1. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES IN 1997

1.1 Overview

The Sri Lanka economy grew by 6.4 per cent in 1997, recovering strongly from the depressed conditions that prevailed in 1996. All major sectors showed significantly higher growth rates. The inflation rate, as indicated by the implicit Gross Domestic Product (GDP) deflator, declined from 12 per cent in 1996 to 9 per cent in 1997, reflecting the improved domestic supply situation and a slow rate of monetary expansion. The unemployment rate declined from 11.1 per cent of the labour force at end 1996 to around 10 per cent, reflecting increased labour absorption mainly in export oriented manufacturing, tourism and trading activities. The overall balance of payments showed a surplus of US dollars 163 million, primarily due to increased earnings from exports and tourism, higher private transfers and capital inflows, including privatisation proceeds. Improved fiscal discipline helped to reduce the budget deficit to 7.9 per cent of GDP in 1997 from 9.4 per cent in 1996. The recent improvement in Sri Lanka's macroeconomic conditions, the maintenance of some capital controls, the low exposure to short-term foreign debt, enhanced surveillance of financial market activity and a rise in short-term interest rates towards the end of the year helped to maintain a reasonable degree of stability in the domestic financial market in a highly volatile and uncertain external environment and to avoid a contagion effect of the East Asian crisis. However, it should be noted that the conflict in the North and East of the country continues to take a heavy toll on the economy.

With the recovery from the setback in 1996 and the decline in the inflation rate, the Central Bank reduced the statutory reserve requirement (SRR) from 15 per cent to 12 per cent during the first quarter of 1997. This was also a move towards greater reliance on indirect instruments of monetary control as well as a move towards a somewhat lower interest rate regime in the context of improving macroeconomic fundamentals. A new foreign currency loan facility through the domestic banks to non-Board of Investment (BOI) exporters was also introduced in 1997, subject to the condition that commercial banks do not increase their net foreign exposure above 15 per cent of their capital funds. The use of this facility, on a net basis, has been within the expected limit - U.S. dollars 72 million, compared with the expected US dollars 100 million.

The economy responded positively to the reduction of the SRR as interest rates declined, although the lending rates declined with a significant time lag. The banks had, among their liabilities, a considerable share of fixed rate term

TABLE 1.1
Selected Macroeconomic Indicators

Item	1996(a)	1997(a)	1993-97 Avg. (a)	1996(a)	1997(a)
	Rs. Million		Percentage Change		
GDP at Current Factor Cost Prices	695,934	803,698	15.7	16.3	15.5
GDP at 1982 Factor Cost Prices	174,261	185,500	5.5	3.8	6.4
GNP at 1982 Factor Cost Prices	171,176	182,950	5.4	3.1	6.9
			Per cent of GDP		
Gross Domestic Investment	186,264	217,103	25.4	24.2	24.4
Government	23,503	29,953	3.4	3.1	3.4
Private	162,761	187,150	22.0	21.1	21.0
Gross Domestic Savings	117,691	154,450	15.8	15.3	17.3
Foreign Savings	68,573	62,653	9.6	8.9	7.1
Foreign Direct Investment Flows (Net)	4,756	7,587	1.0	0.6	0.9
Official Loans and Grants (Net)	19,727	15,827	3.3	2.6	1.8
Other (b)	44,090	34,779	5.3	5.7	4.4
National Savings	145,674	190,965	19.8	19.0	21.4
of which Net Foreign Investment Income	-11,258	-9,934	-1.2	-1.5	-1.1
Worker Remittances (Net)	39,230	46,494	5.2	5.1	5.2
GDP Deflator (1982=100) (c)	399	433	9.8	12.1	8.5
Population ('000) (c)	18,315	18,552	1.2	1.1	1.3
GDP (Real) Per Capita (Rs.)	9,515	10,219	3.2	2.6	7.4

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 three columns give percentage changes.

deposit liabilities. The impact of releasing of liquidity through this measure was immediately felt on the short-term interest rates, mainly the Treasury bill rate and the prime lending rate. The deposit rates also declined, but remained above the inflation rate. The banks were also unusually cautious in extending new credit, having experienced a rise in non-performing loans due to the effects of the drought and power cuts on some economic activities in 1996. Credit to the private sector gradually increased and the year ended with an 11.4 per cent credit growth. The money supply increased by 13.8 per cent in 1997, a somewhat lower rate than the targeted 14.5 per cent, but higher than the previous year's comparison of 10.8 per cent. The commercial banks, having experienced a decline in their net foreign assets in the previous year, used a major share of the increased liquidity to rebuild their net foreign asset position. The declining rate of return on domestic financial assets was another reason for this behaviour by commercial banks.

Another important development in 1997 was the introduction of a medium-term marketable Treasury bond as a step towards developing a market for medium-term securities. This has become an attractive debt instrument for investors and Rs. 10,000 million worth of bonds were issued in 1997. A much higher volume is expected to be issued in 1998.

The stock market showed some improvement during 1997. The All Share Price Index (ASPI) increased by 16 per cent in 1997 while the Sensitive Price Index rose by 19 per cent. There were net inflows of foreign funds of US dollars 13 million through the stock market in 1997.

The fiscal situation improved significantly, primarily owing to improved cash management. Current expenditure has been contained at 20.7 per cent of GDP in 1997, compared to 22.8 per cent in 1996, reflecting a reduction in subsidies, transfers and defence and interest expenditure in relation to GDP. The high level of privatisation proceeds enabled the retirement of a part of the public debt and provided the Government with flexibility in the management of its cashflow. Total security expenditure declined, as a percentage of GDP, from 5.8 per cent in 1996 to 5.1 per cent in 1997. Increases in tax exemptions, reductions in tax rates and other tax concessions resulted in a reduction in total revenue to 18.5 per cent of GDP from 19 per cent in 1996. However, mainly due to the strict discipline imposed on expenditure, including capital expenditure, the overall budget deficit (without grants and privatisation proceeds) was reduced to 7.9 per cent of GDP from 9.4 per cent of GDP. When privatisation proceeds are reckoned as revenue, however, the deficit declined to 5.3 per cent of GDP compared to 8.8 per cent in the previous year. The 1998 Budget expects to consolidate the achievements of 1997 and the overall deficit without grants and privatisation proceeds is targetted at 6.5 per cent of GDP in 1998, with a medium-term target of 4 per cent of GDP by the year 2000. Further, an important development in the last few years has been a decline in the total public debt in relation to GDP. The stock of debt declined to 85 per cent in 1997 from 92 per cent in 1996.

On the external front, the growth of exports continued to be higher than the growth of imports, reflecting the buoyancy in the tea sector and the dynamism of the industrial sector. However, there were indications of a slight slowing down of the growth rate of exports towards the end of the year, as the deflationary impact of the East Asian crisis began to be felt on the world economy. Exports grew

Chart 1.1
Income Growth

Chart 1.1.1
Annual Growth

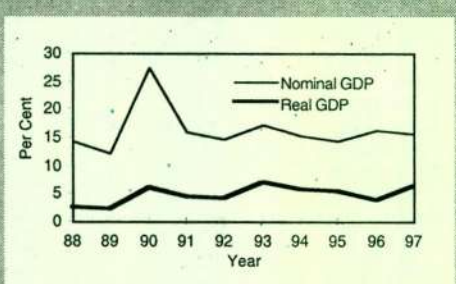
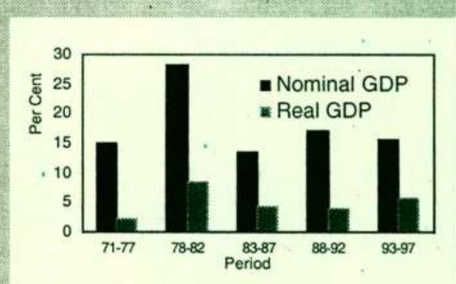


Chart 1.1.2
Period Average Growth



by 13 per cent in 1997 while imports grew by 8 per cent. The trade deficit as a percentage of GDP declined from 10 per cent in 1996 to 8.0 per cent in 1997. With the improvement in the services account and higher private transfers, the current account deficit declined to 2.5 per cent of GDP from 4.9 per cent in the previous year. The services account also improved due to increased earnings from tourism and port services. Earnings from tourism increased by 25 per cent. Private transfers increased by 11 per cent in 1997. Net foreign direct investment in 1997 is estimated at US dollars 129 million. Foreign capital inflows on account of privatisation amounted to US dollars 301 million. Sri Lanka also entered the international capital market after many years, in March 1997, raising US dollars 50 million through a Floating Rate Notes issue. This was intended to establish a benchmark interest rate for other potential borrowers. Overall, the balance of payments showed a large surplus in 1997. This surplus was reflected in an accumulation of net foreign assets of commercial banks by US dollars 200 million and an increase of net official reserves by US dollars 163 million, the latter being shown as the overall surplus according to the revised presentation of the balance of payments.

1.2 Output

Economic Growth

The higher economic growth rate of 6.4 per cent in 1997 reflects not only the recovery of economic activities from the slump experienced in 1996, but also a significant improvement in business confidence, mainly due to the improvement in economic fundamentals. The reduction in inflation, improved fiscal discipline and the ability to maintain relatively stable domestic financial markets, particularly in the context of a highly uncertain international environment, together with relatively low interest rates, created a more favourable investment climate. There was a slight upturn in the stock market and corporate profits improved considerably during the year. There was also an increase in the inflow of foreign direct investment, but inflows from East Asia were below the anticipated levels. However, inadequate infrastructure facilities and rigidities in the labour market continued to affect the growth of private investment. High security expenditure also diverted resources away from productive investment. As a result, the gross domestic investment ratio increased marginally from 24.2 per cent to 24.4 per cent.

GDP at current market prices increased by 15.9 per cent to Rs. 890,485 million in 1997. With a mid year population of 18.6 million, this indicated a per capita nominal income level of Rs. 47,999 (US dollars 814) compared to Rs. 41,940 (US dollars 760) in 1996. When this is adjusted for net factor income from abroad, the per capita national product amounted to Rs.47,409 compared to Rs.41,348 in 1996. Sri Lanka is gradually approaching the income level of a middle income country. Therefore, its access to concessional foreign funds for further development work is likely to diminish gradually. Hence, in the future, a growing share of foreign financing for development projects will have to be raised in foreign capital markets unless domestic savings are raised substantially.

