1. ECONOMIC PERFORMANCE, OUTLOOK, ISSUES AND POLICIES

1.1 Overview

In the year 2000, the Sri Lanka economy expanded strongly, in continuation of the revival of economic activity that commenced in mid-1999, with a significant increase in employment and a moderation of inflation. However, there was a slow-down towards the end of the year, with the fiscal and the balance of payments deficits widening considerably, largely owing to the sharp escalation in world petroleum prices, a shortfall in government revenue and the sudden expansion in security expenditure. Further, unusually low rainfall in the catchment areas resulted in a shortfall in hydro power generation, thereby increasing dependence on costly thermal generation. These developments exerted pressure on foreign reserves, inducing a shift in the exchange rate policy towards greater flexibility. In this context, monetary policy had to be further tightened, with a view to maintaining stability in domestic prices and protecting external reserves. As a result, a rise in short-term interest rates became unavoidable. Thus, macroeconomic management became a vastly more challenging task in 2000.

The positive achievements in the year were the result of the country harnessing benefits from an improved world economic environment and the resilience which the economy has built up, following the economic reforms for over two decades. Yet evident, however, was a vulnerability to which small economies are exposed by external shocks, which underscored the need for adequate and timely responses, and perseverance with strong economic reforms and prudent economic management to build a more diversified and responsive economy.

Despite the political imperatives of the national elections until late 2000, the government took several corrective measures, although some of them may have been taken earlier with greater impact. They included measures to enhance government revenue, rationalise public expenditure, improve government cash management, corrective increases in administered prices, tightening of monetary policy and moving towards a more flexible exchange rate regime. Now that the electoral process has been concluded, an excellent opportunity has arisen to move ahead strongly on further economic reforms to achieve sustainable economic growth in the medium term. The progress, of course, would depend heavily on the restoration of peace. There is tremendous domestic and international goodwill to the country for its efforts at achieving peace

TABLE 1.1
Selected Macroeconomic Indicators

Item	1980-89 Avg.	1990-95 Avg.	1996	1997	1998	1999	2000(a)
GDP (real) growth rate	4.2	5.3	3.8	6.3	4.7	4.3	6.0
GDP deflator	11.8	11.4	12.1	8.6	8.4	4.4	6.7
GDP (nominal), per capita, rupees	9,608	27,102	41,940	47,988	54,220	58,077	64,855
GDP (nominal), per capita, US dollars	362	549	759	814	839	825	856
Unemployment rate , per cent	n.a.	14.0	11.3	10.5	9.2	8.9	7.7
Import coverage of foreign assets, months							
Gross foreign assets	n.a.	n.a.	6.0	6.4	5.9	5.2	3.5
Gross official reserves	1.8	3.8	4.3	4.2	4.0	3.3	1.7
	Per cent of GDP						
Gross domestic investment	26.2	24.4	24.2	24.4	25.1	27.3	28.0
Gross domestic savings	12.9	14.6	15.3	17.3	19.1	19.5	17.3
Foreign savings (b)	13.3	10.3	8.9	7.1	6.0	7.8	10.7
Balance of payments, current account	-8.1	-6.3	-4.9	-2.6	-1.4	-3.6	-6.4
Budget, current account	2.7	-1.8	-3.8	-2.2	-2.4	-1.0	-3.4
Budget, overall balance	-12.4	-9.9	-9.4	-7.9	-9.2	-7.5	-9.9
Money supply (M2b), per cent change (c)	n.a.	n.a.	11.3	15.6	13.2	13.4	12.9
Colombo Consumers' Price Index, per cent change	12.8	12.2	15.9	9.6	9.4	4.7	6.2
Exchange rate (Rs/US$), per cent change (d)	-9.1	-4.9	-4.7	-7.1	-9.6	-6.0	-9.9

(a) Provisional.
(b) Net imports of goods and non-factor services.
(c) Consolidated money supply, including FCBUs.
(d) Changes in end year exchange rate; negative sign indicates depreciation.

