

1. ECONOMIC PERFORMANCE, POLICIES AND ISSUES

1.1 Overview

Sri Lanka registered a moderate economic growth rate of 4.3 per cent in 1999. Economic activities, particularly in the industrial sector, gradually regained their growth momentum after experiencing a difficult period in the wake of the recent global economic crisis. The world economy was on a path towards steady recovery. The intensity of the recent global economic turmoil was contained by strong but painful adjustment efforts by crisis hit countries, the active role played by international organisations and regional banks in managing the crisis and assisting the crisis hit countries in their adjustment efforts, the strong economic growth of the United States and the continuation of robust economic growth in the European Union.

The recent experiences in East Asia and Latin America reveal that rapid shifts in market psychology from extreme optimism to extreme pessimism can create financial market turmoil. The experiences also showed that there are more fundamental factors leading to financial market crises. They include inconsistent monetary, fiscal and exchange rate policies, weak regulatory and supervisory standards, premature liberalisation of financial markets, lack of transparency in financial policies, weak corporate

governance and weaknesses in the international monetary and financial system, including the absence of an international lender of last resort with sufficient financial resources to meet crises. Increased attention is now being paid to addressing most of these problems both by the countries themselves and international organisations.

World trade and output recovered significantly in 1999. World output is estimated to have grown by 3.3 per cent in 1999 compared with 2.5 per cent in 1998. The gross domestic product of developing countries has grown by 3.8 per cent compared with 3.2 per cent in 1998. The crisis hit East Asian economies too were recovering faster than earlier expected, except for Indonesia, which had to contend with a multiplicity of other internal problems. While capital flows to higher-rated emerging market economies have started to recover cautiously from their very low levels in the previous two years, the flows to many other developing countries failed to show any promising signs of recovery.

Non-oil commodity prices remained depressed in 1999. Combined with a 40 per cent increase in crude oil prices during the year, this has led to a sharp deterioration in the terms of trade of oil importing developing countries. The US Federal Reserve Board increased interest rates three

TABLE 1.1
Selected Macroeconomic Indicators

Item	1980-89 Avg.	1990-94 Avg.	1995	1996	1997	1998	1999(a)
GDP (Real) Growth Rate	4.2	5.3	5.5	3.8	6.3	4.7	4.3
GDP Deflator	11.8	12.0	8.4	12.1	8.6	8.4	4.4
GDP (Nominal), per capita, rupees	9,608	25,148	36,869	41,940	47,988	54,220	58,323
GDP (Nominal), per capita, US dollars	362	515	719	759	814	839	829
Unemployment Rate, per cent	n.a.	14.4	12.3	11.3	10.5	9.5	8.8
Import Coverage of Foreign Assets, months							
Gross Foreign Assets	n.a.	n.a.	6.6	6.0	6.4	5.9	5.3
Gross Official Reserves	1.8	3.6	4.7	4.3	4.2	4.0	3.3
Per cent of GDP							
Gross Domestic Investment	26.2	24.1	25.7	24.2	24.4	25.1	27.1
Gross Domestic Savings	12.9	14.4	15.3	15.3	17.3	19.1	19.8
Foreign Savings(b)	13.3	10.3	10.4	8.9	7.1	6.0	7.3
Balance of Payments, Current Account	-8.1	-6.3	-6.0	-4.9	-2.6	-1.4	-3.1
Budget, Current Account	2.7	-1.6	-2.7	-3.8	-2.2	-2.4	-1.0
Budget, Overall Balance	-12.4	-9.8	-10.1	-9.4	-7.9	-9.2	-7.5
Money supply (M2b), per cent change (c)	n.a.	n.a.	21.1	11.3	15.6	13.2	13.4
Colombo Consumers, Price Index, per cent change	12.8	13.1	7.7	15.9	9.6	9.4	4.7
Exchange Rate (Rs/US\$), per cent change(d)	-9.1	-4.4	-7.5	-4.7	-7.1	-9.6	-6.0

Source: Central Bank of Sri Lanka

(a) Provisional

(b) Net imports of goods and non factor services

(c) Consolidated money supply including FCUBs

(d) Negative sign indicates depreciation

times during 1999 to avoid a possible overheating of the US economy due to concerns that the recent high rates of economic growth were not underpinned by a structural or sustainable growth in productivity. Several other industrial countries also raised interest rates in 1999. Although the successful introduction of the euro in 1999 reduced the number of major currencies that countries have to deal with in managing their exchange rates, international exchange market conditions remained highly uncertain, particularly with the euro losing its value sharply against the US dollar and the yen/US dollar rate showing high volatility. Amidst these complexities, the faster recovery of the global economy provided some relief to developing countries including Sri Lanka.

With its improved macroeconomic policy co-ordination, the Sri Lankan economy benefited from the recovery of external demand. Sri Lanka's economic growth rate of 4.3 per cent in 1999 was higher than the developing country average growth rate of 3.3 per cent. After a slow growth of 3 per cent during the first quarter, Sri Lanka's economic performance gathered momentum to reach a growth rate of 6.9 per cent in the fourth quarter.

Sri Lanka's industrial production and export activities, which suffered from depressed global market conditions since late 1997, showed clear signs of recovery during the second half of 1999. Inflation declined steadily throughout the year. Consumer price inflation declined to 4.7 per cent in 1999 from 9.4 per cent in 1998 according to the widely used Colombo Consumers' Price Index. As reflected in the Gross Domestic Product (GDP) deflator, the rate of increase in the overall price level declined to 4.4 per cent in 1999 from 8.4 per cent in the previous year. Prices declined at a faster rate than anticipated at the beginning of the year. This was due to improved domestic food supplies, containment of monetary expansion to below 15 per cent, lower import prices of food commodities and the moderation of the cascading effects in indirect taxation following the introduction of a Goods and Services Tax (GST). Significantly higher positive real interest rates also reduced demand pressure to some extent.

The unemployment rate continued to decline, reflecting the growth of employment in the private sector, particularly in tourism, manufacturing and small businesses, in a more liberalised economic environment and new recruitment to the public sector. Unemployment during the first three quarters of 1999 was recorded at 8.8 per cent of the labour force, compared to 9.7 per in the first three quarters of the previous year.

On the external front, the current account deficit widened from 1.4 per cent of GDP in 1998 to 3 per cent in 1999, reflecting the import of three aircraft as part of capacity expansion of SriLankan Airlines and a terms of trade loss of 7 per cent. The export volume increased by 6 per cent, but earnings declined by 4 per cent as export

unit values declined by 10 per cent in a more competitive environment. Private long-term capital inflows, excluding privatisation proceeds, doubled from US dollars 296 million in 1998 to US dollars 555 million in 1999. Total long-term net capital inflows increased by 16 per cent to US dollars 396 million. The balance of payments showed an overall deficit of US dollars 263 million (1.7 per cent of GDP) due to the decline in exports, higher short-term capital outflows and a reduction in external liabilities of the commercial banks. However, the decline in the country's net foreign assets was less as there was a build up of net foreign assets by commercial banks. The country's gross foreign assets were sufficient to cover 5.3 months of current imports, while gross official reserves had an import coverage of 3.3 months.

The overall deficit in the budget declined significantly from 9.2 per cent of GDP in 1998 to 7.5 per cent in 1999, making further progress towards the medium-term goal of containing the deficit to around 5 per cent of GDP by 2002. The reduction of the fiscal deficit in 1999 came mainly through the containment of non-interest expenditure, including security expenditure, while maintaining investment expenditure close to last year's level. The security expenditures declined from 5.7 per cent of GDP to 4.9 per cent of GDP. There was also a marginal improvement in the revenue buoyancy of the tax system after indicating a declining trend in the last few years. This was attributed to the measures put in place to improve tax administration, particularly to stop the leakage of GST revenues through refunds. As the availability of net foreign resources was lower than in 1998, a larger portion of the deficit was financed through domestic sources, mainly through bank borrowings.

Considering the declining trend in inflation, the Central Bank signalled the desirability of somewhat lower interest rates by adjusting the repurchase rate downward from 11.25 to 9.25 per cent in several steps during the year and a reduction of the statutory reserve requirement from 12 to 11 per cent in August 1999. The overnight reverse repurchase rate was also reduced from 15 per cent at end 1998 to 13.48 per cent at end 1999 in line with market trends. The Central Bank purchased Treasury bills in the primary market to meet the increased demand for liquidity towards the end of the year on account of Y2K related uncertainty. Although currency in circulation increased by a maximum of Rs. 9,000 million in December, the increase was less than originally anticipated as the market had confidence in the country's preparedness for the changeover. The Bank absorbed the additional liquidity through open market operations when the financial market conditions returned to normal in January 2000. The broad money supply increased by 13.4 per cent in 1999. This was within the range of 13-15 per cent envisaged in the financial programme prepared at the beginning of the year.

Bank credit to private sector increased by 10 per cent, which was a rate consistent with the growth of private sector activities in 1999 and the trends in inflation. Provisional estimates of a comprehensive financial survey undertaken recently showed a 12 per cent growth in credit to the private sector from all financial institutions including commercial banks, development banks, finance companies, savings banks and regional development banks. It shows that private sector reliance on institutional credit is about 34 per cent of GDP. The net increase in credit to the private sector was Rs.47 billion in 1999. Credit to government from the banking system increased at a faster rate during the year, as further sales of shares of Sri Lanka Telecom were postponed for 2000. According to the financial survey, credit to government accounted for 26 per cent of the total domestic credit from institutional sources.

The Central Bank has recently strengthened the monitoring and supervision of banking institutions with a

view to further promoting financial system stability. While the regular on-site supervision of individual banks was intensified, quarterly off-site supervision was developed as an early warning system. The banks have been informed of the desirability of improving their disclosure standards and maintaining capital adequacy ratios at 10 per cent even above the level of 8 per cent recommended under the Basle guidelines, from the beginning of 2001. Steps are being taken to improve provisioning for non-performing loans from 6 months to 3 months. Auditors of banks have been given instructions regarding the specific aspects on which they should report. While some slowing down of private sector credit growth in 1999 could be attributed to this enhanced emphasis on prudential norms, the anticipated improvement in credit culture is expected to improve the stability and soundness of the banking system. Regular monthly meetings with banks and financial institutions have also helped to solve problems and improve practices.

