ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1993

A surge in economic activity and a large influx of foreign capital were the major highlights of Sri Lanka's economic performance during 1993. The balance of payments was in overall surplus for the fourth consecutive year and the country's foreign reserves have risen to a level sufficient to finance nearly 6 months of imports. Meanwhile, in March 1993, almost all exchange controls on current transactions (trade and service related) were removed and Sri Lanka became eligible to accept Article VIII obligations of the International Monetary Fund[1]. However, continuing domestic credit expansion and large capital inflows accelerated the pace of monetary growth and intensified demand pressure on domestic prices throughout the year.

OVERALL PERFORMANCE

Gross Domestic Product (GDP), in real terms, rose by 6.9 per cent and the Gross National Product (GNP), which includes net factor income from abroad, marked an impressive growth of 7.6 per cent in 1993, both being the highest on record in recent years. Underpinning this growth

TABLE 1.1

National Income Statistics 1991 – 1993

Item	Amount (Rs. Million)			Growth Rate	
	1991*	1992*	1993*	1992*	1993*
1. GDP at Current Factor Cost Prices	337,399	386,999	453,092	14.7	17.1
2. GDP at Constant (1982) Factor Cost Prices	135,204	140,990	150,783	4.3	6.9
3. GNP at Current Factor Cost Prices	330,032	379,179	447,335	14.9	18.0
4. GNP at Constant (1982) Factor Cost Prices	132,214	138,074	148,499	4.4	7.6
5. GNP at Current Market Prices	369,262	424,313	500,288	14.9	17.9
6. Mid Year Population ('000)	17,247	17,405	17,619	0.9	1.2
7. GNP Per Capita					
i. At Current Factor Cost Prices (Rs.)	19,136	21,786	25,389	13.8	16.5
ii. At Constant Factor Cost Prices (Rs.)	7,666	7,933	8,428	3.5	6.2
iii. At Current Market Prices (Rs.)	21,410	24,379	28,395	13.9	16.5

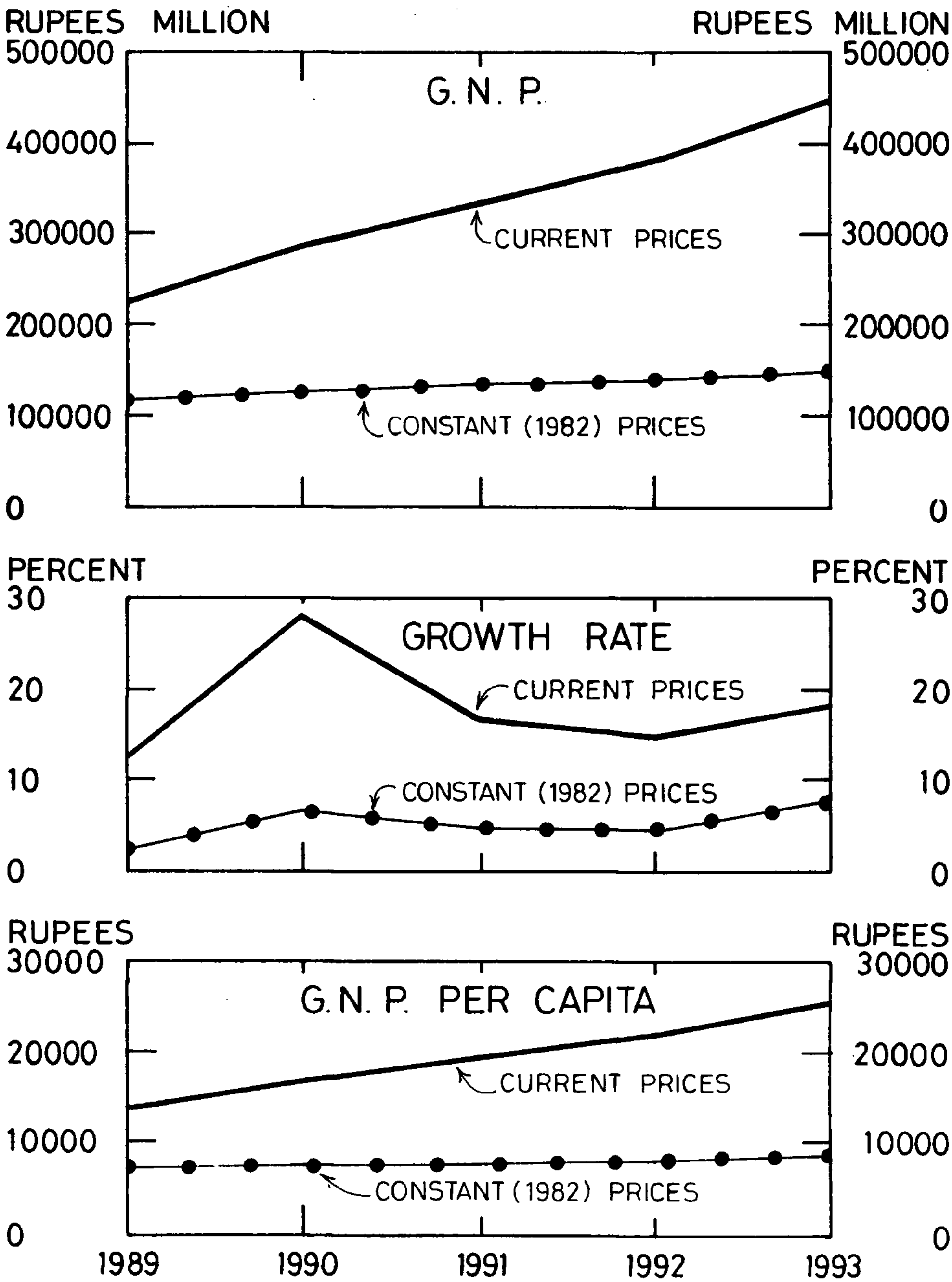
* Provisional

Source: Central Bank of Sri Lanka

performance was a substantial rise in investments by 24 per cent, financed by a significant growth in national savings and foreign capital inflows. There was further progress towards fiscal consolidation and the overall budget deficit was contained at 8 per cent of GDP. Complementary to these

1 Sri Lanka accepted Article VIII obligations of the IMF with effect from March 15, 1994.

GROSS NATIONAL PRODUCT



Central Bank of Sri Lanka.

developments was a further decline in the current account deficit in the balance of payments from 4.5 per cent of GDP in 1992 to 3.8 per cent of GDP in 1993, pointing to sustainable growth prospects with better external sector stability. Furthermore, due to strong inflows the overall Balance of Payments (BOP) was in surplus to the tune of SDR 375 million in 1993, more than double the surplus registered in the previous year.

However, inflationary pressures remained high, largely on account of the rapid monetary growth throughout the year which was induced by high domestic credit expansion and the unprecedented capital inflows. Money growth accelerated to 23.5 per cent from 16.6 per cent in 1992. Consequently, in spite of favourable supply conditions, the Colombo Consumers' Price Index (CCPI) registered an average increase of 11.7 per cent in 1993, as against 11.4 per cent in the previous year.

The high inflation had its inevitable effect on interest rates and the exchange rate. The Treasury bill rate (one year) accelerated sharply from 19 per cent in early 1993 to around 22 per cent by the third quarter, largely influenced by the Central Bank's aggressive open market operations to siphon-off excess liquidity.

The dynamism of the economy driven by high growth momentum built up in response to further liberalisation initiatives and structural reforms continued in 1993, with even greater vigour, following a sustained rise in national savings, a surge in capital inflows induced partly by high interest differentials and a booming financial market, and a strong recovery from the drought brought about by vastly improved weather conditions. Reflecting these developments, GDP real growth accelerated from 4.3 per cent in 1992 to 6.9 per cent in 1993 setting a new record after the 1978 peak of 8.2 per cent. GNP, which takes account of net factor income from abroad, grew at a faster rate of 7.6 per cent, largely owing to a significant increase in investment income inflows arising from the strong build up of the country's foreign reserves.

GNP at current factor cost prices estimated at Rs.447 billion in 1993 rose by 18 per cent over the previous year. Meanwhile, GNP at constant (1982) factor cost prices at Rs.149 billion was an increase of 7.6 per cent. Sri Lanka's mid year population in 1993 has been estimated at 17.6 million, reflecting an increase of 1.2 per cent over 1992. Accordingly, the per capita GNP at current factor cost prices in 1993 was estimated to have grown by 16.5 per cent to Rs.25,389 or US$ 526. In real terms, per capita GNP rose by 6.2 per cent. The per capita GNP in current market prices was Rs.28,395 (US$ 588).

Following rapid economic growth and stimulated by strongly positive real interest rates, the country's Gross Domestic Savings are estimated to have increased from Rs.64 billion in 1992 to Rs.80 billion in 1993. Thus, the domestic savings ratio (savings as a percentage of GDP) which rose from 12.8 per cent in 1991 to 15.0 per cent in 1992 rose further to 16 per cent in 1993. Meanwhile, the national savings ratio – the ratio adjusted for net private transfers and net factor income from abroad – grew from 17.9 per cent in 1992 to 20.4 per cent in 1993 largely reflecting increased inflows of remittances from Sri Lankan expatriates employed abroad.

The rate of capital formation increased considerably in 1993 contributing to current growth and also improving the future growth prospects of the economy. Gross Domestic Capital Formation (GDCF), inclusive of changes in stocks, recorded a substantial rise of 23.9 per cent in 1993 compared with an expansion of 21.2 per cent in 1992. As a consequence, the ratio of GDCF to GDP at market prices rose significantly from 24.1 per cent in 1992 to 26.0 per cent in 1993.

Following the trend in the previous year, a larger contribution to capital formation came from the private sector. The key areas of investments by the private sector were the manufacturing and services sectors; mainly on transport equipment, plant and machinery. Capital formation in the public sector, concentrated in the development of the country's infrastructure, particularly transportation, water supply, rural electrification and electricity distribution, has also shown a considerable increase.

Reflecting an economy-wide expansion in production activities, all sectors performed well in 1993. The services sector (including construction) continued to be the main contributor to GDP growth accounting for 53 per cent in 1993. The share of agriculture (including mining and quarrying) and manufacturing sectors in GDP growth was significantly high at 19 per cent and 28 per cent, respectively.