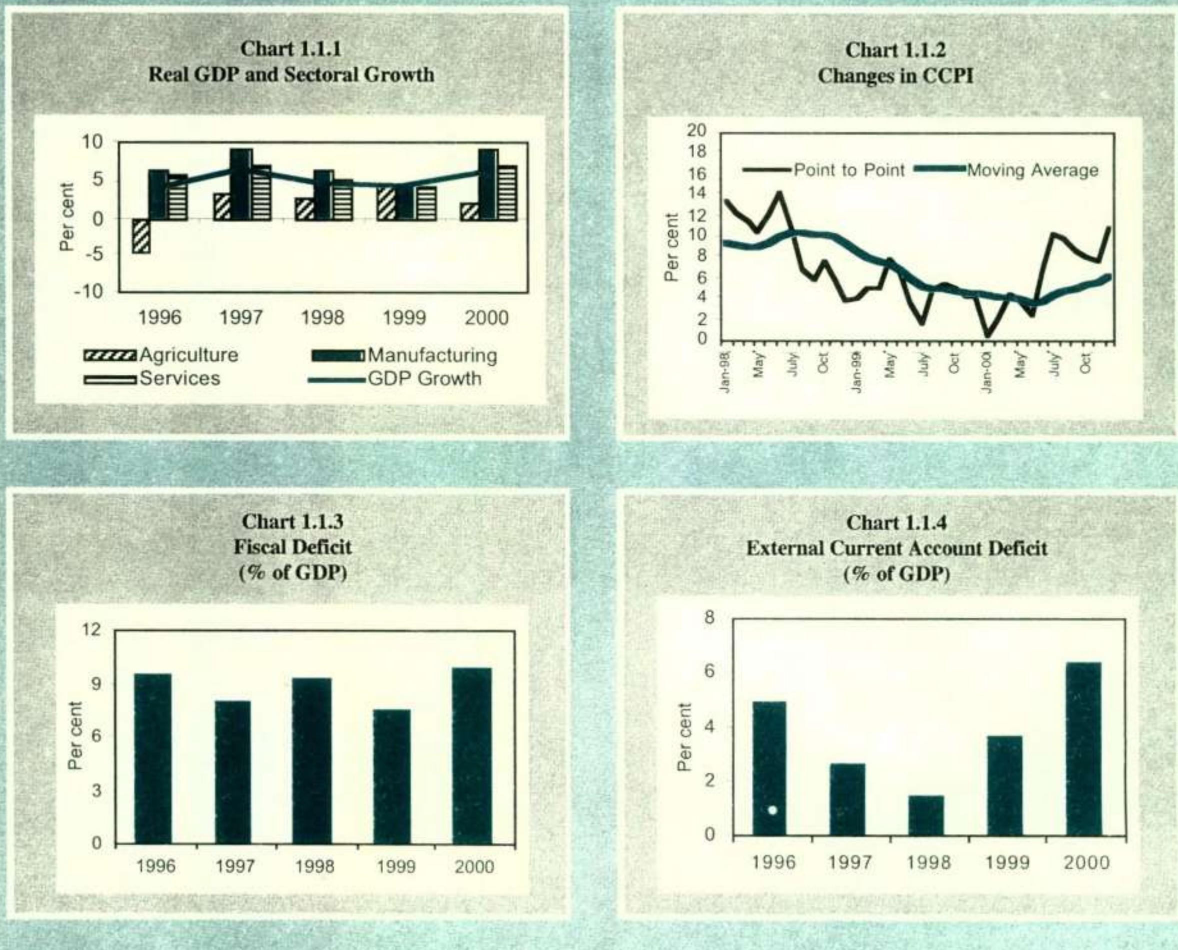
Source:- Central Bank of Sri Lanka

and undertaking reforms to promote a dynamic economy. How the country responds to this challenge will crucially determine the course of the economy in the new millennium.

World output expanded by 4.8 per cent in 2000 compared with 3.5 per cent in 1999. The rate of world trade expansion increased from 5.1 per cent in the previous year to 12.4 per cent in 2000. These developments created a favourable environment for countries which were increasingly integrating themselves into the global economy. Sri Lanka benefitted from the robust economic growth in USA, the continuation of growth momentum in the European Union (EU), the economic recovery in the Commonwealth of Independent States (CIS) and the improved import capacity in the Middle Eastern countries consequent on high oil prices. These favourable developments were instrumental in creating a strong demand for Sri Lanka's exports. Further, the strengthening of the currencies in most crisis affected East Asian countries helped to improve Sri Lanka's external competitiveness.

