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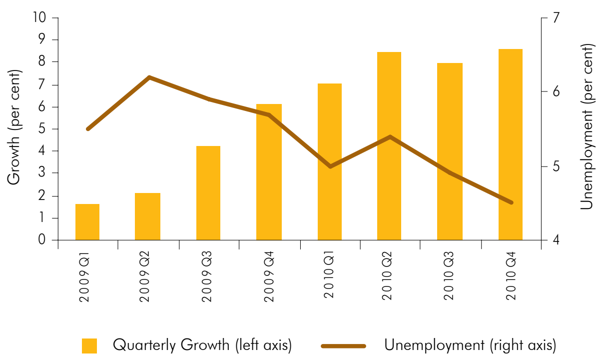
ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

1.1 Overview

Sri Lanka's economy grew by an impressive 8.0 per cent in 2010, reflecting a fast recovery from the setback suffered in 2009 and moved to a high and sustainable growth path. All key sectors of the economy demonstrated a commendable performance in 2010, underpinned by the peaceful domestic environment, improved investor confidence, favourable macroeconomic conditions and gradual recovery of the global economy from one of the deepest recessions in history. Benign inflation and the favourable inflation outlook enabled the Central Bank to continue its accommodative monetary policy stance with further moderation of interest rates in all market segments supporting economic activity. The fiscal situation improved considerably, mainly reflecting the improvement in revenue performance as well as the containment of recurrent expenditure. The external sector, which made a remarkable turnaround since the second quarter of 2009, continued to improve in 2010. Both exports and imports recovered strongly, while increased earnings from the tourism industry and higher inward remittances offset the widening trade deficit to a great extent, reducing the external current account deficit. Increased capital and financial flows resulted in the balance of payments (BOP) recording a surplus in 2010, further strengthening external reserves of the country. Supported by the favourable macroeconomic environment and the supportive regulatory and supervisory framework, the financial sector displayed improved performance and financial system stability strengthened.

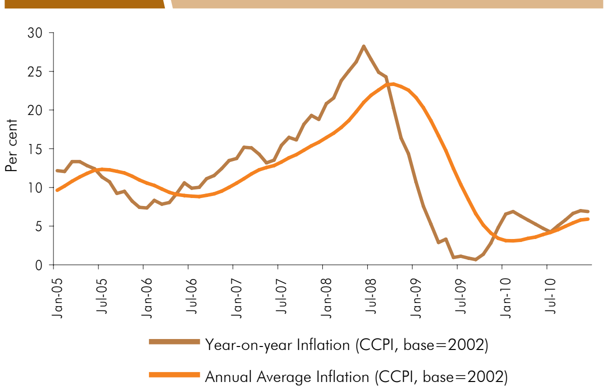
Inflation continued to remain low at around mid-single digit levels and the benign outlook for inflation enabled the Central Bank to ease its monetary policy stance further in 2010. While significant demand pressures were absent, improved domestic supply conditions, downward adjustments of certain administered prices and the reduction of import duties on several

Chart 1.1 Quarterly Growth and Unemployment



consumer items had a favourable impact on prices. The Central Bank reduced its policy interest rates; the Repurchase rate and the Reverse Repurchase rate, by 25 basis points each, in July 2010 and the Reverse Repurchase rate by a further 50 basis points in August 2010 with a view to supporting economic activity further. Market interest rates continued to adjust downwards in line with the policy rate reductions and the overall growth of monetary aggregates remained consistent with the envisaged path. The growth of broad money (M_{2b}) gradually decelerated to 13.6 per cent by September 2010, before picking up to 15.8 per cent by end 2010. This growth was driven by the increase in commercial banks' credit to the private sector, which gradually rose to record a year-on-year growth of 25.1 per cent by end 2010 from a negative 5.8 per cent at end 2009, reflecting the broadbased demand for credit with the recovery in domestic economic activity as well as increased post-conflict capacity

Chart 1.2 Inflation



expansion. However, monetary management could be challenging in the period ahead owing to possible continued high growth in domestic credit as well as a possible increase in capital inflows, thus requiring close monitoring of macroeconomic developments and formulating appropriate demand management policies to prevent the build-up of excessive demand pressures.

An encouraging improvement in the overall fiscal situation was witnessed in 2010 with the recovery in government revenue supported by the expansion of economic activity, the addressing of certain persistent structural issues in the tax system, as well as the containment of recurrent expenditure. The overall deficit was reduced to 7.9 per cent of GDP in 2010 from 9.9 per cent in 2009. The government has affirmed its ongoing commitment to fiscal consolidation by reducing the budget deficit to 6.8 per cent in 2011 and to below 5 per cent in the medium term. In line with the recommendations of the Presidential Commission on Taxation, several vital revisions were introduced to the tax structure focusing on the simplification of the tax system, rationalising exemptions, improving tax compliance and strengthening tax administration. In addition, steps were taken to streamline the tax concessions granted under the Board of Investment (BOI) Act focusing on larger and strategic investments. The continued fiscal consolidation efforts would reinforce the conduct of monetary policy in achieving economic and price stability.

With favourable macroeconomic conditions and the recovery in economic activity, the performance and stability of the financial sector strengthened in 2010. This improved performance was reflected in all prudential indicators. Credit flows significantly recovered, profitability improved, capital adequacy further increased above the threshold and the ratio of non performing loans declined, while provisions for loan losses increased. The performance of finance companies in distress also improved rapidly, while financial markets continued to remain liquid. The branch network of banks and other financial institutions expanded,

BOX 1 Sri Lanka's Graduation to Middle-Income Status from the PRGT Eligible Country List

Sri Lanka was graduated to middle-income status from the list of Poverty Reduction and Growth Trust (PRGT) eligible countries, in January 2010 by the International Monetary Fund (IMF). The decision to graduate Sri Lanka into middle-income status came after its Executive Board approved a new eligibility framework for countries that use the IMF's concessional financial resources under PRGT.[1] A country is graduated from the PRGT eligibility category if it (a) has enjoyed income per capita well above the International Development Association (IDA) threshold for a sustainable period; (b) has the capacity for durable and substantial access to international financial markets; and (c) does not face serious short-term vulnerabilities, such as a sharp drop in per capita income, loss of market access, etc.[2]

The specific factors that have been considered by IMF in graduating Sri Lanka include, mainly:

(a) the strong economic performance in recent years has lifted Sri Lanka's per capita income substantially, reaching US dollars 2,014 by 2008,[3] well above the prevailing IDA threshold and has been on a steady upward trend for, at least, the last 5 years;

(b) gradual decline of projected external debt over the medium term, ensuring a sustainable level of public debt with timely implementation of fiscal consolidation; and,

(c) benefits accrued from increased access to capital markets in recent years, thus meeting the market access criterion of IMF, as reflected, for instance, in heavily oversubscription of the five-year international sovereign bond issued in 2009.[4]

Following this graduation to middle-income status, Sri Lanka projected strongly in international financial markets and it will continue to do so, further opening up for international financial markets, thereby attracting more investments, in the coming years.

[1] However, the World Bank classification of income groups are as follows; low income (less than US dollars 995); low-middle income (US dollars 996 - 3,945); upper-middle income (US dollars 3,946 - 12,195); and high income (US dollars 12,196 or more).

[2] See IMF's Public Information Notice (PIN), No.10/16 (February 2010). http://www.imf.org/external/np/sec/pn/2010/pn1016.htm.

[3] Sri Lanka's per capita GDP increased to US dollars 2,399 in 2010 from US dollars 2,057 in 2009.

[4] Sri Lanka raised US dollars 1 billion from the international sovereign bond issue in 2010, with a ten-year maturity at a very competitive rate.

particularly with the measures taken by the Central Bank to promote financial service delivery to the Northern and Eastern provinces. Improvements to the payments system continued. A mandatory deposit insurance scheme was introduced in 2010 for licensed banks and finance companies to protect small depositors. However, intermediation costs that still remain high, as reflected by high interest rate margins, and the sluggish development in the corporate debt securities market continue to remain areas of major concern.

In terms of raising the social welfare of people, the ultimate goal of macroeconomic policy, the decline in poverty that surpasses the target set under Millennium Development Goals (MDGs) and the continuous decline in unemployment are commendable achievements. The Poverty Headcount Index halved from 15.2 per cent in 2006/07 to 7.6 per cent according to the first-round information from the Household Income and Expenditure Survey 2009/10 conducted by the Department of Census and Statistics, while the improvements were more prominent in the rural and estate sectors. By 2010, the unemployment rate (excluding the Northern and Eastern provinces), which was 8.8 per cent in 2002 had declined to 4.9 per cent. However, further progress is required, especially in raising employment opportunities for and the living standards of people in the Northern and Eastern provinces.

In 2010, the first full year of operation subsequent to the ending of the three-decade long conflict, the economy of Sri Lanka has displayed its true potential, with impressive macroeconomic achievements. The challenge for policymakers today is to sustain these achievements with macroeconomic stability in the face of more frequent internal and external shocks. While appropriate demand management policies are required to maintain low and stable inflation, effective addressing of supply-side impediments is also needed. The continuous advancement of productivity, the adoption of new technology and human capital development would reduce the pressure on the labour market, while improvements to physical infrastructure and appropriate changes to the regulatory framework need to be pursued to facilitate greater labour mobility as well as greater labour availability to maintain the expected high growth. The diversification of exports, in terms of products and markets, is needed to increase the resilience of the economy to external disturbances, and to this end, the effective utilisation of existing bilateral and multilateral treaties and actively persuing the establishment of further trade relations with emerging regional markets as well as promoting private sector investment and strengthening the "Doing Business" environment are necessary. The impact of disturbances arising from adverse external developments including price movements of commodities such as crude oil, could also be lessened through the implementation of necessary reforms to the institutional framework of key public enterprises to operate them more efficiently and in a commercially sustainable way to reflect market conditions. These changes will support the ongoing fiscal consolidation process, which would in turn strengthen demand management policies.

1.2 Macroeconomic Developments, Stability and Policy Responses in 2010

Real Sector Developments

In 2010, the Sri Lankan economy recorded an impressive growth of 8.0 per cent, the highest annual rate of growth reported in the last three decades.[1] This far exceeds the average annual growth of 4.9 per cent recorded since the liberalisation of the economy in 1977. This remarkable performance was supported by the restoration of permanent peace, which created an environment conducive for the expansion in economic activity, the strong macroeconomic environment, increased domestic demand, the development of infrastructure facilities, improved external demand with the gradual recovery in the global economy and favourable domestic weather conditions.

The improved performance in all key sectors of the economy contributed towards the high economic growth in 2010. The Agriculture sector, which contributed around 11.9 per cent of the GDP in 2010, grew by 7.0 per cent, compared to 3.2 per cent in 2009, mainly driven by the increased production of paddy, tea, rubber and minor export crops along with significant improvements in the fisheries sector output. However, coconut production declined by 19 per cent, mainly reflecting the lag effect of adverse weather conditions. The Industry sector grew by 8.4 per cent supported by increased domestic and external demand with enhanced investor and consumer confidence. Improved performance in industries, such as food and beverages, rubber based products, textiles and garments coupled with increased performance in the construction sector and increased hydropower generation contributed to this growth. The share of the Industry sector in total GDP increased marginally to 28.7 per cent in 2010. The Services sector grew by 8.0 per cent in 2010. The wholesale and retail sub sector, which accounts for the largest share in the Services sector, grew by 7.5 per cent with enhanced performance in both domestic and external trading activity. The hotels and restaurants sub sector grew sharply by about 39.8 per cent underpinned by the strong performance in tourism. Other major sub sectors such as transport and communications, and banking, insurance and real estate also recorded significantly higher growth rates compared to 2009.