Chart 1.1
Selected Macroeconomic Indicators - I

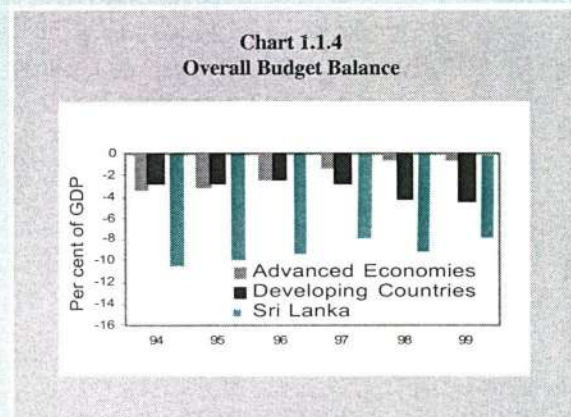
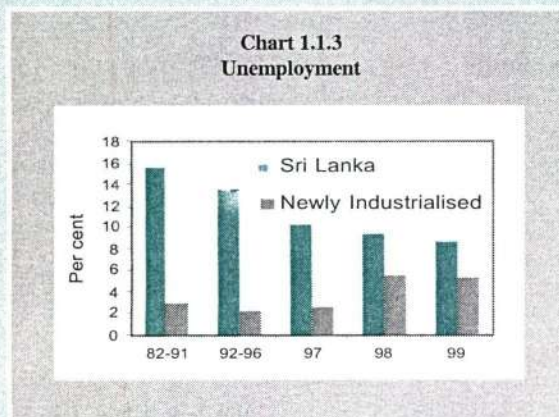
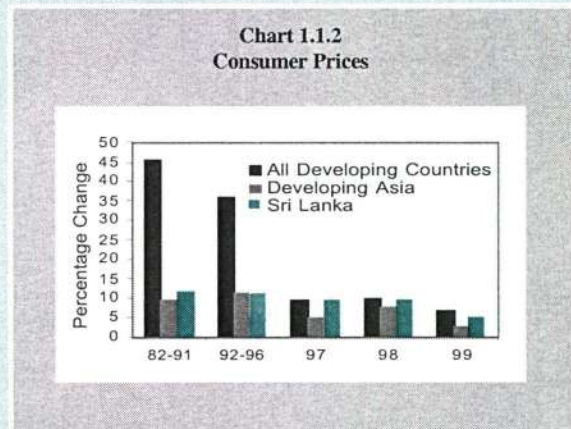
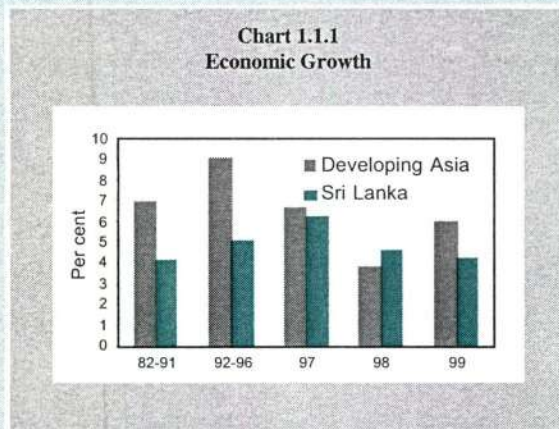
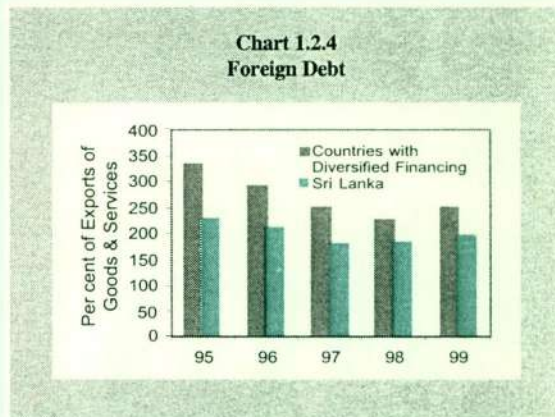
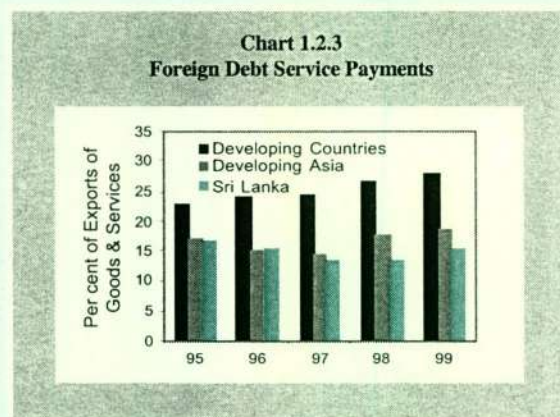
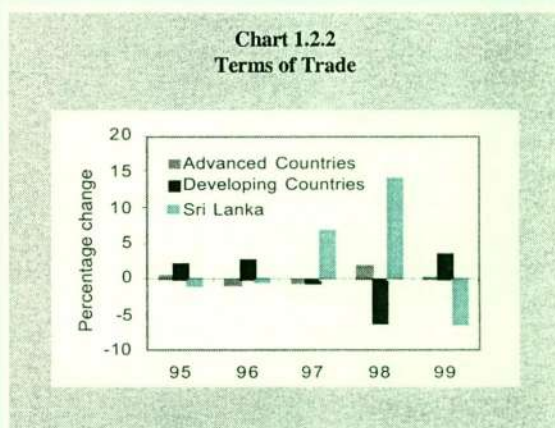
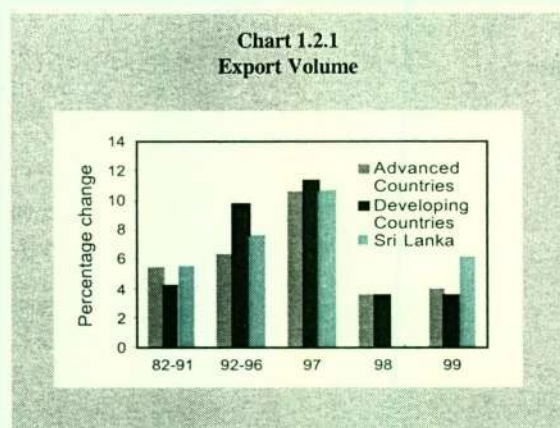


Chart 1.2
Selected Macroeconomic Indicators - II



The financial market remained relatively stable during 1999. Interest rates indicated lower volatility with a slight decline in most interest rates, including yields on medium-term government bonds. The reduction of interest rates was in the range of 1-2 percentage points. While there was some pressure on the exchange rate during the first half of the year, it eased during the second half as the rate of inflation continued to decline. Real interest rates became more attractive for savers and investors in financial instruments. Meanwhile, there was build up of net foreign assets of commercial banks. The annual average depreciation of the rupee against the US dollar was 8.2 per cent in 1999, while the depreciation from end December 1998 to end December 1999 was 6 per cent. This behaviour of the exchange rate reflected the somewhat weaker balance of payments position in 1999.

1.2 Output

Economic Growth

The Gross Domestic Product (GDP), in real terms, grew by 4.3 per cent in 1999. Although this growth rate was lower than the long-run annual average growth rate of around 5 per cent, it was a satisfactory rate given the difficult environment in which the country had to manage its affairs. An acceleration of the quarterly economic growth rates was clearly seen during the year. This was reflected in all major sectors. The fourth quarter results showed an impressive growth rate of 6.9 per cent and the indications are that this growth momentum has continued into 2000, particularly in the case of industrial and trading activities. This high growth rate was achieved largely by a further improvement in productivity in the manufacturing as well as services

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

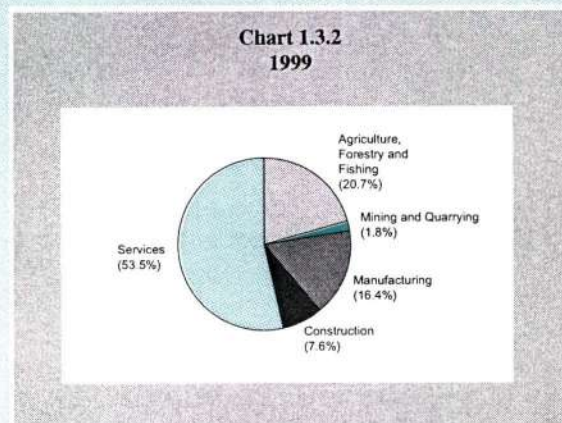
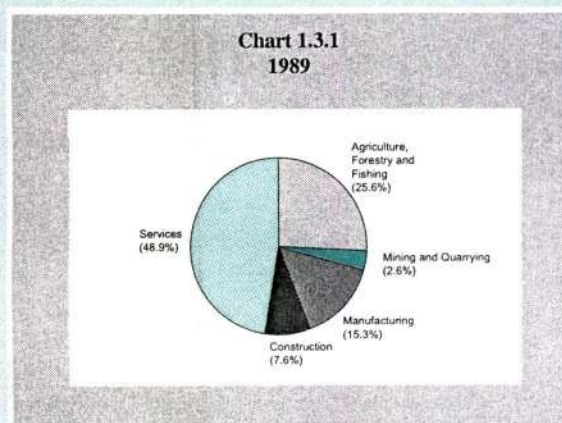
Item	1980-89 Avg. (a)	1990-97 Avg. (a)	1998(b)	1999(b)
1. Agriculture, Forestry and Fishing	2.3	2.3	2.5	4.5
1.1 Agriculture	2.3	2.3	1.8	4.4
Tea	0.3	4.7	1.1	1.3
Rubber	-2.7	0.1	-9.0	1.0
Coconut	3.1	1.1	-3.2	9.1
Paddy	1.4	2.0	18.3	6.6
Other	4.6	3.1	-1.5	3.4
1.2 Forestry	3.3	1.5	1.2	1.3
1.3 Fishing	2.7	3.2	8.3	7.6
2. Mining and Quarrying	6.3	3.4	-5.4	4.1
3. Manufacturing	5.5	8.7	6.3	4.4
3.1 Processing of Tea, Rubber and Coconuts	0.0	2.5	-1.2	3.8
3.2 Factory Industry	7.8	10.0	7.6	4.5
3.3 Small Industry	1.6	6.0	6.5	4.8
4. Construction	1.3	5.1	7.1	4.8
5. Electricity, Gas, Water and Sanitary Services	6.6	7.6	10.1	9.5
6. Transport, Storage and Communications	4.7	5.9	7.7	8.1
7. Wholesale and Retail Trade	4.6	5.8	4.5	1.0
7.1 Imports	2.7	8.0	8.2	-1.4
7.2 Exports	4.4	11.3	0.1	6.1
7.3 Domestic	6.4	2.6	2.0	2.1
8. Banking, Insurance and Real Estate	9.4	8.5	6.4	4.6
9. Ownership of Dwellings	2.9	1.3	1.2	1.2
10. Public Administration and Defence	10.2	3.4	3.0	4.2
11. Services (n.e.s.)	2.2	5.4	3.7	9.8
12. G.D.P.	4.2	5.4	4.7	4.3
13. Net Factor Income from Abroad	43.5	0.7	12.2	41.4
14. Gross National Product	4.0	5.6	4.6	3.8

(a) At 1982 constant factor cost prices

(b) At 1996 constant factor cost prices

Source: Central Bank of Sri Lanka

Chart 1.3
Sectoral Composition of GDP



sectors, resulting from wider use of telecommunications and information technology. In addition, activities such as retail trade, light engineering, hotel and catering services, automobile maintenance services, air-conditioning, computer hardware and software engineering and personal services have contributed notably to economic growth. A 15 per cent increase in tourist arrivals in 1999 supported a growth in related services. The export oriented industries regained competitiveness as the real effective exchange rate depreciated further in 1999 with the gradual appreciation of some of the competitor country currencies and lower domestic inflation. The continuation of favourable inflation trends has helped to subdue wage pressures during the year.

GDP at current market prices increased by 9.1 per cent to Rs.1,111 billion. As the mid-year population is estimated at 19 million, this indicated an increase in per capita annual income to Rs.58,323 in 1999 from Rs.54,220 in 1998. In foreign currency terms, this indicated a per capita income of US dollars 829.

All sectors contributed to economic growth in 1999. The Transport, storage and communications sector made the highest contribution of 23 per cent to economic growth. The Agriculture sector contributed 25 per cent and the Manufacturing sector 19 per cent, while domestic trade, tourism and informal services contributed 15 per cent. The other sectors contributed the balance 18 per cent.

Manufacturing

Overall industrial output grew by 4.4 per cent in 1999. The output of medium and large scale factory industries, which account for about 84 per cent of total industrial output, showed a moderate growth of 4.5 per cent in 1999 amidst increased competition faced by the export sector. The processing of tea, rubber and coconut products showed a positive growth of 3.8 per cent. Manufacturing sector output contributed 16 per cent to overall economic growth in 1999, compared to 23 per cent in the previous year. The growth momentum in the industrial sector was improving steadily in the latter part of the year. The industrial output rising by 7.7 per cent in the fourth quarter. The recovery was prominent in export-oriented industries as world demand was picking up with the continued high growth in the U.S. economy, the robust growth in the EU and the recovery in Japan and East Asia. They also benefited from the depreciation of the real effective exchange rate.

The apparel industry, the largest of Sri Lanka's industries, registered an 8 per cent growth in output in 1999, despite a further decline in export prices by 9 per cent in the face of growing competition. It contributed 63 per cent to industrial sector growth in 1999. Other export industries such as processed diamonds, footwear, plastics, processed fruits, machinery and equipment also recovered significantly in the latter part of 1999. Industries catering

mainly to the domestic market showed a mixed performance, with high output growth in wheat flour, meat, plastics, pharmaceuticals, detergents, cement, building materials and basic metal products, but with a decline in the output of liquor, spirits, tobacco and petroleum products. Labour productivity increased further by 1.9 per cent in 1999. The production capacity of private sector industries increased by 2.1 per cent, reflecting new investment.

The improved industrial performance in the latter part of 1999 is also attributed to modernisation of factories facilitated partly by fiscal incentives offered for adoption of new technology. Further stimulus came from improved telecommunications and the development of other infrastructure facilities under the regional industrial parks programme. While the foreign currency loans facility for non-Board of Investments (BOI) sector exporters continued, its relative attractiveness diminished on account of the easing of domestic interest rates since 1997.

A total of 153 new enterprises registered under the Board of Investment (BOI) and the Ministry of Industrial Development commenced commercial operations during the year. The additional employment generated in the BOI sector was estimated at 33,000 in 1999. Many industrialists achieved increased efficiency and cost reduction by subcontracting and better procurement practices. The advantage of lower import prices were more or less off-set by the reduction in export prices. Wage costs could be moderated because of lower domestic inflation. Lower interest costs and the exchange rate depreciation also helped to improve competitiveness.

Agriculture

Value added in agriculture increased by 4.5 per cent in 1999 reflecting higher output in paddy, tea, rubber, coconut, sugar and fish. Paddy output improved by 7 per cent and recorded the highest paddy production in recent years. The increase came from both an increase in yield and an increase in area under cultivation. Yield improvements were around 1 per cent. Rice prices remained relatively attractive during the year and fertiliser application increased by 25 per cent. With a view to stabilising domestic prices a partial duty waiver on the import of rice had been granted temporarily towards the latter part of the year. Despite the satisfactory performance in paddy production, Sri Lanka had to import 214,000 metric tons of rice in 1999.

Tea production with a further 1 per cent growth reached a new peak of 284 kg million in 1999. Tea prices improved during the second half owing to active participation by Russia at the Colombo auctions and a drop in global production reflecting lower output in India and Kenya. Nearly 60 per cent of the tea output came from smallholders. Despite a significant improvement in tea prices during the second half of the year, the annual

average price at the Colombo auctions showed a decline of 14 per cent in 1999. The average export price of tea was 12 per cent lower. As the quantity of tea exports was also marginally lower, export earnings from tea declined by 13 per cent.