As in the previous year, the largest contribution to economic growth came from the Manufacturing sector, which contributed to 29 per cent of GNP growth in 1997. The

Chart 1.2
Sectoral Composition of GDP

Chart 1.2.1
1978 - 1980

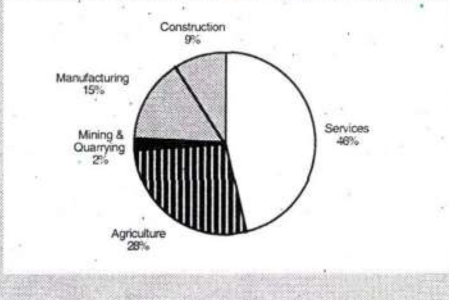


Chart 1.2.2
1997

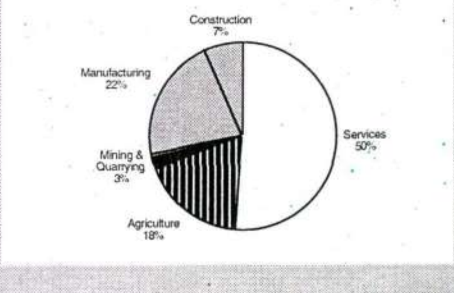


TABLE 1.2

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

	Item	1992-96	1987	1996	1997
1	Agriculture, Forestry and Fishing	1.1	-5.8	-4.6	3.1
	1.1 Agriculture	0.9	-8.1	-5.1	3.0
	Tea	3.0	1.0	5.1	7.2
	Rubber	2.4	-10.6	6.3	-5.8
	Coconut	3.5	-24.6	-7.6	3.3
	Paddy	-1.9	-18	-26.7	8.6
	Other	1.7	1.7	3.5	0.5
	1.2 Forestry	0.9	13.1	1.3	1.3
	1.3 Fishing	2.7	3.8	-3.9	5.0
2	Mining and Quarrying	4.8	19.0	8.9	3.4
3	Manufacturing	8.8	6.8	6.5	9.3
4	Construction	5.8	1.8	3.4	5.4
5	Electricity, Gas, Water and Sanitory Services	7.1	3.0	-2.0	8.0
6	Transport, Storage and Communication	5.4	1.2	7.5	7.8
7	Wholesale and Retail Trade	5.8	2.8	5.2	6.5
8	Banking, Insurance and Real Estate	9.4	6.1	10.1	9.8
9	Ownership of Dwellings	1.2	1.5	1.3	1.2
10	Public Administration and Defence	3.8	3.1	5.0	4.4
11	Services, (n.e.s.)	3.9	2.7	4.0	5.8
12	Gross Domestic Product	5.2	1.5	3.8	6.4
13	Net Factor Income from Abroad	6.1	-3.0	-50.0	17.3
14	Gross National Product	5.3	1.6	3.1	6.9

Source: Central Bank of Sri Lanka

Agriculture sector contributed to 8 per cent or about one third of the contribution of the Manufacturing sector. The Mining and quarrying sector contributed 1 per cent, while the Construction sector contributed 6 per cent. The Services sector, including utility services, contributed to 55 per cent of the growth, reflecting mainly the high growth in electricity, ports, trading and financial services. It is not unusual for the Services sector to be the major sector of a growing economy. However, there is scope for further strong development in the Manufacturing and Services sectors in Sri Lanka.

Agriculture

The Agriculture sector grew by 3 per cent. This mainly reflected the buoyancy of the tea sector due to improved performance of tea plantations under private management and attractive tea prices. The recovery of the paddy sector from the drought affected output level in 1996 also made a significant contribution. Further, agricultural activities in the Northern Province returned to near normalcy. The partial reopening of fishing areas in the North and East and the growth of inland fisheries also made a positive contribution to economic growth.

The tea sector continued to enjoy attractive prices in international markets. Tea prices at the Colombo auctions increased by 15 per cent, after a 44 per cent increase in 1996. Tea production increased by 7 per cent over the previous year's peak output to reach 277 million kg. The high and mid elevations registered their highest output levels after 1971 and 1981, respectively. As a result of the attractive prices, production had commenced even on marginal tea smallholdings. The average yields in plantations increased by 7 per cent to 1,465 kg. per hectare and in smallholdings by 2 per cent to 1,972 kg. per hectare. The cost of production increased by 4 per cent, compared to 14 per cent in 1996. The relatively low yield in the plantations is attributed to the long years of neglect after land reform. There are clear signs of improvement in this sector under private management. Profitability in the tea sector increased further owing to attractive prices, higher yields and the slow increase in the cost of production.

Coconut production showed a moderate growth of 3 per cent, recovering partly from the impact of the 1996 drought. Although there was a tight supply situation in the first few months of the year, the higher production during the second and third quarters of the year eased this situation. The fragmentation of coconut land as a result of the increased demand from the growing industrial sector and housing and development projects continued in 1997. The coconut yields per hectare increased marginally. The cost of production of coconut increased by 4 per cent. While export prices increased marginally in rupee terms, the average domestic price of fresh nuts increased sharply by 26 per cent in 1997. Coconut oil prices declined sharply due to improved supply and increased availability of oil substitutes both internationally and locally. The price declines were also partly attributed to the East Asian currency crisis.

Rubber production declined by 6 per cent mainly because of the decline in prices, which affected the profitability of the sector. There were also labour shortages as the producers were unable to pay competitive wages. Moreover, heavy and unseasonal rains in late 1997 prevented rubber tapping. The average cost of production increased by 10 per cent. Colombo auction prices declined by 17 per cent. The yield declined by 11 per cent. The profitability of the sector declined considerably in 1997.

Paddy production increased by 9 per cent with an improvement in the yield. The other agricultural crops showed a mixed performance. Production of pepper, cloves, cinnamon quills and citronella is estimated to have increased in 1997. Among subsidiary food crops, big onions, sesame, ground nuts and red onions showed higher output levels. However, chillie and potato production declined after the removal of licensing restrictions in 1996 which led to cheaper imports, reflecting lower productivity in Sri Lanka.

Mining and Quarrying

This sector grew by 3.4 per cent in 1997 reflecting the growth of quarrying products, bricks and tiles as a result of the growth in construction activities. This growth rate was lower than in 1996 as there was a slowing down of the export demand for gems and semi precious stones during the second half of the year due to the drop in demand from Japan and other countries following the East Asian financial turmoil. Despite a volume decline, export earnings from minerals (ilmenite, graphite etc.) remained at US dollars 90 million, as in 1996.

Manufacturing

Manufacturing output increased by 10.3 per cent during 1997. The textiles and garments sector grew by 19 per cent, raising its share in GDP from 4.5 per cent in 1996 to 5.1 per cent in 1997. During the last four years, the textiles and garments sector accounted for 38 per cent of the industrial sector output. This share increased to 41 per cent in 1997, indicating an increasing reliance on this sector. Evidently, Sri Lanka has established a strong presence in the international garments industry on account of high quality, efficiency and timely supply. It is noteworthy that 30 per cent of the exports were to countries outside the quota system.

Meanwhile, the production of many other industrial items such as plastics, paints, milk products, processed tea, beverages, sweets, meat products, electrical items, batteries and rubber products also showed high growth rates. The growth rates of these items ranged from 5 to 28 per cent.

TABLE 1.3

Gross National Product (Sector Shares in Per Cent)

	1978	1987	1996	1997
1 Agriculture, Forestry and Fishing	28.7	23.6	18.4	17.8
2 Mining and Quarrying	2.5	2.7	2.5	2.5
3 Manufacturing	15.3	16.2	21.0	21.5
4 Construction	8.3	7.2	6.9	6.8
5 Services	45.3	50.3	51.2	51.4
Electricity, Gas and Water	0.9	1.2	1.4	1.5
Transport, Storage and Communication	11.0	11.7	11.6	11.7
Wholesale and Retail Trade	19.3	21.1	21.7	21.7
Banking, Insurance and Real Estate	3.0	4.7	6.1	6.3
Ownership of Dwellings	3.5	3.1	2.3	2.2
Public Administration and Defence	3.0	4.7	4.3	4.3
Services, (n.e.s.)	4.6	3.8	3.7	3.7
6 Gross Domestic Product	100.0	100.0	100.0	100
7 Net Factor Income from Abroad	-0.4	-2.3	-1.8	-1.4
8 Gross National Product	99.6	97.7	98.2	98.6

(a) 1982 base Source: Central Bank of Sri Lanka

Based on the Central Bank's Annual Industrial Production Survey of 470 firms, industrial sector capacity was estimated to have increased by 5 per cent in 1997, in line with the growth of overall private investment. The Survey also revealed a 2.9 per cent increase in labour productivity. The Manufacturing sector profitability ratio increased to 15.6 per cent from 14.9 in 1996.

The coverage of industries for incentives, mainly in the form of tax and import duty concessions, has been expanding over the last three years to encourage investment. The demand for Sri Lanka's industrial products, mainly for apparel and textiles from western industrial countries, continued to increase. The reduction of the statutory reserve requirements by the Central Bank in early 1997, the new foreign currency loan scheme to non-BOI exporters and a reduction of the crowding out of resources by the Government in 1997 helped to reduce interest rates, though not as much as expected by industrialists. These, together with the moderate depreciation of the rupee against major currencies, helped the industrial sector.

The supply of credit to the industrial sector improved in 1997. The two major development banks and commercial banks continued to provide financing facilities to the industrial sector in the form of direct loans and equity participation. The National Development Bank (NDB) and the Development Finance Corporation of Ceylon (DFCC) Bank approved Rs.15,575 million in 1997 as against Rs.10,844 million in 1996. Commercial bank advances to the industrial sector during the first nine months increased marginally to Rs.25,400 million.

The Government's industrial policy continued to place emphasis on private sector led industrialisation, as announced in 1994. The industrial policy aims at expansion, diversification and upgrading of the industrial base, efficient management of physical and manpower resources, employment generation and raising of income levels, export promotion and regionalising of industries.

Exports of industrial products increased by 14.3 per cent in 1997, with exports of textiles and garments increasing by 20 per cent. Employment in the Manufacturing sector increased by 4 per cent. With the encouragement and growth of manufacturing and investment activities, the imports of intermediate and investment goods also increased during the year.

Services

The Services sector continued to grow steadily. Electricity, telecommunication, trading activities, port services and tourism showed improved performance. In the power sector, the addition of 177 MW of thermal power capacity raised the power-generating capacity of the national grid for the first time after five years, reducing the reliance on hydro power from 81 to 71 per cent and thus improving the reliability of supply. In addition, the first private sector BOO power project, with a capacity of 22.5 MW, was begun by Lakdhanavi Pvt. Ltd. Total electricity generation by all

Chart 1.3
Savings and Investment

Chart 1.3.1
Savings and Investment (Annual)

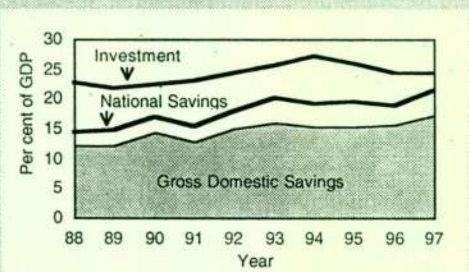


Chart 1.3.2
Savings and Investment (Period Average)

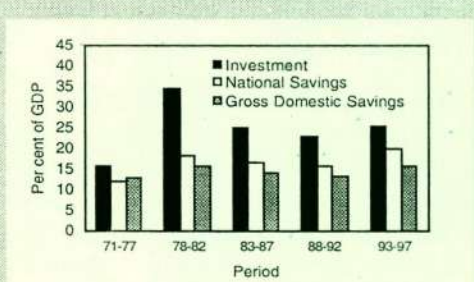


Chart 1.3.3
Composition of Investment (Annual)

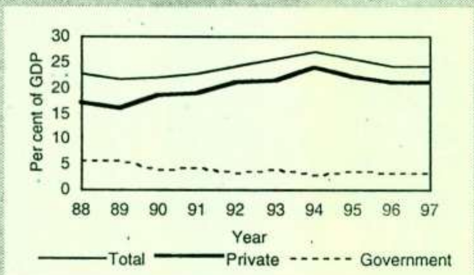
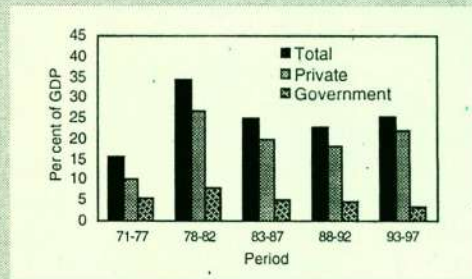


Chart 1.3.4
Composition of Investment (Period Average)



duty waivers for selected consumer goods also helped to contain inflation. The favourable impact of the above factors on inflation was somewhat offset by the increase in administered prices of wheat flour and the consequent rise in bread prices in August, the upward revision of electricity tariffs in September and increases in cigarette prices in June 1997. The depreciation of the Sri Lanka rupee by about 7 per cent against the US dollar also contributed to inflation.