Reflecting the increased availability of employment opportunities alongside enhanced economic activity, the unemployment rate, which increased marginally to 5.8 per cent with the slowing down of economic activity in 2009,

[1] Previously Sri Lanka has recorded an economic growth of 8.2 per cent in 1968 and 1978.

Table 1.1 Gross National Product by Industrial Origin at Constant (2002) Prices

Sector	Value (Rs. million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2009 (a)	2010 (b)	2009 (a)	2010 (b)	2009 (a)	2010 (b)	2009 (a)	2010 (b)
Agriculture	**295,097**	**315,644**	**12.0**	**11.9**	**3.2**	**7.0**	**11.0**	**10.5**
Agriculture, Livestock and Forestry	266,208	283,236	10.9	10.7	2.8	6.4	8.8	8.7
Fishing	28,888	32,407	1.2	1.2	6.9	12.2	2.2	1.8
Industry	**701,129**	**760,219**	**28.6**	**28.7**	**4.2**	**8.4**	**33.9**	**30.1**
Mining and Quarrying	52,030	60,079	2.1	2.3	8.2	15.5	4.7	4.1
Manufacturing	427,334	458,660	17.4	17.3	3.3	7.3	16.3	16.0
Electricity, Gas and Water	58,974	63,567	2.4	2.4	3.7	7.8	2.5	2.3
Construction	162,790	177,912	6.6	6.7	5.6	9.3	10.3	7.7
Services	**1,452,988**	**1,569,569**	**59.3**	**59.3**	**3.3**	**8.0**	**55.2**	**59.4**
Wholesale and Retail Trade	570,698	613,320	23.3	23.2	-0.2	7.5	-1.4	21.7
Hotels and Restaurants	9,901	13,845	0.4	0.5	13.3	39.8	1.4	2.0
Transport and Communication	329,578	368,653	13.5	13.9	6.3	11.9	23.4	19.9
Banking, Insurance and Real Estate etc.	217,819	234,255	8.9	8.9	5.7	7.5	14.1	8.4
Ownership of Dwellings	74,051	74,692	3.0	2.8	1.3	0.9	1.1	0.3
Government Services	191,778	202,187	7.8	7.6	5.9	5.4	12.8	5.3
Private Services	59,164	62,617	2.4	2.4	5.8	5.8	3.9	1.8
Gross Domestic Product	**2,449,214**	**2,645,432**	**100.0**	**100.0**	**3.5**	**8.0**	**100.0**	**100.0**
Net Factor Income from Abroad	-28,262	-33,931			49.8	-20.1		
Gross National Product	**2,420,952**	**2,611,500**			**4.8**	**7.9**		

(a) Revised
(b) Provisional

Source: Department of Census and Statistics

declined even below the 2008 level to 4.9 per cent in 2010. While the labour force participation rate declined marginally from 48.7 per cent in 2009 to 48.1 per cent in 2010, the number of employed persons increased by 1.4 per cent to 7.71 million in 2010. The share of the Services sector in total employment increased from 42.3 per cent in 2009 to 43.1 per cent in 2010, and that of the Industry sector declined from 25.1 per cent to 24.2 per cent in 2010. In terms of employment status, the share of own account workers increased in 2010. However, relatively high unemployment among youth, in particular among educated youth, remains a concern.

Both export and domestic agriculture contributed to the improved performance in the Agriculture sector. Benefiting from favourable weather conditions, the tea sub sector registered the highest ever annual production of 329 million kg compared to the distressed output in 2009, while rubber production also continued to increase. Export agricultural crops such as cloves, pepper and cinnamon contributed positively to the improved performance in the Agriculture sector. Within domestic agriculture, paddy production recorded an impressive growth in 2010 due to increased extent of cultivation particularly in the Northern and Eastern provinces, favourable weather conditions and the continuation of agriculture support schemes. Coconut production declined significantly by 19 per cent in 2010, and sugar production also recorded a marginal decline. The significant expansion in fishery activities in the Northern and Eastern provinces largely contributed to the increase in fish production by 12 per cent in 2010, while domestic milk production increased notably with the committed efforts to enhance domestic milk production.

Prices of key agricultural crops remained high in 2010. Tea prices at the Colombo tea auction recorded historic high levels with increased demand for Sri Lankan tea. The average prices of all varieties of rubber increased due to the severe supply shortages of natural rubber in the international market and increased demand due to global economic recovery and high crude oil prices. The decline in the coconut production together with an increased demand for industrial usage led coconut prices to rise significantly. Despite the increased paddy production in both seasons, prices remained stable assisted by the intervention of the government through its paddy purchasing programme. The average producer price for liquid milk increased to encourage dairy production.

Several measures were taken by the government during 2010 to promote agriculture. To encourage tea re-planting and new planting, the subsidy for tea smallholders was increased while extending the subsidy for coconut re-planting and new planting as well. Despite the high fiscal outlay, the fertiliser support scheme was continued and extended to cover coconut and other field crops from 2011. With a view to promoting supply of high quality seeds, a three-year seed farm development programme was proposed under public-private partnership basis.

The output of the Industrial sector recorded a commendable growth of 8.4 per cent in 2010 compared to 4.2 per cent in the previous year. Factory industry, which contributed approximately 54.6 per cent to the total industry output, recorded a 7.5 per cent growth during 2010. The textile, wearing apparel and leather products category, which was adversely affected by the global economic crisis, showed signs of recovery during the last quarter of the year despite the withdrawal of GSP+ concessions effective from August 2010. The apparel industry remained competitive through increased productivity, improved quality, diversification and gradual recovery in external demand. The high growth in food, beverages and tobacco products category, which accounts for nearly 48.0 per cent of the total factory industry output, was driven by the expansion in domestic demand particularly from the Northern and Eastern provinces and increased tourism-related activity during the year. The major contributors to the increased output in export market oriented industries were ship building and repairing and transport equipment and machinery. The non metallic mineral products category also performed well during the year with high demand for cement and building materials. The substantial improvement in hydropower generation raised value addition from the electricity sector, while the construction sector expanded by 9.3 per cent with the continuation of major infrastructure development projects as well as increased construction activity in the private sector.

The recovery in both domestic and external demand and favourable macroeconomic environment supported industrial sector growth during 2010. The recovery in domestic economic activity with increased demand from the Northern and Eastern provinces, low interest rates, low inflation and increasing business and consumer confidence created a conducive economic environment for growth in domestic market oriented industries. The export market oriented industries benefitted from increased demand from major trading partner countries with the gradual recovery of the global economy, improved productivity, branding strategies, market diversification strategies and the expansion in product portfolios. The government has taken various measures to foster the development of the industrial sector and regionalise the industrial base by developing industrial estates in various parts of the country, promoting small- and medium-scale enterprise (SME) sector and providing fiscal incentives to promote industries with higher domestic value addition.

The Services sector, which contributed 59.3 per cent of the GDP, grew at an encouraging 8.0 per cent, compared to 3.3 per cent in 2009. The wholesale and retail trade sector, displayed an impressive growth following a negative growth in 2009, due to increased external trade with the gradual recovery of the global economy and domestic trade with the restoration of peace. The hotel and restaurant sub sector showed an impressive growth with a rebound in tourist arrivals and increased domestic travel. The transport and telecommunications sector grew with the improved performance in transport, cargo handling, aviation and telecommunications sectors. The banking, insurance and real estate sub sector expanded with increased income from investments and lending activities, foreign exchange operations and widened financial services through the expansion of bank branches and other service outlets.

Reflecting the recovery in economic activity, consumption expenditure increased by 14.9 per cent in 2010, while savings and investment of the country also recovered. As a percentage

Table 1.2 Aggregate Demand and Savings Investment Gap

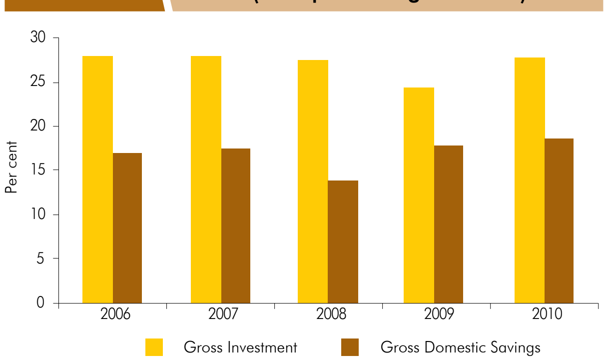
Item	Rs. billion		Growth %		As a percentage of GDP	
	2009 (a)	2010 (b)	2009 (a)	2010 (b)	2009 (a)	2010 (b)
1. Domestic Demand	**5,149.2**	**6,114.1**	**2.7**	**18.7**	**106.5**	**109.1**
1.1 Consumption	3,967.8	4,557.3	4.4	14.9	82.1	81.3
Private	3,116.2	3,684.7	1.0	18.2	64.4	65.8
Public	851.5	872.6	19.3	2.5	17.6	15.6
1.2 Investment (Gross Domestic Capital Formation)	1,181.4	1,556.8	-2.8	31.8	24.4	27.8
Private	863.5	1,209.6	-7.1	40.1	17.9	21.6
Public	318.0	347.2	11.1	9.2	6.6	6.2
2. Net External Demand	**-313.9**	**-511.8**	**48.0**	**-63.0**	**-6.5**	**-9.1**
Exports of Goods and Services	1,031.3	1,215.0	-5.9	17.8	21.3	21.7
Imports of Goods and Services	1,345.2	1,726.8	-20.8	28.4	27.8	30.8
3. Total Demand (GDP) (1 + 2)	**4,835.3**	**5,602.3**	**9.6**	**15.9**	**100.0**	**100.0**
4. Domestic Savings (3 - 1.1)	**867.5**	**1,045.0**	**41.8**	**20.5**	**17.9**	**18.7**
Private	1,047.5	1,163.8	49.6	11.1	21.7	20.7
Public	-179.9	-118.9	-103.3	33.9	-3.7	-2.1
5. Net Factor Income from Abroad	**-55.8**	**-71.9**	**46.9**	**-28.8**	**-1.2**	**-1.3**
6. Net Private Current Transfers	**336.6**	**408.0**	**21.2**	**21.2**	**7.0**	**7.3**
7. National Savings (4 + 5 + 6)	**1,148.3**	**1,381.1**	**46.4**	**20.3**	**23.7**	**24.7**
8. Savings Investment Gap						
Domestic Savings - Investment (4 - 1.2)	-313.9	-511.8			-6.5	-9.1
National Savings - Investment (7 - 1.2)	-33.1	-175.7			-0.7	-3.1
9. External Current Account Deficit without Official Grants (2 + 5 + 6) (c)	**-33.1**	**-175.7**			**-0.7**	**-3.1**

(a) Revised
(b) Provisional
(c) The difference with the BOP estimates is due to the time lag in compilation.

Sources: Department of Census and Statistics
Central Bank of Sri Lanka

of GDP, private consumption increased from 64.4 per cent in 2009 to 65.8 per cent in 2010, while government consumption declined from a high level of 17.6 per cent to 15.6 per cent. Both domestic savings and national savings increased, from 17.9 per cent of GDP and 23.7 per cent of GDP, respectively, in 2009, to 18.7 per cent and 24.7 per cent, respectively. Private investment recovered from 17.9 per cent of GDP in 2009 to 21.6 per cent in 2010, while public investment declined marginally from 6.6 per cent of GDP in 2009 to 6.2 per cent in 2010, and as a result, total investment as a percentage of GDP in 2010 increased to 27.8 per cent. The recovery in total investment resulted in widening the national savings and investment gap to 3.1 per cent of GDP, which was reflected in a higher deficit in the external current account.

