# Sri Lanka
# State of the Economy Report 2012

## Chapter 12
## Prospects

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## 12. Prospects

The outlook for global economic prospects remains subdued with the most recent growth forecast for the world economy seeing a slight reduction to 3.5 per cent in 2012 and 3.9 per cent in 2013. The slowdown in GDP growth is being felt across the world, including in the emerging economic giants, China and India (Table 12.1). With a GDP growth rate of 7.2 per cent in the first half of 2012, Sri Lanka too is expected to see a slowdown in growth for the year overall, after two consecutive years of meeting its 8 per cent target. Whilst the slowdown is in part related to global economic outcomes -- i.e., weak global demand conditions for Sri Lanka's exports – policy interventions to correct underlying macroeconomic misalignments are exerting the greater influence.

The performance of Sri Lanka's export sector in recent times is troubling, losing global market share as well as recording a declining contribution to GDP. Given the greater uncertainty pervading global economic conditions, the lackluster performance in export earnings growth adds to Sri Lanka's vulnerability to periodic BOP stresses. Indeed, in the first half of 2012, export earnings did poorly, contracting by 2.2 per cent to US$ 5 billion, relative to a much healthier growth in earnings of 35 per cent in the corresponding period in 2011 (see Figure 12.2).

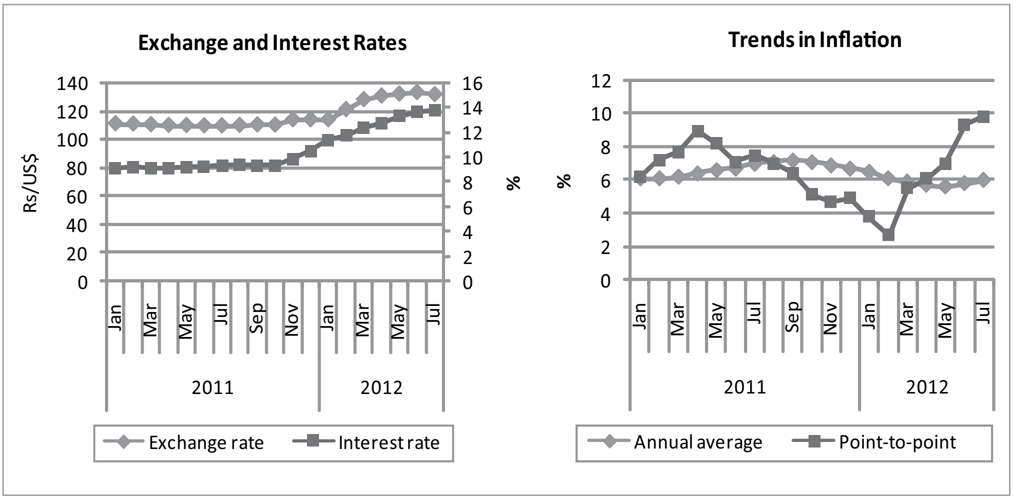
> ***'The prospects for a rapid recovery will depend on investor confidence in macroeconomic stability and enabling institutional environment pervading economic management'***

**Table 12.1**
**World Economic Outlook**

| | 2010 | 2011 | 2012[a] | 2013[a] |
|---|---|---|---|---|
| World output (%) | 5.3 | 3.9 | 3.5 | 3.9 |
| US | 3.0 | 1.7 | 2.0 | 2.3 |
| Euro Zone | 1.9 | 1.5 | -0.3 | 0.7 |
| China | 10.4 | 9.2 | 8.0 | 8.5 |
| India | 10.8 | 7.1 | 6.1 | 6.5 |
| World trade volume (%) | 12.6 | 5.9 | 3.8 | 5.1 |
| Oil prices (US$) | 79.0 | 104.0 | 101.8 | 94.2 |

Notes: a: Projections.
Source: IMF, *World Economic Outlook*, July 2012.

**Figure 12.1**
**Trends in Exchange Rate, Interest Rates and Prices**




Notes: Interest rate refers to the average weighted prime lending rate.
Source: CBSL, *Monthly Economic Indicators*, various issues.

