SRI LANKA: AN EMERGING ECONOMY ON STRONG FUNDAMENTALS

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The environment that emerged since the ending of the internal conflict in mid 2009 in the background of growing investor and consumer confidence as well as global recovery from the recession though slow and protracted has provided ample evidence of greater stability and potential for growth than ever before in Sri Lanka. Recent trends in macro-economic conditions such as low inflation, declining interest rates, strong external reserve position, stable exchange rate, consolidating fiscal outlook are solid indications that the economy is returning to normal from instability that it suffered for nearly three decades since the early 1980s. The growth that suffered from adverse external conditions in recent years has shown a faster recovery towards the fourth quarter 2009 and this trend has gathered further momentum in the 1st quarter 2010 as evident from sustained improvement in growth performance.

Historical Backdrop in a Nut Shell

The post independence period of Sri Lanka can be clearly distinguished between the period from 1948 to late 1977 and the period of post liberalization from 1978 to date. The former period was characterized by different regimes, i.e. the period from 1948 to 1958 when a laissez-faire was in practice. The period since 1958 to 1965 is seen as a period of gradual tightening of exchange controls and state intervention and public ownership. The five year period from 1965 to 1970 saw a partial liberalization of exchange controls and trade though of course state ownership continued to grow. The period of approximately seven years from 1970 to late 1977 was characterized by stringent state controls and rapid growth of state ownership.

At the time of 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$ 850 million as compared to US$42 billion in 2009. The population of 7.0 million then compares with 20.0 million today. The GDP per capita which was US$ 120 in 1948 was only second to Japan in Asia and this compares with US$2053 in 2009, much higher in value but falls much below many countries in Asia. South Korea, one of the poorest countries in Asia and Singapore, a low income country then, are today classified as high income advanced countries with per capita income levels well over US$ 25,000. Malaysia, Indonesia, Thailand and the

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Philippines, to name a few who trailed behind Sri Lanka in the 1950s, are today recognized as middle or high middle income countries in the world. Sri Lanka remained a low income country until early 2010 when the International Monetary Fund upgraded its position to a *"lower middle income"* country.

Sri Lanka remained a welfare state in the post independence period and hence the level of human development was maintained at a high level and the rank stands at 102 today in the Human Development Index (HDI) thanks to free education and free healthcare in particular. A sizeable portion of Government expenditure has been on health, education and extension of other humanitarian services such as sanitation, nutrition and housing. However, in terms of income level, Sri Lanka has lost its relative position due to slower growth of the economy. The annual average real growth of GDP for 60 years since 1948 has been only 3.2 percent which is by no means sufficient for a developing country. Though the GDP of Sri Lanka has grown more than 50 times, its population also has increased nearly threefold thereby slowing down the growth of average income per head of the population.

The economy was expected to expand rapidly due to the surge in demand resulted from the liberalized economic policies that came into force in late 1977. The year immediately following the economic liberalization saw a GDP growth of 8.4 percent in real terms and the growth tapered off in subsequent years until 1982 when growth rate reduced to 5.1 percent. With the escalation of the internal conflict and gradual deterioration of the security situation in the country, performance of the economy suffered severely for a long period of two and a half decades until mid 2009 when terrorism was ultimately defeated and long lasting peace and political stability in the country was re-established. The July 1983 civil disturbance is seen as an event that has had a colossally devastating impact on the economy with severe damage to economic activities. 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 took a heavy toll on the economy towards the latter part of the 1980s when GDP growth in some years during this period fell below 2.0 percent. The defeat of the youth revolt in 1989 was a sigh of relief and in 1990, the year immediately following saw a re-bouncing of the economy as the economy registered a growth of 6.2 percent, the highest rate in a decade. However, the escalation of terrorist activities of the LTTE stole the limelight of the victory over the rebels in the South and the economy continued to suffer.

Since 1991, the economy grew only at a moderate rate of less than 5.0 percent until 2004 with 2001 registering a negative growth of 1.5 percent. The economic growth accelerated since 2005 and for the four year period till 2008, a high growth rate of over 6.5 percent was sustained. The economy suffered from adverse external conditions in 2009 and the rate of growth dropped to 3.5 percent, firstly due to historically high oil and commodity prices, secondly due to global financial crisis and thirdly due to the global recession worst ever since the Great Depression in the 1930s. Sri Lanka's growth of 3.5 percent in 2009, though moderate, compares extremely favourably with negative growth rates of almost all advanced economies and a great majority of developing countries. A few large emerging market economies were able to weather the crisis yet suffered heavily from the adverse external conditions in 2009.