The agricultural sector bounced back in 1993. The value added in this sector (including forestry and fishing) increased by 5 per cent in real terms in contrast to a decline of 2 per cent in the previous year. Benefiting by favourable weather, enhanced fertilizer use, improved management and better prices, tea and paddy sub-sectors showed considerable improvement. Tea production, which suffered a severe 26 per cent decline last year owing to a prolonged drought, recovered strongly by 30 per cent in 1993. Paddy output recorded a growth of 10 per cent in contrast to a decline of 2 per cent in the previous year. The production of subsidiary food crops and minor export crops grew by 5 per cent and 14 per cent, respectively. However reflecting the lagged effect of the drought in the previous year, the coconut sub sector suffered a decline of 6 per cent.

TABLE 1.2

Composition and Growth Rate of GNP 1991 – 1993 at Constant (1982) Factor Cost Prices

Item	Amount (Rs. Million)			Growth Rate		
	1991*	1992*	1993*	1991*	1992*	1993*
1. Agriculture, Forestry & Fishing	30,570	30,090	31,554	1.9	-1.6	4.9
of which						
1.1 Tea	3,100	2,303	2,985	3.2	-25.7	29.6
1.2 Rubber	655	669	681	-8.8	2.1	1.8
1.3 Coconut	2,827	2,971	2,799	-13.3	5.1	-5.8
1.4 Paddy	6,002	5,882	6,447	-5.9	-2.0	9.6
1.5 Other (other Agriculture, Forestry & Fishing)	17,986	18,265	18,642	8.0	1.6	2.1
2. Mining & Quarrying	3,511	3,300	3,693	-10.0	-6.0	11.9
3. Manufacturing	23,949	26,059	28,806	6.8	8.8	10.5
3.1 Processing of Tea, Rubber & Coconut Kernal Products	3,332	2,912	3,157	-5.6	-12.6	8.4
3.2 Other	20,617	23,147	25,649	9.1	12.3	10.8
4. Construction	9,033	9,765	10,400	3.1	8.1	6.5
5. Services	68,141	71,776	76,330	6.2	5.3	6.3
6. G.D.P.	135,204	140,990	150,783	4.6	4.3	6.9
7. Net Factor Income from Abroad	-2,990	-2,916	-2,284	–	–	–
8. G.N.P.	132,214	138,074	148,499	4.6	4.4	7.6

* Provisional

Source: Central Bank of Sri Lanka

Sustaining the recent trend as a leading growth sector, manufacturing made a significant contribution to the growth momentum in 1993. The increase in value added in the manufacturing sector, was an impressive 11 per cent in 1993. The factory industry sub-sector expanded by 11 per cent and contributed around four fifths of the total production of the entire sector. When the output of high value petroleum refined in the public sector is excluded, the bulk of this growth in factory industry has occurred in the private sector, demonstrating a dynamic response to recent economic reforms. The industrial categories that recorded strong performance in 1993 were textiles, apparel and leather products, chemical, petroleum and plastic products and non-metallic mineral products. The construction sector which recorded a growth of 8 per cent in 1992 continued to grow at 7 per cent in 1993 reflecting increasing capacity investment in the manufacturing sector as well as infrastructure investment in the public sector.

The overall services sector grew by 6 per cent in 1993 in comparison to an expansion of 5 per cent in the previous year. The wholesale and retail trade sector reflected a growth of 8 per cent and accounted for 43 per cent of value added in the services sector in 1993. Favourable weather conditions helped a strong growth in hydro-power generation. Together with an expansion in water supplies, the electricity, gas, water and sanitary services sub-sector expanded by 12 per cent in 1993. Meanwhile, under the favourable impact of the on-going financial sector reforms, improved market conditions and further deepening of financial services, the banking, insurance and real estate sector registered a growth of 11 per cent.

Agriculture

Tea production which dipped to 179 million kg. in 1992, the lowest level registered since 1956, made a strong recovery in 1993 reaching a level of 232 million kgs. This was an increase of 30 per cent. The favourable weather conditions, improved management and increased use of fertilizer contributed to an improved performance in all three elevational categories. The output of low grown teas which declined by 27 per cent in 1992 rose by 28 per cent to 112 million kgs in 1993. High and Medium grown teas rose by 35 per cent and 25 per cent to record an output of 73 million kgs. and 47 million kgs., respectively. Meanwhile, CTC (cut, tear and curl) tea production, which seems to be gaining ground in world markets, expanded by 52 per cent to 8 million kgs. during the year.

Following an improvement in the average export (f.o.b.) price from Rs.81.98 per kg. in 1992 to Rs.91.16 per kg. in 1993 (11 per cent), the average gross price of all teas at the Colombo Auctions recorded a 12 per cent rise from Rs.61.75 per kg. in 1992 to Rs.68.88 per kg. in 1993. The bulk of the improvement in the export price came from the nominal depreciation of the Sri Lanka Rupee, as the export (f.o.b.) price in SDR terms rose only by 2 per cent from SDR 1.33 per kg. in 1992 to SDR 1.35 per kg. in 1993.

Meanwhile, the Cost of Production (COP) of tea, which rose sharply by 19 per cent in 1992 rose further by 5 per cent to Rs.75.81 per kg. The continued negative producer margins in tea production in the context of pressures for wage increases demand early remedial action by way of improvements in productivity and containment of costs. Sri Lanka's yields in tea appear to have lagged behind other countries.

Rubber production estimated at 108 million kgs. in 1993 reflected a modest 2 per cent growth over the previous year attributable to both the increases in the tapping extent and average yield realised during the year. The output of all grades of rubber, except sheet rubber and scrap crepe, increased.

Following on improved demand in the major rubber consuming countries, international prices of rubber picked up in 1993. In keeping with this trend, the average export (f.o.b.) price of all grades of rubber rose by 8 per cent, from SDR 0.61 per kg. in 1992 to SDR 0.66 per kg. in 1993. In Rupee terms, prices increased by 18 per cent, from Rs.37.65 per kg. to Rs.44.34 per kg. reflecting the effect of Rupee depreciation. These changes and the effects of abolition of export duty percolated to the Colombo Auctions, where the average price of RSS1 rose by 21 per cent to Rs.35.48 per kg., and the average price of all grades improved by 16 per cent to Rs.34.24 per kg. Meanwhile, the COP of rubber in the private sector is estimated to have increased by 12 per cent from Rs.20.50 per kg. in 1992 to Rs.23.00 per kg. in 1993. Consequently, this sector recorded enhanced producer margins, a welcome development. On account of the expansion of the rubber-based manufacturing sector, the domestic use of natural rubber increased by 11 per cent to 32 million kgs. in 1993, accounting for nearly 30 per cent of the production.

Reflecting the lagged effect of the severe drought in 1992, coconut production, estimated at 2,164 million nuts in 1993, registered a decline of 6 per cent. This affected the production of both desiccated coconut (DC) and coconut oil. The nut equivalent of DC production dropped by 26 per cent while coconut oil production declined by 27 per cent. The nut equivalent of copra and fresh nut exports too dropped by 17 per cent and 12 per cent respectively. Meanwhile, the domestic nut consumption has been estimated to have risen by 2 per cent to 1,668 million in 1993. The consequent sharp rise in nut prices led to the importation of 29,000 metric tons of coconut oil and 900 metric tons of copra during the year. The average wholesale price of fresh coconuts in the Colombo Market rose by 10 per cent from Rs.4.25 per nut in 1992 to Rs.4.69 per nut in 1993. Meanwhile, the average cost of production rose by 3 per cent in 1993 following the 16 per cent increase of the previous year.

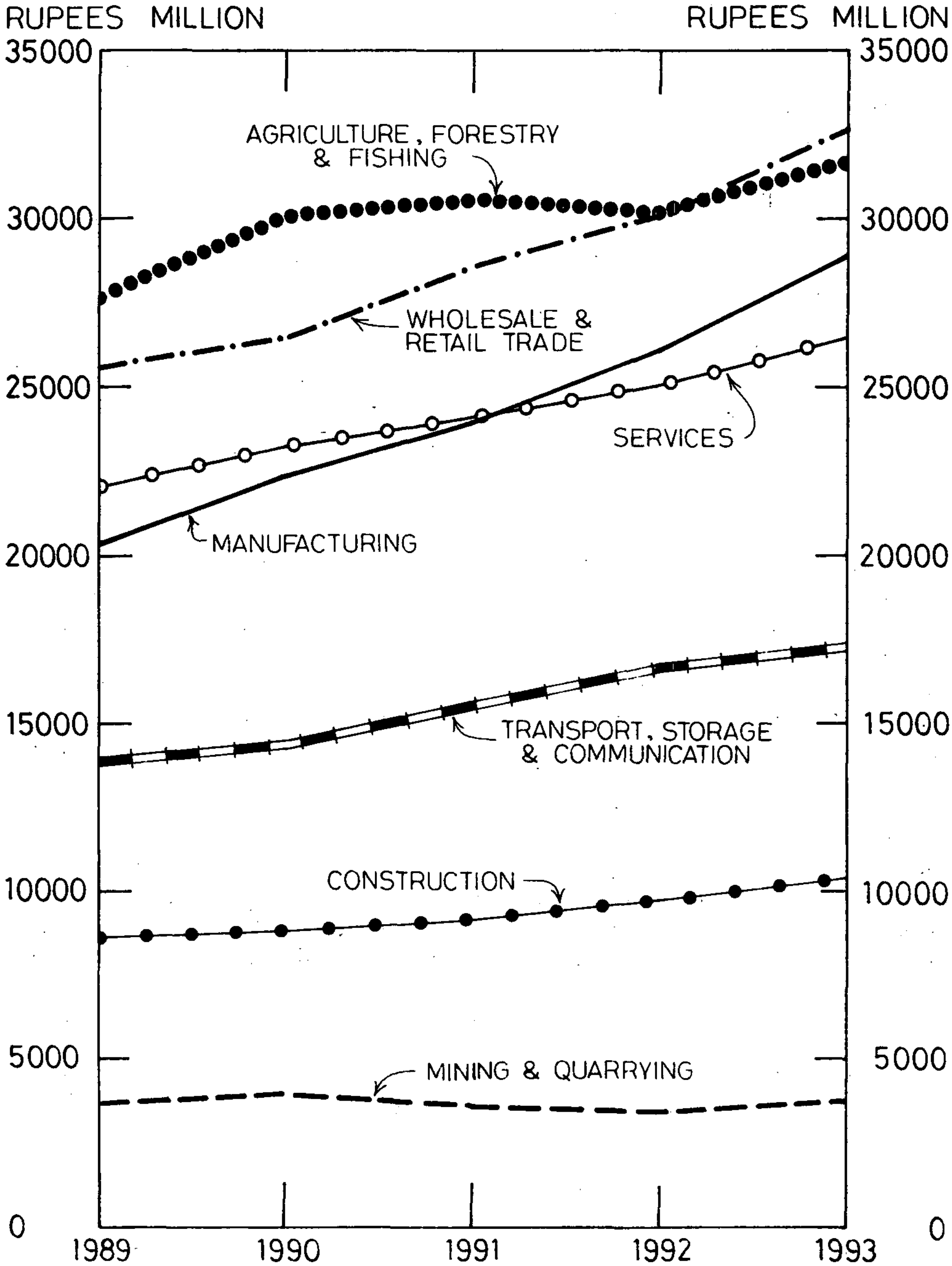
Paddy production estimated at 2.56 million metric tons (123 million bushels of paddy) in 1993, was the highest level of production recorded during the last six years, and reflected a 10 per cent increase from the previous year. This was yet below the peak production of 2.66 million metric tons recorded in 1985. Increased production during both Maha 1992/93 and Yala 1993 brought about by increased extent harvested as well as the improvement in yields owing to favourable weather and better market prices contributed to this improved performance. Paddy production in Maha 1992/93 was 4 per cent higher while production in 1993 Yala was 23 per cent higher.

