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Recent Trends in the Emerging Economy of Sri Lanka

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The end of the three decade long conflict in mid 2009 bolstering investor confidence in the country in the backdrop of global recovery from the recession brought about greater stability and potential for growth of the economy than any time before in the post liberalisation period in Sri Lanka. Recent trends in macro-economic conditions such as low inflation, low and stable interest rates, strong external reserves, stable exchange rate, improving fiscal outlook are solid indications that the economy is returning to normalcy from the instability it suffered for nearly three decades since the early 1980s. Besides domestic factors, the growth that suffered from adverse global conditions in recent years began to show a fast recovery towards the fourth quarter 2009 itself. This positive trend has continued since then and is evidenced through the sustained improvement in growth.

The Economy in the Post-Independence Period

The post-independence period of Sri Lanka can be clearly distinguished into two periods, the pre-liberalisation period, 1948 to late 1977 and the post liberalisation period, 1978 to date. The former period was characterised by different policy regimes. A laissez-faire policy was in practice during the period 1948 to 1958. The period from 1958 to 1965 is seen as a period of gradual tightening of exchange controls and state intervention and increased public ownership. The five year period, 1965 to 1970 saw a partial relaxation of exchange controls and trade but of course, the state sector continued to expand. The period from 1970 to late 1977 was characterised by stringent state controls and rapid growth of state ownership.

At the time Sri Lanka gained independence from the British in 1948, there existed a primary export commodity producing economy heavily biased towards agriculture. Sri Lanka benefited largely from high commodity prices such as those of tea, rubber and coconut due to the Korean war boom in the early 1950s. The gross domestic product of the country in 1948 was approximately US dollars 850 million as compared to US dollars 50 billion in 2010. The population was 7.0 million then in the country compared to 20.0 million today. The GDP per capita which was US dollars 120 in 1948 was only second to Japan in Asia and compares with US dollars 2400 in 2010, which is many fold higher in absolute terms but falls significantly below that of many countries in Asia. South Korea, one of the poorest countries in Asia and Singapore, a low income country 50 years ago, are today classified as high income advanced economies with high per capita income levels. Malaysia, Indonesia, Thailand and the Philippines, to name a few who trailed behind Sri Lanka in the 1950s, are today recognised as middle or high middle income countries by global standard. Sri Lanka remained a low income country until early 2010 when its position was upgraded to a "low middle income" country (IMF, February 2010).

Sri Lanka remained a welfare state in the post-independence period. Hence human development was considered a priority in the policies that were pursued for a long period of time. In terms of the Human Development Index (HDI) Sri Lanka's ranks 102 today thanks to the policies of the welfare state. A sizeable proportion of government expenditure has been spent on health, education and other welfare oriented activities such as sanitation, nutrition and housing. However, in terms of per capita income level, Sri Lanka has lost its relative position to many other countries over the years due to slower growth of the economy. The annual average of real GDP growth for 60 years since 1948 has been only 3.2 per cent which is by no means sufficient for a developing country to reach a high income status for its population. What is implied by this is that though Sri Lanka's GDP has grown more than 50 times, its population has increased nearly threefold thereby slowing down the growth of average income per head of the population to around 20 times during the last 62 years.

The economy was expected to expand rapidly due to the surge in demand resulted from the liberalised economic policies that came into force in late 1977. The year immediately following the introduction of open economy policies saw a GDP growth of 8.4 per cent in real terms and this growth tapered off gradually in the subsequent years until 1982 when growth rate reduced to 5.1 per cent. With the escalation of terrorist activities and rapid deterioration of the security situation in the country, performance of the economy suffered severely for nearly three decades until mid-2009 when the conflict finally ended and long lasting peace and political stability returned. The July 1983 disturbances are seen by many as an event that had a colossally devastating impact on the economy. As violence escalated in the years to follow, the economy continued to suffer at a rapid rate of intensity. In the meantime, the armed insurrection by the youth in the South also took a heavy toll on the economy towards the latter part of the 1980s when growth in some years during this period fell below 2.0 per cent. The defeat of the youth revolt in 1989 was a sigh of relief and in 1990, the economy bounced back and registered a growth of 6.2 per cent, the highest growth rate in a decade. However, successful exploitation of opportunities of a curbed insurrection was dampened by the escalation of terrorist activities of the LTTE in the country and the economy continued to suffer due to instability and unsettled domestic conditions.

