1. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES

1.1 Overview

The Sri Lanka economy displayed considerable resilience under difficult circumstances in 1996, when it recorded a growth rate of 3.8 percent. A prolonged drought, the most severe since 1987, depressed agriculture by 4.6 per cent. It also affected the largely hydro-based supply of electricity, despite efforts to acquire new thermal capacity. The problems were compounded by a few incidents of urban terrorism, which appear to have affected business confidence. Nevertheless, the industrial sector showed healthy growth. So did the financial, communications and transport sectors. It was encouraging to note that the economy showed clear signs of recovery towards the end of the year.

Largely reflecting the drought-induced shortages in food commodities and world price increases, consumer prices, as indicated by available indices, increased by 14 - 16 per cent, whereas the overall price level, as indicated by the Gross Domestic Product (GDP) deflator, showed an increase of 12 per cent. In addition to a liquidity over-hang from 1995, monetary expansion remained high during the first half of 1996 owing to continued high credit growth to both the Government and the private sector. However, there was a substantial deceleration in money growth towards the end of the year, to 11 percent, due to the slowing down of private credit growth and stringent monetary policy. Despite the increase in security-related expenditure, an escalation in the cost of subsidies and a shortfall in privatisation proceeds, the overall budget deficit was contained at 7.8 per cent of GDP.

After slowing down in the first half of the year, exports and imports picked up during the second half. For the year as a whole, exports grew by 13 per cent and imports by 7 per cent, resulting in a reduction in the trade deficit to 9.5 per cent of GDP. This was largely due to an improvement in tea prices, as real exports grew only by 4 per cent. The current account deficit of the balance of payments declined by 1 percentage point to 3.9 per cent of GDP in 1996. However, the overall balance of payments registered a deficit of SDR 63 million, largely reflecting lower official capital inflows. Towards the latter part of the year, private foreign investment recovered significantly, though remaining relatively small compared to past inflows.

TABLE 1.1
Selected Macroeconomic Indicators

Item	1995(a)	1996(a)	1987-91 Avg.	1992-96 Avg.(a)	1995(a)	1996(a)
	Rs. Million		Percentage Change			
GDP at Current Factor Cost Prices	598,327	695,934	15.7	15.6	14.3	16.3
GDP at 1982 Factor Cost Prices	167,953	174,261	3.5	5.2	5.5	3.8
GNP at 1982 Factor Cost Prices	165,897	171,056	3.5	5.3	6.0	3.1
GDP (Real) Per Capita	9,273	9,515	2.1	3.9	4.0	2.6
			Per cent of GDP			
Gross Domestic Investment	171,825	186,264	22.6	25.4	25.7	24.2
Government	23,645	25,618	5.1	3.5	3.4	3.3
Private	148,180	160,646	17.5	21.9	22.2	20.9
Gross Domestic Savings	102,111	119,260	12.8	15.4	15.3	15.5
Foreign Savings	69,714	67,004	9.8	10.0	10.4	8.7
Foreign Direct Investment Inflows (Net)	2,931	6,606	0.6	1.1	0.4	0.9
Official Loans and Grants (Net)	32,106	20,989	6.7	4.0	4.8	2.7
Other (b)	34,677	39,409	2.5	4.9	5.2	5.1
National Savings	129,973	147,552	15.2	19.2	19.5	19.2
of which Net Foreign Investment Income	-6,958	-11,154	-2.2	-1.4	-1.0	-1.5
Worker Remittances (Net)	34,820	39,485	4.6	5.2	5.2	5.1
GDP Deflator (1982=100) (c)	356	399	11.8	9.9	8.4	12.1
Population ('000) (c)	18,112	18,315	1.4	1.2	1.4	1.1

Source: Central Bank of Sri Lanka

(a) Provisional.
(b) Includes net private medium-term and long-term loans, all net short-term capital and change in net foreign assets.
(c) The last four numbers are percentage changes.

Reflecting the higher domestic inflation and the weakening balance of payments, the Sri Lanka rupee depreciated by about 5 per cent. The foreign exchange and money markets became more stable during 1996 largely owing to improved economic management.

With the presentation of the 1997 Budget, the Government re-affirmed its commitment to promote private sector led non-inflationary growth within a medium-term fiscal consolidation framework. It was evident that the persistent fiscal deficit was largely structural in character and a commitment was made to undertake the necessary structural reforms. These reforms entailed a reform of the public sector, a widening of the tax base, a reduction of public debt, a streamlining of the financial sector and a liberalisation of the labour market. The overall objective was to reduce the size of government and to give full encouragement to the private sector, while protecting the welfare of the most vulnerable groups. It was felt that these reforms were essential for creating conditions conducive to sustained non-inflationary growth with progressive reduction in unemployment and reduction in poverty. Needless to say, the success of these policies would depend considerably on the progress achieved towards a settlement of the costly conflict in the North and the East.

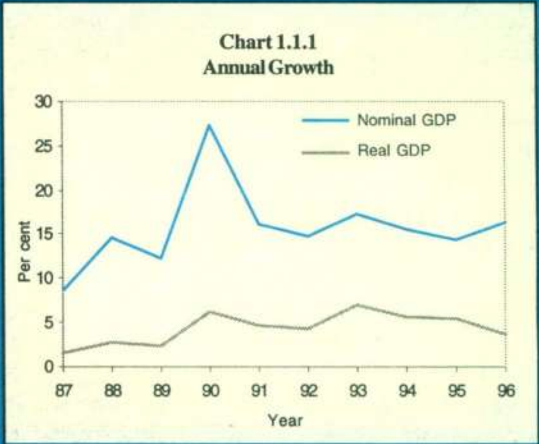
In the context of these developments, the Central Bank was considering some relaxation of monetary policy with a view to ensuring that sufficient financial resources would be available to finance economic recovery, without compromising stabilisation objectives.

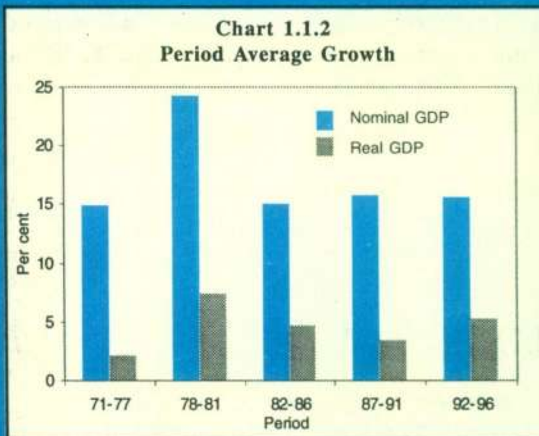
1.2 Real Sector Developments

Economic Growth

The economic performance in 1996 reflected the resilience of the Sri Lanka economy. The real GDP increased by 3.8 per cent, as agricultural and industrial activities recovered steadily from the depressed conditions experienced in the first part of the year due to the drought and power cuts. The economy regained its growth momentum significantly towards the end of the year. The country's economic structure has undergone considerable diversification during the past two decades, benefitting from progressive economic liberalisation. However, the vulnerability of the domestic economy to natural hazards such as the recent drought remained high due to its heavy dependence on hydro power for electricity generation. The power cuts in 1996 clearly demonstrated that there is an urgent need to develop the country's basic economic infrastructure if it is to achieve the high growth rates experienced by fast growing countries in East Asia. Despite this weakness, the country's open trade and payments policy regime helped to minimise output losses and prevented a sharper increase in prices, as it facilitated the recovery process through the system which was already in place for the importation of urgently required capital goods and food commodities, without delay.

Chart 1.1
Income Growth





The GDP at market prices increased by 15.1 per cent to reach Rs.768,934 million. With a mid year population of 18.315 million, this indicated a per capita nominal income level of Rs.41,984 (US dollars 760) in 1996. When this is adjusted for net foreign factor income, the per capita national product would be US dollars 753. The World Development Report 1996 of the World Bank has taken US dollars 725 as the cut-off per capita income level in 1994 for a country to be classified as a middle income developing country. Therefore, in terms of per capita income, Sri Lanka has reached the threshold to become a middle income developing country in the near future. This

TABLE 1.2
Gross National Product at Constant (1982) Factor Cost Prices (Annual Percentage Change)

		1987 to 1991	1992 to 1996	1987	1995	1996
1	Agriculture, Forestry and Fishing	1.1	1.1	-5.8	3.3	-4.6
	Agriculture	0.9	0.9	-8.1	3.3	-5.1
	Tea	2.9	3.0	1.0	1.6	5.1
	Rubber	-5.1	2.4	-10.6	0.9	6.3
	Coconut	-4.7	3.5	-24.6	5.1	-7.6
	Paddy	-0.6	-1.9	-18.0	4.7	-26.7
	Other	4.2	1.7	1.7	2.6	3.5
	Forestry	1.8	0.9	13.1	1.2	1.3
	Fishing	3.8	2.7	3.8	4.9	-3.9
2	Mining and Quarrying	6.5	4.8	19.0	3.4	8.9
3	Manufacturing	6.4	8.8	6.8	9.2	6.5
4	Construction	2.0	5.8	1.8	4.9	3.4
5	Electricity, Gas and Water	5.1	7.1	3.0	10.2	-2.0
6	Transport, Storage and Communication	3.1	5.4	1.2	5.5	7.5
7	Wholesale and Retail Trade	3.7	5.8	2.8	3.6	5.2
8	Banking, Insurance and Real Estate	5.7	9.4	6.1	10.5	10.1
9	Ownership of Dwellings	1.5	1.2	1.5	1.3	1.3
10	Public Administration and Defence	3.7	3.8	3.1	5.4	5.0
11	Services (n.e.s.)	4.8	3.9	2.7	4.5	4.0
12	Gross Domestic Product	3.4	5.2	1.5	5.5	3.8
13	Net Factor Income from Abroad	2.2	6.1	-3.0	23.8	-55.9
14	Gross National Product	3.5	5.3	1.6	6.0	3.1

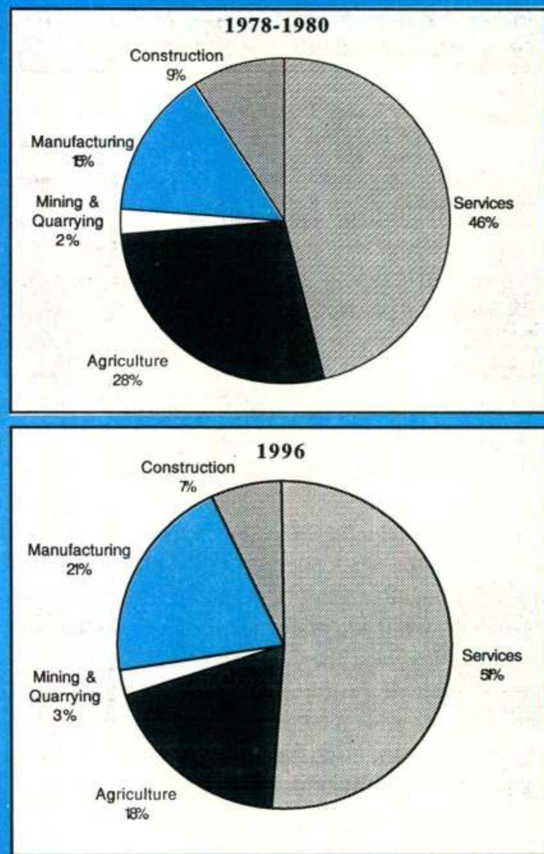
Source: Central Bank of Sri Lanka

factor, as well as the diminishing prospects for highly concessional aid from multilateral lending institutions, calls for an early preparation for a gradual reduction in the access to such concessional assistance, which implies that Sri Lanka would have to rely more on other options such as foreign direct investment and medium and long-term funds raised in the international capital markets to fund its future investments.