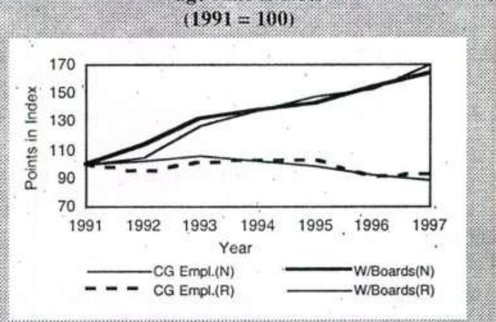
All available aggregate price indicators showed a substantial deceleration in inflation. The year on year increase in consumer prices, as reflected in the Colombo Consumers' Price Index (CCPI), was 9.6 per cent in 1997. The Greater Colombo Consumers' Price Index (GCPI), which has a wider coverage, indicated a faster decline in consumer price increases, from 14.7 per cent in 1996 to 7.1 per cent in 1997. A provisional price indicator prepared by the Central Bank, using data from the first round of the 1996/97 Consumer Finance Survey, indicated a consumer price inflation of 7.3 per cent in 1997. The Wholesale Price Index, which reflects the trends in all prices at the primary market level, showed a 6.9 per cent inflation compared to 20.5 per cent in 1996. The Gross Domestic Product Deflator, which is an implicit price indicator for the whole range of goods and services produced in the country, increased by 8.5 per cent in 1997, compared to 12.2 per cent in 1996.

1.5 Wages

Wage determination in the organised sector is based on mechanisms established by statute or on mechanisms which have evolved over the years. In the case of the public and local government sector, sometimes Pay Review Commissions are appointed and wage adjustments are made according to Cabinet decisions. In the organised private sector, wage adjustments are made on decisions of Wages Boards and Remunerative Tribunals, which are binding on the semi-government and co-operative sectors. In addition, in the organised private sector, wages are based on arbitration and conciliation procedures, collective bargaining, individual bargaining and unilateral employer decisions. In the unorganised private sector, wage determination is based on individual bargaining and unilateral employer decisions.

In 1997, the Government took the first step in a major overhaul of public sector salaries by accepting the recommendations of the Salaries Review Committee appointed in 1994 with Mr. B.C.Perera as Chairman. This was the first comprehensive review of public sector emoluments in more than 20 years. Accordingly, the proposed new salary scales entailed a unification of base wages and allowances. The first stage of the salary increase of 40 per cent of the proposed increase, subject to a minimum of Rs.325 per month, was granted from 1 January 1997. The balance increase, for those in the higher end of the salary structure, which was to be effective from 1 January 1998, has been deferred until July 1998. Many public sector employees, except school teachers who received substantial wage increases in 1995, received significant nominal wage increases under these proposals. As a result, the Wage Rate Index of government employees increased by 10.8 per cent in 1997 compared to 3.2 per cent in 1996. Government school teachers received a modest nominal wage increase of 2.4 per cent in 1997. Correction of certain anomalies in the salary scales of government school teachers was under consideration.

Chart 1.5
Wage Rate Indices
(1991 = 100)



In the organised private sector, minimum wages applicable to several wages boards were revised upwards by 5.9 per cent following an increase of 8.3 per cent in 1996. Minimum daily wages of workers in the tea sector have remained at Rs.83 since August 1996. The wage rate in rubber plantations reached Rs.83.22 by October 1997 with wage increases in line with the cost of living index, and was frozen at the level of 83 from November.. In the unorganised sector, provisional data revealed that nominal wages had increased significantly, by 9-19 per cent, for most activities, such as building construction, paddy, tea and coconut cultivation.

Overall, given an average consumer price increase of around 9.6 per cent, real wages increased significantly in 1997.

1.6 Population

According to the Registrar General's Department, the mid year population in 1997 is estimated to be 18.6 million, compared to 18.3 million in 1996. The addition of nearly 237,000 persons to the population during the year resulted in raising the density of population from 292 persons per square kilometer in 1996 to 296 persons in 1997. Despite the slow growth compared to the past, the addition to the sources increased by 13 per cent with the value addition increasing by 8 per cent compared to the 2 per cent decline in 1996.

The telecommunication sector continued to expand with increased participation by the private sector and a higher level of performance by Sri Lanka Telecom Ltd. Several new suppliers entered the telecommunication sector, adding to the competition. A 35 per cent share of Sri Lanka Telecom was sold to Nippon Telegraph and Telephone Corporation (NTT) of Japan for US dollars 225 million. The number of telephone subscribers increased by 72,453 to 315,241 in 1997. There were 24 licensed private sector companies providing various telecommunication services at end 1997, adding 2 more to the total. The share of the private sector in telecommunication services is growing rapidly. The telecommunication sector grew by 33 per cent in 1997 compared to 25 per cent in 1996.

The share of port services continued to grow, reflecting the growth of Sri Lanka's import and export trade and an increase in transshipment cargo handled. The profitability of port services increased by 13 per cent in 1997 with a 22 per cent increase in total revenue.

Among other services, the tourism sector recovered sharply by about 22 per cent in 1997. Reflecting the growth in most other sectors, the trading sector grew by 6.5 per cent compared with 5.2 per cent in 1996.

1.3 Investment and Savings

The country's investment rate increased marginally to 24.4 per cent of GDP. The relatively slow growth in investment was mainly due to the decline in public investment largely reflecting the resource constraints faced by the Government. Private investment increased further to 18.9 per cent from 18 per cent in 1996. However, this sluggish growth of investment needs to be noted seriously. With this level of investment the prospects for faster growth in the medium-term remain bleak, if the impediments to private investment are not removed early.

The developments regarding savings are encouraging. With the faster growth in real incomes, the domestic savings rate increased to 17.3 per cent of GDP from 15.3 per cent in 1996. This indicates an improvement in the marginal propensity to save despite a reduction in the real interest rates. This also partly reflects the decline in Government dis-savings, mainly through the rationalisation of public spending in 1997, and increased corporate savings. The country could have maintained a higher level of investment with this level of savings, allowing for a somewhat higher external current account deficit. However, this did not happen as there were other factors inhibiting the growth of private investment, which need to be addressed early.

1.4 Prices

The inflation rate decelerated sharply in 1997 mainly due to the improvement of the domestic supply situation and a reduction in the demand pressure as a result of the moderation of monetary expansion. In addition to the improvement in the domestic supply of food commodities, the availability of imported consumer goods also improved after the removal of licensing requirements on the imports of onions, potatoes and chillies. The granting of temporary

Chart 1.4
Changes in Prices

Chart 1.4.1
Inflation (Annual)

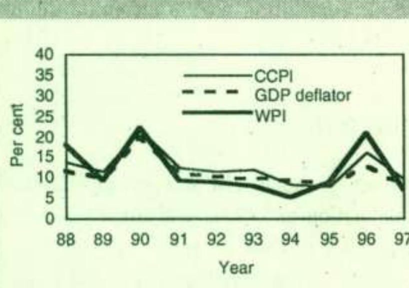
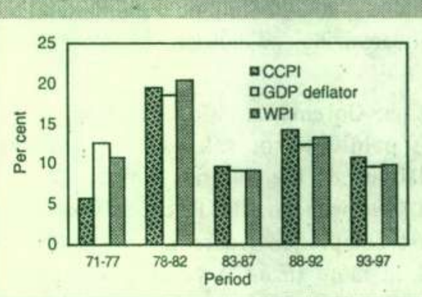


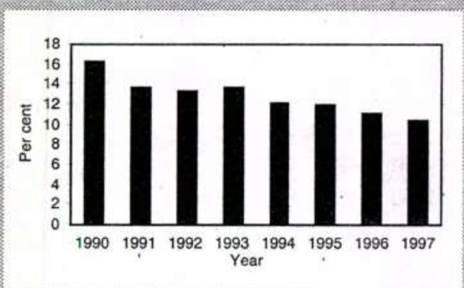
Chart 1.4.2
Inflation (Period Average)



population has created major problems such as high unemployment, high population density and land fragmentation. Long-term population projections indicate several noteworthy features that are likely to emerge over the next few decades. These are the ageing of the population, a rising dependency ratio and a possible tightening of the labour market in the first decade of the next century. Among these, the ageing of the population and related economic and social policy issues need immediate attention.

The decline in fertility rates, along with the improvement in life expectancy, has led to a faster increase in the older age groups than in the younger age groups over the past few decades. The old age dependency ratio reflected a significant increase from 5.9 per cent in 1946 to 7.4 per cent in 1997. It is projected that this rate will be as much as 17.4 per cent by 2021.

Chart 1.6
Unemployment Rate



The ageing of the population will have a number of diverse effects on the labour force, education, health and other social welfare programmes. Additional resources will be required to meet the basic needs of the aged. The number of youth entering the labour force will peak before 2020 and will fall thereafter. Meanwhile, the future rate of growth of the labour force is expected to decline significantly and reach a steady state of zero growth from the year 2010 onwards. As a consequence, the problem of labour scarcity is likely to emerge in the first decade of the next century. This change in the labour market and the immediate problem of absorbing those who are currently unemployed into productive employment need to be given due consideration in the design of economic policies for the next twenty five years. In the short run there is an urgent need to promote investment, particularly in the private sector, for the economy to be able to provide productive employment to the currently unemployed labour force. Labour market policies are complementary to investment promotion policies, as making the labour market more flexible and the labour force more productive and easily adaptable to industry demands would encourage private investment. This would help to accelerate economic growth and employment generation. This would also provide an opportunity for some of the retirees after the compulsory retirement age to be actively engaged in economic activity. The education and training systems would also need to be reoriented towards promoting new skills to keep pace with technological developments.

A gradual deceleration in the unemployment rate was observed during the 1990s. Expansion of informal sector activities, creation of new job opportunities in the fields of computer services, electronic media and financial services and a continuation of high migration for foreign employment appeared to be the major contributory factors to the decline in unemployment. However, youth unemployment still remains high. A continuation of high unemployment, while some economic sectors experienced labour shortages, has been another special feature in the Sri Lanka labour market. Therefore, a major challenge ahead is to reduce unemployment by reformulating the education system so as to match the growing labour force to the changing needs of the economy, particularly the needs of the private sector.

1.7 Fiscal Policy and Budgetary Operations

In 1997 budgetary policies were formulated with the objective of making further progress towards firm fiscal consolidation. The primary emphasis was placed on reducing the fiscal deficit in 1997, while correcting existing weaknesses in fiscal management, with a firm commitment to the continuation of the privatisation programme. Accordingly, several improvements were expected. They were, cleaning of public accounts, rationalisation of off-budget transactions, strengthening of financial controls and accountability, improving of revenues, reduction of wasteful expenditure, elimination of corruption and consolidation of social expenditure. The budget deficit was expected to be financed through non-inflationary sources. Considerable progress was made in 1997. The growth of expenditure was contained and the privatisation programme proceeded successfully. The overall fiscal deficit, without grants and privatisation proceeds, was reduced to 7.9 per cent of GDP in 1997, from 9.4 per cent in 1996. This enabled a net reduction in debt to the banking system with a larger reduction in government debt to the Central Bank. These achievements, together with a cautious monetary policy adopted in 1997, helped to maintain domestic financial markets relatively stable in a highly unstable global environment. The 1998 Budget was presented, within a relatively favourable macroeconomic environment, with a view to further strengthening these achievements and accelerating economic development.

Box 1

Inflation-Unemployment Trade-Off and Misery Index

The relationship between the wage inflation rate and unemployment rate, popularly known as the 'Phillips Curve', was first introduced by A. W. Phillips in 1958[1]. He studied a century of British data and concluded that the two variables show a systematic inverse relationship, in other words, that there is a trade-off between wage inflation and unemployment. In the 1960s, two American economists, Paul Samuelson and Robert Solow, showed that the inverse relationship exists for U.S. data too. Hence, at that time, policymakers thought they had two clear alternative intermediate targets: if the unemployment rate is targetted, it also implies an automatic targetting of the inflation rate, and vice versa.