Since 1991, the economy grew only at a moderate rate of less than 5.0 per cent until 2004 and it must be noted that year 2001 registered a negative growth of 1.5 per cent. The economic growth accelerated since 2005 and for the four year period till 2008, a high rate of growth of over 6.5 per cent was sustained. The economy suffered from adverse global conditions in 2009 and growth dropped to 3.5 per cent. The economy was affected by adverse external conditions firstly, by historically high oil and other import commodity prices, secondly by global financial crisis and thirdly by the global recession, worst ever since the Great Depression in the 1930s. Sri Lanka's growth rate of 3.5 per cent in 2009, though moderate, compares extremely favourably with negative growth rates of almost all advanced economies and the great majority of low income developing countries. A few large emerging market economies were able to weather the crisis due mainly to prudent domestic policies, despite sluggish global market conditions.

Current Performance and Near Term Prospects for the Economy

Since the 1st quarter 2009, the economy has shown a fast recovery as quarterly GDP indicates a rapid improvement. GDP growth during the last quarter of 2009 was appreciably higher at 6.2 per cent compared to 1.5, 2.1 and 4.2 per cent of the first three quarters of 2009, respectively. In the 1st quarter 2010, growth was even higher at 7.1 and growth rates of 2nd, 3rd and 4th at 8.5, 8.0 and 8.6 per cent showed an improving trend and consequently overall annual growth of 2010 rose to a high of 8.0 per cent in comparison to a low of 3.5 per cent in the previous year. The growth is expected to rise further and sustain at a level over 8.0 per cent in 2011 and beyond. Thereby the economy would be moving into a high growth trajectory in the medium to long run.

The Sri Lankan economy had a reasonably high level of growth since 2005 with growth rates of 6.2, 7.7, 6.8 and 6.0 per cent, respectively, for the four year period up to 2008. This provides clear evidence that despite adverse domestic conditions, the country's economy has performed well. The growth that suffered from the global crisis during late 2008 until about end of first half of 2009 has since shown strong signs of a solid recovery. The increasingly high growth performance that is shown by the economy today is bolstered by heavy public investments on a number of large scale infrastructure development projects and large and growing private investments which are clearly evident from rising foreign inflows of capital and growing domestic investment. Though the revival of the economy is more evident in the post conflict period, it must be noted that the country was prepared for a high and fast tracked growth much before the end of the internal conflict. Public investments on large infrastructure development projects commenced much earlier and the adverse external conditions due to global crisis during late 2008 and 2009 prevented the economy from harnessing the full potential. However, the end of the conflict which plagued the country for nearly three decades, was a turning point in Sri Lanka's economic history as the stable political conditions provided an enormous impetus to growth and stability of the economy. Moreover, the successful implementation of the Stand By Arrangement of the International Monetary Fund since July 2009 has been instrumental in boosting up international investor confidence on Sri Lanka. Today, overall business and investor confidence in Sri Lanka is buoyant and growing fast as evident by well performing stock market, tighter spreads on Sri Lanka's sovereign bonds traded in the international capital market and strong demand for Treasury bills and bonds in the domestic debt market, high and rising foreign remittances and capital inflows.

Unemployment and Incidence of Poverty Continue to be in Secular Improving Trend

Despite gloomy prospects for employment in the world due to slow and protracted recovery from the global recession, unemployment in Sri Lanka continued to drop from 5.8 per cent in 2009 to 4.9 per cent in 2010 and further to 4.3 per cent in the 1st quarter 2011. Since 2004, there was a gradual decline in the unemployment from a high rate of 8.3 per cent to a moderate level of 5.2 per cent in 2008. Though the unemployment rate rose to 5.8 per cent in 2009, in the year as a whole, since the 2nd quarter of the year, the rate has dropped from 6.2 per cent to 5.4 per cent in the 4^{th} quarter and to an even lower level of 4.9 per cent by end 2010. With a third of the country's labour force in agriculture, opening up of new land and fishing territories are providing huge gains in the Eastern and Northern provinces which have been integrated back with the mainstream economy since the dawn of peace in the country in mid 2009. The manufacturing and services sectors are growing fast and as this trend is expected to continue in the future too, more prospects for employment are likely in those sectors thus bringing the current level of unemployment down to an even lower level as evident from the promising prospects of the near term outlook of the economy.