Current Performance of the Economy and Near Term Outlook of Growth

Since the 1st quarter 2009, the economy is showing a fast recovery as quarterly GDP numbers indicate a rapid improvement. The last quarter 2009 GDP growth was appreciably higher at 6.2 percent compared to 1.5, 2.1 and 4.2 percent of the first three quarters, respectively. In the 1st quarter 2010, growth was even higher at 7.1 and overall, the economy in 2010 is projected to grow at 7.2 percent. The growth is expected to rise further to 7.5 percent in 2011 and 8.0 percent in 2012 thereby maintaining the high growth trajectory in the years to come.

A high growth performance of the economy was seen since 2005 with annual growth rates of 6.2, 7.7, 6.8 and 6.0 percent, respectively for the four year period up to 2008. This provides clear evidence that despite adverse security conditions, the country's economy has performed well. With the growth now bouncing back having suffered from the spillover effects of the global crisis, the economy is now showing strong signs of a solid take off. The high growth of the economy that we are seeing today is bolstered by heavy public investments on a number of mega infrastructure projects and growing private investments which are clearly evident from rising foreign inflows of capital. Though the economic revival is seen in the post conflict period, it is clearly evident that the country was prepared for a high and fast tracked growth path much prior to the time of ending of the internal conflict. Public investments on mega infrastructure development projects commenced much earlier and the temporary setback of the economy in late 2008 and early part of 2009 was due to adverse conditions that were quite exogenous to the domestic economy. However, the end of the conflict which plagued the country for over two and a half decades, was a turning point in its economic history as the victory over terrorism has given an enormous impetus to growth and stability. The successful implementation of the Stand By Arrangement of the International Monetary Fund since July 2009 has bolstered international investor confidence on Sri Lanka. Overall business and investor confidence in Sri Lanka is very buoyant and growing fast further as evident by stock market performance, tightening of spreads on its sovereign bonds in the international market and declining yields of Treasury bills and bonds in the domestic market, high and rising foreign investment inflows and remittances.

Unemployment Continues to be in Secular Improving Trend

Despite gloomy prospects for employment in the world due to global recession, unemployment in Sri Lanka remained at an exceptionally low level and 1st quarter 2010 indicates a historic low of 5.1 percent in the unemployment rate. There was a gradual decline in unemployment from a high of 8.3 percent in 2004 to 5.2 percent in 2008. Though the unemployment rate rose to 5.7 percent in 2009, in the year as a whole, since the 2nd quarter of the year, the rate has dropped from 6.2 percent to 5.4 percent in the 4th quarter and to an even lower level of 5.1 percent in the 1st quarter 2010. With a third of the country's labour force is 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. The expansion of the manufacturing and services sectors has been faster in the past and as the trend continues 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 prospects of the near term outlook of the economy.

Fiscal Reforms and Consolidation

Sri Lanka has had deficit budgets since 1948 except in two years in the 1950s. One salient feature was the expansion in the budget deficits since late 1970s. In some instances, the budget deficit was well over 10.0 percent of GDP and correspondingly the public debt stock has grown over the years. High fiscal deficits are naturally due to low revenue performance and high public expenditure. Fiscal reforms 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 7.0 percent of GDP or lower since 2005 until 2008. However, in 2009, it expanded to 9.9 percent and this again was a result of adverse external conditions responsible for low revenue and high 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 the panacea for crisis hit economies all around the world and for this norm, Sri Lanka was by no means an exception.

Of the 9.9 percent budget deficit of 2009, a high proportion of 6.7 percent was on account of capital expenditure and hence this high budget deficit would have been brought down to 3.2 percent if capital expenditure component was reduced to zero. Similarly in the 2010 budget estimates which show a deficit of 8.0 percent, the capital expenditure component is 6.5 percent and in a scenario of zero capital expenditure, overall budget deficit would be mere 1.5 percent. Even though it sounds prudent to have a low budget deficit of 1.5 percent compared to a high of 8.0 percent, a fiscal scenario of zero capital expenditure in a developing country like Sri Lanka would not be justifiable.