The rice equivalent of paddy production during the year, when adjusted for wastage and seed paddy requirements, was 1,534,000 metric tons, compared with the estimated total annual consumption of 1,824,000 metric tons. This means that the country was 16 per cent below the threshold of "self-sufficiency" in 1993. Rice imports to meet the short-fall and maintain buffer stocks in 1993 were 210,000 metric tons.

Sugar production at 68,603 metric tons in 1993, the highest on record, was an increase of 15 per cent over 1992. The contribution to total production came from Pelwatte (58 per cent), Sevanagala (23 per cent) and Hingurana (19 per cent) plantations. Increased cane production and improvements in recovery rates contributed to the growth in production of sugar at Hingurana and Pelwatte by 35 per cent and 15 per cent, respectively. The production at Sevanagala improved by 17 per cent, in spite of a marginal decrease in the recovery rate, due to a 19 per cent increase in cane output. Production at the Kantale plantation declined sharply by 85 per cent, reducing its share in total production to a negligible proportion.

GROSS DOMESTIC PRODUCT BY INDUSTRIAL ORIGIN

AT CONSTANT (1982) FACTOR COST PRICES



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According to provisional data, the performance of minor food crops in 1993 was mixed. There were notable increases in production of black gram (two fold), chillies (72 per cent), potatoes (72 per cent), maize (48 per cent), big onions (38 per cent) and ground nuts (26 per cent), attributable to increased cultivation and yield improvements. Decreases were recorded in the production of gingelly (35 per cent), soya bean (12 per cent) and cowpea (7 per cent). The performance of the minor export crops was better than in the previous year. Exports indicate that there was a notable increase in the production of pepper, cocoa, cloves and cinnamon.

According to provisional data, fish production in 1993 was estimated at 220,900 metric tons, an increase of 7 per cent over the previous year. This was attributable to some improvement in the security situation in the Eastern Province, the assistance given by the government for off-shore and deep-sea fisheries by the supply of more efficient fishing vessels and substantial increases in disbursements under various subsidised lending schemes. The output of the coastal fishery sub-sector, whose share in total production was 77 per cent, rose by 4 per cent. Production of the off-shore and deep-sea sub-sector expanded by 50 per cent. Inland fisheries recorded a decline of 14 per cent. Meanwhile, egg production appears to have remained unchanged at 812 million in 1993 while milk production increased marginally by 1 per cent to 320 million litres.

Industry

The industrial sector, which provided the main impetus for economic growth in recent years, recorded a commendable level of growth brought about by the expansion in output of both the domestic and export-oriented industries, stimulated by further economic reforms and liberalisation measures as well as fiscal and other incentives. The value of industrial output which grew by 12 per cent in 1992, expanded by a further 14 per cent in 1993. The bulk of the growth in industrial production originated in the private sector whose output grew by 13 per cent. The output of public sector industry, which now accounts for only one eighth of the total industrial production, increased by 20 per cent during the year.

Industrial sub-sectors that recorded noteworthy increases in production in 1993 were: chemicals, petroleum, rubber and plastic products (25 per cent), paper and paper products (18 per cent), wood and wood products (18 per cent), textile, wearing apparel and leather products (17 per cent), non-metallic mineral products (9 per cent), food, beverages and tobacco (7 per cent) and manufactured products n.e.s. (20 per cent). The sub-sectors that recorded decreases in 1993 were basic metal products (9 per cent) and fabricated metal products (2 per cent).

The private sector industries showed an increase in output of 13 per cent in real terms. This growth was evident in textiles, wearing apparel and leather, chemicals, rubber and plastic products, non-metallic mineral products, food, beverages and tobacco, wood and wood products and paper and paper product categories.

In real terms, public sector industrial output increased by 20 per cent in 1993, in contrast to the 19 per cent decline in the previous year. This improvement came largely from a 40 per cent increase in output of the Ceylon Petroleum Corporation's refinery and ancillary operations, which accounts for about three fourths of the public sector industrial output. In the previous year, the refinery was closed for 14 weeks for a major modification, but in 1993 the new installed capacity came into operation and there were no close-downs for maintenance.

The other public sector industrial enterprises that recorded production increases during the year were Ceylon Mineral Sands (85 per cent), State Timber (23 per cent), National Paper (11 per cent) and State Rubber Manufacturing (8 per cent). The enterprises that recorded production decreases during the year were Lanka Salt (61 per cent), Ceylon Steel (26 per cent), State Mining and Mineral Development '(25 per cent), Sri Lanka Cement (15 per cent) and Lanka Ceramic (10 per cent).

The Board of Investment of Sri Lanka (BOI) which functions as a "One-stop Investment Promotion Centre" approved 455 new projects during 1993, bringing the total number of projects approved to 1,179. Of these, 721 projects had concluded agreements with the BOI to set up operations. A total of 305 enterprises were in commercial operation as at end of 1993 compared with 211 at the end of 1992. Of the projects that were in operation, 84 were in Katunayake Investment Promotion Zone (KIPZ), 40 in Biyagama Investment Promotion Zone (BIPZ), 10 in Koggala Investment Promotion Zone (KgIPZ) and 171 in other parts of the country. In 1993, employment in BOI enterprises increased by 17 per cent, bringing the total number employed in these enterprises to 122,165 persons. Of these, 69,952 or 57 per cent were engaged in the textile, wearing apparel and leather product sector.

Prices

Inflation continued unabated in 1993. The annual average of the Colombo Consumers' Price Index (CCPI) increased by 11.7 per cent in 1993. The comparable rise in 1992 was 11.4 per cent. On a point to point basis, (December 1993 over December 1992), the index registered a lower increase of 10.3 per cent, down from 13.8 per cent in 1992. The Wholesale Price Index (WPI), which measures price changes at the primary market level, rose by 7.6 per cent in 1993, in comparison with an increase of 8.8 per cent in 1992.

The rise in the overall average of the consumer price index in 1993 reflected significant price increases in the sub-indices for the food, clothing and miscellaneous categories and a sharp increase in energy prices. Because of its high weight (62 per cent) in the index, two-thirds of the increase was caused by rises in food prices. Clothing prices rose by 8 per cent, and contributed 4 per cent to the rise in the index. Energy prices rose sharply by 17.0 per cent in 1993 compared with 3.6 per cent in 1992. Its share in the increase in the index rose from 2.7 per cent to 11.4 per cent.

However, price increases at the producer level which are measured by the Wholesale Price Index were lower in 1993 than in 1992. The index rose by 7.6 per cent in 1993 compared to an increase of 8.8 per cent in 1992. The rise in food prices by 7.0 per cent, though lower than the 10.9 per cent increase in 1992, was largely responsible for the increase in the overall index accounting for 58 per cent. Sharp price increases were recorded for non-metallic products (15.5 per cent) and metallic products (12 per cent). Prices of petroleum products rose by 9.2 per cent in 1993 owing to several upward revisions of the prices of petrol, kerosene and diesel.

Wages and Employment

There were significant improvements in wages in the government sector in 1993. The nominal wage rate index for all government employees rose by 21.1 per cent during the year, compared to 4.3 per cent in the preceding year. However, real wages (nominal wages corrected for inflation) improved only by 8.3 per cent, although it was better than the deterioration of 6.4 per cent in 1992. The wage rate index for all non-executive officers rose by 22.7 per cent while that of minor employees grew by 19.4 per cent in 1993. In 1992, nominal wage increases for these two categories were only 3.9 per cent and 4.7 per cent, respectively.

In the organised private sector, minimum wages for workers in the trades covered by Wages Boards, as measured by the relevant wage rate index, rose by 16.2 per cent in 1993 compared with 13.7 per cent in the preceding year. Real wages improved by 4.1 per cent compared to 2.1 per cent in 1992. This increase in overall wages of workers in Wages Boards largely reflected the rise in wages of workers in agriculture (plantation workers have a weight of about 66 per cent in the overall index) whose wages increased sharply by 21.1 per cent in 1993 compared to 14.9 per cent in 1992. Workers in industry and commerce experienced a wage improvement of only 3.4 per cent in 1993, in contrast to a rise of 11.1 per cent in 1992. Given that the rate of inflation in 1993 was around 11.7 per cent, this represents a deterioration of real wages in this sector by 7.5 per cent. Nominal wages in the services sector remained stagnant in 1993. As a result, real wages for workers in this sector deteriorated by 10.6 per cent.

Wages in the unorganised sector rose substantially in nominal terms, ranging from 11 to 15 per cent in tea cultivation, 11 to 19 per cent in coconut, 7 to 19 per cent in paddy and 13 to 17 per cent in construction. Real wage improvements were registered for most activities in these sectors.

The Central Bank's annual survey of public sector employment disclosed that the total employment in the public sector (which includes government and semi-government institutions), is estimated to be around 1.3 million at the end of 1993, recording a marginal increase of 0.3 per cent over the previous year.

Employment in the central government, provincial councils and local authorities increased by 3.4 per cent in 1993, largely owing to the recruitment of school teachers and health personnel during the year. The school teacher category recorded an increase of 7 per cent. The number of doctors in public sector employment rose significantly by 28 per cent in 1993 mainly as a result of the new appointments given to the back-log of medical students who had graduated from the universities.

Indicators such as employees registered in provident funds are used to assess the employment situation in the formal private sector, in the absence of time series data on employment in that sector. The number of active accounts in the Employees' Provident Funds has risen over the last 5 years, the increase in 1992 being 5 per cent. There are indications that this trend continued in 1993.