Coconut production improved by 10 per cent and reached the highest output level since 1986. Lagged effects of favourable weather conditions in the previous year, as well as well distributed rainfall and increased fertiliser use contributed to increasing output. Value added in coconut increased by 9 per cent, compared with a 3 per cent decline in 1998. Export earnings from coconut kernel products increased by 64 per cent, while the earnings from other coconut products increased by 27 per cent in 1999.

Rubber production showed a small recovery after declining for several years. Owing to continued depression of prices, the rate of new planting has declined by 58 per cent, fertiliser use too has declined. However, the rubber based domestic industry has been growing recently and this trend continued during 1999 as well. Domestic use of rubber by the industrial sector accounts for about 56 per cent of total production. The tyre industry, particularly the production of industrial tyres, has been performing well and Sri Lanka appears to have a high potential in this area. It is expected that natural rubber prices will pick up with the recovery of world demand.

Among other export crops, coffee, cinnamon quills, cloves, cardamom, nutmeg and mace and citronella registered higher output levels. Among other field crops, big onion output increased threefold while potato and kurakkan production increased by 5 and 9 per cent, respectively. Chillies, black gram, sesame and green gram production was lower. Fish production increased by 8 per cent during 1999. Production of poultry meat and sugar also improved during the year.

The Agriculture sector performed well in 1999 as the combined outcome of shifting cultivation to crops with higher comparative advantage, trade liberalisation, better plantation management under privatisation, improved cultivation practices and more efficient distribution systems. The Agriculture sector has tended to move from subsistence production to high value-added products based on improved technology and rational cultivation practices. This process will lead to commercialisation of agriculture and the development of agro-processing and agro-business activities. Further, with a view to improving the marketing network and assisting the small farmers, a forward market mechanism was initiated by the Central Bank during the year. Under this mechanism named the 'Govi Sahanaya', farmers are encouraged to enter into forward contracts with buyers at pre-determined remunerative prices. This scheme is expected to reduce the volatility of farmer incomes and to promote agro-business and agro-processing enterprises. In

TABLE 1.3
Gross National Product
(Sector Shares in per cent)^(a)

	1978	1988	1998	1999
1. Agriculture, Forestry and Fishing	30.3	26.3	21.1	20.7
2. Mining and Quarrying	2.2	2.7	1.9	1.8
3. Manufacturing	18.4	15.4	16.5	16.4
4. Construction	4.7	7.3	7.6	7.6
5. Services	44.4	48.3	52.9	53.5
Electricity, Gas, Water and Sanitary Services	0.4	1.2	1.5	1.5
Transport, Storage and Communication	10.7	10.8	11.1	11.4
Wholesale and Retail Trade	19.7	19.9	21.5	21.2
Banking, Insurance and Real Estate	2.2	4.5	7.6	8.1
Ownership of Dwellings	3.7	2.6	1.9	1.8
Public Administration and Defence	3.6	5.4	5.3	5.3
Services (n.e.s.)	4.1	3.9	4.0	4.1
6. G.D.P.	100.0	100.0	100.0	100.0
7. Net Factor Income from Abroad	-0.6	-2.6	-1.3	-1.8
8. G.N.P.	99.4	97.4	98.7	98.2

(a) At current factor cost prices

Source: Central Bank of Sri Lanka

addition, in keeping with the government's broad policy of liberalisation and encouraging private sector participation in economic activities, further liberalisation of the agricultural input and support services such as seed, planting materials, insurance and extension activities, created a more market friendly atmosphere.

Increased attention is being paid to the development of high quality seeds in Sri Lanka. In this regard the government has already initiated several measures, which include the duty free importation of seed and planting materials. The government allocated Rs.100 million to help strengthen the basic seed production centres at Maha Iluppallama, Batalagoda, Ambalantota, Bata-Ata and Nikaweratiya in 1999. The private sector is expected to play an important role in the seed industry. The Hingurakgoda seed farm of the Department of Agriculture was privatised in 1998 and the preliminary work connected with the privatisation of the Pelwehera seed farm has been completed. The privatised seed farm at Hingurakgoda is progressing well. There has been some improvement in seed paddy availability during the last Maha season.

During the year, four new rice varieties were released by the Rice Research and Development Institute at Batalagoda. One of these was a three month variety, while the others were three and a half month varieties. A new high yielding pole bean seed and a high yielding green gram variety were also released during the year.

New legislation has been enacted in 1999 to enhance the scope of agricultural insurance activities. The former Agricultural Insurance Board (AIB) was reconstituted with

wider scope and re-named the Agricultural and Agrarian Insurance Board (AAIB). The new law will also permit private insurance companies to undertake crop insurance activities.

Agricultural extension services have hitherto been provided free of charge by the public sector. However, with a view to improving efficiency and make the extension activities competitive and vibrant, a fee based private extension service was initiated as a pilot project during the year under the Second Perennial Crop Development Project.

Under the programme for privatisation of the management of state owned plantation companies, which commenced in 1995, the remaining shares in the Namunukula and Talawakelle plantations were sold to the public through the Colombo Stock Exchange during 1999.

Granting of cultivation loans under the New Comprehensive Rural Credit Scheme (NCRCS) continued in 1999. Under the NCRCS, loans to farmers are granted at an interest rate of 12 per cent by participating credit institutions. The government gives an interest subsidy of 10 percentage points to the banks. The total amount of credit granted during the 1998/99 cultivation year amounted to Rs.463 million.

Economic and Social Overheads

Improvement of infrastructure has been a top priority in the country's economic development strategy. With the declining share of security expenditure due to improved financial discipline, public investment in infrastructure was speeded up during the last two years, albeit not as much as expected. The declining trend in public investment was reversed in 1998, while also encouraging private sector participation in this area. Public investment increased by about one per cent of GDP, while investment by the private sector in infrastructure development also expanded. Government investment was mainly in the water supply and sanitation, roads, housing and transport sectors. Construction of the proposed highways from Colombo to Matara, Katunayake, and Kandy is expected to be expedited.

Private sector participation in infrastructure services increased further in 1999 with the commencement of the Queen Elizabeth Quay (QE) port terminal development project by South Asia Gateway Terminals (Pvt.) Ltd. (SAGT). The QE project will increase the present container handling capacity of the Port of Colombo by 750,000 container units per year. This is the largest ever privately funded project commenced on a BOT basis. The re-fleeting programme of SriLankan Airlines commenced in 1999 and three new aircraft were brought in during the year. Private investment in other areas, particularly telecommunications, housing, and power, expanded further. Private infrastructure projects attracted about 60 per cent of the foreign direct investment realised during 1999 under

BOI facilities. The Bureau of Infrastructure Investment (BII) continued to facilitate private investment in infrastructure development, while the Private Sector Infrastructure Development Company Ltd. (PSIDC) provided financial assistance to private infrastructure projects.

Despite these improvements, however, the present level of investment in infrastructure is yet inadequate. Therefore, while the private sector is called upon to play a vital role, given our stage of development, the public sector would also need to play a major role in infrastructure development in areas where private sector participation is not forthcoming. Public sector leadership is essential in large infrastructure projects such as roads, railroads, dams, water supply and port development. Along with rapid improvement in economic infrastructure, investment in human resources has also become a pressing need to improve labour productivity. In this respect, education and health sector reforms are being implemented. The current strategy for improving the availability and quality of infrastructure includes construction of new infrastructure, rehabilitation and modification of existing facilities, institutional and management reforms and privatisation.

In line with the above strategy, public investment in the power sector increased by an estimated 27 per cent in 1999. The installed capacity of the Ceylon Electricity Board (CEB) was augmented by 3 per cent with the commissioning of a 40 MW thermal power plant at Sapugaskanda. The reliance on hydropower in 1999 remained at 67 per cent of total power generation. Improvement in the passenger transport sector was only moderate. Public and private sector bus fleets have expanded slightly. Further consolidation of public sector passenger transportation was under consideration to improve operational efficiency. Steps have been taken to augment the rolling stock of Sri Lanka Railways (SLR). However, more fundamental reforms of the SLR appears to be necessary to reduce its large operational losses and to improve the service. The operating loss of the SLR increased further to Rs. 1,848 million in 1999 from Rs.1,066 million in 1998. Meanwhile, fares have not been revised since 1996. With regard to road transport, the construction of the proposed expressways is expected to ease traffic congestion and improve access to regions. Several projects were underway to expand the capacity of the Port of Colombo. However, demand for port services has been almost stagnant during last two years, mainly due to competition from regional ports. In an analysis of port efficiency, the problem of staffing in the Port of Colombo would need to be examined. Further, as there could be competition between the SAGT and the rest of the port in the future, there is a need to appoint a regulator for the industry.

Investment in housing and water supply further expanded during 1999. The housing finance market needs to be developed further. Currently, bank lending to the real

estate sector is about 12 per cent of its loan portfolio. However, these loans are for largely employee owned houses. Three large housing projects approved by the BOI commenced in 1999. A record number of new water connections were provided in 1999. The high share of non-revenue earning water has been the major problem in this sector. More realistic pricing of urban water would be necessary if private investment is to be encouraged.

Private sector participation in the power sector improved significantly in 1999. Three major private thermal power projects with a capacity of 265 MW were approved and are to be commissioned within the next two years. This will significantly reduce the heavy dependency on hydropower. There are a large number of small private sector hydropower projects with about 100 MW of capacity at various stages of construction. The robust growth seen in the telecommunications sector during the last 3 years continued in 1999. Fixed telephone lines increased by 29 per cent, while the mobile telephone network expanded by 47 per cent. Investment by Sri Lanka Telecom (SLT) increased by 31 per cent, while other private sector investments in telecommunications rose by 19 per cent in 1999.

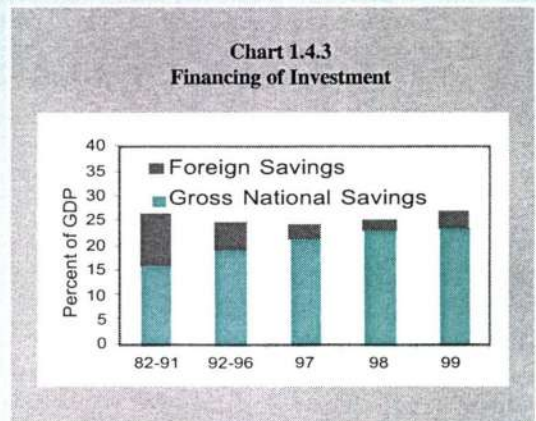
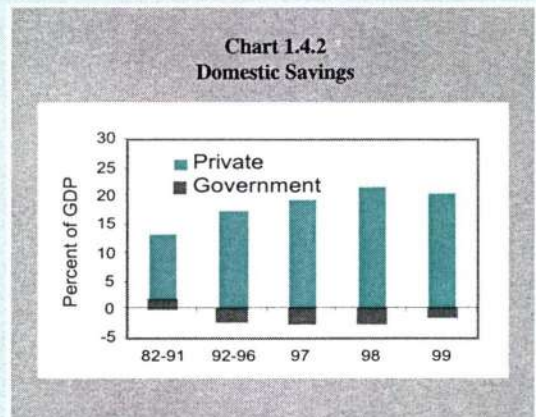
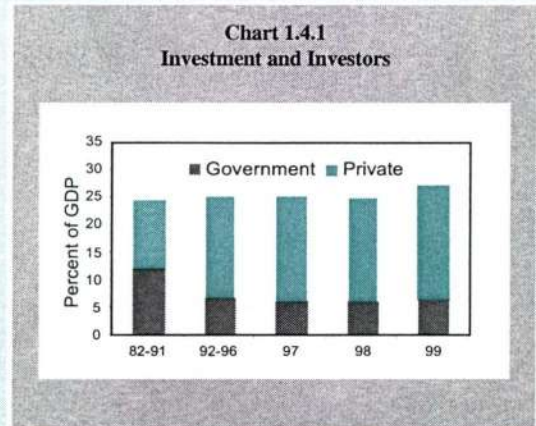
General education reforms, implemented on a pilot basis in 1998, were implemented islandwide in 1999 and are progressing satisfactorily, although there were some problems relating to resource constraints and training. The teaching of English and computer education have been accorded high priority under the reforms. Implementation of university education reforms was rather slow due to slow response from the universities.

Implementation of health reforms was also slow, mainly due to financial constraints and non-adherence to a specific time frame. However, some progress has been made in the areas of developing one major hospital in each district and in training.