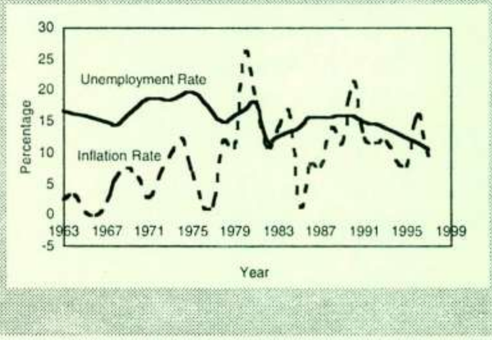
Over time, more data on inflation and unemployment were obtained and by the early 1970s, economists felt that the 'Phillips Curve' relationship could not be supported in the long-run. Milton Friedman and Edmund Phelps (1969, 1972) came out with the proposition that there is no trade off between inflation and unemployment, and that in the long-run, an economy moves towards a long-run equilibrium of full employment, a 'natural rate of unemployment', irrespective of the rates of change of prices and wages.[2]

The applicability of these theories to the Sri Lankan case is a matter of considerable interest. However, a facile application of the theory is faced with some problems. Many long-run macroeconomic trends of the Sri Lankan economy are yet to be fully explored. For example, it is not yet ascertained whether the economy is moving towards or moving around a long-run equilibrium path. It is also not clear whether the concept of a 'natural rate of unemployment' is relevant in a developing economy such as Sri Lanka where labour market participation and composition are changing towards the manufacturing and services sectors with the structural changes in the economy.

However, a desired goal for the rate of unemployment can be set at around 5-6 per cent for the next decade. The economy appears to be moving towards a long-run equilibrium low rate of unemployment. The remaining structural impediments mentioned elsewhere need to be eliminated for this trend to be sustained. On inflation, the Monetary Law Act indicates a month over month annual inflation rate of 10 per cent as the upper limit of the desirable rate. This is consistent with many economists' perceptions of a single digit inflation rate desirable for all economies. In the case of Sri Lanka, inflation rates of 4-5 per cent should be the medium-term target. Despite the theoretical inconclusiveness of the relationship, governments in most countries now prefer fairly low rates of unemployment and inflation. Given the current level of unemployment of 10-11 per cent in Sri Lanka, lower unemployment with lower inflation is feasible.

Table 1 and Chart 1 show a very volatile inflation rate (measured by the percentage change of the annual average Colombo Consumers' Price Index) and a comparatively less volatile unemployment rate (measured by unemployed persons as a percentage of the labour force). In the early sixties, there seemed to have been a trade-off between the inflation rate and the unemployment rate. The adoption of a fixed exchange rate policy, price controls and subsidies and other inward looking policies led to suppressed inflation and high unemployment. After the early 1980s, the trade-off is less pronounced. The period after the early 1990s has seen no trade-off between unemployment and inflation, and in fact, the relationship was positive. The unemployment rate was declining with a declining inflation rate, except in 1996, when the inflation rate surged largely due to the effect of a severe drought (Chart 1). The estimated overall relationship for the period 1963-1997 (excluding three extreme outlier data points), using a semi-log regression, shows a significant negative relationship (Chart 2).

Chart 1
Behaviour of Unemployment Rate and Inflation Rate



1 'The Relation between Unemployment and the Rate of Change of Money Wages in the United Kingdom 1861-1957', A.W. Phillips, *Economica*, November 1958.

2 The Role of Monetary Policy' Milton Friedman, *American Economic Review*, March 1969 and '*Inflation Policy and Unemployment Theory*', Edmund Phelps, 1972.

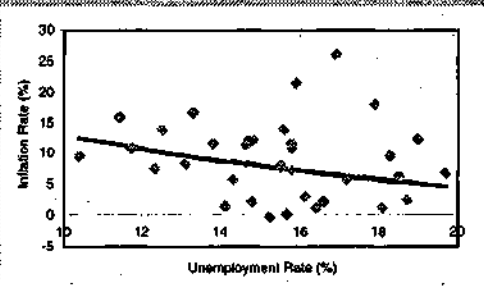
TABLE 1
Price Index (CCPI), Inflation Rate, Unemployment Rate And Misery Index 1963 - 1997

Year	CCPI	Inflation Rate (%)	Unemployment Rate (%)	Misery Index
(1)	(2)	(3)	(4)	(5)=(3)+(4)
1963	108.8	2.4	16.6	19.0
1964	112.2	3.1	16.1 *	19.7
1965	112.5	0.3	15.7 *	16.9
1966	112.3	-0.2	15.2 *	16.4
1967	114.8	2.2	14.8 *	18.8
1968	121.5	5.8	14.3	20.1
1969	130.5	7.4	15.8 *	21.7
1970	138.2	5.9	17.2 *	20.2
1971	141.9	2.7	18.7	21.4
1972	150.9	6.3	18.5 *	25.0
1973	165.4	9.6	18.3	27.9
1974	185.8	12.3	19.0 *	30.6
1975	198.3	6.7	19.7	26.4
1976	200.7	1.2	18.1 *	20.9
1977	203.2	1.2	16.4 *	20.9
1978	227.8	12.1	14.8	26.9
1979	252.3	10.8	15.8 *	25.6
1980	318.2	26.1	16.9 *	40.9
1981	375.4	18.0	17.9	35.9
1982	416.1	10.8	11.7	22.5
1983	474.2	14.0	12.5 *	25.7
1984	553.1	16.6	13.3 *	28.3
1985	561.2	1.5	14.1	15.6
1986	606.0	8.0	15.5	23.5
1987	652.8	7.7	15.5 *	23.2
1988	744.1	14.0	15.6 *	29.5
1989	830.2	11.6	15.8 *	27.1
1990	1008.6	21.5	15.9	37.4
1991	1131.5	12.2	14.7	26.9
1992	1260.4	11.4	14.6	26.0
1993	1408.4	11.7	13.8	25.5
1994	1527.4	8.4	13.1	21.5
1995	1644.6	7.7	12.3	20.0
1996	1906.7	15.9	11.4	27.3
1997	2089.1	9.6	10.4	20.0

Source: Central Bank of Sri Lanka

* unemployment rates are estimated using linear trends between adjoining data points.

Chart 2
Trade-off between Unemployment Rate and Inflation Rate[1]



1. The solid line is given by the following equation which has been estimated from the data points:

Inflation = 40.9 - 12.2 log (unemployment)

Both coefficients are significant at 2.5 % level

The sum of unemployment and inflation, defined by some economists as the 'Misery Index', is illustrated in Chart 3. The Misery Index is not a comprehensive indicator of the poverty in an economy, but it summarises the trends in two key macroeconomic variables affecting the living standards of people. A high and rising misery index depicts an economy suffering from high inflation or high unemployment or both. Since 1990, except in 1996, the index has been declining.

Chart 3
Behaviour of the Misery Index

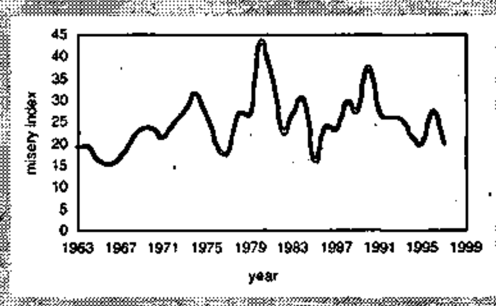


Chart 1.7
Fiscal Overview

Chart 1.7.1
Revenue and Expenditure

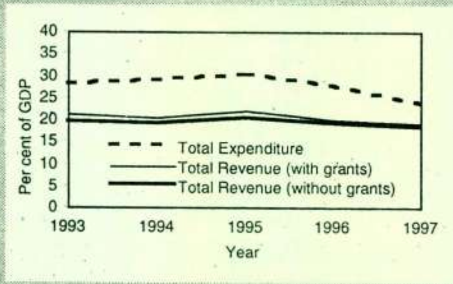
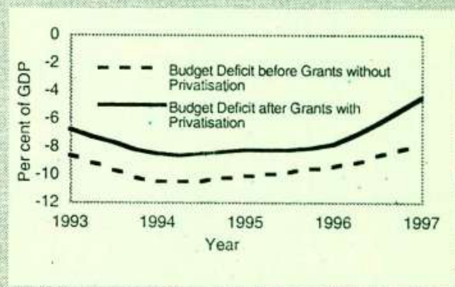


Chart 1.7.2
Budget Deficit



The overall budget deficit, after grants and privatisation proceeds, was brought down to 4.5 per cent of GDP, which was a 3.3 percentage point reduction compared to a deficit of 7.8 per cent in 1996. Compared to the original Budget target, the overall deficit in 1997 was lower by 1.6 per cent of GDP. This improvement was mainly the outcome of the larger than expected receipts from privatisation (Rs.22,535 million), improved collection of non-tax revenues, improved

TABLE 1.4
Summary of Government Fiscal Operations

Item	1980	1985	1990	1993	1994	1995	1996	1997
	(as a percentage of GDP)							
1. Revenue	19.6	22.3	21.1	19.7	19.0	20.4	19.0	18.4
2. Expenditure and net Lending	41.8	34.0	31.0	28.1	29.0	30.0	27.8	23.8
2.1 Current Expenditure	18.5	20.1	22.3	20.5	21.9	23.1	22.8	20.7
2.1.1 Security	1.3	3.6	4.1	4.1	4.6	6.4	5.8	5.1
2.1.2 Interest	3.4	4.6	6.4	6.0	6.6	5.7	6.4	6.2
2.1.3 Wages (a)	4.5	3.6	4.1	3.3	3.2	3.4	3.3	3.1
2.1.4 Subsidies and Transfers	8.4	5.5	6.5	5.4	5.9	6.1	6.0	5.1
2.1.5 Others	0.9	2.8	1.1	1.6	1.7	1.5	1.3	1.2
2.2 Capital and net Lending	23.3	13.9	8.7	7.6	7.0	6.9	5.0	3.1
2.2.1 Public Investments	18.5	13.7	8.3	8.0	7.0	7.9	6.0	5.8
Aquition of real assets	7.9	4.5	3.6	3.9	2.9	3.4	2.7	2.9
Capital Trasfers	9.4	8.6	2.3	2.8	2.4	2.9	2.2	2.1
On lending	1.2	0.6	2.4	1.3	1.7	1.7	1.1	0.8
2.2.2 Other	4.7	0.2	0.4	-0.4	0.0	-1.0	-0.9	-2.7
Restructuring Cost	0.0	0.0	0.0	0.3	0.6	0.0	0.0	0.2
Privatisation	0.0	0.0	0.0	-0.2	-0.5	-0.4	-0.6	-2.5
Others	4.7	0.2	0.4	-0.4	-0.1	-1.0	-0.3	-0.4
3. Current Account balance	1.1	2.2	-1.2	-0.8	-2.9	-2.7	-3.8	-2.2
4. Overall deficit before grants and excluding privatisation	-22.2	-11.7	-9.9	-8.7	-10.5	-10.1	-9.4	-7.9
5. Overall deficit before grants and including privatisation	-22.2	-11.7	-9.9	-8.4	-10.0	-9.6	-8.8	-5.3
6. Financing	22.2	11.7	9.9	8.4	10.0	9.6	8.8	5.3
6.1 Foreign Financing	9.2	6.4	5.7	3.6	3.5	4.5	2.3	1.9
6.1.1 Loans	5.3	4.4	3.6	2.0	2.0	3.2	1.3	1.1
6.1.2 Grants	3.9	2.0	2.1	1.6	1.4	1.4	1.0	0.8
6.2 Domestic Financing	13.0	5.3	4.2	4.9	6.5	5.1	6.5	3.4
6.2.1 Banks	9.8	2.9	0.1	-1.2	0.2	1.1	1.7	-0.2
Memo; Total Wage bill	5.0	4.2	4.9	5.3	5.1	5.2	5.0	5.0

(a) Excluding those paid to defence staff

Source; Central Bank of Sri Lanka

cash management with strict control over unproductive, wasteful expenditure and supplementary expenditure, and interest savings due to retirement of high cost debt. The upward adjustment of wheat flour prices by 12 per cent from Rs.16.95 per kg. to Rs.18.95 per kg. in line with international price trends also contributed to containing the growth of recurrent expenditure in 1997. However, project implementation delays, particularly in port development, power, energy and telecommunication, resulted in a shortfall in capital expenditure and affected the utilisation of foreign aid.

