Sri Lanka
State of the Economy Report 2014

Chapter 2
Macroeconomic Performance

by
Dushni Weerakoon

2. Macroeconomic Performance

2.1 Introduction

Sri Lanka has witnessed a period of impressive growth in recent years, averaging 7.5 per cent per annum during 2010-13. Whilst growth dipped in 2012 to 6.3 per cent, a recovery to 7.3 per cent in 2013 appears to herald renewed optimism that the country can hold its medium term growth at above 7 per cent without significant overheating of the economy. Indeed, Sri Lanka is seen as one of the better performing emerging-market economies in Asia.

During the decades of conflict that Sri Lanka endured, the country's economic fortunes were subject to intermittent shocks in addition to taking a heavy toll on government resources. Now that the country has enjoyed a period of sustained peace, the demand for better infrastructure, jobs and public services is at the forefront of people's minds. Indeed, the government has viewed 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 private sector involvement.

Private investment has been a persistent problem. The ratio of private investment to GDP has declined from 23.9 per cent in 2006 to 22.7 per cent in 2013, even as government investment rose from 4.1 per cent to 6.9 per cent of GDP over the same period. Whilst the government has been asking businesses to invest more and at the same time exerted moral suasion on the country's banking sector to lend more, private investment continues to be lacklustre. Indeed, a more visible and heavy-handed state presence in the economy - fuelled by the large public investment led infrastructure projects - appear to be one factor obstructing greater private sector participation in Sri Lanka's growth success story.

An enhanced private sector role in driving investment and job creation are essential if the government is to focus on bettering the social and economic advances already made. Sri Lanka has seen a sharp improvement in addressing poverty and inequity over the last eight years. Renewed focus on social sector investment to raise productivity, and reforms to cut red tape, simplify taxes and improve regulatory laws, will help get private investment on track to support the country's long-term development objectives.

2.2 Sri Lanka in an Asian Growth Perspective

The depiction of Sri Lanka's economic future comes from the government's stated goal to develop the country as the 'Wonder of Asia'. The belief that Sri Lanka is gaining ground towards this goal is pervasive in sections of the country's policy elite, backed by seemingly indisputable numbers on many economic indicators. Indeed, in March 2014, Sri Lanka was recognized by France-based credit insurer Coface as one of the brightest emerging economies to watch, alongside Peru, the Philippines, Indonesia and Colombia.[1]

[1] http://www.coface.com/.

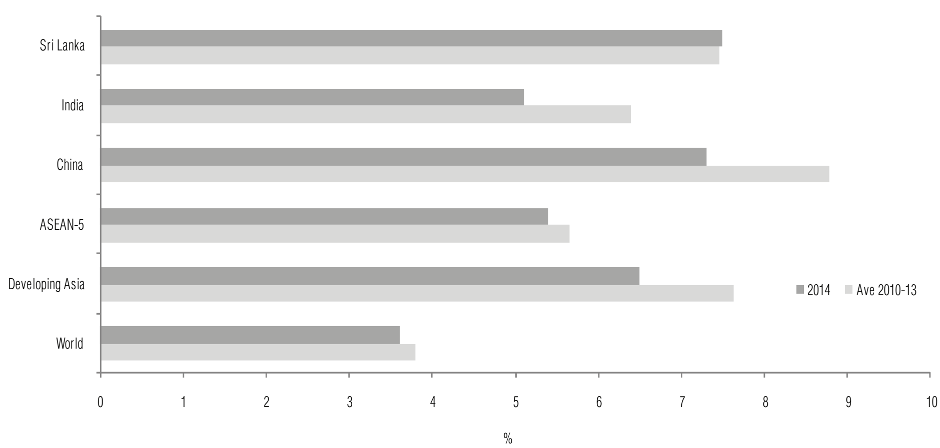
An enhanced private sector role in driving investment and job creation are essential if the government is to focus on bettering the social and economic advances already made.

Despite the many drawbacks to GDP as a measure of economic success, it is inevitably one of the key comparative statistics employed to assess the health of a country vis-à-vis its global partners. By any yardstick, Sri Lanka has performed creditably on the growth front. GDP growth has averaged 7 per cent per annum during 2010-13 at a time when even its historically better performing competitors in Southeast Asia were struggling (Figure 2.1).

However, predictions of Sri Lanka's promising future outlook are being based not only on GDP growth, but also on broader indicators of macroeconomic performance and socio-economic development indicators. On the fiscal front, the country has seen a steady improvement in key indicators such as the fiscal deficit and public debt. The annual average rate of inflation has been held in check at single digit levels since mid-2009. With continued strong foreign investor appetite for Sri Lanka's sovereign bond issues, external sector pressures on the exchange rate from negative current account positions have been held back. Whilst Sri Lanka's performance on some of these indicators compares less favourably with key competitors in neighbouring Asian economies as evident from Table 2.1, the overall trend is showing significant improvement over time.

On the current trajectory, Sri Lanka appears reasonably close to achieving the government's target of doubling per capita GDP to US$ 4,000 by

Figure 2.1
Sri Lanka's GDP Growth in a Comparative Context



Source: IMF, *World Economic Outlook*, various issues.

Table 2.1
Comparative Macroeconomic Indicators

	Fiscal Deficit[a]	Debt[a]	Inflation[b]
India	-3.8	49.7	6.8
Indonesia	-1.7	28.4	8.1
Malaysia	-4.5	53.3	2.4
Philippines	-1.9	51.5	4.7
Sri Lanka	-6.1	79.1	10.4
Thailand	-2.2	28.6	2.9

Notes: a. Percentage of GDP; b. Annual average growth 2000-2012.
Source: World Bank, "Word Development Indicators 2014", World Bank, Washington, D.C.

2016, up from US$ 3,200 in 2013. But, there are misgivings on how far and how fast the economy can sustain growth without over-extending itself. Indeed, a recent study by the IMF estimates Sri Lanka's long-term potential output to be around 6.8 per cent, well below the more ambitious target of 8 per cent pursued by the government.[2] Sri Lanka's more recent sources of higher growth do suggest that impediments to faster growth exist in key sectors of the economy that need to be addressed if future generations are to benefit from achieving the goal of 'Miracle of Asia'.

2.2.1 Growth and Productivity

For Sri Lanka, the most assured source of immediate economic growth following the return of peace and stability in 2009 was to be found in a sustained infrastructure development effort. Not surprisingly, many of the sectors seeing higher growth in recent years is thus concentrated in construction and related economic activities, tourism and utilities (Figure 2.2). This has led to a