Chart 1.3 Savings and Investment (as a percentage of GDP)



Consumer price inflation continued to remain at mid-single digit levels in 2010, with the annual average increase of the Colombo Consumers' Price Index (CCPI, 2002=100) and its year-on-year change recording 5.9 per cent and 6.9 per cent, respectively, by end 2010. The relatively low and stable inflation during the year was mainly due to improved domestic supply conditions, supportive fiscal policies aided by the adjustment in import duties and downward revisions to administered prices as well as the prudent monetary policy stance of the Central Bank.

External Sector Developments

The external sector of the country further improved in 2010 with favourable developments on both domestic and external fronts. Sri Lanka's graduation to the status of a "middle-income economy" by the International Monetary Fund (IMF) in January 2010, enabled the country to project itself strongly in international financial markets. Upgrading of the sovereign credit rating of the country by international rating agencies, the successful continuation of the Stand-by Arrangement (SBA) with the IMF, increased long term capital flows to the government including the successful issuance of the third international sovereign bond in October 2010 as well as increased inflows to the private sector helped strengthen the performance of the external sector. Further relaxation of restrictions on foreign exchange transactions also helped improve investor confidence and the external sector.

External trade rebounded strongly in 2010, reversing the sharp contraction observed during the global recession of 2009. Earnings from exports increased by 17.3 per cent, reflecting higher earnings from the industrial and agricultural sectors. Expenditure on imports grew by 32.8 per cent, led by intermediate goods imports. As a result, the trade deficit expanded to US dollars 5,205 million in 2010. Although export earnings were volatile in the early part of the year amidst uncertainties regarding the global recovery, they improved towards the latter part of the year, indicating a new growth path, despite the withdrawal of GSP+ concessions. This reflected the peace dividend and the dynamism of local exporters. Meanwhile, international commodity prices rose due to the global economic recovery, higher demand for commodities from emerging economies, and global supply constraints. Consequently, agricultural exports continued to

Chart 1.4 Value of Petroleum Imports and Average Price of Crude Oil Imports

fetch high prices in the international market. Higher commodity prices, particularly crude oil prices, caused expenditure on imports to increase in 2010. Imports of consumer durables, such as personal motor vehicles and electronic goods also increased following the tariff reductions and the increase in domestic economic activity. Similarly, imports of investment goods also increased in 2010, led by higher expenditure on imports of machinery and transport equipment.

External trade in services improved significantly generating a higher surplus during 2010, while the income account continued to record a deficit. All sub sectors of the services account, mainly transportation, travel, computer and information, construction and insurance services, performed well during the year. Net income from transportation and travel services grew substantially due to higher income from ports and aviation industries and a sharp increase in tourist arrivals. Meanwhile, the deficit in the income account increased to US dollars 572 million in 2010 as outflows on account of repatriation of profits and dividends exceeded the interest earned on investments and profits earned on trading of foreign currency and foreign securities.

A substantial increase in inward workers' remittances to US dollars 4.1 billion helped offset the trade deficit to a great extent in 2010. Establishing collective agreements with overseas employers for higher wages and salaries, the expansion of the exchange houses network by commercial banks, an increase in the number of persons taking up high-end jobs overseas, the government's ongoing initiative to promote inward remittances through formal channels and opening of new bank branches in the Northern and Eastern provinces were instrumental in attracting a higher level of workers' remittances.

The external current account recorded a deficit of US dollars 1,498 million or 2.9 per cent of GDP in 2010. The current account deficit widened due to a large trade deficit, as a result of an increase in import demand supported by the

Table 1.3 External Sector Developments

Item	US dollars million 2009 (a)	US dollars million 2010 (b)	% Change
Exports	7,085	8,307	17.3
Agricultural Products	1,690	2,041	20.8
Industrial Products	5,305	6,173	16.4
Mineral Exports	89	93	4.4
Other Exports	-	-	-
Imports	10,207	13,512	32.4
Consumer Goods	1,972	2,870	45.6
Intermediate Goods	5,669	7,496	32.2
Investment Goods	2,451	2,970	21.2
Other	115	176	53.2
Trade Balance	*-3,122*	*-5,205*	*66.7*
Services (net)	391	698	78.5
Receipts	1,892	2,468	30.5
Payments	1,501	1,770	18.0
Income (net)	-488	-572	17.2
Receipts	116	323	178.7
Payments	603	895	48.5
Current Transfers (net)	3,005	3,660	21.8
Private Transfers (net)	2,927	3,608	23.3
Receipts	3,330	4,116	23.6
Payments	403	508	26.1
Official Transfers (net)	77	52	-31.9
Current Account	-214	-1,418	562.8
Capital Account	*233*	*164*	*-29.7*
Financial Account	*2,361*	*2,713*	*14.9*
Direct Investment (net)	384	435	13.3
Inflows	404	478	18.2
Outflows	20	43	112.5
Private, Long Term (net)	79	149	88.0
Inflows	390	580	48.6
Outflows	311	431	38.6
Government, Long Term (net)	840	1,796	113.8
Inflows	1,780	2,460	38.2
Outflows	940	665	-29.3
Private, Short Term (net)	-311	-198	-36.4
of which:Portfolio Investment (net)	-6	-230	3,728.9
Government, Short Term (net)	1,369	531	-61.2
Errors and Omissions	346	-537	
Overall Balance	*2,725*	*921*	
Gross Official Reserves (c)	5,097	6,610	
Months of Imports	6.0	5.9	
Total External Reserves (c)	6,770	8,035	
Months of Imports	8.0	7.1	
Export Price Index	112.5	124.9	
Import Price Index	109.1	127.9	
Terms of Trade	103.1	97.6	
Exchange Rates (Average)			App(+)/Dep(-)
Rs./US dollar	114.94	113.06	1.7
Rs./Japanese yen	1.23	1.29	-4.6
Rs./Euro	160.21	150.10	6.7
Rs./ Pound sterling	179.87	174.81	2.9

(a) Revised
(b) Provisional
(c) Excluding Asian Clearing Union (ACU) receipts

Source: Central Bank of Sri Lanka

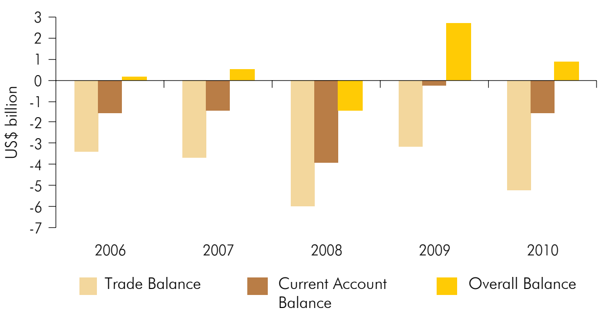
recovery of domestic demand and expansion of economic activity. However, this was well below the average deficit of the previous few years, with the exception of 2009, which recorded a deficit of 0.5 per cent of GDP, reflecting weak external and domestic demand in the context of the global recession.

Inflows to the capital and financial account exceeded the current account deficit. The medium and long term loan inflows to the government increased during 2010 compared to 2009, mainly due to faster disbursement of foreign loans to finance major infrastructure development projects. The third international sovereign bond of US dollars 1 billion with a tenor of 10 years was successfully issued in October 2010. However, foreign direct investments (FDIs), including loans to BOI enterprises, decreased further to US dollars 516 million in 2010, mainly due to the impact of the global financial crisis on foreign financial flows. Net foreign inflows to the government rupee securities market declined in 2010, as the outstanding value of government securities issued to foreigners reached the maximum allowed limit of 10 per cent of the total outstanding value of government securities. Meanwhile, foreign loan inflows to the private sector increased in 2010, whereas short term net capital outflows reduced, largely due to the decline in foreign assets and the increase in foreign liabilities of commercial banks during 2010, despite the repayment of substantially high oil import bills by the Ceylon Petroleum Corporation (CPC) during 2010.

In 2010, the BOP recorded a surplus of US dollars 921 million, following a significantly higher surplus of US dollars 2,725 million in 2009. Higher inflows to the capital and financial account, which exceeded the current account deficit generated the surplus in the overall balance of the BOP. The financial inflows to the government as well as to the private sector for long term investment contributed to the surplus in the BOP.

The external reserves of the country further improved to record its highest level in 2010. By end 2010, gross official reserves (excluding ACU receipts) increased to a record high level of US dollars 6,610 million (equivalent to 5.9 months of imports) compared to US dollars 5,097 million

Chart 1.5 Balance of Payments



at end 2009. Higher disbursements of project financing, continuation of the IMF-SBA facility, the proceeds from the third international sovereign bond issue, and the absorption of foreign exchange from the domestic foreign exchange market contributed to the buildup of reserves. Meanwhile, total external assets (excluding ACU receipts) increased by 19 per cent to US dollars 8,035 million by end 2010 (equivalent to 7.1 months of imports), compared to US dollars 6,770 million at end 2009.

The total external debt of the country as a percentage of GDP moderated to 43.3 per cent in 2010. Higher foreign inflows to the government including the proceeds from the sovereign bond issue to finance infrastructure development projects, and disbursements under the IMF-SBA facility, which is managed by the Central Bank, were the major factors that contributed to the increase in the outstanding external debt stock. Of the medium to long term debt, the government debt accounted for 85.9 per cent, while the remainder represented borrowings of the private sector and public corporations, and debt obligations to the IMF. The total foreign debt service payments, consisting of amortisation and interest payments as a percentage of exports of goods and services, declined from the unusually high ratio of 19.0 per cent in 2009 owing to crisis-affected level of exports of goods and services, to 15.2 per cent in 2010.

The exchange rate policy in 2010 focused mainly on maintaining stability in the domestic foreign exchange market. In the face of continued foreign exchange inflows into the domestic market, the Central Bank regularly absorbed foreign exchange, in order to mitigate excessive volatility in the exchange rate and to further strengthen the reserve position. However, during the last quarter of 2010, the Central Bank had to supply foreign exchange to the market to ensure adequate foreign exchange liquidity in the face of substantial outflows arising from the settlement of petroleum bills.

Fiscal Sector Developments

Significant improvements in fiscal operations in 2010 helped contain the overall fiscal deficit at 7.9 per cent of GDP from 9.9 per cent in the previous year. For the first seven months of the year, fiscal operations were conducted initially under a Vote on Account framework and then under the provisions of paragraph 3 of Article 150 of the Constitution by a Presidential Decree. The budget for 2010 was approved by the Parliament in July 2010. Despite the delay in presenting the budget and the limited scope for introducing new revenue and expenditure measures, the overall fiscal deficit was maintained within the original target of 8 per cent of GDP.

The pickup in domestic economic activity and the strong recovery in imports increased government revenue in nominal terms above the original target set in the budget for 2010. Revenue as a percentage of GDP increased to 14.6 per cent in 2010 from 14.5 per cent in the previous year. The rationalisation of the tariff structure to four bands and the removal of the import duty surcharge as well as the reduction of effective taxes on various major imports, including motor vehicles, caused a surge in import demand and a resultant increase in revenue collection from import related taxes. However, to mitigate the impact of rising international commodity prices on the domestic market, the government revised taxes on several key commodities, including petrol and diesel. In addition, the government provided various tax concessions to assist industries affected by the global economic and financial crisis and to support certain identified industries.

Government expenditure was maintained within the original budgetary targets for 2010 with the strict monitoring of recurrent expenditure, while maintaining capital

expenditure for the accelerated implementation of planned infrastructure projects. Total expenditure and net lending declined from 24.9 per cent of GDP in 2009 to 22.9 per cent of GDP in 2010. The reduction of total expenditure and net lending by 2 percentage points was the combined outcome of a reduction in recurrent expenditure by 1.5 percentage points and capital and net lending by 0.5 percentage points. Concerted efforts taken to rationalise recurrent expenditure enabled government expenditure to be contained within the original budgetary allocations, while the public investment programme was carried out largely unhindered.