The Gross National Product (GNP) increased by 3.1 per cent in real terms in 1996 as there were higher net investment outflows (the sum of profits and dividends and net interest earnings). When this is adjusted for population growth of 1.1 per cent, the per capita real GNP increased by 2.0 per cent in 1996, compared with 4.5 per cent in the previous year.

As in 1995, the highest contribution to the growth in real GDP came from the Manufacturing sector. This sector contributed 36 per cent to economic growth in 1996, compared with 33 per cent in 1995. The Services sector including utility services, contributed to 77 per cent of GDP growth in 1996, compared with 47 per cent in 1995, reflecting the growth in transport and communication services (22 per cent) and financial services (16 per cent). The Mining and Construction sectors contributed about 6 per cent each to GDP growth in 1996, with the Mining sector making a greater contribution compared to the previous year. The Agriculture sector's contribution to real GDP growth was negative 25 per cent.

Chart 1.2
Sectoral Composition of GDP



The Manufacturing sector, which grew at about the same rate (1.3 per cent) as the Agricultural sector (1.4 per cent) during the 1971-77 period on an annual average basis,

TABLE 1.3
Gross Domestic Product
(Sector Shares as Percentage of GDP) (a)

		1978	1987	1996
1	Agriculture, Forestry and Fishing	28.7	23.6	18.4
2	Mining and Quarrying	2.5	2.7	2.5
3	Manufacturing	15.3	16.2	21.0
4	Construction	8.3	7.2	6.9
5	Services	45.3	50.3	51.2
	Electricity, Gas and Water	0.9	1.2	1.4
	Transport, Storage and Communication	11.0	11.7	11.6
	Wholesale and Retail Trade	19.3	21.1	21.7
	Banking, Insurance and Real Estate	3.0	4.7	6.1
	Ownership of Dwellings	3.5	3.1	2.3
	Public Administration and Defence	3.0	4.7	4.3
	Services, (n.e.s.)	4.6	3.8	3.7
6	Gross Domestic Product	100.0	100.0	100.0
7	Net Factor Income from Abroad	-0.4	-2.3	-1.8
8	Gross National Product	99.6	97.7	98.2

(a) 1982 base

Source: Central Bank of Sri Lanka

gradually overtook the growth rate of the Agricultural sector and emerged as the lead sector of the economy. During the five years from 1992 to 1996, Manufacturing sector output had grown by 8.8 per cent, compared with 1.1 per cent growth in Agriculture output.

Agriculture

The Agriculture sector suffered most from the drought. Consequently, the real value added declined by 4.6 per cent in 1996, in contrast to an annual average growth rate of 2.4 per cent during the 1991-95 period. This was the lowest growth in the Agriculture sector since 1987, a year in which drought conditions had a similar impact on agriculture. In that year agricultural output had declined by 5.8 per cent, depressing the overall economic growth rate to 1.5 per cent.

The 1996 drought affected mainly the domestic agricultural output and coconut in the plantation sector. Tea production, after a record output in 1995, rose further by 5 per cent, while tea prices increased by 44 per cent to reach record levels at the Colombo Auctions. Attractive prices, enhanced productivity of smallholders and improved efficiency of certain privately managed plantations were the contributory factors for this increase in output. Rubber production recorded a 6 per cent increase. Rubber prices too remained attractive. Coconut production declined by 7.6 per cent.

The paddy sector, which was hard hit by the drought, registered a 27 per cent drop in output, while prices increased by 31 per cent. Almost all paddy growing districts experienced crop damage. The worst affected were Kurunegala, Anuradhapura and Polonnaruwa. With a sharp drop in the extent sown, credit granted to farmers under the New Comprehensive Rural Credit Scheme (NCRCS) also dropped from Rs.792 million during the previous year to Rs.396 million in 1996. The open market price of paddy remained well above the guaranteed price of Rs.155 per bushel (Rs.7.42 per Kg.). The Paddy Marketing Board was virtually inactive as it could purchase only 1,000 metric tons compared to 282,000 metric tons in the previous year. The country had to import 341,000 metric tons of rice, the highest amount of imports since 1977. With a view to relieving the burden on consumers and facilitating imports, the import duty on rice was waived from April 1996.

The performance of other field crops was mixed with some items such as potatoes, cowpea and green gram showing higher production levels while some others showed production declines. Sugar production increased by 3 per cent. Value added in other agriculture, including animal husbandry, grew by 3.5 per cent, mainly reflecting the increased output of vegetables and minor export crops. There was an increase in aquaculture fish production, but due to the decline in marine fish output, total fish production declined by 4 per cent.

Mining and Quarrying

Real value added in Mining and Quarrying rose by 8.9 per cent, compared with 3.4 per cent in 1995. Gem mining, which has the largest share in this sector, has performed well during this year. Gem exports in SDR terms increased by 16 per cent. Graphite and mineral sands also performed well.

Manufacturing

Within the Manufacturing sector, factory industries has been the most dynamic sub sector, followed by small scale industries. During the five years ending 1996, factory industries had grown by about 10 per cent per annum, while small industries had grown by about 6 per cent. The sub sector which is involved in the processing of plantation crops has been volatile, in line with the production trends in the three major crops. In 1996, the value addition in factory industries grew by 7.3 per cent, and contributed to more than 90 per cent of the growth of the Manufacturing sector. The processing of non-plantation products has also been gaining momentum. Some of these industries, such as fruit processing, have developed very high standards. As in the past, the growth of manufacturing industries in 1996 has been export driven.

Manufacturing output grew by 7.3 per cent in 1996 despite the adverse impact of the prolonged power cuts. The comparable growth rate in 1995 was 10.2 per cent. The measures put in place to encourage private sector power generation by way of import duty concessions and special credit facilities through the National Development Bank and the Development Finance Corporation to import power generators and by the provision of indirect subsidies through the purchase of electricity generated by the private sector to the national grid at a premium, helped to minimise the loss of industrial output due to power cuts. The growth in industrial output in 1996 was mainly attributed to a 10 per cent increase in manufacturing output in the Export Processing Zones (EPZ) which were least affected by power cuts. Output of other industries increased by 3.7 per cent in 1996. The uninterrupted operation of the state-owned petroleum refinery and a moderate growth of industrial production in private sector industries outside the EPZ also made a positive contribution to the overall growth of industrial output. Factory industries, which accounted for 83 per cent of total manufacturing output, contributed 33 per cent of the economic growth in 1996. Small and medium scale industries, which tend to be under counted, increased by 6.3 per cent.

A marked increase of realized investment in the enterprises registered under Section 17 of the Board of Investment (BOI industries) contributed substantially to the expansion of export oriented industries. The expansion of export oriented industries was also supported by the increased demand in the U.S.A and other western countries, although the full benefit could not be reaped due to the temporary production dislocations experienced in 1996. The moderate depreciation of the Sri Lanka rupee also helped the export sector. Labour unrest in 1996 was less compared to the previous year. Lack of industrial infrastructure facilities continued to be a major barrier for faster growth of the industrial sector.

The textile, wearing apparel and leather products category grew in real terms by 5.1 per cent in 1996, compared with 14.8 per cent in 1995. This category, in the case of BOI industries, increased by 6 per cent, while the increase in the case of non-BOI industries was 1.7 per cent. Although showing a slower growth in 1996, this category still accounted for 39 per cent of total industrial production and contributed 34 per cent of the growth in private sector industrial output.

The food, beverages and tobacco category grew by 6.9 per cent in 1996 and contributed 27 per cent of the growth in private sector industrial output. The output of processed tobacco and cigarettes, CTC (cut, tear and curl) teas and tea bags, beer and liquor, dairy products, processed coconut and meat products recorded positive growth rates. Tobacco production increased by 5.7 per cent despite the higher taxes on cigarettes. The lowering of excise duties on beer in November 1995 pushed up domestic demand and raised domestic production by 70 per cent. The tea processing industry grew in 1996 reflecting an increased level of production as well as higher prices. The meat products sector, which experienced a production loss during the period of power cuts, recovered fully during the second half of the year. The output of processing wheat flour dropped due to a relatively lower volume of imports compared to 1995, in which year domestic demand for bread was higher due to the large subsidy element in price.

The value of production in the private sector chemical category grew by 14.2 per cent in 1996 reflecting the increased output of BOI industries. The non-metallic mineral products category achieved a 6.7 per cent growth in 1996 reflecting the higher output growth in glazed ceramic tiles, porcelain figurines, terra-cotta items, processed silica quartz and granite slabs. The output levels of ceramic tiles and other ceramic products, roofing products and cement also rose in 1996 to meet the increased demand from the domestic construction industry.

While the production capacity of the non-BOI industrial sector increased by 2 per cent, the capacity utilization ratio declined slightly from 84 per cent in 1995 to 83 per cent in 1996, mainly due to power cuts.

The average factory profit ratio (profit as a ratio of total cost of production) of the non-BOI industrial sector declined from 16.2 per cent in 1995 to 14.7 per cent in 1996 reflecting an 18 per cent increase in the cost of production and a 17 per cent increase in ex-factory value of production. The profitability varied from 10 to 23 per cent across the industries. The textile, wearing apparel and leather product category showed the highest profit ratio of 23 per cent, though this was slightly lower than the 24 per cent of 1995.

Labour productivity in non-BOI industries is estimated to have decreased by 1.1 per cent in 1996, as employers maintained employment at the maximum possible levels, despite the interruption of production due to power cuts. While the growth of real value added in non-BOI industries declined to 7.3 per cent from 10.2 per cent in 1995, the number of employees declined only by 1.7 per cent, thus resulting in a reduction in labour productivity.

Construction

The Construction sector expanded by 3.4 per cent compared with 4.9 per cent in 1995. This was partly reflected in the slowing down of public investment due to implementation delays and reduction in private sector investment activities. Estimates on the availability of basic inputs such as cement and asbestos confirmed the lower growth in the Construction sector. There was some evidence to indicate that the investment activities recovered in the latter part of the year.

