Sri Lanka

Despite recovery in agriculture and improved services performance, growth remained subdued in 2018 as industry slowed. Inflation softened as food inflation eased, but core inflation picked up. Fiscal and structural reforms continued and remain critical to averting repeated macroeconomic stress. Growth is projected to recover moderately in 2019 and 2020, but with a downside risk stemming from upcoming elections. Sri Lanka is highly vulnerable to climate change and needs to become more disaster resilient.

Economic performance

Growth in 2018 edged lower to 3.2% (Figure 3.21.1). Political uncertainties in 2018 weighed on economic sentiment and worsened in the last quarter, affecting Sri Lanka's risk perception and prompting all three major agencies to downgrade its rating.

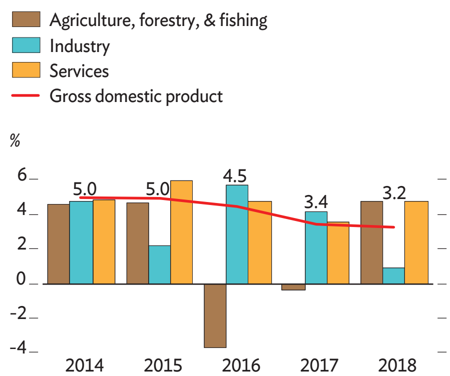
On the supply side, a turnaround in agriculture and a pickup in services supported growth. However, growth was held back by a slowdown in industry with contraction in construction and weaker manufacturing.

Agriculture grew by 4.8% in 2018 as rice production increased by 33.9%, reversing sharp contraction in 2017, and production expanded as well for a number of other crops. However, a dip in tea production by 0.8% following excessive rain and lackluster performance of fisheries, both sizeable contributors to agriculture, slowed the sector's recovery.

As growth in fixed investment slipped lower in 2018, construction shrank by 2.1%, pulling down industry growth from 4.1% in 2017 to 0.9%. Manufacturing growth remained moderate at 3.0% despite a turnaround in food and beverages, the largest category. Other important areas such as garments, rubber products, basic metals, and nonmetallic mineral products slowed, while some others contracted. Services grew by 4.7%, with finance expanding by 11.8% and wholesale and retail trade up by 5.0%. Transportation, the largest service industry, continued to be weak, growing by only 2.8%. Public administration shrank by 0.6%.

On the demand side, consumption expenditure remained subdued and dropped to 1.6% growth as government consumption contracted for the second straight year. Private consumption growth slowed to 2.3% from 2.5% in 2017.

3.21.1 GDP growth by sector



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk/ (accessed 20 March 2019).

This chapter was written by Nimali Hasitha Wickremasinghe and Savindi Jayakody of the Sri Lanka Resident Mission, ADB, Colombo.

Gross fixed capital formation experienced a marginal decline in the face of fiscal consolidation and political uncertainty, while 29.6% expansion in inventories meant growth in gross capital formation (Figure 3.21.2).

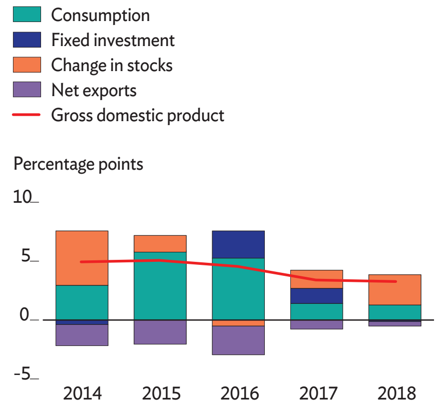
Headline inflation, driven by food price deflation with recovery in agriculture, trended lower in 2018 to average 2.1% for the year (Figure 3.21.3). Headline inflation decelerated during 2018 from 5.4% year on year in January 2018 to 0.1% in October and then picked up to 2.4% in February 2019. Average food prices fell by 0.2% in 2018, while nonfood inflation averaged 4.1%. Nonfood inflation trended higher from 2.5% year on year in January 2018 to 6.7% in February 2019, while core inflation was broadly stable in the first half of 2018 but picked up in the second half and reached 5.5% year on year in February 2019. These movements reflect currency depreciation and the pass-through of fuel prices to production costs.

