Sri Lanka's below-investment-grade "B1" credit to "positive." By end 2011, Sri Lanka's official reserves had dipped to US$ 5,958 million with a further drop to US$ 5,522 million by February 2012, sufficient for 3.2 months of imports. The depletion of reserves compelled the CBSL to allow the exchange to move in line with market conditions from February 2012. Indeed, as would be expected, there was significant volatility and overshooting of the exchange rate in the immediate aftermath of the policy change. In effect, the currency saw a nominal depreciation in the range of 20 per cent following the relaxation of controlled intervention by the CBSL.

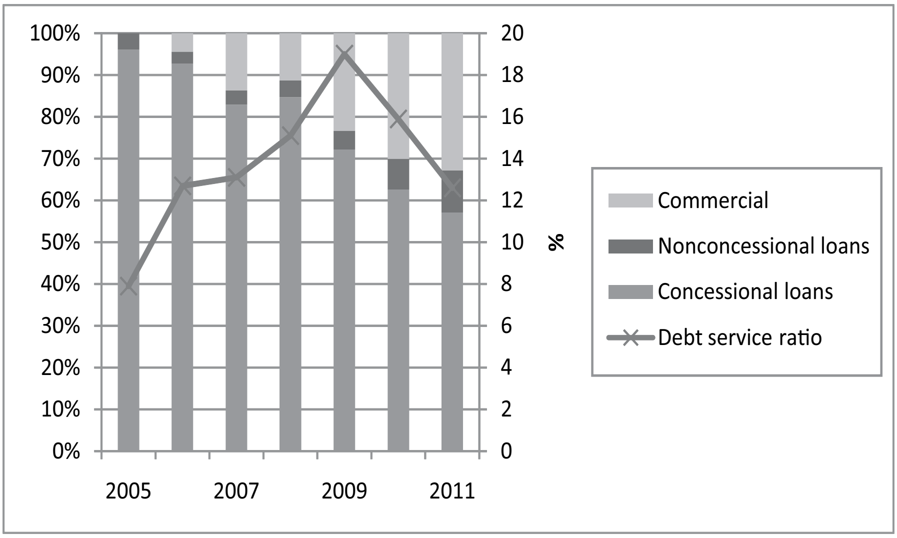
Figure 2.9
Gross Official Reserves



Notes: Official reserves exclude Asian Clearing Union (ACU) balances.

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

Figure 2.10
Outstanding Public External Debt



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

The policy correction was welcomed, not least to avert a potential foreign exchange crisis as that experienced in 2009 from a similar attempt to prop up a currency under pressure, that eventually led to Sri Lanka's approach to the IMF for a SBA. Most importantly, however, the policy stance to allow the exchange rate to reflect underlying macroeconomic fundamentals is welcome from the stance of meeting the country's long term structural challenges. Sri Lanka's accumulation of reserves since the end of the conflict, and the initial resultant upward pressure on the exchange rate, was primarily driven by a rebalancing of flows on the capital account with larger volumes of foreign currency denominated borrowing by the government.

The accumulation of costlier commercial and non-concessional forms of foreign debt has been swift. Indeed, the share of concessional funding in Sri Lanka's outstanding foreign debt has dropped sharply from 96 per cent in 2005 to 57 per cent by 2011. While there may be year-to-year fluctuations in the resultant external debt service ratios in response to exchange rate policy, export earnings performance, bunching of debt service repayments, etc., the overall trend is suggestive of higher external debt service ratios in the medium to longer term. This calls for a strategy that will support stronger demand for Sri Lanka's goods and services overseas, allowing the country to service its fast growing external debt obligations comfortably.

2.7 Conclusion

Sri Lanka's overall post-conflict development focus on accelerated, but balanced regional growth has yielded positive results since the end of the conflict in May 2009. GDP growth has averaged 8 per cent with significant improvements in achieving better regional parity as made evident by the country's overall achievements in tackling poverty and deprivation. Nonetheless, the country's growth strategy propelled by a rapid roll-out of a public infrastructure investment drive, financed largely by borrowed funds -- especially foreign currency denominated debt -- does impose challenges on macroeconomic policy management. It raises a country's vulnerability to external shocks and can often constrain the space for policy manoeuverability. In such circumstances, any deviation from prudent and timely policy adjustments can be costly for macroeconomic stability and medium term growth sustainability.

Sri Lanka did come up against such constraints and instituted policy corrections, particularly reversing the approach to maintain the exchange rate within a pre-determined band. The imposition of credit ceilings on commercial bank lending, policy interest rate revisions, re-imposition of import duties, etc., were other changes effected to ensure that the country retains stability on the macroeconomic front. The overall impact of these policy adjustments will be to lower Sri Lanka's GDP growth in 2012, forecast to be in the region of 7.0 per cent, down from the previous estimate of 8 per cent growth.

A slowdown in GDP growth in 2012 should not be viewed with concern. It is often better to ensure an early trade-off between growth and stability as opposed to encouraging rampant growth and potential instability in the macroeconomic front that will require sharper policy adjustments that drag growth down more and for longer. For Sri Lanka, the immediate priority is to regain stability, particularly on the exchange rate front. A weakening global economic outlook will help, easing pressure on international oil prices that together with reduced domestic demand will allow the exchange rate to stabilize. Although inflation will pick up in the second half of 2012, monetary tightening will ensure that inflation remains fairly moderate, allowing the country to renew efforts to raise its GDP growth target back on track to 8 per cent in 2013.