Employment in enterprises operating under the Board of Investments of Sri Lanka (BOI) expanded by 17 per cent from 104,220 at the end of 1992 to 122,165 at the end of 1993. Around 44 per cent of the employment in these enterprises was in the Katunayake Export Promotion Zone in which 84 projects were in commercial operation. The Koggala Export Promotion Zone provided employment to 5,160 persons in 1993.

Migration for foreign employment continued unabated. An Airport survey conducted by the Sri Lanka Foreign Employment Bureau (SLFEB) revealed that in 1993 a total of 129,076 persons had secured employment through licensed agencies, the SLFEB and other channels, an increase of 4 per cent over 1992.

Trade and Balance of Payments

A sustained increase in exports, a matching increase in imports, a further decline in the external current account deficit and large inflows of foreign capital were the major developments in the external sector in 1993. Export earnings grew by 17 per cent from SDR 1,745 million (Rs.107,855 million) in 1992 to SDR 2,046 million (Rs.138,174 million) in 1993 and imports increased by 15 per cent from SDR 2,485 million (Rs.153,640 million) to SDR 2,871 million (Rs.193,660 million). As a result, the trade deficit widened from SDR 740 million (Rs.45,785 million) in 1992 to SDR 825 million (Rs.55,486 million) in 1993. However, a turnaround in the services account from a deficit of SDR 23 million (Rs.1,430 million) to a surplus of SDR 31 million (Rs.2,043 million) and a rise in net private transfers by SDR 74 million (Rs.6,837 million) or 23 per cent to SDR 402 million (Rs.27,090 million) helped to reduce the current account deficit (including grants) of the BOP from SDR 306 million (Rs.18,935 million) in 1992 to SDR 277 million (Rs.18,604 million) in 1993. As a result, the current account deficit as a ratio of GDP narrowed from 4.5 per cent to 3.8 per cent. Reinforced by a large inflow of foreign capital, the overall balance of payments was in surplus for the fourth successive year to the tune of SDR 375 million. This augmentated the country's foreign reserves to a level sufficient to finance nearly 6 months of imports.

The major impetus to overall export growth was generated from industrial exports which recorded a 20 per cent rise, whereas agricultural exports rose by 9 per cent. Higher earnings from textiles and garments and other industrial products were the major contributory factors for the substantial growth in industrial exports while increased earnings from agricultural exports came mainly from tea and minor agricultural exports.

The value of tea exports rose from SDR 241 million (Rs.14,893 million) in 1992 to SDR 296 million (Rs.19,911 million) in 1993 owing to enhanced export volume and improved prices. With increased production, the volume of tea exports rose by 20 per cent from 182 million kgs. in 1992 to 218 million kgs. in 1993. Meanwhile, the average export price increased by 2 per cent from SDR 1.33 per kg. (Rs.81.98) to SDR 1.35 per kg. (Rs.91.16) between the two years. In contrast, the value of rubber exports declined by 4 per cent to SDR 46 million (Rs.3,086 million) in 1993 solely due to a drop in export volume by 12 per cent. The adverse impact of the drop in export volume was partly offset by an increase in the average export price of 8 per cent from SDR 0.61 per kg. (Rs.37.65 per kg.) in 1992 to SDR 0.66 per kg. (Rs.44.34 per kg.) in 1993 that resulted from active demand by the major rubber consuming countries following global recovery.

Earnings from the export of coconut products dropped by 30 per cent from SDR 60 million (Rs.3,691 million) in 1992 to SDR 42 million (Rs.2,796 million) in 1993 owing to a marked decline in both the export volume and price. The nut equivalent of the export volume declined by 29 per cent from 422 million nuts in 1992 to 293 million nuts in 1993, following a decrease in production caused by the drought conditions that prevailed in 1992. Meanwhile, the average export price per nut declined by 10 per cent to SDR 0.09 per nut in 1993.

The value of industrial exports at SDR 1,490 million (Rs.100,420 million) in 1993 recorded an increase of 20 per cent. High growth was recorded for all major categories of industrial products. Textile and garment exports rose by 17 per cent to SDR 1,011 million. The value of refined petroleum exports grew by 24 per cent from SDR 45 million in 1992 to SDR 56 million in 1993 largely due to increased volume. Meanwhile, the aggregate earnings from other industrial products including food, beverages and tobacco, cut and polished diamonds, chemical products, leather and rubber products and machinery and mechanical appliances increased by 26 per cent. Mineral exports which suffered a setback in 1992 expanded by 20 per cent to SDR 54 million (Rs.3,653 million). The entirety of this increase came from gem exports, whose earnings rose by 25 per cent.

The total expenditure on imports rose by 16 per cent to SDR 2,872 million (Rs.193,550 million) in 1993. This increase was reflected in all major categories of imports. The import outlay on consumer goods which accounted for 19 per cent of total imports rose by 6 per cent from SDR 521 million (Rs.32,197 million) in 1992 to SDR 555 million (Rs.37,370 million) in 1993. This was largely due to an increase in durable consumer good imports by 15 per cent. Import outlay on food and drink remained unchanged at SDR 298 million. The value of other consumer good imports rose from SDR 224 million (Rs.13,801 million) in 1992 to SDR 257 million (Rs.17,304 million) in 1993. In this category, increases were recorded in the imports of rubber tyres and tubes (SDR 6 million), motor cars and cycles (SDR 4 million), radio receivers and television sets (SDR 2 million) and other consumer goods (SDR 23 million).

Prompted by the high growth of the economy, expenditure on imports of intermediate goods rose by 15 per cent to SDR 1,543 million (Rs.103,951 million) in 1993. Major increases were recorded in fertilizer, chemicals, textile and clothing, wheat grain and paper. Consonant with the expansion in the textile and garment industry, expenditure on imports of textile and clothing increased by SDR 76 million (Rs.8,188 million) to SDR 619 million (Rs. 41,740 mn.) and accounted for 37 per cent of the rise in imports of intermediate goods. The increased level of output in agriculture and industries led to enhanced imports of chemicals and fertilizer. Reflecting the increases in both the import volume and price, the outlay on wheat grain imports rose by 12 per cent to SDR 83 million (Rs.5,609 million) in 1993.

The outlays on investment good imports increased significantly by 24 per cent from SDR 604 million (Rs.37,294 million) in 1992 to SDR 750 million (Rs.50,508 million) in 1993 largely due to a rise in the importation of transport equipment and machinery. Transport equipment imports rose by SDR 95 million (Rs.7,123 million) or by 74 per cent. The importation of two aircrafts under the Air Lanka refleeting programme and assembly parts for buses and railway coaches to augment the public transport system were the major contributory factors for this increase. The outlay on investment goods excluding these exceptional items increased by 4 per cent. Meanwhile, the import outlay on machinery and equipment increased by 20 per cent from SDR 277 million (Rs.17,098 million) in 1992 to SDR 332 million (Rs.22,378 million) in 1993.

A noteworthy favourable development in the BOP in 1993 was the turnaround in the services account to a surplus position of SDR 31 million (Rs.2,043 million) in 1993 from a deficit of SDR 23 million (Rs.1,430 million) in 1992. The major factors contributing to this improvement were the increase in net inflows on account of port earnings and enhanced investment income accrued from the growth in the country's external assets. Meanwhile, the performance of the travel category was commendable, despite a marginal decline in the number of tourist arrivals. Increases in the average duration of stay and average expenditure per tourist day mitigated the impact of this decline and earnings in this category rose from SDR 139 million to SDR 146 million between the two years.

Investment income inflows increased by over 64 per cent from SDR 48 million to SDR 79 million between 1992 and 1993. The bulk of this increase was on account of investment income of the Central Bank whose gross foreign assets rose from SDR 658 million to SDR 1,145 million between the two years. Meanwhile, repatriation of profits and dividends remained at around the same level as in the previous year. With the interest payments declining by SDR 10 million to SDR 141 million, net outflows on account of investment income were SDR 85 million in comparison to SDR 127 million in the previous year.

The transfers account continued to experience increased net inflows, particularly in respect of private transfers. Gross receipts from private transfers rose by 17 per cent from SDR 389 million

(Rs.24,037 million) in 1992 to SDR 454 million (Rs.30,591 million) in 1993. Meanwhile, outflows on account of private transfers in 1993 at SDR 52 million were somewhat lower than the outflows of SDR 61 million recorded in 1992. Official transfers in the form of commodity and project grants to the government declined from SDR 130 million to SDR 115 million. Reflecting the impact of the sharp rise in private transfers, there was an overall increase in net inflows in the transfers account from SDR 457 million (Rs.28,280 million) to SDR 517 million (Rs.34,839 million).

An improved performance in the services and transfers accounts resulted in a narrowing of the current account deficit from SDR 306 million in 1992 to SDR 277 million in 1993, despite the widened deficit in the trade account. Consequently, the current account deficit as a ratio of GDP declined from 4.5 per cent to 3.8 per cent between the two years. Excluding grants this ratio decreased from 6.4 per cent of GDP to 5.3 per cent of GDP. The decline in the current account deficit for the second year in succession further reinforced the improved performance with better external sector stability.

A surge in net inflows to the private sector was the most noteworthy development in the capital account in 1993. Non-monetary capital inflows registered a substantial increase of 60 per cent from SDR 381 million (Rs.23,450 million) in 1992 to SDR 609 million (Rs.40,917 million) in 1993. This increase was entirely due to inflows of different types of private foreign capital, in part associated with the privatisation proceeds.

There was a considerable expansion in enterprises under the Board of Investment (BOI) during 1993 as reflected in the number of new enterprises in commercial operation rising from 58 in 1992 to 94 in 1993, bringing the total number of such enterprises to 305 at end-1993. Commensurate with this growth, foreign direct investment to enterprises under the BOI as well as in the form of investment in public enterprises that were privatised during the year, totalled SDR 134 million in 1993, in comparison to a total of SDR 86 million in the previous year - an increase of 56 per cent. Complementary to this, inflows on account of portfolio investment primarily in the stock exchange rose to SDR 48 million in 1993 from SDR 18 million in the previous year. Meanwhile, direct private long-term capital inflows also rose substantially. Also there were major inflows providing foreign financing towards Air Lanka's refleeting programme and the government-sponsored bus assembly projects and foreign loan capital towards on-lending by the development finance institutions and enterprises associated with the increase in foreign direct investment. The main outflows were on account of further payments by Air Lanka towards the purchase of aircrafts and repayment of previous loans to enterprises under the BOI. Reflecting these developments, net inflow on account of private long term capital amounted to SDR 132 million,compared to a net inflow of SDR 18 million in the previous year.