The government relied more on external sources to finance the fiscal deficit, thus reducing pressure on the domestic market and interest rates. Improved investor confidence and the favourable borrowing conditions that prevailed in international financial markets enabled the government to issue a 10-year international sovereign bond at a lower rate of interest of 6.25 per cent, attracting an order book of six times the value of the bond and to issue Sri Lanka Development Bonds (SLDBs) with extended tenor at lower interest rates. In financing the deficit through domestic sources, the government reduced its reliance on bank financing, thus releasing resources to the private sector and easing pressure on domestic interest rates. Total net domestic financing in 2010 amounted to 3.6 per cent of GDP, while net foreign financing was 4.4 per cent of GDP, which consisted of foreign loans (3.5 per cent of GDP) and foreign investments

Chart 1.6 Revenue, Expenditure and Overall Fiscal Deficit (as a percentage of GDP)

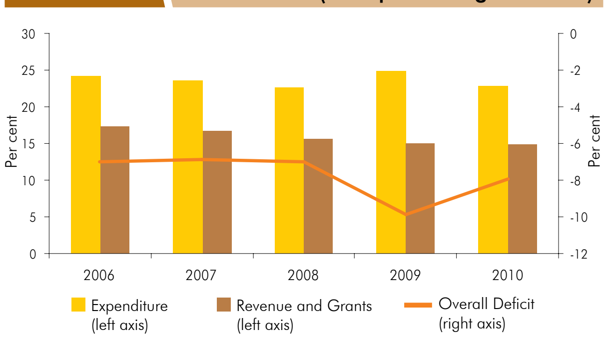
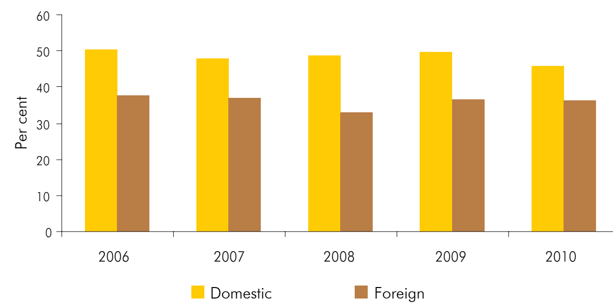


Chart 1.7 Government Debt (as a percentage of GDP)



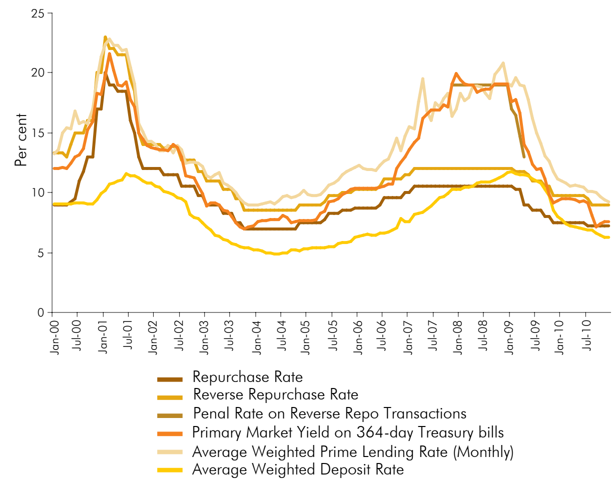
in government securities (0.9 per cent of GDP). Meanwhile, the outstanding government debt to GDP ratio declined from 86.2 per cent in 2009 to 81.9 per cent in 2010 mainly due to a lower budget deficit and higher growth in nominal GDP.

Monetary Sector Developments

The Central Bank eased its monetary policy stance further in 2010 by reducing the policy interest rates in the second half of 2010 with a view to stimulate credit growth to support economic activity. The continuous deceleration in money supply growth during the first three quarters of 2010 reflected subdued demand pressures, while the benign outlook for domestic consumer prices prompted the Central Bank to continue its accommodative monetary policy stance during the year. With the reduction in both the Repurchase rate and the Reverse Repurchase rate by 25 basis points in July, and a further reduction of the latter by 50 basis points in August, the policy rate corridor was narrowed, and by end 2010, the Repurchase rate was 7.25 per cent, while the Reverse Repurchase rate was 9.00 per cent. Policy rates were reduced again in January 2011, narrowing the corridor further, which has since remained bounded by the Repurchase rate of 7.00 per cent and the Reverse Repurchase rate of 8.50 per cent.

Following the turnaround in rupee liquidity in the domestic money market from mid 2009, the money market liquidity continued to be in excess in 2010. The build-up of excess liquidity was largely due to the absorption of foreign exchange inflows to the country by the Central Bank with a

Chart 1.8 Central Bank Policy Rates and Selected Market Interest Rates



view to preventing an undue appreciation of the rupee. The issue of the sovereign bond in October to international investors, net foreign investments in Treasury bonds and Treasury bills, and other inflows of foreign funds to both the government and the private sector, resulted in the excess of foreign exchange in the domestic foreign exchange market during the first three quarters of the year.

The Central Bank continued its efforts to manage liquidity, thereby stabilising interest rates and guiding reserve money along the targeted path. As the stock of government securities held by the Central Bank depleted, the Bank issued its own securities to absorb liquidity on overnight and term bases. Foreign exchange swap agreements, adopted under open market operations (OMO) in 2009, were also utilised to absorb a portion of the excess liquidity. In October 2010, the Central Bank implemented a bond-borrowing programme and the borrowed bonds were used for OMO in the latter part of the year to absorb the excess liquidity in the market. Meanwhile, from 20 October 2010, the overnight and term auctions under OMO were discontinued as the primary market yield rate on three-month Treasury bills declined to levels below the Bank's Repurchase rate, an outcome of intense competition among banks, who had a large volume of excess liquidity, to acquire short term government securities to manage their portfolios. Accordingly, market participants continued to place their excess liquidity with the Central Bank through the standing facility. By end 2010, the overall excess liquidity in the money market amounted to Rs. 124.3 billion compared to Rs. 159.6 billion at end 2009.

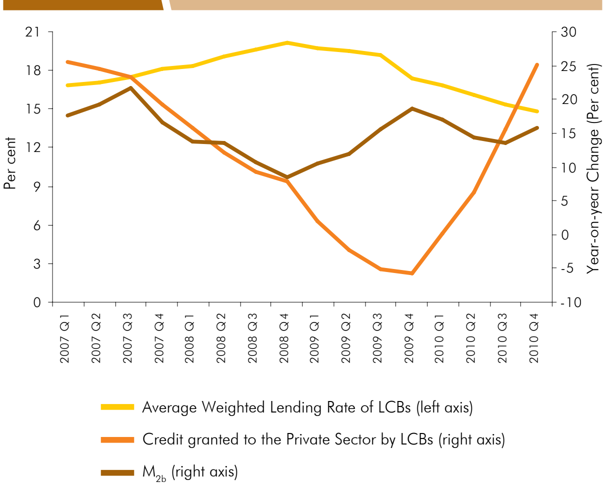
The monetary operations of the Central Bank continued within a monetary targeting framework and were guided by its monetary programme, which is prepared taking into account the projected key macroeconomic developments. Accordingly, broad money (M_{2b}) continued to be the intermediate target for monetary policy, while reserve money, which is linked to broad money through a multiplier, remained the Bank's operating target for monetary policy. The Central Bank's monetary programme was initially prepared stipulating the targets for annual average growth of broad money and reserve money at 14.5 per cent each. Subsequently however, the Bank revised the monetary programme for the year as it became evident by mid-year that the domestic economy was expanding at a higher rate in 2010 than originally projected, and it was necessary to include information from the government's budget for 2010, which was presented to the Parliament in June 2010. Accordingly, the targeted growth of broad money in 2010 was revised upward to 15 per cent in July 2010. Meanwhile, a notable increase in the 'currency held by the public' component within the money supply, particularly in view of the restoration of economic activity in the Northern and Eastern provinces, led to an increase in the currency to deposit ratio, in turn leading to a decline in the money multiplier. Taking into account these developments, the target for year-on-year growth of annual average reserve money was raised to 21.2 per cent in July 2010, consistent with the upward revision to the broad money target.

Year-on-year growth of daily average reserve money in 2010 was at a level consistent with the target stipulated in the revised monetary programme for 2010. Viewed from the source side, the expansion of reserve money during the year 2010 was entirely due to the increase in net foreign assets (NFA) of the Central Bank. NFA expanded mainly as the government used a part of the funds (US dollars 492 million) it raised by issuing a sovereign bond in international markets to retire Treasury bills held by the Bank amounting to Rs. 55 billion and sold a further US dollars 386 million thus raised to the Central Bank. Meanwhile, net domestic assets (NDA) of the Central Bank decreased as a result of the substantial decline in the amount of Treasury bills held by the Bank.

Annual average growth of broad money (M_{2b}) was 15.3 per cent in 2010, remaining consistent with the targeted growth of 15 per cent. On the use side, the growth of broad money was reflected in the increases in both currency held by the public as well as deposits, particularly demand deposits. Interest bearing deposits, that is, savings and time deposits (Quasi money) held by the public with commercial banks increased at a slower pace of 14.6 per cent, year-on-year, in 2010, compared to the growth of 18.0 per cent in 2009.

The expansion of broad money was driven by the increase in NDA of the banking system as NFA contracted during the year. The NDA expanded largely due to the substantial increase in credit obtained by the private sector from commercial banks, which rebounded strongly in 2010 recording a year-on-year growth of 25.1 per cent compared to a negative growth of 5.8 per cent in 2009. The decline in lending rates along with factors, such as improved post-conflict economic conditions, enhanced business confidence and the recovery under way in the global economy helped spur credit flows to the private sector. Credit granted to public corporations, particularly to the CPC, also increased during the year, thereby contributing to the monetary expansion in 2010. However, net credit granted to the government (NCG) declined during the year. Meanwhile, NFA of commercial banks declined partly due to the decline in placements overseas by commercial banks, along with an increase in their investments in Sri Lanka Development Bonds (SLDBs) during the year and supplying foreign exchange to the CPC to settle oil bills.

Chart 1.9 Money, Credit and Interest Rates



Following the reduction of the Central Bank's policy interest rates, market interest rates adjusted further downwards in 2010, providing additional impetus to economic activity. During the year, the average weighted call money rate (AWCMR) continued to hover around the middle of the policy interest rate corridor, thus contributing to the effective transmission of monetary policy. Also, yields on government securities declined during the year. Meanwhile, the secondary market yield curve for government securities, which shifted downward, extended to longer maturities in 2010. This downward shift in the rate structure can also be attributed to the continued excess liquidity in the money market as well as the benign outlook for inflation that prevailed. Commercial banks reduced their deposits and lending rates gradually during 2010 in response to the easing of the monetary policy stance by the Central Bank. The declining trend in interest rates continued into 2011, as the Central Bank reduced its policy interest rates further in January 2011.

Financial Sector Performance and System Stability

The performance of the overall financial sector improved in 2010, leading to a strengthening of the stability of the country's financial system. In addition to the continued supervisory measures relating to examination and problem resolution, several regulatory measures were introduced to further strengthen the stability of the financial sector, thereby enhancing public confidence. The improved performance, which was reflected in all leading indicators of financial institutions, markets, payment systems and safety nets, was recorded amidst the resolution of concerns and stresses that had arisen in 2008 and 2009 due to certain domestic and external shocks adversely impacting on the public and investor confidence and business operations.