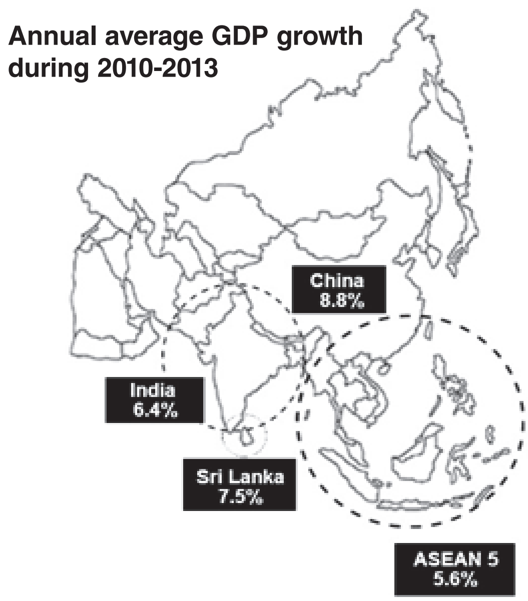
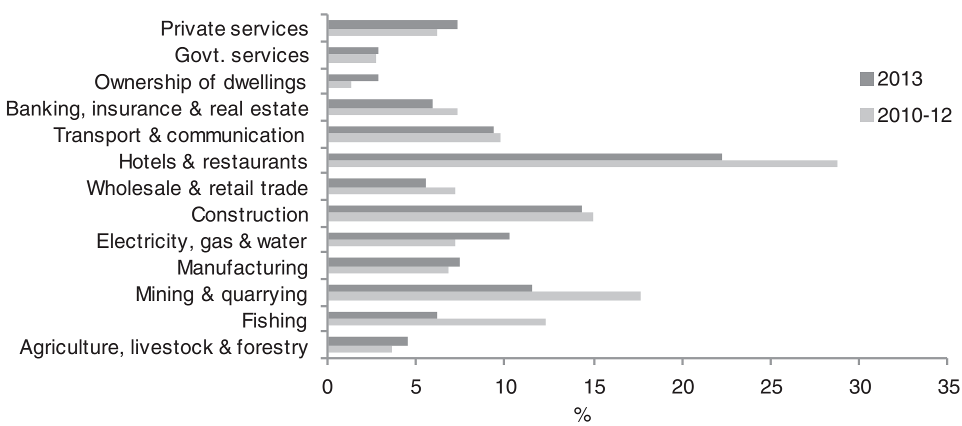


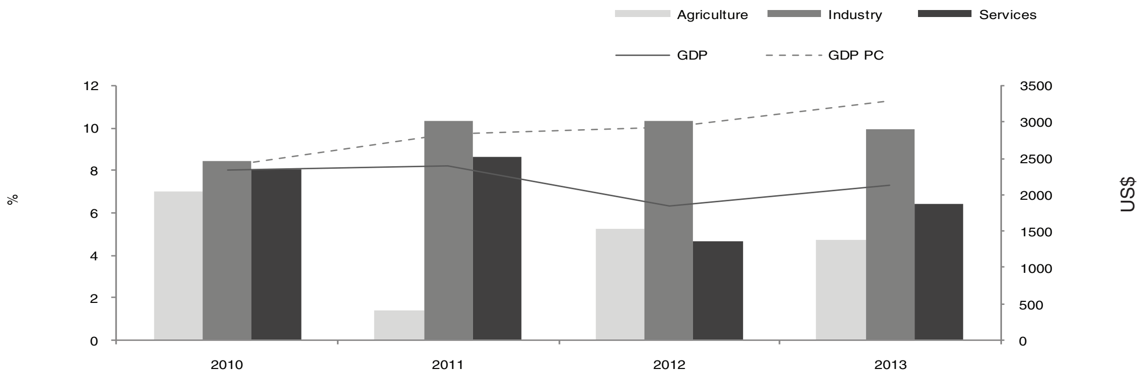
Figure 2.2
Sources of Growth



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

[2] D. Ding, *et al*., (2014), "Estimating Sri Lanka's Potential Output", IMF Working Paper WP/14/40, International Monetary Fund, Washington, D.C.

Figure 2.3
Output Trends



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

tilt towards the non-tradable sector assuming primacy as a source of higher growth viz., the tradable sector.

The balance between non-tradable and tradable sector growth matters in determining a long-term sustainable growth path, with the tradable sector an important driver of growth for developing economies. Indeed, for a small developing economy such as Sri Lanka, external demand is critical as an enabler of sustained long-term high growth, generating demand, absorbing surplus labour and raising productivity. In this context, the decline in Sri Lanka's exports-to-GDP ratio in recent years - from 28 per cent in 2004 to 15 per cent in 2013 - is of grave concern. Clearly, Sri Lanka's higher growth has not been driven by external demand for its goods and services, but rather by domestic demand financed with external debt.

In fact, robust industry sector growth during 2010-13, averaging well above GDP growth, is misleading (Figure 2.3). Much of that improved growth is derived from the construction and utilities sectors, with the more important sub-sector of manufacturing performing less impressively. However, there are positive signs that manufacturing sector growth is firming up, with annual average growth of 7.2 per cent during 2010-13 relative to 4.9 per cent during 2007-09 (Table 2.2). But, Sri Lanka's manufacturing sector remains heavily dominated by the food, beverages and tobacco sector, accounting for 47 per cent of total value added in manufacturing. This sector is far less export oriented compared to the

Table 2.2
Manufacturing Value Added

	Share	Growth	
	2013	2007-09	2010-13
Food, beverages & tobacco	47.0	5.9	6.7
Textile, wearing apparel & leather	22.9	3.7	7.4
Chemical, petroleum, coal, rubber & plastic	16.3	5.0	8.7
Fabricated metal products, machinery & transport equipment	8.5	4.9	7.1
Total		5.0	7.2

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

For a small developing economy such as Sri Lanka, external demand is critical as an enabler of sustained long-term high growth, generating demand, absorbing surplus labour and raising productivity.

textile and wearing apparel sector, comprising 23 per cent of total value added in manufacturing. On a more positive note, the latter has seen an improvement in growth during 2010-13, but it is not of a magnitude to reverse Sri Lanka's declining exports-to-GDP ratio.

A second and related concern with regard to the lopsided growth in the non-tradable sector arises with regard to productivity which has a direct bearing on growth as well as on other indicators such as price stability. Productivity in these sectors is much more difficult to estimate, with quality rather than the quantity of inputs carrying the greater weight in determining productivity in many services sectors for instance. Many non-tradable sectors, particularly in services are dominated by state presence such as in education, health, banking, utilities, etc. Thus, a worrying concern is the extent to which productivity in the non-tradable sector is compromised by the lack of sufficient competition, particularly in those areas where state-owned enterprises (SOEs) dominate the market.

Productivity improvements will be vital to stable and sustained long-term growth. With an ageing demographic profile, Sri Lanka's labour force has to be employed more efficiently to drive higher growth. Despite a progressive decline in agriculture's share of GDP to 10.8 per cent by 2013, it still continues to absorb nearly 30 per cent of the labour force. Those who have moved out of agriculture have tended to be absorbed into services, accounting for over 44 per cent of the labour force in 2013.

A breakdown of employment shares in the services sector indicates a high percentage in relatively low skilled services provision such as in retail trade, transport, etc. (Table 2.3). By contrast, employment shares in high skill activities such as information and communication, and financial activities tend to be rather low. If, as envisioned, Sri Lanka intends to transition to a higher middle-income economy by positioning itself as a hub in vital services-oriented activities - including that of a knowledge hub, a commercial hub, etc. - equipping its labour force with the requisite skills for gainful and productive employment in higher skilled services sector activities will be a key determining factor for success.

In this context, Sri Lanka's continuing high youth unemployment - estimated at 18.7 per cent in the age group of 15-19 years and 19.2 per cent in the age group of 20-24 years in 2013 - is of major concern.[3] Even more worryingly, a persistent high rate of unemployment of 8.6 per cent amongst those with education levels of GCE A/L and above reported in 2013 is another indication of loss of labour market efficiency in the economy. These numbers remain well above the national rate of unemployment of 4.4 per cent in 2013.

Thus, while enhanced volumes of investments, particularly in physical infrastructure, have boosted GDP growth in the medium term, sustaining higher growth into the longer term requires reforms that will unlock emerging supply side constraints in the labour market and related skills competencies provided through the education system in the

[3] CBSL, *Annual Report* 2013.

