1. ECONOMIC PERFORMANCE, PROBLEMS AND POLICIES

1.1 Overview

Sri Lanka's economic performance in 1998 has to be assessed in the context of a highly unstable external environment where the entire world economy was experiencing the worst economic crisis since the Great Depression in the early 1930s. World financial markets and exchange rates had been experiencing tremendous instability since mid 1997. The East Asian financial market turmoil had immediate contagion effects and more lasting adverse repercussions on the world economy, particularly the financial and commodity markets. The subsequent eruption of a payment and currency crisis in Russia and the economic problems in South Africa, Brazil and several Latin American countries intensified the instability. In addition, there were concerns about the stability of some leading international banks and global investment funds due to their large exposure to countries in financial distress. Meanwhile, the Japanese economy continued to struggle with serious financial problems. Such worldwide financial and economic distress strained the resources of the International Monetary Fund, the World Bank and other institutions with global responsibilities to promote orderly international trade and payments. The crisis also spotlighted the vulnerability of financial systems in many countries, related to weaknesses in corporate governance, regulatory frameworks and supervisory standards, excessive government involvement in running financial and business enterprises, inadequate timely information and political instability. Many financial institutions in crisis countries had to be closed down or restructured with public funds. Globally, financial flows to developing countries slowed down significantly and financial policies were tightened, initially raising interest rates to stabilise exchange rates. There was also continuous speculation on whether China would be compelled to devalue its currency to regain competitiveness, which could threaten the post crisis recovery in many Asian countries. Most crisis ridden countries adopted painful but necessary adjustment measures, which have tended to restore international confidence. Altogether, the growth of the world economy fell by nearly half, from 4.3 per cent in 1997 to 2.5 per cent in 1998, leading to a 70 per cent contraction of the growth of world trade. Non-debt creating capital flows to developing countries declined by over 20 per cent in 1997, with other capital flows also declining sharply. With this instability in world commodity and financial markets, exchange rate movements became highly volatile, particularly among key currencies, which made the task of managing the exchange rate and monetary policy of relatively more open and small economies like Sri Lanka a most challenging task. Survival in a sea of turbulence became an achievement and the Sri

TABLE 1.1
Selected Macroeconomic Indicators

Item	1980-89 Avg.	1990-94 Avg.	1994	1995	1996	1997	1998(a)
GDP (Real) Growth Rate	4.2	5.3	5.6	5.5	3.8	6.3	4.7
GDP Deflator	11.8	12	9.3	8.4	12.1	8.6	8.4
GDP (Nominal), per capita, rupees	9,608	25,148	32,414	36,869	41,940	47,988	54,035
GDP (Nominal), per capita, US dollars	362	515	656	719	759	814	837
Unemployment Rate, per cent	n.a	14.4	12.1	12.0	11.1	10.3	9.1
Import Coverage of Foreign Assets, months							
Gross Foreign Assets	n.a	n.a	7.2	6.6	6.0	6.4	5.9
Gross Offical Reserves	1.8	3.6	5.1	4.7	4.3	4.2	4.0
		Per cent of GDP)					
Gross Domestic Investment	26.2	24.1	27.0	25.7	24.2	24.3	25.4
Gross Domestic Savings	12.9	14.4	15.2	15.3	15.3	17.3	18.9
Foreign Savings	13.3	10.3	11.8	10.4	8.9	7.0	6.4
Balance of Payments, Current Account	-8.1	-6.3	-7.3	-6.0	-4.9	-2.6	-1.8
Budget, Current Account	2.7	-1.6	-2.9	-2.7	-3.8	-2.2	-2.4
Budget, Overall Balance	-12.4	-9.8	-10.5	-10.1	-9.4	-7.9	-9.2
Money Supply (M2b), per cent change (b)	n.a	n.a	18.7	21.1	11.3	15.6	13.2
Colombo Consumers' Price Index, per cent change	12.8	13.1	8.4	7.7	15.9	9.6	9.4
Exchange Rate (Rs/US$), per cent change	-9.1	-4.4	-0.8	-7.5	-4.7	-7.1	-9.6

(a) Provisional.
(b) Consolidated money supply including FCBUs

Source: Central Bank of Sri Lanka

Lanka economy could be deemed to have fared reasonably well during the biggest crisis it faced since the 1930s.

Sri Lanka achieved a moderate 4.7 per cent economic growth in 1998, reflected in almost all economic sectors. This is commendable in the context of many countries recording slow or negative growth. Although this growth rate was lower than the average growth of 5.6 per cent during the previous five years, it compares favourably with the estimated growth of 2.8 per cent for all developing countries in 1998. The inflation rate continued to decline in 1998 owing to improved supply conditions, a slowing down in the growth of money supply and the decline in prices of imported goods whose prices have declined sharply in world markets. The deceleration of the growth of money supply and higher positive real interest rates reduced the demand pressure on prices. A sharp reduction in the import prices of many essential commodities such as wheat, crude oil, fertiliser and sugar kept the domestic prices of these items from rising in spite of the depreciation of the rupee in 1998. The annual average inflation, as measured by the Gross Domestic Product deflator, declined marginally to 8.4 per cent from 8.6 per cent in 1997. Consumer prices increased by 7-9 per cent with a sharper decline in the rate of increase during the second half. The rate of unemployment continued to decline with the increased absorption of labour into the manufacturing, construction, trade, hotel and informal services sectors. In the balance of payments, the trade deficit declined, owing mainly to higher tea prices and a sharp decline in import prices; the current account deficit declined too, from 2.6 per cent of GDP in 1997 to 1.8 per cent in 1998 owing to a continued increase in private transfers and a lower trade deficit. Foreign direct investment inflows increased to US dollars 150 million as

Chart 1.1
Selected Macroeconomic Indicators

Chart 1.1.1
Economic Growth

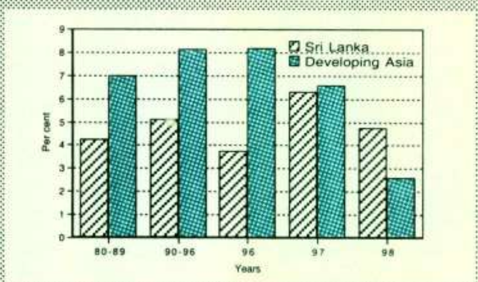


Chart 1.1.2
Consumer Price Changes

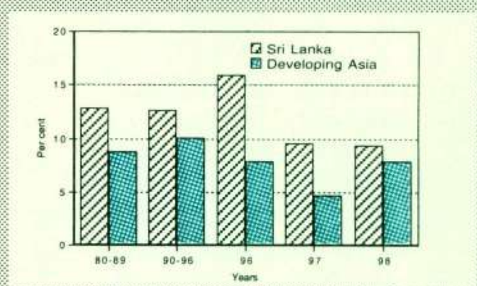


Chart 1.1.3
Unemployment

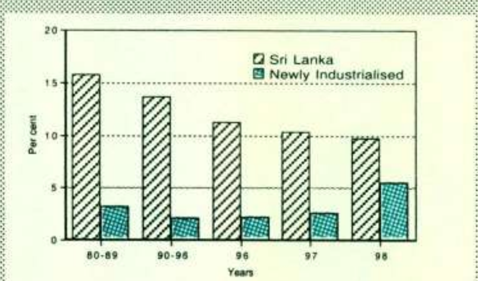
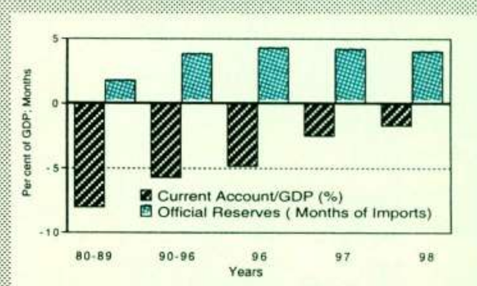


Chart 1.1.4
Balance of Payments and Reserves



several major private sector infrastructure projects started operations in 1998 in the telecommunication and power sectors, in addition to inflows to other sectors. The overall balance of payments registered a surplus of US dollars 37 million. The external reserves remained at a reasonably satisfactory level, adequate to finance 5.9 months of imports. The gross official international reserves were sufficient to cover four months of imports.

The performance on the fiscal front, however, indicated a setback as the overall budget deficit increased to 9.2 per cent of GDP in 1998 from 7.9 per cent in 1997, due largely to higher security related expenditures, an increased wage bill, transfers to loss making public sector institutions and a significant reduction in tax buoyancy due to extensive tax concessions granted in the 1997 and 1998 Budgets and the less than optimal rate fixed for the Goods and Services Tax. Despite the adverse external environment and an expansionary fiscal out-turn, Sri Lanka's financial market remained relatively stable in 1998 as in the previous year, mainly as a result of a flexibly managed exchange rate, perseverance with tight monetary controls which led to a slight increase in interest rates in the market and strengthening of the regulatory and supervisory environment for financial institutions.

In view of the high fiscal deficit, a further relaxation of monetary policy was not possible in 1998 to allow interest rates to decline in consonance with declining inflationary pressure. Instead, interest rates for government debt instruments and the prime lending rate edged upward somewhat owing to higher domestic resource utilisation by the government for deficit financing. A further relaxation of monetary policy would have had adverse implications on price stability and the exchange market. Although in terms of the overall deficit the fiscal performance in 1998 was a setback compared with the commendable progress made during the previous three years, further progress was made in the structural reform area, mainly relating to the tax system, debt management and public enterprise reforms. However, it underlined the need to strengthen structural reforms in the coming years because of uncertainties relating to security related expenditure.

1.2 Output

Economic Growth

The economic growth rate of 4.7 per cent achieved in 1998 was almost equal to the historical long-term average growth rate of around 5 per cent and reflected the resilience of Sri Lanka's economy under the extremely difficult conditions of a global recession. The average economic growth during 1980-89 was 4.3 per cent, while it was 5.4 per cent during 1990-97, when external conditions were far more propitious. It was achieved in the midst of a global recession which had severe adverse effects on some of Sri Lanka's exports, mainly rubber, coconut products, processed diamonds, gems and jewellery.

The adverse effects of the slowing down of exports on the country's foreign exchange resources were more than offset by the declines in import prices of essential commodities. Yet, some of the affected sectors were hit hard by this recession. The rubber sector was the hardest hit. The nominal incomes in this sector, measured in terms of value added, declined by 21 per cent in 1998, following a similar decline in 1997. The real output of the rubber sector declined by 9 per cent in 1998. The coconut sector, which was affected by price competition due to the East Asian crisis and domestic production declines related to the lagged effect of adverse weather in 1997, experienced a slower growth of

Chart 1.2
Sectoral Composition of GDP

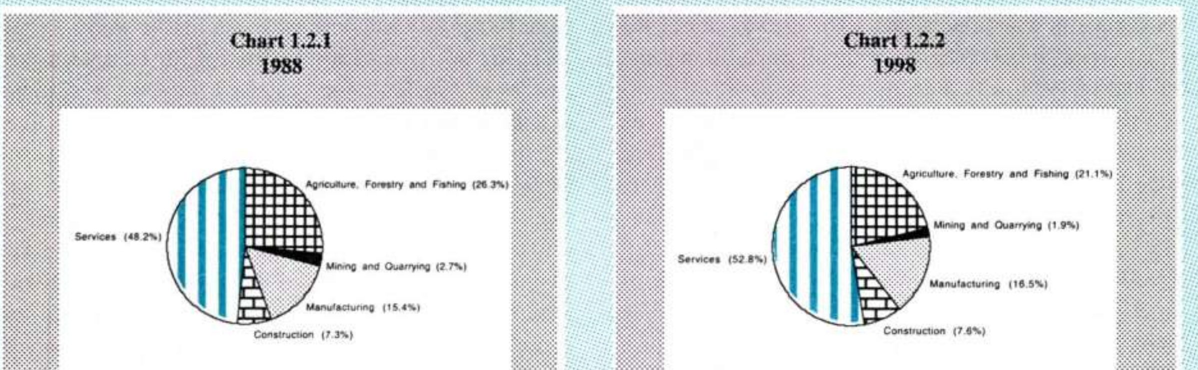


TABLE 1.2

Gross National Product at Constant Prices (Annual Percentage Change)

Item	1980-89 Avg.(a)	1990-96 Avg.(a)	1997(b)	1998(b)
1 Agriculture, Forestry and Fishing	2.3	2.2	3.0	2.5
1.1 Agriculture	2.3	2.2	2.9	1.8
Tea	0.3	4.4	7.1	1.1
Rubber	-2.7	0.9	-5.4	-9.0
Coconut	3.1	0.8	3.3	-3.2
Paddy	1.4	0.8	11.2	18.3
Other	4.6	3.5	0.5	-1.5
1.2 Forestry	3.3	1.5	1.3	1.2
1.3 Fishing	2.7	2.9	5.0	8.3
2 Mining and Quarrying	6.3	3.3	3.8	5.4
3 Manufacturing	5.5	8.6	9.1	6.3
3.1 Processing of Tea, Rubber and Coconuts	0.	2.4	3.5	-1.2
3.2 Factory Industry	7.8	10.0	10.3	7.6
3.3 Small Industry	1.6	5.8	7.0	6.5
4 Construction	1.3	5.0	5.4	7.1
5 Electricity, Gas, Water and Sanitory Services	6.6	7.5	8.1	10.1
6 Transport, Storage and Communication	4.7	5.5	8.8	7.7
7 Wholesale and Retail Trade	4.6	5.7	6.3	4.5
7.1 Imports	2.7	7.8	9.6	8.2
7.2 Exports	4.4	11.2	12.0	0.1
7.3 Domestic	6.4	2.7	2.2	2.0
8 Banking, Insurance and Real Estate	9.4	8.2	10.2	6.4
9 Ownership of Dwellings	2.9	1.3	1.3	1.2
10 Public Administration and Defence	10.2	3.1	5.2	3.0
11 Services (n.e.s.)	2.2	5.3	6.1	3.7
12 Gross Domestic Product	4.2	5.3	6.3	4.7
13 Net Factor Income from Abroad	43.5	4.4	-21.7	11.9
14 Gross National Product	4.0	5.4	6.8	4.6

(a) At 1982 constant factor cost prices
(b) At 1996 constant factor cost prices

nominal income than any other sector except rubber. The real value added in the coconut sector declined by 3.2 per cent. The gem and diamond processing industries also experienced a slow growth in nominal incomes (5 per cent) with a decline in real value added. The growth rate of the industrial sector also slowed down significantly during the second half of 1998, with a deceleration in exports.