In 1997, both current and capital expenditure as a percentage of GDP declined. It is noteworthy that security expenditure declined from 6.4 per cent of GDP in 1995 to 5.8 per cent in 1996 and further to 5.1 per cent in 1997. The non-defence salaries and wages also declined marginally in 1997 to 3.1 per cent of GDP from 3.3 per cent.

The use of domestic resources by the Government to finance the deficit was significantly lower in 1997, indicating a reduction in the crowding out impact. The proceeds of the Floating Rate Notes (FRN) issue, amounting to US dollars 50 million, were also available to the Government. Part of the privatisation proceeds were used to retire high cost public debt and a commitment was made to reduce the statutory limit of Treasury bills from Rs.125 billion to Rs.115 billion. The 1998 Budget expects to make further progress in privatisation and to use such divestiture proceeds for further retirement of public debt.

Reflecting the retirement of debt, Treasury bill holdings of the Central Bank declined from Rs.17,100 million at end 1996 to Rs.7,222 million at end 1997. Part of the privatisation proceeds was also placed in a special deposit with the Central Bank. The outcome was a reduction in net credit to government from the Central Bank by Rs.13,991 million. However, net credit to government by the entire banking system declined by Rs.2,172 million as commercial bank holdings of Treasury bills increased after the reduction of the SRR. In addition, the Government's stock of administrative borrowings was reduced by Rs.6,654 million in 1996 to Rs.4,584 million in 1997. The 1998 Budget has targetted an overall deficit of 6.5 per cent of GDP (before grants and privatisation). This deficit is expected to be reduced to 4 per cent of GDP by the year 2000.

1.8 Public Enterprise Reforms

The public enterprise reform programme generated Rs.22,535 million, contributing to 11.5 per cent of total receipts of the Government in 1997, enabling the Government to retire part of the public debt and restructure its debt portfolio. This helped to reduce the interest cost, but the full effect on interest cost will be felt in 1998 and beyond.

A major step forward in the public enterprise reform programme was the sale of a 35 per cent stake in Sri Lanka Telecom Limited to NTT of Japan for Rs.13,274 million (US dollars 225 million). The accompanying management contract with NTT was another vital step towards improving the operational efficiency of Sri Lanka Telecom. The Government also earmarked 3.5 per cent of the shares of Sri Lanka Telecom for its employees.

The sale of convertible debentures of the NDB held by the Government generated Rs.4,500 million. The transaction was the largest single public offering made through the Colombo Stock Exchange. Convertible debentures of the NDB amounting to Rs.275 million, which had been issued to the Government in January 1993, were divested. The convertible debentures, which were to mature in 1999, 2000 and 2001 were converted into 18.33 million ordinary shares at a par value of Rs.10 per share and offered to the market through the Colombo Stock Exchange. As the issue was too large to be absorbed by the domestic market, 16.5 million shares were offered abroad, while 916,667 shares were offered to domestic investors. The remaining 916,666 shares were purchased by the NDB for its Employee Stock Ownership Plan. The international issue was priced at Rs.260 per share and the domestic issue was priced at Rs.250 per share.

The divestiture of 51 per cent of shares of each of seven plantation companies (Namunukula Plantations Limited, Maturata Plantations Limited, Malwatte Valley Plantations Limited, Kahawatte Plantations Limited, Elpitiya Plantations Limited, Talawakelle Plantations Limited, and Pussellawa Plantations Limited) was completed. Proceeds realised from this amounted to Rs.2,914 million. Public share issues for the divestiture of 19 per cent of each of five plantation companies, namely, Bogawantalawa Plantations Limited, Kegalle Plantations Limited, Agalawatte Plantations Limited, Horana Plantations Limited and Kelani Valley Plantations Limited, contributed Rs.635 million to government revenue in 1997.

The sale of 90 per cent of shares of Lanka Salt Limited and Puttalam Salt Limited generated Rs. 575 million, while the public share issue of 17.33 per cent of shares of Lanka Ceramic Limited generated Rs. 206 million in 1997.

Mattegama Textile Mill Limited, which was re-acquired by the Government as a failed privatised public enterprise, was restructured and rehabilitated. This was re-divested through the sale of the entire ownership for Rs.29.5 million to Kabool Lanka Ltd.

1.9 Government Debt and Debt Service Payments

Government debt at the end of 1997 stood at Rs.758,714 million, recording an increase of 7 per cent. The total debt/GDP ratio declined to 85 per cent in 1997 compared to 92 per cent in 1996. This is a favourable trend observed since 1993. The total domestic debt accounted for 50 per cent of the total government debt.

The debt structure improved significantly with the issue of Treasury bonds, issue of Rupee Loans with options for early retirement, and a reduction in the level of short-term debt. This made the debt structure more flexible and yield determination more market oriented. Of the total domestic debt, the share of short-term debt declined to 35 per cent at the end of 1997 from 41 per cent at the end of 1996. Treasury bills accounted for 86 per cent of the short-term debt. Medium and long-term debt (including long-term restructuring bonds) increased by 21 per cent and accounted for 65 per cent of the total domestic debt in 1997. Treasury bonds accounted for 4 per cent of the total outstanding medium and long-term debt. The debt profile is likely to improve further in 1998 towards more medium-term and long-term debt instruments with more Treasury bonds being issued to the market and the Treasury bill limit being frozen at Rs.115,000 million.

The outstanding foreign debt increased by 5 per cent to Rs.375,752 million at the end of 1997. Of this increase, Rs.1,959 million was due to exchange rate variations. The share of concessional debt in total foreign debt stock stood at 96 per cent at the end of 1997.

The debt service payments of the Government increased by 14 per cent to Rs.92,519 million. The interest component accounted for 60 per cent of total debt service payments. Interest payments also accounted for 30 per cent of current expenditure and absorbed 34 per cent of government revenue.

1.10 International Environment and External Sector Developments

International Economic Environment

The year witnessed one of the most disturbing events in the international economic environment in recent years. The East Asian currency crisis that erupted in July 1997 and continued through the end of the year had far reaching economic and financial implications on the global economy. The world economy grew by 4.1 per cent in 1997, the same rate as in 1996. This was below the 4.3 per cent growth anticipated at the beginning of the year. This was due to the slowing down of the growth rate of developing countries from 6.6 per cent in 1996 to 5.8 per cent in 1997. Yet, Asia with an estimated 6.7 per cent economic growth, continued to be the mainstay in world output growth. Robust economies in the United States, the United Kingdom and Canada, improved performances in the rest of Europe, and a turnaround in countries in transition, underpinned the expansion in world output. A significant slowing down of the economic growth in Japan from 3.9 per cent to 0.9 per cent, a slide in the growth of newly industrialised Asian countries to 6.1 per cent from 6.4 per cent in 1996, and a notable decline of the growth in emerging East Asian countries (ASEAN-4 i.e. Indonesia, Malaysia, the Philippines and Thailand) from 7.1 per cent to 3.9 per cent were observed. Commitments by governments to price stability were manifested by the subdued global inflationary pressures.

The global macroeconomic environment prior to the East Asian turmoil was conducive to economic growth. With strong commitments to price stability, world inflation remained favourable and at its lowest levels for the past quarter century. While the inflation rate in advanced economies declined further to 2.1 per cent from 2.4 per cent in 1996, that of developing countries dropped from 13.7 per cent to 8.5 per cent. Meanwhile, the inflation rate in countries in transition registered a notable decline from 41 per cent to 28 per cent. Interest rates tended to decline in many countries. World trade on the other hand, registered a growth of 9.4 per cent in 1997 against 6.6 per cent in the previous year, the major impetus coming from advanced and developing countries.

With the increased supply conditions, international prices of major commodities declined during the year. In particular, fuel prices declined sharply towards the end of the year as a result of higher supply. Sugar, wheat and rice prices declined by 14 per cent each during the year due to improved world supply conditions. International rubber prices continued to decline due to the increased global supply and the release of buffer stocks by the United States. Rubber prices were also hard hit towards the end of the year as a result of the currency turmoil in East Asia which accounted for over 85 per cent of world exports of rubber. International prices of coconut products, which increased during the early part of the year declined towards the end of the year as a result of improved supply conditions as well as the East Asian crisis which had a notable impact on the Philippines, the world largest exporter of coconut products. In contrast, tea prices remained buoyant throughout the year as a result of supply shortages, caused mainly by a drought in Kenya. Strong demand for tea from the Middle East and the Commonwealth of Independent States (CIS) also provided a strong stimulus for tea prices.

The most notable events of 1997 occurred in the exchange markets and began in Thailand with a speculative attack on the baht. While the baht depreciated by about 46 per cent against the US dollar, the Indonesian Rupiah and the Korean Won depreciated by 57 per cent and 50 per cent, respectively. The Malaysian ringgit and the Philippines peso depreciated by 35 per cent each against the US dollar. With strong economic performance, the US dollar strengthened against almost all major currencies. Financial market uncertainties and a weak economy caused the Japanese yen to weaken by about 11 per cent against the dollar. The Deutsche mark also reflected a correction during the year. Against the backdrop of these developments, short term interest rates in the global market, which remained relatively high up to mid 1997, tended to decline towards the end of the year. Meanwhile, long-term interest rates continued to drop as commitments by governments to make progress towards price stability strengthened. For example, 6-month LIBOR, which was at 5.93 per cent per annum at end May 1997 declined to 5.84 per cent by the end of the year, while the 30-year US Treasury bond rate declined from 6.30 per cent in December 1996 to 5.81 per cent in December 1997.

The developing countries continued with structural reforms particularly in the areas of trade liberalisation and addressing macroeconomic issues. The International Monetary Fund (IMF) was heavily involved as a crisis manager in East Asia. It also took initiatives to increase its quota with a view to increasing its liquidity, thereby, inter-alia, facilitating financing arrangements of such reforms. The debate on capital account liberalisation received renewed interest in 1997. The developing countries emphasized the importance of orderly and gradual liberalization of the capital account depending on the circumstances of each country. They also urged that there should be an equitable sharing of costs of post-crisis financial stabilisation among private creditors, borrowers and governments. The IMF, while highlighting the positive role of capital flows in the economic progress in Asian countries before the crisis, was also of the view that capital account liberalisation has to be orderly and properly sequenced.

The contagion effect of the crisis on other countries was felt with a dramatic change in the sentiment of both domestic and foreign investors who attempted to protect themselves against the adverse effects of an imminent deterioration of the value of the local currencies.

Several key domestic and external factors triggered the crisis in East Asia and its contagion and spillover effects. The domestic factors that triggered the crisis are the overheating of the economies, which was reflected in large external current account deficits and inflated property and stock market prices; exchange rate overvaluation due to the maintenance of pegged exchange rates over a long period; excessive foreign exposure of both financial and corporate sectors; sharp deterioration in the quality of loan portfolios of the financial institutions due to weak management and poor control of risks, lax enforcement of prudential regulations, weak supervision, and government directed lending; lack of transparency; and problems of general and corporate governance including political instability. Among the external factors, the most important were the heavy injection of funds into those emerging economies in search of higher returns by international investors who had underestimated the associated risks; large exchange rate swings among key currencies and losses of international competitiveness which led to substantial slowing down of exports; and behaviour of hedge funds who were seeking to hedge their foreign exposure through forward booking in the context of the imminent crisis.