Services

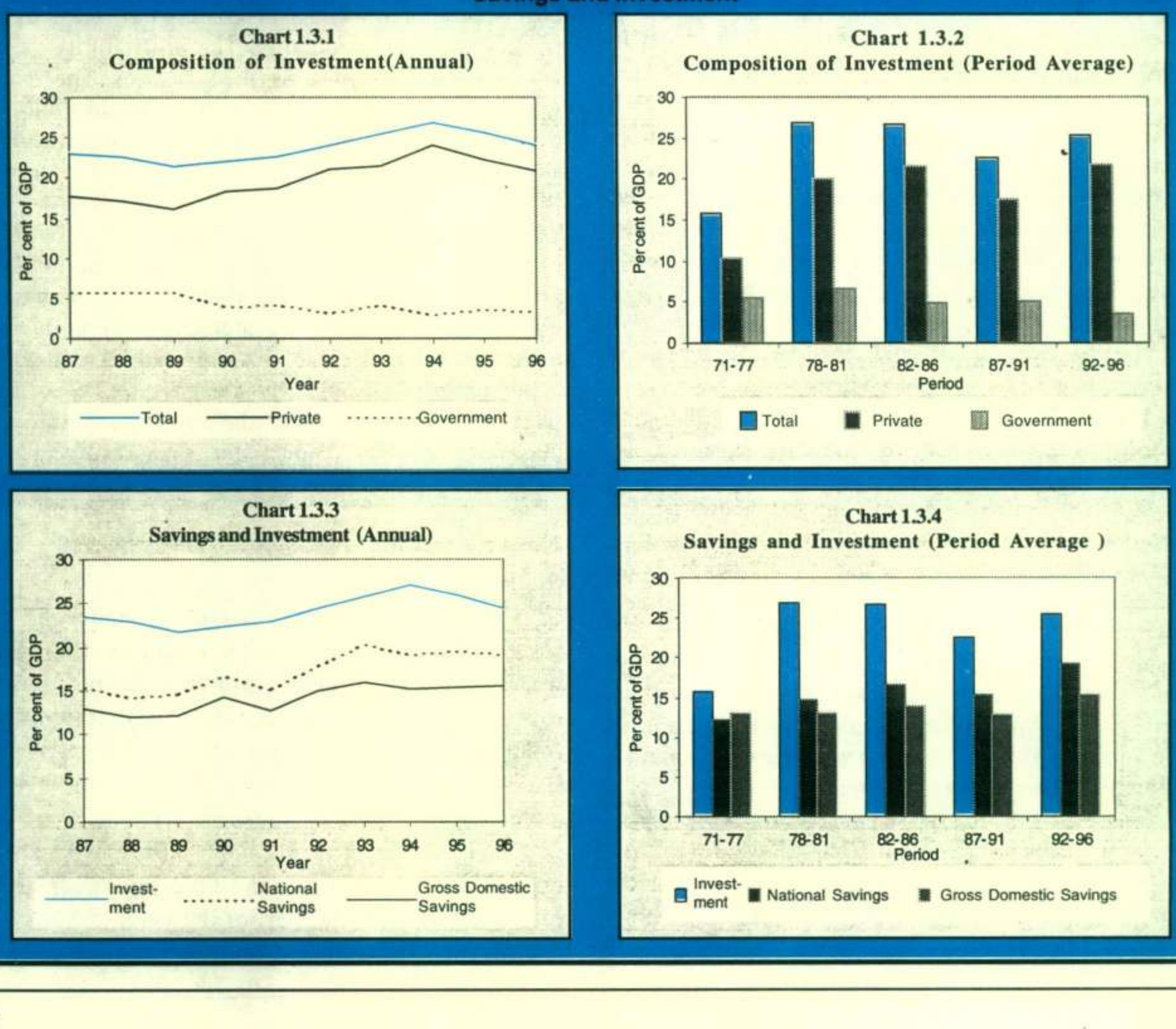
Value added in the Electricity, gas and water supply services sector declined by 2 per cent mainly owing to a 28 per cent drop in hydro power generation. The decline was partly off-set by additional thermal power generation and the encouragement of self-generation of power through the attractive incentives mentioned earlier. Communication services recorded a 25 per cent increase reflecting the rapid growth of various types of telecommunication services such as cellular mobile phones, wireless access telephones, data communication services, public pay-phones and Internet facilities. This is a potentially high growth sector. The transport sub sector as a whole reflected a growth rate of 4.7 per cent.

The Banking and insurance sector has been one of the dynamic sectors in the recent past. This sector achieved a growth rate of 10.1 per cent as in the previous year. The relative size of this sector has expanded from 3.2 per cent of GDP in the early 1980s to over 6 per cent in 1996. The insurance sub-sector grew by 9.5 per cent in 1996. The slowing down of the economy generally affected both sectors.

Investment and Savings

In 1996, Sri Lanka's investment activities remained depressed due to the uncertainties created by the drought and power cuts and the slowing down of public investment. Investment activities in the non-BOI sector started picking up in the second half of the year. This was indicated by the growth in the imports of investment goods. There was a marginal decline in gross domestic capital formation from 25.7 per cent of GDP in 1995 to 24.2 per cent of GDP. The decline in investment was larger in the private sector due to a tendency to delay investments owing to uncertainty. However, direct foreign private investment increased, but remained small (3.7 per cent of total investment or 0.9 per cent of GDP).

Chart 1.3
Savings and Investment



The Gross Domestic Savings ratio increased marginally from 15.3 per cent in 1995 to 15.5 per cent in 1996. The Government's dissavings increased as reflected in an increase in the current account deficit from 2.7 per cent to 3.2 per cent. Private sector savings relative to GDP increased in 1996 due to higher corporate savings, mainly in the plantation sector.

Prices

In 1996, the general price levels increased sharply owing to temporary supply shortages of domestic food items due to the drought, corrective upward adjustments of administered prices of wheat flour, fuel including kerosene, electricity and transport fares, increased import prices, increased cost of production due to higher wages in some sectors and higher energy costs.

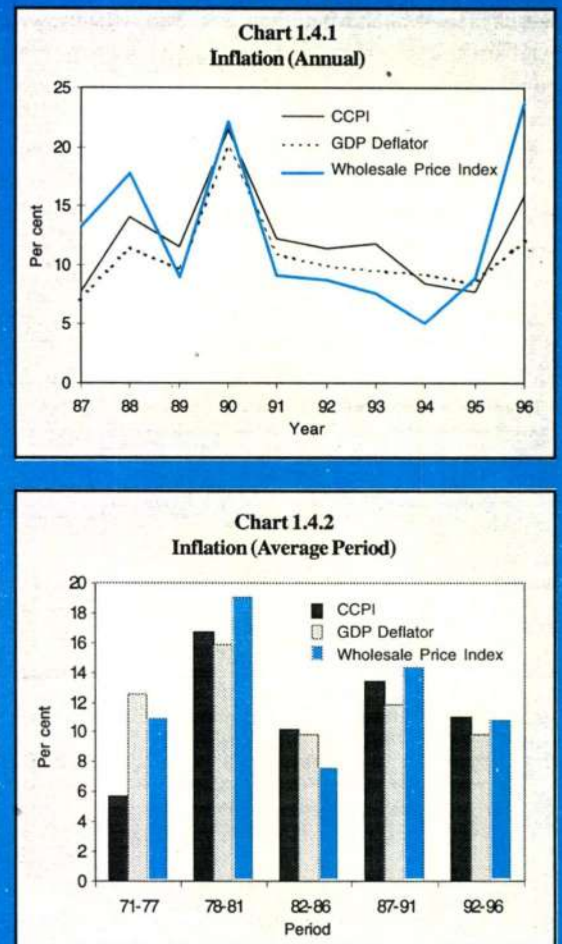
The Colombo Consumers' Price Index (CCPI), reflecting the living standards of workers in the Capital, indicated an annual average inflation rate of 15.9 per cent compared with 7.7 per cent in 1995. The other available price indices also indicated a similar trend. The rise in food prices accounted for more than 80 per cent of the increase in the CCPI. In addition, a sharp increase in the average international price of wheat compelled the Government to raise the domestic price of wheat flour to reduce the strain on the budget. These changes contributed to a 2.2 percentage point increase in the CCPI.

The Greater Colombo Consumers' Price Index (GCPI), which has a wider area coverage, indicated a similar trend as the CCPI, increasing by 14.7 per cent in 1996. The Wholesale Price Index (WPI) increased by 20.5 per cent during the year. The higher rate of increase in the WPI compared with the consumer price indices was mainly attributed to the increases in export prices. The GDP Deflator (GDPD), which has the widest coverage of goods and services, had risen by 12.1 per cent in 1996.

If the corrective price adjustments had not been made, the immediate increase in prices would have been much less. However, in that situation, the Government would have been compelled to resort to expansionary financing to meet the additional cost of the wheat flour subsidy. This would have led to a further build up of inflationary pressure in the economy, thus complicating macroeconomic management. The increases in administered prices contributed to 29 per cent of the increase in CCPI.

Import duty concessions on sugar, rice and edible oil and removal of licensing on potatoes, onions and chillies were granted to improve the supply situation and reduce the inflationary impact of the drought. Meanwhile, the sharp deceleration in the rate of monetary expansion during the second half of the year eased the demand pressure on prices considerably. Price levels, which peaked in September, declined sharply in the last quarter. All price indicators reflected this decline. The point to point inflation, as reflected in the CCPI, dropped from 21.5 per cent in September 1996 to 16.8 per cent by December.

Chart 1.4
Changes in Prices

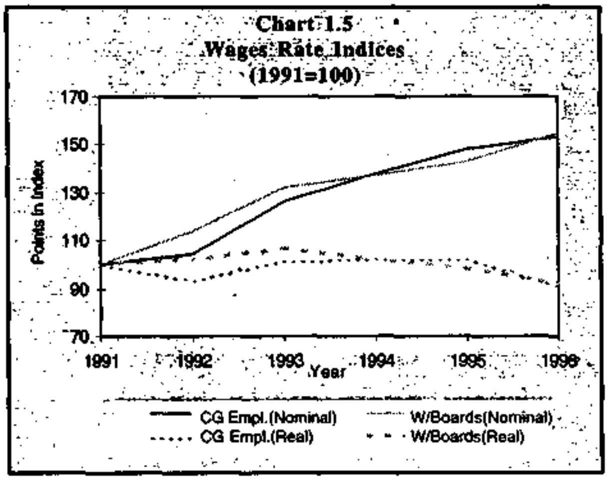


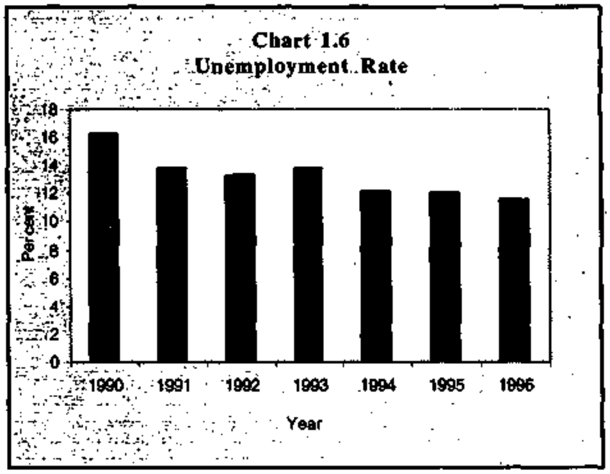
Wages

The average nominal wages of all categories of employees increased over the 1995 levels, except in the case of government teachers, whose wages were increased by 28 per cent in 1995. However, some of the gains were lost owing to higher inflation. Wages for public sector employees remained unchanged in 1996. In the organised private sector, wages of plantation workers were revised upwards. There were also wage increases in the Match Manufacturing, Paddy Hulling and Journalism trades. In the unorganised sector nominal wage increases were sharper.

With the above revisions, wages for workers in the organised private sector, as measured by the Minimum Wage Rate Index for Workers in All Wages Boards Trades, increased on average by 8.3 per cent in nominal terms in 1996. Wages for workers in agriculture rose by 9.3 per cent reflecting the increase in wages of plantation workers. Wages for workers in industry and commerce rose by 4.8 percent during the year. Nominal wages for workers in services rose by 6.7 per cent in 1996.