1.3 Investment and Savings

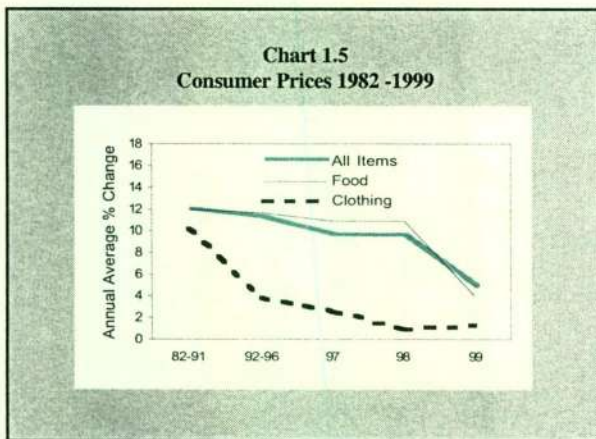
Gross domestic investment increased to 27.1 per cent of GDP in 1999, up from 25.1 per cent in 1998. As public investment remained around the same level as in the previous year, the higher investment came from the private sector, mainly the acquisition of aircraft by SriLankan Airlines. The increased investment was financed through higher national savings and increased foreign savings, reflected mainly in higher private capital inflows. The gross national savings ratio increased from 23.4 per cent of GDP in 1998 to 23.9 per cent in 1999, while the gross domestic savings ratio, i.e. savings excluding overseas employee remittances increased, to 19.8 per cent of GDP. These were reflected in the reduction of fiscal dissavings, i.e., or a reduction in the current account.

**Chart 1.4
Domestic Investment**



1.4 Prices

The decline of inflation to its lowest since 1985 was one of the major favourable developments on the macroeconomic front during the year. The low inflation in 1999 was a combined outcome of improved monetary controls and fiscal discipline, rationalised tax and tariff structures, greater agricultural production, low world market prices for imported food items and improved domestic marketing network and dissemination of price information systems using modern communication media. The low inflation trend helped to ease the pressure on interest rates, wages and the exchange rate considerably while improving international competitiveness and thereby eased the task of overall macro economic management. However, inflationary expectation continued to remain high, apparently the aftereffect of a long period of high inflation in the recent past. This reinforces the need to persevere with low inflation for some time, so that public perceptions could be fashioned appropriately.



As measured by the Colombo District Consumer Price Index (CDCPI), computed by the Central Bank, the annual average inflation in 1999 was 3.6 per cent. The Colombo Consumers' Price Index (CCPI) computed by the Department of Census and Statistics, indicated an inflation rate of 4.7 per cent in 1999. These two indices as well as the Greater Colombo Consumers' Price Index (GCPI), showed substantial deceleration in the increase in consumer prices. The Wholesale Price Index (WPI) reflected a decline of 0.3 per cent in 1999. The rate of increase in food prices in the CDCPI decelerated sharply from 8.9 per cent in 1998 to 2.4 per cent in 1999, owing to improved domestic supply of rice, vegetables, coconuts and fish and improved marketing, as well as increased availability of imported food.

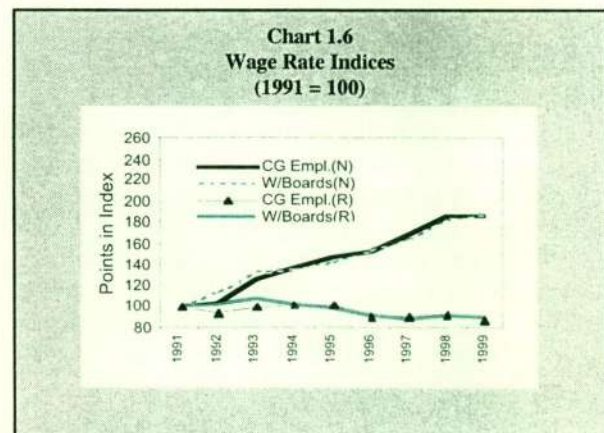
The narrowing of regional price variations during 1999 was a favourable outcome emerging from the development

of regional marketing centres, which have gradually helped to improve efficiency in wholesale marketing and distribution of agriculture commodities. Wider dissemination of information on market conditions and prices through the media appears to have helped reduce price fluctuations. There was also a significant drop in the prices of all varieties of fish, owing to both marine and inland fisheries continuing to improve as a result of the growth in investment in fishing vessels, including multi-day boats, and expansion of infra-structure facilities such as fisheries harbours. Coconut prices too dropped in 1999 reflecting increased production. The monetary measures aimed at easing domestic demand pressures also helped to moderate inflation. The containment of the growth of money supply to around 13-14 per cent, despite a somewhat higher than originally anticipated demand for domestic resources by the government, prevented a build up of excessive demand pressure in the economy. The relatively slower growth in wages in both public and private sectors also helped to ease inflation.

Although the rupee depreciated against the US dollar by 6 per cent in 1999, the drop in the world market prices of major imported consumer items such as rice, sugar and wheat grain more than compensated for the upward pressure on prices through the currency depreciation. The price of imported rice in terms of US dollars dropped by 13 per cent. Sugar and wheat prices dropped by 26 per cent and by 10 per cent, respectively. Following the world market trends, the domestic price of wheat flour was reduced administratively to extend a part of the benefit to consumers. This was a refreshing change from the past policy of holding wheat flour prices.

1.5 Wages

There were no significant wage increases in the public sector during 1999. However, wages in the organised private sector were raised at different rates for different categories, resulting in an overall increase of 2.5 per cent. Workers in agriculture, commerce and industry experienced



an increase in nominal wages. There was an increase of 10.6 per cent in nominal wages in the services sector. In the unorganised sector, the nominal wages of those involved in paddy, coconut and rubber cultivation as well as building construction, experienced significant increases.

1.6 Unemployment

The rate of unemployment continued to decline, reflecting growth in both the private sector and the public sector. The proportion of public sector employment in total employment increased, indicating a deviation from the recent trend of a declining share of public sector employment. Tentative estimates based on available information indicate that the economy created about 85,000 – 90,000 new employment opportunities in 1999. The problem of high unemployment among youth continued to be a prominent feature. The number who left for employment abroad in 1999 has been estimated at 178,000.

1.7 Fiscal Policy and Budgetary Operations

Despite the constraint of the ongoing conflict in the North and the East, the fiscal performance improved significantly in 1999. The overall deficit declined from 9.2 per cent of GDP in 1998 to 7.5 per cent of GDP in 1999. The current account of the budget showed a lower deficit of 1 per cent of GDP from 2.4 per cent in 1998. While the revenue performance improved marginally as a percentage of GDP, arresting the declining trend seen during the last few years, current expenditure was contained at 18.7 per cent of GDP compared with 19.6 per cent of GDP in the previous year. Public investment as a ratio of GDP was 6.4 per cent compared with 6.7 per cent in 1998. As a further sale of shares of Sri Lanka Telecom was postponed and foreign resources available were lower in 1999, nearly 90 per cent of the overall deficit was financed from domestic sources. As credit to the private sector from the banking system was relatively sluggish and there was a decline in net foreign assets, largely reflecting the adverse terms of trade, the higher domestic resource absorption by the government in 1999 was met without creating a serious expansionary impact on money supply.

On the expenditure side, it is particularly noteworthy that growth of current expenditure has been kept below the growth of nominal GDP and its ratio to GDP has been declining since 1995. This trend continued in 1999, confirming the government's commitment to maintain fiscal discipline. Accordingly, non-interest current expenditure was maintained around the same level as in 1998. The growth of the wage bill was contained at 9 per cent compared to 21 per cent in previous year. The expenditure on purchases of goods and services declined by 9 per cent in 1999. Capital expenditure did not reach the originally expected level owing to significant shortfalls in expenditures in

several major projects in ports, agriculture, railways and energy. As a percentage of GDP, investment expenditure indicated a marginal decline, but remained higher than the levels in 1996 and 1997.

On the revenue side, import tariffs were further rationalised with the maximum rate for non-agricultural products being reduced to 30 per cent. Raw materials and machinery not manufactured in Sri Lanka were subjected to a tariff rate of 5 per cent, while food items were kept at 10 per cent. Crude oil and petroleum imports were brought under a 30 per cent rate and the import tariff on motor vehicles was unified at 30 per cent. Excise tax adjustments were made to bring the overall tax incidence on petrol motor vehicles to 73 per cent and diesel vehicles to 172 per cent, except utility vehicles. In this process, an excise tax on petrol driven motor vehicles was introduced while the excise tax on diesel driven motor vehicles, except utility vehicles, was increased by 10 per cent. The national security levy was raised to 5.5 per cent from 4.5 per cent. Upward revisions were also made to excise taxes on cigarettes and hard liquor. The excise tax on malt liquor was rationalised by introducing the universally accepted tax based on alcohol strength. Measures were also introduced to improve tax administration, including the introduction of a voucher system for GST refunds.

Fiscal incentives were granted to improve capital and debt markets and for development of information technology and training in various skills. The tariffs on agricultural products were kept at 35 per cent to provide protection under the current liberalised trade policy framework, while infrastructure development programmes were undertaken to develop the sector. The poverty reduction programme through Samurdi income supplements and grants and schemes to help displaced families in the North and East were continued during 1999.

The government debt securities market was made more market oriented, by placing greater reliance on marketable Treasury bonds and extending the maturity structure of debt instruments up to 6 years. In addition, preparatory work to set up a dedicated primary dealer system for government debt securities was completed and measures were under way to introduce scripless debt securities.

Steps were also taken to improve the transparency in fiscal operations further. The publication 'Budget at a Glance' provided a concise summary of the government's annual budget proposals, public investment and development programmes and incentives for targeted groups and sectors. It also provides a medium-term fiscal policy scenario and a strategy for achieving these targets. 'Trends in Public Finance' provides information on fiscal developments, the broad policy direction of economic reforms and key economic indicators. Moreover, the publication 'Path to Development' gives a detailed presentation of the

TABLE 1.4
Summary of Fiscal Operations

Item	(as a percentage of GDP)									
	1980	1985	1990	1994	1995	1996	1997	1998	1999(a)	
1 Revenue	19.6	22.3	21.1	19.0	20.4	19.0	18.5	17.2	17.6	
2 Expenditure and Net Lending	41.8	34.1	31	29.5	30.5	28.5	26.4	26.3	25.1	
2.1 Current Expenditure	18.5	20.1	22.3	21.9	23.1	22.8	20.7	19.6	18.7	
2.1.1 Security	1.3	4.5	4.1	4.6	6.5	5.8	5.1	5.0	4.4	
2.1.2 Interest	3.4	4.6	6.4	6.6	5.7	6.4	6.2	5.4	5.6	
2.1.3 Wages(b)	4.5	3.6	3.9	3.1	3.4	3.3	3.1	3.0	3.0	
2.1.4 Subsidies and Transfers	8.4	5.5	6.5	5.9	6.1	6.0	5.1	4.6	4.2	
2.1.5 Others	0.9	1.9	1.4	1.8	1.4	1.3	1.3	1.6	1.4	
2.2 Capital and Net Lending	23.3	13.9	8.7	7.5	7.4	5.7	5.7	6.7	6.4	
2.2.1 Public Investments	18.5	13.8	8.3	7.0	7.9	6.0	5.8	6.7	6.4	
Aquisition of Real Assets	7.9	4.5	3.7	2.9	3.4	2.7	2.9	3.2	2.9	
Capital Transfers	9.4	8.6	2.3	2.4	2.9	2.2	2.1	2.2	2.5	
On Lending	1.2	0.6	2.2	1.7	1.7	1.1	0.8	1.4	1.0	
2.2.2 Other	4.7	0.2	0.4	0.6	-0.5	-0.3	-0.1	-	-	
Restructuring Cost	0.0	0.0	0.0	0.6	0.5	0.0	0.2	0.4	0.4	
Others	4.7	0.2	0.4	-0.1	-1.0	-0.3	-0.3	-0.3	-0.4	
3 Current Account Balance	1.1	2.2	-1.2	-2.9	-2.7	-3.8	-2.2	-2.4	-1.0	
4 Overall Deficit before Grants and excluding Privatisation	-22.2	-11.7	-9.9	-10.5	-10.1	-9.4	-7.9	-9.2	-7.5	
5 Financing	22.2	11.7	9.9	10.5	10.1	9.4	7.9	9.2	7.5	
5.1 Foreign Financing	9.2	6.4	5.7	3.5	4.5	2.3	1.9	1.7	0.7	
5.1.1 Loans	5.3	4.4	3.6	2.0	3.2	1.3	1.1	1.0	0.1	
5.1.2 Grants	3.9	2.0	2.1	1.4	1.4	1.0	0.8	0.7	0.6	
5.2 Domestic Financing	13.0	5.3	4.2	6.5	5.1	6.5	3.4	7.1	6.7	
5.2.1 Banks	9.8	2.9	0.1	0.2	1.1	1.7	-0.2	1.9	2.3	
5.3 Privatisation	0.0	0.0	0.0	0.5	0.4	0.6	2.5	0.4	-	
Memorandum Items :										
Total Wage Bill	5.0	4.2	4.9	5.1	5.2	5.0	5.0	5.3	5.3	
Gross Defence Expenditure (c)	1.3	4.5	4.1	4.6	6.5	6.0	5.4	5.6	4.9	

(a) Provisional

(b) Excluding those paid to defence staff.