Both bank and non bank financial institutions displayed improved performance in 2010, reflecting the increase in financial transactions to facilitate the growing economy. The banking sector, which is the most dominant and systemically important sector in the financial system, grew at a high rate, while recording a significantly high level of profitability. Capital adequacy ratios and liquidity ratios in the banking sector remained well above the statutory limits. With regard to non bank financial institutions, the registered finance companies (RFC) sector gradually recovered in 2010 after experiencing liquidity problems in 2009. Timely measures implemented by the Central Bank restored depositor confidence in RFCs. Specialised leasing companies (SLCs) continued to grow in 2010 with an improvement in credit quality and favourable provisioning for bad and doubtful accommodations. Key financial indicators of the primary dealers in government securities improved during 2010, while risk management indicators were maintained within prudent levels. The insurance sector also reported improved performance in 2010.

The expansion of the branch network of financial institutions continued during 2010. The banking network further expanded with the establishment of 85 branches, 97 extension offices and 130 automated teller machines (ATMs). Out of the new banking outlets, 67 branches and 77 extension offices were outside the Western province, including 48 outlets in the Northern and Eastern provinces. Along with the issuance of two new licences, the total number of RFCs increased to 37, while their branch network increased by 98 during the year. The branch network of SLCs further expanded with the opening of 44 branches, of which, 15 were opened in the Northern and Eastern provinces.

The Central Bank further strengthened its supervisory and regulatory framework to improve the soundness and risk management systems of banks. The new regulatory measures introduced included the increase in the minimum capital that is required to be maintained by licensed commercial banks (LCBs) and licensed specialised banks (LSBs), on an annually staggered basis from 2010 to 2015; the implementation of a mandatory deposit insurance scheme, relaxation of classification of loans as non performing loans; the reduction of the required level of general loan loss provisions; the application of the assessment of the fitness and propriety to officers performing executive functions; the requirement for unlisted locally incorporated private banks to obtain a listing on the Colombo Stock Exchange (CSE) by 31 December 2011; and the issuing of Directions on outsourcing of activities. Regulations were issued stipulating maximum rates of interest that can be offered by RFCs in order to prevent unhealthy competition among deposit taking institutions and to secure public confidence and sustainability. The drafting of the Finance Business Act to replace the current Finance Companies Act was finalised with the approval of the Cabinet of Ministers and the Bill is to be presented to the Parliament in 2011. In relation to SLCs, to facilitate their future growth with prudence, the required minimum core capital and the required minimum capital for a public company to qualify for registration were increased on a staggered basis.

During the year, efforts were made to rehabilitate the RFCs affected by the liquidity crisis. The major measures included the appointment of a managing agent, attracting new investors to infuse capital and taking over the management, converting deposit liabilities and debt into equity, rescheduling of deposits and interest, disposing of real estate properties and fast tracking the recovery of non performing assets. In addition, the Central Bank Credit Guarantee Scheme was in place to support the granting of credit to RFCs by licensed banks. Accordingly, three RFCs were able to commence normal business operations, while managing agents of two RFCs have been discontinued. Strategic investors were identified for two RFCs, while prospective investors for other RFCs were under the review and due diligence process. All distressed RFCs will be able to revive their businesses fully during 2011. Investigations into institutions allegedly engaged in finance business without authorisation were continued, while assisting courts with respect to pending litigation. Parallel public awareness programmes, such as country wide seminars/workshops were conducted and advertisements were placed in national newspapers to educate the public on the risks of investing in unauthorised institutions.

Action was taken to strengthen the regulatory framework for insurance companies. The proposed amendments to the Regulation of Insurance Industry Act to strengthen prudential regulation and supervision in order to protect the interest of policyholders were presented to the Parliament in 2010. All insurance companies will be required to list on the stock exchange. The removal of the war risk premium for Sri Lanka by the London Joint Cargo Committee in June 2010 and the reduction of the premia for terrorism cover by the National Insurance Trust Fund by 75 per cent in April 2010 will reduce the cost of insurance to policyholders.

Improvements to the payment and settlement systems continued in 2010. The procedure of granting intra-day liquidity facility (ILF) to institutions under the real time gross settlement (RTGS) system was upgraded to enable them to obtain ILF at their discretion, deviating from providing ILF only on their request. SLIPS was upgraded to provide online connectivity to participating institutions. To eliminate the time lag associated with the movement of physical cheques to LankaClear (Pvt) Ltd, participating banks were instructed to capture the cheque images directly at the branch level and submit those images to LankaClear (Pvt) Ltd.

The activity at the CSE rose to historically high levels in 2010, and the CSE became one of the best performing stock exchanges in the world with all indicators recording high performance. The All Share Price Index (ASPI) rose by 96 per cent and the Milanka Price Index (MPI) increased by 83 per cent in 2010, while all the sub sector price indices increased. The number of shares traded increased four-fold and the average daily turnover rose more than three-fold. The market price earnings ratio increased further and the market capitalisation of the CSE reached Rs. 2.2 trillion by end 2010. Net foreign sales increased driven by the realisation of capital gains amidst high price increases of many stocks, and more local investors engaged in the market. There were 10 initial public offers (IPOs) in 2010 and all were significantly oversubscribed, while 31 companies made rights issues.

1.3 Global Economic Environment and Outlook[2]

The global economy gradually recovered in 2010 from its deepest recession since the 1930s. The global recovery could be largely attributed to the pickup in private demand and policies taken towards fiscal consolidation and external rebalancing, although it was weakened by high unemployment and systemic risks and renewed stresses in the financial sector. According to the World Economic Outlook (WEO) of the IMF, the world economy is estimated to have expanded by 5.0 per cent in 2010 compared to its contraction by 0.6 per cent in 2009. Being the less affected by the financial turmoil that preceded the recession in 2009, emerging economies continued to be the engine of economic recovery in 2010. Advanced economies, which were worst hit by the economic downturn in 2009, were estimated to have expanded by 3.0 per cent. This modest growth is primarily a result of the weak private domestic demand in advanced economies, mainly due to the prevailing high unemployment levels. The Japanese economy expanded by a

[2] The analysis in this section is based on the World Economic Outlook of the IMF, October 2010 and January 2011 (update), and publications by the World Bank and the Asian Development Bank.

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ECONOMIC, PRICE AND FINANCIAL SYSTEM STABILITY, OUTLOOK AND POLICIES

TABLE 1.4 Global Economic Development and Outlook (a)

Item	Actual		Projections	
	2008	2009	2010	2011
World Output	**2.8**	**-0.6**	**5.0**	**4.4**
Advanced Economies	0.2	-3.4	3.0	2.5
United States	0.0	-2.6	2.8	3.0
Euro Area	0.5	-4.1	1.8	1.5
United Kingdom	-0.1	-4.9	1.7	2.0
Japan	-1.2	-6.3	4.3	1.6
Emerging and Developing Economies	6.0	2.6	7.1	6.5
Developing Asia	7.7	7.0	9.3	8.4
China	9.6	9.2	10.3	9.6
India	6.4	5.7	9.7	8.4
World Trade Volume (Goods and services)	**2.9**	**-10.7**	**12.0**	**7.1**
Imports				
Advanced Economies	0.4	-12.4	11.1	5.5
Emerging and Developing Economies	9.0	-8.0	13.8	9.3
Exports				
Advanced Economies	1.9	-11.9	11.4	6.2
Emerging and Developing Economies	4.6	-7.5	12.8	9.2
Price Movements				
Consumer Prices				
Advanced Economies	3.4	0.1	1.5	1.6
Emerging and Developing Economies	9.2	5.2	6.3	6.0
Commodity Prices (US dollars)				
Oil	36.4	-36.3	27.8	13.4
Non fuel	7.5	-18.7	23.0	11.0
Six-month London Interbank Offered Rate (LIBOR) on US dollar Deposits (per cent)	**3.0**	**1.1**	**0.6**	**0.7**

(a) Annual percentage change unless otherwise indicated.

Source: World Economic Outlook (January 2011 & October 2010), IMF

notable 4.3 per cent in 2010 after a contraction of 6.3 per cent in 2009. The recovery of the Euro region economies was affected by regional fiscal instability and vulnerabilities in financial linkages and therefore the region recorded only a modest growth of around 1.8 per cent in 2010. Fuelled by the gradual increase in global demand, emerging and developing economies expanded by 7.1 per cent in 2010 while developing Asia expanded at an estimated 9.3 per cent.

With the gradual recovery of global demand, commodity prices also increased particularly towards the latter half of 2010. Inflation in advanced economies increased from 0.1 per cent in 2009 to 1.5 per cent during 2010, while in emerging and developing economies, inflation increased from 5.2 per cent in 2009 to 6.3 per cent in 2010. In the midst of increasing global demand, there were several supply-side shocks raising commodity prices further. The adverse weather conditions in several major food commodity producing countries caused food prices to increase, while geopolitical instability during the latter part of 2010 resulted in higher crude oil prices. The Food and Agriculture Organisation's (FAO) food price index increased by 25.1 per cent from 177.9 in 2009 to 222.6 in 2010. Meanwhile, the average Brent crude oil price of US dollars 61.83 per barrel in 2009 increased to US dollars 79.97 per barrel in 2010.

Short term interest rates continued to remain low in 2010 in response to the continuation of a relaxed monetary policy stance in many advanced and emerging economies. The large policy rate cuts by major central banks in the previous year have resulted in the policy interest rates remaining close to zero in many advanced economies. However, during the latter part of 2010, with looming inflationary pressures, several economies took measures to curb the rise in price levels, by raising interest rates. Several other advanced economies, including the United States and some emerging economies that were still recovering from the recession in 2009, resorted to a range of unconventional measures to further ease financial conditions during 2010 as room for further rate cuts had already been exhausted. Such stimuli included quantitative easing,[3] credit easing and expansionary fiscal policy to boost demand and lower uncertainty and systemic risk in financial markets.

Heightened volatility in the currency markets was observed in many economies. Central banks around the world intervened, in varying degree, in the foreign exchange markets to dampen rapid appreciations of local currencies. This intensified during the first half of 2010 as global financial turbulence led to sharp currency movements. The pound sterling and the euro depreciated sharply against the US dollar during the first half of 2010 due to the sovereign debt crisis in the European region. However, during the latter part of 2010, China's

[3] Quantitative easing refers to the action by a central bank to increase the size of its balance sheet through buying assets from the market in order to increase liquidity in the money market, thereby stimulating the economy and mitigating the threat of deflation. This was made popular by the use of it as an unconventional monetary policy measure, primarily by the US Federal Reserve and the Bank of Japan, during the recent global financial crisis, as policy interest rates of these countries were at or near zero, thus being unavailable to use as an instrument of monetary policy.

diversification of its foreign assets resulted in the appreciation of the Japanese yen, Korean won and the euro. Coupled with continued current account surpluses in Japan, the yen appreciated sharply, prompting the Japanese authorities to intervene in the foreign exchange market. China, subsequent to a marginal revaluation of the currency, too allowed the renminbi depreciate marginally to preserve competitiveness. Quantitative easing announced by the Bank of Japan and the move by the US Federal Reserve to purchase up to US dollars 600 billion worth of long term government bonds had an impact on currency movements.

Equity and debt markets in many emerging and developing economies improved with increased foreign investment flows during 2010. However, losses were reported in many equity markets in the European region due to concerns about sustainability of the recovery. The sovereign debt crisis that surfaced during the first quarter of 2010 as a result of unsustainable fiscal policies in some Euro member economies hindered the growth prospects of the region. As a result, investors moved away from several European economies, and the IMF and the European Central Bank (ECB) continued their efforts to bring stability to the European sovereign debt market. Unprecedented liquidity and credit support and substantial fiscal action in affected countries arrested the financial turmoil, moderating its adverse impact on Europe's economic activity. Towards the latter part of 2010, there were signs of improvements in global financial conditions, especially in advanced economies. The bank lending conditions in advanced economies improved while risk spreads continued to tighten.