As most of the large infrastructure projects are now in progress and some are nearing completion and as more and more public-private partnerships are going to be in place in the future, the need for a high level of public expenditure of capital nature will gradually taper off in the years to come. The fiscal deficits in the near term are projected to be smaller and the budget deficit in 2013 is expected to be lower than 5.0 percent. 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. A Presidential Commission of Taxation was appointed last year with a terms of references, inter alia of making recommendations on simplification of the current tax system and enhancing the government revenue performance.

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 dropped to lowest level during the last 25 year period enabling substantial policy rate reductions in 2009. The recent most policy rate cut was in July 2010 and currently the policy rate corridor stands between a repo rate of 7.25 percent and a reverse repo rate of 9.50 percent.

In line with policy rate adjustments, market interest rates too 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. Bank deposit rates have fallen to low levels even though lending rates have not fallen in proportion thereby further widening the spreads between lending and deposit rates. This needs to be examined having regard to lag effect, if any and the time taken for the adjustment process of the overall interest rate structure.

Inflation in Low Single Digit Levels

Sri Lanka's high inflation was an issue of concern for many years, may be ever since the liberalization of the economy which marks the beginning of monetary expansion of our time. In fact, judging by the crude measure of the rate of increase in the Colombo Consumers' Price Index, Sri Lanka's inflation was on average around 11.5 percent for the period 1978 to 2008. This rate is now brought down to a level below 5.0 percent 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 inflation at low single digit level. Inflation will remain subdued at this level for the rest of 2010. From the demand side, money supply will remain at targeted levels stipulated in the monetary programme of the Central Bank. Credit to the private sector, which contracted on a year on year basis since April 2009 having impacted by the slowdown in economic activity, showed a positive growth since March 2010. Credit to the private sector is expected to continue to improve in the ensuing period given the enhanced prospects for economic activity. The lending to deposit rate of the banking institutions, on average, is far too low suggesting that the potential for lending remains high.

External Conditions

Sri Lanka, with its relatively high 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 much lower levels in 2009 compared to that 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 percent of GDP in 2008 dropped to a low of 0.5 percent in 2009. However, with the gradual rise in import prices more than in proportion to that of export prices as reflected in the terms of trade effect, the current account deficit is likely to rise but is expected to be within a manageable level of around

3.5 percent 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 percent 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 approaching US$ 5.8 billion mark sufficient to meet nearly six months of imports.

Measures are now deemed necessary to make adjustments to face challenges associated with the increasing external reserves. The cost of managing the excess rupee liquidity in the domestic market is an issue that needs attention. The excess rupee liquidity may also be observed as a situation of the transition process that is seen in the economy at present. With the growth of private sector credit that we observe at present, the pressure of excess liquidity in the domestic rupee market will gradually ease. Rapid growth of external reserves also calls for measures to further liberalize the capital controls relating to outflows. Another welcome development is the stability in the exchange rate which was subject to high fluctuations in the past necessitating Central Bank intervention on a frequent basis. With greater stability in the exchange rate, the Central Bank operation in the domestic foreign exchange market has become a part of reserve management strategy than intervention to defend the exchange rate from either falling or rising. The stability of the exchange rate has posed new challenges to forex dealers as they are forced to operate with much narrower spreads and reduced forward premia sufficient only to compensate any funding costs. The low domestic inflation has impacted favourably on the real effective exchange rate (REER). With sustained low domestic inflation, REER is expected to improve and remain in alignment with currency movements in the market.

Conclusion

Sri Lanka's macro-economic fundamentals, political stability and national security today are much stronger than ever before. At no stage in the post liberalization period that macro indicators, on the whole were 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 programs that have commenced much prior to the dawn of peace. With the ending of the conflict, the resulting environment of unprecedented political stability set the stage for the economy to take off on a rapid growth path. The unemployment and poverty levels have dropped to historic minimum manifesting a favourable distributional outcome.

Fiscal performance appears to be improving towards 2010 and more particularly, 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 key to fiscal consolidation. Greater debt sustainability is inevitable as indicated by improving debt to GDP ratio and prudent management of public debt.

Inflation has dropped to low single digit levels and near term outlook appears to be favourable with low and stable domestic commodity prices even though some upward pressure may come from import commodities and oil prices. Low and falling inflation has provided the comfort for a significant easing of monetary policy and interest rates have sharply moved downward in recent months. The lending rates are expected to follow suit and provide a conducive environment to support the demand for credit by the private sector.

The external sector that suffered from the global crisis has improved significantly towards 2010 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 will no longer be significant.

With the Northern and Eastern provinces being integrated with the main stream economic activity, the country's production possibility frontier has expanded 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.

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