Table 2.3
Services Sector Employment by Activity

	Percentage of Total Employment
Wholesale & retail trade, repair of motor vehicles & motor cycles	13.7
Transport & storage	6.1
Accommodation & food services activities	2.2
Information & communication	0.7
Financial & insurance activities	1.8
Professional, scientific & technical activities	0.8
Administrative & support service activities	1.3
Public administration & defence	7.5
Education	3.9
Human health & social work activities	1.7
Other	4.3

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

country. The sources and elements that have driven Sri Lanka's higher growth in recent years need to be reviewed. A re-balancing between tradable and non-tradable sector growth in the immediate years ahead is important. This is particularly so in view of significant external debt incurred for investment purposes to drive growth, in an environment of continuing low domestic savings and investment.

2.3 Savings and Investment

The Sri Lankan economy is heavily consumption driven, with consumption as a percentage of GDP hovering at over 80 per cent (Table 2.4). Real consumption growth has remained relatively strong during the period 2007-13, particularly private consumption growth at 6.1 per cent, averaging just below GDP growth of 6.6 per cent per annum during the same period.

A high consumption rate implies low savings. Whilst the government has been a persistent dissaver, the other sectors of the economy - i.e., household and corporate sectors - also are not big savers. High and volatile inflation rates that result in low real returns on savings has been a deterrent to generating a culture of savings in the past. As a result, the savings-investment gap has seen Sri Lanka running a high and persistent current account deficit. The gap would be much wider if not for the remittances from overseas that has helped prop up national savings as well as helping to narrow the current account deficit.

Investment grew much more strongly over the same period, with government investment growing at a high speed of 15.7 per cent per annum in real terms during 2007-13. As a share of GDP, the increase is remarkable, growing from a ratio of 2.8 per cent in 2003-04 to 6.9 per cent during 2012-13.

What is of concern, however, is the decline in private investment growth since it peaked in 2010 on the back of a sharp slowdown in growth in the preceding year (Figure 2.4). Private consumption growth has also tapered off. These trends are reflective of a general lack of positive investor and consumer confidence in the economy despite improvements in key indicators such as inflation, interest rates and

Table 2.4
Consumption, Savings and Investment

	As Percentage of GDP				Growth (%)[a]
	2010	2011	2012	2013	2007-13
Consumption	80.7	84.6	83.1	80.8	6.1
Private	65.2	69.8	69.6	66.8	6.6
Government	15.6	14.8	13.5	13.1	4.4
Investment	27.6	29.9	30.6	29.6	7.8
Private	21.4	23.7	23.7	22.7	6.5
Government	6.2	6.3	6.9	6.9	15.7
Domestic savings	19.3	15.4	16.9	20.0	
National savings	25.3	22.1	24.0	25.7	

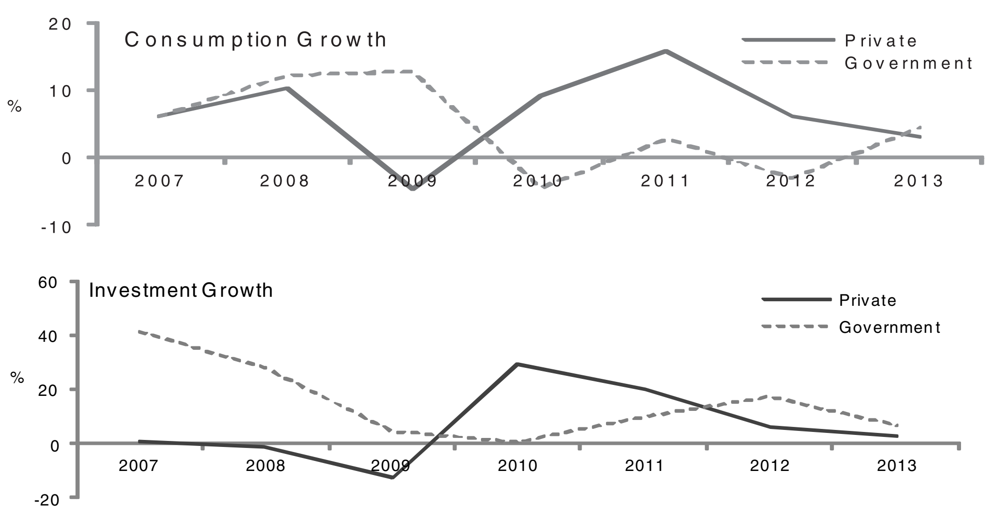
Notes: Annual average growth in 2002 constant rupee prices.
Source: CBSL, *Annual Report,* various years.

overall growth prospects of the economy. Indeed, the lack of private investor appetite in particular prompted monetary authorities to take measures from mid-2012 to encourage private sector credit growth through monetary policy interventions. However, such efforts have had only limited success in spurring the private sector to adopt a more bullish approach on the business front.

2.4 The Trials of Monetary Policy: Making Credit Work

A singular achievement of monetary policy in recent years has been ensuring a measure of price stability in the Sri Lankan economy. Since mid-2009, the

Figure 2.4
Real Consumption and Investment Growth



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

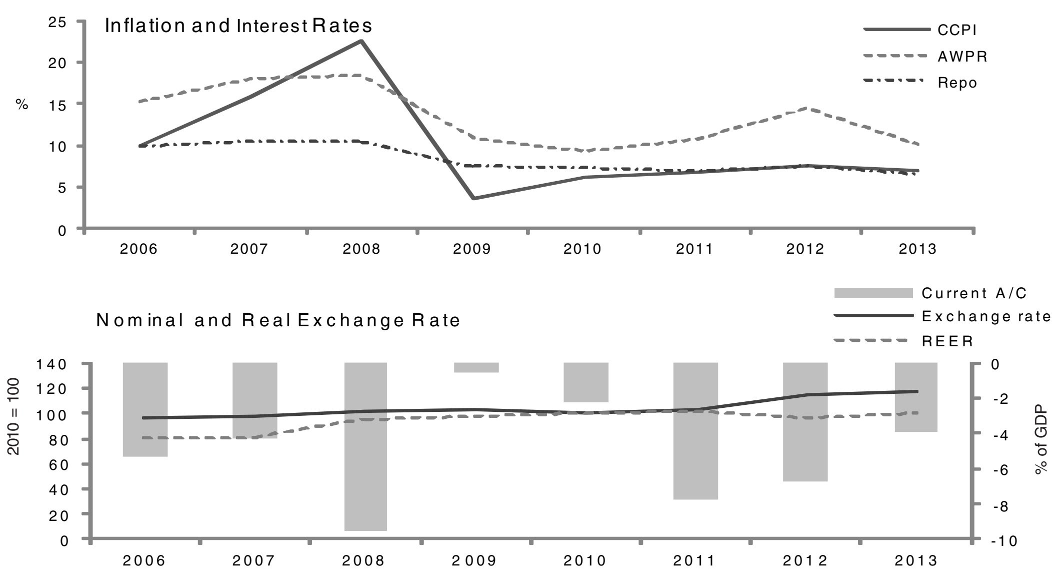
inflation rate has been held under single digit figures (Figure 2.5). Achieving a measure of price stability - the primary objective of monetary policy - has certainly been an uphill task, given that Sri Lanka's inflation rate reached a high of 22.6 per cent in 2008, just months before inflation settled to single-digit levels from February 2009.