Gross Domestic Product at current market prices increased by 13.3 per cent to Rs. 1,015 billion in 1998. This, with the estimated mid-year population of 18.772 million, indicates an increase in per capita nominal income to Rs. 54,035 (US dollars 837) in 1998 from Rs. 47,988 (US dollars 814) in 1997. In the World Bank classification of countries according to income, Sri Lanka has now been recognised as a 'lower middle income' country, moving up from the 'low income' group. Some of the other Asian countries in this group are Indonesia, the Philippines, Thailand, China and the Maldives. The next layer is the 'upper middle income' group whose per capita GNP is in the range of US dollars 3,116 – 9,635. Sri Lanka needs a steady 8.5 per cent annual economic growth for it to become an upper middle income developing country within the next ten years. In view of the recent slowing down of the economic growth and poor prospects for the world economy, achieving this is not feasible. Even if Sri Lanka remains in the 'lower middle income' category for some more time, it is unlikely that it will be able to find concessional foreign aid to meet all of its foreign resource requirements for development projects, particularly in an environment where foreign aid to developing countries has been declining. A gradual increase in economic growth to about 7 per cent per year may be possible if the domestic investment ratio is raised to about 30 per cent early. Although the recent increase in the savings rate is a welcome development, raising the domestic savings rate to 30 per cent of GDP or more within the next three years may not be possible, unless budgetary savings are raised through a surplus in the current account. Given this limitation, some amount of foreign financing for future development projects will have to be raised in international capital markets.

In terms of the sectoral contribution to the increase in output, the manufacturing sector made the largest contribution of 23 per cent to GNP in 1998. The next highest contributions were from trade (22 per cent) transport and communication (18 per cent), construction (11 per cent) and financial services (11 per cent). The agriculture sector contributed 7 per cent, with a 12 per cent contribution by the paddy sub sector and overall negative contributions by other agricultural sectors. The manufacturing and services sectors continued to gain importance in the economy.

Manufacturing

The manufacturing sector grew by 6.3 per cent in 1998, a somewhat lower rate compared to 9.1 per cent in 1997. Reflecting a strong performance in the domestic market oriented industries such as petroleum products, cement, building materials, wheat flour, animal feed, liquor, milk products, pharmaceuticals, beverages and chemicals, the output of factory industries other than the processing of tea, rubber and coconut increased by 7.6 per cent in 1998, compared to 10.3 per cent in 1997. Export oriented industries showed a mixed performance. Fish products, rubber and ceramics maintained high positive growth rates, while diamonds, gems and jewellery exports declined. Textiles and garments, the leading industry, slowed down during the second half in the face of increased global competition. Factory industries, which accounted for 84 per cent of the manufacturing sector, contributed 22 per cent to the overall economic growth in 1998. The industrial sector production capacity is estimated to have increased by 4 per cent in 1998, while capacity utilisation remained at 84 per cent as in 1997. The labour productivity in the non-BOI sector is also estimated to have increased by 4 per cent in 1998.

The growth in the industrial sector was achieved in the midst of a depressed global trading environment where the growth of international trade declined by two thirds following the East Asian financial crisis and subsequent economic problems in many countries including Russia, Japan and in South and Central America. In depressed world market conditions, the competition among exporting countries intensified. The Sri Lanka rupee also depreciated faster (9.6 per cent compared to an annual depreciation of 5-6 per cent during the last few years) and helped the industrial sector to some extent. The economic downturn in the Asia-Pacific region depressed the demand for exports of processed diamonds, jewellery and ceramic products. Some export oriented industries continued to perform reasonably well, as the major buyers, who looked for product quality and reliable supply sources, continued to place orders with Sri Lankan manufacturers. However, a general slowing down of the export oriented industrial sector cannot be avoided.

The policy measures, including fiscal incentives for advanced technology in industries, provision of foreign currency loans to non-BOI exporters and the liberalisation of textile imports, together with relatively low interest rates compared to high rates in the past, had a favourable impact on industrial growth. Production capacity has expanded with technology gains and new investments and the industrial base has become more diversified. Benefiting from the removal of the duty on capital goods, imports of investment goods increased by 12 per cent to refurbish existing factories and to start new industries during the year. Use of advanced technology has improved productivity in many industries (e.g., fruit and meat processing, rubber and garments), which has helped to offset a modest increase of wages and salaries.

A gradual increase in labour productivity appears to be taking place in the manufacturing sector and this sector, in terms of its implicit price deflator which measures the overall increase in cost of production, has been one of the relatively low cost areas. For example, the price deflator in factory industries was 6 per cent in 1998, compared to the overall GDP deflator of 8.4 per cent. Further improvement of competitiveness of this sector will have to come mainly from productivity improvements. In addition to timely upgrading of machinery and human skills, further development of the road and transport systems, port facilities and the communication network would be necessary for faster growth in this sector. The mismatch between demand for and supply of labour and rigidities in the labour market have been a constraint to faster industrial expansion.

Agriculture

The real output in agriculture is estimated to have increased by 2.5 per cent in 1998, compared to 3 per cent in 1997. A significant increase in the land under paddy, due to favourable weather conditions, and higher yields contributed to the increase in paddy output by 20 per cent. Improved output levels were shown in both Maha and Yala seasons. The Maha paddy output was higher by 22 per cent and the Yala output was higher by 16 per cent following a partial recovery from the drought in 1997. The average producer price of paddy declined by 7 per cent to Rs.215 per bushel. With the increased domestic production, rice imports declined to 168,000 metric tons in 1998 from 306,000 in 1997. The import duty on rice was restored at 35 per cent with a view to maintaining a reasonable price for rice in the domestic market in the interests of both consumers and producers.

Tea continued to attract higher prices until mid 1998 and production, which was increasing under the privatised management, increased further by 1 per cent to a new record level of 280 million kgs. in 1998. Tea prices started declining with the payments and currency crisis in Russia in July 1998 and the considerable increase in world tea supply, mainly following the recovery of production (30 per cent) in Kenya. Tea production in India also increased, exerting downward pressure on prices. On average, the

Colombo Auction price of tea increased by 13 per cent while the export price increased by 17 per cent (7 per cent in US dollar terms). In 1998, 40 per cent of Sri Lanka's tea exports went to the Commonwealth of Independent States (CIS), Turkey and the UAE. Tea exporters faced difficulties due to non-settlement of export bills by Russian buyers. Tea exports to Russia during the second half of 1998 had declined to 14 million kgs., from 25 million kgs. in the first half. The average cost of production of tea increased by 14 per cent to Rs. 107 per kg. The increase in the daily wage rate in the tea sector from Rs. 83 per day to Rs. 101 was a major contributory factor to the cost increase in 1998. Sri Lanka maintained its status as the largest tea exporter in the world in 1998.

Rubber production declined by 9 per cent, mainly due to the erosion of profit margins of rubber producers as a result of a continued decline in prices since 1996. The average export price of rubber declined by 10 per cent to Rs.68 per kg., while the Colombo Auction prices declined by 12 per cent to Rs.49.76. The price decline was a result of the depressed world demand, the release of stocks by the Thai government in early 1998 and price effects of currency depreciations in East Asian countries. The International Natural Rubber Price Stabilisation arrangement could not arrest the price decline and the International Natural Rubber Treaty was in disarray due to financing problems. However, the steady increase in the use of local rubber as a raw material in the industrial sector for export as well as domestic use has been an encouraging trend. In 1998, more than 50 per cent of the total rubber output was used by the domestic industries.

The decline in coconut production is attributed largely to the after effects of adverse weather experienced in 1997. However, some signs of recovery in output were observed during the second half of 1998. Production of desiccated coconut declined by 31 per cent, while oil production increased by 16 per cent. In addition, local consumption has also been rising recently, due to the use of coconut products by local industries such as confectioneries and biscuit manufacturing. The price of fresh nuts remained high throughout the year due to overall supply constraints.

Other export crops showed a considerable improvement, with pepper, cocoa, coffee, cardamom, nutmeg and cinnamon oil recording increased outputs. These crops benefited from favorable prices. Among other field crops, the output of black gram, green gram, cowpea and soya bean increased, while the output of chillies, red onions, big onions and potatoes declined to low levels as the local high cost producers could not compete with imports from India and Pakistan after the complete liberalisation of Sri Lanka's trade policy relating to agricultural commodities in 1996.

Fish production during the year increased by 8 per cent, particularly due to an improvement in marine fisheries. The livestock sector also showed an improvement in 1998.

Mining and Quarrying

The mining and quarrying sector suffered a decline in 1998. The Asian crisis reduced the demand for gems and semi-precious stones, thus adversely affecting the mining sub sector. Export earnings from gems declined by 34 per cent in US dollar terms. The quarrying sub sector, boosted by the growth in construction, performed well and partly offset the negative developments in the mining sub sector.

Economic Overheads

Insufficient infrastructure facilities has been one of the factors that has affected the competitiveness of Sri Lankan products and constrained faster economic expansion in Sri Lanka. The conflict in the North and the East has curtailed the development of key sectors due to resource constraints. Public investment had gradually declined from 13 per cent of GDP in 1985 to 5 per cent in 1997. Accordingly, the overall investment ratio had not been growing sufficiently to facilitate a growth rate of more than 5 per cent in the next few years. Realising this, the government maintained capital expenditures almost as planned in the 1998 Budget, despite a shortfall in revenues and increased security expenditures. Public investment increased to 6.8 per cent of GDP in 1998 and the target in the 1999 Budget is 7.5 per cent of GDP.

In 1998, investment in infrastructure by both the public and the private sectors made considerable progress. Private sector involvement in areas such as power, telecommunication and ports increased in 1998. The telecommunication sector further improved with increased private sector participation and improved efficiency of Sri Lanka Telecom (SLT) due to reorganisation of the

TABLE 1.3

Gross National Product (Sector Shares in per cent)[a]

	1978	1988	19976	1998
1 Agriculture, Forestry and Fishing	30.4	26.3	21.7	21.3
2 Mining and Quarrying	2.3	2.7	2.0	1.8
3 Manufacturing	18.5	15.4	16.6	16.5
4 Construction	4.8	7.3	6.9	7.1
5 Services	43.9	48.2	52.8	53.0
Electricity, Gas, Water and Sanitary Services	0.5	1.2	1.3	1.4
Transport, Storage and Communication	10.8	10.8	11.1	11.2
Wholesale and Retail Trade	19.9	19.9	22.0	22.3
Banking, Insurance and Real Estate	2.4	4.4	7.4	7.5
Ownership of Dwellings	3.8	2.6	1.9	1.9
Public Administration and Defence	3.8	5.4	5.0	4.9
Services (n.e.s.)	4.3	3.8	4.0	3.9
6 Gross Domestic Product	100.0	100.0	100.0	100.0
7 Net Factor Income from Abroad	-0.6	-2.6	-1.2	-1.3
8 Gross National Product	99.4	97.4	98.8	98.7

(a) At current factor cost prices   Source: Central Bank of Sri Lanka management of SLT by NTT of Japan. In addition, the Ceylon Electricity Board (CEB) was evaluating proposals for the construction of a number of small hydro power projects by the private sector. The divestiture of a portion of Air Lanka Ltd., with a management contract to improve its performance, was a major step forward in the public enterprise reform programme. A preliminary agreement between the Government of Sri Lanka and South Asia Gateway Terminal (Pvt.) Ltd. has been signed to develop the Queen Elizabeth Quay (QEQ) on a BOT basis at a cost of US dollars 240 million.

Investment in power generation, transmission and distribution grew sharply by 58 per cent. With the commissioning of new thermal plants, the power generating capacity of thermal plants grew by 4 per cent, reducing the reliance on hydro power to 69 per cent. The telecommunication sector grew rapidly, outpacing the growth of demand and the waiting list for telephones is expected to be eliminated by 2002. The availability of telephones, in terms of the number of persons per telephone, including cellular and wireless phones, improved from 41 in 1997 to 27 in 1998. Efforts to maintain the national road network were strengthened considerably. Initial work on large road infrastructure projects such as the Matara – Colombo Expressway, Colombo – Katunayake Highway and the Outer Circular Road connecting major highways in Colombo commenced in 1998.