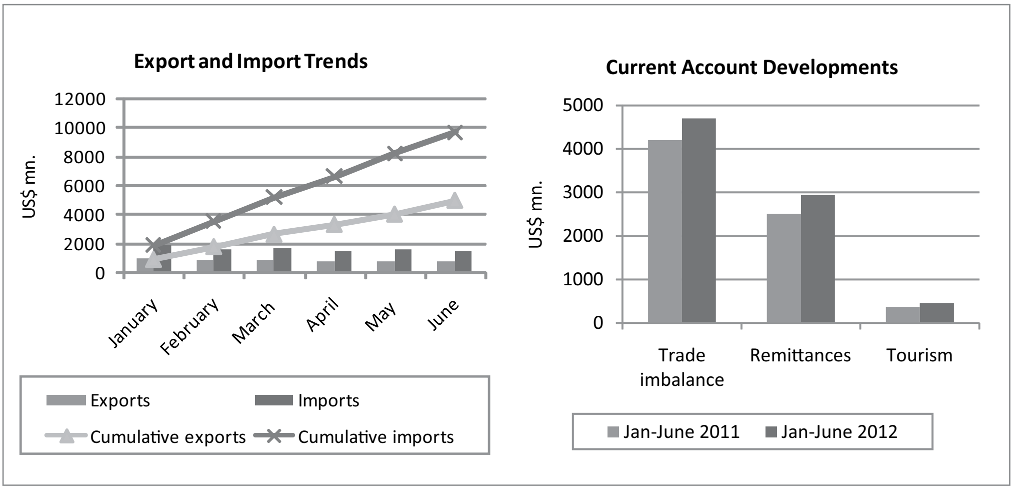
As argued previously, domestic macroeconomic policy management has a strong bearing on Sri Lanka's export performance. Sri Lanka's exchange rate policy in recent years has not helped, ensuring that an overvalued real exchange rate hindered the competitiveness of the country's exports in international markets. Whilst the realignment of exchange rate policy in February 2012 provided welcome relief, the hike in interest rates, raising the cost of working capital for exporters, created another constraint (Figure 12.1). Thus, stability and predictability in the macroeconomic environment has been a missing element in promoting sustained export sector growth.

The rapidly deteriorating trade balance -- driven by a surge in import expenditure on the back of an overvalued currency, import duty reductions and access to easy credit -- prompted a direct policy intervention in the form of a sharp reversal of import duties on the main import item, i.e., motor vehicles in March 2012. Indirect policy measures of allowing the exchange rate to float and a ceiling on commercial bank lending also helped curb import expenditure. Indeed, total import expenditure growth in the first half of 2012 declined 4.2 per cent to US$ US$ 9.7 billion, relative to a growth rate in excess of 46.5 per cent in the corresponding period in 2011.

Primarily as a result of the curb on imports, an expanding trade deficit is being reined in. Sri Lanka's trade deficit stood at US$ 4.7 billion in the first half of 2012, slightly above the US$ 4.2 billion deficit recorded in the comparative period in 2011 (Figure 12.2). The trade deficit is likely to narrow further in the second half of 2012, as the anticipated slowdown in economic growth reinforces a declining demand for imports. The forecast trend for international oil prices – US$ 101.8 per barrel in 2012 with a decline to US$ 94.2 per barrel in 2013 -- will also help ease pressure on the trade balance.

The relatively healthy growth in earnings from workers' remittances and tourism receipts – 17.4 per cent and 24.3 per cent respectively during the first half of 2012 – will also help to moderate the country's external current

**Figure 12.2**
**Trends in the Trade Balance and Current Account (January-June 2012)**




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

account deficit from a high 7.8 per cent of GDP in 2011. Indeed, by June 2012, remittances and tourism earnings absorbed 72 per cent of the trade deficit in comparison to a much lower figure of 60 per cent in the course of 2011.

Nonetheless, Sri Lanka's external current account balance will remain under stress in 2012. The outcome for the overall BOP position will depend on capital account inflows. To this end, available data suggest gross inflows of FDI have improved -- estimated to be US$ 452 million in the first half of 2012, relative to an inflow of US$ 393 million over the same period in 2011.[1] In July 2012, Sri Lanka received the final tranche of US$ 415 million under the SBA from the IMF, and raised US$ 1 billion by placing the country's fifth US dollar benchmark offering in international bond markets.