The benign inflationary environment, however, has not had the desired impact in boosting private investor sentiment despite aggressive efforts to bring down the cost of borrowing. A 25 basis point reduction in policy rates in December 2012 was followed by a further rate reduction of 50 basis points in May 2013. The CBSL lowered commercial banks' Statutory Reserve Requirement (SRR) of Licensed Commercial Banks (LCBs) by 2 percentage points from 8 per cent to 6 per cent in June 2013. From August 2013, all LCBs were requested to reduce the penal rates of interest charged on all loans and advances including credit facilities already granted to a level not exceeding 2 per cent per annum, whilst finance and leasing companies were requested to reduce the penal rate of interest to 3 per cent per annum. In October 2013, policy rates were cut by a further 50 basis points to stand at 6.5 per cent.

Lending rates that remained fairly sluggish in the first half of 2013 owing to high government borrowing began to decline sharply from mid-2013. The Average Weighted Prime Lending Rate (AWPR) has fallen from 14.4 per cent in February 2013 to 7.9 by June 2014. Despite the steep fall, credit uptake by the private sector has remained poor. Credit growth to the private sector was a low 7.5 per cent in 2013 compared to 17.6 per cent in 2012. By June 2014, this had fallen further to a growth rate of 2 per cent on a year-on-year basis.

The poor credit uptake by the private sector in the latest round of interest rate easing is perhaps best explained by the spillover effects of the most recent credit boom of 2011-12. Post-2009, high domestic demand financed by external debt brought added complexity to monetary and exchange rate policy management. An interventionist exchange rate policy to prevent appreciation of the currency in the

Figure 2.5
Inflation, Interest and Exchange Rate Movements



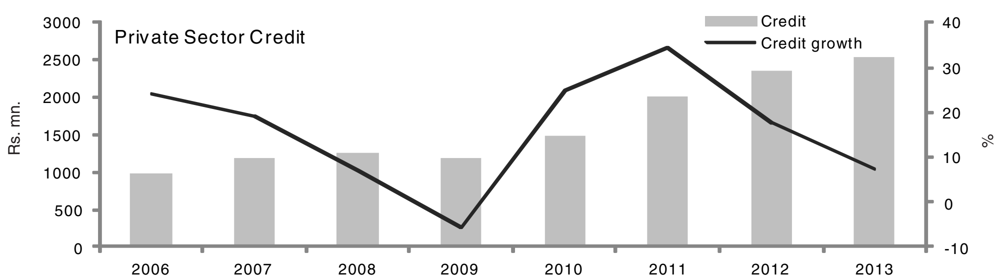
Source: CBSL, *Annual Report*, various years.

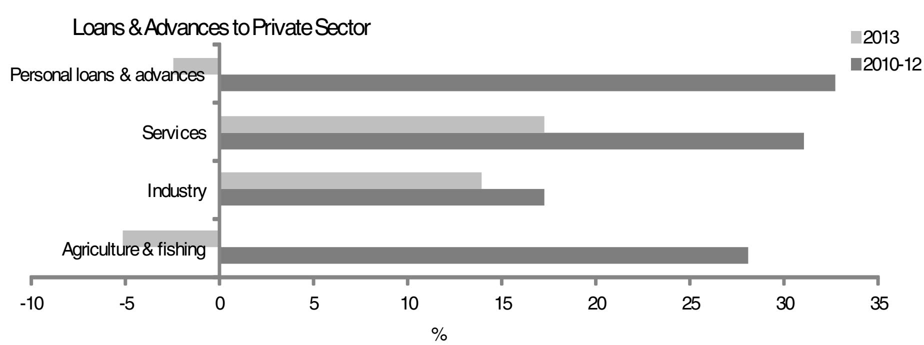
face of foreign capital inflows saw an expansion of the monetary base, with significant volumes of excess liquidity in the financial market. Credit growth to the private sector accelerated from mid-2010 - even as policy rates remained unchanged throughout 2011 - fuelling an import surge and precipitating the imposition of a mandatory ceiling on commercial bank credit growth, reversal on import tariff reductions on select products, and move to a flexible exchange rate policy in February 2012.

In view of the doubling in volume of credit to the private sector between 2009 and 2012, the lack of credit appetite in the latest round of monetary policy easing is not difficult to understand. Not only did it lead to macroeconomic volatility but it also led to significant policy swings in monetary policy, exchange rate policy and tariff policy that is unsettling for private sector investors.

On the other side of the coin, the past credit excesses have left LCBs to combat their own set of challenges. Much of the credit expansion was in the area of personal loans and advances, including pawning that suffered subsequent to a drop in gold prices. With a slower rate of economic output post-2012, the combined impact has been to expose the banking sector to rising non-performing loans (NPLs), with the gross NPL ratio climbing sharply to 5.6 per cent in 2013 from 3.7 per cent in 2012.[4] The banking sector is experiencing significant excess liquidity with the Statutory Liquid Assets Ratio (SLAR) at 37.7 per cent by end 2013, significantly exceeding the minimum requirement of 20 per cent. Overall profitability of the banking sector also declined with profits after tax contracting by nearly 10 per cent in 2013.

Figure 2.6
Credit Growth to the Private Sector





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

[4] CBSL, *Annual Report* 2013.

In the midst of a challenging business environment for both bank and non-bank financial institutions (NBFIs), the CBSL is pursuing its second objective of financial system stability via a financial consolidation effort. Whilst it undoubtedly has long-term objectives, the immediate concern is primarily to minimize systemic risks posed by deposit taking finance companies at high risk. At present, banks and NBFIs account for 64 per cent of the entire financial system assets, with banks accounting for 57 per cent and NBFIs for 7 per cent. Several NBFIs came under severe liquidity pressure in 2009 following the collapse of some legal and illegal entities run on the lines of pyramid schemes, with the contagion effects spreading to banks and finance companies. In total, 8 NBFIs faced liquidity problems in 2009 with another NBFI facing similar problems in 2013. Post-2009, the NFBI sector has continued to expand with the CBSL elevating some Specialized Leasing Companies (SLCs) to Licensed Finance Companies (LFCs) whilst also granting new licences to LFCs so that by end 2013, the total stood at 58 (Table 2.5).

The immediate consolidation process aims to bring down the numbers of NBFIs from 58 to 20. These have been divided into three categories of A (19 NBFIs), B (38 NFBIs), and C (1 NBFIs). Category B NBFIs are to merge with local banks or Category A NBFIs, or merge among themselves so that they fulfill conditions of Category A NBFIs, the most important being an asset base of over Rs. 8 billion.

Table 2.5
Non-bank Financial Sector

	LFCs (No.)	SLCs (No.)
2013	48	10
2012	47	13
2011	39	16
2010	37	21
2009	35	21

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

The end goal through consolidation and mergers of banks and NBFIs is to ensure that at least five domestic banks emerge with total assets in excess of Rs. 1 trillion, and those with less than Rs. 100 billion to achieve this threshold benchmark. In the case of the NBFIs, the intention is to bring the total number down to 20 NBFIs, each with an asset base of over Rs. 20 billion.

Efforts to encourage mergers and acquisitions to bring about consolidation in the financial sector are being pursued quite strenuously by the regulator. Whilst the consolidation is in the right direction, it is incumbent on the regulator to ensure that it is carried through in the best interests of all the entities involved, with long-term goals in mind.

For Sri Lanka, the consolidation process is also expected to ease conditions for the country's commercial banking sector to tap foreign savings.