Inflation remained low during 2000 in many regions of the world, reflecting improved supply conditions and the continuation of tight monetary policies, particularly in industrial countries. Many countries attempted to contain inflation at low levels through improved fiscal and monetary management, while an increasing number of countries adopted inflation targeting within their policy framework. Oil prices increased sharply, while non-fuel commodity prices improved marginally, causing balance of payments difficulties in oil importing developing countries. Reflecting these international developments, Sri Lanka's external terms of trade weakened further by 6 per cent in 2000, the second

Chart 1.1
Macroeconomic Indicators



consecutive year of deterioration, preventing the country from realising the full benefits of increased international trade activities.

International financial markets remained relatively stable in 2000, though key currencies showed volatility, making macroeconomic management difficult for most countries, especially for small developing economies. Reflecting the continued buoyancy of the US economy, and differences in growth momentum among major industrial countries, the US dollar strengthened against all major currencies. Foreign exchange markets in the Asian region, except in a few crisis affected countries, showed a relative stability, reflecting economic recovery in East Asian countries and the continuation of high economic growth in China and India.

Short-term interest rates were raised in industrial countries as an anti-inflation measure. Consequently, borrowing costs of emerging market economies from international financial markets rose, despite improved stability in their own economies. Meanwhile, the reversal of the upward trend in stock prices in the information technology (IT) sector in industrial countries had a contagion effect on emerging market economies. Consequently, net private capital flows into emerging market economies declined, even though gross capital inflows to them increased. Official development assistance (ODA) to developing countries improved to 0.21 per cent of gross domestic product (GDP) of OECD countries in 2000, but remained well below the UN agreed target of 0.7 per cent of GDP. Meanwhile, Asia experienced a net outflow, partly due to the settlement of large amounts of financial assistance received by crisis affected East Asian countries in 1997 and thereafter.

Sri Lanka's economy recorded a real GDP growth rate of 6 per cent in 2000, significantly above the rate of growth of 4.3 per cent in 1999. The annual average growth rate during the decade was 5 per cent. Gross national product (GNP) grew by 5.8 per cent in 2000 compared with 3.8 per cent in the previous year. Economic recovery had started in the second half of 1999 and continued through the first three quarters of 2000, following a period of slow down in the second half of 1998 and 1999. The high growth in GDP, together with relatively low population growth, raised Sri Lanka's per capita GDP to Rs.64,855 (US dollars 856) in 2000, from Rs.58,077 (US dollars 825) in 1999. Consequently, the country's position in the international classification moved further up within the lower middle income category, which consists of countries with a per capita income in the range of US dollars 795-3,125.

Output increased in all major sectors, but manufacturing and services sectors became the major contributors to growth accounting for 26 per cent and 61 per cent of total growth, respectively. On the demand side, domestic consumption, investment and exports all contributed to the high growth in 2000. The highest contribution came from exports of goods and services, which accounted for 47 per cent of the growth in the overall demand, and recorded an annual growth rate of 18 per cent in real terms in 2000. Reflecting the implementation of a number of infrastructure development projects by both the public sector and the private sector, gross domestic capital formation in real terms grew by 9.5 per cent in 2000. This compares with 6.4 per cent in 1999. On the supply side, both gross domestic production and imports of goods and non-factor services, expanded at higher rates in 2000 than in 1999, increasing the availability of goods and services.

TABLE 1.2

Growth in Gross National Product at Constant Prices (Annual Percentage Changes)

Item	1990-1998 Avg.(a)	1999(a)	2000(a)
1. Agriculture, forestry and fishing	2.3	4.5	1.8
1.1 Agriculture	2.2	4.4	1.7
Tea	4.3	1.3	7.8
Rubber	-0.9	1.0	-9.7
Coconut	0.6	9.1	8.0
Paddy	3.8	6.6	-0.3
Other	2.6	3.4	0.9
1.2 Forestry	1.5	1.3	1.6
1.3 Fishing	3.8	7.6	2.5
2. Mining and quarrying	2.4	4.1	4.8
3. Manufacturing	8.4	4.4	9.2
3.1 Process. of tea, rubber and coconuts	2.1	3.8	4.2
3.2 Factory industry	9.7	4.5	10.4
3.3 Small industry	6.1	4.8	5.5
4. Construction	5.3	4.8	4.8
5. Electricity, gas, water and sanitary services	7.9	9.5	4.5
6. Transport, storage and communication	6.1	8.1	7.8
7. Wholesale and retail trade	5.7	1.0	8.7
7.1 Imports	8.0	-1.4	12.9
7.2 Exports	10.1	6.1	18.3
7.3 Domestic	2.5	2.1	2.4
8. Banking, insurance and real estate	8.2	4.6	6.4
9. Ownership of dwellings	1.3	1.2	1.7
10. Public administration and defence	3.4	4.2	4.2
11. Services (n.e.s.)	5.2	9.8	2.3
12. Gross domestic product	5.3	4.3	6.0
13. Net factor income from abroad	2.0	41.6	19.6
14. Gross national product	5.5	3.8	5.8