(c) Including settlement of deferred payments.

Source: Central Bank of Sri Lanka

Chart 1.7
Government Budget

Chart 1.7.1
Current Account and Overall Balance

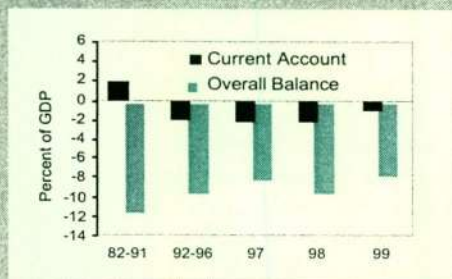
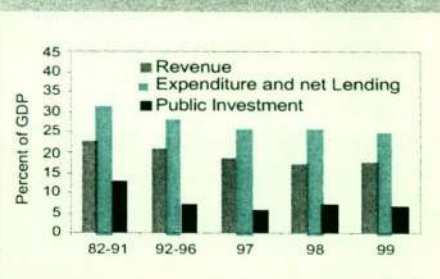


Chart 1.7.2
Revenue, Expenditure and Investment



government's medium-term investment plan. The 'Budget Estimates' of the government is presented in a new simplified format, giving the underlying assumptions used in the preparation of budget estimates and explanatory notes on the method of estimation.

1.8 The International Environment and External Sector

International Environment

The global economy, which has faced highly turbulent times since the eruption of the East Asian crisis in July 1997 and a host of other disruptions in Japan, Russia and South America, has shown signs of slow recovery since the middle of 1999. Financial markets in emerging economies displayed a return to stability with the gradual build up of investor confidence stemming from firm implementation of reforms in domestic markets. Although the risk of a global recession appears to have receded, market conditions point to the continuation of economic slowdown in many regions, particularly in Japan, Europe, Russia and most developing countries. The sharp increase in oil prices, particularly since August 1999, could have serious adverse implications on the world economy, particularly on oil-importing countries.

The world economy is estimated to have grown by 3.3 per cent in 1999, up from the slow growth of 2.5 per cent in the previous year under very adverse and volatile market conditions. Output in industrial countries rose by 3.1 per cent in 1999 owing largely to robust growth in the United States and Canada and a mild recovery in Japan. Flexible markets, prudent fiscal and monetary policies and a remarkable growth in high technology industries helped the United States to withstand the global financial turbulence and sustain an impressive growth of 4.2 per cent in 1999, while the positive spillover effects have resulted in a growth of the same magnitude in Canada.

The Japanese economy indicated signs of a turn around from the recession and is estimated to have grown by 0.3 per cent in 1999 due to a rebound in private demand as well as increased public investment under the fiscal stimulus package put in place in 1998. Newly Industrialised Asian economies grew by 7.7 per cent in 1999 against a contraction in output by 2.3 per cent in the previous year, due to faster recovery in Korea and Singapore supported, inter alia, by mildly expansionary fiscal policies. The emerging economies of Asia registered a growth of 6.0 per cent in 1999 against 3.8 per cent in the previous year. The ASEAN-4, (Indonesia, Malaysia, Philippines and Thailand), which suffered the brunt of the currency turmoil with a contraction of 9.5 per cent in output in 1998, recovered with an estimated growth of 2.5 per cent. Continued high growth in China (7.1 per cent) and India (6.8 per cent) also contributed to the recovery in Asia. While fiscal and monetary stimuli played an important role in the economic

recovery of Malaysia and Thailand, the revival in economies in Indonesia, India and the Philippines was driven mainly by a turnaround in agriculture. Meanwhile, China, aided by the fiscal stimulus introduced in mid 1998, was able to weather the effects of the Asian crisis relatively well. As a result, the growth in developing countries improved from 3.2 per cent in 1998 to 3.8 per cent in 1999.

However, economic growth in the Euro area reflected a slow down from 2.8 per cent in 1998 to 2.3 per cent in 1999 as a result of tight macro economic policies introduced to stem signs of overheating. Growth in the Western Hemisphere declined to 0.1 per cent owing largely to economic slowdown in Argentina, Chile, Colombia, Ecuador and Venezuela as a result of political uncertainties and fragile market conditions. The slow down in Southern America was partially off-set by improved performance by Brazil and a relatively strong growth in Mexico under the impact of stabilisation policies and positive spillover effects of robust North American economies.

After an improvement in growth in 1998, economic growth in the African region declined marginally to 2.3 per cent owing to a host of factors such as drought, weak market confidence and slippages in fiscal and monetary policies. Meanwhile, the continued economic and political uncertainties prevailing in Russia, which resulted in capital flight and a sharp decline in foreign direct investment, resulted in a further contraction in economic activity, with negative effects on neighbouring economies.

Inflation in many regions reflected a convergence to lower levels. Evidently, strengthened global consensus on the merits of low inflation and the positive effects of low and stable prices on growth has induced self discipline in fiscal and monetary management. The deregulation of markets under open economic policies, the benefits of integration into economic blocs and improvements in information have also contributed to firming the commitment to achieve low inflation. Meanwhile, an increasing number of countries had either adopted or were in the process of adopting, inflation targeting in their monetary policy framework in an effort to achieve low and stable inflation. These efforts were also supported by declining commodity prices during most of the year. In this backdrop, global inflation declined to its lowest level in four decades. Consumer price inflation in advanced economies declined from 1.5 per cent to 1.4 per cent in 1999, while in developing countries it moderated from 10.1 per cent to 6.5 per cent. However, inflation in countries in transition increased sharply from 21.8 per cent in 1998 to 43.7 per cent in 1999 due to supply constraints and deteriorating fiscal positions.

International trade is estimated to have accelerated from 4.2 per cent in 1998 to 4.6 per cent in 1999, owing to a partial recovery in imports and exports in advanced

economies, with the volume of imports increasing from 5.5 per cent to 7.4 per cent and the volume of exports growing from 3.7 per cent to 4.4 per cent. The major impetus for the growth in imports came from Japan with a growth of 5.2 per cent against a drop of 7.6 per cent in the previous year, Canada with an improvement to 9.7 per cent and the newly industrialised Asian economies with an improvement of 7.3 per cent. Imports by developing and transition economies, however, are estimated to have declined by 0.3 per cent and 5.4 per cent, respectively in 1999. In contrast, growth in exports registered a further slowdown in 1999 with a notable strain on exports by developing countries and countries in transition, which grew by only 1.7 per cent and 3.9 per cent, respectively. Exports by advanced economies increased by 4.4 per cent, marginally higher than the 3.7 per cent registered in 1998. Notable improvements in exports were registered by the United States and the emerging Asian economies with growth rates of 3.8 per cent and 7.5 per cent, respectively. Terms of trade moved mainly in favour of developing countries with an improvement of 3.6 per cent in 1999 against a deterioration by 6.2 per cent in the previous year. However, gains in terms of trade by developing countries as a whole contained a further deterioration in terms of trade for Asia and countries in transition. As a result of these changes in international trade, current accounts of the balance of payments in advanced countries deteriorated from a surplus to a deficit in 1999, while those in developing and transition economies improved somewhat owing to better performance in the export sectors.

Meanwhile, the decline in non-fuel commodity prices seen in 1998 continued with an overall drop of 7 per cent in 1999. Sugar prices declined by 27 per cent owing to excess supply and a slowdown in demand, while wheat prices dropped by 10 per cent as a result of increased production in the US and the EU, two major producers of wheat. Increased rice production reduced international prices of rice by 8 per cent, while fertiliser prices declined by 3 per cent in 1999. Meanwhile, despite a drop in production as a result of weather related setbacks to production in Kenya, India, Bangladesh and Indonesia, tea prices declined by about 4 per cent in 1999 due to surpluses carried over from the previous year and a fall in demand from Russia, due both to falling real income levels and foreign exchange payment restrictions. International prices of tea indicated some improvement after July, but remained lower than in the previous year. The declining trend in rubber prices continued with a decline of about 8 per cent in 1999. Rubber prices reflected some improvement towards the end of the year due to improved demand and disruption to supply. Meanwhile, adverse weather affected coconut production in the two largest coconut exporting countries, the Philippines and Indonesia. As a result, coconut prices registered an improvement of 12 per cent in 1999. In

contrast to many non-fuel commodity prices, crude oil prices, which remained relatively low until July, registered an increase of 39 per cent during 1999 in response to a production cut-back by the OPEC countries and the non-OPEC countries such as Mexico, Norway and Russia, and an improved demand by the east Asian economies.

The major developments in international exchange markets during the year were the launch of a single currency, the euro, in eleven European Union member countries on 1 January 1999, return of market stability to most East Asian economies after high volatility observed since the eruption of the currency turbulence in 1997 and noticeable variation among the three major currencies. Robust economic conditions in the United States in an uncertain global economic environment and increased acceptance as a store of value strengthened the dollar against all major currencies except the yen during the year. After a successful launch, the euro could not maintain its initial rate of 1.17 per US dollar and depreciated by 14 per cent against the background of a weakening economy in the euro area. Meanwhile, the Japanese yen, which depreciated by 5 per cent until early July, began to appreciate thereafter as a response to signs of economic recovery. The yen appreciated by 8.8 per cent against the US dollar during the year as a whole. Meanwhile, the exchange markets in the East Asian countries exhibited relative stability during the year. The Indonesian rupiah reflected a correction and appreciated by 12 per cent against the dollar in comparison to a depreciation of 31 per cent in the previous year, while the Korean won and the Singapore dollar appreciated marginally by 2 and 1 per cent, respectively. The Philippine peso and the Thai baht depreciated by 5 per cent and 3 per cent, respectively. Meanwhile, Malaysia continued with its fixed exchange rate policy with capital controls throughout the year. Worsening financial sector conditions and exchange restrictions resulted in a further depreciation of the Russian rouble by 24 per cent in 1999. The Brazilian real depreciated by 32 per cent, while the Mexican peso appreciated by 4 per cent against the dollar during 1999.

Short-term interest rates reflected an upward movement during the year due to tight monetary policies adopted by industrial economies in an attempt to addressing overheating economic conditions. The six month LIBOR increased from 5.06 per cent at the end of 1998 to 6.05 per cent at the end of 1999. In response to movements in short-term interest rates, long-term interest rates increased by about 0.9 percentage points during the year. For example, the 30 year US Treasury bond rate increased from 5.59 per cent in 1998 to 6.47 per cent in 1999.

With the restoration of stability in many emerging market economies in response to corrective policies, investor confidence improved substantially during the year with significant reductions in risk perceptions regarding

their bond issues. This was a welcome development, given the prohibitively high risk premiums factored into emerging market bond issues during the past two years. For example, interest spreads declined by over 575 basis points (bps) for international bond issues by Malaysia, by 325 bps for issues by Korea and 225 bps for issues by India and Thailand. The spreads narrowed by 175 bps for bond issues by the Philippines while those for China and Hong Kong declined by about 160 bps and 65 bps, respectively. On average, interest spreads for bond issues by these countries fell from a range of 180 – 2,150 bps at the end of 1998 to a range of 85 – 600 bps at the end of 1999. In response to these developments, Hong Kong, Malaysia and Thailand re-entered to tap international capital markets in a big way after a lapse of more than a year. On the whole, the year witnessed a marginal improvement in net private capital flows to emerging market economies from US dollars 75 billion in 1998 to US dollars 81 billion in 1999. However, Asia continued to suffer from a net outflow of private capital, albeit on a smaller scale than in the previous year, reflecting the still high risk perception in the region and the interest rate hikes in the United States and Europe.

The need for a new international financial architecture capable of addressing emerging issues and the problems faced by developing countries in the face of their economic and financial needs received renewed global emphasis. While there was a virtual consensus on the need for reform of the international financial system, how to accomplish this continued to be a much debated issue. Several noteworthy developments aimed at strengthening the international financial system were seen during the year.

While the International Monetary Fund (IMF) continued its efforts to increase the transparency in the conduct of policies by member countries by declaring a code of good practices on transparency in monetary and financial policies, increased emphasis was placed on strengthening the Special Data Dissemination Standards (SDDS) by including more comprehensive information on external debt and investment and also by encouraging member states to join, by providing technical assistance. In April, the IMF introduced a Contingency Credit Line (CCL) as a precautionary line of defence for member countries that are implementing sound economic policies but would be vulnerable to the contagion effects of financial crises elsewhere. The CCL was intended to serve as an instrument of crisis prevention. Meanwhile, the Group of Seven (G-7) nations created the Financial Stability Forum (FSF) in September 1999 with a view to establishing more formal co-ordination among the lending economies to promote more orderly conditions and reduce systemic risks.

A notable development witnessed during the year was the increased focus on poverty reduction. The World Bank

and the IMF proposed the adoption of an enhanced framework for poverty alleviation, especially among the poorest countries. The World Bank introduced a Comprehensive Development Framework (CDF) which calls for a long-term development vision which incorporates improvements in the economic and social sectors. Meanwhile, the IMF transformed the Enhanced Structural Adjustment Facility (ESAF) into a Poverty Reduction and Growth Facility (PRGF) with a view to giving a greater prominence to poverty reduction efforts in structural reforms undertaken by countries. As these initiatives were linked to the write off of debts of the poorest countries, concerns have emerged on the possible neglect of countries which are not classified in the poorest category.