In view of the stresses on the BOP, the recovery of gross official reserves from a peak of US$ 8 billion in July 2011 (sufficient for 5.7 months of imports) has been slow. In February 2012, official reserves stood at US$ 5.5 billion after the aborted attempt to prop up the currency. By end July 2012, reserves had risen to US$ 7 billion, sufficient for 3.5 months of imports. The foreign currency generated through the US$ 1 billion Sovereign Bond helped to add to the country's gross official reserves bringing reserves to US$ 7 billion by end July 2012. However, it is building up the share of non-borrowed reserves that Sri Lanka needs to focus on if it is to ensure a sustainable BOP position in the medium to long term.

Under the circumstances, it is not surprising that the inflow of foreign capital in July 2012 by way of the IMF drawings and the Sovereign Bond helped to calm the foreign exchange market only temporarily. Pressure on the currency continued to be exerted with the rupee at Rs. 131 to the US dollar at end July 2012, relative to Rs. 113 per US dollar

[1] CBSL, *A Summary of External Sector Performance*, various issues.

in January 2012. In line with expected developments in the current account of the BOP, pressure on the rupee will ease in the second half of 2012. This will come about as a result of compressed import demand, as opposed to the more desirable path of a robust export earnings trajectory.

The initial compression on import demand through tax hikes, exchange rate adjustments and interest rates will align with a general slowdown in the economy. Indeed, the full impact of the tighter monetary policy environment on output will begin to manifest more clearly in the second half of 2012 as dampened investments and consumer demand drags down economic growth. However, the trade-off between growth and macroeconomic stability should not be viewed as a permanent set-back. It is a necessary adjustment for past policy misalignments and can pave the way for a resumption of steady growth in the medium term.

The lagged effects of a spiral of credit growth, adjustments to administered prices, and a depreciating currency have consequences on price stability. Inflation will begin to edge up, as evident from movements in point-to-point inflation rate from a low of 2.7 per cent in February 2012 to 9.8 per cent by July 2012 (see Figure 12.1). As the lagged effects work through, the annual average rate of inflation has begun to climb from May 2012. Whilst the annual inflation rate still remains fairly moderate at 6 per cent by July 2012, there is limited room to ease the current monetary policy stance in the coming months.

Developments on the fiscal front do not support an easing of monetary policy in the immediate future. The forecast fiscal deficit of 6.2 per cent of GDP for 2012, down from 6.9 per cent of GDP in 2011, is likely to come under pressure in view of the post-Budget 2012 policy changes, particularly with regards to import duties and the exchange rate. Already, in the first five months of 2012, Sri Lanka has seen a sharp deceleration in revenue collection, with revenue growth dropping to 9.1 per cent, as opposed to revenue growth of 23.8 per cent in the same period in 2011 (Table 12.2). The upward revision on excise duties on motor vehicles from March 2012 has had a dampening effect on revenue collection as the volume of imported vehicles dropped sharply. Indeed, in the first five months of 2012, growth of excise duties collected on petroleum and motor vehicles dropped to 13.8 per cent, from a rapid increase of over 118 per cent in the corresponding period of 2011. The general downturn in economic activities will further erode revenue generation in the coming months.

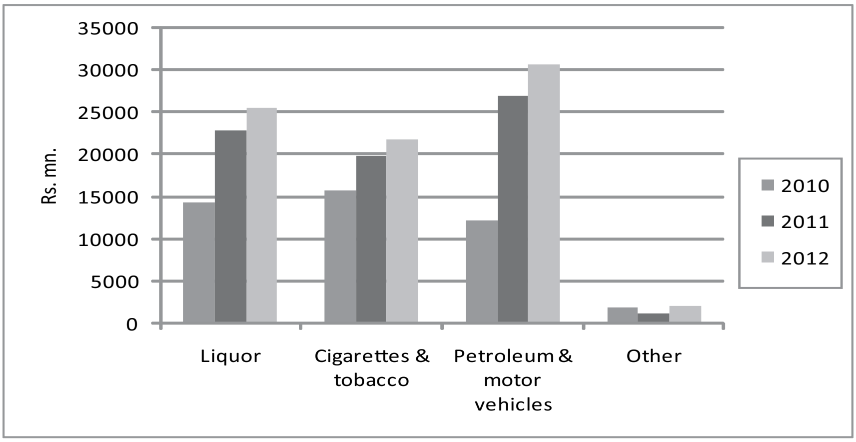
**Table 12.2**
**Fiscal Outcomes (January-May 2011 and 2012)**