The net inflow of private short-term capital increased from SDR 91 million in 1992 to SDR 105 million in 1993. The Ceylon Petroleum Corporation reduced its outstanding stock of short-term debt significantly. Meanwhile, short-term credits to BOI enterprises towards financing their raw material imports expanded considerably. These developments resulted in a net inflow of private short-term capital to the tune of SDR 105 million.

Net inflows to the government at SDR 190 million remained at about the same level as in the previous year. Disbursements on account of concessional loans increased somewhat, but a corresponding increase in amortisation payments over the previous year resulted in net inflows remaining at the same level. The main sources of concessional assistance to the government continued to be the Asian Development Bank (ADB) (SDR 88 million), the International Development Association (IDA) (SDR 87 million) and Japan (SDR 66 million).

Following these developments, the overall balance of payments recorded a surplus of SDR 375 million, the highest on record and for the fourth consecutive year, and the country's gross external assets reached a level of SDR 1,543 million at end-1993 from SDR 1,047 million at end-1992. In addition to the improvement in the balance of payments items discussed thus far, a net inflow of SDR 38 million from transactions with the IMF contributed to this build up of reserves. The overall growth in external assets mainly reflected the growth in external assets of the Central Bank, which rose by 74 per cent to SDR 1,145 million. Gross official reserves comprising external assets held by the Central Bank and the Government increased from SDR 681 million to SDR 1,168 million and external assets of the commercial banks expanded from SDR 366 million to SDR 375 million. Gross external assets at the end of 1993 were sufficient to finance 5.6 months of projected imports for 1994, while gross official reserves provided 4.2 months of projected import cover.

The movements of the Sri Lanka Rupee (SLR) against major international currencies during 1993 were somewhat mixed, mainly reflecting the fluctuations in cross rates of the major currencies during the year. From end-1992 to end-1993, the SLR has depreciated in nominal terms by 7.2 per cent against the US Dollar, the intervention currency. The movements against the other currencies reflected the sum total of this change and fluctuations of the US Dollar against other currencies during the year. Thus, the overall impact was the nominal depreciation of the SLR from end-1992 to end-1993 against the Japanese Yen by 16.6 per cent, Pound Sterling by 5.5 per cent, French Franc by 0.9 per cent and the Deutsche Mark by 0.6 per cent. Consequently, the SLR had depreciated by 7.1 per cent against the SDR between the two years. Meanwhile, the SLR appreciated by 11.1 per cent against the Indian Rupee during the period under review, reflecting the impact of the major devaluation of the Indian Rupee in March, 1993.

The external debt of Sri Lanka at end-1993 was estimated at SDR 5,548 million, registering an increase of SDR 503 million from end of the previous year. Medium and long-term debt of the government increased from SDR 3,841 million to SDR 4,081 million mainly on account of concessional assistance from the ADB, IDA and Japan. The release of the second tranche under the Second-Year Programme of the Enhanced Structural Adjustment Facility (ESAF) arrangement with the International Monetary Fund (IMF) amounted to SDR 56 million. However, with a repayment of SDR 18 million during the year, outstanding debt to the IMF increased only by SDR 38 million to SDR 376 million. Outstanding short-term debt rose to SDR 526 million entirely owing to the increased stock of short-term foreign credits drawn by enterprises under the auspices of the BOI.

The country's debt service payments, which include amortisation of medium and long term debt and interest payments fell by SDR 28 million to SDR 354 million in 1993. The decline was reflected in both amortisation and interest payments. Amortisation payments on account of non-IMF loans increased by SDR 18 million while repurchase of the IMF drawings declined to SDR 18 million in 1993 from SDR 54 million in 1992. At the same time, the outstanding credit from the IMF since March consisted entirely of highly concessional assistance under the SAF and ESAF. Consequently, interest payments to the IMF also fell significantly. The decline in both interest and amortisation payments, combined with the increase in earnings from the export of goods and services and private transfers led to a sharp reduction in the debt service ratio from 17.1

TABLE 1.3

Summary of Balance of Payments 1990 – 1993

Rs. Million (SDR Million in brackets)

Item	1990	1991(a)	1992(a)	1993(b)
Merchandise (Net)	-28,145	-41,252	-45,785	-55,486
	(-518)	(-726)	(-740)	(-825)
Non-Factor Services (Net)	2,781	3,594	6,391	7,800
	(51)	(65)	(104)	(116)
Factor Services (Net)	-6,685	-7,367	-7,821	-5,757
	(-123)	(-130)	(-127)	(-85)
Private Transfers (Net)	14,518	16,623	20,253	27,090
	(268)	(293)	(328)	(402)
Official Transfers (Net)	7,142	8,407	8,027	7,749
	(130)	(148)	(130)	(115)
Current Account Balance	-10,390	-19,995	-18,935	-18,604
	(-192)	(-352)	(-306)	(-277)
Overall Balance	7,480	10,140	9,469	24,130
	(138)	(152)	(133)	(375)
Some Key Indicators				
Terms of Trade (1985 = 100)	87.4	85.7	89.1	90.9
Net Petroleum Imports	10,393	9,598	11,167	11,119
	(191)	(170)	(180)	(165)
Current Account Deficit as a percentage of G.D.P	-3.2	-5.4	-4.5	-3.8
Gross International Reserves	34,472	49,223	66,236	105,239
	(602)	(809)	(1,047)	(1,543)
International Reserves in Months of Current Imports	3.7	4.4	5.1	6.5

(a) Revised (b) Provisional

Source : Central Bank of Sri Lanka

per cent in 1992 to 13.7 per cent in 1993 pointing to a further improvement in the country's external sector viability.

Government Finance

The budgetary outcome in 1993 showed further progress on fiscal management, with the budget deficit contained at 8 per cent of GDP. In spite of a slight weakening in the revenue effort which caused a decline in the revenue to GDP ratio from 20.2 per cent in 1992 to 19.8 per cent in 1993, the current account deficit of the budget declined from 0.9 per cent of GDP to 0.5 per cent of GDP due to a contraction in current outlays from 21.1 per cent of GDP in 1992 to 20.3 per cent of GDP in 1993. In contrast to the experience of the previous year, the government was able to maintain a high level of public investment, which rose to 8.0 per cent of GDP in 1993 from 7.3 per cent in 1992. Reflecting the combined effect of the moderate increase in current expenditure and enhanced growth in capital outlays, the total expenditure/GDP ratio was contained at 27.9 per cent in 1993. These developments were conducive to containing the overall budget deficit as planned at 8 per cent of GDP.

Government revenue at Rs.98,495 million registered a growth of 15 per cent in comparison to

13 per cent in 1992. Tax revenue at Rs.87,274 million accounted for 89 per cent of government revenue, as in the previous year. However, reflecting revenue growth falling behind the growth in nominal GDP, the revenue/GDP ratio declined from 20.2 per cent in 1992 to 19.8 per cent in 1993. With enhanced revenue from the defence levy, turnover tax and excise tax, the share of taxes on domestic goods and services rose from 50 per cent to 55 per cent. Meanwhile, import duties which generated Rs.20,615 million accounted for 24 per cent of tax revenue, considerably lower than the previous year's share of 27 per cent. Income taxes amounted to Rs.13,658 million, reflecting a buoyant growth of 25 per cent and a share of 15.6 per cent of tax revenue.

Non-tax sources generated Rs.11,221 million of government revenue, registering a growth of 19 per cent in 1993. As in the previous year, revenue from such sources accounted for 11 per cent of the total revenue collection. Revenue from profits and dividends at Rs.2,135 million rose by Rs.1,976 million due largely to the imposition of special levies on Sri Lanka Telecom and on the Ceylon Petroleum Corporation (CPC) under the Finance Act. The share of interest income in non-tax revenue declined from 38 per cent in 1992 to 31 per cent in 1993.

Total expenditure consisting of current outlays and capital expenditure and net lending at Rs.138,604 million showed an increase of 18 per cent. Current expenditure amounting to Rs.100,951 million reflected an increase of 13 per cent - but in relation to GDP it declined to 20.3 per cent in 1993 from 21.1 per cent in 1992. In spite of a large increase in government salaries, expenditure on account of purchases of goods and services in the form of salaries, wages and other goods and services totalling Rs.45,171 million witnessed a growth of 14 per cent owing to a compression in expenses on other goods and services. Interest payments on government debt which accounted for 29 per cent of current outlays of the government showed a growth of 11 per cent. In contrast to a decline in the previous year, transfer payments to households which absorbed a fifth of current expenditure in 1993 registered a rise of 14 per cent owing to increased expenditure on pension payments.

Capital expenditure and net lending in 1993 amounted to Rs.37,653 million. This was the combined result of an increased public investment of Rs.39,569 million and a reduction in other liabilities by Rs.1,915 million largely on account of proceeds from privatisation and loan repayments to public corporations. Under the public investment programme, capital expenditure directly incurred by line ministries and departments for the construction and development of capital assets totalled Rs.20,633 million in 1993 in comparison to Rs.12,604 million in the previous year.

Revenue and expenditure flows resulted in a deficit of Rs.40,109 million or 8 per cent of GDP. With the use of foreign grants amounting to Rs.8,025 million, the budget deficit after grants at Rs.32,084 million in 1993 showed an increase of Rs.9,172 million in contrast to a decline of Rs.12,566 million in the previous year. In financing this deficit, a sum of Rs.16,839 million was utilised from foreign sources, of which Rs.12,511 million was in the form of project loans. With a repayment of Rs.6,984 million, net foreign borrowings in 1993 amounted to Rs.9,855 million, an increase of Rs.2,494 million over 1992.

