Daily Mirror Friday April 11, 2014 5

World Bank sees accelerated growth for Sri Lanka in 2014

Economic growth looks to have risen to 7.3 percent in 2013, from the 6.3 percent registered the previous year, driven by the services and industry sectors. The bounce-back began in the second quarter of 2013 and is expected to continue through the last quarter and beyond.

The services sector, accounting for nearly 60 percent of gross domestic product (GDP), grew by an average 6.4 percent for the year, underpinned by strong performance in wholesale and retail trade (another 23 percent of the economy), hotels and restaurants, transport and communications, as well as the banking and finance sub-sectors. While industrial-sector growth moderated in the third quarter of 2013, it remained buoyant at 9.9 percent, from 10.3 percent in 2012, propelled mainly by the construction and manufacturing subsectors.

The agricultural sector bounced back strongly in the second-half of 2013 to record a growth of 4.2 percent for the year. This was especially impressive since flooding had ravaged the country's main maha season and contracted output by 0.4 percent in the first half of the year. The rebound was due largely to impressive paddy production in the secondary yala season; one-third of total paddy production originates in the formerly war-affected North and East Provinces.

Inflation remained subdued, with headline inflation moderating to 6.9 percent in 2013 from 7.6 percent in 2012. The outlook for inflation remains favourable supported by subdued international commodity prices, improved domestic supply conditions and well-contained demand-driven inflationary pressures. Lower inflationary expectations are evident in the sharp reduction in treasury yields. Over the past 16 months (from 12.85 percent in November 2012 to 7.07 percent in February 2014) 12-month treasury-bond yields in primary auctions have declined by 578 basis points, while longer-term T-bonds (one to four years) have seen a yield decrease of 100 basis points.

Private sector credit growth has been sluggish through most of 2013. The overall policy stance remains accommodative because the monetary authorities have prioritized high economic growth, targeting 8 percent. Therefore, the two main reasons to justify monetary easing are declining core-inflation and the availability of space for monetary easing – lower credit growth and lower imports growth.

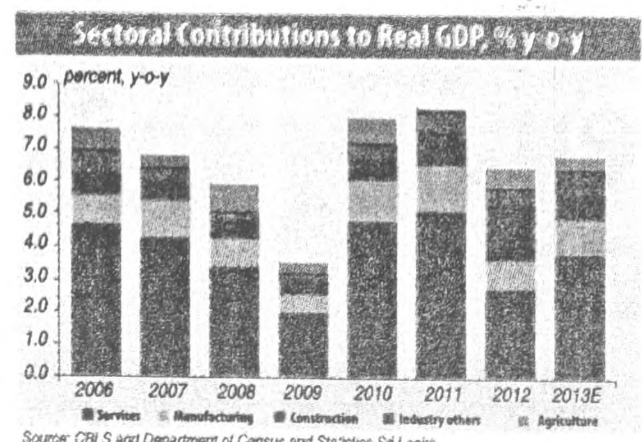
By contrast, public sector borrowing continued to rise, by 24 percent for the central government and 25 percent for state-owned enterprises (SOEs), during the year. The increases were due mainly to the government placing higher budgetary emphasis on domestic sources for financing, the lower interest rates making domestic borrowings more attractive and the private sector's aversion to credit in the climate of monetary accommodation, which prompted banks to place their excess funds in government securities.

The government curtailed expenditures during the first nine months of 2013 in an attempt to meet the fiscal deficit target of 5.8 percent of GDP. This was in response to poor revenue performance from the shortfall in trade-related taxes and followed a trend towards stricter management of fiscal spending in recent years.

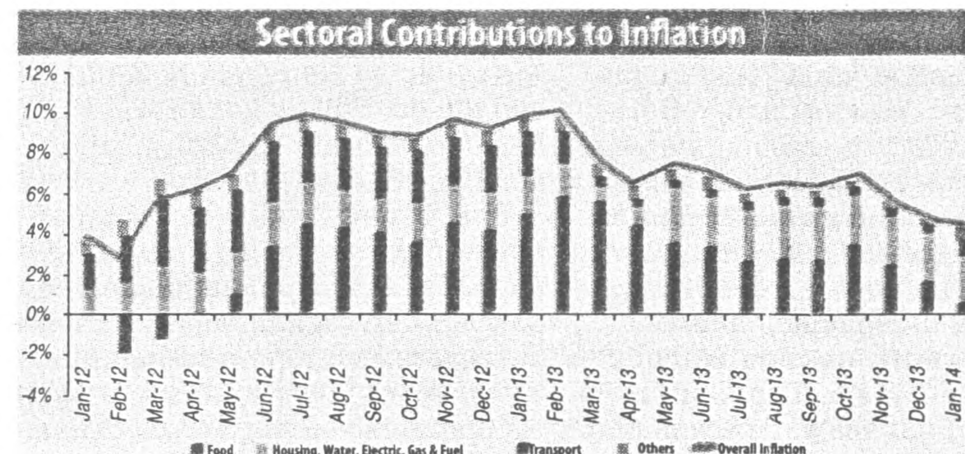
External finances

External finances were poor during the first nine months of 2013. The external financing during the period was Rs.95 billion but authorities expect this to reach Rs.149 billion by year-end. In the absence of a Euro bond issue for the first time in four years, domestic bank funding will finance the bulk of the fiscal deficit in 2013.