| | Growth (%) | | Share of Approved Estimate (%) | |
|---|---|---|---|---|
| | **2011** | **2012** | **2011** | **2012** |
| Total revenue | 23.8 | 9.1 | 36.8 | 34.9 |
| Tax revenue | 19.8 | 11.9 | 36.6 | 35.3 |
| Current expenditure[a] | 10.2 | 23.6 | 35.4 | 40.2 |
| Public investment | 16.6 | 46.6 | 25.1 | 30.6 |

Notes: a: Expenditure estimates are for January-April.

Source: Ministry of Finance and Planning, *Mid-year Fiscal Position Report*, various years.

**Figure 12.3**
**Revenue from Excise Duties (January-May)**



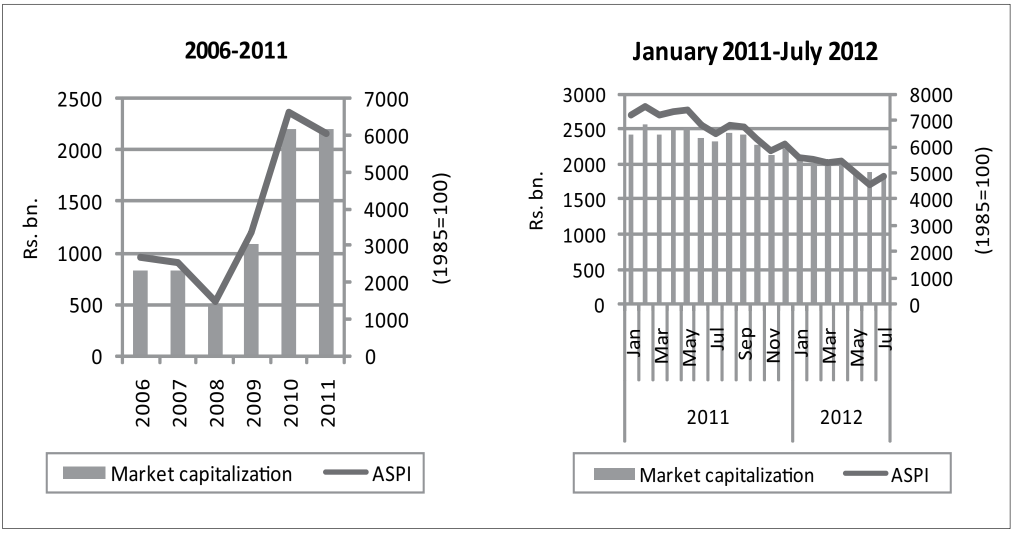

Source: Ministry of Finance and Planning, *Mid-year Fiscal Position Report*, various years.

Even as revenue growth has declined in 2012, expenditure growth on both current and public investment spending has risen relative to 2011. Current expenditure growth of 23.6 per cent in the first five months of 2012 is far in excess of the 10.2 per cent growth recorded for 2011 (Table 12.2). With the depreciation of the currency and rising interest rates, Sri Lanka's interest payments on both its domestic and foreign debt is on the rise. Despite heavier current spending, the momentum on public investment has been maintained, with expenditure growth at 46.6 per cent during January-May 2012, accounting for nearly a one-third of the allocated expenditure for the year. Whether the public investment programme will continue at the forecast level in the second half of 2012 will clearly depend on overall revenue generation efforts. Should revenue fall short of expectations, the temptation to slow public investment will be a factor in efforts to ensure a manageable fiscal deficit.

Even temporary interruptions to planned investment programmes can be costly. More critically, as economic growth slows in 2012, a cutback in public investment will prolong the recovery to the targeted 8 per cent growth for 2013. The most likely outcome is that public investment will remain around the same as that for 2011 (around 6.0 per cent of GDP), as opposed to a higher target of 6.6 per cent of GDP set out in Budget 2012 forecasts, leaving some room to adjust fiscal deficit outcomes. Thus, if as expected, the actual public investment-to-GDP ratio continues relatively unchanged, and the overall fiscal deficit remains below 7 per cent of GDP, Sri Lanka can weather a downturn in economic growth in 2012 and anticipate a reversal of fortunes in 2013. Indeed, if fiscal conditions are not allowed to get out of hand, and global demand conditions continue to remain relatively subdued in 2013, it will allow Sri Lanka an opportunity to reset interest rates at a lower level once again, without heightened risks of igniting inflationary pressures.