Gross borrowings for budgetary operations from domestic sources amounted to Rs.48,407 million in 1993, in comparison to Rs.39,479 million utilised during the previous year. A gross borrowing of Rs.28,205 million was made through the floatation of Rupee loans. However, with a total repayment of Rs.20,004 million, net borrowings through Rupee loans amounted to Rs.8,200 million in 1993, Rs.5,221 million higher than that in the previous year. Meanwhile, a further sum of Rs.9,807 million was raised through the issue of Treasury bills in 1993. Altogether, net borrowings

TABLE 1.4
Summary of Government Fiscal Operations

Rs. Million

Item	1989	1990	1991	1992	1993 Provisional
Total Revenue	53,979	67,964	76,179	85,781	98,495
Tax Revenue	47,513	61,206	68,157	76,353	87,274
Non-Tax Revenue	6,466	6,758	8,022	9,428	11,221
Total Expenditure & Net Lending	82,164	99,814	119,527	116,973	138,604
Recurrent	56,884	71,771	83,756	89,639	100,951
Capital & Net Lending	25280	28,043	35,771	27,334	37,653
Current Account Surplus/ Deficit (-)	-2,905	-3,807	-7,577	-3,858	-2,456
Deficit (before grants)	-28,185	-31,850	-43,348	-31,192	-40,109
Financing	28,185	31,850	43,348	31,192	40,109
Foreign Grants	6,407	6,697	7,870	8,280	8,025
Foreign Borrowings	5,926	11,645	19,329	7,361	9,855
Domestic Financing	15,852	13,508	16,149	15,551	22,229
Non Bank	16,385	13,251	16,114	17,873	28,308
Bank	-533	257	35	-2,322	-6,079
			GDP Ratios (%)		
Total Revenue	21.4	21.1	20.4	20.2	19.8
Tax Revenue	18.9	19.0	18.3	17.9	17.6
Non-Tax Revenue	2.6	2.1	2.2	2.2	2.3
Total Expenditure and Net Lending	32.6	31.0	32.1	27.5	27.9
Recurrent	22.6	22.3	22.5	21.1	20.3
Capital & Net Lending	10.0	8.7	9.6	6.4	7.6
Current Account Surplus/ Deficit (-)	-1.2	-1.2	-2.0	-0.9	-0.5
Deficit (before grants)	-11.2	-9.9	-11.6	-7.3	-8.1
Financing	11.2	9.9	11.6	7.3	8.1
Foreign Grants	2.5	2.1	2.1	1.9	1.6
Foreign Borrowings	2.4	3.6	5.2	1.7	2.0
Domestic Financing	6.3	4.2	4.3	3.7	4.5
Non-Bank	6.5	4.1	4.3	4.2	5.7
Bank	-0.2	0.1	...	-0.5	-1.2

Source : Central Bank of Sri Lanka

from non-bank sources rose from Rs.17,873 million in 1992 to Rs.28,308 million in 1993. Meanwhile, reflecting the change in ownership of debt from the banking system to non-bank sources, net borrowings by the banking system recorded a reduction of Rs.6,079 million in 1993.

Government debt inclusive of Rs.24,088 million of long term restructuring bonds at the end of 1993 stood at Rs.483,568 million. Total government debt exclusive of these bonds amounted to Rs.459,480 million, an increase of 13 per cent in 1993 compared with 11 per cent in 1992. Domestic debt net of restructuring bonds at Rs.189,597 million accounted for 41 per cent of total debt in 1993, down from 42 per cent in the previous year. Short term debt (maturity of less than one year) in the domestic debt at Rs.101,845 million declined from 58 per cent in 1992 to 54 per cent in 1993. Meanwhile, medium and long term debt totalling Rs.87,752 million in 1993 increased its share of domestic debt from 42 per cent to 46 per cent in 1993. The debt held by the Central Bank declined sharply from 20 per cent in 1992 to 9 per cent in 1993 owing to aggressive open market operations.

Meanwhile, the outstanding liability on account of foreign debt at Rs.269,883 million rose by 15 per cent in comparison to a growth of 10 per cent during the previous year. However, as a percentage of GDP, it declined from the equivalent of 55 per cent of GDP at end-1992 to 54 per cent at end-1993. Highly concessional project loans of Rs.215,064 million continued to account for nearly 80 per cent of foreign debt. Ninety six per cent of total foreign debt was in the form of concessional loans, mostly bilateral loans.

Government debt service payments comprising amortisation and interest payments at Rs.56,009 million in 1993 was an increase of 8 per cent, considerably lower than the rise of 30 per cent witnessed in the last year. Consequently, debt service payments as a ratio of GDP declined from 12.2 per cent in 1992 to 11.3 per cent in 1993. Amortisation of domestic debt amounting to Rs.20,099 million accounted for 36 per cent of total debt service payments. Meanwhile, repayments of foreign debt at Rs.6,984 million were 12 per cent lower than that in 1992.

Interest payments on domestic debt consisting of Rs.12,971 million on Treasury bills and Rs.10,772 million on government securities totalling Rs.23,743 million showed an increase of 12 per cent. Meanwhile, interest payments on foreign loans rose by 9 per cent in 1993 to Rs.5,183 million in comparison to a growth of 15 per cent witnessed during the previous year.

Money and Banking

A rapid acceleration in the growth of monetary aggregates was a worrisome feature in the field of macro-economic management during 1993. The Narrow Money Supply (M_1), comprising currency and demand deposits held by the public, rose by 19 per cent in 1993 in comparison to an increase of 7.3 per cent in the previous year. Reflecting a similar trend, the annual growth in Broad Money Supply (M_2), consisting of M_1 plus time and savings deposits held by the public with commercial banks, increased by 23.5 per cent, up from 16.6 per cent witnessed in the previous year. In spite of a moderation in the growth of domestic credit brought about by successful open market operations, the rate of growth of monetary aggregates accelerated sharply owing to a sharp rise of 88 per cent in Net Foreign Assets (NFA) of the banking system, which enhanced liquidity and threatened to fuel inflation.

The monetary base (or reserve money) expanded by Rs.11,609 million or 25.9 per cent in comparison to a modest expansion of Rs.4,802 million or 12 per cent in the previous year. On the source side, the build up of NFA of the Central Bank by Rs.24,676 million was the main contributory factor to the sharp rise in reserve money. However, a reduction in Treasury bills from the Central Bank portfolio by Rs.17,848 million following aggressive open market operations by the Central Bank helped to sterilise a part of the liquidity impact of this large increase in NFA in 1993. The decline in overall credit on account of Central Bank refinance schemes by Rs.568 million was also a favourable move in reserve money management in 1993. Thus, in spite of a use of Rs.4,654 million by the government through provisional advances and cash items in process of collection, net of government deposit balances, the Central Bank was able to reduce its Net Domestic Assets (NDA) by Rs.13,067 million, thereby containing the reserve money expansion at Rs.11,609 million.

A large influx of foreign funds and a sustained rise in credit to the private sector intensified pressure on monetary aggregates in 1993. In response to further liberalisation initiatives and economic reform undertaken during the year, NFA of the banking system expanded by Rs.21,238 million (88 per cent) considerably higher than the rise of Rs.6,731 million (39 per cent) in 1992 and Rs.7,225 million (70 per cent) in 1991. Meanwhile, despite high interest rates, credit to private sector rose by Rs.19,800 million (21 per cent). In 1991 and 1992, credit to the private sector increased by Rs.13,165 million and Rs.17,626 million, respectively. The sustained high growth in credit to the private sector was a reflection of buoyant economic activity following the recent policy reforms directed at inducing the private sector to play the lead role in the economy.

In contrast to an increase of Rs.673 million (5 per cent) in 1992, the overall credit utilisation by public corporations declined by Rs.6,975 million (47 per cent) in 1993. Under the restructuring programmes of the two state banks, outstanding levels of credit of the Janatha Estate Development Board (JEDB) and the Sri Lanka State Plantation Corporation (SLSPC) were settled by the government through the issue of long term bonds to the tune of Rs.4,676 million. The Ceylon Electricity Board (CEB) which borrowed heavily in the previous year reduced its outstanding level of credit by Rs.1,967 million through funds generated by a 30 per cent increase in electricity tariff and the postponement of capital expenditure projects during the year. An improved cash flow position enabled the Co-operative Wholesale Establishment (CWE) to reduce its liabilities to the banking system by Rs.723 million. The Ceylon Petroleum Corporation however increased its borrowings from the banking system by Rs.416 million (14 per cent). Meanwhile, outstanding bank credit to co-operative institutions declined by Rs.118 million to Rs.1,903 million in 1993.

In spite of high domestic borrowings by the government, the level of credit to the government from the banking system declined by Rs.7,346 million (particularly the Central Bank financing of the Budget deficit) owing to aggressive open market operations by the Central Bank. During the year, although the government absorbed Rs.2,053 million through provisional advances, net credit to government from the Central Bank declined by Rs.14,932 million, reflecting a sharp reduction in Central Bank holdings of Treasury bills by Rs.17,846 million. In contrast, net credit from commercial banks increased by Rs.7,585 million largely due to increased holdings of Treasury bills and the use of deposit balances during the year.

The balance of payments developments exerted a large expansionary impact on the money supply in 1993 as the increase in net foreign assets was wholly concentrated in the Central Bank, inducing reserve money expansion. The net foreign assets of the Central Bank increased by Rs.24,676 million while those of commercial banks declined by Rs.3,438 million. The decline in net foreign assets of commercial banks reflected an increased foreign currency exposure in these banks.

In 1993, the commercial banking system remained liquid. The total liquid assets of commercial banks which increased by Rs.4,749 million in 1992 witnessed a sharp rise of Rs.12,504 million in 1993. The expansion in liquid assets was mainly reflected in increases in Treasury bills and trade bills. Meanwhile, demand deposits rose by Rs.2,501 million compared with Rs.4,821 million in the previous year. Accordingly, the liquid assets to demand deposits ratio moved up from 167 per cent in 1992 to 191 per cent in 1993. However, the ratio of liquid assets to total deposits remained unchanged at 40 per cent in 1993, reflecting enhanced time and savings deposits in commercial banks.

The total assets/liabilities of the Central Bank at Rs.133,634 million registered a sharp rise of Rs.32,380 million (32 per cent), in comparison to a modest increase of Rs.5,419 million (6 per cent) in the previous year. On the assets side, this increase was reflected in external assets which rose by Rs.36,307 million (89.9 per cent). This was the fourth successive year in which external assets showed substantial increases. Meanwhile, domestic assets of the Central Bank decreased by Rs.3,927 million (6 per cent) following a decline of Rs.6,014 million (9 per cent) in the previous year. The decline in domestic assets of the Bank is largely explained by the reduction in the holdings of government and government guaranteed securities by Rs.17,848 million which was

TABLE 1.5

Monetary Magnitudes 1988 – 1993

Rs. Million

Item	1988	1989	1990	1991	1992	1993
Change in Domestic Credit	21,302	5,454	17,543	14,362	19,121	5,362
Increase in Net Credit to Government	9,017	54	3,078	2,595	558	-7,346
Increase in Credit to Government Corporations	3,421	3,075	1,774	-1,559	673	-6,975
Increase in Credit to Co-operatives	195	-140	418	161	264	-118
Increase in Credit to other Private Sector	8,669	2,465	12,273	13,165	17,626	19,800
Change in Net External Banking Assets	-2,233	-2,326	5,474	7,225	6,731	21,238
Change in Total Assets / Liabilities	19,069	3,128	23,017	21,587	25,852	26,599
Increase in Broad Money Supply (M_2)	9,611	8,487	14,584	21,080	18,604	30,661
Increase in other Liabilities (Net)	9,458	-5,359	8,433	507	7,248	-4,062
Percentage Increases in Monetary Magnitudes						
Percentage Increase in Total Domestic Credit	28.2	5.6	17.1	12.0	14.2	3.5
Percentage Increase in Total Assets and Liabilities	22.4	3.0	17.7	16.6	17.0	15.0
Government as a percentage of Total Domestic Credit Increase	42.3	1.0	17.5	18.1	2.9	-137.0
Non-Government as a percentage of Total Domestic Credit Increase	57.7	99.0	82.5	81.9	97.1	237.0
Percentage Increase in:						
Broad Money Supply (M_2)	16.4	12.4	19.1	23.2	16.6	23.5
Narrow Money Supply (M_1)	29.1	9.1	12.8	18.0	7.3	19.0

Source: Central Bank of Sri Lanka

brought about by open market operations. The overall credit on account of the Central Bank's refinance schemes was brought down by Rs.568 million during 1993.