The current account deficit is estimated to decline to 4.0 percent of GDP in 2013, from 6.6 percent in 2012 on the back of lower imports and continued healthy inflows of workers' remittance and tourism receipts.



Source: CBLS and Department of Census and Statistics Sri Lanka



The Central Bank has cut policy rates three times for a combined 125 basis points since December 2012. In December 2013, the Central Bank established a Standing Rate Corridor (SRC) in place of the current Policy Rate Corridor. The Monetary Board also decided to reduce the Standing Lending Facility Rate of the Central Bank by 50 basis points to 8.00 percent, thereby compressing the Standing Rate Corridor to 150 basis points from 200 basis points.

It is expected that this compression will facilitate the reduction of the interest spread of banks without affecting the deposit rates offered by banks to their customers. In June 2013, the Central Bank removed the credit ceiling for commercial banks and amended regulations to permit commercial banks to hold required reserves against an average of two weeks of liabilities rather than one week, in order to provide the banks greater flexibility in managing liquidity. In line with monetary policy easing, between November 2012 and February 2014, money market interest rates have responded accordingly, with the T-bill yield and Average Prime Lending Rate (APLR) dropping by 578 basis points and 486 basis points.

In January 2014, the Central Bank released a master plan for consolidation of the financial sector. Banking and non-bank financial institutions (NBFIs) will be consolidated by mergers and absorption of businesses. The Central Bank also prohibited the institutions involved in the consolidation from retrenching staff or reducing wages after the fact. The Central Bank has made the move in order to strengthen capital buffers for the financial sector. It is expected that the project will leave at least five Sri Lankan banks with assets of Rs.1 trillion or more each and about 20 NBFIs with an asset base of over Rs.20 billion each. The Central Bank expected completion of the NBFI consolidation by end-March 2014 and the entire process to be finalized by the end of the year.

Outlook and policy

GDP growth is expected to accelerate further, to 7.3 percent in 2014. The stronger momentum of activity projected for the second half of 2013 will also lead to stronger carry-over into 2014. This growth is supported by an increase in capacity from new infrastructure investments and rebuilding. But a relatively protracted recovery in high-income countries and tightening of international financial conditions will constrain a more robust rebound for Sri Lanka within the forecast horizon.

Risks to the outlook include:

Maintaining fiscal consolidation. Recent efforts at fiscal consolidation could go off track if the authorities are unable to collect the budgeted tax revenue and/or rising interest costs should the currency depreciate. In such an event, the central government may resort to increased borrowing from the domestic banking sector, possibly crowding out private sector credit.

The precarious financial position of two of the largest state-owned corporations, the Ceylon Electricity Board (CEB) and Ceylon Petroleum Corporation (CPC). A drought in 2014 would increase the already-substantial losses of the CEB. Inadequate rainfall increases the cost of electricity generation because it is produced by furnace oil rather than hydropower. The unresponsiveness of electricity tariffs to changing conditions has already undermined the viability of the CEB. As a result of its higher dependence on thermal power, the CEB's operating loss would increase. This would trigger further below-cost provisions of furnace oil by the CPC to the CEB increasing the CPC's losses as well. The greater the losses of the CEB the more it undermines private-sector credit growth and by extension, investment and GDP growth.

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The situation could be aggravated by the government having to transfer additional resources to bolster the balance sheets of these two state-owned corporations – a substantial fiscal cost. Increased administered prices to cover the losses of CPC and the CEB could have temporary inflationary impact and reduce overall consumption expenditure.

Weathering global commodity prices. Rising global oil prices and depreciation of the Sri Lanka rupee could put pressure on prices. Oil prices could rise due to geopolitical tensions in the Middle-East, particularly Syria.

Declining exports-to-GDP. Given that the growth in the two key export sectors – i.e., tea and apparel – remains stagnant, there is a risk that there will be a continued decline in the exports-to-GDP ratio. There needs to be a new thrust towards diversification of both product and export markets to ensure that the trade balance remains manageable.

Managing the economic fundamentals in the face of currency fluctuations of major trading partners. Further depreciation of the Indian rupee could reduce FDI inflows and tourist arrivals from India and inhibit Sri Lankan exports to India. India represents the single largest trading partner and the single largest source of tourist arrivals. Furthermore, since India is the single largest source of imported goods to Sri Lanka (19 percent of total imports in 2012), a deprecation of the Indian rupee would likely drive up imports from India, thereby inflicting further deterioration in the trade balance.

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