Employment generation in 1996 was largely constrained by the slowing down of economic activities in mid 1996. During the previous five years, employment opportunities rose annually by 1.7 per cent with an annual average GDP growth rate of 5.5 per cent, thus indicating that economic growth of at least 3.5 - 4.0 per cent is required to increase employment opportunities by 1 percentage point. In 1996, with a moderate economic growth rate of 3.8 per cent, it is estimated that the economy generated about 75,000 new employment opportunities compared with an annual average of about 90,000 during the previous five years. Total employment generation was largely attributed to the expansion in activities in the private sector, as the relative size of the government sector has become significantly smaller. BOI industries contributed to about 11 per cent of this increase.





According to provisional data on small scale construction received from the Country Wide Data Collection System of the Central Bank, wages of carpenters and masons increased by 14 to 15 per cent, while those of their unskilled helpers rose by 13 per cent. Wages in tea, rubber and coconut cultivation increased by 8 to 10 per cent. Wage increases for most activities in the paddy sector were between 6 and 13 per cent.

Labour Force and Employment

With a population of 18.315 million in 1996, Sri Lanka had a labour force of around 6.2 million (3rd Quarter 1996). Of this total labour force, 5.5 million or 88 per cent were employed. The labour force participation rate, which is the working age population actively seeking employment, as a percentage of the total population, was estimated at 48.6 per cent.

According to the estimates of the Department Census and Statistics, the rate of unemployment had declined to 11.6 per cent in the 3rd Quarter of 1996. Growth of economic activities in the informal sector and the increased migration for foreign employment appeared to be the major factors which contributed to this decline.

According to the Sri Lanka Foreign Employment Bureau (SLFEB), a total of 162,511 persons have departed for employment overseas in 1996. Although this indicates a decline compared to the figure of 170,130 reported in 1995, the actual number may have been higher because the registration scheme operated by the SLFEB was made voluntary in 1996. There has been a gradual decline of migration to the Middle East, while the Maldives, Singapore, Hong Kong and Italy have grown in importance as sources of demand for foreign labour.

The unemployment rate is unlikely to increase from the present levels if the economy generates about 90,000 new employment opportunities per year during the next five years. However, this would imply an increase in the absolute number of unemployed to about 782,000 by the year 2001. The objective is to reduce the rate of unemployment significantly. If the unemployment rate is to be brought down to about 6 per cent, the economy will have to generate about 158,000 new employment opportunities annually. On the basis of the current rate of labour absorption capacity (i.e. 1.0 per cent increase in employment for every 3.7 per cent increase in economic growth), an annual real GDP growth rate of 7 per cent would be required to reduce the rate of unemployment to about 6 per cent by the year 2001.

1.3 Fiscal Policy and Budgetary Operations

The fiscal strategy of the Government is aimed at moving to a sustainable budget deficit reduction path within a medium-term fiscal consolidation framework to provide the basis for private sector led non-inflationary economic growth with external viability. The experience in the two previous years has been somewhat disappointing. In terms of the deviation of the realised budget deficit from the targetted deficit, there was a fiscal slippage of 3.2 per cent of GDP in 1994 and 2.1 per cent in 1995. The 1996 Budget anticipated significant progress in fiscal policy reforms and a reduction in the budget deficit to 6.6 per cent of GDP (7.8 per cent before grants). The deficit was expected to be financed through non-bank sources. Some progress was made on the fiscal policy front in 1996. The realised overall fiscal deficit of 7.8 per cent of GDP (8.9 per cent before grants) was also lower than in 1995, but fell short of the 1996 budgetary expectation. This was mainly due to a sharp rise in defence expenditure, a steep increase in international wheat prices adding to the cost of the wheat flour subsidy, a shortfall in privatization proceeds and the adverse effects of the prolonged drought and the power cuts on government revenue. Total expenditure as a percentage of GDP declined to 27.9 per cent from 30.0 per cent in 1995, while total revenue decreased to 19.0 per cent from 20.4 per cent. Resource constraints on the domestic front and delays in project implementation, particularly in the areas of energy, telecommunication and water supply, reduced the inflow of foreign resources for budgetary purposes. Hence 82 per cent of the deficit was financed through domestic borrowings, including 21 per cent through bank financing. The 1997 Budget re-emphasized the need for urgent fiscal consolidation and has set a medium-term budget deficit target of 3.5 per cent of GDP (4.5 per cent of GDP before grants) for 1999. The overall deficit in 1997 is expected to be 6.1 per cent of GDP (7.3 per cent of GDP before grants).

There were clear indications of a major deterioration of the fiscal position in the wake of unexpected developments such as the increase in international wheat prices, escalation of defence expenditures and possible revenue shortfall due to the drought and the power cuts. The Government implemented several new revenue measures to arrest this situation. The excise tax on cigarettes and hard liquor was raised and non-priority expenditures were pruned. A courageous decision was taken to raise the administered price of wheat flour considerably during 1996, which raised the price of wheat flour by 42 per cent. In order to impose stricter fiscal discipline, the Government did not raise the Rs.125,000 million limit on the outstanding level of Treasury bills, although there was a need for additional domestic financing. With the corrective measures introduced during the year, the overall fiscal deficit was contained at 7.8 per cent of GDP, thus falling short of expectations in the original Budget for 1996 by 1.2 per cent of GDP.

TABLE 1.4
Summary of Government Fiscal Operations
(as per cent of GDP)

	1985	1990	1995	1996(a)
Total Revenue	22.4	21.1	20.4	19.0
Current Expenditure	20.1	22.3	23.1	22.2
Interest	4.6	6.4	5.7	6.0
Salaries and Wages	4.2	4.9	5.2	5.0
Defence	0.3	0.7	1.8	1.7
Non-Defence	3.9	4.1	3.4	3.3
Defence other than Salaries	2.5	1.4	4.6	4.0
Pensions	1.7	1.4	2.2	2.0
Capital Expenditure and Net Lending	14.0	8.7	6.9	5.7
Current Account Surplus / Deficit(-)	-2.2	-1.2	-2.7	-3.2
Budget Deficit (before Grants)	-11.7	-9.9	-9.6	-8.9
Budget Deficit (excluding Defence)	-8.9	-7.8	-3.2	-3.2
Primary Budget Deficit	-7.1	-3.5	-3.9	-2.9
Financing	11.7	9.9	9.6	8.9
Foreign (including Grants)	6.4	5.7	4.6	2.5
Domestic	5.3	4.2	5.0	6.4
of which: Banks	2.9	0.1	1.1	1.6

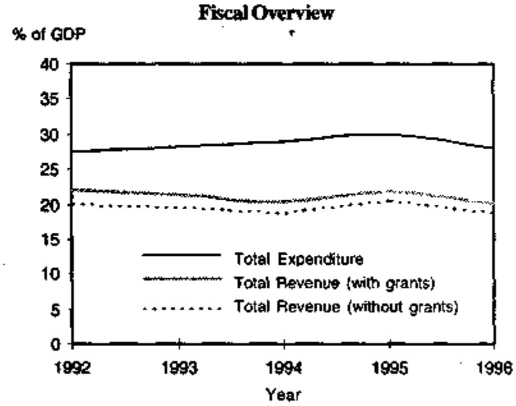
Source: Central Bank of Sri Lanka

(a) Provisional

The total revenue collection declined from 20.4 per cent of GDP in 1995, to 19.0 per cent of GDP in 1996, owing to a relatively lower level of taxable imports, a decline in the average rate of import duty due to various tax relief measures and exemptions granted, and a decrease in non-tax revenue collections. The measures taken to curtail wasteful expenditure were effective in containing the recurrent expenditure at around 22.2 per cent of GDP, compared with 23.1 per cent in the previous year. Thus, there was a current account deficit of 3.2 per cent of GDP in 1996.

Public investment dropped to 6.2 per cent of GDP, compared with the expected 7.5 per cent of GDP in the 1996 Budget, reflecting the underutilisation of foreign resources, mainly in the telecommunication and energy sectors. The net lending category did not show the anticipated inflow of 0.6 per cent of GDP. Instead, an outflow of 0.5 per cent of GDP was recorded due to slow progress in the privatisation programme. The containment of the budget deficit was achieved partly by a reduction in public investment by 1.3 per cent of GDP, which is not a desirable feature.

Chart 1.7
Fiscal Overview



Net foreign loans available for financing the budget deficit decreased from 3.2 per cent of GDP in 1995 to 1.4 per cent of GDP in 1996. The net utilisation of domestic resources increased from 5.1 per cent of GDP in 1995 to 6.4 per cent of GDP in 1996. It is important to note that, contrary to the expectation of a zero level of bank financing in the 1996 Budget, credit to government from the banking sector amounted to Rs.12,344 million in 1996. As a ratio of GDP, bank financing increased from 1.1 per cent in 1995 to 1.6 per cent in 1996. With the net new issues of Treasury bills amounting to Rs.11,225 million, the outstanding Treasury bill level reached its approved limit of Rs.125,000 million by October 1996. As this limit was not revised upward, the Government resorted to borrowing from public sector institutions and statutory funds. Such borrowings, including carry forward liabilities of Rs.2,715 million, amounted to Rs.10,363 million in 1996.

1.4 International Environment and External Sector Developments

International Economic Environment

World economic growth recovered during 1996 from 3.7 to 4 per cent. The country performances were mixed. Among the industrial countries, there was strong economic recovery in Japan and the USA, while all others recorded a slow-down. The governments were committed to price stability and inflation remained subdued. The economic growth of newly industrialised Asian economies moderated from a high level of 7.5 per cent in the previous year to 6.2 per cent in 1996. Meanwhile, growth picked up in the developing countries of Africa to nearly 5 per cent, while those of Asia recorded a moderate slowdown to over 8 per cent following on nearly 9 per cent growth in 1995. Output in the countries in transition in Central and Eastern Europe and Central Asia showed a positive, albeit small, growth for the first time, with some progress in their market reforms.

The overall growth in output took place against a background of lower inflation, declining interest rates and lower growth in volumes of world trade in goods and services, the latter indicating higher domestic consumption of the higher output. However, international prices of major commodities fluctuated during the year. In particular, fuel prices rose dramatically towards the end of the year, driven by strong demand, low stocks and supply shortfalls aggravated by the indefinite postponement of Iraqi crude oil exports under the United Nations Oil for Food Programme. Wheat and rice prices rose during the early part of the year and then declined, thereby recording higher average prices than in 1995, mainly driven by the supply situation. World sugar production improved, from the low levels of 1995, thereby leading to a drop in prices. Meanwhile, although global tea production had grown by around 4 per cent in 1996, international prices of tea rose significantly due to continued high demand from the Commonwealth of Independent States (CIS), which has emerged as the world's second largest consumer of tea. Demand for tea from the CIS is estimated to have grown dramatically in 1996. International prices of rubber fell from the exceptionally high levels of 1995 due to surpluses in major producing countries and slack demand. In contrast, international prices of coconut products rose dramatically, due to weather driven supply shortfalls in the Philippines, the worlds largest exporter of coconut products.