The need to improve the quality of education had been well recognised and an ambitious reform programme commenced in 1998. In the area of health, under the health sector reforms, the priorities of the health sector were redirected, taking into consideration the emerging requirements in the sector. Initial work on health reforms began in 1998. The government plays a key role in both health and education. In view of the government's resource constraints and to improve efficiency, direct private sector participation in both areas needs to be promoted effectively. Meanwhile, the Presidential Task Force on Housing and Urban Development has emphasised the need to encourage private sector involvement in providing housing facilities.

1.3 Investment and Savings

Gross domestic investment is estimated to have increased in 1998 to 25.4 per cent of GDP from 24.3 per cent in 1997. While this increase is entirely due to higher public investment, it is noteworthy that investment by the private sector has been maintained as in the previous year at 18.5 per cent of GDP, despite weak prospects for faster economic expansion in the next two years due to the uncertain global economic environment. The new investments were largely in infrastructure projects and capacity expansion in manufacturing industries. There has been a gradual increase in private investment during the last four years, but this was not sufficient to raise Sri Lanka's potential growth significantly.

Chart 1.3
Savings and Investment

Chart 1.3.1
Investment and Investors

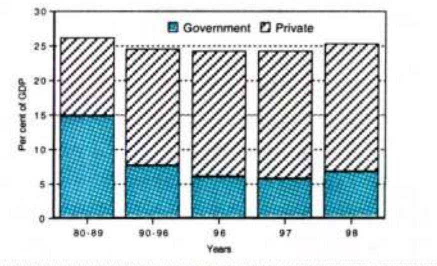


Chart 1.3.2
Savings and Savers

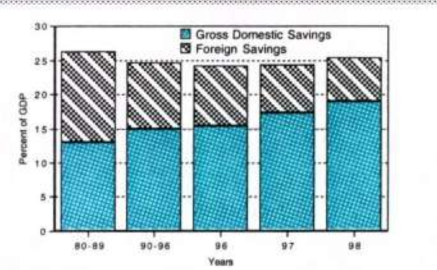
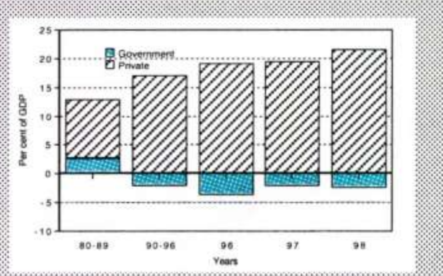


Chart 1.3.3
Financing of Investment



Sri Lanka's gross domestic savings ratio increased from 17.3 per cent in 1997 to 18.9 per cent in 1998. The Gross National Savings ratio also increased from 21.5 per cent of GDP to 23.2 per cent. The growth of savings is mainly attributed to growing per capita incomes and positive real interest rates. The real interest rates for investors in government debt instruments became more positive during the second half of 1998, as inflation declined and nominal interest rates increased by about 2 percentage points. While the average weighted commercial bank deposit rate declined from 10 per cent in 1997 to 9.2 per cent in 1998, the point to point inflation rate has been below six per cent since August 1998, making the real interest on bank deposits also more positive. The marginal savings ratio has remained at 30 per cent during the past two years. The gradual increase in savings has been an encouraging sign because it reflects the country's growing ability to finance a higher level of investment out of its own resources. However, it is a matter for concern that the growth of investment has been slow compared to savings.

1.4 Prices

All available price indices reflected a decline of inflation in 1998. The consumer prices increased by 6.9-9.4 per cent, compared to 7.1-9.6 per cent in 1997. The Wholesale Price Index (WPI), which measures prices at the primary market level, showed an increase of 6.1 per cent in 1998, compared to an increase of 6.9 per cent in 1997. The more comprehensive GDP deflator, which is an aggregate index of all price changes, declined to 8.4 per cent in 1998, compared to 8.6 per cent in 1997.

Price increases subsided, notably during the second half of the year. Consumer price inflation remained below 6 per cent from August 1998. Food prices continued to remain high, despite a slowing down of the rate of increase in prices in the second half of the year. Food prices increased by 8-10 per cent and contributed to about 80 per cent of the increase in consumer prices in 1998. The rate of increase in food prices had decelerated to around 2-4 per cent by the end of the year, due to improved domestic supplies, including the successful paddy harvest both in the Maha and Yala seasons, as well as the increased availability of imported food. The indirect impact of the revision of electricity tariffs in September 1997 was felt in 1998. Price increases in clothing, footwear, telecommunication and health services have declined considerably due to the improved performance of these sectors. The introduction of the Goods and Services Tax (GST) in April in place of the turnover tax also raised consumer prices by 2-3 per cent initially, as traders used this opportunity to raise prices without offsetting turnover taxes.

1.5 Wages

After several years of slow growth, there were significant increases in both nominal and real wages in most sectors, including the public sector in 1998. With the implementation of the second stage of the salary increases following the Salary Review Committee recommendations, the Nominal Wage Rate Index for Government Employees increased by 10.5 per cent in 1998. In the organised private sector, the minimum wages applicable to a large number of Wages Boards were revised upwards and as a result, a substantial increase in wages was recorded for most categories of workers. From January 1998, the daily wage rate of workers in tea plantations covered by collective agreements increased from Rs.83 to Rs.95, with a share price bonus of Rs.6 per day when the price exceeded a given level, subject to a review at the end of every 18 months. The rubber sector

Chart 1.4
Changes in Prices

Chart 1.4.1
Inflation (Annual)

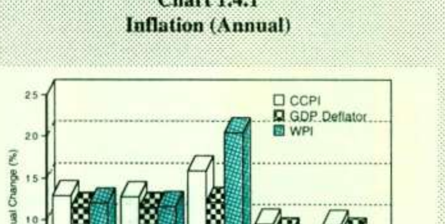


Chart 1.4.2
Consumer Prices (CCPI)

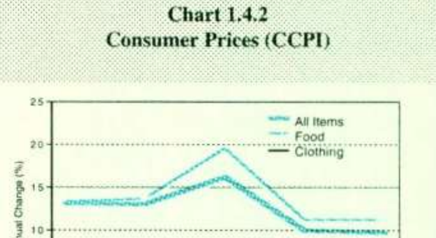
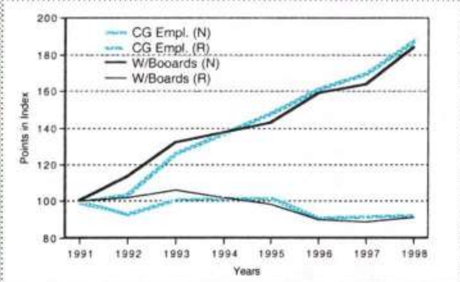


Chart 1.5
Wage Rate Indices
(1991 = 100)



employees covered by the same agreement were also given a price wage supplement at a rate of 30 cents for each one rupee increase of the rubber price above Rs.65 per kg. The minimum wage rates of employees covered under 19 other Wages Boards were also raised. Accordingly, the overall Minimum Wage Rate Index for workers covered under the Wages Boards increased by 12 per cent.

Most informal sector employees, consisting of carpenters and masons in small scale construction activities and workers in small scale agriculture (tea, coconut and paddy), experienced wage increases in the range of 7-15 per cent, while those in some activities in the rubber sector experienced a decline in nominal wages, reflecting the deterioration of rubber prices.

1.6 Employment and Unemployment

The unemployment rate has continued to decline in 1998. According to the Quarterly Labour Force Surveys of the Department of Census and Statistics, it has fallen from 16 per cent of the labour force in early 1990 to 9.1 per cent by the third quarter of 1998. However, the past data on unemployment and the recent data are not strictly comparable, as the coverage has now been improved to include unpaid family workers as employed. If unpaid family workers were excluded, the unemployment rate would be about 10.3 per cent, which still confirms a declining trend in unemployment. Manufacturing, construction, trade, hotels, insurance, real estate and personal services were key areas of employment generation. The BOI firms, along with 137 new projects commencing operations in 1998, generated direct employment for nearly 36,000 persons, a considerable increase compared to 16,000 in 1997. New employment provided by the public sector was estimated at about 19,000. The manufacturing sector is estimated to have generated around 27,000 new employment opportunities at the end of the third quarter of 1998 compared to the third quarter of 1997. The construction sector, which has been growing at a faster rate than in 1997, had also generated about 5,400 new employment opportunities. The employment in the agricultural sector, estimated at 2.4 million, represented 38 per cent of the employed work force. A little over 15 per cent of the employed were in the manufacturing sector, while the remaining 47 per cent were in the services sector. The share of public sector employment has been declining from 25 per cent in 1993 to about 18 per cent in 1998. Casual workers accounted for 9 per cent of public sector employment in 1998.

1.7 Fiscal Policy and Budgetary Operations

The successful fiscal deficit reduction achieved in the last two years could not be maintained in 1998. The target in the 1998 Budget was to reduce the overall fiscal deficit to 6.5 per cent of GDP while generating a surplus in the current account. However, slow growth of tax revenues and large expenditure overruns, particularly in the area of defence, led to larger current account and overall fiscal deficits. The current account deficit increased to 2.4 per cent of GDP in 1998 from 2.2 per cent in 1997, while the overall deficit (before grants and excluding privatisation proceeds) rose to 9.2 per cent from 7.9 per cent in 1997. The primary budget deficit, i.e., deficit excluding interest payments, increased to 3.8 per cent of GDP in 1998 from 1.7 per cent in 1997. Unlike in the past where capital expenditures were pruned in the face of large current account deficits, public investment in 1998 was significantly increased as envisaged in the Budget, to reduce shortcomings in infrastructure facilities. Thus, the larger overall deficit in 1998 was partly attributed to increased public investment.

The revenue buoyancy of the tax system continued to erode in 1998 largely owing to numerous tax exemptions and concessions that have been granted to promote private investment. In addition, the GST did not generate the expected revenue owing to transitional problems. Further, the rate of 12.5 per cent was below the estimated revenue neutral rate (vis a vis the turnover tax which it replaced) of about 17 per cent. Tax collections as a ratio of GDP declined to 14.5 per cent in 1998 from 16 per cent in 1997. Import tax revenue declined, mainly as a result of exemptions and concessions and a reduction in import values, reflecting a decline in the prices of Sri Lanka's major imports. The effect of the slow growth of tax revenues was partly offset by a marked increase of non-tax revenues in the form of additional profit transfers from public enterprises, increased rent payments from plantation companies and the timely collection of other non-tax revenue such as interest, levies and dividends. Total revenue declined to 17.3 per cent of GDP in 1998 from 18.5 per cent in 1997. This shortfall accounted for 44 per cent of the increase in the actual deficit, from the budgeted deficit.

Current expenditures were contained at 19.7 per cent of GDP, a decrease from 20.8 per cent in 1997, through a reduction in interest costs and payment of subsidies to households. Interest payments as a ratio of GDP declined from 6.2 per cent to 5.4 per cent in 1998, reflecting the favourable impact of improved fiscal performance during the last two years, including the retirement of part of the public debt in 1997 using privatisation proceeds. Transfers to households, as a ratio of GDP, declined from 4.1 per cent in 1997 to 3.7 in 1998. However, the wage bill increased from 5 per cent of GDP in 1997 to 5.3 per cent of GDP in 1998. This was the result of increased employment as well as wage increases granted during the year. Total security expenditures, including repayments on account of the procurement of security equipment, are estimated to have increased from Rs.47,718 million (5.4 per cent of GDP) in 1997 to a record Rs.56,390 million (5.6 per cent of GDP) in 1998.

Public investment in 1998 (6.7 per cent of GDP) almost reached the 1998 Budget target of 6.9 per cent of GDP. This was a significant increase, compared with a decline to 5.8 per cent in 1997 from 7.9 per cent of GDP in 1995. The increase in public investment in 1998 was possible due to increased utilisation of foreign aid. As the government was committed to maintaining the investment programme, unlike in the past, the required matching rupee resources were released more expeditiously. Capital expenditure was mainly concentrated in key areas such as energy, transport, telecommunication, port and water supply and drainage. Investment in these areas increased sharply by 55 per cent and accounted for 66 per cent of the total public investment. The increase in public investment was particularly important in a context where private investment has slowed down due to depressed world market conditions. This would have a positive impact on the overall economic growth in the coming years.