Source:- Central Bank of Sri Lanka

(a) At 1996 constant factor cost price

The increasing integration of the Sri Lankan economy into the global economy has been clearly demonstrated by the close association between domestic growth rates and the growth momentum in the world economy in recent years. Following the recovery path in the world economy, the quarterly growth rate in Sri Lanka accelerated from 4 per cent in the third quarter of 1999 to 7.4 per cent in the second quarter of 2000. In the fourth quarter of 2000, economic growth eased, despite continued high exports, as poor and delayed monsoons affected agricultural output adversely, while some pre-election uncertainty and high interest rates had an impact on the general business environment.

The ratio of gross domestic investment/GDP increased to 27.3 per cent in 2000, continuing the upward trend experienced since 1997, mainly due to increased private sector investment activities. The relative share of private investment in total capital accumulation increased gradually, reaching 89 per cent, reflecting the growing role of the private sector in the economy. Meanwhile, public sector investments were mainly concentrated on economic and social infrastructure development activities. The economy also attracted foreign investors, with foreign direct investment (FDI) inflows amounting to US dollars 175 million in 2000, despite the potential adverse impact of the ongoing civil conflict on investor sentiments.

The development of infrastructure facilities continued in 2000 with increased investment by both public and private sectors to meet fast growing demand. However, the government's investment in infrastructure facilities fell short of expectations due to delays in project implementation and the curtailing of capital expenditure to accommodate the increased defence expenditure in the middle of the year. The realised government investment, including infrastructure development, amounted to 6.4 per cent of GDP, when compared with a budgetary target of 8.1 per cent of GDP. Despite this drop, a number of new large infrastructure development projects were initiated in 2000 by the public sector as well as the private sector, mainly in the transport, power, telecommunication and port sectors. Over the past few years, budgetary allocations made for education and health have increased, enabling further improvements in the social indicators. The percentage of households with electricity, access to safe water, telecommunication facilities and transport, health and education facilities improved, but further efforts and resources are necessary to improve the living standards of people and to remove existing infrastructure bottlenecks constraining the achievement of a faster economic growth.

TABLE 1.3
Gross National Product
(Sector Shares in percent) (a)

Sector	1978	1998	1999	2000
1. Agriculture, forestry and fishing	30.3	21.1	20.7	19.4
2. Mining and quarrying	2.2	1.9	1.8	1.9
3. Manufacturing	18.4	16.5	16.4	16.8
4. Construction	4.7	7.6	7.6	7.3
5. Services	44.4	52.9	53.5	54.6
Electricity, gas, water and sanitary services	0.4	1.5	1.5	1.2
Transport, storage and communication	10.7	11.1	11.4	11.7
Wholesale and retail trade	19.7	21.5	21.2	22.6
Banking, insurance and real estate	2.2	7.6	8.1	8.1
Ownership of dwellings	3.7	1.9	1.8	1.8
Public administration and defence	3.6	5.3	5.3	5.2
Services (n.e.s.)	4.1	4.0	4.1	4.0
6. Gross domestic product	100.0	100.0	100.0	100.0
7. Net factor income from abroad	-0.6	-1.3	-1.8	-2.0
8. Gross national product	99.4	98.7	98.2	98.0