In 1996, exchange rate movements among key currencies partly reflected continued disparities in relative cyclical positions among major economies. The dollar strengthened against most major currencies, but weakened against the pound sterling. There was a global correction of the rapid appreciation of the Japanese yen and Deutsche mark in early 1995. Interest rates declined against a background of lower inflation and remained stable. Inflation declined among the industrial countries, developing countries and countries in transition, supported by appropriate tight monetary and fiscal policies in many countries.

As structural reforms continued in many developing countries, coupled with further liberalisation of their trade and payments systems, direct investment flows to these regions continued to grow. This was a positive development, especially in the aftermath of the Mexican financial crisis and in the context of an economic recovery in the USA and Japan. Meanwhile, the first inter-ministerial meeting of the World Trade Organisation (WTO) after its establishment in January 1995, was held in Singapore in December. The outcome of the meeting was considered unsatisfactory by developing countries as much time was spent on new issues raised by the developed countries, while inadequate time was allocated to items on the agenda relating to problems of implementation of agreements under the Uruguay Round (UR). In this context, there was concern that future WTO activities would be dominated by the developed nations, unless necessary action was taken to stem this unfavourable tendency at the outset.

These global developments, were, on balance, favourable to Sri Lanka's economic performance during 1996, which was beset by considerable hardship due to adverse weather conditions and internal security problems, unrelated to the international economic environment.

External Sector Developments

The external sector displayed considerable resilience during 1996. Exports grew by 13 per cent and imports grew by 7 per cent. Consequently, the trade deficit declined from Rs.77,435 million or SDR 997 million (11.6 per cent of GDP) in 1995 to a deficit of Rs. 72,731 million or SDR 909 million (9.5 per cent of GDP) in 1996. The services account, which had shown a surplus since 1993, registered a deficit of Rs.5,427 million (SDR 68 million) in 1996, mainly owing to a drop in earnings from tourism. Private transfers increased by 10 per cent. Thus, the current account of the balance of payments, aggregating trade, services and transfers, indicated a narrower deficit of Rs. 30,196 million or SDR 378 million (3.9 per cent of GDP) in 1996. In the previous year, the deficit amounted to Rs.32,957 million or SDR 425 million (4.9 per cent of GDP). Non debt creating capital inflows, namely direct investment including privatisation proceeds, showed a noteworthy improvement to Rs. 6,606 million (SDR 83 million) in 1996 after a setback in the previous year. However, net official capital inflows showed a notable decline. Overall, the balance of payments recorded a deficit of Rs. 4,148 million (SDR 63 million), which can be attributed to a reduction in official capital inflows.

The tea sector benefited from increased prices owing to the sustained high demand from the countries of the Commonwealth of Independent States (CIS). Global tea production is estimated to have risen by around 4 per cent in 1996. Demand for tea from the CIS had grown significantly in 1996. The terms of trade improved by 2 per cent reflecting mainly the high prices for tea and coconut products. In the area of industrial exports, owing to temporary supply dislocations experienced in 1996, Sri Lanka was not able to benefit fully from the recovery of economic growth in industrial economies in the West. Additional food imports, mainly rice, were necessary to fill the gap created by the domestic supply shortfall. There were higher petroleum imports to meet the increased demand for furnace oil and diesel to generate thermal power. The outlay on imports of generators in 1996 was estimated at SDR 43 million. Investment good imports, excluding aircraft imports by Air Lanka in 1995 and the generators in 1996, grew by 10 per cent in 1996.

Despite slow progress in the privatisation programme there was an inflow of SDR 23 million as privatisation proceeds in 1996, as in the previous year. Net private long-term loan capital dropped significantly from SDR 49 million to SDR 2 million due mainly to the increased repayments on account of past loans taken by Air Lanka for its refleeting programme without resorting to new borrowings and lower net inflows in the form of off-shore borrowing by Board of Investment (BOI) enterprises. Net official capital inflows were also lower in 1996.

In the exchange market, the Bank operated within a margin of 2 per cent between its daily buying and selling rates for the US Dollar, the intervention currency. The domestic exchange market was free and commercial banks were free to decide their own buying and selling rates. The Rs./US dollar rate mainly reflected the market trend, where the commercial banks preferred to absorb part of the exchange market pressure by allowing some depletion of their net foreign assets rather than trying to maintain their net foreign exchange balances by purchasing in the inter-bank market.

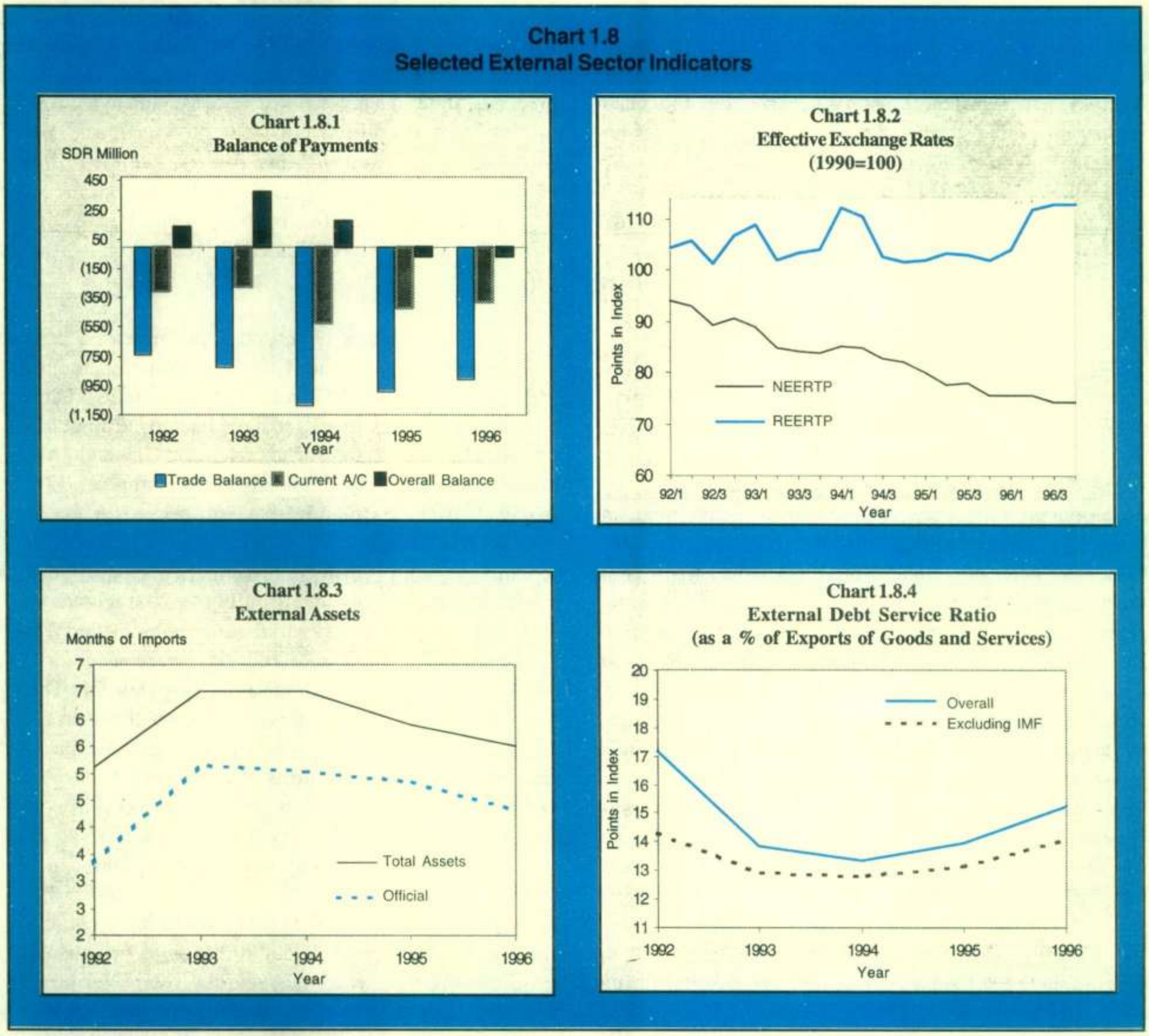


Chart 1.8
Selected External Sector Indicators

The international reserve position of the Central Bank also remained comfortable and the Bank did not have to consciously intervene in the market to defend reserves. This approach on the part of commercial banks as well as the Central Bank made the exchange rate an effective nominal anchor against inflation in a high inflationary situation in 1996, where a significant share of inflation was not a result of macro-economic imbalances, but a transitory phenomenon related to temporary supply dislocation.

As a concession to overcome the problem of rising food prices, a full duty waiver (35 per cent) for imports of rice was granted for a period of eight and a half months from 15 April 1996. Imports of generators were encouraged by granting a full duty waiver (10 per cent) for a period of 7 months from 1 June 1996. A duty waiver of 30 per cent was granted on edible oils and copra for a period of 7 months from 12 June 1996 to bring down edible oil prices and also to assist local industries in the wake of high international prices of coconut kernel products. Duty waivers were also granted on yarn and shrimp and poultry feed as a relief measure to local producers of textiles, shrimp and poultry.

In order to increase productivity in small and medium scale export industries and to enhance international competitiveness, it was proposed to provide an opportunity for small and medium scale exporters to benefit from the existing scheme of duty and tax exemptions on capital and intermediate goods which is presently available to exporters who export over 90 per cent of their production. Under this scheme, 100 per cent exemption from duty and taxes on capital and intermediate goods was granted to exporters who export over 50 per cent, and 50 per cent exemption for those exporting between 25 and 50 per cent of their total production.

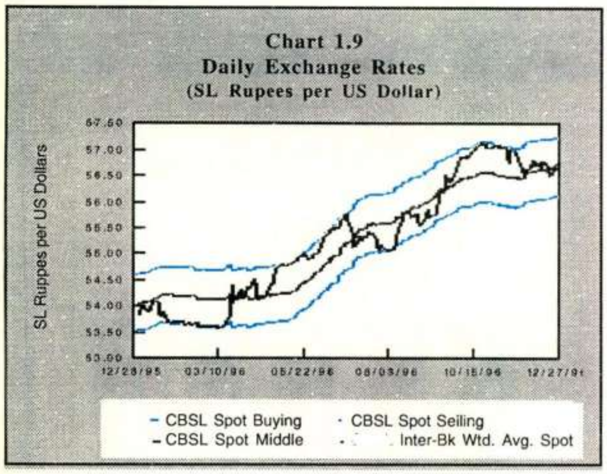


Chart 1.9
Daily Exchange Rates
(SL Rupees per US Dollar)

Following the announcement in the 1997 Budget, with a view to reducing interest rates and making more funds available to the private sector, a scheme was drawn up by the Central Bank to permit commercial banks to grant foreign currency loans, from the funds available in their Foreign Currency Banking Units and Domestic Banking Units, to exporters who have adequate foreign currency exposure to meet their working capital and fixed capital requirements. Indirect exporters approved by the Controller of Exchange were also eligible to receive foreign currency loans to finance their imports required to manufacture accessories supplied to exporters. This scheme became effective with the issue of operating instructions to commercial banks on 3 January 1997.

The external assets of the country declined by SDR 28 million during 1996. The level of gross external assets, which stood at SDR 1,701 million at end December 1996, was sufficient to finance about 5 months of imports projected for 1997. Debt service payments as a ratio of earnings from goods, services and private transfers increased from 11.9 per cent in 1995 to 13.0 per cent in 1996.