On the liabilities side, foreign liabilities rose by Rs.11,630 million (60 per cent) owing to an increase in liabilities to the International Monetary Fund. Meanwhile, domestic liabilities rose by Rs.20,750 million (25 per cent) largely due to a rise in deposit liabilities on account of reserve requirements on commercial bank deposits and currency in circulation. The sale of Central Bank securities to the public during the year to further absorb excess liquidity raised the liabilities of the Central Bank by a further Rs.2,155 million.

The continuing high rate of monetary expansion and underlying price developments called for further intensified action on the monetary policy front in 1993. The Central Bank relied entirely on market based indirect policy instruments in monetary management and the major thrust was placed on intensified open market operations (OMO) and the Statutory Reserve Ratio (SRR) to contain liquidity growth within manageable limits.

The major thrust of reserve money management was on open market operations. The Central Bank engaged in aggressive open market operations through the sale of Treasury bills to siphon-off excess liquidity, taking into account the budgetary requirements, developments in refinance credit and changes in net foreign assets. Accordingly, the sale of Treasury bills from both the primary and secondary markets were intensified to reduce Treasury bills from the Central Bank portfolio and absorb liquidity from the economy.

In the context of intensified actions by the Central Bank to siphon-off excess liquidity and heavy government borrowings through the issue of Treasury bills to finance budgetary needs, yields on Treasury bills rose sharply during the year, particularly during the first three quarters of the year. Accordingly, the weighted average yield on Treasury bills with 3 months maturity increased from 17.7 per cent at the end of 1992 to 20.84 per cent in September, 1993 before showing a declining trend in October. Following a similar trend, the yield on Treasury bills with one year maturity increased from 19 to 21.98 per cent. Reflecting these developments in the Primary Treasury bill market, the discount and rediscount rates in the secondary market for Treasury bills also increased during the year. However, yields on Treasury bills in both primary and secondary markets moved in a downward direction towards the latter part of the year owing to enhanced liquidity conditions prevailing at that time.

In response to high yields on Treasury bills, market participation in Treasury bills remained active during 1993. Thus, the Treasury bill holdings of the non-banking sector rose by Rs.20,102 million during the year. Conversely, despite fresh issues of Treasury bills which raised the outstanding stock of Treasury bills from Rs.87,095 million to Rs.97,195 million at the end of the year, holdings of Treasury bills by the Central Bank dipped from Rs.21,795 million in 1992 to Rs.3,949 million in 1993.

Meanwhile, several steps were taken to strengthen the market framework for Treasury bills. On most occasions, the entirety of Treasury bill issues, arising from existing stocks as well as from fresh issues for government budgetary operations, were placed before the public at auctions with comprehensive information pertaining to Treasury bill operations. This facilitated the process of a market-determined yield on Treasury bills. The Central Bank also held regular meetings with primary dealers to promote a better dialogue and transparency in the operations of the Treasury bill market. The introduction of a repurchase market for Treasury bills in October, 1993 facilitated the development of the short-end of the Treasury bill market which in turn influenced the management of liquidity on a daily basis.

As the Central Bank's stock of Treasury bills was rapidly depleted by these open market operations, the Bank commenced the issue of its own securities from October, 1993 with a view to further containing reserve money growth. Accordingly, Central Bank securities which were issued for 3 months and 6 months maturities raised Rs.2,155 million during the latter part of the year. The average yield on these securities also remained high in the range of 18.6-21.4 per cent.

Meanwhile, the Central Bank also continued restraint on refinance credit to contain reserve money expansion. Consequently, total refinance outstanding under short-term refinance and Medium and Long Term Credit Fund (MLCF) declined though some demands for refinance from ailing finance companies were accommodated. The short-term refinance outstanding dropped from Rs.923 million as at end December, 1992 to Rs.752 million by December, 1993 while total MLCF (excluding facilities granted to finance companies) declined by Rs.632 million during the same period. Hence, in spite of an increase in refinance granted to finance companies from Rs.1,811 million in 1992 to Rs.2,045 million in 1993, the overall refinance outstanding declined by Rs.568 million during 1993.

The continued rapid growth in commercial bank credit to the private sector and high liquidity in the economy called for the intensive use of the SRR during the year. Accordingly, the SRR on Rupee deposits which was fixed at 13.5 per cent on January 29, 1993 was raised to 14 per cent in April, 1993. In respect of foreign currency deposits, the SRR on time and savings deposits was raised from 6 per cent to 8 per cent and that on demand deposits was kept at 10 per cent. Further tightening the policy stance, the SRR on Rupee deposits was raised to 15 per cent in May while the SRR on foreign currency time and savings deposits was raised to 9 per cent. At the same time, the SRR on foreign currency demand deposits was fixed at 11 per cent. In June, 1993, the SRR on foreign currency deposits was unified at 12 per cent while in August 1993, the reserve ratios on all deposits were unified at 15 per cent. These measures strengthened the effectiveness of the SRR as a policy instrument. However, in order to ease the burden, commercial banks were allowed to maintain reserves against foreign currency deposits in the form of foreign currency.

Meanwhile, under the impact of intensified monetary policy actions to contain liquidity growth during the year, interest rates remained high in 1993, moving upward till October. The weighted average yield on Treasury bills with 3 months maturity rose from 17.7 per cent at the end of 1992 to 20.8 per cent in September 1993, before showing a declining trend since October. Similarly, the yield on Treasury bills with 12 months maturity moved up from 19.00 per cent to 21.98 per cent. Following a similar trend, the discount and the rediscount yield on 3 month Treasury bills in the secondary market rose from 17.3 per cent and 18.9 per cent at the end of 1992 to 20.1 per cent and 21.6 per cent by the end of September, 1993. However, these rates moved in a downward direction towards the latter part of the year. Meanwhile, interest rates in the call money market which varied within a range of 10-32 per cent at the end of 1992 narrowed to a range of 14.0-23.0 per cent in October before widening to a range of 16.5-28.0 per cent by the end of the year.

The interest rates offered on deposits by the National Savings Bank (NSB) remained unchanged until December, 1993 when the interest rate on 12 month fixed deposits was reduced by

1 percentage point to 16 per cent. The rate offered on 24 month deposits was reduced from 18.5 per cent to 17 per cent. The deposit rates of commercial banks which showed marginal increases during most of 1993 declined towards the end of the year in response to declining yields on Treasury bills and downward revisions effected by the NSB. Meanwhile, long-term rates reflected an increasing trend, with the rise in interest rates on government securities of 2-5 years maturity to a range of 18.5-16 per cent towards the end of the year from the 17-15 per cent that prevailed in 1992.

Problems and Policies

The year 1993 marked the fifth year of the comprehensive adjustment programme initiated by the government in 1989 with assistance from donors and international institutions in order to improve economic performance through structural reforms. The programme, which called for the implementation of prudent macro economic policies, together with structural reforms over the medium-term, aimed at a steady reduction in the fiscal and external current account deficits, coupled with the achievement of near 6 per cent growth in 1993. Another key goal was the maintenance of a low rate of inflation.

Structural reforms covered a wide range of areas in 1993. In rationalising taxes, the government brought down the corporate income tax rate by a further 5 percentage points to 40 per cent and introduced a 3 band rate structure for turnover taxes to facilitate the transition to the proposed Value Added Tax (VAT) or Goods and Services Tax (GST). In the area of public enterprise reforms, a number of public enterprises were privatised. Budgetary transfers to commercial public enterprises were avoided with the additional funds generated from increases in electricity tariff and wheat and diesel prices. Considerable progress was also made in reducing public expenditure through a reduction in non-priority expenditure items and better targetting of major welfare programmes. In the financial sector, new prudential capital adequacy guidelines for commercial banks were introduced with a view to improving the prudential and regulatory environment. The government also infused Rs.24 billion to the capital base of the two state banks in the form of interest bearing government bonds to re-capitalise these two banks. Further consolidating trade liberalisation, the government lowered import duties and eliminated export taxes. Moreover, the remaining licensing requirements on imports were eliminated except on a few selected items, which continued to be subjected to licensing on account of environment, health and security considerations. As a major step towards the convertibility of current international transactions, the requirement that export proceeds must be repatriated and forwarded to a Sri Lankan bank was removed in March, 1993 . At the same time most current or trade and service related transactions were exempted from exchange control. Thus, during the year Sri Lanka virtually removed all impediments towards accepting obligations under Article VIII of the IMF Articles of Agreement. These measures were expected to build international and local confidence in Sri Lanka's economic policies, which will ultimately render exchange controls redundant and foster foreign investment and economic growth.

The foregoing analysis shows that Sri Lanka has set the stage for a broadening and deepening of the adjustment process to expand production and to ensure its sustainability in years ahead. During the last four years, under the on-going stabilisation and structural reforms, domestic savings and investments have risen from 12.2 per cent of GDP and 21.7 per cent of GDP, respectively in 1989 to 16 per cent of GDP and 26.0 per cent of GDP, respectively in 1993. Economic growth accelerated from 2.3 per cent in 1989 to an average level of 5 per cent during 1990-1992 and to 6.9 per cent in 1993. In spite of considerable stress, fiscal consolidation brought about a reduction in the budget deficit from 11.6 per cent of GDP in 1989 to 8 per cent of GDP in 1993. On the external front, the balance of payments viability improved significantly with the reduction in current account deficit (excluding grants) from 6.4 per cent of GDP to 5.3 per cent of GDP reflecting a substantial improvement in industrial exports. This trend reinforced by a sizeable net-inflow of private foreign capital raised the country's import capacity to the highest level recorded in recent years. Moreover, the removal of non-tariff barriers and the liberalisation of virtually all current international transactions gave confidence to the international community that Sri Lanka is committed to pursue sound economic policies to sustain its development effort.