Poverty alleviation has been a main focus of economic policies of successive governments in the past. In the recent history of Sri Lanka the poverty level (poverty head count ratio) was highest at 28.8 per cent in 1995/96 . This ratio has dropped gradually to 22.7 per cent in 2002 and to 15.2 per cent in 2006/07. The latest calculation of poverty indices show that poverty level of the country has further declined to 8.9 per cent in 2009/10 (DCS, May 2011).

Decline in poverty is significant mainly in the estate and rural sectors while in the urban sector the trend has been moderate. This is an indication of the success of public policies in leveling social welfare (CBSL, 2010). At present several poverty alleviation programmes are in place targeting approximately 1.6 million families in the country. Further, reduction in poverty level is expected with gradual growth of household income and more equal distribution of wealth as envisaged in the current policy framework.

Fiscal Reforms and Fiscal Consolidation

Sri Lanka has had deficit budgets since 1948 except in only two years in the 1950s. One salient feature was the increasingly expanding budget deficits during this period, particularly since late 1970s. In some instances, the budget deficit was well over 10.0 per cent of GDP and correspondingly the public debt that was raised to finance the deficit has grown over the years and reached a high of 105.6 per cent of GDP in 2002, but this ratio has since dropped to a low of 81.9 in 2010. High fiscal deficits are naturally due to low revenue generation and high public spending. Fiscal reforms and consolidation efforts therefore, need to focus on enhancing revenue, curtailing expenditure and maintaining public debt at a sustainable level.

Budget deficit has been maintained at a level of 7.0 per cent of GDP or lower since 2005 until 2008. However, in 2009, it expanded to 9.9 per cent and this again was a result of adverse conditions external to the economy responsible for low revenue performance and high public expenditure. Low commodity prices and sluggish demand were the reasons for low revenue from imports and inevitably this affected the main revenue source of the government. Fiscal stimulus was considered to be a panacea for all ills of crisis hit economies all around the world and for this norm, Sri Lanka was by no means an exception. However, the impact of the crisis on Sri Lanka was relatively small and hence the expenditure commitment was at a minimum. Fiscal stimulus in Sri Lanka was also constrained by lack of fiscal space due to already a high fiscal deficit.

Of the 9.9 per cent budget deficit in 2009, 6.4 per cent was on account of capital expenditure and hence the high budget deficit would have been brought down to 3.5 per cent if capital expenditure component was reduced to zero. Similarly, in the 2010 budget which shows a deficit of 8.0 per cent, the capital expenditure component was 6.1 per cent and in a scenario of zero capital expenditure, overall budget deficit would be mere 1.9 per cent. Even though it sounds prudent to have a lower budget deficit compared to a high of 8.0 per cent, a fiscal scenario of zero capital expenditure in an emerging market economy like Sri Lanka would not be justifiable in view of the need to ensure a fast growth of the economy.

As most of the large infrastructure projects now in progress are nearing completion and as more public-private partnerships are expected in the future than before the high level of public expenditure of capital nature currently being experienced is expected to gradually taper off in the long run. The fiscal deficits in the near term are projected to be smaller at around 6.8 per cent in 2011, 6.2 per cent in 2012 and to fall below 5.0 per cent in 2013 and beyond. Recommendations such as revenue enhancement measures are in place through simplification of the tax system, reduction of tax concessions, base broadening of income tax and indirect taxes and improvement in tax administration among other things proposed by the Presidential Commission of Taxation have been incorporated into the budget 2011 and were implemented during the year.