Revenue collection, mostly of domestic indirect taxes, improved by 4.8% in 2018 over 2017, but the ratio of revenue to GDP still declined, to 13.4% (Figure 3.21.4). Expenditure increased by 4.7% on higher current expenditure, with interest payments increasing by 15.8%, while public investments declined by 4.9%. A primary surplus, equal to 0.6% of GDP, was recorded for a second consecutive year in 2018 as fiscal adjustment continued under an International Monetary Fund (IMF) program, but the budget deficit for 2018, estimated at 5.3% of GDP, missed the 4.8% target. As the Sri Lanka rupee sharply depreciated, the ratio of central government debt to GDP spiked, from an estimated 76.9% in 2017 to a provisional 84.0% in 2018, illustrating the need to sustain fiscal consolidation (Figure 3.21.5).

As inflation eased and growth slowed, the Central Bank of Sri Lanka lowered its standing lending facility rate by 25 basis points in April 2018 to 8.50%, leaving the standing deposit facility rate unchanged at 7.25% (Figure 3.21.6). In response to liquidity constraints, and with call rates hovering near the upper end of the policy rate corridor, the central bank reduced the statutory reserve ratio in November 2018 by 1.5 percentage points to 6.0% to bolster liquidity, and at the same time it increased the standing deposit facility rate by 75 basis points to 8.0% and the standing lending facility rate by 50 basis points to 9.0% to neutralize any potential effect on inflation from excess liquidity. Despite increased lending rates, credit to the private sector accelerated marginally after September (Figure 3.21.7). The central bank further lowered the statutory reserve ratio to 5.0% in February 2019 to address liquidity deficits, while leaving policy rates unchanged.

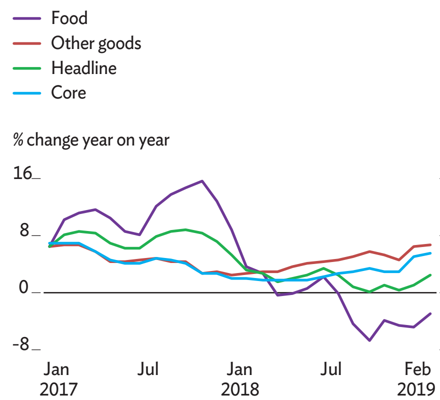
Export earnings expanded by 4.7% in 2018 as industrial exports grew by 8.4% and agricultural exports fell by 6.8% with declines across all major agriculture export categories. Garment export growth accelerated moderately from 3.0%

3.21.2 Demand-side contributions to growth



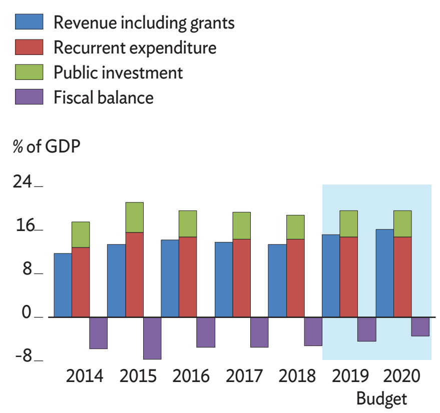
Sources: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 19 March 2019); ADB estimates.

3.21.3 Inflation



Source: Department of Census and Statistics of Sri Lanka. http://www.statistics.gov.lk (accessed 19 March 2019).

3.21.4 Government finance



Note: Figures exclude revenue and expenditure transfers to provincial councils.

Sources: Central Bank Annual Report various years, Ministry of Finance; ADB estimates.

in 2017 to 4.7%, while tea exports reversed 20.5% growth in 2017 to contract by 6.6% with both lower volume and lower prices. Imports expanded by 6.0%, driven by large increases for vehicles, fertilizer, and fuel, causing the trade deficit to widen even as rice imports shrank on recovery in agriculture and gold imports declined following the imposition of customs duty. Motor vehicle imports increased sharply in the first 9 months but showed declines month on month in the last 2 months of 2018. This followed the imposition of import controls in September 2018 that included a 200% cash margin on letters of credit for motor vehicles, suspension of vehicle imports by all state institutions for 1 year, and disallowing government employees concessionary duty rates on car imports for 6 months.