Meanwhile, preliminary discussions were held during the year with the International Monetary Fund (IMF) and the World Bank to agree upon areas for structural reforms to form the basis for a second arrangement under the Enhanced Structural Adjustment Facility to be concluded in 1997.

Tourism

The tourist sector, which suffered a major set back after the bomb attack in Colombo in January 1996, was recovering slowly toward the end of the year. However, tourist arrivals in 1996 dropped by 25 per cent to 302,265 in 1996. Consequently, the gross earnings from the tourist industry declined by 23 per cent from SDR 149 million (Rs. 11,569 million) in 1995 to SDR 115 million (Rs. 9,195 million) in 1996. Tourist arrivals increased by 12 per cent in December 1996.

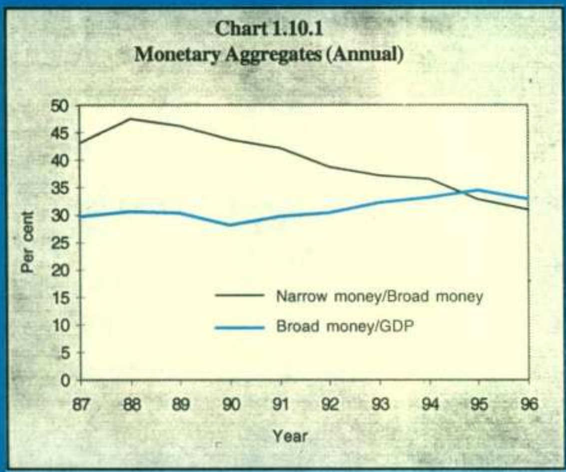
1.5 Monetary Sector Developments

Money Supply

Monetary expansion decelerated considerably owing to a slowing down of economic activity, greater caution exercised by banks in their credit operations, particularly during and in the aftermath of the drought and power cuts, and liquidity constraints faced by banks due to a rise in non-performing loans and the continuation of tight monetary policy. Central Bank credit to the Government rose sharply, reflecting the increased credit needs of the Government. Credit to the private sector decelerated sharply in the second half of the year. The growth of Broad Money (M2) declined to 10.8 per cent on a point to point basis at the end of 1996, compared with 19.2 per cent at the end of 1995. As in the previous year, the Narrow Money supply (M1) grew at a much lower rate of 4.0 per cent in 1996, compared with the growth of Broad Money. The increased sophistication of banking facilities, such as automated teller machines, credit cards and electronic banking, which tend to increase the liquidity of quasi-money, and greater prudence in the use of transaction balances by the public in an environment of high interest rates, were responsible for the slower growth of M1. The liquidity overhang (i.e. the growth of money in excess of the growth of nominal GNP) which arose towards the end of the previous year owing to excessive credit growth gradually dissipated during the second half of 1996.

Net domestic assets of the banking system increased by 18.1 per cent in 1996, compared with a much sharper increase of 27.4 per cent in 1995, mainly reflecting the slower growth of private sector credit. Bank credit to the private sector increased by 14.7 per cent, compared with 28.2 per cent in 1995. Increased expenditure on defence and the wheat flour subsidy, together with revenue shortfalls due to lower than expected privatisation proceeds, required the Government to resort to increased bank credit. Despite the increased financing needs, the Government did not raise the existing limit of Rs.125,000 million on the outstanding level of Treasury bills. This, together with improved government cash management and adjustments in administered prices, helped to contain the fiscal deficit as a percentage of GDP below the level of the

Chart 1.10
Monetary Aggregates



previous year. Nevertheless, net credit to the Government from the banking sector increased by Rs.12,344 million as against an increase of Rs.7,067 million in 1995. Of this increase, Rs.9,873 million came from the Central Bank. Even with this level of bank financing of the deficit, monetary conditions appeared too tight, particularly in a situation where the economy was recovering from the setback in mid 1996. This called for some relaxation of monetary controls, which became effective in early 1997.

The net foreign asset (NFA) position of the banking sector declined by Rs.4,671 million following an overall balance of payments deficit for the second successive year. The major portion of this decline was shown in the NFA position of commercial banks, which declined by Rs.4,156 million. The decline in NFA exerted pressure in the exchange market to some extent and the rupee depreciated by 5 per cent against the US dollar in 1996.

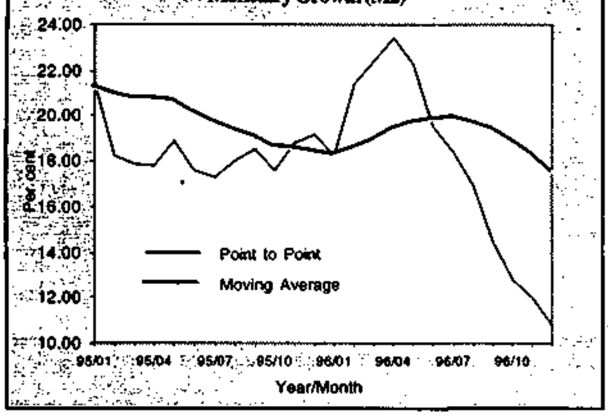
Reserve money (high powered money or monetary base) increased by Rs.6,922 million or 8.8 per cent in 1996, compared with an increase of Rs.10,532 million or 15.5 per cent in 1995. This slow growth in reserve money indicated a significant tightening of liquidity in the presence of an overall increase in net domestic assets of the banking system by 18 per cent. The liquidity tightness was manifested in a somewhat higher broad money multiplier, which remained around 3 during the second half of the year.

Monetary Policy

The Central Bank had to conduct monetary policy in an environment where the economy was experiencing a temporary slowing down in mid 1996. Increased demands for concessional credit were being made by firms which were adversely affected by the power cuts. There was also a continuation of a significant amount of liquidity overhang from the previous year. The Central Bank continued to give priority to the price stabilisation objective. The difficulties in implementing monetary policy in such circumstances were reduced by improved fiscal management where measures were put in place to contain the fiscal deficit by raising the administered price of wheat flour, bread and petroleum products, together with measures to reduce non-priority expenditure. The temporary supply dislocations consequent on the drought and power cuts, tended to raise prices. In view of the continued high rate of monetary expansion in the first three quarters of the year (which was above 20 per cent in terms of broad money) and rising prices, relaxation of monetary controls was not warranted until the underlying inflationary pressure abated.

The high statutory reserve requirements were maintained and moral suasion was used to advise commercial banks to reduce risky lending and consumption oriented credit. At regular monthly meetings with commercial bank managers, the Central Bank emphasised the importance of maintaining sound banking practices to ensure the stability of the financial system. Open market operations constituted the main instrument of monetary policy. When there were increased demands for subsidized credit in mid 1996 by firms which were facing liquidity shortages, the Central Bank used moral suasion to persuade banks to meet the temporary credit needs of their clients on a case by case basis, after rescheduling of such credit where necessary.

Chart 1.11
Monetary Growth (M2)



With increased government expenditure and a shortfall in privatization proceeds, the Central Bank had to accommodate part of the financing needs of the Government, and by December, net credit to the Government had risen by Rs.9,873 million. With the outstanding level of Treasury bills reaching the limit of Rs.125,000 million approved by Parliament, direct Government borrowing through the issue of new Treasury bills was constrained after August 1996. This limit on Treasury bills imposed some discipline on fiscal management in that it helped to curtail less productive expenditure and contain the fiscal deficit. In addition, it was one of the factors which helped to maintain interest rates on Treasury bills consistently below the levels in 1995. A part of the financing needs of the Government was met through administrative borrowings (i.e. direct use of excess funds of some public sector institutions).

Throughout the year, the Central Bank had a portfolio of Treasury bills sufficient to conduct open market operations (OMO). The Central Bank monitored money market developments continuously and adjusted interest rates applicable for repo and secondary market operations with a view to reducing the volatility of call market rates. For purposes of monetary control, the Statutory Reserve Ratio (SRR) was maintained at 15 per cent for all deposits, except foreign currency deposits placed abroad, for which the ratio was lower at 5 per cent.

With the reduction in the growth of monetary aggregates towards the end of the year and the gradual decline in price increases, financial and exchange markets became more stable. The volatility of short-term interest rates was reduced considerably. Deposit mobilisation by banks through time and savings deposits increased by 15 per cent. Non-resident foreign currency (NRFC) deposits increased by 16 per cent. As economic activities were recovering towards the latter part of the year and the inflationary pressure had significantly abated, the Bank was considering an appropriate relaxation of monetary policy, largely through a reduction of the statutory reserve requirement and permitting non-BOI exporters to obtain foreign currency loans. It was also felt that the progressive reduction of the SRR to a reasonable level would enable the Bank to resort to market related interventions, such as open market operations, to regulate money supply.

Interest Rates

Interest rates were generally lower in 1996 than in 1995, with less volatility. With an injection of liquidity into the system both through government operations and through the net inflow of foreign assets in the first few months, the short-term interest rates declined sharply early in 1996. Thereafter, with increases in government demand for credit and a deficit in the balance of payments, rates gradually picked up until mid November. A decline was again witnessed at the end of the year. The medium and long-term rates remained relatively stable during the year.

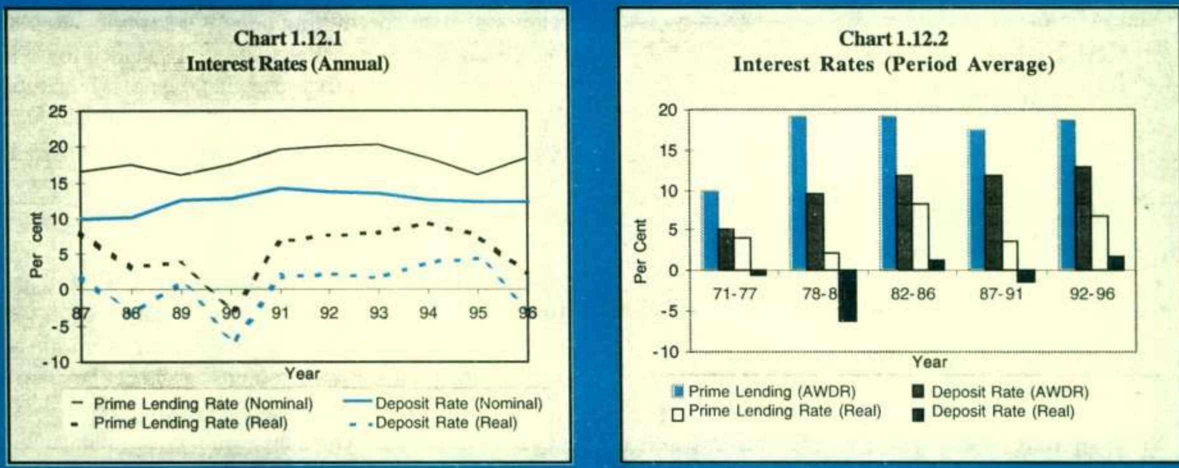
Commercial Banking

In a somewhat uncertain situation characterised by the mid year downturn in agricultural and industrial output and tourism, some increase in non-performing loans and security related uncertainties, commercial banks were more cautious in their lending operations and shifted their asset portfolios to less risky assets such as Treasury bills and government securities (34 per cent increase during the year), while maintaining overdrafts virtually unchanged (only 2 per cent growth).