Table 2.6
Distribution of Banks and NBFIs

Asset Base (Rs. bn.)	Domestic Banks[a] No.	Market Share	Asset Base (Rs. bn.)	NBFIs No.	Market Share (%)
> 500	5	66.3	> 20	10	61.5
250-500	1	6.3	8-20	7	13.8
100-250	3	9.2	< 8	40	24.1
50-100	3	5.2	Litigation	1	0.5
< 50	4	3.1			

Notes: a. Excludes four small state-owned banks with assets less than Rs. 100 billion.
Source: CBSL, "Master Plan on Consolidation of the Financial Sector".

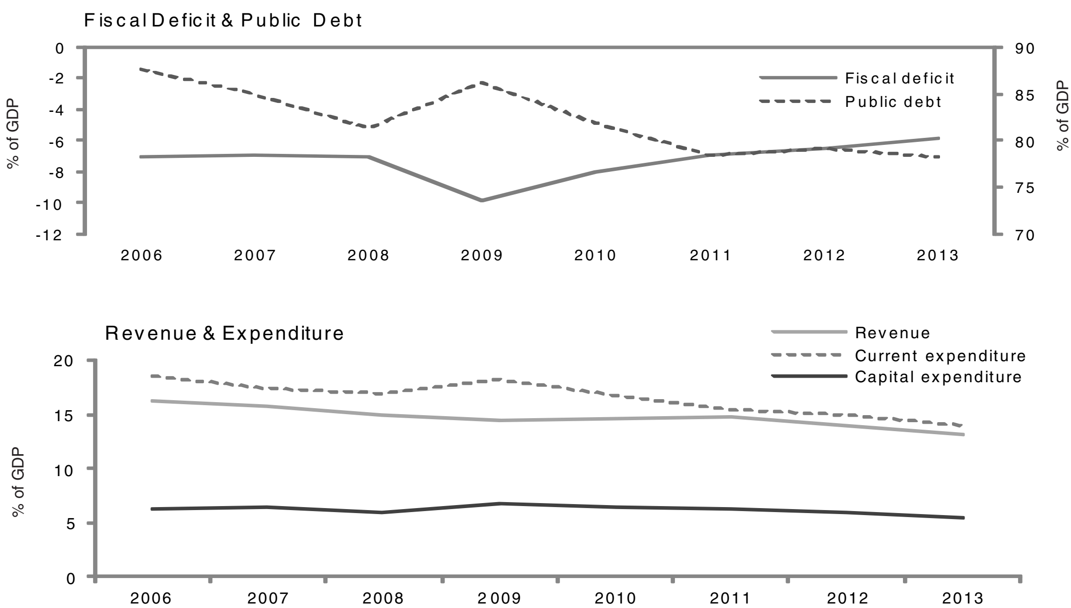
The National Savings Bank (NSB) shelved initial plans to issue a 10-year US$ 1 billion bond and instead issued a five-year bond for US$ 750 million bond at 8.875 per cent in September 2013. Subsequently, in accordance with Budget 2013 proposals where the DFCC and NDB banks were encouraged to raise long-term foreign development finance up to US$ 250 million each, the DFCC raised a five-year bond of US$ 100 at 9.625 per cent in October 2013. This was below its US$ 250 million quota, while its counterpart NDB Bank raised US$ 125 million and US$ 75 million in March and June 2014, respectively. The foreign exchange risk on such borrowing is underwritten by the government.

The government did not have plans to issue sovereign bonds in 2013. Instead, it relied on financial entities to do so. In effect, such borrowing amount to proxy borrowing by the government, with added risks of multiple parties exposing their balance sheets to international capital markets. Moreover, by underwriting exchange rate risk, such efforts do not necessarily help develop financial institutions in the country to tap capital markets on their own efforts. To an extent, the proposed financial consolidation efforts - that between DFCC and NDB for example - are partly driven by intentions to develop institutional strength to tap foreign capital markets in the future. This is seen as the answer to domestic resource constraints, especially continued low revenue generation by fiscal authorities to meet Sri Lanka's development expenditure needs.

2.5 Fiscal Stimulus for Growth

Sri Lanka's fiscal outlook in terms of the overall deficit and public debt has been improving progressively over time. The fiscal deficit, from having weakened to 9.9 per cent of GDP in 2009 has improved steadily to 5.9 per cent in 2013. The most positive feature of the adjustment has been a steady decline in the share of current expenditure whilst maintaining public investment at around 6 per cent of GDP.

Figure 2.7
Fiscal Indicators



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

Despite improvements in headline numbers, concerns do remain with regards to weak financial positions of many SOEs, not captured in the fiscal deficit numbers, and adjustments made in terms of delayed payments from time to time. Additionally, robust GDP growth has meant that many indicators have benefited from the denominator effect. For instance, all three major current expenditure items - salaries and wages, transfers and subsidies, and interest payments - have shown a decline in share of GDP. However, in real terms, expenditure on these items has grown. For example, wages and salaries have recorded a real growth in expenditure of 2.7 per cent per annum during 2010-13 despite declining as a share of GDP from 5.4 per cent in 2010 to 4.5 per cent in 2013 (Table 2.7).

By contrast, where a robust denominator should have helped raise revenue, there has in fact been a sharp decline. Tax revenue which comprises approximately 85 per cent of total revenue has dropped from 12.9 per cent of GDP in 2010 to a low of 11.6 per cent in 2013 (Table 2.8). Critically, VAT collection which accounted for approximately 25 per cent of tax revenue in 2013 has not kept pace with higher economic output in the country post-2009. The widespread use of tax exemptions - be it on VAT, import duties or FDI approved projects - has been a critical factor weakening the tax base in the country, despite efforts put in to improve overall tax administration and compliance.

Slack revenue generation means that Sri Lanka will continue to look for foreign savings to bridge resource gaps as done over recent years. Besides planned physical infrastructure projects, attention will also need to focus increasingly on investments to raise productivity and efficiency in social infrastructure, especially in vital areas of health and education. With an ageing demographic profile and rising incomes, the country's health sector challenges are in transition and will become more acute in the coming years. Similarly, the education sector needs to exponentially transform the skills and competencies of the country's shrinking labour force. All these require a re-balancing of existing investment priorities and call also for fresh investments.

Clearly, some of this re-balancing is already taking place viz., government expenditures. Current spending on defence has contracted in real terms and fallen as a share of GDP post-2009 (Table 2.9). Education sector spending has grown in real terms, although its share as a percentage of GDP has declined marginally to 1.7 per cent in 2013. However, government spending on education has grown in real terms at an annual average of 3.6 per cent during 2010-13. Whilst Sri Lanka's spending on education as a share of GDP remains an under-estimate in view of significant private sector investments, it is clearly rather low to meet expanding demand. At present, only 3.6 per cent of those in the age group of 20-24 years are at university and another 3.6 per cent at technical and vocational training institutes.[5] Public spending on

Table 2.7
Current Expenditure Patterns

	Share of GDP 2010	Share of GDP 2013	Real Growth[a] 2010-13
Total current expenditure	16.7	13.9	1.3
Salaries & wages	5.4	4.5	2.7
Transfers & subsidies	3.5	2.9	0.1
Interest payments	6.3	5.1	2.6

Notes: Deflated using 2006/07 CCPI index.
Source: CBSL, *Annual Report*, various years.

[5] Weerakoon. D., and N. Arunatilake (2011), "Macroeconomic Policy for Full and Productive Employment and Decent Work for All: Sri Lanka Country Study", Employment Working Paper No. 110, International Labour Organization, Geneva.