Net foreign financing and receipts on account of sales of shares of public enterprises provided 2 per cent of GDP for financing the budget deficit in 1998, while the other 7 per cent of GDP had to be financed through additional domestic borrowing. The increased domestic resource needs of the government led to a marked increase in bank borrowings, including the use of US dollars 100 million as a short-term loan from the Foreign Currency Banking Units. Generally, such a large increase in bank borrowings would have led to strong pressure on interest rates. However, as growth of credit to the private sector had slowed down, thus leaving additional resources in the banking system, a sharp

TABLE 1.4
Summary of Government Fiscal Operations

Item	(as a percentage of GDP)							
	1980	1985	1990	1994	1995	1996	1997	1998(a)
1 Revenue	19.6	22.3	21.1	19.0	20.4	19.0	18.5	17.3
2 Expenditure and Net Lending	41.8	34.1	31.0	29.5	30.5	28.5	26.4	26.4
2.1 Current Expenditure	18.5	20.1	22.3	21.9	23.1	22.8	20.7	19.7
2.1.1 Security	1.3	4.5	4.1	4.6	6.5	5.8	5.1	5.0
2.1.2 Interest	3.4	4.6	6.4	6.6	5.7	6.4	6.2	5.4
2.1.3 Wages(b)	4.5	3.6	3.9	3.1	3.4	3.3	3.1	3.0
2.1.4 Subsidies and Transfers	8.4	5.5	6.5	5.9	6.1	6.0	5.1	4.6
2.1.5 Others	0.9	1.9	1.4	1.8	1.4	1.3	1.3	1.6
2.2 Capital and Net Lending	23.3	13.9	8.7	7.5	7.4	5.7	5.7	6.8
2.2.1 Public Investments	18.5	13.8	8.3	7.0	7.9	6.0	5.8	6.7
Aquisition of Real Assets	7.9	4.5	3.7	2.9	3.4	2.7	2.9	3.2
Capital Transfers	9.4	8.6	2.3	2.4	2.9	2.2	2.1	2.2
On Lending	1.2	0.6	2.2	1.7	1.7	1.1	0.8	1.4
2.2.2 Other	4.7	0.2	0.4	0.6	-0.5	-0.3	-0.1	0.0
Restructuring Cost	0.0	0.0	0.0	0.6	0.5	0.0	0.2	0.4
Others	4.7	0.2	0.4	-0.1	-1.0	-0.3	-0.3	-0.3
3 Current Account Balance	1.1	2.2	-1.2	-2.9	-2.7	-3.8	-2.2	-2.4
4 Overall Deficit before Grants and excluding Privatisation Proceeds	-22.2	-11.7	-9.9	-10.5	-10.1	-9.4	-7.9	-9.2
5 Financing	22.2	11.7	9.9	10.5	10.1	9.4	7.9	9.2
5.1 Foreign Financing	9.2	6.4	5.7	3.5	4.5	2.3	1.9	1.7
5.1.1 Loans	5.3	4.4	3.6	2.0	3.2	1.3	1.1	1.0
5.1.2 Grants	3.9	2.0	2.1	1.4	1.4	1.0	0.8	0.7
5.2 Domestic Financing	13.0	5.3	4.2	6.5	5.1	6.5	3.4	7.0
5.2.1 Banks	9.8	2.9	0.1	0.2	1.1	1.7	-0.2	1.9
5.3 Privatisation	0.0	0.0	0.0	0.5	0.4	0.6	2.5	0.4
Memorandom Items :								
Total Wage Bill	5.0	4.2	4.9	5.1	5.2	5.0	5.0	5.3
Gross Defence Expenditure (c)	1.3	4.5	4.1	4.6	6.5	6.0	5.4	5.6

(a) Provisional
(b) Excluding those paid to defence staff.
(c) Including settlement of deferred payments.

Source: Central Bank of Sri Lanka

increase in interest rates could be avoided with a moderate monetary expansion. The Central Bank financing of the fiscal deficit increased by Rs. 5,609 million, compared to a repayment of Rs. 13,991 million in 1997.

Although the fiscal performance in 1998 was a setback in terms of the overall deficit, further progress was made in structural reforms relating to the tax system, public enterprise reforms and debt management.

Tax policy reforms, aimed at further simplifying the tax structure, improving the tax base and increasing transparency of the tax system, were continued during 1998. The introduction of the Goods and Services Tax (GST) with effect from 1 April 1998 in place of the Turnover Tax (TT) was a major structural change made in the tax system. The GST was put in place to eliminate the cascading effect of the TT system, improve tax compliance and increase transparency in the tax system. All exports are zero rated under GST, while domestic consumption is subject to taxation. Unprocessed agricultural products, public transport, fertiliser, cement, pharmaceuticals and most essential food items were exempted from the GST. Imports for the processing of exports, which were exempted under TT, were brought under the GST system. Financial services continued to be under TT, but at a lower rate of 1 per cent, compared to the previous 2 per cent. Many countries, when introducing a GST, had designed the system to be revenue neutral or revenue enhancing. However, Sri Lanka is one of the few countries to introduce a GST with a less than revenue neutral rate of 12.5 per cent. The revenue neutral rate was estimated to be about 17 per cent. Although a full year cycle will only be completed in April 1999, the indications in 1998 were that the GST was not generating sufficient revenues. This was due to the transitional problems at the initial stage and the lower GST rate. This was a major reason for the reduction of the revenue buoyancy of the tax system. Tax revenue as a ratio of GDP declined to 14.5 per cent from 16 per cent in 1997.

Tariff rates were reduced further by replacing the existing 3-rate band structure of 10, 20 and 35 per cent with a 5,10 and 30 per cent rate structure. All imports of industrial raw materials and machinery not manufactured in Sri Lanka were brought under the 5 per cent band, while imports of transport, communication and medical equipment were classified as zero rated. Duty on motor cars and jeeps was brought down from 50-100 per cent to 30 per cent, while a 10 per cent additional excise tax was enforced on all vehicle imports to offset the revenue shortfall resulting from this reduction. With a view to protecting the domestic agricultural sector, the duty on agricultural products was maintained at 35 per cent, while the 20 per cent rate also continued for some imports. After all these revisions, Sri Lanka now has a 5-rate tariff structure. A 2-rate tariff structure is expected to be adopted in the year 2000, following the recommendation of the Presidential Tariff Commission Report.

Chart 1.6
Fiscal Overview

Chart 1.6.1
Government Budget

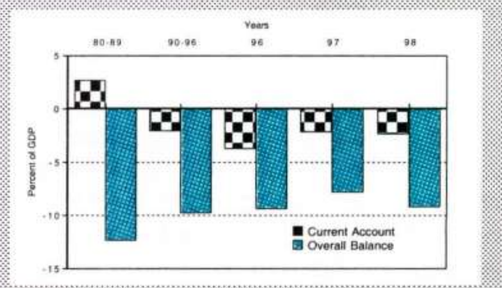


Chart 1.6.2
Government Budget

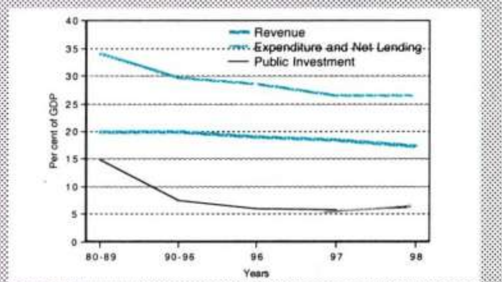
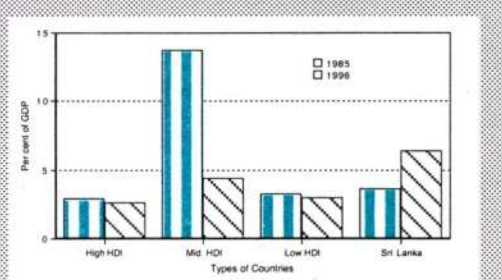


Chart 1.6.3
Security Expenditure Comparison



Other major policy changes under fiscal operations in 1998 were the liberalisation of textile imports and the subsequent acquiring of the textile sector debt liabilities by the government and the establishment of a Textile Debt Recovery Fund (TDRF) to assist the affected manufacturers, fixing the tariffs on garments at 10 per cent, and the introduction of various support schemes to assist research and development, vulnerable groups, selected priority sectors and regional industrialisation.

The 1997 Budget had announced a reduction of the corporate profit tax and maximum personal income tax rate from 35 per cent to 30 per cent in 1998 and then to 25 per cent in 1999. However, owing to revenue considerations, the proposal was not implemented in 1998. Instead, income tax concessions were granted to selected priority sectors. Accordingly, the corporate tax rate for enterprises in agriculture, fisheries, livestock and tourism was reduced to 15 per cent. Several changes were also made to the excise taxes, including the raising of taxes on liquor by 10 per cent and on petrol from 25 per cent to 50 per cent. Stamp duty on repurchase agreements, pro-notes, bills of exchange, mortgage backed securities and mortgage bonds on lease agreements were substantially reduced in 1998 with a view to lowering the cost of financial market transactions and improving the secondary market for government securities.

Debt Management

Further progress was made toward making the government debt programme more market oriented and reducing the reliance on short-term debt. Most of the new deficit financing needs of the government were met through Treasury bonds. In 1997, Rs.10,000 billion worth of Treasury bonds were issued while this increased to Rs.38,915 million in 1998. Consequently, the share of Treasury bonds in the total net domestic borrowings rose from 22 per cent in 1997 to 72 per cent in 1998. While the total stock of debt increased from 86 per cent of GDP in 1997 to 89.4 per cent in 1998, the short-term debt declined from 40 per cent in 1997 to 37 per cent in 1998. The share of foreign debt increased to 45.4 per cent of GDP in 1998, with 84 per cent of the increase in 1998 being on account of exchange rate depreciation. The total government debt service payments increased to 11.3 per cent of GDP in 1998 from 10.4 per cent in 1997. Interest payments accounted for 48 per cent of the total debt service payments.

Several measures were taken to improve the market orientation of Treasury bonds. The direct participation of the EPF at the Treasury bond auctions was discontinued in 1998. This eliminated the submission of non-competitive bids, i.e., bids without a rate, which was not consistent with market principles. The maturity period of Treasury bonds was gradually extended from 2 to 4 years, with the expectation that there would be a further extension to at least 6 years in 1999. A system of 'Jumbo' issues of Treasury bonds (one large block of Treasury bonds with a given maturity, but sold in smaller lots at different periods) was introduced with the objective of giving greater flexibility to investors in the management of their portfolios. Commercial banks were permitted to hold Treasury bonds as part of their liquid assets. In addition, commercial banks and Primary Dealers were permitted to use Treasury bonds for transactions at the Central Bank's secondary window for investment of excess funds or to obtain temporary liquidity. In addition, high cost Rupee loans obtained in the past, amounting to Rs.16,000 million, were retired using the early retirement option.

1.8 The International Environment and External Sector

The international economic environment was plagued by a host of disturbing events in 1998. In particular, the impact of the East Asian currency crisis was felt acutely by the global economy during 1998. Continued deep recession in Japan, the rouble crisis in Russia since August and, to a lesser extent, the problems in South America, added fuel to a kindling uncertain global economic and financial environment. Against this background, the global economy continued to suffer from severely depressed demand, deflationary pressures with declining commodity prices and a flight of capital from many emerging market economies.

The world economy grew by only 2.2 per cent, a sharp slow down from 4.2 per cent in 1997. The growth rate of developing countries in Asia declined to 3.8 per cent from 6.6 per cent in 1997, while the growth of advanced economies slowed down to 2.2 per cent from 3.2 per cent in 1997. Japan's output declined by 2.8 per cent in 1998. In the euro area the output increased by 2.9 per cent, a slightly higher rate than in 1997. Asia, which remained the mainstay in world output growth for quite a long time, suffered a setback due to the currency crisis, registering a growth of 1.8 per cent against an initial forecast of 7.4 per cent. The most disturbing deterioration in output was seen in the ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand) which recorded a 9.5 per cent decline, after slowing down to 3.8 per cent in 1997. An encouraging feature in the global economy in 1998 was the continued robustness of the economies of the USA and many countries in Europe which contribute to about 60 per cent of world output. The US economy grew by 3.9 per cent as in 1997. Economic growth in countries in transition declined by 0.1 per cent, reflecting a 4.6 per cent decline in output in Russia.

Declining commodity prices due to depressed global demand, coupled with strong commitments by governments to price stability, ensured that inflation continued to drop in most regions except in Asia and in countries in transition. Consumer price inflation in advanced economies declined from 2.1 per cent in 1997 to 1.5 per cent in 1998, while in developing countries it increased from 9.3 per cent to 10.4 per cent. Meanwhile, inflation in countries in transition

Box 1

The Euro

The euro is the common currency of the newly formed "Euroland", a single economic zone formed by the integration of 11 of the 15 member countries of the European Union (EU)[1]. The concept of a single currency for Europe has its origins in the attempt towards economic integration of Europe suggested in the Treaty of Rome in 1957, that established the European Economic Community (EEC), but the idea only crystalised during the Hague summit of European leaders in 1969. The final breakthrough came in 1992 when the Maastricht Treaty on European Union (EU) was signed and ratified by the member countries.

The formal introduction of European Monetary Union (EMU) and the euro has taken place in three stages. Stage I commenced on 1 July, 1990 and focused on the removal of capital controls and reducing the regional disparities within the European Union (EU). Stage II, which commenced on 1 January 1994, aimed at promoting the goal of achieving fiscal and monetary convergence among member states and the establishment of the European Monetary Institute which was the forerunner to the European Central Bank (ECB). The final stage commenced on 1 January 1999 with the formal introduction of the euro and the irrevocable fixing of the exchange rates between the participating countries[2]. Euro notes and coins will be made available in physical form alongside national currencies only on 1 January 2002. The national currencies of participating countries will be completely replaced on 1 July 2002 after a six months transition period. These 11 national currencies will no longer be accepted as legal tender thereafter.