It is unlikely that there would be an early reversal of quantitative easing policies by monetary authorities in advanced economies, as the recovery is still under way and unemployment rates are still high, although deflationary concerns have subsided. For many emerging market economies, the result of quantitative easing in advanced economies, has been substantial inflows of foreign capital and appreciation of their exchange rates. Sterilisation action by central banks in order to mitigate the impact on export competitiveness through excessive appreciation of their currencies has resulted in significant sterilisation costs to prevent the excess liquidity in domestic money markets of these emerging market economies, and these economies have taken steps to slowdown capital flows through taxing inflows and outflows, introducing caps on investments, while strengthening their financial systems.

In response to various policy measures adopted, the economic growth in 2011 is expected to be encouraging, though several downside risks remain. Thus far, the economic recovery in the Asian region has been rapid and strong. It is expected that the growth in the emerging economies would drive the global economic recovery in the short to medium term. In its latest forecast, the IMF has projected the global growth in 2011 to be around 4.4 per cent, led by emerging and developing economies, which are expected to grow at around 6.5 per cent in 2011. The growth in advanced economies is projected to be around 2.5 per cent in 2011. However, the prevailing high unemployment rate, high fiscal deficits, financial imbalances, as well as geopolitical developments in the Northern African and Middle Eastern regions as well as more recent developments in Japan caused by natural disasters still pose challenges to global economic recovery. The demand for energy, mainly in the form of petroleum products and coal, would increase over the medium term as the global economy is poised to recover. However, safety concerns at the Japanese nuclear reactors at Fukushima are unlikely to exert pressure on the demand for petroleum products and coal as alternate energy sources for nuclear energy in the short term. Given the increased demand as a result of expanding economic activity, supply-side shocks due to adverse weather conditions and geopolitical instability, commodity prices are expected to remain above 2010 levels. The IMF has projected the consumer prices in advanced economies to marginally increase to around 1.6 per cent, and in emerging and developing economies, to stabilise at around 6.0 per cent.

1.4 Medium Term Macroeconomic Outlook, Challenges and Policies

Supported by post-conflict optimism and strengthening global demand, the medium term outlook for Sri Lanka's economy is encouraging. Following the 8.0 per cent real growth in the economy in 2010, in the medium term, the economy is expected to grow by 8 - 9 per cent per annum. Greater capacity utilisation with the development of infrastructure facilities, expansion in the agriculture sector with a larger contribution coming from the Northern and Eastern provinces, improved productivity, product and market diversification and expansion of industries, expansion of trade and services sectors including tourism, ports, transportation, banking and insurance, are expected to provide the required impetus for realising such higher growth prospects. Further, the opening up of new investment opportunities with the dawn of peace, together with the commitment shown by the government by implementing necessary changes to the tax system as well as improving operations of public enterprises will help achieve higher growth levels in the medium term, while ensuring overall macroeconomic stability. Meanwhile, in order to maintain higher economic growth, investment will need to be gradually augmented to a level close to 35 per cent of GDP, while domestic savings requires to be brought up to at least 25 per cent of GDP to support the envisaged level of investment in the medium term.

While credit flows to the private sector is expected to continue, these flows, together with claims of the banking system on the government and public corporations, will be closely monitored to contain the build-up of excessive demand pressures. Supply-side improvements are expected to continue, and along with prudent demand management policies, inflation in the medium term is expected to be maintained at a mid single digit level. Meanwhile, the fiscal strategy will continue to focus on a gradual reduction of the overall fiscal deficit and public debt, as envisaged in the Medium Term Macro Fiscal Framework. This will be achieved through a higher tax revenue collection, supported by a simplified tax structure, a broadened tax base, the rationalisation of government recurrent expenditure and prudent public debt management, while maintaining public investment at a level that can facilitate higher economic growth.

The external sector is expected to remain strong in the medium term, enabling the maintenance of an international reserve position that is adequate to finance over 5 months of imports. Given the gradual recovery in the global economy, improved productivity and enhanced product quality of domestic enterprises, exports are expected to maintain its upward momentum in the forthcoming years. Agricultural exports are expected to grow, lured by the attractive prices fetched in the international markets, which has propelled cultivation of marginal lands and the hitherto unutilised lands in the Northern and Eastern provinces. Growth in industrial exports is also expected to accelerate with the emergence of new industries and higher levels of value addition in existing industries. The apparel industry has made significant strides in the international value chain by incorporating design aspects, catering to reputed international brands and expanding to hitherto untapped markets. Exports of food and beverages, rubber products and machinery and equipment could also be developed through higher levels of value addition and the development of new products. The expenditure on imports would also increase with the development projects around the country, reconstruction activities in the Northern and Eastern provinces, the development of the tourism industry and other export oriented industries. Imports of consumer durables are also expected to increase with the improved living standards of the people. With the commissioning of the coal power plant, expenditure on petroleum products is expected to be offset to some extent by the imports of coal, which is relatively cheaper. The geopolitical tensions in the oil producing regions, are likely to exert pressure on international crude oil prices as well as Sri Lanka's oil import bill, and thereby on the trade deficit, particularly, in 2011. A key development with regard to the BOP would be that earnings from services would record significant increases in the medium term, supported by increased earnings from tourism, port and airport related activities and information technology. It is expected that the political tensions in the Middle East would not have a major impact on inward remittances by expatriate workers, which is likely to remain a significant source of foreign exchange receipts that would continue to lower the deficit in the current account. Supported by higher financial flows to the government and private sector including FDI inflows, the BOP is expected to record a surplus over the medium term.

The relaxation of exchange controls, focused fiscal incentives and improved macroeconomic environment are expected to attract higher levels of foreign inflows to the government and to the private sector including FDIs in 2011 and beyond. By end 2010, the government had a cumulative financial commitment of around US dollars 7.1 billion from Sri Lanka's development partners, in comparison to US dollars 6.6 billion at end 2009. The project implementation duration for these commitments is in the range of 2-5 years and is mostly for infrastructure projects, which would facilitate the development process and earnings sources of people. In addition, more FDIs are expected to be realised with continued development work in the Northern and Eastern provinces, especially in the tourism sector including hotels, telecommunication, ports, property development, agricultural and manufacturing sectors.

Table 1.5 Medium Term Macroeconomic Framework (a)

Indicator	Unit	2009 (b)	2010 (c)	Projections 2011	2012	2013	2014
Real Sector							
GDP at Market Prices	Rs. bn	4,835	5,602	6,440	7,405	8,513	9,790
Real GDP Growth	%	3.5	8.0	8.5	9.0	9.5	9.5
GDP Deflator	%	5.9	7.3	6.0	5.5	5.0	5.0
Per Capita GDP	US$	2,057	2,399	2,794	3,200	3,660	4,190
Total Investment	% of GDP	24.4	27.8	29.5	32.0	33.0	34.0
Domestic Savings	% of GDP	17.9	18.7	19.9	23.2	25.0	27.0
National Savings	% of GDP	23.7	24.7	25.8	29.1	30.7	32.3
External Sector							
Trade Gap	US$ mn	-3,122	-5,205	-6,762	-7,399	-7,993	-8,531
Exports	US$ mn	7,085	8,307	9,626	10,876	12,341	14,027
Imports	US$ mn	10,207	13,512	16,389	18,275	20,334	22,558
Services (net)	US$ mn	391	698	1,148	1,487	1,778	2,209
Current Account Balance	US$ mn	-214	-1,418	-2,140	-1,953	-1,738	-1,500
Current Account Balance	% of GDP	-0.5	-2.9	-3.7	-2.9	-2.2	-1.7
Overall Balance	US$ mn	2,725	921	775	525	825	1,325
External Official Reserves (d) (e)	US$ mn	5,097	6,610	8,004	8,938	9,668	10,281
Debt Service Ratio (f)	%	18.9	14.6	13.5	16.2	12.6	14.3
Fiscal Sector							
Total Revenue and Grants	% of GDP	15.0	14.9	15.6	16.3	16.6	16.7
Total Revenue	% of GDP	14.5	14.6	15.2	16.0	16.5	16.5
Grants	% of GDP	0.5	0.3	0.4	0.3	0.2	0.2
Expenditure and Net Lending	% of GDP	24.9	22.9	22.4	21.5	21.3	21.5
Current Account Balance	% of GDP	-3.7	-2.1	-0.8	1.0	1.7	1.6
Overall Budget Deficit	% of GDP	-9.9	-7.9	-6.8	-5.2	-4.8	-4.8
Domestic Financing	% of GDP	5.1	3.6	4.6	4.2	3.9	3.9
Government Debt	% of GDP	86.2	81.9	80.0	75.0	71.0	67.0
Financial Sector (g)							
Reserve Money Growth	%	13.1	18.8	14.5	14.5	14.5	14.5
Broad Money Growth (M_{2b})	%	18.6	15.8	14.5	14.5	14.5	14.5
Change in Credit to Government	Rs. bn	57.4	-13.1	42.0	32.4	25.0	0.0
Change in Credit to Private Sector	Rs. bn	-73.4	300.0	281.3	303.1	340.1	383.7
Growth in Credit to Private Sector	%	-5.8	25.1	18.8	17.1	16.4	15.9

(a) Based on the information available by mid March 2011
(b) Revised
(c) Provisional
(d) Excluding receipts of Asian Clearing Union
(e) External official reserves include the proceeds from the IMF Stand-by Arrangement facility-2009.
(f) Total debt service payments as a percentage of earnings from exports of goods and services
(g) Year-on-year growth in end year values

Sources: Ministry of Finance and Planning
Department of Census and Statistics
Central Bank of Sri Lanka

The key challenge facing the economy in the coming years is to maintain the significant macroeconomic improvements that were achieved in 2010. In 2010, economic growth rebounded with notable positive contributions from all key sectors while inflation was kept under control. The external sector performed remarkably and official reserves were maintained at a comfortable level, while fiscal consolidation efforts displayed tangible results. Supported by these developments, market interest rates declined and the flow of credit to the private sector increased. These macroeconomic achievements are by no means trivial, and Sri Lanka's ability to record these in a single year when the major economies and regional economies continue to battle with various economic imbalances, is impressive. Maintaining and building on these achievements in the medium term will be the challenge faced by policymakers, amidst internal and external shocks, and possible demand pressures. Appropriate demand management policies as well as addressing supply-side bottlenecks effectively would be imperative to sustaining macroeconomic stability.

Sri Lanka's current and expected high growth momentum has posed new questions about tightening of the labour market conditions. The key indications of tightening are, first, that Sri Lanka's unemployment rate (excluding the Northern and Eastern provinces) has gradually declined from 8.8 per cent in 2002 to 4.9 per cent by 2010, and second, in terms of the number of hours worked per week, the percentage of the 40 plus hours category has increased from 60.9 per cent in 2002 to 67.6 per cent by the third quarter of 2010. However, other labour market indicators point towards the possible availability of a pool of labour that could be absorbed into the labour force without having a significant impact on wages. In particular, the labour force participation rate, i.e., the economically active population as a percentage of the working age population, has declined from 50.6 per cent in 2002 to 48.1 per cent in 2010, a trend that could reverse with market conditions, increasing the availability of labour. While the Industry sector and the Services sector employ 24.2 per cent and 43.1 per cent of the employed, respectively, the percentage employed in the Agriculture sector is still as high as 32.7 per cent. While the increase in hours worked signals a reduction in underemployment, it still remains a serious concern particularly in the Agriculture sector. The ongoing improvements to agricultural productivity including mechanisation are expected to push a large proportion of the current agricultural labour force away from agriculture, while ongoing infrastructure developments, in particular, the improvements to the road network, are expected to facilitate greater labour mobility. Although Sri Lanka's archaic labour regulations were updated early in the current decade, labour flexibility still remains low due to legal and social barriers as well as the mismatch between the available skills and the skills required. Some possible policy measures that could facilitate greater labour mobility as well as greater labour availability are, encouraging the adoption of new technology including computerisation to reduce labour requirements while increasing availability of employment domestically through introducing flexible working hours, promoting part time work, facilitating working parents by providing high quality day care and after-school care facilities for children, strengthening social security nets, the continuation of improvements to infrastructure, in particular, intercity and intracity transport services, as well as the possible reduction in departures for foreign employment. Improvements in the standards of education, in terms of quality and relevance to the market needs, through regular updating of school and tertiary education curricula will also enhance labour mobility.