With the slowing down of economic activities in mid 1996, there was a reduction in the expansion of loans and advances and the total assets of commercial banks increased by 16.2 per cent in 1996, compared to a rise of 19 per cent in the previous year.

On the liabilities side, major increases were recorded in deposit liabilities, domestic inter-bank borrowings, paid up capital, reserves and undistributed profits and other liabilities. Total deposits rose by 14.8 per cent (Rs.33,675 million) in 1996 mainly due to the increases in demand deposits and time and savings deposits by 14.8 per cent (Rs.6,291 million) and 14.7 per cent (Rs.27,384 million), respectively. Total deposits as a percentage of total resources declined from 69 per cent in 1995 to 67 per cent in 1996 reflecting a slight reduction in deposit mobilisation which was evidently a result of slower growth in income. Banks relied more on the domestic interbank market than on foreign borrowings for their short-term liquidity needs, resulting from the relatively lower call market rates,

Chart 1.12
Interest Rates



compared to 1995. Domestic inter-bank borrowings increased by 83.8 per cent, while foreign borrowings decreased by 28.6 per cent during the year.

1.6 Problems and Issues

The Sri Lanka economy has undergone significant diversification since economic liberalisation commenced in the late 1970's. The export structure is now less dependent on primary agricultural exports and less vulnerable to external and domestic shocks. New manufacturing and service activities have emerged and more employment opportunities generated, including increased opportunities for employment abroad. The banking and financial system has also experienced significant deepening and broadening. However, further structural reforms in several areas are necessary to accelerate sustained economic growth. Areas that deserve primary focus of attention are highlighted below.

In non-plantations agriculture, there is a need to introduce greater dynamism; farmer incomes could be raised by infusing new technology to raise productivity, increasing the market orientation of the sector and eliminating government intervention in the procurement and distribution of agricultural products which could be handled efficiently by the private sector. The Government's role in the sector should be to improve the efficiency of product and factor markets by maintaining a transparent agricultural policy consistent with the objective of creating a climate which would encourage the private sector to play a more effective role in the development of these markets. The removal of licence requirements for the import of chillies and onions is a step in the right direction. In this regard, market distortions due to the presence of State trading agencies such as the CWE and the Paddy Marketing Board should be eliminated.

State trading organisations have often been justified on the grounds that they are necessary for food security, price stabilisation, protection of both producers and consumers from middlemen and to induce fair competition. The underlying assumption for all these is that the market will not be able to meet these requirements efficiently, which is hard to justify. The well known concept of 'market failure' applies to cases where there are externalities such as damage to the environment due to exploitation of natural resources and careless waste disposal, and where the free rider problem, related to public goods such as street lighting etc., exists. It would not be correct to assume that a competitive market without government intervention would fail to function efficiently in the procurement, import and distribution of the goods that are presently being handled by the CWE. The presence of a state owned enterprise in import trade always introduces a greater degree of uncertainty in the trading environment, keeps away potentially more efficient private traders and undermines market efficiency. Hence, any further expansion of the CWE as a completely state owned trading organisation may not be advisable. The operations of the Paddy Marketing Board also became a burden to the People's Bank as the PMB was not able to meet its financial obligations on loans obtained for paddy purchases. It is hard to justify the continuation of the Paddy Marketing Board. This may be an opportune time to wind up its operations, as was done with the Department of Commodity Purchase.

The domestic agricultural sector should be able to generate a greater internationally competitive exportable surplus than at present. The areas that need to be developed are agro-processing, packaging, storage and handling of field crops, improving hybrid varieties and developing markets. A close link should be established between the agricultural research and education systems and extension work to transfer technology to improve productivity in this sector.

Prices of commodities vary across the country due to several factors. These include the cost of transport, characteristics of marketing channels, spoilage during transport and diversity in tastes which determine regional demand patterns. A part of these variations could be attributed to underdeveloped infrastructure. If these regional variations could be minimised through the development of the required institutional arrangements, farmers are bound to benefit through higher incomes. The marketing network for agricultural products, which was largely concentrated around the Pettah market, is decentralising to other regions and this has reduced price variations to some extent. Despite this decentralisation, about 30 per cent of agricultural output is estimated to be lost in handling and transport. Regional price variations and losses could be minimised by improving extension services to disseminate price information to farmers more quickly and by helping to improve their knowledge of efficient and cost effective methods of packaging and handling.

According to the Ministry of Agriculture the role of farmer organisations established under the Agrarian Services Act is to be enhanced. These farmer organisations are expected to develop subsequently into farmer companies. These organisations, together with government officials, manage and operate the Agrarian Service Centres renamed 'Govi Jana Kendrayas' (Production Service Centres). All agricultural programmes and special projects are implemented through these Centres. While co-operative arrangements among farmers for the development of the domestic agricultural sector should be encouraged, activities undertaken by these Centres should be on a self sustaining basis and should not rely on resources from the Government. The medium-term objective of the Government should be to curtail its involvement in all economic activities that could be undertaken more efficiently by the private sector. The Government however, would need to play a supportive role for the development of markets and infrastructure.

The need to promote regional industrialisation had been recognized by successive governments and there have been serious attempts to regionalise industries in the recent past. These efforts include the 200 Garment Factory programme, the Koggala Export Processing Zone and the Industrial Park at Pallekelle. More recently, the emphasis has been placed on the promotion of regional industrial parks and the Southern Area Development Project as part of the overall regional development strategy, in addition to fiscal incentives announced in the 1997 Budget for industries in remote areas. These are ambitious programmes which would require the building up of large scale infrastructural facilities and would require considerable foreign resources. The plan is to undertake these through private sector participation. Finance for these projects should come from the private sector. Government involvement in the projects should be minimal and should be within domestic resource constraints. Indirect financial commitments by the Government, such as guarantees of loans, should be avoided. The direction of trade policy is to minimise quantitative restrictions progressively by limiting them to a well defined narrow llist, considered necessary mainly for national security, public health and phyto-sanitary reasons. Whenever a minimum trade protection is necessary for certain industries, such protection should ideally be provided through price based measures, i.e., a suitable tariff within the simplified tariff structure. Sri Lanka has been moving away from a highly protective trade policy regime to a lower protection structure. Further progress was made during the year by eliminating import licensing on potatoes, onions and chillies. The imports of wheat and meslin continue to remain under licence as this has been considered necessary to fulfill the contractual obligations between the Government and Prima Ceylon Ltd., a flour milling company.

The CWE has been given the monopoly right to import wheat. This is an inefficient trading arrangement where the private sector is completely cutoff and benefits of competitive trading arrangements are closed to consumers. It is important to re-examine this arrangement with a view to eliminating the present licensing scheme to provide for private imports.

The demand for health services is rising with increased awareness and concerns about health conditions by an educated public and an ageing population due to declining fertility and mortality rates. On the supply side, the Government continued to provide a large share of inpatient care. The private sector contribution was largely in outpatient services and has expanded significantly. This contribution has improved health services, despite continuing resource constraints. Therefore, it is necessary to encourage private sector participation in the health sector for both preventive and curative health services. The recommendations made in various reports should be carefully examined and a clear plan of action designed to improve the health sector.

The education system should be able to provide the skills required by a growing economy and minimise the current mismatch between educational achievements and labour market requirements. It has become imperative that the education system be geared to provide the technical, language, managerial and entrepreneurial skills required by the growing needs of the private sector. The poor quality of general education and uneven access to good quality primary and secondary education by various groups and regions have been continuing problems. There is also an urgent need to improve the quality of teaching staff including those involved in higher education. A proper assessment of training needs, development of a system for career development for teaching staff at all levels and enhancement of opportunities for technical education will have to receive priority in the education reform programme.

In the energy sector, a clear long-term plan will have to be designed to reduce the heavy dependence on hydro power. In the transport sector, prolonged systemic and management deficiencies continued to be entwined with problems of commercial viability. The sector is not adequately equipped to meet the growing demand for transport services. Despite a significant improvement in telecommunication facilities, only 50 per cent of the demand for new lines can be satisfied at present. In order to meet the increasing demand for cargo handling facilities, the port network needs to be expanded and modernised. The resource requirement for upgrading and expanding these infrastructure services would be considerable, and hence these will have to be undertaken with private sector participation as far as possible, including participation by the foreign private sector.

There are inflexibilities and distortions in Sri Lanka's labour market. The labour market is highly segmented. There is a formal and highly regulated market, which includes the state plantation sector, and an unregulated informal market which includes small scale manufacturers, service providers and a major part of the agricultural labour force. Interaction between these markets is minimal. Labour laws are highly complex and restrictive. Sporadic labour unrest and protracted labour dispute settlement procedures have negative effects on private investment. There is an urgent need to simplify and make labour market policies transparent to infuse flexibility, educate both employees and employers of their social responsibilities and to link wages to productivity. Labour market reform aimed at achieving these objectives are complementary to structural reforms in other areas and would enhance the benefits of those reforms.

Sri Lanka has a clear comparative advantage in tourism, which had been a major source of income and employment generation, in addition to its contribution to foreign exchange resources. Assuming that the problems related to the ethnic conflict will be eventually settled, the tourism sector will rebound quickly. In this context, adequate transport facilities, airport services etc. should be available to cater to a growing tourist industry. Sri Lanka will be more attractive to tourists if airline services are available at competitive prices. The proposed privatisation of Air Lanka, the national carrier, would be an important step in this regard. It should not be accompanied by a provision of monopoly rights for foreign investors, which would eventually restrict the presence of other airlines in the country.

Sri Lanka has gone a long way in its financial reform programme (Box 1). However, further progress needs to be made, particularly with a view to reducing financial intermediation costs in Sri Lanka. In addition to the need for strengthening the supervision of the financial system, reforms are necessary to improve the commercial viability of the two state banks. The two state banks still account for nearly two thirds of the total assets of the banking system and any inefficiencies are quickly transmitted to the entire financial system. The spread between lending and deposit rates of banks is high due mainly to very high intermediation costs of state banks which enjoy oligopoly powers in the market. Monetary policy instruments, particularly the interest rate policy, become less effective when interest rates exhibit downward rigidity due to such structural weaknesses. High lending rates have an adverse effect on private investment and economic growth. Therefore, it is of paramount importance that the root causes of high intermediation costs are eliminated.

The first best scenario to achieve this target would be the privatisation of the state banks which would enable them to improve their operational efficiency. Privatisation of state banks is a delicate issue and may not be immediately feasible as a great deal of preparatory work would have to be undertaken. Meanwhile, it is essential that the public and the employees be made aware of potential benefits of privatisation. The next option would be the re-structuring of the state banks, within state ownership, to improve their commercial viability. This is essential, particularly in the context of increasing competition in the financial system where the two state banks have to compete not only with their counterparts, but also with other non-commercial banks.

In a competitive environment, the role of the supervisory mechanism becomes extremely important. Hence, recent legislative amendments have already given the Central Bank the supervisory authority over foreign

Box 1

Chronology of Financial Reforms in Sri Lanka

1977 Commencement of major reform programme

Interest Rates : National Savings Bank (NSB), the government owned savings institution, raised its deposit rates sharply with a view to ensuring a reasonable positive real rate of return to savers. Subsequently, commercial bank deposit and lending rates also revised upward.

Exchange Controls : Delegation of authority to commercial banks with regard to selected current account transactions. Enhanced exchange entitlements for travel, business, medical treatment, education and emigration.