Table 2.8
Tax Revenues as a Percentage of GDP

	2010	2011	2012	2013
Tax revenue	12.9	12.4	12.0	11.6
Income taxes	2.4	2.4	2.3	2.4
VAT	3.9	3.3	3.0	2.9
Excise taxes	2.3	2.8	3.0	2.9
Import duties	1.1	1.2	1.1	1.0
Other taxes	3.1	2.7	2.7	2.5

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

health too has grown in real terms during 2010-13, albeit at a much faster pace.

To meet Sri Lanka's expenditure needs for development, the country has increasingly relied more heavily on external financing of its fiscal deficit (Figure 2.8). In 2013, the trend reversed in the face of low private sector demand for credit, allowing the government to rely more heavily on domestic financing without fear of crowding out private investment. By and large, however, Sri Lanka is likely to continue to tap foreign savings for its development financing. Unlike in the past, grants and long-term concessionary development finance has played only a very limited role in the country's resource mobilization efforts. Instead, Sri Lanka has resorted to non-concessionary forms of borrowing, including sovereign bonds, foreign investment in Treasury bills and bonds and bilateral loans from countries such as China. The mix has meant a rapid transformation of outstanding government foreign debt, with the non-concessionary component rising sharply to 50 per cent of the total share.

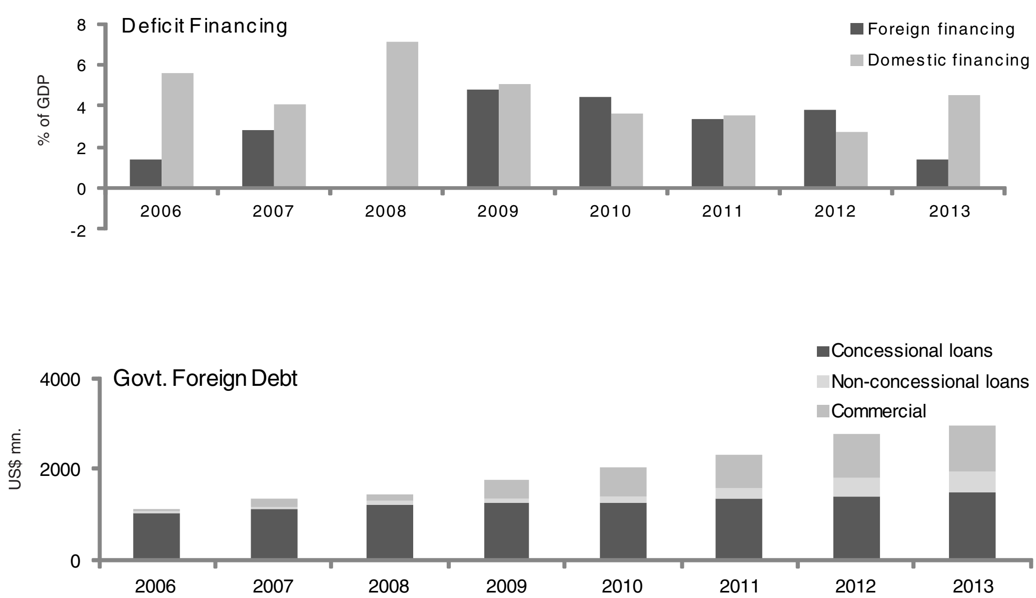
Sri Lanka has resorted to non-concessionary forms of borrowing, including sovereign bonds, foreign investment in Treasury bills and bonds and bilateral loans from countries such as China.

Table 2.9
Functional Expenditures in Select Sectors

	Share of GDP 2010	Share of GDP 2013	Real Growth[a] 2010-13
Defence[b]	2.6	2.0	-2.4
Education[c]	1.9	1.7	3.6
Health[c]	1.3	1.4	6.8
Transport & communications[c]	3.5	2.8	8.7

Notes: Deflated using 2006/07 CCPI index; b. Current expenditures only; c. Current and capital expenditures.
Source: CBSL, *Annual Report,* various years.

Figure 2.8
Deficit Financing and Government External Debt



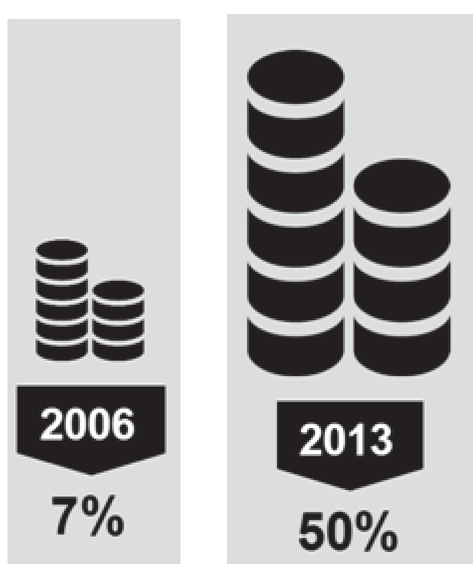
Source: CBSL, *Annual Report,* various years.

Sri Lanka's uptake of non-concessionary foreign debt has helped not only to bridge the fiscal deficit, but also to prop-up the country's foreign exchange reserves and provide balance of payments (BOP) support over the years. The risks associated with greater exposure to sentiments of international capital markets and foreign investors are linked to a country's external sector performance and its medium to long-term outlook. In this respect, there have been positive developments, but also continuing concerns regarding the overall competitiveness and health of Sri Lanka's export sector.

2.6 External Sector Stability

Despite higher overall GDP growth in recent years, what appears to be an inexorable decline in the ratio of exports-to-GDP - falling to a low of 15.5 per cent

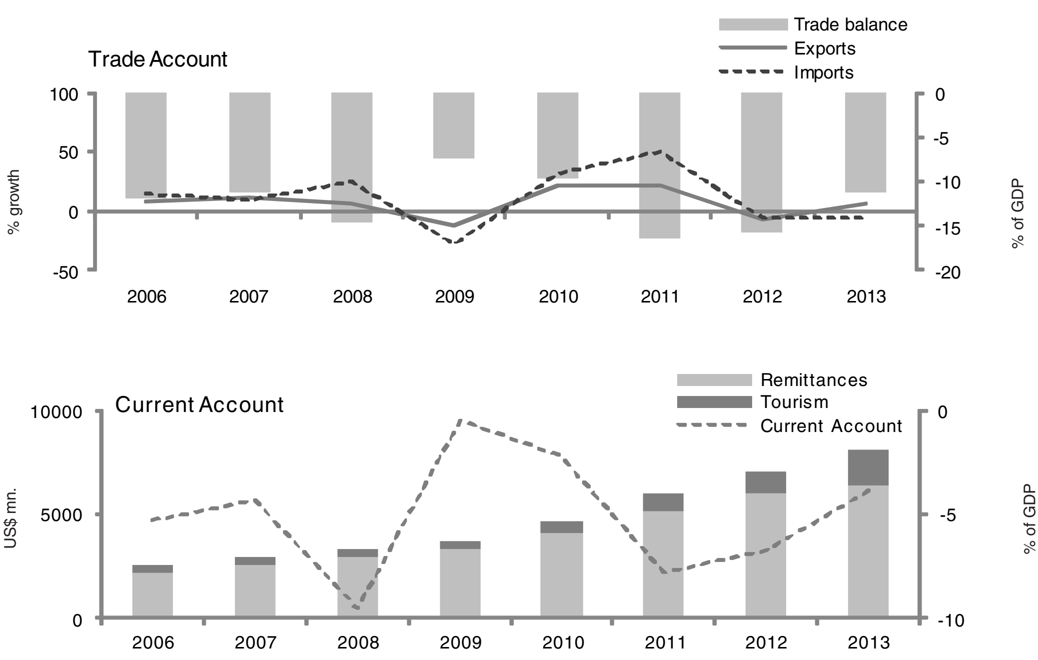
Share of non-concessionary and commercial borrowing in total external debt