With the end of the conflict in mid-2009, the economy swiftly moved to a high growth trajectory and the excess capacity in the economy, i.e., the negative output gap, started to narrow gradually. During the conflict, Sri Lanka's productive capacity and productive resources were highly under-utilised as a result of both the direct and the indirect impact of the adverse security situation. However, since mid-2009, land and marine resources, especially in the Northern and Eastern provinces, labour, particularly by way of reduced need for military personnel and greater inter-regional mobility, and capital, through the optimal utilisation of existing capital, the end to destruction of physical infrastructure and through lower crowding-out of private investment, are being utilised more productively for economic activity. While narrowing of the output gap could signal inflationary pressures wafting into the economy, the greater availability of resources is expected to push the production possibility frontier outwards and raising potential output, marking a significant structural break in Sri Lanka's growth record. Managing the simultaneous improvements in actual and potential output in the medium term is another key challenge faced by the economy in order to avoid volatility in the general price level.

The government displayed its commitment to fiscal consolidation by reducing the overall budget deficit from 9.9 per cent of GDP in 2009 to 7.9 per cent of GDP in 2010, with improvements in both revenue collection and expenditure management. The government also reduced its exposure to the banking sector with the retirement of a large portion of Treasury bills held by the Central Bank and the repayment of some high cost borrowings from commercial banks, reducing crowding out of private investment. With credit to the private sector rebounding, fiscal consolidation assisted the Bank to keep overall monetary expansion on track in 2010, although credit to public corporations increased, raising a concern. The challenge in the years ahead is to continue the fiscal consolidation process without slippages. In this respect, the absence of sudden financial needs by the government that existed during the years of conflict stands supportive of better expenditure planning by fiscal authorities. At the same time, the government has taken bold steps to address the lingering problems in the tax system through introducing changes that would enhance revenue collection in the medium term by simplifying and broadening the tax base, rationalising the tax concession regime and strengthening the tax administration. It is expected that the overall budget deficit would reduce further to 6.8 per cent of GDP in 2011 and to below 5 per cent in the medium term, and the net domestic financing of the budget deficit would remain as planned. The fiscal consolidation process would support the effective conduct of monetary policy and help the containment of demand-driven inflationary pressures.

Improvements in the performance of public enterprises also need to be continued and strengthened to ease the pressure on government fiscal operations and prevent excessive monetary expansion. With their exposure to the fluctuations in international crude oil prices and their direct impact on domestic price movements, the CPC and the Ceylon Electricity Board (CEB) have historically been focal points in institutional reform. While some strategic improvements have occurred in relation to the CEB with lower expected reliance on high cost petroleum for power generation, the continuation of planned improvements will reduce its burden on the government budget. The CPC, which is directly impacted by frequent fluctuations in international crude oil prices and the sluggish and delayed adjustment of domestic prices, requires urgent improvements to its institutional framework to make domestic prices adjust more flexibly to reflect international market conditions, and any non adjustment of prices should only be to iron-out short term fluctuations. In addition to the CPC and the CEB, there are several other state owned enterprises (SOEs) that either operate with a low level of efficiency or are non operative. These SOEs need to be revitalised without further delay to make them viable either under the government or with private sector participation in order to eliminate their excessive burden on the public. Another key challenge in managing strategic enterprises is the lack of expertise and management skills, which highlights the need for human capital development through reforms to the system of education.

The movements in international commodity prices during the latter part of 2010 and so far during 2011, in particular, those of crude oil, once again highlight the possible challenges to macroeconomic stability. The geopolitical disturbances in several Northern African and Middle Eastern oil producing countries and the natural calamities more recently in Japan and several other countries have raised international crude oil prices that averaged around US dollars 80 per barrel in 2010, to over US dollars 110 by March 2011. While with the expected recovery in global demand in 2011 some increase in energy prices was anticipated, the current trends show that the projections of energy prices by international agencies early this year are unlikely to hold. While there would be a one-off increase in the domestic price level if these unanticipated increases are passed on to the consumer, the adverse consequences would be greater and more persistent if absorbed by the government or the CPC. The pass-through of changes in energy prices to the end user also ensures that economic decisions reflect more realistic input prices. Current efforts to promote the use of alternative energy sources and conservation of energy, by the use of hybrid vehicles, better road discipline and improved road conditions, better public transport, and introducing new public transportation systems, need to be strengthened and expedited to lessen the impact on the economy arising from high international crude oil prices.

With domestic peace and global economic recovery under way, Sri Lanka's exports have the potential to reach a new growth trajectory, with significant levels of value addition, the development of a range of new products and the diversification of export markets. With skilled labour, certain industries have immense potential to move further up the value chain, in order to offer value added products and services to the global market through the infusion of modern technologies and greater foreign investment. Ease of doing business and improved macroeconomic environment could attract more investments from the expatriate community as well as foreign investors. Sri Lanka could also strive to capture the market for high quality components of products, which ultimately are imported, assembled and re-exported by other countries. The recent increase in electrical equipment exports reflects a portion of this niche market. While diversification of exports improves the resilience of the economy to external disturbances, the recent trends in global growth patterns underscore the availability of untapped markets particularly within emerging Asia. For centuries under foreign rule and thereafter, Sri Lanka's exports and foreign trade have been oriented towards the Western markets. Hence, it would require special efforts to diversify trade towards emerging markets in Asia. In this regard, the existing bilateral and multilateral trade agreements need to be strengthened and renegotiated to remove policy and non policy obstacles to trade. It is imperative that traders are well informed of the benefits of trade agreements, so that these are optimally utilised to improve trade. This would raise the standard of living of the people of member countries as it enables them to enjoy a wider range of products and services at lower costs. Trade promotion should be made more market and information specific to capture global supply chains that have direct access to the consumers.

It is necessary for Sri Lanka to attract more non debt creating foreign investment flows if it is to increase the level of investment required to maintain the envisaged economic growth path, given the shortfall in domestic savings. Creating a business friendly environment is needed to improve investor confidence and attract foreign investments. While the recent relaxation of exchange control regulations, a strengthened macroeconomic environment as well as the re-establishment of peace in the country incentivise investment, further steps need to be taken to encourage foreign investments. Currently, Sri Lanka's ranking in the Doing Business Index is 102 and the government has targeted to improve the ranking to 30 by 2014. The government has already established a working group to recommend required changes to operations of key institutions to rectify existing weaknesses and reduce bureaucratic barriers and costs at each stage of running a business enterprise, and the Central Bank coordinates this process of improvement with relevant institutions and the World Bank group. The Bank published "A Step by Step Guide to Doing Business in Sri Lanka" in October 2010 to provide information to investors. Executing the required reforms as planned and

BOX 2 The Ease of Doing Business Ranking

It is widely accepted that the corporate sector plays a key role in economic development. Therefore, governments seeking rapid development need to focus attention on creating a conducive regulatory framework that governs the corporate sector in the country. Economic activities require good rules including those that establish and clarify property rights, reduce the cost of solving disputes, increase the predictability of economic interaction and provide contractual partners with provisions against abuse. The existence of conducive rules not only increases the dynamism of business but also its resilience during economic and financial crisis.

The Doing Business project was initiated 9 years ago by the World Bank and International Finance Corporation (IFC). Its main goal is to provide an objective basis for understanding and improving the regulatory environment for business. "Doing Business 2011: Making a Difference for Entrepreneurs" is the eighth in a series of annual reports investigating regulations that enhance business activity and those that constrain it. Doing Business presents quantitative indicators on business regulations and the protection of property rights that can be compared across 183 economies, from Afghanistan to Zimbabwe, over time. A set of regulations affecting 9 stages of a business's life are measured: starting a business, dealing with construction permits, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts and closing a business. Data in Doing Business 2011 are current as of 01 June 2010. All topics are given equal weight and the overall index is calculated as the ranking on the simple average of percentile rankings on each of the 9 topics. Two types of data are considered for each stage of business. The first type is based on laws and regulations, while the second is on time and motion indicators. The indicators considered for each stage of business are summarised in Table B 2.1.

The data for the Doing Business ranking is collected through a questionnaire designed by the "Doing Business Team" of the World Bank together with academic advisers. The respondents to this questionnaire (typically) include local experts, such as lawyers, business consultants, accountants and

Table B 2.1 Doing Business Indicators 2011

No.	Indicator	Description
1	**Starting a Business**	Procedures, time, cost and paid-minimum capital to open a new business
2	**Dealing with Construction Permits**	Procedures, time and cost to obtain construction permits, inspections and utility connections
3	**Registering Property**	Procedure, time and cost to transfer commercial real estate
4	**Getting Credit**	Strength of legal rights index, depth of credit information index
5	**Protecting Investors**	Strength of investor protection index: extent of disclosure index, extent of director liability index and ease of shareholder suits index
6	**Paying Taxes**	Number of tax payments, time to prepare and file tax returns and to pay taxes, total taxes as a share of profit before all taxes borne
7	**Trading across Borders**	Documents, time and cost to export and import
8	**Enforcing Contracts**	Procedures, time and cost to resolve a commercial dispute
9	**Closing a Business**	Recovery rate in bankruptcy

Source: http://www.doingbusiness.org

government officials of the relevant country. Several interactions are conducted by the compilers of the ranking, and these responses and data are tested for robustness before the rankings are finalised. The ranking of a particular country can change not only when it implements reforms but also when other countries implement reforms, when new countries are introduced to the ranking and when there are methodological changes in the ranking criteria. According to the ranking for 2011, the highest ranking (No. 1) was achieved by Singapore while Sri Lanka was ranked 102 out of 183 economies. The worst performing country was Chad (No. 183).

Limitations of the Doing Business Ranking

There are, however, several limitations in this ranking. It is very important to note that the ranking captures only a few of the large number of factors that matter to firms or investors or impact on competitiveness. Macroeconomic stability, security, strength of institutions, quality of infrastructure, size of domestic market, corruption and skills of the labour force are some of the factors not considered. In particular, it does not consider the strength of the financial sector, which could be considered a serious shortcoming in view of the fact that the fragility of the financial sector was one of the main causes of the recent financial crisis. Although it measures the regulatory environment, it does not measure all regulatory goals in an economy. Even in the stages of business considered, it does not cover all regulations. Another limitation is that it is only relevant to the situation faced by a corporate that exists in the country's largest business city and pertains only to a specific form of business (domestic small and medium limited liability companies), and therefore, is not reflective of the situation that exists in other forms of business (sole proprietorships, partnerships, etc.). Also, a certain amount of judgment is involved in the ranking. An underlying assumption made when computing the ranking is that entrepreneurs have all the required information with them and do not need to spend time to search for the same. In actual fact, this is not the case and search for information involves considerable effort.