Exchange Rate : Dual exchange rate system abolished and unified rate adopted with a 44 per cent devaluation of the rupee against the US dollar. Fixed exchange rate system replaced by managed float system. US dollar adopted as intervention currency. Central Bank quotes fixed daily rates for six major currencies.

1978 Selective credit ceilings on commercial bank credit to finance companies engaged in lending and hire purchase activity relaxed, while those on commercial bank credit to government corporations and statutory boards were withdrawn.

Exchange Controls : Exchange allowance for business travel and education increased. Commercial banks permitted to open Non-Resident Foreign Currency (NRFC) accounts for Sri Lankans and foreign nationals. Procedures simplified and more exchange control functions delegated to commercial banks.

GCEC: Greater Colombo Economic Commission (GCEC) set up to facilitate foreign and domestic invesment in Export Processing Zones in Sri Lanka.

1979 Supervision: Central Bank of Sri Lanka initiated its activities on the supervision and regulation of finance companies under the Control of Finance Companies Act No.27 of 1979.

Institutional: Following liberalisation, three foreign banks open branches in Sri Lanka.

Foreign Currency Banking Units (FCBUs) established to provide off-shore banking facilities, especially for foreign investors in the Export Processing Zones.

1980 Administered interest rates revised upward (Bank rate, Treasury bill rate, government securities rate and deposit rates of NSB); commercial banks followed.

Exchange Controls : Introduction of Resident Non-National Foreign Currency (RNNFC) Account Scheme.

Monetary Policy : Monetary aggregate used for monetary policy purposes broadened to take cognizance of new innovations in banking system. Accordingly, concept of Broad Money Supply (M2) introduced.

1981 Secondary market for Treasury bills introduced.

Exchange Controls : Commercial banks permitted to encash inward remittances and travellers' cheques and foreign currency notes upto US$ 500 without obtaining details on source or purpose of receipt.

1982 Selective credit ceilings on bank credit to residents or companies registered in Sri Lanka for purchase of plantations or immovables withdrawn.

Exchange Rate : Central Bank limits daily fixed quotations of rates to the intervention currency, i.e. the US dollar.

Employees Trust Fund (ETF) : Government establishes second superannuation fund.

1983 Overall credit ceilings on commercial banks were removed.

Institutional Changes: Approval granted for establishment of venture capital companies and merchant banks.

Box 1 (contd.)

1984 **Monetary Policy** : Main emphasis placed on indirect monetary policy instruments, open market operations.

1985 **Regional Rural Development Banks (RRDBs)** established under RRDB Act No.15 of 1985.

1986 **Exchange Controls** : Exchange entitlements for education abroad further enhanced. Requirement of obtaining exchange control approval for encashment of travellers' cheques exceeding Rs.100,000 per day withdrawn.

1987 **Stock Market** : Securities Council to regulate the securities market set up under Securities Council Act No.36 of 1987.

1988 **Interest rates** in the primary Treasury bill market allowed to be determined by market conditions as against previous practice of administratively determining rates.

Supervision : Banking Act No.30 of 1988 came into effect and new directions and guidelines on commercial banks issued under new Act. Central Bank given wider powers in terms of Control of Finance Companies Act No.78 of 1988 to regulate finance companies and set up a new department for supervision of non-bank financial institutions.

1989 **Prudential Regulations** : Minimum liquid asset ratio and single borrower limit for commercial banks imposed.

1990 **Exchange Controls** : Permission granted to approved country funds, regional funds and non-resident individuals to invest in shares in listed companies up to 40 per cent of issued share capital. With this, a scheme of Share Investment External Rupee Accounts (SIERA) introduced through authorised dealers to facilitate and monitor such investments.

Exchange Rate : Central Bank stops fixed quotations for US dollar. Begins announcing buying and selling rates for US dollar at the beginning of each day. The rates could be varied during the day.

Credit Information Bureau established.

Debt Recovery : Debt Recovery (Special Provision) Act No.2 of 1990, Mortgage (Amendment) Act No. 3 of 1990 and Recovery of Loans by Banks (Special Provisions) Act No. 4 of 1990 passed to facilitate debt recovery procedures of commercial banks.

1991 **Presidential Commission on Finance and Banking** commences work.

Stock Market : Securities Act amended to form Securities and Exchange Council (SEC) with wider powers, including regulation of unit trusts. Companies incorporated abroad permitted to invest in securities traded in the Colombo Stock Exchange, subject to certain terms and conditions.

Institutional Changes: Approval granted to issue licences for Unit Trusts.

Exchange Controls : Exporters permitted to borrow from Foreign Currency Banking Units (FCBUs) for financing imports of inputs to execute export orders.

Money changers appointed and authorised to purchase and exchange foreign currency against Sri Lanka Rupees or against other foreign currencies.

Sri Lankan residents and non residents allowed to open Resident Foreign Currency Accounts (RFCs).

1992 **Credit ceilings** on commercial bank lending to selected non-priority sectors removed.

Exchange Controls : Permission granted to approved country funds, regional funds, non-resident individuals, and corporate bodies incorporated outside Sri Lanka to invest in shares in listed companies up to 100 per cent of issued share capital, subject to exclusions, limitations and conditions set out by Controller of Exchange.

Treasury Bill Market : Appointment of Accredited Primary Dealers (APD) to participate in primary Treasury bill market; public required to bid through APDs.

Box 1 (contd.)

Foreign Investment : Status of the Greater Colombo Economic Commission (GCEC) elevated to level of a Board of Investment (BOI) and its area of influence extended from limited zones to cover entire country.

1993 **New capital adequacy** standards for commercial banks introduced, based on Basle guidelines.

Recapitalisation of two state banks in order to restore financial viability and profitability and to raise capital to internationally accepted levels.

Expansion in capital base of National Development Bank (NDB), a leading development bank in Sri Lanka, through a public share issue.

Exchange Controls : Repatriation and surrender requirements in respect of export proceeds abolished. Export proceeds permitted to be retained in foreign currency accounts either in Sri Lanka or abroad.

Remaining restrictions on payments in respect of travel, education overseas and remittances for miscellaneous purposes removed.

Treasury Bill Market : Introduction of sale of Treasury bills under repurchase agreements (Repos) by Central Bank.

1994 **Exchange Controls:** All remaining restrictions on current international transactions removed. Sri Lanka accepts obligations under Article VIII of IMF Charter.

Treasury Bill Market : Accredited Primary Dealer System revamped and replaced by a system of Primary Dealers who have specific privileges and responsibilities.

1995 **Treasury Bill Market** : Central Bank introduces reverse repurchase agreements (reverse repos) for secondary market transactions.

Foreign Borrowings : Commercial banks permitted to obtain foreign loans upto 5 per cent of their capital and reserves.

Exchange Rate : Margin between Central Bank's buying and selling rates quoted daily for US dollar raised from 1 per cent to 2 per cent to permit greater flexibility to the market.

Legislative Amendments : Several important Acts amended to make provision for improvement in financial market activity.

Credit Information Bureau Act - to permit more institutions to have access to the Bureau.

National Savings Bank Act - to restructure capital base and make NSB operations more market oriented.

Banking Act - to bring NSB, DFCC, NDB and SMIB under Central Bank supervision and to enable closer Central Bank supervision of FCBUs.

Monetary Law Act, Registered Stock and Securities Ordinance and Local Treasury Bills Ordinance - to promote establishment of a scripless government securities system, to create market oriented Treasury bonds and increase efficiency of secondary market in government securities.

currency banking units and licensed specialised banks, in addition to commercial banks and finance companies.

Conducting monetary policy in the new economic environment is a challenging task faced by the Central Bank. In a fully open economy in which the domestic financial market is integrated with the global economy, traditional policy instruments of direct control become less effective. It is essential therefore, that market based monetary policy instruments are used to improve financial markets. Improving the supervisory mechanism to ensure adherence to sound banking practices would also facilitate monetary management. The Central Bank has already initiated action towards this objective.

On the fiscal front, there has been a clear commitment to move quickly on to a sustainable fiscal reduction path to accelerate non-inflationary growth. Several positive measures have been taken during the past two years to achieve this goal. On the revenue side, these included enhancing the tax base, simplifying the tariff structure and reducing tariff rates, minimising duty waivers, improving tax administration and reforming public enterprises. On the expenditure side, the reforms included targetting welfare programmes, minimising wasteful expenditure and reducing transfers to corporations and revising upwards tariffs for utility services. Wheat flour prices were also raised almost up to the market clearing level. However, in the case of the latter, there is no guarantee that the subsidy element would not re-emerge in the future as the Government is still the price setter for wheat flour. Therefore, it is necessary to devise a mechanism to ensure flexible free market pricing for wheat flour and bread. This could be facilitated by permitting the entry of the private sector into the import trade for wheat grain as well as by allowing them to transact directly with the flour milling company. A flexible pricing formula for petroleum products and the encouragement of private sector participation in the import and processing of petroleum products would be important steps for further progress towards privatisation.

Large budget deficits have been one of the major macroeconomic destabilising factors in Sri Lanka. Ad hoc measures to reduce the interest burden on the Budget through undue interference in the market would distort interest rates in the financial market. This has been the case with administrative borrowings for deficit financing. In 1996, administrative borrowings exceeded one per cent of GDP. Although this has temporarily depressed interest rates and reduced the cost of government borrowing, it may not be advisable to rely on this instrument for fiscal management in view of its distortionary effects on the financial market. The recent introduction of Treasury bonds was a positive move as it would facilitate establishment of a market based yield curve for medium and long-term government bonds, instead of fixed interest rupee securities.

A heavy fiscal burden has also emerged as a result of the rapidly rising interest cost on a high volume of public debt, public sector salaries and transfers to households in addition to rising defence expenditure. There are major constraints in fiscal management. Interest on public debt, public sector salaries and wages and pension payment account for nearly 70 per cent of total government revenue, thus leaving only 30 per cent to meet other expenditures, including capital formation, public debt amortisation and maintenance of other essential services. These structural weaknesses in the Budget need to be corrected through a programme aimed at eliminating these weaknesses as early as possible. The programme should include strong measures to reduce public sector inefficiencies through civil service reforms and pension reforms with the aim of moving towards a contributory sustainable retirement benefit scheme, improving the Treasury cash management and improving public debt management with a clear definitive plan of action to phase down the size of the Government in the economy.

The trend behaviour of most macroeconomic indicators has been somewhat favourable. The real GDP growth rate has been higher during the last five years (1992-96) compared to the previous five years. The inflation rate has been lower, except in 1996. Interest rates have been positive in real terms, with some decline in 1996 when there was high inflation, a part of which was due to exogenous factors. Very high fiscal deficits experienced in the 1980s have been reduced to below 10 per cent of GDP. These achievements however, are by no means sufficient. Overall performance has been lagging behind many fast performers in the East Asian region. The country's economic stabilization attempts have often met with large slippages and shortfalls in achievement compared to expectations. The country's macroeconomic indicators reveal that it has never been able to get on to a sustainable deficit reduction path. Budgetary management has become complicated by populist measures in the past and rising security expenditures. A growth rate of 7-8 per cent of GDP in the medium-term is feasible. However, this would need a carefully planned strategy with full commitment to fiscal consolidation and to expedite structural reforms in all major areas mentioned above. An early settlement of the problem in the North and East would be a plus factor in this regard.