in 2013 - is a matter of serious concern on two counts. First, it is a reflection that higher GDP growth is being driven by domestic demand rather than exports, which is an untenable long-term strategy for a small open economy. Second, the declining share in GDP is compounded by loss of market share globally, which is an indicator of the country's waning competitiveness in international markets.[6] The country's exchange rate policy too has not helped to maintain competitiveness. With significant capital inflows as a result of higher foreign borrowing, the tendency has been for the rupee to appreciate in real terms (see Figure 2.5). Clearly, the currency movements are not reflecting the underlying fundamentals of the economy - i.e., a weak current account position reflective of external demand for Sri Lanka's goods and services. Rather, it is being distorted 'artificially' and hurting the competitiveness of the country's export sector.

Despite higher overall GDP growth in recent years, what appears to be an inexorable decline in the ratio of exports to GDP - falling to a low of 15.5 per cent in 2013 - is a matter of serious concern.

Figure 2.9
Trade and Current Account Trends



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

[5] IPS (2013), "Global Developments and External Sector Competitiveness" in *Sri Lanka: State of the Economy 2013*, Institute of Policy Studies of Sri Lanka, Colombo.

Sri Lanka's trade deficit has averaged 13 per cent of GDP per annum during 2010-13. Import expenditure grew by over 50 per cent in 2011 following the easing on import duty rates on select products in 2010, particularly on motor vehicles, fuelled by consumption driven credit growth in the economy and an artificially over-valued exchange rate. Policy corrections introduced in early 2012 - a much delayed depreciation of the currency, re-imposition of high import duties and a curb on lending by banks - saw Sri Lanka's trade account begin the slow journey towards a measure of stability. After contracting in 2012, export earnings grew by 6.3 per cent in 2013, holding out some optimism of a more sustained growth in export earnings in the immediate future.

The signs so far are good. Export earnings have continued to grow by 16.8 per cent in the first half of 2014, with strong growth in earnings from garments of 20.5 per cent. Import expenditure is also picking up, an early signal of a more positive renewal of economic activity.

For Sri Lanka, worker remittances, and increasingly earnings from tourism are the stabilizing factors in the external current account. Remittances have historically been the mainstay. However, there is a disquieting development in 2013, whereby remittances grew by only 7 per cent compared to an annual average growth rate in excess of 21 per cent per annum during 2010-12 (Table 2.10). This is surprising in view of continued growth in the numbers of migrant workers departing for work overseas, with total numbers at 293,105 in 2013. The explanation perhaps lies in an easing-off of transfers to former conflict-affected households in the aftermath of 2009. Another explanation may well be the low interest rate climate that prevailed for much of 2013, prompting workers to remit only a part of their earnings. In the first half of 2014, remittances continued to grow at a lower rate of 10.6 per cent.

The explanation may also lie in a discrepancy on data compilation. Remittances were reported at US$ 6.8 million at end 2013 on the basis of monthly compilation of figures; the annualized figure is reported at US$ 6.4 million.[7] On that basis, remittances grew by 13 per cent. At the same time, tourism earnings figures have undergone a re-adjustment, rising from US$ 1.4 million on a monthly basis to US$ 1.7 million on an annualized basis, accounting for the sharp increase in earnings of 65 per cent. Even without the adjustment, tourism earnings did rise at a healthy rate (35 per cent), with Sri Lanka recording the highest ever numbers of arrivals at 1.3 million in 2013. Indeed, with much of FDI inflows concentrated in tourism and related sectors, it is expected to be a significant driver of growth and employment in the coming years.

Table 2.10
Migrant Remittances and Tourism Earnings

	Growth in Numbers (%)		Earnings Growth (%)	
	2010-12 average	2013	2010-12 average	2013
Migrant workers	4.7	3.8	21.6	7.1
Tourism	31.5	26.7	44.6	65.1

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

[7] See CBSL, "External Sector Performance - December 2013" and *Annual Report* 2013, respectively.
[8] From 2013, Sri Lanka started compiling its external accounts under the latest BOP Manual BPM6.

Net FDI in 2013 stood at US$ 916 million compared to US$ 941 million received in 2012.[8] This includes total direct investment received by BOI companies (US$ 887 million), non-BOI companies and listed companies under the Colombo Stock Exchange (CSE). In addition to the direct investment, BOI companies also received US$ 505 million by way of loans, raising the total FDI to US$ 1.4 million from US$ 1.3 million received in 2012. The total for 2013 fell short of the US$ 2 billion target that was set. Little of the FDI received has gone into technology and knowledge enhancing economic activities, with the bulk concentrated in infrastructure and tourism sector developments. Besides this drawback, the quantum of FDI is still so low that Sri Lanka has to keep relying on other forms of foreign funds to bridge its savings-investment gap.

In 2013, Sri Lanka relied heavily on non-direct foreign borrowing by state entities and private sector, especially by the country's banking sector. Inflows to commercial banks and savings banks together amounted to US$ 1.5 billion, up from US$ 970 million in 2012. In the face of indirect borrowing by state-owned banks and private banks with a government stake in 2013, the government focused on issuing Sovereign bonds to the value of US$ 1.5 billion in 2014. The target was met by April 2014, with two consecutive Sovereign bonds issued in January and April for US$ 1 billion and US$ 500 million, respectively (Table 2.11). Sri Lanka has indeed been successful in getting ever more attractive pricing on its Sovereign bonds, particularly in the more recent issues in the wake of foreign investors leaving many emerging markets.

Greater recourse to tapping international capital markets by a cross-section of actors also means that the sources of Sri Lanka's outstanding external debt are changing rapidly. Total government external debt has remained flat at about 36 per cent of GDP, and has in fact shrunk to 34 per cent in 2014 (Figure 2.10). This is of course not withstanding the significant changes in the composition of that debt towards non-concessionary sources as detailed earlier.

What is notable is that Sri Lanka's total external debt has in the interim risen quite sharply, especially post-2011 with the inclusion of banking sector liabilities. Whilst the argument can be made that non-sovereign backed debt is not under the purview of the government and relies on corporate balance sheets, the East Asian financial crisis offers a salutary lesson that at times of intense stress, the lines between government, government-backed or private debt become blurred when a 'herd instinct' strikes investors.