Monetary Sector Developments and Further Easing of Monetary Policy

The global recession that resulted in sluggish demand and declining economic activity necessitating fiscal stimuli globally across all the countries brought about conditions conducive for relaxing monetary policies that were pursued at the time of the financial crisis. Average inflation in Sri Lanka dropped to its lowest levels during the last 25 year period enabling substantial policy rate reductions since 2009. The last policy rate cut was in January 2011 and currently the policy rate corridor stands between a repo rate of 7.00 per cent and a reverse repo rate of 8.50 per cent.

In line with downward policy rate adjustments, current market interest rates have fallen to low levels. The overnight interbank call money rate is now pitching close to the middle point of the policy rate corridor. The bench mark 91 day Treasury bill rate has fallen to a level below the interbank call money rate suggesting further downward pressure on interest rates. In this environment, it is inevitable that other administratively determined rates such as bank lending rates will fall in line with market determined interest rates of Treasury bills and Treasury bonds. Both bank deposit rates and lending rates have fallen though not in proportion but interestingly the spreads between lending and deposit rates have contracted to some extent.

Sri Lanka's current interest rate structure appears to be more stable and consistent than any time during the post liberalisation period. With inflation remaining low, stable and predictable, some stability in positive real interest rates appears to be sustainable and this would contribute significantly to the stability of the economy at large. However, it may be noted that Sri Lanka's interest rates are still too high and further lowering of interest rates would be desirable in view of integration of the Sri Lankan economy with the global economy.

Inflation at Low Single Digit Levels

Sri Lanka's high inflation was an issue of concern for many years, particularly since the liberalisation of the economy in late 1977 which policy change marks the beginning of an era of high monetary expansion of our time. Judging by the crude measure of Colombo Consumers' Price Index (CCPI), Sri Lanka's inflation was on average around 11.5 per cent for the period 1978 to 2008. This high rate of inflation has now reduced to a mid-single digit level both in terms of year on year basis and moving average basis. Strong growth in the domestic agriculture sector, particularly the expansion of domestic output due to resumption of economic activities in the North and East and stable prices of key food imports, have assisted in maintaining the headline inflation at benign levels. Inflation is expected to remain subdued at this level for the near term. From the demand front money supply is required to be maintained at levels stipulated in the monetary programme of the Central Bank in order to anchor inflation at desired levels. Credit to the private sector, which contracted on a year on year basis since April 2009 due to the slowdown in economic activity, showed a positive growth since March 2010 and this trend is expected to continue in the ensuing period given the excess capacity of the economy and enhanced prospects for expansion of economic activity. The lending to deposit ratios of banks on average are far too low suggesting that the potential for lending remains high. In view of arresting the demand pressure from monetary expansion, Central Bank of Sri Lanka (CBSL) took a precautionary measure by raising the Statutory Reserve Ratio (SRR) by one percentage point from 7.0 to 8.0 per cent effective from 29 April 2011.

Credit growth (year on year) that peaked at 34.4 in July 2011 has now shown signs of deceleration and is expected to normalise towards the end of 2011 to a sustainable level in the near term. Any realistic estimation of credit needs is hindered by non availability of data on potential demand for credit relating to the private sector activities in the North and East and excess capacity that exists in the economy as a whole. Benign asset prices, low and declining inflation, robust and resilient banking system with low NPL ratios and comfortable levels of capital adequacy of banks suggest that the economy has further capacity for expansion.

External Conditions

Sri Lanka, with its increasing openness, is vulnerable to global conditions and this was evident from the poor external sector performance during the recent global crisis. Both exports and imports dropped to significantly low levels in 2009 compared to those of the previous year. However, the drop in imports was much greater than that of exports and hence the trade balance showed an improvement and the current account deficit which rose to a high of 9.5 per cent of GDP in 2008 dropped to a low of 0.5 per cent of GDP in 2009. However, with the gradual rise in import prices more than in proportion to those of exports as reflected in the terms of trade effect, the current account deficit rose to a higher level of 2.9, nonetheless will remain within a manageable level of around 3.5 per cent in the near term. Sri Lanka's balance of payments was generally in surplus in the last few years but in 2008, due to heavy outflows of capital, the overall balance turned into negative. However, with high capital inflows and improved current account performance, the balance of payments in 2009 showed a significant improvement. The external imbalance of the country has now improved significantly and the risk of capital outflows will further reduce as inflows of short term capital is capped at 10.0 per cent of the amount of Treasury bills and Treasury bonds outstanding. The external sector sustainability appears to be greater now than any time before with the country's official foreign reserves gradually reaching all time high at US dollars 8.0 billion, sufficient to cover nearly 5.8 months of the country's imports.