The introduction of the euro, which is considered to be the most significant event in institutional developments in the global financial arena, after the Bretton Woods Institutions, would have far reaching implications on the global economy. If the euro succeeds in becoming a stable, internationally dependable currency, then the monetary union, which has the potential to create the largest domestic financial market in the world, would not only affect global economic relations and the potential balance of power, but also change their face in the long-term.

The potential benefits of the euro stem from different dimensions. The sheer potential size of the market in euros implies that it will have a greater depth and liquidity second only to the US dollar[3]. As the table below indicates, domestic currency bonds, listed equities and government debt within the EU are much larger than in Japan in absolute terms. A similar pattern could be seen in international debt and foreign exchange markets as well.

Capital Market Instruments
(US dollars billion as at 31 March 1997)

	Domestic Currency Bonds	Listed Equities	Government Debt
USA	4,677	6,939	7,231
EU(a)	2,776	4,359	4,689
Japan	1,368	3,106	3,203

(a) Includes all 15 countries

1 At present 11 of the 15 EU members have joined the EMU. They are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The United Kingdom, Denmark and Sweden have voluntarily opted out for their own reasons, while Greece is an involuntary exclusion due to non-compliance with the convergence criteria, which include (a) price stability (defined as the rate of inflation within 1.5 percentage points of the three best performing EU countries) (b) low long-term interest rates (defined as within 2 percentage points of the three member states with lowest interest rates), (c) exchange rate stability (meaning that for at least two years a country has kept within the normal fluctuation margins as specified under the European Monetary System (EMS)) and (d) a sustainable government financial position (defined as (i) a budget deficit no higher than 3% of gross domestic product (GDP) and (ii) a ratio of government debt no more than 60% of GDP.)

2 The exchange rates between the euro (EUR) and the national currencies of members of the EMU were fixed on 1 January 1999 as follows.

	Belgium	Germany	Spain	France	Ireland	Italy	Luxembourg	Netherlands	Austria	Portugal	Finland
1EUR =	40.3399	1.95583	166.386	6.55957	0.787564	1936.27	40.3399	2.20371	13.7603	200.482	5.94573

3 In 1997, the EU accounted for 24 per cent of the world's output, while exports and imports accounted for 39 per cent and 35 per cent of world trade, respectively. In contrast, the United States and Japan contributed to about 27 per cent and 14 per cent, of global output, respectively. While their exports accounted for nearly 13 per cent and 8 per cent, imports accounted for 16 per cent and 6 per cent, respectively. Sri Lanka's exports to and imports from the EU accounted for 30 per cent and 17 per cent, respectively, during the same year.

Box 1 (contd.)

This potential size of euro markets would lead to the development of new euro denominated financial instruments with lower financing costs. The euro will also eliminate the foreign exchange risk in long-term real and financial contracts between entities in the euro region, providing incentives to narrow interest spreads by increasing transparency and efficiency. Moreover, the increasing competitive pressures within the euro region would eliminate hitherto existing geographical advantages, paving the way for increased market integration. The convergence in macro-economic variables within the euro region, in particular the European System of Central Banks (ESCB) having been empowered with a mandate to maintain price stability as a priority (defined as an annual inflation rate of less than two percent) would have favourable spill over effects on the rest of the world. While the impact of the euro in reducing global interest rates would be beneficial for net capital importing countries such as Sri Lanka, the potential growth prospects for euro region economies would induce higher foreign direct investments and international trade vis-à-vis developing countries such as ours.

The concept of a single currency and the required structural changes are not devoid of serious challenges for the success and sustainability of EMU. The evolution of the system heavily depends on the political and social cohesion of member countries. With the surrender of sovereignty in monetary and exchange rate policies to the ECB, which appears to have compelled the United Kingdom to opt out voluntarily from adopting the single currency, the only instrument available for member countries to influence the economy is the fiscal policy, which, in turn, is governed by the convergence criteria. However, achieving the appropriate policy mix at the Euroland level would be a challenging task, because policies that are necessary to deal with structural problems at national level would have implications on the conduct of a single monetary policy and the euro exchange rate. Most of the member countries of the euro region are beset by structural problems with considerable regulation. The mobility of labour is restricted, national labour markets are very rigid and there is very high unemployment in some member countries. The future strength and stability of European Monetary Union depends on the continued commitment to sustained macro economic convergence of member countries, the pace of structural reforms, and the political cohesion among euro members on key policy issues. However, the European Council, consisting of the Heads of State or Government and the President of the European Commission, has well recognised the need for this enhanced policy co-ordination.

increased from 28.2 per cent to 30.8 per cent. Parallel to a decline in the rate of inflation, global interest rates continued to decline. A sharp slow down in world trade from a high of 10 per cent in 1997 to 3.4 per cent was registered in 1998. The slow down in trade was seen in all regions. Developing country exports declined from 11.4 per cent in 1997 to 1.8 per cent in 1998. The advanced country exports slowed down to 3.6 per cent from 10.4 per cent in 1997. Imports to Asian countries declined by 4.2 per cent in 1998. Terms of trade moved in favour of advanced economies, with an improvement of 0.9 per cent against a further deterioration of 3.2 per cent for developing countries. Meanwhile, current accounts of the balance of payments in developing countries continued to deteriorate from a deficit of 4.9 per cent in 1997 to a deficit of 6.4 per cent in 1998.

International prices of major commodities declined further during 1998 due both to increased supply as well as depressed demand. Fuel prices declined sharply by 32 per cent in US dollar terms from already low levels amidst continued weak demand and supply overhang. Non-fuel commodity prices declined by 15 per cent. International sugar prices continued to drop throughout the year due both to excess supply in the market for the fourth consecutive year and a slowing down in demand by the Russian Federation and Asian countries due to their poor economic conditions. Meanwhile, wheat prices also continued to drop during 1998, mainly as a result of weaker demand due to the economic slow down in Asia. Rice prices, on the other hand, increased sharply during the year in response to rice stocks falling to a 25 year low. The drop in world rice production is mainly a result of lower production in China and India which account for over a half of the world rice production and for a quarter of world rice exports. International rubber prices, although higher during most of the year than the low levels that prevailed at the beginning of the year, remained well below the previous year's level. International prices of coconut products continued to increase sharply during the first five months with some moderation thereafter. The rising trend in prices of coconut products was the result of a drop in world coconut production, particularly in the Philippines and Indonesia, due largely to abnormal weather. Tea prices, which remained buoyant in 1997, suffered a setback during 1998 due to both increased supply and lower demand. Favourable weather enabled Kenya, a key tea producer, to increase its production by about 30 per cent, while production in India and Sri Lanka increased by 3 per cent and 1 per cent, respectively. Weaker demand from Russia, which accounts for 65 per cent of India's tea exports and about 20 per cent of Sri Lanka's, contributed to the decline.

A correction of large misalignments of exchange rates in most countries, particularly in the affected East Asian countries, which tumbled in 1997 and in early 1998, was witnessed during the latter part of the year. The reform efforts to address financial sector issues in domestic economies helped build investor confidence, resulting in an appreciation of the Korean won by 42 per cent, the Thai baht by 29 per cent, the Philippine peso by 3 per cent and the Malaysian ringgit by 2 per cent, against the US dollar. The Indonesian rupiah however, continued to depreciate and fell by 31 per cent against the US dollar against a backdrop of an uncertain economic and political environment. The Japanese yen appreciated against the US dollar by 12 per cent in response to initiatives undertaken to address financial sector reforms. Meanwhile, most European currencies appreciated against the US dollar in anticipation of the much awaited introduction of the euro on 1 January 1999. Financial sector problems in Russia led to a collapse of the rouble, which depreciated by 71 per cent against the US dollar in 1998. The South African rand and the Brazilian real depreciated by 17 per cent and 8 per cent, respectively, indicating the continuing uncertainty in international currency markets.

Short-term interest rates continued to drop in response to declining inflation rates world-wide. Six months LIBOR declined from 5.84 per cent per annum at the end of 1997 to 5.06 per cent per annum at the end of 1998. Commitments towards price stability and the perception of long-run low inflation rates resulted in a further drop in long-term interest rates. For example, the 30 year US Treasury bond rate declined from 5.81 per cent in December 1997 to 5.59 per cent in December 1998. However, despite this declining trend in interest rates, one of the disturbing factors observed during 1998 was the high risk premiums factored into bond issues in international capital markets, particularly by emerging market economies, which in turn prolonged the time required for economic recovery in those countries. While both sovereign issues and private issues were affected adversely, the latter took the full brunt. For example, interest spreads increased by over 300 basis points (bps) for issues by India, the Philippines and Thailand, while those for Korea and Hong Kong increased by over 500 bps. Spreads on Indonesian and Malaysian issues increased by over 1,000 bps. As a result, net private capital flows world-wide declined sharply from US dollars 124 billion in 1997 to US dollars 57 billion in 1998. Asia suffered the most, with a net outflow of US dollars 44 billion in 1998 in comparison to a net inflow of US dollars 29 billion in 1997.

In the aftermath of the East Asian currency crisis and the subsequent adverse developments in other regions, particularly in Russia and South America, and the failure of Bretton Woods institutions to contain the global effects of these developments in a relatively short period, much of the debate during 1998 was on crisis resolution and prevention and the need for a new international financial architecture. Both the International Monetary Fund (IMF) and the World Bank took the lead in efforts to stabilise crisis driven economies by providing technical assistance and financial resources. The IMF proposed a 45 per cent increase of its quota to meet global resource needs in the current context. It re-activated the General Agreement to Borrow (GAB) to facilitate extended financing arrangements for Russia in the wake of the rouble crisis, while activating the New Agreement to Borrow (NAB) to support the Brazilian economic and financial programme.

The IMF-led initiatives to strengthen the architecture of the international monetary and financial system, which was firmly advocated by developing countries, aims at reducing the risk of disruptive shifts in market sentiments, limiting contagion and spillover effects, and strengthening the efficiency of crisis resolution efforts. Emphasis is being given to the development and implementation of international standards and principles of good practice with the ultimate goal of strengthening effective financial market supervision and regulation, improving the institutional infrastructure, enhancing transparency, market discipline and corporate governance, and improving risk management by financial institutions.

The severity and the complexity of the currency turbulence underscored the importance and relevance of the developing country voice on an orderly and cautious approach to liberalising the capital account and institutional arrangements for systemic reforms. During the year, developing countries also emphasised the need for meaningful measures on debt alleviation, orderly debt workouts for Heavily Indebted Poor Countries (HIPC) and implementing well-structured post-conflict programmes.

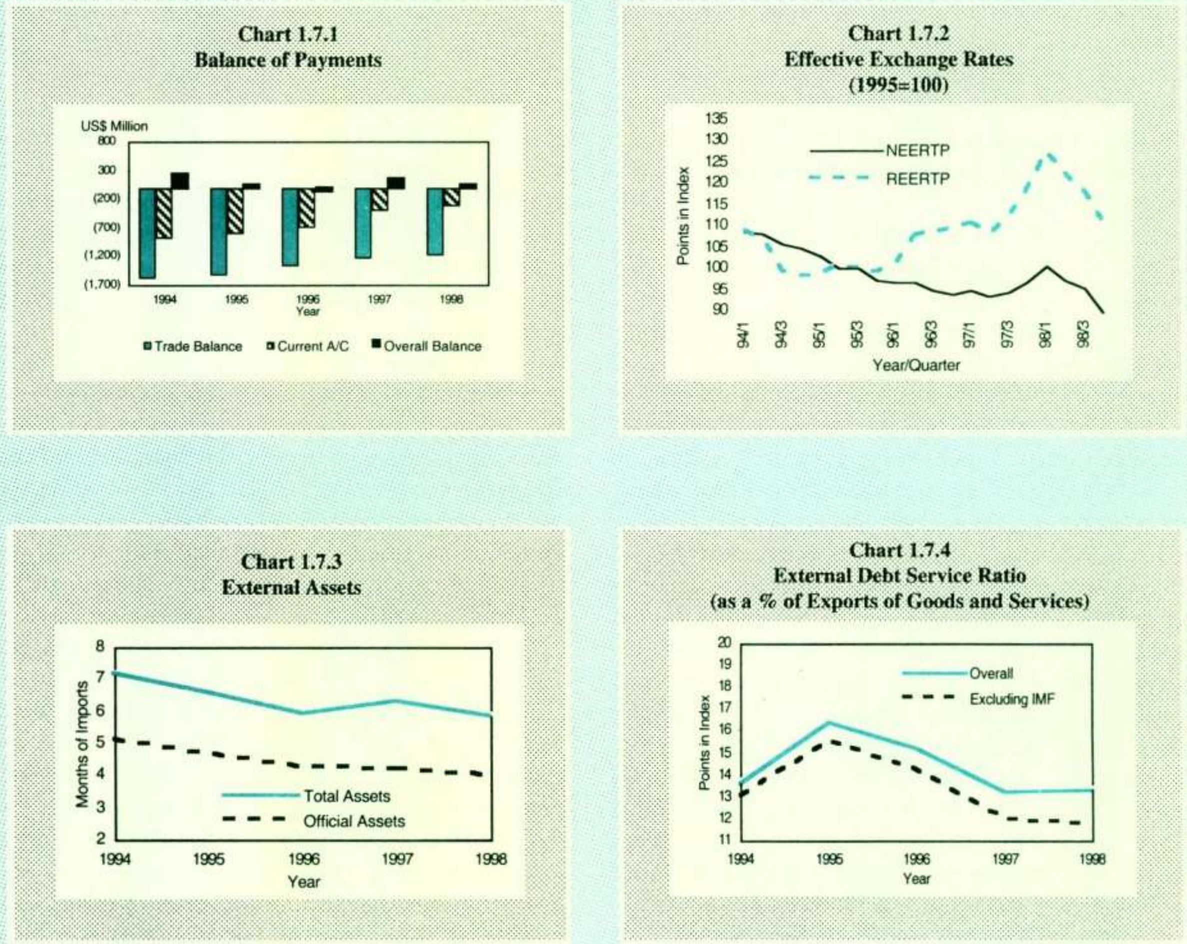
Meanwhile, progress towards the introduction of the euro on 1 January 1999, one of the most significant events of the century in the international monetary system, continued with much enthusiasm. The single currency was expected to be an essential building block for competition in Europe, which has been hitherto beset by high labour costs, inflexible labour markets and higher taxes that made Europe relatively less competitive than other leading advanced economies such as the USA. The direction of policy strategies by the European Union will have a significant influence on the global economy. The important role played by the USA, Japan and the European Union in the world economy underscores the responsibility placed on these economies in taking a lead in directing the global economy towards economic recovery.