Source:- Central Bank of Sri Lanka

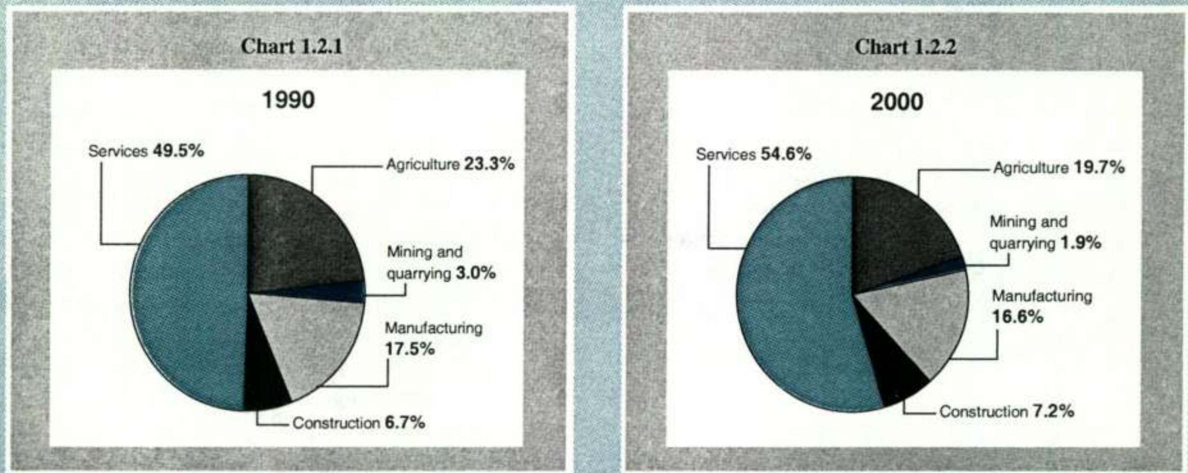
(a) At current factor cost price

Private savings rose to a higher rate of 20.7 per cent of GDP, benefiting from the increased per capita incomes, attractive positive real interest rates and increased private remittances by Sri Lankans working abroad. However, total domestic savings declined to 17.3 per cent of GDP due to increased government dissaving from 1.0 per cent in 1999 to 3.4 per cent of GDP, a result of fiscal slippage in 2000.

High economic growth and expanding investment activities generated more employment opportunities, largely in the private sector. Consequently, the unemployment rate declined to 7.7 per cent. Some of the new employment was in foreign countries. This is the seventh consecutive year in which a downward movement in the unemployment rate has been recorded. However, unemployment still remained high, particularly among the youth with higher education. Meanwhile, unfilled vacancies continued to exist in some industries, reflecting the mismatch in the labour market between demand and supply. Nominal wages and salaries increased in 2000, preserving real wages at the previous year's levels in most economic sectors.

The inflation rate, which declined from the early part of 1998 into the first half of 2000, experienced a trend reversal in the latter part of the year, owing to upward revisions in some administered prices following the surge in international oil prices, increases in prices of imports such as sugar, milk products and fertiliser, and the depreciation of the rupee. The expansion in domestic agricultural output improved the supply situation, thereby mitigating the inflationary pressures to some extent. The annual average inflation rate, measured by the increase in the Colombo Consumers' Price Index (CCPI), was contained at 6.2 per cent in 2000. However, on a point-to-point basis, it rose to 10.8 per cent by December 2000 from

Chart 1.2
Sectoral Composition of GDP



4 per cent at end 1999 indicating growing inflationary pressures in the economy. In this context, the Central Bank tightened its monetary policy stance in order to neutralise potential inflationary pressures from the aggregate demand side and to ensure stability in the foreign exchange market.

As a part of the efforts to consolidate recent fiscal improvements, the government in the Budget 2000 attempted to contain the overall fiscal deficit at 7.6 per cent of GDP with a surplus in the current account of 0.6 per cent of GDP, while reducing domestic borrowing for deficit financing to 3.5 per cent of GDP. However, the fiscal situation deteriorated, creating a higher deficit and increased domestic borrowings. In place of a surplus, the current account deficit turned out to be 3.4 per cent of GDP. The overall fiscal deficit, excluding grants, rose to 9.9 per cent of GDP, the highest since 1995 when the deficit was 10.1 per cent. The deficit was recorded, despite some corrective measures taken to arrest the situation in mid 2000. This was due to a shortfall in revenue collection from import duty and income tax and an increase in recurrent expenditure, mainly due to high defence expenditure and increased interest payments.