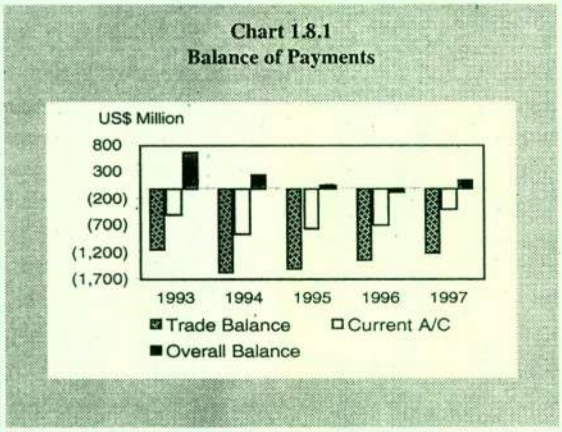
The evolution of the European Monetary Union (EMU), which is scheduled to be in place at the beginning of 1999 would also constitute a major change in the international monetary system. Meanwhile, the time for submission of commitments on financial services for negotiations under the World Trade Organisation (WTO) expired at the end of the year. Sri Lanka also submitted its offers on financial services in 1997 (Box 9).

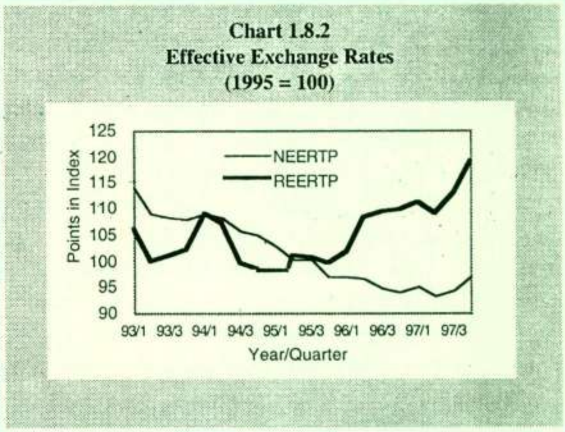
External Sector Developments

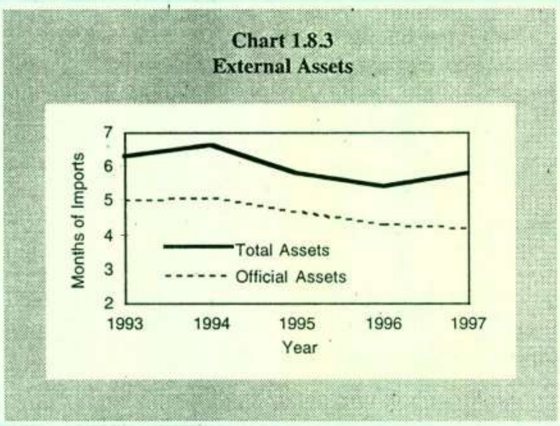
The balance of payments position improved significantly in 1997, mainly reflecting increased exports, services receipts, private transfers and higher capital inflows. Exports grew faster than imports thereby narrowing the trade deficit considerably. The services account registered a larger surplus mainly due to the growth of tourism and port services. Net outflow on account of investment income declined due to increased interest earnings. There were higher capital inflows both in terms of privatisation proceeds and foreign direct investment reflecting an improvement in investor confidence. A lower trade deficit, a significantly lower current account deficit, a respectable surplus in the overall balance and a relatively stable foreign exchange market were the highlights of the external sector developments in 1997.

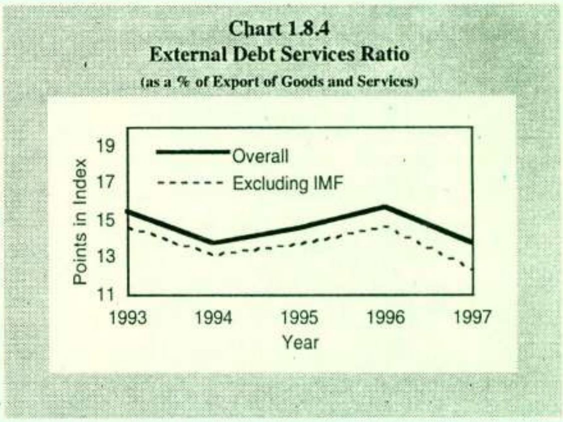
On the external policy front, the managed floating exchange rate regime was maintained, allowing the currency to move within the band of 2 per cent between the Central Bank's buying and selling rates, gradually keeping in mind the need to minimise erratic movements in the exchange rate. The annual average real effective exchange rate showed some appreciation in 1997 reflecting the sharp depreciation of East Asian currencies during the second half of 1997. This indicator alone may not reveal the complete picture with regard to the external competitiveness of Sri Lankan

Chart 1.8
Selected External Sector Indicators





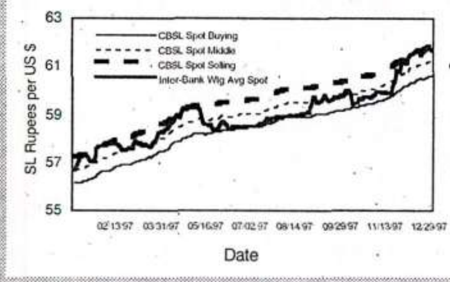




products, particularly given the inflationary impact of the large depreciation of East Asian currencies, and the credit crunch experienced by East Asian countries. However, some adverse effects of the East Asian currency and financial market crisis cannot be totally ruled out, as some of these countries are likely to put their houses in order with lower real wages and controlled inflationary pressures. While it will take some time for this process to go through its full cycle, export demand is likely to contract somewhat due to the contraction of their domestic demand as well as the demand in the rest of the world due to slow growth in real incomes. This could be reflected in the volume as well as unit prices of exports.

The resilience displayed by the external sector in the previous year amidst difficult conditions was strengthened in 1997, with a rapid recovery in the economy. Exports increased by 13 per cent while imports grew by 8 per cent. As a result, the trade deficit narrowed, for the third consecutive year from 10 per cent of GDP in 1996 to 8 per cent in 1997. The net service receipts increased by 51 per cent due to a strong recovery in the tourist industry and expansion of port related activities. Net factor income outflows declined by US dollars 38 million as there were higher inflows on account of interest earnings in respect of external assets invested abroad. Net private transfers increased by 11 per cent due to higher receipts on account of compensation payments to Sri Lankan workers who were displaced from Kuwait by the Gulf war in 1990. The current account deficit of the balance of payments declined sharply to 2.5 per cent of GDP in 1997 or US dollars 387 million from 4.9 per cent of GDP or US dollars 683 million in 1996 continuing its downward trend for the third consecutive year.

Chart 1.9
Daily Exchange Rates



Net long-term private capital inflows increased substantially from US dollars 123 million to US dollars 491 million due mainly to privatisation proceeds. Foreign funds received by the NDB for its lending activities and the foreign sale of NDB shares and 35 per cent of the shares of Sri Lanka Telecom, totalling US dollars 376 million, were the major sources of foreign private capital inflows to the country in 1997. Despite an increase in short-term trade credits of the private sector, net short-term liabilities declined as there was an increase in the net external assets of commercial banks in the context of declining domestic interest rates. The Government successfully raised US dollars 50 million through a FRN issue in the international capital market after 15 years. However, net official capital inflows declined by about 35 per cent during the year due to weak utilisation of foreign aid. Net capital transfers too declined by 29 per cent due to a reduction in project grants. According to the new BPM5 presentation format, the overall balance of the balance of payments registered a healthy surplus of US dollars 163 million during 1997. Gross official external assets at US dollars 2,029 million were sufficient to finance 3.9 months of imports projected for 1998, compared to 4.0 months import cover at end 1996. Meanwhile, total assets, including those of commercial banks, had risen to 5.4 months of import cover from 5.0 months at end 1996.

1.11 Financial Sector

There were two major challenges in the conduct of monetary policy in 1997. First, the economic recovery process had to be supported without disturbing the declining trend in inflation, while maintaining a proper balance between the money market and foreign exchange market. Second, in the context of the East Asian currency turmoil, the domestic financial system had to be guarded against speculative attacks to ensure stability. Accordingly, there was some relaxation of the tightness of monetary policy at the beginning of the year to support an orderly reduction in interest rates and a slight tightening towards the end of the year, to preserve stability in the domestic financial market.

Towards the end of 1996, the economy was gradually recovering from the setback due to the drought. The rate of monetary expansion had decelerated and inflationary pressures were abating, as economic activities recovered. Government borrowing from the banking system was reduced as fiscal management improved and the deficit was narrowed. However, credit growth to the private sector was slow and some liquidity constraints were being observed in the market.

The tightness of monetary policy was relaxed somewhat in early 1997 by reducing the SRR. The SRR on rupee deposit liabilities of commercial banks was reduced from 15 per cent to 14 per cent in January 1997. The SRR on foreign currency deposits placed abroad, which stood at 5 per cent, was also abolished, while maintaining the SRR on foreign currency deposits lent domestically at 15 per cent. Subsequently, in March 1997, the SRR on all deposit liabilities was reduced to 12 per cent, excluding the foreign currency deposits placed abroad. The SRR on foreign currency deposits placed abroad was maintained at the zero level.

Following the announcement made in the 1997 Budget, commercial banks were permitted to provide foreign currency loans to non-BOI exporters either from their domestic units or from their foreign currency banking units (FCBUs). This was also considered a further liberalisation of the external capital account. However, in providing this facility, due precaution was taken by placing specific limits on net foreign liabilities of commercial banks, at 15 per cent of capital funds. The conversion of domestic currency to repay these loans was not permitted, requiring borrowers to repay only in foreign currency.

The reductions in the SRR were designed to provide an immediate injection of liquidity into the system by releasing around Rs.8,000 million of reserve money held by the Central Bank, to the commercial banks. The consequent increase in the money multiplier would then create the potential for commercial banks to increase their credit levels ultimately by about Rs.20,000-Rs.25,000 million which would help boost credit to the private sector and support the recovery of the economy. In addition, the reduction in the SRR would reduce the effective cost of funds of commercial banks, thus enabling them to reduce their lending rates. This measure also represented a further step in the Central Bank's move away from the use of direct controls to the use of more market oriented instruments in the implementation of monetary policy. The provision of foreign currency loans to non-BOI exporters was designed to increase liquidity in the market and to enable them to obtain credit at relatively low rates.

The funds released by the reductions in the SRR were initially invested in Treasury bills through purchases from the secondary window of the Central Bank. The funds moved back into the credit operations of the commercial banks. Commercial banks also reduced their lending rates somewhat on many of their loan schemes reflecting the impact of the reduction in the SRR on their cost of funds. However, as has been observed by many economists, while increases in SRR are effective in reducing credit, if there is no excess liquidity, reductions in SRR do not necessarily lead to corresponding increases in credit unless there is additional demand for credit. Thus, due to caution on the part of both borrowers and lenders, the realised credit expansion consequent on the reduction in SRR was slower than expected. Together with additional liquidity arising from the inflow of foreign funds into the system, this led to a situation where commercial banks began increasing their portfolio of government securities and reducing the rates offered on deposits, resulting in lower interest rates at Treasury bill auctions. Overall, the reduction in deposit rates exceeded the reduction in lending rates, as evidenced by a fall in the average weighted deposit rate (AWDR) from 12.3 per cent in December 1996, to 10.0 per cent in December 1997, in comparison to a fall in the average weighted lending rate (AWLR) from 21.0 per cent to 20.1 per cent in the same period. However, the average prime lending rate (AWPR) declined faster from 18.4 per cent to 14.2 per cent during the same period, but the volume of lending at prime lending rate was relatively small.

A considerable inflow of foreign assets was experienced through the receipts from the Government's privatisation efforts, mobilisation of foreign funds by the development finance institutions and international compensation to victims of the war in Kuwait. These inflows added to the liquidity in the system and led to a further reduction in interest rates. Monetary policy during the second and third quarters of 1997 was therefore directed towards ensuring an orderly reduction in interest rates. Towards this end, the Central Bank engaged in open market operations (OMO) to mop up excess liquidity. When the Central Bank's holdings of Treasury bills were exhausted, the Bank issued its own securities for OMO. This is the first occasion since 1994 that the Bank has issued its own securities. Short-term Central Bank securities, with maturities of 7 days and 28 days were issued to stabilise the lower end of short-term rates. The potential for monetary expansion due to the inflow of privatisation proceeds was offset to a large extent by an immediate retirement of Rs.10,000 million worth of Treasury bills held by the Central Bank and the build up of government deposits with the Central Bank.