External Sector Developments

Sri Lanka's balance of payments experienced mixed blessings in 1998. A sharp decline in import prices acted as an automatic stabiliser, helping to offset the adverse impact of a considerable slowing down of exports on the trade balance. The trade and current account deficits declined further, leading to an overall balance of payments surplus of US dollars 37 million in 1998. Despite a sharp contraction of world exports, Sri Lanka's exports managed to record a modest growth of 2 per cent, in contrast to a 13 per cent growth in 1997. The value of imports increased marginally (0.5 per cent) as import prices of crude oil, wheat, fertiliser and sugar declined sharply under depressed world market conditions. The services account generated a surplus of US dollars 143 million, compared to US dollars 159 million in 1997. A continued growth in private transfers and compensation payments of US dollars 78 million received on account of Sri Lankan workers displaced from Kuwait by the Gulf war in 1990, helped to reduce the current account deficit to US dollars 289 million from US dollars 393 million in 1997. The current account deficit as a ratio of GDP declined from 2.6 per cent in 1997 to 1.8 per cent in 1998. Foreign long-term private capital inflows continued to increase while there was a net outflow of short-term capital through the share market. Sri Lanka's exchange and money markets remained relatively stable, as domestic monetary and exchange rate policies were effective in maintaining financial market stability.

Net inflows in the financial account were lower in 1998, reflecting the fact that inflows in 1997 included a large

Chart 1.7
Selected External Sector Indicators



Box 2

Monetary Conditions Index

Central banks use operational and intermediate targets to guide policy. When a central bank makes a change to monetary instruments with the objective of having an impact on the final targets, the inflation rate and the growth rate of the economy, the transmission could take place through several channels. Interest rates and exchange rates have been identified as two main channels through which the effect of changes in monetary policy are transmitted to the final targets[1]. Therefore, interest rates and exchange rates could serve as operational targets, and could be used to guide the monetary policy. The Monetary Conditions Index (MCI) is a combination of interest rates and exchange rates that could be used as an operational target.

Both interest rates and exchange rates influence the aggregate demand and supply which are the deciding factors of inflation and economic growth. An increase in interest rates will reduce aggregate demand by discouraging investment and consumption as well as the aggregate supply while encouraging savings. Usually, the impact on aggregate demand is greater than on aggregate supply thereby causing a reduction in the equilibrium price level and output. A depreciation in the exchange rate increases cost of production and causes a reduction in aggregate supply if firms use a large percentage of imported intermediate goods. It also enhances exporters' income causing an upward pressure on demand. The combined effect is an increase in the price level. Thus, an increase in interest rates and a depreciation of the exchange rate have opposite impacts on prices. Or, viewed another way, a decrease in interest rates and a depreciation of the exchange rate both lead to higher prices. Since both interest rates and exchange rates respond to policy changes and both variables have an impact on the final target, it is not sufficient to monitor the two variables individually and independently. Therefore, a more appropriate indicator is the MCI, a weighted average of the two variables. The MCI provides the policy maker with the flexibility to make smaller changes to one variable and make compensatory changes to the other as sometimes required by market conditions. This flexibility is more useful when exchange rates are freely floating without much intervention by the monetary authority.

The impact of monetary policy changes on short-term interest rates and exchange rates (equivalently, MCI) takes place immediately. The transmission from those operational targets to final targets takes a fairly long time depending on the structure of the economy. Both in the United Kingdom and Canada this transmission takes place within about 8 to 10 quarters. In Sri Lanka, with a high degree of openness, it appears that the transmission takes place within 3 to 4 quarters.

Relative weights of the interest rates and exchange rates to be used in the MCI are usually derived using either a large structural model of the economy, a reduced form model, or a vector auto regressive model. The MCI could be constructed as a real variable or a nominal variable. Central banks estimate the predicted path of the MCI and the desirable path of the MCI. When the two paths deviate considerably further monetary policy changes are employed to eliminate deviations.

The MCI is constructed as the weighted deviation of the interest rate and exchange rate from the level that prevailed in a base period[2]. It measures the pressure of the interest rate and exchange rate deviations on the deviation of inflation from the level that prevailed in the base period. Generally, the weight associated with the interest rate is calibrated as 1 and the weight associated with the exchange rate is calibrated as $1/\omega$. This implies that an increase of one percentage point in the interest rate has the same impact on the MCI as ω percent change in the exchange rate. The weight depends on the openness of an economy. Relatively less open economies could have a weight as high as 10 (i.e. a 100 basis point change in interest rates has 10 times the impact of a one percent change in the exchange rate) while open economies with heavy dependence on imports could have smaller weights around 1[3].

The usefulness of an MCI as an operational target in Sri Lanka can be demonstrated using the real MCI and its ability to predict inflationary pressures. As data on freely moving interest rates and exchange rates in Sri Lanka are available for a relatively short period of time, a parsimonious reduced form model was used to construct weights for the MCI. The month to month variation of the Colombo Consumers' Price Index was taken as the inflation rate. The three-month Treasury Bill rate determined in the primary market was used as the nominal interest rate. The real interest rate was derived by subtracting the expected inflation rate from the nominal interest rate. The expected inflation was derived by assuming the existence of forward looking rational expectations on inflation. Thus, the expected inflation at any month was taken as the average month-to-month inflation rate of the future nine months[4]. The real effective exchange rate (REER) with respect to five major importing countries is used as the exchange rate. The base period was taken as January 1993. The relevant lag period is nine months. Relative weights were obtained by regressing the 9 month lagged real interest rate and the REER on the

Box 2 (contd.)

current inflation rate. Thus, the weight for the exchange rate movements in the MCI (MCI ratio or ω) is the ratio between the regression coefficients of the real interest rate and the REER[5]. The estimated MCI ratio is 1.5, indicating Sri Lanka's relatively high exposure to the external sector.

Figure 1 shows the behaviour of the interest rate and the exchange rate. An upward deviation of the exchange rate shows an appreciation of the exchange rate, and easing of the pressure on inflation. Similarly, a downward deviation shows a depreciation, and an increase of the pressure on inflation. An upward deviation of the interest rate also indicates an easing of inflationary pressures. Thus, an upward movement of the MCI shows easing of inflationary pressures, and a downward movement shows increasing pressures on inflation. This behaviour is clearly seen in Figure 2 which shows the behaviour of the 9 month lagged MCI, and deviation of the inflation from the base period inflation.

Central banks use the MCI as an aid to policy, and not as a mechanical rule to set exchange rates and interest rates. It measures the pressure on inflation due to aggregate demand and supply changes arising from changes in the interest rate and exchange rate. Therefore, the MCI is not a predictor of the headline inflation. The headline inflation is a combination of the pressures indicated by the MCI and other exogenous demand and supply shocks such as changes in autonomous consumption and weather associated changes in production. The MCI should also not be treated as a fundamental measure of monetary policy. It is only an operational target. The MCI also has some technical drawbacks. It is not clear if more variables than the interest rate and exchange rate should be included in the MCI. It suffers from the difficulties in estimating the other relative weights of its components. Further research is being conducted on the inclusion of variables in the MCI, estimating more refined weights for the MCI, and its appropriateness as an operational target.

One of the major users of the MCI, the Reserve Bank of New Zealand (RBNZ) had to abandon the use of the MCI as an aid of the monetary policy in February 1999. The exchange rate in New Zealand depreciated as a result of the Asian Crisis, and to match this decline interest rates had to be raised so that the desirable path of the MCI is maintained. This sharp rise in interest rates weakened the economy considerably. The RBNZ is now following a more relaxed approach on determining required change in interest rates.

Although it is not advisable to use MCI as a mechanical tool to determine changes in monetary and exchange policies, it provides a useful conceptual framework to evaluate policy effects and guide future policy directions.

Figure 1
Deviations of Real Interest Rate and Real Effective Exchange Rate from the Levels in January 1993 and MCI

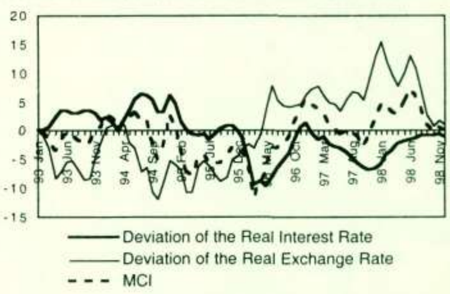
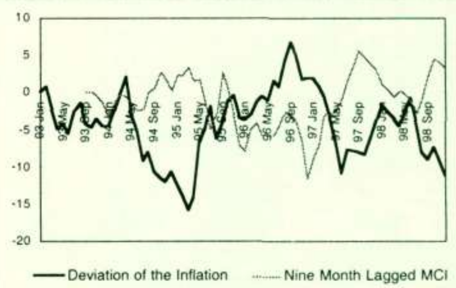


Figure 2
Deviation of Inflation from Level in January 1993 and Nine Month Lagged MCI



1 Other channels are the availability of credit and expected inflation.

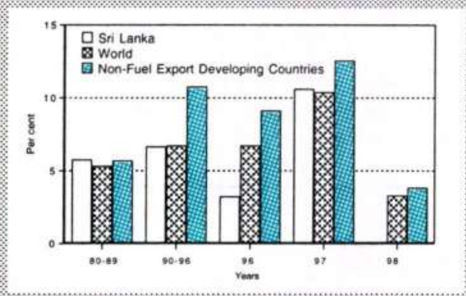
2 Thus MCI= [Real Interest Rate-Real Interest Rate at Base Period]+(1/w)[{Real Effective Exchange rate Index(REER)/ REER at base period-1}*100]; where w is the relative weight of the exchange rate.

3 Mayes, David G. and Viren Matti, 1998 'Exchange Rate Considerations in a Small Open Economy: A Critical Look at the MCI as a Possible Solution', *mimeo*, South Bank University and Bank of Finland

4 Expected inflation outside the period where data are not available was derived using official statements on future inflation combined with the long-term trend in inflation.

5 Suppose that the regression coefficients on the real interest rate and the REER are α and β respectively. Then $(1/\omega) = \beta/\alpha$ and $\omega=\alpha/\beta$.

Chart 1.8
Export Volume Growth



volume of privatisation proceeds amounting to US dollars 301 million, compared to US dollars 56 million in 1998. Net short-term private capital outflows declined in 1998 despite a reduction in external liabilities of commercial banks and an outflow of short-term capital through the share market. It is noteworthy that long-term private capital inflows, including foreign direct investment, continued to increase in 1998. Long-term concessional capital inflows to the government increased during the year reflecting the government's commitment to maintaining a higher level of capital expenditure. Gross capital inflows to government (excluding the Floating Rates Notes issued in 1997) were higher by 8 per cent in 1998. Net capital inflows declined due to higher amortisation payments. Long-term capital flows to the private sector included a Floating Rate Notes (FRN) issue by DFCC Bank for US dollars 65 million in international capital markets and loans amounting to US dollars 43 million raised by Sri Lanka Telecom. Net long-term capital flows to this sector, however, declined due to higher outflows arising mainly from an advance payment of US dollars 48 million by Air Lanka Ltd. towards its refleeting programme.

The appreciation of the yen alone increased the debt stock by around US dollars 200 million. The debt/GDP ratio stood at 56 per cent. About 1 percentage point of this increase was due to the appreciation of the yen. The stock of short-term debt accounts for only 6 per cent of total debt. Sri Lanka's debt service ratio in 1998 was estimated at 11 per cent, the same as in 1997.