Benefits of Improving the Doing Business Ranking

Despite its shortcomings, the Doing Business ranking is very useful for benchmarking. The ranking assesses the regulatory environment in selected areas. A conducive regulatory environment aids the growth of the formal sector in an economy, whereas an onerous regulatory environment forces businesses to remain in the informal sector. Formal sector firms tend to grow faster, be more productive, employ more workers and have better access to credit, and thereby bring greater benefits to the economy. In the area of trade, the quality of a country's contracting environment is a source of comparative advantage, while in the area of credit, greater information sharing through credit bureaus is associated with high bank profitability and lower bank risks. Although Doing Business ranking does not focus on regulations specific to foreign investment, the ranking is one of the indicators considered by foreign investors before deciding to invest in a particular country. Therefore, improving the country's ranking will tend to attract more foreign investment.

Sri Lanka's Doing Business Ranking

In "Doing Business 2011", Sri Lanka's ranking was 102 out of 183 economies. Its rankings in the 9 stages of business evaluated in the 2011 report are given in Table B 2.2.

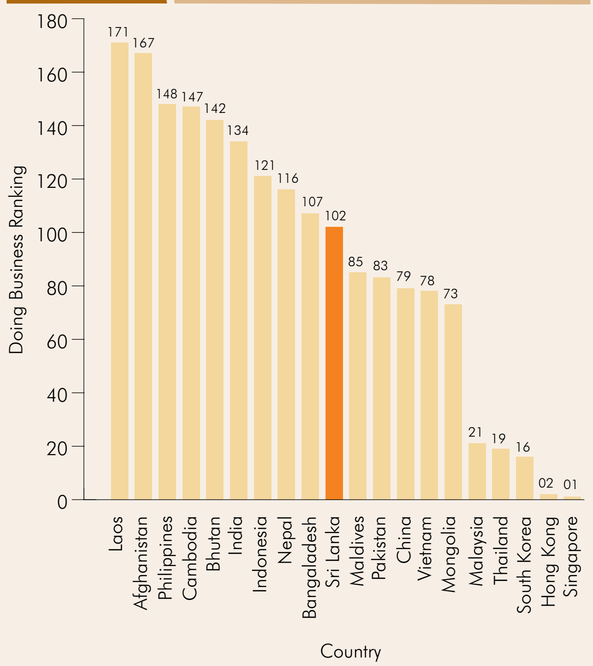
It is clear that Sri Lanka's performance in the different stages varies considerably. Its performance in the stages of Dealing with Construction Permits, Registering Property, Paying of Taxes and Enforcing Contracts is particularly weak as it ranks below 100 of the 183 economies considered and therefore,

Table B 2.2 **Sri Lanka's Ranking in Doing Business 2011 Compared with the Best and Worst Performing Economies**

Indicator	Doing Business 2011 Rank		
	Singapore	Sri Lanka	Chad
Ease of Doing Business	**1**	**102**	**183**
Starting a Business	4	34	182
Dealing with Construction Permits	2	169	101
Registering Property	15	155	137
Getting Credit	6	72	152
Protecting Investors	2	74	154
Paying Taxes	4	166	179
Trading Across Borders	1	72	171
Enforcing Contracts	13	137	164
Closing a Business	2	43	183

Source: http://www.doingbusiness.org

Chart B 2.1 Doing Business Ranking: Sri Lanka Compared to Selected Asian Economies



pulls down the country's overall ranking. In fact, in the areas of Dealing with Construction Permits and Registering Property, it fares worse than the worst performing country, Chad. Any reform strategy should focus on these areas.

Chart B 2.1 compares Sri Lanka with selected Asian economies. Out of the economies considered, Sri Lanka's performance falls below 10, namely Singapore, Hong Kong, South Korea, Thailand, Malaysia, Mongolia, Vietnam, China and even the South Asian countries like Pakistan and Maldives. As some of Sri Lanka's competitors in trade are included in this group, it is a matter of concern that Sri Lanka performs worse than them.

Improving Sri Lanka's Doing Business Ranking

His Excellency the President in his address to the United Nations General Assembly has stated that Sri Lanka aims at improving its Doing Business ranking to 30 by 2014. This is a huge challenge and needs the hard work and commitment of all stakeholders. Most countries use the Doing Business ranking to identify better performing economies with similar characteristics and model their laws and regulations according to those countries. In Sri Lanka, the Central Bank of Sri Lanka (CBSL) together with the Ministry of Economic Development is coordinating the strategy to achieve the goal articulated by his Excellency the President. The Budget for 2011 has already made significant strides to simplify taxation, and thereby improve the ranking in the area of "Paying Taxes." There is also ample scope for eliminating a large number of "procedures" involved in various areas by establishing "one stop shops" where an entrepreneur needs to submit required documents at one point only and all the necessary formalities and clearances are undertaken by the agency concerned. This could be effectively done in the area of Dealing with Construction Permits and Trading across Borders. In the area of land registration, introduction of title registration could reduce time involved substantially. Court procedure also has to be closely studied in order to devise a method to reduce the delay and improve the ranking in Enforcement of Contracts.

The CBSL will be looking at other aspects also to facilitate business. In particular, to reduce the time and effort spent on searching for information, CBSL has already produced a booklet "A Step by Step Guide to Doing Business", which contains necessary information needed by an entrepreneur during each stage of operation of his/her business.

credibly achieving the targeted rankings in the interim years are necessary to boost the investment climate and realise the full growth potential of the economy.

The government has planned to transform Sri Lanka into a strategically important economic centre by developing five strategic hubs; a knowledge hub, a commercial hub, a naval/ maritime hub, an aviation hub and an energy hub, taking advantage of Sri Lanka's strategic location and resources. The main elements of a knowledge hub are to generate knowledge, to transfer knowledge to sites of application and to transmit knowledge to others through education and training. The initial focus of the knowledge hub in Sri Lanka has been in the area of information technology. The tremendous progress that has already been made in this area and the availability of a highly skilled workforce in related fields, make this an ideal starting point for setting up the knowledge hub in Sri Lanka. Implementing the commercial hub and naval/maritime hub include, developing the Port of Colombo into a major transshipment hub, Galle as a tourist port, Trincomalee as an industrial port, Oluvil as a fisheries harbour and Hambantota as a logistic centre and developing the country as a shipping, trading and finance centre. Developing Sri Lanka as an aviation hub includes, modernising the Bandaranaike International Airport and constructing a second international airport at Mattala, improving domestic airports and developing the aviation industry. Developing Sri Lanka as an energy hub would involve developing new energy sources, developing new refineries and acquiring the technical know-how to conduct international trade in oil. While taking steps to harness the potential benefits of the strategic location of the country by promoting these hubs is commendable, it is important to formulate a national policy for the effective and early establishment of each of the hubs. To implement these hubs it would be necessary to set up a central point to coordinate the various activities that need to be carried out by different institutions in order to ensure that all players work together towards the establishment of the five hubs. One of the major constraints to developing these five hubs is the lack of skilled personnel. Part of the strategy to developing Sri Lanka as a knowledge hub should include training persons in the skills required for the jobs that would be created with the establishment of these hubs. Parallel to the improvements to state education, it is important to promote non state education and training provision to develop the human capital base of the country to provide the skills required by the market. This would entail teaming up with the universities to commence degree programmes to develop the necessary knowledge and skills required by the respective hubs.

Recognising that the tourism sector could be a key driver of economic activity and considering the vast income generation potential of the industry, tourism related infrastructure and facilities around the country would need to be expanded to cater to the 2.5 million tourist arrivals envisaged in 2016. Activities in the periphery of the main tourism attractions would ensure tourists spend more time and money in these areas. A Tourism Master Plan is of essence to expedite tourism related projects and prevent haphazard development. In this respect, the government and the private sector would need to work together in partnership to promote the country's diverse array of tourist attractions. While the government's role should focus on developing tourism related infrastructure and institutions, capturing markets, and creating a conducive environment for investment by the private sector, the private sector should take the lead in product development aspects. Human resources would also need to be developed among the various stakeholders of the tourist sector to ensure the provision of quality service to tourists, thus helping promote the wealth of attractions in Sri Lanka, through positive publicity. As tourists are attracted by diversity and seek interactive experiences to understand and appreciate the procedures taken to develop goods to the consumable level, the way forward in the tourism arena is to diversify the range of products to cater to different groups of tourists. Although all tourism related projects are expected to generate income and employment and provide a fillip to economic growth prospects of the country, the environmental and socio-cultural factors would also need to be considered in order to ensure that the development of tourism resources occur in a sustainable manner.

Recent international evidence has reaffirmed that countries that suffered financial system crises had deeper recessions than those countries that did not undergo financial system crises, and thus confirming the importance of strengthening the financial system stability.[4] A troubled financial system is shown to reduce the efficiency of financial intermediation as well as the monetary transmission mechanism. While supporting reforms to the global monetary and financial order

4 See Stanley Fischer, "Central Bank Lessons from the Global Crisis", *RBI Monthly Bulletin,* March 2011, pp. 281-290, and Carman Reinhart and Kenneth Rogoff, *This Time is Different,* Princeton: Princeton University Press, 2009.

to reduce the effects of contagion, the ongoing improvements to financial surveillance domestically, strengthening the coordination between regulators, strengthening macroprudential regulation, raising public awareness through various publications and other forms of communication, and including financial sector analysis within the dual approach to monetary policy analysis recently adopted by the Central Bank are expected to strengthen financial system stability further. Meanwhile, the contribution of the financial sector to raise private sector investment, particularly in terms of higher lending to small- and medium-scale enterprises, increased long term lending, expanding the outreach of the financial sector to include economically backward regions of the country in the development process, and the adoption of cutting-edge technology and financial sector innovation need to be actively encouraged and supported.

While 2010 has seen significant improvements to the Northern and Eastern provinces in terms of reconstruction, physical, social and financial infrastructure development and livelihood development, it is necessary to continue this process. Developments to the physical infrastructure, especially to the road and railway network would enhance connectivity with other regions. In terms of agricultural development, introducing land usage policies that would improve agricultural productivity, supporting agricultural research that could introduce new crops to these regions, the continuous improvements to fishery harbours and facilitating deep sea fishing, resolving the issues relating to South Indian and Sri Lankan fishermen amicably, would raise the supply of agricultural produce in the economy, while transmitting the financial benefits to the producers in the Northern and Eastern provinces. Promoting private sector-led agri-based industries, small- and medium-scale enterprises, as well as revitalising large-scale industries need to continue. Further developments to the Services sector, through facilitating tourism related activity, developing Trincomalee as an industrial port that could potentially serve as a supply hub to the broader Indian subcontinent, and promoting health and education services through greater private sector investment are required. More essentially, in addition to rapid developments to the road and rail network, making sea and air routes to the Northern and Eastern provinces available to the tourist industry and the general public would strengthen integration and distributing the benefits of development across the entire economy.

The vision of the Government of Sri Lanka to double the country's per capita income to US dollars 4,000 by 2016 and to turn Sri Lanka into the "Wonder of Asia", requires a growth rate of around 8.0 per cent to be maintained over the years ahead. While the past year saw the acceleration of the country's economic growth rate and the return to a high growth trajectory in line with expectations, inflation remained at a stable low level supported by appropriate demand management policies. The key challenge in the years ahead is to create an enabling environment for private sector investment and to facilitate the ongoing infrastructure and reconstruction projects that are needed to sustain the growth momentum of the economy, while continuing to maintain a low and stable rate of inflation. Although the ongoing growth process could give rise to short term price pressures through greater demand for domestic resources, it would lead to long term stability by enhancing the country's resilience to adverse domestic and external demand and supply shocks.