Towards the end of the year, when there was some uncertainty in the foreign exchange market due to the East Asian currency crisis and with inflation being a little higher than expected, short-term interest rates were increased slightly. The repurchase rate, which had been gradually reduced to 7 per cent by April, and stood at 9 per cent during most of the fourth quarter, was increased to 11 per cent in December. This was both to ensure a positive real rate of return in the short-end of the market when somewhat tighter inflation was seen in November and December, and to stabilise the foreign exchange market. The margin between the Central Bank's discount and rediscount rate for Treasury bills was also increased to influence the cost of liquidity provided by the Bank.

Money Supply

Despite the relaxation of the monetary policy stance in the early part of the year, the rate of monetary growth

Chart 1.10
Monetary Aggregates

Chart 1.10.1
Monetary Aggregates (Annual)

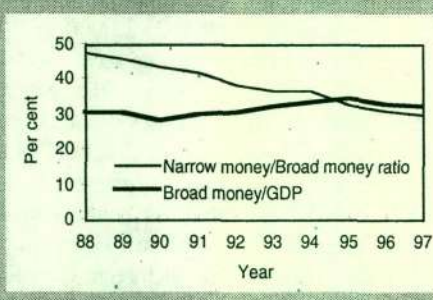


Chart 1.10.2
Monetary Aggregates (Period Average)

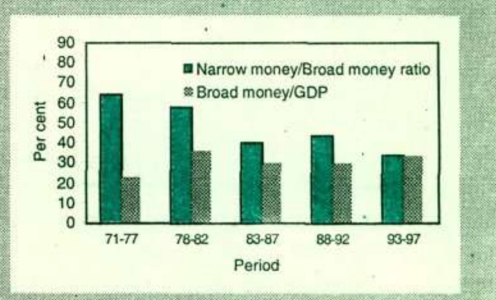


Chart 1.11
Monetary Growth

Chart 1.11.1
Monetary Growth (M_2)

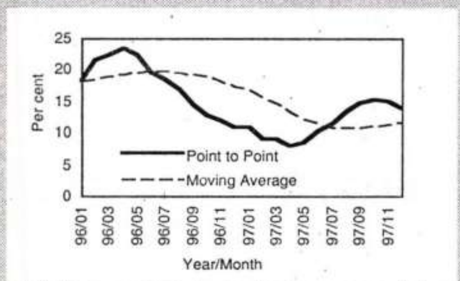
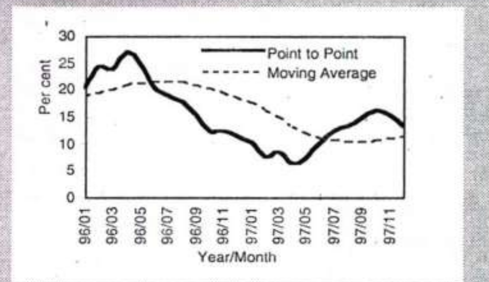


Chart 1.11.2
Monetary Growth with FCBUs



remained low throughout 1997. Although, in contrast to the developments in the previous two years, there was a large increase in the net foreign assets of the banking system in 1997, slower growth in domestic credit helped contain monetary expansion. In fact, net credit to government contracted in 1997 generating an expansionary impact on money supply. The growth of Broad Money (M2) stood at 13.8 per cent in December 1997. With the sharp decline in interest rates and inflation in 1997, the opportunity cost of holding cash or demand deposits declined and Narrow Money (M1) grew at a faster pace than in the past two years. The growth in M1 increased from 4 per cent in 1996 to 9.8 per cent in 1997.

Private sector credit grew moderately by 11.4 per cent, as against 7.8 per cent in 1996. Both supply and demand factors contributed to this moderate growth. Commercial banks exercised greater caution in extending credit from their domestic units. Demand too was constrained, with some borrowers adopting a wait and see approach towards large scale investments, while others resorted to credit from FCBUs or development finance institutions. Some corporate borrowers also obtained funds directly from investors through rights issues and the issue of commercial paper due to a downward rigidity in commercial bank lending rates, reducing the demand for bank credit. However, a somewhat different picture emerges when one considers total lending, inclusive of credit from FCBUs.

Chart 1.12
Interest Rates

Chart 1.12.1
Interest Rates (Annual)

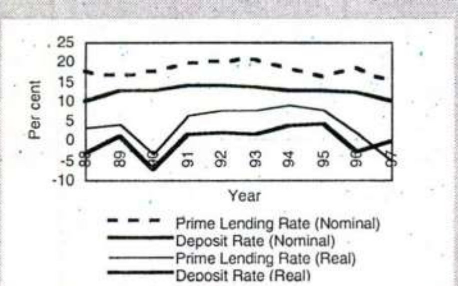


Chart 1.12.2
Interest Rates (Periood Average)

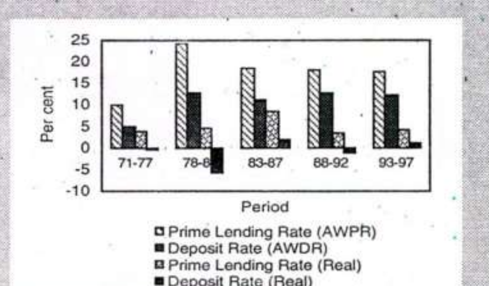


TABLE 1.5
Private Sector Credit from Financial Institutions (a)

Rs.Million

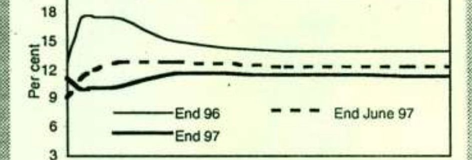
	1992	1993	1994	1995	1996	1997(b)
Commercial Banks	96,188	115,928	140,004	179,825	193,842	216,030
State Banks	72,825	69,333	85,728	105,781	106,007	111,650
Other Commercial Banks	23,363	46,595	54,276	74,044	87,835	104,380
FCBUs	23,995	28,671	32,260	38,884	44,591	46,621
RRDBs	1,112	1,514	1,873	2,431	2,899	3,200
Specialised Banks	11,955	14,812	16,935	20,037	26,930	30,911
DFCC	5,505	6,895	8,536	10,457	10,526	11,584
NDB	6,450	7,917	8,399	9,580	16,404	19,327
Finance Companies	5,874	5,280	6,492	9,664	12,086	14,544
National Savings Bank	1,522	2,626	3,108	3,441	4,396	6,664
Total Credit	128,691	154,019	183,737	234,245	257,814	287,059

Source: Central Bank of Sri Lanka

(a) Value at end year.
(b) Provisional

In view of the increasing impact of FCBU transactions on the domestic economy, a consolidated monetary survey including both the domestic units and the FCBUs of commercial banks has been compiled. The consolidated monetary survey indicated a 13.2 per cent point to point growth in broad money at end 1997, in comparison to a growth of 11.3 per cent at end 1996. As in the case of the conventional monetary survey including the domestic units alone, net credit to the government from the banking system showed a contraction. However, in contrast to the results in the domestic unit monetary survey, credit to the private sector has grown by 14.3 per cent in 1997, in comparison to 8.9 per cent in 1996. Total credit extended to the private sector amounted to Rs.32,878 million in 1997, as against Rs.30,789 million in 1996, indicating an increase in the credit from FCBUs. This credit from FCBUs is obtained mainly by BOI firms. With approximately 16 per cent of GDP coming from the manufacturing sector and 82 per cent of industrial exports being accounted for by BOI firms, it is clear that FCBUs have provided a significant amount of credit for economic activity in the country. The consolidated monetary survey also indicates that the slower growth in credit from the domestic units of commercial banks is offset by the additional credit provided by the FCBUs.

Chart 1.13
Yeild Curve - Government Securities



Credit to the private sector from all financial institutions (domestic units of commercial banks, FCBUs, RRDBs, development banks, finance companies and the National Savings Bank) grew by 11.3 per cent compared to 10.1 per cent in 1996.

1.12 Problems and Issues

The Sri Lanka economy has shown its resilience again in 1997 in the context of a highly uncertain global environment. The East Asian crisis which is considered to be one of the most serious crises since the breakdown of the Bretton Woods system in the early 1970s, had little impact on the Sri Lanka economy in 1997. The East Asian crisis has underscored the importance of sound financial systems, consistent macroeconomic and exchange rate policies and effective prudential and supervisory systems in the context of capital account liberalisation.

Sri Lanka's current account transactions are fully liberalised. In addition, there is no surrender requirement for export proceeds. The country has adopted a cautious approach in moving towards capital account liberalisation. The capital account has been partially liberalised, and is relatively freer than in many other developing countries. Foreign portfolio investors are permitted to invest in the share market with the freedom to repatriate capital, capital gains and dividends, but transactions have to be channelled through special accounts, known as 'Share Investment External Rupee Accounts' (SIERA). Foreign direct investment is permitted up to 100 per cent ownership, except in a few restricted areas, and up to 49 per cent ownership in financial institutions, without any restriction on the repatriation of capital, profits and dividends. Exporters have access to foreign currency borrowing from either the domestic banking units or from FCBUs without restriction, but subject to the capacity of banks to lend. All enterprises under Section 17 of the Board of Investment Law have been permitted to borrow from FCBUs. All other foreign private investment inflows and outflows are allowed with approval. With this relatively liberal capital account, the existing capital controls which limit the short-term foreign exposure of commercial banks and existing restrictions on private sector foreign borrowings have been one of the major factors that protected the economy against the short-run contagion and spillover effects of the East Asian financial crisis. The inflow of short-term debt has been around 10 per cent of total capital inflows and most of it had been in the form of supply of raw materials for export processing industries.

Prior to end 1995, Sri Lanka's commercial banks, except the FCBUs, were not allowed to borrow abroad. They could only maintain day to day working balances. The net short-term exposure on account of these working balances amounted to only 5-10 per cent of their capital funds, including reserves. However, when there was heavy demand for foreign borrowing by industrialists, particularly in view of the high domestic interest rates, it was thought appropriate to allow this facility under a system with adequate safeguards. Hence, a facility to obtain foreign currency loans was granted to non-BOI exporters through domestic banks in January 1997, while placing a limit of 15 per cent on the net foreign liabilities of commercial banks in relation to their capital funds. The scheme has been operating smoothly and net outstanding liabilities have been maintained below the expected total limit of US dollars 100 million while the gross rollover of credit had been US dollars 253 million in 1997. This helped to protect the banks as well as the local entrepreneurs against excessive foreign exposure.

Another factor which helped to maintain relatively stable financial markets in 1997 in the midst of the East Asian financial market turmoil, was the flexible management of the exchange rate. The exchange market plays a significant role in the rate determination, while the Central Bank intervenes to reduce excessive volatility of rates with a band of 2 per cent between its buying and selling rates. The rate determination is monitored on the basis of a large basket of 24 currencies of competitors and trading partners, while also taking into consideration underlying trends in the balance of payments and other macro economic indicators. However, given the degree of import dependence, particularly for some essential consumer goods, as well as intermediate goods, such as petroleum and fertiliser, and investment goods, the inflation feedback effects are relatively large. The current exchange rate management system has the flexibility to allow the exchange rate to change according to underlying macro economic fundamentals while also giving due consideration to the inflation/exchange rate feedback effect.

Sri Lanka also had favourable balance of payments and external assets positions, in addition to a declining debt burden. The balance of payments had an overall surplus of US dollars 163 million the external assets were sufficient to finance 5.8 months of imports, total stock of debt as a ratio of GDP had declined sharply from 70 per cent in 1996 to 63 per cent in 1997 and the debt service payments were manageable. These, together with timely and appropriate monetary policy responses, including those through moral suasion and enhanced surveillance on bank operations, helped to counteract excessive speculative forces that appeared to emerge in the domestic financial markets during the height of the East Asian currency turmoil. The Central Bank intervened in the exchange market to help stabilise financial markets.