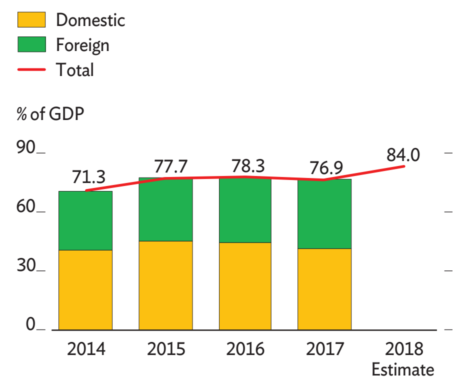
A decline in outmigration since 2015 meant a second consecutive year of lower worker remittances, falling by 2.1% in 2018 (Figure 3.21.8). Earnings from tourism increased by 11.6% in 2018 to reach $4.4 billion as tourist arrivals increased by 10.3% to reach 2.3 million. With service account and income net outflows, the current account deficit widened from the equivalent of 2.6% of GDP in 2017 to an estimated 3.0% in 2018 (Figure 3.21.9).

Capital outflows brought the rupee under significant pressure in 2018, causing it to depreciate against the US dollar by 19.6% year on year to the end of December 2018 (Figure 3.21.10). Global conditions precipitated capital outflows and pressure on exchange rates in many emerging markets, with some recovering by the end of the year. However, in Sri Lanka, the pressure on the currency continued as a political crisis unfolded in the last quarter.

Foreign currency reserves rose from $8.0 billion at the end of December 2017, or cover for 4.6 months of imports, to an all-time high of $9.9 billion in April 2018 as Sri Lanka successfully raised $2.5 billion in international markets. By the end of December 2018, reserves had fallen again to $6.9 billion, or 3.7 months of imports (Figure 3.21.11). A month later, reserves had fallen further to $6.2 billion after the government repaid debt using $1.0 billion from its reserves. As the political crisis reached resolution and discussions with the IMF restarted, pressure on the rupee eased.

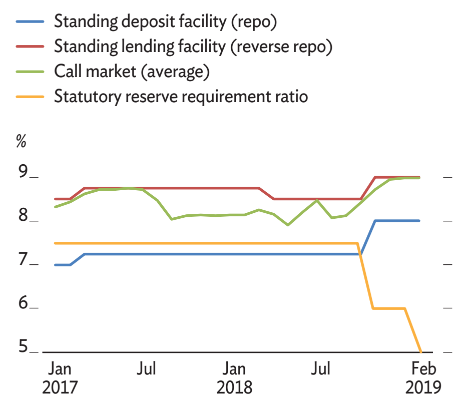
The government continued a raft of reforms in 2018: opening the Single Window Investment Facilitation Taskforce, a web portal to streamline and fast-track investment approval; setting up as a one-stop shop and portal with trade information for exporters and importers; and simplifying business procedures to obtain online construction permits, as well as property registration and other information. Sri Lanka's rank in the World Bank's ease of doing business index improved from 111 in 2017 to 100 in 2018. Major reforms to support fiscal operations were the passage of the Active Liability Management Act, which enables the government to raise funds for debt repayment, and the implementation of the new Inland Revenue Act.

3.21.5 Government debt



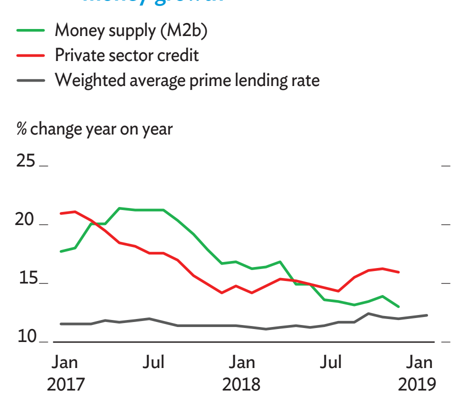
Sources: Central Bank of Sri Lanka, *Monthly Economic Indicators*, Ministry of Finance (accessed 20 March 2019); ADB estimates.

3.21.6 Policy rates



Source: Central Bank of Sri Lanka.

3.21.7 Interest rate, credit, and money growth



Source: Central Bank of Sri Lanka.