The IMF's Eleventh General Review of Quotas, which was completed in January 1998 took effect on 22 January 1999. This raised the total quotas (capital) of the Fund by 35 per cent to SDR 312 billion. Sri Lanka's quota would increase from SDR 304 million to SDR 414 million. Meanwhile, the International Development Association (IDA) successfully accomplished its twelfth replenishment during the year. This would enable IDA to enhance its soft lending for poverty reduction programmes in poor countries. The World Trade Organisation (WTO), which continued to emphasise improved market access and further reducing barriers to trade, received worldwide criticism for not being able to address the concerns of the developing countries adequately.

The international community, including the Group of 24 (G-24,) in which the chairmanship was held by Sri Lanka during 1999, emphasised the need for developing countries to become active partners in the next round of trade negotiations to make use of the international trading system effectively to promote growth and reduce poverty. The G-24 made a critical evaluation of the world economy following the unprecedented crisis in financial markets and called for, among other things, an international lender of last resort, more frequent use of SDRs to supplement international liquidity, a cautious approach to capital account liberalisation and a more co-ordinated approach by industrial countries in their macroeconomic management to reduce excessive volatility of exchange rates among key currencies. It stressed the need to keep developed country markets open for developing country exports. Developing countries also emphasised the need for an equitable burden sharing of costs adjustment and private sector involvement in forestalling and resolving financial crisis.

Despite the signs of a global economic recovery many challenges remain unresolved, which if not addressed efficiently, would be a threat to the sustainability of recovery. Uneven growth patterns in industrialised countries, international payments imbalances and large variation among major currencies pose serious challenges for

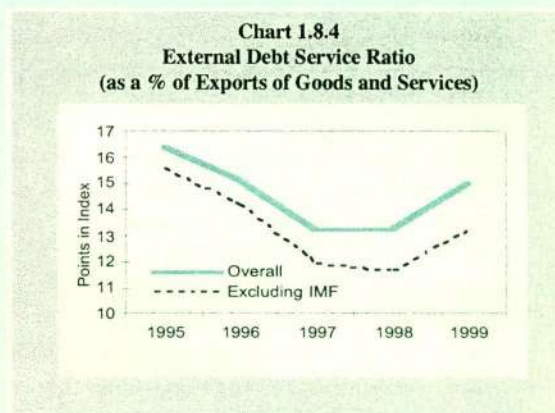
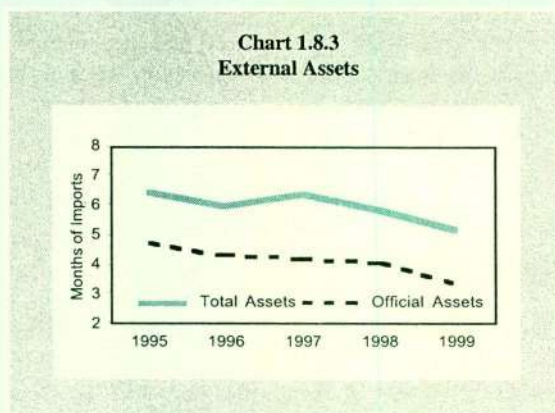
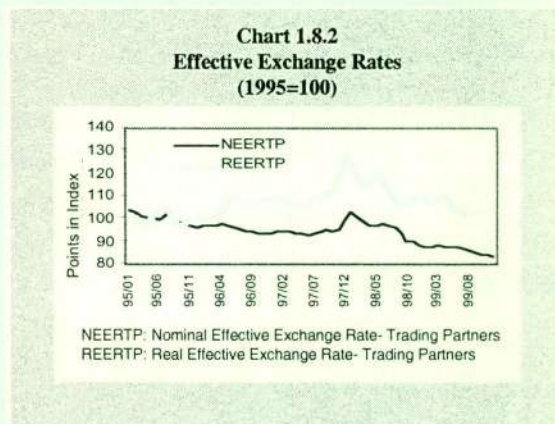
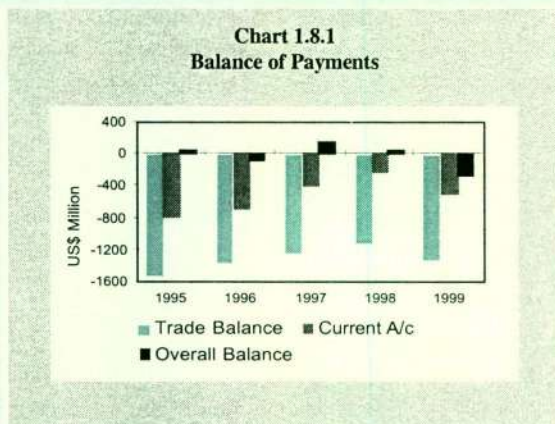
maintaining macroeconomic stability. As such, the world economic outlook for the next couple of years depends much on how, the industrialised countries, in particular, face the challenges arising from the global economic slowdown during the past two years and commitments by countries to structural reforms to foster stronger and more stable growth in the world economy. Policy strategies and growth performance in the United States, Japan and the euro area, the three key players in the global economy, would have significant influence on the direction of the global economy particularly at a time when the world economy is witnessing a slow turnaround after a depressed period of two years.

External Sector Developments

Sri Lanka’s external sector developments during 1999 were dominated by the lagged effects of depressed global demand and the resultant decline in commodity prices. The external trade and balance of payments weakened somewhat during

the year. The trade deficit widened owing largely to the import of three aircraft by SriLankan Airlines during the year. The services account indicated an improvement reflecting the rapid recovery in the tourism sector. Net current transfers registered a marginal increase of 1 per cent mainly due to the combined effect of an increase in net private transfers and a decline in net official transfers during 1999. Consequently, the deficit in the current account widened from US dollars 226 million in 1998 to US dollars 495 million in 1999. The current account deficit in the balance of payments as a ratio of GDP increased from 1.4 per cent in 1998 to 3.1 per cent in 1999. Gross private long-term capital inflows recovered significantly. However, there was a decline in long-term capital flows to the government. Total gross long-term capital inflows were much higher than in the previous year. Altogether, the overall balance of payments registered a deficit of US dollars 263 million in 1999.

**Chart 1.8
Selected External Sector Indicators**



The impact of declining global commodity prices on Sri Lanka's external trade as a result of depressed global demand during the first half of the year moderated towards the latter part of the year with improvements in both exports and imports. Exports which declined by as much as 11 per cent during the first eight months of 1999, registered a significant recovery thereafter to reduce the annual decline to 4 per cent. Export prices declined by 10 per cent while export volume increased by 6 per cent, mainly due to the resilience of the garments sector. Meanwhile, imports excluding aircraft declined by 5 per cent due both to lower international commodity prices and a decline in the volume of imports. Imports including aircraft increased by 0.2 per cent in 1999. Consequently, the trade deficit widened by 19 per cent to US dollars 1,299 million in 1999. The trade deficit as a percentage of GDP thus increased from 7 per cent in 1998 to 8.2 per cent in 1999.

Increased tourist receipts helped to generate a surplus of US dollars 147 million in the services account. Port related services, which contributed heavily to the services account in the past, remained somewhat stagnant owing largely to competition from neighbouring ports. The deficit in the income account widened from US dollars 180 million to US dollars 254 million due to lower income on investments and a 3 per cent increase in interest payments on foreign debt. Private transfer receipts increased by 6 per cent to US dollars 1,056 million, which included compensation payments amounting to US dollars 112 million received by over 50,000 Sri Lanka expatriates in Kuwait who were displaced during the Gulf war. Overall, the current account deficit increased from US dollars 226 million to US dollars 495 million during 1999.

The capital account showed higher gross inflows of US dollars 905 million in long-term capital compared with US dollars 845 million in 1999, reflecting mainly the financing of aircraft by SriLankan Airlines. There were net outflows of US dollars 13 million on account of portfolio investment. In addition, external liabilities of commercial banks declined by US dollars 120 million during the year. These short-term capital investments and higher debt repayments reduced the net capital inflows by US dollars 84 million.

The external debt stock of the country, the major portion of which consists of concessional loans, increased by 3 per cent in 1999, mainly reflecting the significant appreciation of the yen towards the latter part of the year. The debt/GDP ratio increased from 56 per cent to 57 per cent in 1999. The debt service ratio increased from 11 per cent in 1998 to 12.5 per cent in 1999.

Exchange markets remained stable during the year in contrast to the high volatility observed in the previous year. The declining trend in inflation eased the pressure on the exchange rate particularly towards the latter part of the year.

The Sri Lanka rupee depreciated by 6 per cent against the US dollar during 1999, a lower rate of depreciation than in the previous year. The real effective exchange rate of the Sri Lanka rupee against the 24 currency basket depreciated by 7 per cent in 1999, indicating a protection of the external competitiveness of the economy.

Gross external assets of the country, at US dollars 2,582 million at the end of 1999, were sufficient to finance 5.3 months of imports for 1999, while gross official reserves, at US dollars 1,640 million, were sufficient to finance 3.3 months of imports for 1999.

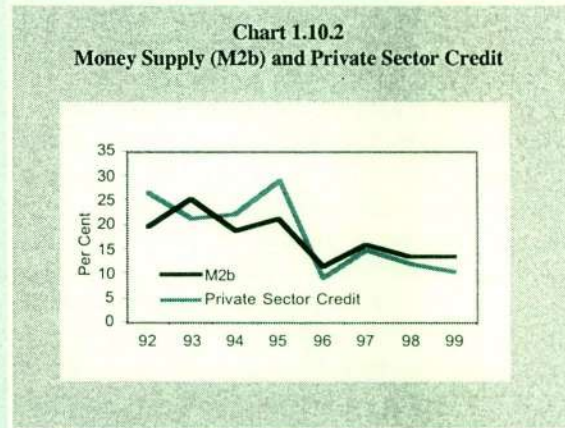
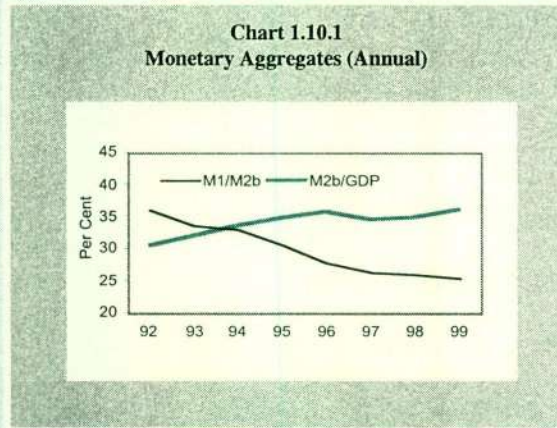
1.9 Financial Sector

Monetary Policy

Monetary policy was essentially directed at maintaining financial stability by containing monetary expansion to moderate inflation. A decline in net foreign assets due to weakening of the balance of payments had a contractionary impact on money supply, while liquidity had to be provided to meet the Y2K related additional demand for liquidity. Also, the domestic financing needs of the government increased significantly during the year. Further efforts were made to improve the market orientation of monetary policy management.

The instability displayed in financial markets since late 1997 continued into the first half of 1998, as a consequence of the uncertainties generated by the global financial crisis. However, a significant degree of stability was achieved by the second half of 1998, and this stability was maintained into 1999. With the exception of a short period in April, when market uncertainty increased and interest rates fluctuated considerably as a result of elections and labour unrest, both the call market and the exchange market exhibited considerable stability because of better co-ordination between interest rate and exchange rate policies. Even in December, when general elections and the Year 2000 uncertainties created the potential for market instability, the markets remained relatively stable. This stability and the continuous decline in inflation enabled the Central Bank to relax its monetary stance continuously in the second half of the year, when the statutory reserve requirement (SRR) was reduced by 1 percentage point, from 12 to 11 per cent, in August. The Bank Rate was also reduced, by one percentage point, to 16 per cent. The additional liquidity the market received through the relaxation of the SRR served primarily to offset the drain of liquidity caused by the outflow in the balance of payments and any excess liquidity was mopped up through open market operations. This helped to avert a re-emergence of inflationary pressure or instability in the foreign exchange market. Open market operations continued to be the major tool for implementing monetary policy and the

Chart 1.9
Money and Credit



repurchase (reverse repo) rate were the primary means of conveying signals to the market.

The continuation of the decline in inflation and the stability in the exchange market enabled the Bank to effect a 200 basis point reduction in the repo rate in 1999. The repo rate was reduced from 11.25 per cent at end 1998, to 9.25 per cent at end 1999 in several steps. As a result, some downward movement was seen in most market interest rates.

The reduction of the SRR was also a step toward enhancing market orientation of monetary policy. It also helped to reduce the effective cost of funds of commercial banks and enabled them to reduce their lending rates. This measure resulted in a release of around Rs.2,000-2,500 million of funds sterilised by the Central Bank, to the market. The expansionary impact of this release was offset by the contractionary effect of the deficit in the balance of payments. It had the added advantage of mitigating any crowding out that would result from the increased credit obtained by the government from the banking sector.