Sri Lanka's debt service ratio - measured by the conventional definition as a ratio of the exports of goods and services - is also on the rise (Figure

Table 2.11
Sovereign Bond Issues

Issue Date	Amount (US$)	Expiry Date	Yield (%)
October 2007	500 million	October 2012	8.25
October 2009	500 million	October 2015	7.40
September 2010	1 billion	October 2020	6.25
July 2011	1 billion	July 2021	6.25
July 2012	1 billion	July 2022	5.875
January 2014	1 billion	January 2019	6.00
April 2014	500 million	April 2019	5.125

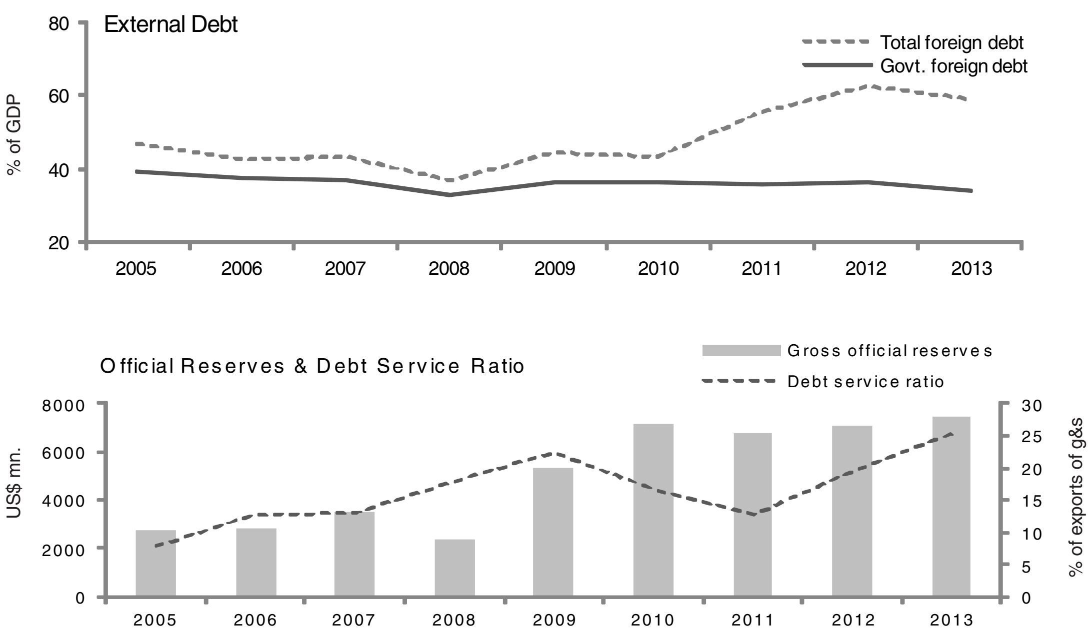
Source: CBSL, www.cbsl.gov.lk.

The East Asian financial crisis offers a salutary lesson that at times of intense stress, the lines between government, government-backed or private debt become blurred when a 'herd instinct' strikes investors.

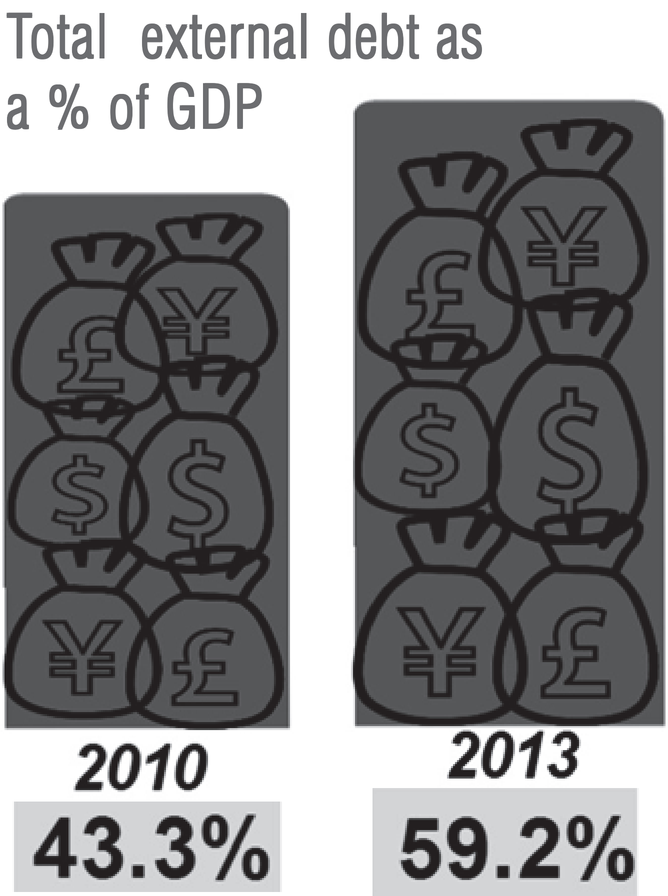
2.10). Despite a healthy-looking improvement in the country's official reserves position over the last four years, there is limited comfort to be had in view of the fact that almost the entirety of it is currently made up of borrowed funds. It reinforces the reason why Sri Lanka must focus acutely on strengthening the country's export earnings potential through goods and services. Even if workers' remittances are factored in to re-calculate the debt service ratio, it indicates a sharp increase from 13.5 per cent in 2012 to 17.6 per cent in 2013.

With Sri Lanka's medium term Sovereign bond settlements gathering pace from 2019, retaining investor confidence on the long-term outlook for the country will require a continuous bridging of its current account deficit to surplus levels, supplemented by higher volumes of FDI inflows in the capital account. This will mitigate risks inherent in rolling over debt over time. For now, the exchange rate remains stable in view of lacklustre import demand and subdued international oil prices.

Figure 2.10
External Sector Trends



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



However, these conditions can change, particularly commodity prices in the face of growing unrest in the Middle East and Russia. With the country more exposed to external shocks, any inability to withstand and ride them out, can unravel the many significant achievements already made in improving the overall macroeconomic fundamentals. The remedy lies in instituting reforms to improve productivity, efficiency and competitiveness of the Sri Lankan economy that will complement the strides being made in strengthening infrastructure services.

2.7 Conclusion

On the socio-economic front, Sri Lanka has made rapid strides in addressing poverty and inequity - the cornerstones of the government's vision for a peaceful post-conflict society. With GDP growth averaging 7.5 per cent per annum post-2009, and a relatively stable set of macroeconomic indicators - a prolonged spell of single digit inflation, a shrinking fiscal deficit, and a relatively steady exchange rate - Sri Lanka has partially established its economic credentials as an emerging economy to watch. The achievements have been magnified in view of weaker accomplishments from the country's historically better-performing competitors, particularly in Southeast Asia.

Yet, much remains to be done. The core of Sri Lanka's higher growth trajectory has been domestic demand financed with external debt. It is having an inevitable impact on the structure of the supply-side of the economy, in particular the balance between the tradable and non-tradable sectors. The latter has been driving growth, with greater state involvement in many of these sectors - such as construction, utilities, and many services sectors. An unintended consequence is that it is perhaps also keeping the private sector less engaged in Sri Lanka's post-2009 development efforts than might have otherwise been the case.

The main policy focus since the end of 2012 has been to encourage the private sector to borrow and raise levels of investment and economic participation. The response has been muted, partly as a result of past credit booms, the reverberations of which are yet to settle and work their way through the economy. A second, and equally disquieting, reason is likely tied to limited investment opportunities across a broad spectrum of economic activities, that will stimulate not only the big players, but also the small and medium sized enterprises that are sub-contractors and suppliers of goods and services. Addressing the latter requires a commitment to engage the private sector and create a policy environment that is perceived as truly pro-business. For instance, the causes of Sri Lanka's export competitiveness problem go far deeper than the exchange rate. There exist long-ignored impediments to growth - developing a skilled and flexible work force; a consistent, predictable and cohesive policy framework to drive exports or attract FDI to high-tech knowledge-driven sectors; an efficient, cost-effective bureaucracy to reshape public spending; and transparent and effective institutional and governance mechanisms to support overall development efforts. Sri Lanka has much to learn from its Asian neighbours in many of these areas - best practices as well as pitfalls to be avoided - if the country is to achieve its dream of being a 'Wonder of Asia' in the years to come.