May 2018 saw the introduction of a fuel pricing formula that revises prices to align with global prices every 2 months. However, electricity pricing reform, a key component of energy pricing reform, could not be completed in 2018.

Economic prospects

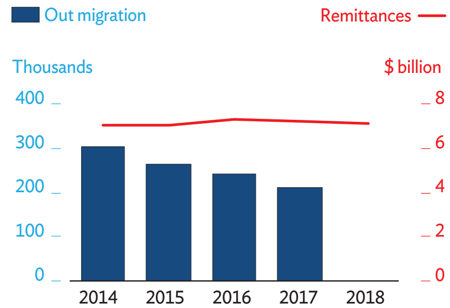
Growth is expected to pick up to 3.6% in 2019 and then to 3.8% in 2020. Having normalized in 2018, agriculture is expected to continue to grow at about the same rate in the next 2 years, assuming normal weather. Tea and marine fishing, both large contributors to agriculture, will turn around in 2019 from the dip experienced in 2018. Industry will pick up gradually over the 2-year period, reversing the slowdown in 2018. Construction is expected to reverse contraction last year with marginal growth this year thanks to a base effect but also a higher budget for public investment. Services will continue moderate growth at 4.6% in 2019, picking up marginally to 4.8% in 2020 with support from trade and financial services, as well as from accommodation and food and beverage services, which will benefit from continued expansion in tourism.

On the demand side, the 2019 budget includes proposals to increase public sector salaries and allowances and to address pension anomalies. This will support private expenditure and thereby growth. The government continues to consolidate its finances, but the primary surplus target of 1.5% in 2019 is downgraded from the original target of 2.0%. This may provide an impetus to public investment as the 2019 budget includes several capital expenditure projects. Uncertainties surrounding an upcoming election will affect private investor sentiment. The Colombo Port City Project is expected to bring in new investment, but the pace may depend on the passage of supporting laws.

Headline inflation is expected to be higher coming off a low base in 2018 and fueled by rising economic activity in 2019 and 2020. Food inflation, which slowed throughout 2018 and was negative toward the end of 2018, will pick up from the low base. A weak currency will exert upward pressure on prices and may offset anticipated lower fuel prices. Inflation is expected to edge up to 3.5% in 2019 and then reach 4.0% in 2020.

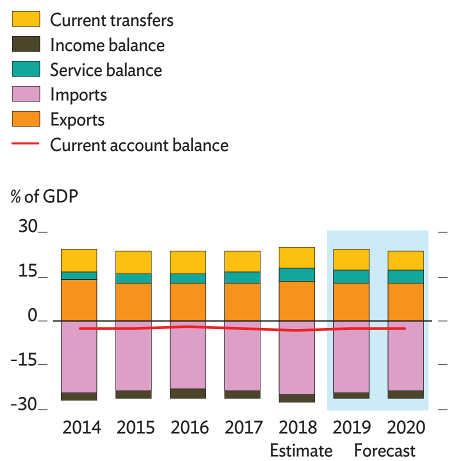
Agriculture exports will turn around from contraction in 2018 with improved performance from tea exports. Garment exports will continue to grow only moderately as export markets expand more slowly over the next 2 years. Downside risks to garments arise from a scenario of a no-deal Brexit and tariff escalation between Sri Lanka and UK (Box 1.1.4). The introduction of an excise duty and a luxury tax on motor vehicles will keep vehicle imports in check. After shrinking in 2018, remittances will remain more or less the same over the next 2 years under a structural decline in outmigration

3.21.8 Labor migration and remittance earnings



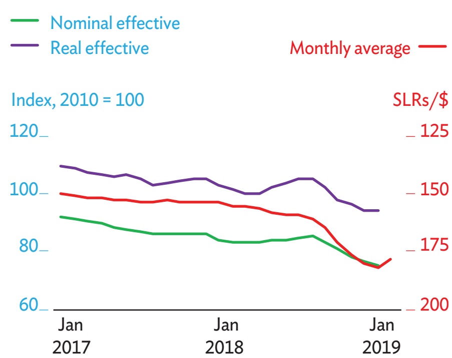
Note: The number of out migrants in 2018 is not available.
Source: Central Bank of Sri Lanka.