Much of the prospects for a rapid recovery will depend on investor confidence, not only on the outlook for macroeconomic stability in the medium term, but also on the enabling legal, institutional and regulatory environment pervading economic management. In this context, volatility in Sri Lanka's stock market performance has been an area drawing the attention of both domestic and foreign investors. The All Share Price Index

**Figure 12.4**
**Equity Market Trends**



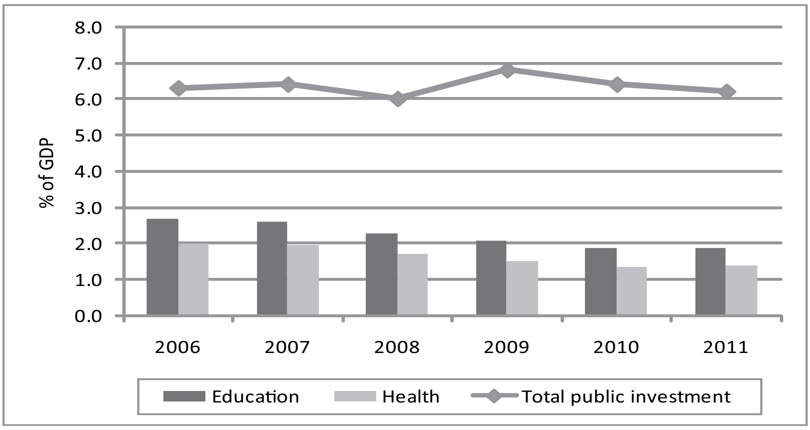

Source: CBSL, *Weekly Economic Indicators*, various issues.

(ASPI) has shown significant volatility, surging upwards from 2008 before beginning a sharp reversal from 2011. Indeed, the ASPI peaked at 7,798 in February 2011 before regulatory intervention to restrict credit extended by brokers halted the upsurge (Figure 12.4). More damaging to investor perception has been regulatory concerns that have beset activities in Sri Lanka's share market in recent months.

Whilst the activities of the CSE have limited bearing on the country's long term development objectives, it is an important -- albeit imperfect – barometer of private investor activity in the country. Regulatory lapses can have damaging consequences in efforts to build up Sri Lanka's debt and equity markets, identified as key areas for development to generate long term private investment in the Sri Lankan economy. Such investment is critical if Sri Lanka is to generate GDP growth in excess of 8 per cent to sustain its long term development efforts. Active private sector investment participation – be it in infrastructure development or investment in health and education -- needs to be encouraged to allow government finances to play a supportive role in critical areas such as provision of effective social security and safety nets for the vulnerable. Already, it is clear that even as public finances have been focused on facilitating private investment in economic activity through enhanced infrastructure services, public investment in improving Sri Lanka's health and education outcomes have fallen behind (Figure 12.5).

As discussed extensively in preceding chapters of this report, gearing Sri Lanka's shrinking labour force with the necessary skills to be productively employed is a must to sustain long term growth and related development objectives that the country has set for itself. This requires investments, particularly to strengthen Sri Lanka's tertiary education sector. Indeed, in the absence of productivity gains, and more savings and investment, some of the sources of Sri Lanka's faster growth of recent years – especially the heavy outlay on physical infrastructure – will exhaust itself. The greater reliance on costlier

**Figure 12.5**
**Public Investment Trends**




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

sources of foreign borrowing that has underpinned Sri Lanka's development efforts, also means that the country has to generate sufficient foreign exchange earnings to service its debt repayments in the coming years. If Sri Lanka is to do this comfortably, the country must move from demand-induced growth that relies heavily on foreign savings to growing its real economy, i.e., that part of the economy that is concerned with actually producing goods and services. This requires sound monetary, fiscal and regulatory policies that will encourage private investment spending to improve productivity, and allow the country to build on what has already been achieved in its post-conflict phase of development.