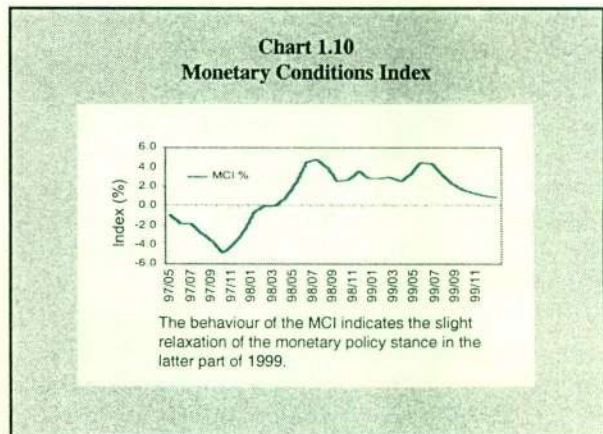
In November and December 1999, the Central Bank used its operations in the primary and secondary markets for Treasury bills particularly to provide additional liquidity needed to meet high seasonal credit demands and liquidity needs of the Y2K transition. In order to avoid any excessive increase in interest rates due to market aberrations, the interest rate applicable to the Bank's reverse repurchase facility was maintained at a fixed level throughout the second half of December. In addition, the tenor of reverse repurchase transactions, which is usually restricted to one day, was temporarily extended upto 30 days. These measures achieved their objectives by providing confidence to the market and prevented any undue pressure on interest

rates or excessive volatility in liquidity. Despite expectations in some sectors of the market for higher interest rates in December, the interest rates remained relatively stable without addition of too much liquidity.

The policy of not granting refinance under the Medium and Long-Term Credit Fund or any other short-term facility was continued to prevent market distortions.

Money Supply

The growth in money supply was relatively stable and monetary aggregates moved within a comparatively narrow range of 13-15 per cent as programmed at the beginning of the year. A faster growth in domestic assets was partly offset by a decline in net foreign assets. The growth of consolidated broad money (M_{2b}), which includes the operations of foreign currency banking units (FCBUs), was 13.4 per cent in 1999. Narrow money (M_1) moved in a slightly wider range of 8-14 per cent.



BOX 1

Financial Survey

The coverage of monetary statistics was improved recently by introducing a consolidated monetary survey incorporating the accounts of foreign currency banking units into monetary aggregates. Accordingly, a broad money supply called M_2 was presented. As a further step forward, a financial survey has now been produced to incorporate accounts of the non-commercial bank financial institutions in the monetary aggregates.

In the generally accepted framework for classifying financial statistics, monetary and financial data are presented on three levels. The first level contains a consolidation of financial data into three functional groups with the preparation of separate balance sheets for monetary authorities (MAs), deposit money banks or licensed commercial banks (LCBs) and other financial institutions (OFIs). The second level consolidates the data for monetary authorities and the commercial banks into the monetary survey which provides a measure of the volume of liquidity and covers the accounts of the banking sector whose activities are of the greatest importance in finance and in liquidity creation. Finally, the third level and most consolidated level combines the monetary survey and the balance sheets of OFIs into a 'financial survey' by which one expects to capture the dynamic interlinks between the banking system and the rest of the organised financial sector. It measures overall private sector liquidity and provides an explanation of the origin of liquidity, assisting analysts and policy makers to make more focussed decisions.

The need for the compilation of a comprehensive financial sector survey encompassing not only the monetary authorities and LCBs, but also OFIs, arises because in a deregulated environment, with the rapid growth of the financial sector and financial innovations, the distinction between LCBs and OFIs becomes blurred, making it important to widen the institutional categories which could be the focus of policy. This development is clearly seen in Sri Lanka in recent years. In the Sri Lankan context, the financial system consists of the banking system, OFIs and the unorganised financial sector. The banking system, which consists of the monetary authorities and commercial banks, is the core of the financial system. Information from these institutions is used to compute narrow money (M_1) and broad money (M_2), which

have hitherto been the main variables considered in determining monetary policy. The changing conditions in Sri Lanka are reflected when one considers the treatment of the foreign currency banking units (FCBUs) of commercial banks. Initially, these were excluded from the computation of broad money aggregates, as their interaction with the domestic economy was limited. However, over time, the impact of their operations on the domestic economy increased, and the concept of consolidated broad money (M_2), which includes FCBU transactions, was introduced in the second half of the 1990s.

Apart from monetary authorities and the commercial banks, the most important segments in the financial sector in Sri Lanka are Licensed Specialised Banks (LSBs) and finance companies, whose liabilities include a considerable amount of deposits. The LSBs comprise 6 Regional Development Banks, the National Savings Bank, National Development Bank, DFCC Bank, the State Mortgage and Investment Bank and two private savings and development banks. There are 25 finance companies registered with the Central Bank and authorised to accept deposits from the public. The importance of LSBs and finance companies in the domestic economy has grown substantially over the years. For example, total assets of OFIs increased by more than threefold from 1990 to 1998, with their total assets amounting to Rs 223 billion at end 1998. They provide a variety of services similar to those of commercial banks although they do not provide chequing facilities to their customers. Another important feature of LSBs is that most of their liabilities are medium-term to long-term in nature.

In view of these developments in the financial sector, a preliminary financial survey has been compiled, which consolidates the operations of the monetary authorities, licensed commercial banks, licensed specialised banks, and the 25 finance companies. This is designed to provide a more comprehensive understanding of the operations of the financial sector in formulating policies.

The new monetary aggregate that is generated in this exercise has been named M_3 rather than M_2 . Although the definition of M_3 varies from country to country, it generally includes broad money (M_2), plus a wider range of instruments and issuing institutions, e.g., travellers' cheques and commercial paper. M_3 , however, is generally defined to include the liabilities of other financial intermediaries as well. Hence, the

BOX 1 (Contd.)

new monetary aggregate has tentatively been named M_3 . Computation of M_3 is to be developed.

Some of the highlights of the financial survey and differences from the consolidated monetary survey as currently computed are

1. An increase in money supply - The significant amount of public deposits placed with the NSB and finance companies leads to an increase in the monetary aggregates. However, the growth in this more comprehensive measure of money (M_3) in 1998 and 1999 is very close to the growth in the currently computed consolidated broad money (M_2) (M_3 - 13.5 per cent and 13.0 per cent; M_2 - 13.6 per cent and 13.4 per cent).
2. A decrease in net foreign assets (NFA) - The two development financial institutions (NDB and DFCC Bank) have obtained funds from foreign sources for their domestic long-term lending activities. This liability results in NFA in the financial survey being less than NFA in the consolidated monetary survey and provides a more accurate assessment of the foreign exposure of the country.
3. An increase in net credit to the government (NCG) - The LSBs, in particular the NSB, and to a lesser extent the finance companies, hold significant amounts of government paper, which is reflected in this increase. This measure provides a better assessment of the amount of resources absorbed by the government from the financial sector, and the growth in such absorption, than the current measure contained in the consolidated monetary survey.
4. An increase in claims on the private sector - A substantial increase is seen in the amount of funds provided to the private sector, indicating that the financial resources available to the private sector are significantly higher rather than the values reflected in the consolidated monetary survey. Economic activity is financed by not only by credit from commercial banks, but also from LSBs and finance companies.

TABLE 1
Financial Survey

	Rs. Mn.		
	1997 Dec (a)	1998 Dec (a)	1999 Dec (a)
Broad money (M4)	426,617	486,313	549,520
Narrow money (M1)	85,027	95,979	106,896
Currency	44,853	51,407	56,623
Demand Deposits	40,173	44,572	50,273
Quasi-money (Total)	343,590	390,334	442,824
Quasi-money (DBU)	227,963	257,995	298,158
Quasi-money (FCBU)	19,853	23,478	21,607
Quasi-money (LSB)	81,769	92,799	103,968
Quasi-money (Finco)	14,006	16,061	19,091
Net foreign assets	81,106	96,827	93,748
Monetary authorities	89,930	101,744	89,287
Commercial banks (DBU and FCBU)	565	3,904	12,805
LSB and Finco	-9,389	-8,821	-8,344
Net domestic assets	347,510	389,484	455,773
Domestic credit	445,888	513,812	598,770
Public sector	113,364	131,030	170,608
Claims on government (net)	98,705	120,190	154,792
Monetary authorities	20,300	25,909	46,716
Commercial banks (DBU)	26,065	32,682	39,166
Commercial banks (FCBU)	-1,115	6,027	8,033
LSB	51,867	53,562	58,579
Finco	1,587	2,011	2,298
Claims on public corporations	14,659	10,839	15,816
Commercial banks (DBU and FCBU)	14,658	10,835	15,816
LSB and Finco	1	4	0
Claims on private sector	332,524	382,782	428,162
DBU	216,030	243,549	272,885
FCBU	47,108	50,515	50,272
LSB	54,396	70,800	84,101
Finco	14,990	17,913	20,904
Other items (net)	-96,378	-124,329	-142,997
Memorandum Items:			
Consolidated broad money (M_2)	333,668	377,741	428,319
Broad money MA and DBU only (M_1)	288,258	316,174	358,076
Reserve Money	83,736	92,866	100,444
Money Multiplier (M_2)	5.12	5.24	5.47
Percentage change (Dec. to Dec.)			
Broad money (M4)		13.5	13.0
Narrow money (M1)		12.9	11.2
Net foreign assets		19.4	-3.2
Net domestic assets		12.1	17.0
Domestic credit		15.2	16.5
Claims on Government (net)		21.8	28.8
Claims on public corporations		-26.1	45.9
Claims on private sector		15.1	11.9
Consolidated broad money (M_2)		13.2	13.4
Broad money MA and DBU only (M_1)		9.7	13.3

Source: Central Bank of Sri Lanka

- (a) All values are highly provisional
 (b) DBU - Domestic banking units
 FCBU - Foreign currency banking units
 LSB - Licensed specialised banks
 Finco - Finance companies
 MA - Monetary Authorities

Monetary expansion was held down by the decline in net foreign assets of the banking system. The deficit in the balance of payments was reflected in a reduction in the net foreign assets of the monetary authorities by approximately Rs.12.5 billion. In contrast, the commercial banks built up their foreign asset positions.

A sharp growth in net credit to the government (NCG) and credit to government corporations, together with continued credit expansion to the private sector, led to a considerable increase in net domestic assets. Lower than expected budgeted revenues, a shortfall in privatisation proceeds and reduced foreign borrowings caused the government to borrow more from the domestic banking system. Credit to government corporations increased sharply in 1999, in contrast to the decline in 1998. This increase was due mainly to increased international oil prices, a growth in the use of domestic funds for investment and expanded retail activity by some key state corporations. Credit to the private sector increased by 10-12 per cent during the year. The contraction in imports and exports and the slower overall growth in the economy tended to exert a dampening effect on the demand for credit. The two long-term lending institutions (i.e., NDB and DFCC Bank) also provided approximately Rs.6,400 million of credit to this sector. Foreign currency borrowing was less attractive to domestic borrowers and credit to the domestic sector from FCBUs declined in dollar terms. This was due to a decline in interest rate on rupee credits and a slowing down of exports.

While being concerned about additional credit needs and the need to contain excessive monetary expansion, the Bank provided sufficient amount of reserve money to ensure the smooth functioning of economic activity. Total reserve money increased by Rs.7,578 million in 1999, in comparison to Rs.9,130 million in 1998. The reduction of the SRR also helped to provide additional liquidity to the market.

Interest Rates

The Central Bank's overnight repo rate and reverse repo rate served as the primary signalling mechanisms for the expected direction of market interest rates and were also instrumental in restraining volatility in the call money market. The steady decline in inflation enabled the Central Bank to reduce its overnight repo rate, which serves as a leading indicator in determining other interest rates in the market, in several steps in 1999. Interest rates were broadly stable in 1999 with some downward movement. The reduction in interest rates was, however, much less than the fall in inflation, resulting in an increase in real interest rates. The reduction in the SRR in August 1999 also contributed to the stability of the interest rates. The regular

Chart 1.11
Interest Rates

Chart 1.11.1
Short-Term Interest Rates

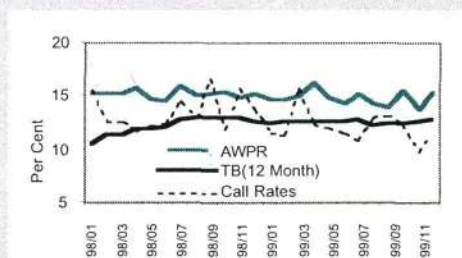


Chart 1.11.2
Real Interest Rates
(Based on Point to Point Inflation)

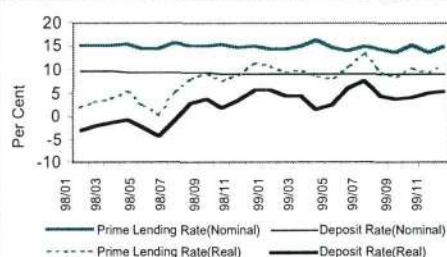
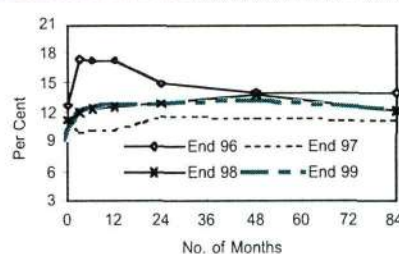


Chart 1.11.3
Yield Curve for Government Securities



over-subscriptions at Treasury bill and Treasury bond auctions reflected the improved liquidity conditions in the market throughout the year. This availability of liquidity, partly caused by slower growth in private sector credit and declining inflation, helped to keep yields on government paper stable, despite increased borrowing by the government.