The Central Bank continued to manage the exchange rate flexibly, playing a moderator's role in the exchange market. The exchange rate developments were monitored using a number of money market and exchange market indicators, including a real effective exchange rate index with a twenty four currency basket. The Central Bank's operating exchange rate band between its buying and selling rates for the U.S. dollar was 2 per cent. The world currency markets became more volatile than in 1997. The volatility of the US dollar/yen almost doubled in 1998 compared to 1997, due to the poor prospects for early recovery in Japan. The Sri Lanka rupee depreciated by 9.6 per cent in 1998. The real effective exchange rate depreciated by 12 per cent bringing this competitiveness indicator to the July 1997 level .

Gross official external assets were sufficient to finance 4.0 months of 1998 imports. Total gross external assets of US dollars 2,907 million, which include official assets and those of commercial banks, were sufficient for 5.9 months of import cover.

1.9 Financial Sector

Monetary policy had to be conducted in a highly unstable external environment. The world banking industry and financial markets had been experiencing tremendous

Chart 1.9
Money and Credit

Chart 1.9.1
Monetary Aggregates (Annual)

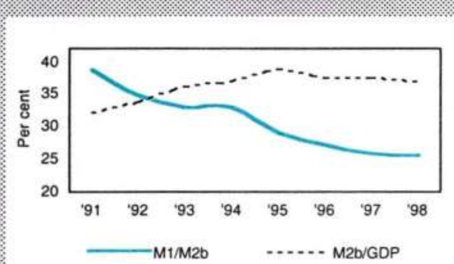
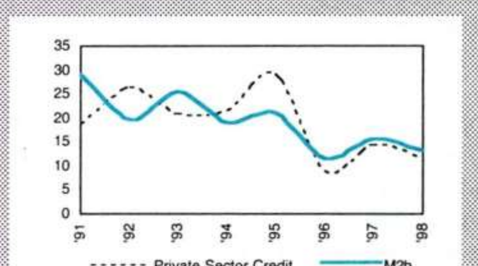


Chart 1.9.2
Money Supply (M2b) and Private Sector Credit



instability in the context of the global financial market crisis. On the domestic front, the government needed more resources to finance a larger fiscal deficit. Hence, a further relaxation of monetary policy could not be made to bring down interest rates, despite significant deceleration of the inflation during the second half of 1998.

The uncertainty in regional financial markets and somewhat higher domestic inflation at the beginning of 1998 required tightening of the policy stance in the first few months of the year. Although a slight relaxation was effected in the second quarter by reducing the repurchase rate from 12.00 per cent to 11.65 per cent by mid May, renewed volatility in the foreign exchange market required a further tightening of policy. A resurgence of international volatility and associated domestic speculative activity thereafter, prompted the Central Bank to tighten policy again by raising the repo rate to 12.00 per cent in May.

The recent developments have clearly demonstrated the need to maintain consistent exchange and monetary policies. The global financial crisis and the resultant volatility in international currency markets led to some uncertainty in the domestic foreign exchange market. This continued into 1998 with some articulate elements in the market demanding a large depreciation of the rupee. Under the current managed floating system, where the exchange rate has been allowed to change reflecting the underlying changes in macroeconomic conditions, such ad hoc depreciation of the rupee was not necessary. However, despite a trend decline in the rate of inflation, short-term interest rates were allowed to remain high, to counteract pressure on the exchange rate without undue intervention in the exchange market. Accordingly, in order to discourage the use of relatively inexpensive call market funds for speculative purchases of foreign currency, the repo rate was raised by 200 basis points in December 1997 and by a further 100 basis points in January 1998. Adjustments were also made to the Central Bank's discount and rediscount rates and the margin between these rates to support this tightening of the policy stance. These measures, together with some progress towards financial market and exchange rate stability in East Asia, were successful in reducing the speculative pressures. Commercial banks sold US dollars 54 million to the Central Bank in March and April, but for the year as a whole, the Central Bank was a net seller of foreign exchange to the market.

Open market operations continued to be the primary instrument of monetary policy, with the repo rate serving as the main signalling mechanism. From May onwards, commercial banks were permitted to include their holdings of Treasury bonds as a part of their liquid assets and to use those for secondary market transactions with the Central Bank in their liquidity management. In November, an overnight reverse repurchase facility was reintroduced to help stabilise short-term interest rates. With the Central Bank now

Chart 1.10
Interest Rates

Chart 1.10.1
Short-Term Interest Rates

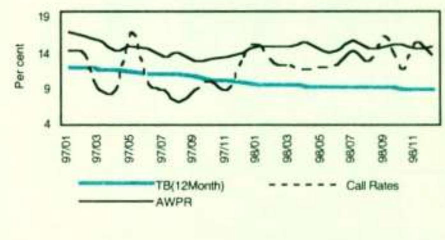


Chart 1.10.2
Interest Rates
(Real Rates Based on Point to Point Inflation)

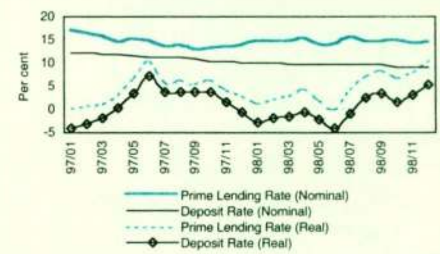


Chart 1.10.3
Interest Rates
(Real Rates Based on Average Inflation)

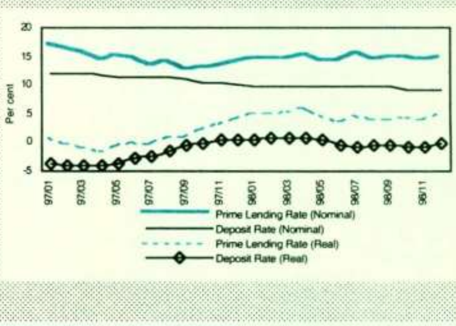


TABLE 1.5

Private Sector Credit From Financial Institutions

Rs. Million

	Dec 94	Dec 95	Dec 96	Dec 97	Dec 98(a)
Commercial Banks	163,278	210,704	229,771	263,139	294,064
Domestic Units	140,004	179,825	193,842	216,030	243,549
State Banks	85,728	105,781	106,007	111,650	122,512
Other Commercial Banks	54,276	74,044	87,835	104,380	121,037
Foreign Currency Banking Units	23,274	30,879	35,929	47,109	50,515
State Banks	9,813	10,047	10,393	14,649	16,734
Other Commercial Banks	13,461	20,832	25,536	32,460	33,781
Other Financial Institutions	33,960	38,023	62,670	73,627	89,675
Regional Rural Development Banks and Regional Development Banks	1,872	2,406	2,888	3,397	3,750
Licensed Specialised Banks	23,987	28,349	46,118	54,053	66,938
Development Finance Institutions (b)	16,935	20,037	31,411	38,023	47,320
National Savings Bank	3,108	3,441	8,537	8,150	9,495
Housing (c)	3,945	4,871	6,170	7,344	8,150
Other Savings and Development Banks (d)	-	-	-	536	1,972
Finance Companies	8,100	7,269	13,664	16,178	18,987
Total Private Sector Credit	**197,238**	**248,727**	**292,441**	**336,766**	**383,739**

(a) Provisional

(b) Consists of DFCC Bank and National Development Bank

(c) Consists of State Mortgage and Investment Bank and the Housing Development Finance Corporation

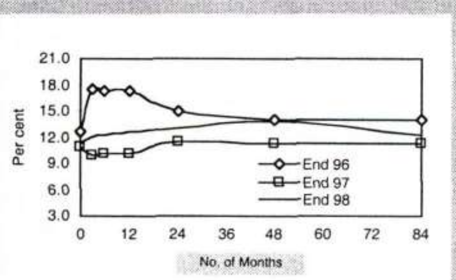
(d) Consists of Pramuka Savings and Development Bank and SANASA Development Bank

Source: Central Bank of Sri Lanka

providing both an overnight repo facility and an overnight reverse repo facility, volatility in the call market was expected to be restrained, thus bringing about greater stability in the money market.

The Central Bank's own securities continued to be available on tap throughout the year for mopping up operations. These securities had a maturity of 7 days and carried a yield equal to the 7-day repo rate. This facility was rarely used, as the portfolio of Treasury bills in the Central Bank was sufficient for its open market operations in 1998. The Central Bank continued its policy of not granting refinance under the Medium and Long-Term Credit Facility (MLCF) or any short-term facility. The outstanding level of refinance granted in the past declined from Rs.1,691 million at the end of 1997 to Rs.1,122 million at the end of 1998, due to continuation of repayments to the Central Bank.

Chart 1.11
Yield Curve for Government Securities



Money Supply

The growth of consolidated broad money supply (M2b), i.e. broad money supply including FCBUs, continued to decline from 15.6 per cent in 1997 to 13.2 per cent in 1998, helping to contain inflationary pressure. A significant reduction in net foreign inflows and slow growth in credit to the private sector offset the expansionary effect of faster growth of credit to government. Net credit to government increased by 43 per cent, in contrast to a decline of 4 per cent in 1997. Credit to the private sector increased by 12 per cent in 1998, compared to 14.5 per cent in 1997, mainly reflecting the slowing down of the growth in economic activity. The slowing down of economic activity, together with strengthened supervision of banks, also contributed to the slow growth of credit to the private sector.

The deceleration of credit to the private sector was more pronounced in FCBUs, where credit growth fell from 31 per cent in 1997 to 7 per cent in 1998. The continuing uncertainty in foreign financial markets and slowing down of Sri Lanka's exports led to a contraction of lending by FCBUs and a reduction of their net foreign exposure. The volatility in the foreign exchange markets and the comparatively low domestic interest rates made borrowing from the FCBUs less attractive to domestic enterprises. FCBUs used some of their funds to syndicate a loan of US dollars 100 million to the government. Credit from the domestic units grew at a faster rate, i.e., at 12.7 per cent in 1998 compared with 11.4 per cent in 1997, and offset the decline in the FCBU credit expansion. It is notable that most of the increase in credit to the private sector came from the domestic commercial banks, not the foreign banks.

Credit to public corporations declined by 26 per cent in 1998, following a decline of 5 per cent in 1997. Lower international prices for petroleum and wheat improved the financial position of the Ceylon Petroleum Corporation (CPC) and the Co-operative Wholesale Establishment (CWE), enabling them to reduce their bank liabilities. The resulting improvement in the liquidity position of banks caused an increase in their investments in government debt instruments.

Reserve Money Programming

The Central Bank continued to use reserve money (high powered money or base money) as an important intermediate target in implementing monetary policy. An excessive expansion in reserve money was avoided to contain inflationary pressure, while providing sufficient liquidity to the market to ensure that economic activity was not constrained by liquidity shortages. Reserve money increased by 9 per cent, a lower rate than the growth in broad money supply. Accordingly, the broad money multiplier increased marginally from 3.98 at the end of 1997, to 4.07 at the end of 1998, reflecting the slight tightening of monetary policy in 1998.

1.10 Problems and Issues

The Sri Lankan economy continued to show its resilience to the turbulence in world financial markets and performed relatively better than many other developing countries, registering an economic growth rate close to 5 per cent in 1998, with lower inflation and unemployment than in 1997, a surplus in the overall balance of payments and relatively stable financial markets. As mentioned in the 1997 Annual Report, the resilience was due to the maintenance of an open economy with a fully liberalised current account and capital controls being maintained for prudential reasons and to avoid excessive accumulation of short-term debt, a flexibly managed exchange rate, improved co-ordination of macroeconomic policies and strengthening of the regulatory and supervisory framework for financial institutions.

The growth rate achieved in 1998 was better than the average economic growth of 4.2 per cent during 1980-89 and somewhat lower than the 5.3 per cent growth during 1990-97. It was close to the long-run growth rate of around 5 per cent. A major challenge in 1998 was to maintain a reasonable growth rate without disturbing monetary and price stability. This objective was achieved. The medium-term objectives are to achieve a faster improvement in living standards through accelerated non-inflationary economic growth, better income distribution and a viable balance of payments situation.

Policy prescriptions toward this goal are largely those necessary to eliminate the remaining structural weaknesses in the economy, which tend to retard faster economic growth. They include reforms aimed at improving financial market efficiency; improving commercial viability of the state owned financial institutions; making labour markets more flexible and improving labour productivity; public service reforms to make it more efficient and productive; pension reforms to contain the budgetary burden and avoid an erosion of pension benefits through inflation; public enterprise reforms aimed at improving their commercial viability and tax reforms to simplify the tax structure, reduce distortions and improve revenue buoyancy. In addition, in the context of the recent world financial market crisis, greater emphasis needs to be placed on financial system soundness and improving corporate governance. Significant progress has been made in some areas, particularly financial market reforms, improving financial market soundness, public enterprise reforms through private sector participation and tax reforms including tariffs. Progress in other areas, however, is inadequate. Meanwhile, there are several short-term challenges and disturbing trends that need to be highlighted.

Although Sri Lanka's financial markets were not seriously affected by the contagion effect of the international financial crisis, the continuing world economic recession has threatened to affect Sri Lankan exports. Sri Lanka maintained an export volume growth rate of 8 per cent during the past four years. In 1997, the country's export volume grew by 11 per cent, comparable to the growth of world exports and of developing countries. With the sharp contraction of the world export growth to 3.6 per cent in 1998, developing country export growth has decelerated to 1.8 per cent and Sri Lanka's export growth declined to 0.1 per cent. Prospects for 1999 are not very encouraging. The current expectations are that world trade will recover somewhat during the second half of 1999 and that the developing country export volumes would grow by 4.7 per cent. However, a complete recovery is unlikely within the next two years. This would be a challenge for open small economies like Sri Lanka, which are attempting to achieve faster economic growth through greater integration with the world economy. Therefore, a continuation of the depressed world market conditions is likely to slow down economic growth and employment generation in 1999.