In contrast to the economic growth and external sector performance, domestic price developments remained a matter of serious concern. The realisation of price stability has fallen short of expectations. In spite of an initial success in bringing down the pace of inflation from over 20 per cent in 1990 to 12 per cent in 1991, the realisation of a durable reduction in the rate of inflation to a single digit level has not been achieved in the past two years.

Thus, a persistent upward pressure on prices has remained unabated for quite some time. The annual average inflation which decelerated moderately from 12.2 per cent in 1991 to 11.4 per cent in 1992 remained slightly higher at a level of 11.7 per cent in 1993. The 12-month moving average inflation which slid in a steady downward direction from December, 1991 till August 1992 started mounting since then and stayed closer to 12 per cent throughout the year underscoring the unabated demand pressure in the economy. The uptrend in prices manifest during 1992-1993 still persists under the intense influence of rapid monetary expansion.

The continuing build-up of inflationary pressure in the economy is explained by (*a*) high fiscal imbalances which undermine effective demand management, (*b*) a large increase in low-productive expenditure in the budget, (*c*) the sustained increase in monetary aggregates, (*d*) high cost of production stemming from recent wage hikes and administrative price corrections, particularly in the energy sector and (*e*) the consequent inflationary expectations. In spite of considerable progress in fiscal adjustments towards lower budget deficits, fiscal imbalances still remain above the desirable level for macro-economic stability. The current account of the budget has been in deficit for several years in the past and deficit financing by the creation of domestic debt remained at a very high level. This practice over a long period of time has not only increased the public sector's financial burden on the rest of the economy, but also pre-empted resources otherwise available for productive investments in the private sector, hindering the exploitation of the country's full growth potential. On average, annual domestic borrowings of the government during the past five years accounted for 4.5 per cent of GDP undermining the imperatives of freeing a larger share of financial resources for private sector activity in the economy. Moreover, when the government resorts to high domestic borrowings, it raises domestic interest rates, encouraging speculative foreign capital inflows which complicate domestic liquidity management. This has imposed serious constraints on the use of market-based indirect monetary policy instruments such as open market operations to contain liquidity growth in recent months, underscoring the need for strong fiscal adjustments to achieve much needed price stability.

The composition of government expenditure and its productivity also have a bearing on prices. Although the government has made progress in reducing its overall expenditure from 33 per cent of GDP in 1989 to 28 per cent of GDP in 1993, only limited success has been achieved in improving the quality of public expenditure. Defence expenditure which was less than 1 per cent of GDP prior to 1983 has increased to 4 per cent of GDP in 1993 and imposed a significant fiscal burden, absorbing about 17 per cent of total government expenditure in 1993. Periodic adjustments in salaries, pension payments and household transfers also contributed to a high level of consumption – oriented expenditure in the budget. Consequently, overall current expenditure as a proportion of total expenditure rose from 69 per cent in 1989 to 73 per cent in 1993. Meanwhile, fiscal adjustments towards achieving a lower budget deficit during this period unfortunately fell heavily and disproportionately on growth-oriented capital investments, undermining the country's development prospects. The ratio of public investment to GDP declined from 10.6 per cent in 1989 to 8.0 per cent in 1993. Enhanced defence expenditure and other consumption-oriented outlays of the government budget, together with restraint on growth-oriented public investment thus continued to fuel consumption demand with consequent pressure on the general price level.

Another contributory factor for inflation was the continued high growth in monetary aggregates due to enhanced demand for credit from the banking system and a sustained increase in capital inflows. Strong growth in commercial bank lending to the private sector, partly supported by directed credit under various special schemes of the government, maintained aggregate demand at a higher level than was warranted by the aggregate supply situation. On an overall basis, commercial bank credit to the private sector showed an average annual increase of 20 per cent since 1990, in spite of high interest rates prevailing during this period. Although it is necessary to provide a large quantum of credit to the private sector which has been buoyant in recent years, a large flow of commercial bank credit to the private sector can be accommodated only if the public sector reduces its demand for credit. In the light of a generally high demand for credit from major public enterprises and heavy investments by banks in government securities the high demand for credit from the private sector contributed significantly towards rapid monetary growth in recent years with consequent pressure on prices.

Reinforced by the intense influence of domestic credit on the money supply, a sustained increase in foreign assets of the banking system under the impact of a continuing large overall surplus position in the balance of payments also exerted a considerable expansionary impact on the money supply fueling continued pressure on domestic prices. There are limits to the effectiveness of sterilisation in containing the inflationary impact of strong capital inflows, because the resulting rise in interest rates could encourage further inflows and also dampen investment. Hence, sterilisation of capital inflows will have to be reinforced by increased fiscal restraint. With the inflexibility of several expenditure items of the government budget and with considerable fiscal tightening in the recent past, further restraint of the fiscal situation becomes difficult. It should be noted however that fiscal tightening is the most effective means of preventing the overheating that typically results from surges in capital inflows.

There are dangers of cost-push pressures on inflation aggravating the current situation further. Pressures of wage and other cost increases could exacerbate the already existing pressures for price increases from the demand side, ultimately leading to spiraling inflation. Supplementary measures are, therefore, needed to remove the structural and institutional impediments to efficiency, mobility and greater competitiveness in both labour and product markets to increase productivity and supply. Attempts should also be made to remove barriers to trade and discourage any subsidies that can distort the smooth functioning of the allocative mechanism.

Many facets of inflation, particularly its consequences on the economy and economic performance, need some scrutiny. Inflation distorts the allocative efficiency of the market forces which has serious implications on the ultimate objective of economic policy to foster the maximum sustainable rate of economic growth. The attainment of this objective depends fundamentally on incentives for savings, investment and innovation. Markets perform these tasks most effectively in an environment of sustained price stability, when individuals can take longer term decisions to forego current consumption to reap adequate benefits in the future. Inflation insidiously undermines such confidence and distorts decision-making. It raises doubts in savers' minds about the future real value of their savings and if the expected inflation would exceed nominal interest rates, there would be little incentive for financial savings. Thus, inflation induces individuals to reduce their money balances and changes saving behaviour, undermining the process of financial deepening, thereby making less funds available for investment. Persistently high inflation can therefore severely impede private sector investment by constricting the flow of funds to the organised financial system, if nominal interest rates are not allowed to reflect expected rates of inflation.

Inflation may also lure firms into unwise investment decisions because of difficulties in forward planning. Faced with this additional risk of investment decisions, investors tend to move away from investments in durable projects normally associated with long term benefits and instead concentrate on quick-yielding, often speculative projects.

The most observable fact of inflation is the drop in the purchasing power of the Rupee and the consequent redistribution of incomes and wealth, because of the unevenness of its impact. Unanticipated inflation will redistribute real purchasing power (income) from those whose money incomes rise less rapidly relative to the prices they pay to those whose incomes rise more rapidly. An unexpected rapid surge in inflation will also redistribute existing wealth from creditors to debtors when debts are designated in fixed Rupee terms. Also, inflation tends to favour the rich at the expense of the poor, as the rich normally possess the capacity to hedge against inflation by carrying stocks and holding real assets, such as real estate and durable goods, whose value increases with inflation. Continuing high inflation causes undue hardships to fixed income earners such as pensioners, the elderly and the poor, e.g. recipients of fixed income welfare benefits, through an erosion in their purchasing power, causing the incidence of poverty to rise. Thus, inflation renders poverty alleviation programmes less effective. It is noteworthy that almost all countries that achieved rapid growth were those who kept inflation in check.

Quite apart from adverse effects on saving, investment and distribution of income and wealth, inflationary pressure may hold back the growth of the economy through its impact on the balance of payments. A sustained rise in prices would fuel demand for high wages with a consequent impact on cost of production, particularly in labour intensive industries, igniting a wage-price spiral. This will, in turn, lead to an erosion in international competitiveness of domestic industry, affecting the capacity to export. At the same time, high domestic prices will encourage imports, lead to a deterioration in competitiveness of domestic industry and worsen the trade balance. In a typical policy response, the domestic currency might be depreciated to maintain international competitiveness, but each successive depreciation would raise import prices resulting in "imported inflation,". In addition, export competitiveness too would be affected as the import content of many exportable goods is normally high. Furthermore, a persistently high rate of inflation would cause potential foreign investors to shy away, particularly in the case of foreign direct investment, because of risks associated with exchange rates and investment projects, and capital outflows will have further adverse consequences for balance of payments and macro-economic stability.

While many complex factors have contributed to the sustained rise in the price level in recent years, the high level of aggregate demand stemming from a large fiscal deficit, and a rapid growth in monetary aggregates have been the prime causes in sustaining price pressure in the economy.

The forgoing analysis would show that a tight monetary policy stance with restraint on domestic credit is a necessary condition in containing inflation, but not a sufficient condition, unless accompanied by strong fiscal restraint. For a durable solution, appropriate macro-economic management with a low fiscal deficit has become an inescapable necessity particularly in the context of large capital inflows. First, fiscal restraint will reduce aggregate demand and reduce domestic inflationary pressure. Second, the reduction in government expenditure and re-composition of such expenditure to improve productivity of public expenditure will ease pressure on prices. Third, lowering the buget deficit will reduce demand for domestic borrowing thereby easing pressure on interest rates and inflation and will release resources for private sector investment. All in all, a tight fiscal policy appears to be the only means of controlling inflation and maintaining a low interest rate that will maintain the desired saving-investment levels in the current context in the country.

Strong fiscal and monetary restraint together with structural reforms, particularly trade and financial sector reforms, are needed to curb inflationary pressures in the economy on a sustainable basis. To maintain the present high growth momentum a range of policy measures including tariff and financial sector reforms and removal of various bottlenecks in production and distribution are necessary to improve the allocative efficiency of the market mechanism. Moreover, it requires the management of aggregate demand through an appropriate fiscal and monetary policy mix in order to keep demand in line with domestic supply conditions. In this context, the short term corrective measures have to be viewed in a medium term framework. In sum, the use of a credible and well co-ordinated fiscal and monetary policy stance to counter the continuing build up of inflationary pressure is an inescapable necessity, if Sri Lanka is to consolidate the gains from recent economic reforms and bolster support for the on-going policy reforms, and sustain high growth momentum in the period ahead.