3.21.9 Current account components



Sources: Central Bank of Sri Lanka, *Annual Report 2017*; ADB estimates.

3.21.10 Exchange rates



Source: Central Bank of Sri Lanka.

and lower oil prices affecting economic activity in key host countries. The current account deficit will shrink to 2.5% in 2019, widening marginally to 2.6% in 2020.

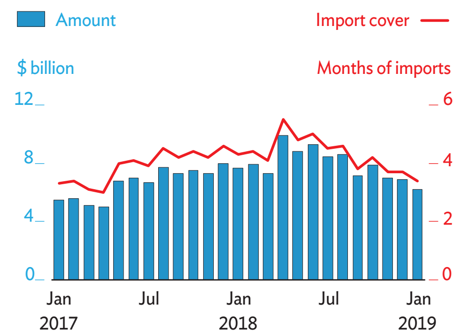
The 2019 budget aims to reduce the budget deficit to the equivalent of 4.4% of GDP, mainly with higher revenue collection. The revenue ratio is expected to improve to 15.1%, a large portion of the increase coming from tax revenue. Expenditure is budgeted to increase marginally to equal 19.5% of GDP with public investment increasing to 4.8% of GDP. The budget deficit is projected to fall to 3.5% of GDP in 2020. The primary surplus is targeted to increase progressively to 1.5% of GDP in 2019 and 2.4% in 2020. From an election year perspective, the budget was a positive development, signaling commitment to restoring fiscal order. To support export growth, the budget announced accelerated reduction in the cess on intermediate goods used in key sectors. To encourage women to participate in the labor force, corporate tax deductions were announced for companies that grant 3–4 months of maternity leave.

In February 2019, the IMF completed its fifth review of the program, and a staff-level agreement was reached to extend the program for an additional year until June 2020. This will allow more time for the government to complete the economic reform agenda.

Political uncertainty and large payments to service external debt may affect market sentiment and exert pressure on the rupee. In January 2019, Sri Lanka entered into a swap arrangement worth $400 million with India through the South Asian Association for Regional Cooperation swap facility. Soon after the conclusion of the IMF review and the presentation of the 2019 budget, Sri Lanka issued a 5-year $1.0 billion bond and a 10-year $1.4 billion bond, both of which were oversubscribed. Together, these measures promise to shore up reserves and support the currency.

Downside risks to the forecast emanate from political developments connected to elections and the ensuing policy direction, as well as weather uncertainties. International risks would be a deeper slowdown in the advanced economies, fuel prices or import volume above expectations, or fallout from Brexit that is difficult to fully assess at this point.

3.21.11 Gross official reserves



Source: Central Bank of Sri Lanka. http://www.cbsl.gov.lk.

3.21.1 Selected economic indicators (%)

	2019	2020
GDP growth	3.6	3.8
Inflation	3.5	4.0
Current account balance (share of GDP)	–2.5	–2.6

Source: ADB estimates.

Policy challenge—building disaster resilience

Sri Lanka is susceptible to weather-related hazards partly because of climate change. These hazards, from severe floods to extreme droughts, are recurrent events in Sri Lanka, with greater frequency in the recent past, with heavy rain in May 2016 and May 2017 causing flooding and landslides, and drought striking in late 2016 (Table 3.21.2). The Global Climate Risk Index ranked Sri Lanka among the top four countries globally most affected by adverse weather in 2016 and 2017 in terms of fatalities and economic losses.

3.21.2 Hazard consequence in Sri Lanka, 1965–2018

Hazard	Number of occurrences	Number of deaths	Number of people affected	Damage ($ million)
Flood	67	1,977	16,418,587	2,574
Drought	11		10,756,000	45
Storm	8	810	1,709,457	503
Tsunami	1	35,399	1,019,306	1,317
Landslide	6	360	1,927	
Epidemic[a]	10	1,015	440,537	
Total	**103**	**39,561**	**30,345,814**	**4,438**

[a] Bacterial, viral, and parasite diseases.

Sources: Emergency Events Database (EM-DAT). http://www.emdat.be; ADB estimates.