Measures were deemed necessary to make adjustments to face challenges emanating from growing external reserves. The cost of managing the high level of excess rupee liquidity in the domestic market was an issue of concern to CBSL. The excess rupee liquidity may also be observed as part of the transition process that the economy is undergoing at present. With the growth of private sector credit and import financing that is observed at present, the pressure caused by excess rupee liquidity in the domestic market resulting from the accumulation of foreign currency reserve would gradually ease. Rapid growth of external reserves also calls for measures to further liberalise capital controls relating to outflows and such measures would also among other things contribute to improved investor confidence and further stability of the economy. Another development would be the stability in the exchange rate which was often subject to high fluctuations in the past necessitating intervention by the central bank on a frequent basis. With greater exchange rate stability, CBSL operations in the domestic foreign exchange market has become an integral part of reserve and liquidity management strategy rather than a matter of intervention in the market. In the meantime the stability of the exchange rate has posed new challenges to forex dealers in the market as they are forced to operate with narrow spreads and reduced forward premia sufficient only to compensate their funding cost. The low domestic inflation has impacted favourably on the real effective exchange rate (REER) which is expected to improve and remain in alignment with currency movements in the market, and ensure competitiveness of the economy.

Conclusions

Sri Lanka's macroeconomic fundamentals today are much stronger than they were ever before. At no stage in the post liberalisation period were macro indicators, on the whole, as sound as what they are at present.

The economic growth is moving towards a high trajectory bolstered by steadily improving private investment and high capital expenditure of the government, particularly on mega infrastructure development programmes, most of which were commenced prior to the end of the conflict. The favourable environment that resulted from the end of the conflict with unprecedented political stability and security situation in the country set the stage for the economy to take off on a rapid growth path. The unemployment and poverty levels have dropped to a historic minimum manifesting a favourable distributional outcome while ensuring fast tracked growth.

Fiscal sector performance shows improvement since 2010 with a more promising outcome in the near term after slipping into a high deficit in 2009. Simplification and base broadening of the current tax system and improved revenue performance are vital to fiscal consolidation. Improved debt sustainability is inevitable as indicated by improving debt to GDP ratio and prudent management of public debt where minimisation of the cost of debt and increased tenure of debt maturity while promoting the debt market development are priorities in the policy framework for the medium to long run.

Inflation has dropped to mid-single digit levels from substantially high levels in 2008 and 2009 and the near term outlook appears to be favourable with low and stable domestic commodity prices even though some upward pressure may come about from likely higher cost of import commodities and oil prices. Low and stable inflation has provided the comfort for a significant easing of monetary policy and interest rates have moved downward sharply in recent months. The lending rates have also fallen providing an environment conducive to support the growing demand for credit by the private sector. No demand pressure on inflation from credit growth has been observed and CBSL has adjusted SRR upward as a precautionary measure.

The external sector that suffered from the recent global crisis has improved significantly since late 2009 and the overall balance of payments remains comfortably in surplus. The growth in foreign inflows has been phenomenal and the country's external reserves have risen to a historic high. The external sector imbalance that remained earlier has now reduced sharply and the risk associated with short term capital inflows would no longer be significant.

The integration of the Northern and Eastern provinces with the main stream economic activity has added additional resources causing the country's production possibility frontier to expand significantly. Sri Lanka's economy was not performing to its potential for nearly three decades and the favourable macro-economic environment that emerged since the cessation of the conflict supported by strong fundamentals has enabled faster growth with sustained stability in the economy in the medium to long term.

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