With the currency crisis in East Asia, there has been renewed interest in the debate on the choice of an appropriate exchange rate regime. It is has been widely accepted that the maintenance of fixed or pegged exchange rate regimes is not possible in the absence of supportive fiscal and monetary policies and the choice of an appropriate exchange rate regime has been left to the individual governments. In the context of Sri Lanka, the current managed float system where there has been a gradual depreciation, reflecting underlying macro-economic conditions, has functioned well. It is likely that some East Asian countries will have improved upon their international competitiveness once the pass through effects of the exchange rate depreciation to prices, wages and cost of production have completed their full course. This is unlikely to be a major challenge for Sri Lanka, as many other countries will face this situation, and the exchange rate will flexibly adjust at the required speed.

While the short-term contagion effects of the East Asian crisis have been avoided, some specific export items such as diamonds, rubber and coconut appear to face tougher competition due to the sharp contraction of demand in East Asia and price declines after the currency depreciation. The affected East Asian countries are responding to the crisis by trying to put their houses in order through strong and painful adjustment measures. According to the April 1998 World Economic Outlook (WEO) of the International Monetary Fund, the near term growth prospects for affected East Asian countries are weaker than expected mainly due to the sharp contraction of domestic demand. The report, however, predicts a continuing recovery of confidence and a moderate pick up in economic activity is expected. Based on a survey of 500 companies, which included 100 of the largest multinational companies (MNC), and a response rate of 40 per cent, the UNCTAD expects inward foreign direct investment to increase in the short and medium-term due to lower costs for MNC operations in the region. The more

Box 2

Banking System Soundness

Banks are the repositories of the liquidity of an economy and form the backbone of the financial and payments system in a country. Banks are therefore special and countries all over the world intervene to protect the banking system from systemic risk, mainly through monitoring and supervision. However, monitoring and supervision alone cannot ensure the soundness of the banking system. They have to be complemented by a mix of internal and external financial discipline. Banks are companies that operate in a competitive environment and the primary responsibility for solvency of a bank rests with its management. Supervision should not create a moral hazard in that the public is led to believe that banks would be protected from failure even due to excessive risk taking by both the bankers and their depositors, as such belief could undermine the safety of the entire financial system.

In addition, banking soundness requires market discipline. In the absence of competitive markets and penalties resulting from failure, there will be inadequate incentives for bank owners, senior management and customers to make appropriate financial decisions. Market forces reinforce management incentives to operate a bank safely, since the funds of the owners are at risk.

The Central Bank's responsibilities in maintaining confidence in the underlying stability of the banking system is enforced by setting prudential standards and regulating/supervising the work of commercial banks on a continuous basis. Prudential policies, while not panaceas, attempt to limit risks and make sure that banks are managed properly. These are governed by a regulatory framework to regulate the entry, operation and exit of banks. In Sri Lanka, the regulatory framework is set out in the Banking Act No.30 of 1988, as amended by Act No.33 of 1995, and the Monetary Law Act. Such regulations establish the authority of supervisors to regulate banks. Several broad categories of regulations are used to reinforce the operating environment, internal governance and market discipline of banks.

Prudential regulations typically control entry into the banking industry and the scope of banking. Prudential regulations relating to internal governance provide assurance that owners and managers are fit and proper persons to undertake their responsibilities and that they share the risk to which they expose the depositors. These regulations also intend to ensure that portfolio quality and risk management standards are high. Not only do such regulations provide a formal control over a bank's behaviour, but they also provide a basis for the production of additional information that can be used by owners, supervisors and the market in disciplining the banks.

Regulations relating to capital adequacy are intended to ensure that when a bank becomes less sound, its owners recapitalise it and that the bank's capital is adequate so that owners have an incentive to do their best to protect their stake and avoid a potential loss. In addition, there are prudential regulations relating to loan classification rules and minimum provisioning requirements in respect of bad and doubtful debts. Regulations restricting exposure to single borrowers, foreign exchange exposure and maturity mismatch help to check a bank's management ability to assume excessive credit, exchange rate, liquidity and interest rate risks. The role of prudential policy in supporting internal governance is to ensure that banks have proper internal procedures and that managers are knowledgeable and are involved in the risk assessment process.

Bank supervisors ensure that bank managers comply with the regulations stipulated by the regulatory authorities. Supervision is conducted both off-site by monitoring reports that banks submit to the supervisory authority, and on-site by actually verifying the adequacy of asset valuation, accuracy of prudential reports and the quality of internal controls. In this process, supervisors attempt to analyse the financial condition of banks, evaluate management, restrain unsound practices and force the exit of insolvent banks.

The regulatory authorities are agents of the Government and, therefore, in the end, of the people, whose wealth may be put at risk by an imprudent and irresponsible bank. To guard against such an eventuality, the Central Bank is given the power and responsibility to appoint regulators whose task is to continuously monitor the operations of the commercial banks. Generally, officers of considerable experience and reputation are appointed to this task by the Central Bank. This is because diligent and strong regulators will influence the expectations in the financial sector appropriately. If the likelihood of being punished when something goes wrong is high, banks will have a stronger incentive to keep their internal controls in good order. Sri Lanka's bank supervision standards are being further strengthened to be in line with the internationally accepted norms.

comprehensive WEO of the IMF predicts a sharp slowing down of net private capital flows to all developing countries. World economic growth is expected to be lower by one-percentage point with a negative growth rate for ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand). Total imports by economically developed countries are expected to be lower by about 1.8 percentage points, from 8.6 per cent in 1997 to 6.8 per cent in 1998. Sri Lanka, which is an open economy, cannot be totally insulated from the effects of the changes in the world economy and may be somewhat affected by the expected slowing down in world economic growth.

There are several ways that the country can minimise the possible adverse implications of the slowing down of the global economy. First and foremost is the need to further improve fiscal consolidation with a view to reducing the crowding out of resources by the Government and to provide the basis for non-inflationary growth. This programme is already underway aiming at reducing the overall budget deficit to 4 per cent of GDP in the medium term. A current account surplus will help to increase domestic savings in a situation when both private foreign direct investment and official capital inflows would be slowing down due to factors outside the control of Sri Lanka. As mentioned above, the adverse developments in the world economy have been taking place when Sri Lanka's macroeconomic fundamentals were improving due to improved macroeconomic management. However, it is important that recent macroeconomic achievements are not allowed to be reversed. In fact, they should be further strengthened with a view to achieving a sustained reduction in the inflation rate and accelerating economic growth. In this regard, further fiscal consolidation towards a significant current account surplus and an overall deficit of not more than 4 per cent of GDP should be the medium-term target.

The globalisation of economies will continue, possibly with a slight slowing down of the process during the next 2 to 3 years, with the lessons from the East Asian crisis. The key lesson to be learnt from the East Asian crisis is that globalisation was not the root cause of the crisis. Rather, the lack of preparation to meet the challenges after full liberalisation of the capital account and a host of other factors mentioned above were the forces behind the crisis. In this context, Sri Lanka has to ensure that the financial system is regulated, monitored and supervised to ensure its soundness. The strengthening of the financial system has received priority in the ongoing financial sector reform agenda. Measures are being taken to strengthen the financial system. The necessary legal background has been prepared and directives have been issued to the banks to ensure banking system soundness.

Meanwhile action is being taken to improve the operational autonomy of the state banks in the form of memoranda of understanding between the Government and the two state banks. In the past, the cost of operational inefficiencies and government directed lending had be borne by the average consumer in the form of high inflation, as the Government had to incur heavy expenditure to bail out these banks and this expenditure had to be financed through high taxes or expansionary borrowing.

Monetary policy is being conducted with the prime objective of maintaining price stability, with a low rate of inflation. A large exchange rate depreciation is not necessary if inflation is brought under control. High inflation requires currency depreciation, which raises cost of production and erodes industry profitability. In the case of Sri Lanka there is a strong relationship between wage increases and inflation. Given the country's high trade dependence (70 per cent of GDP) and the need to maintain international competitiveness, there is a growing need to link wage increases to productivity gains. The widespread practice of linking wages to inflation indicators introduces an inflationary bias to the labour market. Thus there is an immediate need to eliminate this inflationary bias.

The above relates to the next important policy reform which is essential to promote private investment. That is labour market reforms. The Government is working on a labour charter, which is expected to lay down the guidelines on wage norms and labour mobility. The following matters need urgent attention.

The need to promote labour market flexibility in employment, because labour rigidities discourage new employment in a background of high unemployment;

Linking wage increases to productivity gains and flexible wage systems linked to incentives;

Moderation of labour laws to give equal protection to employers and employees;

Promotion of an active competition policy.

It is increasingly recognised that labour market reforms to promote competitive conditions are vital for the success of economic liberalisation and promotion of new employment. Pending a full scale review of the efficiency of labour markets, promotion of liberal sub contracting and outsourcing may prove helpful for the emancipation of labour markets.

The Government has been the provider of most economic and social infrastructure services in Sri Lanka.

Meanwhile, it is increasingly recognized that many economic infrastructure services are not public goods and that those can be provided more efficiently through the private sector. The policy environment for private sector participation in economic infrastructure has been strengthened through a general improvement in the macro economic conditions, the privatisation programme and various fiscal incentives. To provide financial support, the institutional structure is being strengthened. The Private Sector Infrastructure Development Company Ltd. was established in 1997, with financial support from the World Bank. The private sector has gradually entered some areas such as health, education, postal services, mass media, telecommunication and transport on its own initiative as well as a result of the Government's conscious policy of promoting private sector led growth. Despite all these efforts, the current levels of investment in these sectors are still inadequate. Considerable improvement is necessary in key areas such as roads, the transport network including railways, supply of energy, ports, and social infrastructure, over and above what has already been achieved.

The investment policy needs to concentrate on the development of infrastructure and raising government investment in areas such as roads, education, and health and community development without increasing the size of government in terms of employment. The implementation and the management of these projects need to be assigned to the private sector including the use of foreign experts, where necessary, to improve the quality and efficiency of operations. This will help to raise the investment ratio. As the availability of domestic resources and foreign concessional aid would be limited, raising of foreign funding to finance infrastructure through international capital markets would be necessary to supplement domestic resources. A reduction in the access to concessional aid has been a common problem faced by developing countries and the Group of 24 (G24) developing countries already expressed deep concern about the continuation of the declining trend in Overseas Development Assistance (ODA) that began in the early 1990s. ODA to all countries from OECD countries fell to 0.25 per cent of their GNP in 1996 - the lowest level in the last three decades. In this context it would be advisable for Sri Lanka to establish an international credit rating and make its presence felt in the international capital markets through a medium-term bond issue for a limited sum. This needs to done while making further progress in the area of structural reforms to facilitate accelerated investment by the private sector while preserving macroeconomic stability at all times. The international environment for bond issuers in emerging market economies is improving and some countries in East Asia has already re-entered the international private capital markets.

The trade policy relating to the non-plantation agricultural sector has not been transparent. Ad-hoc changes in tariffs and state intervention in trade has made the policy environment unpredictable. This has become a constraint for efficient functioning of markets. The Government needs to clearly define the degree of protection that should be afforded to the domestic agricultural sector through tariffs. The tariff rate for agricultural commodities which have to compete with imports may be placed at the current maximum duty rate of 35 per cent for a stipulated period with a plan for gradual reduction thereafter to be in line with further rationalisation of tariffs.

The Central Bank's Annual Report for 1996 highlighted the need to strengthen structural reforms in many other areas to remove impediments to accelerated economic expansion. They included the introduction of a flexible pricing formula for wheat flour, minimising Government involvement in economic activities such as procurement, importing and trading of agricultural commodities to improve market efficiency, strengthening of research and development in the non-plantation sector and extension services to improve productivity; and civil service and pension reforms to improve the efficiency of the service and reducing the burden on the budget due to rising wage and pension bills. Courageous decisions will have to be taken in all these areas for the country to be able to grow faster as an emerging market economy.