Disasters have multiple impacts on the economy. With two rice cultivation cycles disrupted since 2016, agricultural GDP contracted by 3.7% in 2016 and 0.4% in 2017, domestic food prices surged by 14.4% in December 2017, and food imports increased in 2017 by about 13%, or $214 million, to equal 0.2% of GDP. The extended dry spell in 2016 affected large swathes of land across the country, reducing yields and causing other crop losses. The drought forced power generation to shift from hydro to more expensive thermal production, raising oil imports by 40%, or $950 million, equal to 1.1% of GDP. Government spending to repair the damage wrought by disasters amounted to 3% of government expenditure in 2016, or 0.4% of GDP, and 2% of expenditure in 2017, or 0.5% of GDP. The cost of damage caused by disasters in 2016 and 2017 was more than twice as high in rupee terms as the worst disaster years in the past (Figure 3.21.12). Disasters were felt disproportionately by the poor, upending the livelihoods of more than 2 million people. Rising food prices and falling production can deny food to the most vulnerable households, aggravating the malnutrition prevalent in hazard-prone areas as the poor limit the number and size of meals they consume each day. They may cope by prioritizing feeding their children, limiting expenditures on education and health care. Financial instruments to mitigate the impact of weather-related hazards, such as insurance, are not readily available for the vulnerable, including women.

Quick government action through higher imports, public food distribution, and increased fiscal spending on an expanded social safety net mitigated the hardship inflicted on the disaster-struck poor. However, the recurrence of disasters signals the need to develop a preemptive strategy to deal with similar shocks in the future.

The government has started to build disaster resilience by emphasizing environment protection and disaster management in its strategy document Vision 2025 and in the 2019 budget. It is developing national targets for disaster risk reduction based on the Sendai Framework for Disaster Reduction 2015–2030, proposing a national disaster reserve fund for reconstruction after disasters, strengthening disaster insurance and increasing mitigation spending, ratifying nationally determined contributions to achieve the objectives of the Paris Agreement on climate change, and developing its National Disaster Master Plan with balanced investment to implement its Comprehensive Disaster Management Program.

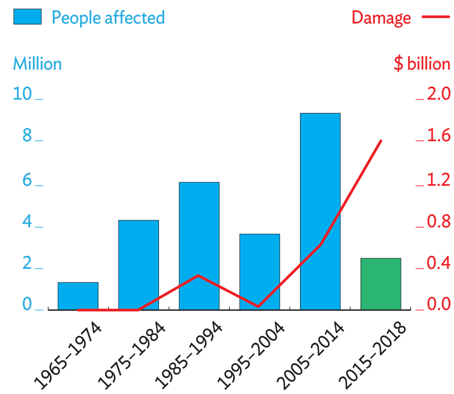
The government can further improve disaster risk management by articulating a policy for the near term and expediting its implementation. It is important to prevent disasters and mitigate the consequences of those that occur through risk-informed investment planning and effective risk management enabled by timely financing.

The economic consequences of recent disasters would not have been as bad as they were if the economy had been robust in general and more diversified in terms of employment. Recurrent weather-related disasters may threaten significant gains in poverty reduction made over the past 20 years. Further efforts to reduce poverty will be sustainable over the longer term only if they successfully incorporate disaster risk reduction and climate change adaptation into development planning.

The focus needs to shift to areas prone to disaster and to determining how to make people, assets, and infrastructure more resilient. Measures to mitigate disasters include formulating risk management action plans and early warning systems, especially localized warnings to vulnerable communities, through community-based disaster risk management, holding community education sessions and emergency drills, and assembling evacuation plans and kits. Reliable risk profiles and timely hydrometeorological data and information on disasters are core inputs for many disaster risk management initiatives. This requires effective capacity building in data-generating agencies and a comprehensive mechanism for sharing data and information among all users.

Major efforts need to be mounted to mobilize funds for risk reduction and adaptation, establish correct policy frameworks, and build institutional capacity. Beyond the near term is a need to develop a comprehensive disaster risk financing strategy that is consistent with debt sustainability. It should use a risk-layering approach to promote the use of instruments to retain and transfer risk, as well as build up infrastructure and implementation capacity.

3.21.12 Impact of weather-related hazards



Sources: Emergency Events Database (EM-DAT). http://www.emdat.be; ADB estimates.