The large widening of the fiscal deficit in 1998 was somewhat disturbing. Some widening of the fiscal deficit may not have been avoidable in a global recession where government revenue tends to decline owing to slowing of export demand and national income. This was partly the case in Sri Lanka in 1998. The Keynesian solution in a recessionary condition is expansionary fiscal policy to induce domestic demand to counteract declining export demand. It should be mentioned that the final objective of expansionary fiscal policies is to help maintain domestic employment and incomes. Although there has been a renewed emphasis on expansionary policies recently, those may be difficult to justify in Sri Lanka, given its continuing high fiscal deficits and high inflation. Higher fiscal deficits could trigger galloping inflation, aided by stronger depreciation of the rupee.

Sri Lanka is already a high inflation country. A high budget deficit, high inflation and high interest rates discourage private investment and slow down economic expansion. There is an urgent need to bring the fiscal deficit reduction programme back on track to protect balance of payments viability, avoid a rekindling of inflation, reduce pressure on the exchange rate and avoid an erosion of private sector confidence in the government's economic policies.

It should be mentioned that inflationary pressures of the enlarged budget deficit were not clearly felt during 1998 as the country benefited from the sharp reduction in import prices, particularly for crude oil, wheat grain, fertiliser and sugar, under depressed world market conditions. These price reductions helped to contain the growth in the import bill despite a depreciation of the rupee (9.6 per cent against the US dollar), thus leaving more resources with the banking system. It is clear that the resources freed by these reductions in the international prices of key commodities imported to Sri Lanka and the relatively slow growth of private sector credit enabled the banking system to finance a large proportion of the enlarged budget deficit without exerting excessive pressure on interest rates. Current trends indicate that a further large reduction in import prices is unlikely to occur. In this context, the government may not have the flexibility of running an expansionary fiscal policy without reversing the recent favourable trend in inflation.

The overall budget deficit increased in absolute terms by Rs.23,758 million to Rs.93,819 million. Increased security expenditures and revenue shortfalls were the major reasons for the enlargement of the fiscal deficit. Revenue shortfalls, reflected mainly in lower than anticipated turnover taxes/ GST, income taxes and import duties, contributed to nearly 50 per cent of the increased deficit. Higher expenditures in non-defence areas such as salaries and wages and transfers to loss making public sector entities (Sri Lanka Railways and the Postal Department) also contributed to the increased deficit. Given the size of fiscal slippage in 1998 and the weaker prospects for higher economic growth in 1999, measures should be put in place to reduce the fiscal deficit to around 7.5 per cent of GDP in 1999, so that further fiscal consolidation could be targeted for 2000. Sri Lanka is yet to achieve a sustainable reduction of inflation, which would reduce inflationary expectations in the economy. Although the average consumer price inflation has declined, according to the CCPI, to 10.2 per cent during the last five years from 13.5 per cent during the five years 1989-93, a steady reduction of the inflation rate to below 5 per cent would be required for the country to emancipate itself from an inbuilt inflationary bias. Sri Lanka's inflation rate has generally been higher than the average inflation rate of her trading partners and competitors. This has led to the depreciation of the exchange rate by about 5-6 per cent per year to enable Sri Lanka to remain competitive in world markets. As mentioned in the 1997 Annual Report, the exchange rate depreciation has a feedback effect on inflation as Sri Lanka is a highly trade dependent economy where exports and imports together account for about 70 per cent of GDP. The internal wage setting mechanism, which links many wages directly or indirectly to inflation rather than to labour productivity, has been another channel in this inflation-wage-exchange rate nexus. This has been further complicated by the increased security expenditures. Thus, continuing high budget deficits have made it a challenging task to eliminate high inflationary expectations among the public. Hence, measures have to be in place for a sustainable reduction in inflation by containing the fiscal deficit at below 5 per cent within the next three years and introducing a productivity based wage setting mechanism. These have to be supplemented with other measures to eliminate structural weaknesses in the labour market - measures which would make the labour market more flexible, while providing equal protection to both workers and employers in a competitive environment.

Among the structural policies mentioned above, pension reforms aimed at a sustainable social security system should be a priority. The demographic transition, together with improvements in other socio-economic conditions, has substantially reduced the growth rate of the population to well below that of most other developing countries. However, an annual addition of over 200,000 to the population has become a burden on other limited resources. There are several socio-economic issues associated with the current structure and trends in population. Unemployment, land fragmentation, the high cost of social welfare such as education and health, housing problems and an ageing population are major issues that need to be addressed early. The ageing of the population and a rising old age dependency ratio require a well planned strategy and a carefully designed social security system to avoid excessive burdens on the working population and an erosion of standards of living during old age. This has to be done in the context of policies designed to make labour markets more flexible, adaptable to the changing labour market needs and complementary to other growth-oriented policies.

At a time when Sri Lanka's exports are facing a major challenge in international markets, there have been some disturbing developments in the textile quota administrative

Box 3

Information Technology Innovations – Challenges for the Financial Sector

Technology has made remarkable headway in the field of telecommunications, providing the impetus for information technology (IT) to transform the way in which trade, commerce and banking are conducted in the world. Electronic commerce (e-commerce) is already opening up and countries like Sri Lanka will have to adapt to the changes or fall behind and miss out on the opportunities that may present themselves. Cross border transactions will not only grow in volume and value, but will also take on new dimensions. The way these transactions are conducted is undergoing rapid change. Resistance to change and failure to respond to these changes could prove to be harmful and would damage the economic strategy. Countries that are ready to participate in world trade in both goods and services under these new arrangements will benefit in the form of larger market shares and comparative advantage, while those that are not, will tend to languish in the midst of low productivity and high levels of inefficiency.

The Central Bank, in partnership with other institutions in the banking sector, will endeavour to promote the creation of the infrastructure necessary to respond effectively to the changes taking place in the global banking scenario. It is also in the interests of banks themselves to participate fully in this endeavour. With growing competition, escalating cost of funds, pressure on margins, disintermediation and the associated uncertainty, credit no longer constitutes the main source of profit for banks. Instead, fee based services are becoming the primary source of income with computers and communication playing a key role. The new developments that have come on stream in developed economies in cash management, funds transfer, payments systems and clearing systems make the banking system global instead of local.

Similarly, the introduction of Electronic Funds Transfer (EFT) systems has made retail branch networks obsolete in some respects as a delivery system for banking services. In terms of day to day transactional capabilities, banks are moving towards a two tier system. The provision of complex banking services requiring inputs from skilled personnel, such as arranging credit, are performed at regional branch offices where the specialist personnel work. For the provision of routine banking services, banks are automating their procedures to reach inside the home through interactive approaches and to restructure the large majority of their branch offices into computer driven, modular low cost operations, based on extensive use of EFT, Automated Teller Machines (ATM) and plastic cards.

A further development emerging in developed financial markets is the gradual encroachment of the traditional territory of banks by other business organisations such as insurance companies, supermarkets, departmental stores, real estate agents etc. Increasingly, insurance companies not only insure houses, but also finance them; supermarkets and department stores have enormous databases on customers, easily accessible in computer storage, which could be used to provide routine financial services just as banks do; brokers who traditionally deal in financial instruments are extending their sphere of activity into banking operations; and real estate agents who handle the sale and transfer of property increasingly delve into mortgage business. All these and many more business organisations, such as oil companies and multi national corporations, have the financial resources, skills and expertise to provide banking services. An additional factor in their favour is that none of these organisations are constrained by regulatory requirements imposed on banks by regulators and bank supervisors.

It will not be long before these changes spread into developing financial markets. Sri Lanka will also witness some of these changes in the next decade. Some of the advancements in IT contemplated by the Central Bank will hasten this process. Proposals are under consideration by the Central Bank to modernise the payments system of the country by enlarging the scope of the existing off line Sri Lanka Interbank Payment System (GIRO System) to cover direct debit transfers, to strengthen the cheque clearing system through introduction of imaging, to move to an on line accounting system within the Bank, to introduce a real time gross settlements system (RTGS) as in leading financial markets and to promote existing ATM networks to build a shared network to expand the coverage of the existing systems. At the same time, the Central Bank will undertake modernisation of the government debt securities market through the introduction of a Central Depository and a scripless system to encourage the growth and improve the efficiency of the secondary market for government debt. In this effort, the Employees' Provident Fund will also receive attention to ensure its continued growth to serve its members more efficiently.

Recognising the transformation that has been taking place gradually in the 1980s in the economic strategy of the country, the Central Bank of Sri Lanka equipped itself with the necessary statutory powers under Section 105A of the Monetary Law Act No.26 of 1995 to participate in the equity of companies established for the purpose of furthering technological advancement in the field of banking. This measure is the direct result of its realisation that modernisation of the banking system, in line with developments abroad, will be important for the Sri Lankan economy to derive the full benefits of globalisation in industry, commerce and banking.

system recently, introducing further uncertainty among manufacturers. Quotas have been an important regulator of world trade in textiles and garments. The various schemes that have evolved now entail cumbersome procedures that require close supervision and monitoring to achieve maximum utilisation. Quota administration in Sri Lanka had been in some disarray in 1998 as quotas to the USA for some items such as men's and boys' jackets and shirts were over utilised and the Textile Quota Board had to take action to avoid the possible imposition of an embargo by the USA. Until quotas are fully phased out in 2005 under the Uruguay Round Agreement on Textiles and Clothing, optimal utilisation of quotas needs to be ensured to reap the full potential benefits under the existing international trade framework. Hence, the quota administration needs to be done efficiently. Although market based quota distribution through auctioning of quotas would have produced better results in terms of quota utilisation, various other objectives, such as the need to promote new investments, regionalise industries and generate more employment, have entered into the quota administration in Sri Lanka. Although a fundamental change in the quota allocation system may not be necessary, it should be the responsibility of quota administrators to ensure the smooth functioning of the system, so that the growth of the textile and garment industry and trade will not be interrupted. This is all the more important as the global competition among suppliers has intensified in the context of depressed world market conditions and there is a need to ensure a smooth transition to face more intense competition in a quota-free trading environment after 2005.

The growth of investment in Sri Lanka has been sluggish. This slow growth is due to a number of reasons. First, public investment slowed down in the wake of increased security expenditures as the government was committed to containing budget induced inflationary pressures. While a somewhat higher level of public investment could have been achieved by pruning expenditures in other areas (e.g., reducing transfers to loss making public sector entities), the political economy had not permitted this. Second, the uncertainty regarding the security situation discouraged private investment, both domestic and foreign. Third, Sri Lanka had very high lending rates of above 20 per cent for a long period, discouraging private investment. High fiscal deficits, high inflation rates, which averaged 13 per cent during 1980-96, and operational inefficiencies of the state banks had pushed up interest rates. Although interest rates have declined significantly after a slight relaxation of monetary policy in early 1997 and an improvement in the fiscal situation during 1994-97, several years of low inflation are required for people's perceptions regarding high inflation and high interest rates to disappear and private long-term real investment to pick up. Sri Lanka is yet to make sufficient progress towards a steady reduction in the fiscal deficit, inflation and interest rates. Fourth, Sri Lanka maintained a complicated investment regime which discriminated against all non-export oriented sectors, including the traditional plantation crops, after the economic liberalisation in 1977, with a view to promoting export-led industrialisation with foreign participation. This biased incentive regime has existed for a long period. New elements have been added towards equalisation of incentives among different sectors through measures such as provision of foreign currency loans to non-BOI exporters, new fiscal incentives to the non-BOI sector including the relaxation of the export share requirement to be eligible for BOI concessions. However, the current investment regime needs to be simplified, particularly with a view to eliminating the inbuilt discretionary elements. A simple and transparent investment regime, with equal incentives for all sectors, and a narrow negative list would encourage new investment. Fifth, insufficient infrastructure facilities were another constraint to private sector investment. Significant improvements have been made in the power and telecommunication sectors, but further progress in all key areas of infrastructure, including health and education, is necessary. Sixth, the trade policy regime, particularly the provisions related to agriculture, has not been transparent. Ad hoc changes in tariffs and licensing have introduced uncertainty regarding the future direction of trade policy, discouraging the entry of the private sector into commercial farming in a consistent manner and developing better marketing links with the small scale non-plantation agricultural sector. This problem is now being addressed. The last remaining licenses were eliminated in 1996 and agricultural products are now placed at the maximum tariff rate of 35 per cent. Requests for greater protection of the agricultural sector are still voiced at various fora. Steady commitment to the current liberal policy for several years is required for investors to be convinced that there is a credible and consistent trade policy related to agricultural products. Seventh, inflexible labour markets and rigid labour laws that do not give sufficient weight to the concerns of investors are considered to be a major obstacle for faster growth of private investment. These are some of the long-term structural policy issues that have to be addressed, if Sri Lanka is to accelerate investment and economic growth within the next three years.