1.10 Policies and Issues

The medium-term economic policy objective of the government as consistently stated in several policy documents is to promote sustainable non-inflationary economic growth in a market friendly framework, while ensuring balance of payments viability and protection for vulnerable groups. As elaborated by the President in her Vision 21 policy statement as well as in the presentation of the Budget 2000, the growth rate of the economy is to be accelerated to 7-8 per cent during the first decade of this new millenium by creating an environment for accelerated domestic investment and higher domestic savings. While statistical estimates are already available to show that higher investment, a lower fiscal deficit, a flexibly managed exchange rate, proper co-ordination of macroeconomic policies and productivity improvements could generate the desirable outcome in terms of higher per capita income, lower unemployment, lower inflation, declining poverty levels and stronger balance of payments, there are serious challenges that have to be overcome to make the process practicably feasible.

The greatest challenge to the above outcome is the ongoing armed conflict in the North and the East. While some estimates can be made of the direct and as well as some of the indirect costs of the armed conflict, it is not easy to quantify other costs such as the loss of human life, dislocation of families and the general disruption of the social fabric. In the absence of the conflict, Sri Lanka's annual investment would have been about 2 to 3 percentage points higher due to higher private investment, supported by accelerated foreign direct investment and higher public investment. All sectors in the economy would have grown faster to generate an economic growth about 2 to 3 percentage points higher. Such higher growth during the last 16 years of conflict would have elevated Sri Lanka from a low income country status to a low middle income country status in 1994 with a per capita annual income of about US dollars 800 in that year. The country's per capita income would have reached approximately US dollars 1,200 in 1999 instead of US dollars 829. This means that the monthly income of an average Sri Lankan would have been Rs. 7,040 in 1999 instead of Rs. 4,875. These approximate figures underscore the paramount need to take all steps to end the senseless conflict. If allowed to continue, the

conflict could seriously drain the resources and energies of the people and marginalise the country in the international community.

The government's economic policies during the past few years have played more than a damage minimising role, in this context, to generate an annual economic growth rate of around 5 per cent of GDP. The policies implemented have been successful in maintaining a considerable degree of monetary and financial market stability and addressing some of the major structural weaknesses in the economy. These policies included the privatisation of gas, plantations, telecommunications, the national airlines, simplification of the tariff and tax structure including the introduction of a goods and services tax, reduction of the tax rates, financial sector reforms to improve efficiency and the soundness of the system, provision of greater operational autonomy for the state owned banks, flexible management of the exchange rate, making the government debt management more market oriented, rationalisation of the welfare programmes and many more reforms. These policies not only helped to promote market oriented economic growth under very difficult conditions, but also helped to protect the economy to a large extent against the adverse spillover effects of the recent global economic recession.

Despite these positive developments on the economic policy front, Sri Lanka has been lagging behind many other fast growing developing countries, although she has performed relatively better than developing countries as a whole. For example, during 1982-91, the developing economies in Asia grew by 6.9 per cent, while Sri Lanka's average growth during that period was only 4.2 per cent. During 1992-96, Sri Lanka's annual economic growth rate of 5.2 per cent was 4 percentage points lower than the 9.1 per cent growth achieved by the developing countries in Asia. In 1999, the Asian countries grew by 6 per cent, particularly reflecting higher growth in India and China, while Sri Lanka registered a growth rate of 4.3 per cent. Growth promoting economic policies alone cannot narrow this growing gap without effectively seeking a solution to the conflict.

Despite the recent favourable trends in inflation, fiscal and other economic indicators, the continuing conflict has made these achievements less appealing to most of the rest of the world, although the achievements are commendable, given the difficult environment in which the government has to conduct its economic policies. The overall fiscal deficit in Sri Lanka has been considerably higher than the average in the rest of the world. During 1992-96, the average fiscal deficit of developing countries was 2.8 per cent of GDP, while Sri Lanka had a fiscal deficit of 10.1 per cent of GDP. Although the average fiscal deficit in developing countries in general has increased somewhat recently, Sri

Lanka's fiscal deficit continued to be much higher than the developing country average. The developing country average fiscal deficit has been estimated at 4.4 per cent of GDP in 1999, while Sri Lanka had a fiscal deficit of 7.5 per cent of GDP. Although the high deficits in Sri Lanka are dictated by the cost of the conflict, it is the potential costs and uncertainties associated with high fiscal deficits that discourage investment. High fiscal deficits make the investment climate uncertain due to their adverse effects on inflation, interest rates and exchange rates. It is due to these concerns and in order to release more resources to the private sector that recent policy statements of the government, including the medium-term fiscal framework presented with the budget expect to contain the overall fiscal deficit significantly in the medium-term. Early peace settlement to the on going conflict is essential if these medium-term fiscal and other macro-economic targets are to be realised. In this context, the current attempts to find a solution to the conflict through a process of national consensus building as well as outside facilitation should be welcomed.

The Government of Sri Lanka has proven its commitment to implement some of the essential economic policy reforms effectively. However, there are major reforms that need to be undertaken to accelerate the economic growth process to ensure that Sri Lanka will not lag behind in the process of increasing globalisation of product and factor markets. It needs to be mentioned that it is only through improved national productivity that a country can remain competitive in the global market. Investment in economic and social infrastructure becomes crucial in this context. Unfortunately, the resources available for investment in infrastructure is constrained by the larger need of resources for national security. In this connection, the government has commendably sought private sector partnership in infrastructure investment in the fields of energy and communications.

Although the global economic conditions have improved, uncertainties still remain about their sustainability. Despite the high growth in the United States and signs of recovery in Japan, these two large countries appear vulnerable. The unbalanced growth among major industrial countries and lack of progress in policy co-ordination among them to reduce their impact on world commodity and financial markets remained a major concern for developing countries including Sri Lanka. There is already a spate of macro economic policy adjustments taking place, which have reflected in increases in interest rates in the United States and some of the major industrial countries and pressures for fiscal stimulus in Japan. In this context, the future direction of international interest rates, exchange rates and capital flows to

developing countries are highly uncertain. The implications of possible adverse external shocks arising from such uncertainties can be minimised only through sound management of the economy while strengthening the market friendly economic policy regime.

A recent phenomenon in the world has been the renewed move towards formation of trading blocs with exclusive benefits to their members. Despite claims to the contrary, these trade blocks could result in considerable trade creation. In such an environment, Sri Lanka also has moved a step forward in this direction. The recent Free Trade Agreement with India provides enormous potential for access to a large market which can facilitate higher economic growth not only through greater trade, but also through investment and tourism.

As indicated in the 'Sri Lanka Economy in 1999 and the Medium-term Prospects' published by the Central Bank in February 2000, the economic reform agenda in the next few years needs to include the following:

- Improving the efficiency of the public sector through the introduction of productivity based incentive schemes; training and re-training of workers as well as managers; reducing the size of the public sector; elimination of bureaucratic delays and controls and disengaging the public sector from activities which could be more efficiently be provided by the private sector.
- Pension reforms to protect the retirement benefits of people, which tend to be eroded by inflation, and to make the system financially viable in the future.
- Education reforms, as currently planned, for the system to be able to produce an easily trainable and productive labour force to meet the demands of a growing economy.
- Health reforms to improve the efficiency and financial viability of the sector and provide adequate health services in rural, estate and urban areas.
- Further encouragement of private sector participation in commercial activities currently undertaken by the government.
- Development of infrastructure through private sector participation.
- Improvement of the operational efficiency of the state banks.
- Further development of the domestic debt and capital market by permitting foreign investors to

invest in listed debt instruments and further improving the market orientation of medium and long-term government debt.

- Gradual relaxation of exchange controls on capital payments, with adequate safeguards.
- Making further progress towards equalisation of the incentive structure between BOI and non-BOI sectors.
- Reforming the controls of labour markets so as to promote private employment.
- Gradual move towards a complete free float of the exchange rate system.

The government's commitment to undertake these difficult reforms is commendable. One of the top priorities in the reform programme should be public sector reforms to improve the efficiency of public service. This could be combined with a reform of the pension system, a consolidation of the national contributory provident funds and liberalisation of the insurance sector.

While emphasising the importance of the above medium-term measures, there are several other short-term issues that need urgent attention. One of these relates to the transport sector which affects the lives of all people. There are long standing issues in this sector which arise from inadequacies in policy co-ordination among different modes of transport. Maintenance of roads and railway track needs urgent attention. With inadequate competition and inflexible fare structures, the road and rail passenger transportation suffers from inadequate investment and poor quality of service. As a result, people have to resort to expensive private means of transport, which inflict high congestion and environmental costs as well. It raises the costs of transportation and affects the competitiveness and regional dispersion of economic activities. Although the road passenger transportation sector has undergone several major changes in its organisational structure during the last two decades, the most appropriate formulation is yet to be achieved. The rail transport system incurs substantial losses and needs to be reformed to make it efficient and commercially viable. In this respect, improvement to the existing rail track, electrification and expansion of rolling stock, along with restructuring of the Railways as had been proposed earlier is critical for it to be able to provide a better service. It is highly irrational not to have increased the rail fares since 1996 despite significant increases in costs.

Another on going problem is the weakness in the electricity tariff structure where tariff adjustments have not been flexible relative to cost increases and one group of consumers is being subsidised at the expense of others. The cost of power generation has increased with increasing reliance on thermal power. The share of thermal power in total power generation increased to 33 per cent in 1999 from 6 per

cent in 1995. In 1999 alone, thermal power generation expanded by 16 per cent, while the cost increased by 39 per cent. By 2005, the share of thermal power is likely to be in the region of 60 per cent of the total and it has been projected that it further increase to 83 per cent by 2017. Despite the increased cost of power generation, the tariffs have not been revised since 1997. The existing tariff structure enabled the CEB only to generate a 4.9 per cent rate of return, which was below the financially viable rate of 8 per cent agreed with the lending institutions. The CEB was able to arrest a drastic deterioration in its financial position in 1999 due to the availability of internal funds and diesel at duty exempted prices. This rising cost of electricity generation is one of the major problems that need to be addressed early. The other problem is the imbalanced tariff structure where industrial and commercial enterprises are required to pay higher charges making it difficult for them to remain competitive in international markets. Therefore, the tariff policy has to be reviewed to establish a more reasonable and flexible tariff structure. There is also a need to explore cost minimising measures, as frequent sharp increases in tariff may not be possible. In this context, large scale power projects will have to be added to the national grid in accordance with a properly designed and executed generation plan. The coal power plant, which was scheduled to be commissioned in 2004, was postponed to 2006, while the Kukule Ganga project is expected to be commissioned only in 2004, after signing the loan agreement in 1995. An improvement in efficiency in the power sector, particularly through minimisation of losses in generation, transmission and distribution, which have reached 20 per cent, and a rational management of water supply should be given priority.

The recent increase in world petroleum prices has sharply raised the import bill and has generated a large financing gap in the Ceylon Petroleum Corporation. A part of the cost increase has been shifted to the consumers, who will eventually have to bear the burden. The adjustment has been inadequate considering the financing gap of around Rs. 8,000 million for this year. While a further adjustment of domestic prices cannot be avoided, it would be desirable to make the petroleum prices flexible, with more frequent changes in prices to reflect international petroleum price trends, adjusted for exchange rate variations.

While monetary, exchange rate and fiscal policies, i.e. the key macro economic policies, have a large role to play in creating a climate favourable for accelerated private investment to push the economy forward to be able to achieve a real income growth of 7-8 per cent in the present decade, each institution should have a clear vision and strategy to improve its performance, whether it be a public sector or a private sector entity. The strategy should include mechanisms to improve work ethics and performance, with appropriate performance evaluation systems, training and

retraining schemes, financial and other incentives based on performance, accountability and transparency of operations and other mechanisms to ensure adaptability to changing conditions including absorption of new techniques and technology. This will help to enhance productivity and external competitiveness, which is essential for achieving sustainable economic growth, raising living standards and eliminating poverty within this decade.

The financial services industry is increasingly becoming more dynamic and competitive. The Central Bank will continue to focus primarily on price stability while strengthening its financial sector regulatory, supervisory and monitoring functions to ensure domestic financial market stability. In this context, financial sector reforms will include an amendment to the Monetary Law Act to provide greater flexibility to conduct monetary policy.