The increased deficit, together with a delay in completing the planned privatisation process and less than anticipated foreign financing inflows, raised government's domestic borrowing to 9.4 per cent of GDP, exerting strong pressure on domestic interest rates. As available non-bank domestic resources were limited, the government was compelled to meet the balance resource requirement from the banking system. Consequently, government's bank borrowings increased by Rs 53.4 billion to 4.3 per cent of GDP, the highest level during the last 12 years. A large part of this (84 per cent) was reflected in borrowings from the Central Bank, as commercial banks used the Central Bank's reverse repurchase facility to acquire the liquidity needed to finance private sector credit demand and increased credit requirements of the public sector. Borrowing by public corporations surged by Rs.25.2 billion, mainly due to delays in effecting the price revisions needed in response to higher world prices of oil. Thus, the consolidated deficit of the public sector (government and public corporations) rose to about 11.9 per cent of GDP in 2000, from about 7.8 per cent in 1999, raising domestic credit demand and exerting pressure on interest rates.

Consequently, total government debt stock increased by Rs.167 billion (or by 16 per cent) to Rs.1,219 billion (97 per cent of GDP) at end 2000, indicating a higher debt service burden in the future. In line with the medium-term government debt management strategy, the reliance on market oriented borrowing instruments (i.e., Treasury bonds) increased, while the use of non-market oriented borrowing instruments (Rupee securities) decreased sharply in 2000.

Despite a surge in exports and increased inflows through private transfers, the current account deficit as well as the overall deficit in the balance of payments (BOP) widened sharply in 2000, mainly due to significant increases in energy and defence related imports. The current account deficit increased to 6.4 per cent of GDP in 2000, from 3.6 per cent of GDP in 1999, while the overall BOP deficit deteriorated to US dollars 516 million from US dollars 263 million in the previous year.

The higher BOP deficit led to a fall in the gross official reserves by 36 per cent or US dollars 596 million, to US dollars 1,043 million (1.7 months of imports) by the end of 2000. However, the country's gross external reserves declined by a smaller amount, viz., US dollars 456 million (18 per cent) to US dollars 2,126 million (3.5 months of imports) at the end of 2000, as external assets of commercial banks increased by US dollars 141 million during the year.

The increased external sector deficit and the continuously declining international reserves exerted pressure on the rupee to depreciate faster during the second half of 2000. The Central Bank gradually widened the margin between its buying and selling rates for the US dollar, the intervention currency, to release the pressure in the exchange market, while raising its short-term interest rates to discourage speculative holding of foreign currency balances. The rupee depreciated by 9.9 per cent against the US dollar during 2000 as measured by the Central Bank's middle rate (12.5 per cent as measured by the interbank foreign exchange market average exchange rate), compared with 6 per cent in 1999. Because of the weakening of other partner and competitor country exchange rates vis-à-vis the US dollar, the rupee depreciated only by 6.7 per cent in nominal effective terms against a basket of 24 currencies. However, given the higher inflation in Sri Lanka, the real effective exchange rate (REER) recorded a marginal appreciation of 0.6 per cent, indicating that the country's external competitiveness remained almost the same.

The drain on the country's foreign exchange reserves arising from the increased deficit in the balance of payments led to an inevitable downward adjustment in the exchange rate, particularly during the second half of 2000. Accordingly, the Central Bank widened the margin between its buying and selling rates from 2 per cent to 5 per cent in June 2000 and again to 6 per cent in November and to 8 per cent in December, before widening it to 10 per cent in January 2001. Meanwhile, regular adjustments were made under the crawling band system by taking into account market developments. The widening of margins and regular adjustments based on market developments released the pressure in the foreign exchange market gradually, thus preventing any significant misalignment of the exchange rate with macroeconomic fundamentals, thereby avoiding a potential financial crisis as experienced in a number of developing countries, particularly in East Asia and Latin America.

However, it became clear that in the current economic environment, regular widening of the intervention band leads to a formation of market expectations of continuous depreciation of the rupee, thus exerting pressure on the official international reserves of the country. Meanwhile, the increases in the interest rates that were effected to provide stability in the foreign exchange market could not be maintained for a long period, as such high interest rates would be detrimental to financial sector soundness and prospects for long-term economic growth. At the same time, the foreign exchange market reached a level of maturity and gained experience in determining the exchange rate in a more flexible and competitive market environment.

The Central Bank introduced a new exchange rate regime on 23 January 2001 by taking into account all these factors and long-term economic prospects, as another step forward in the evolution towards a floating exchange rate system initiated in 1977, along with the introduction of an outward oriented economic liberalisation framework. Under the new system, the Central Bank refrained from announcing its buying and selling rates for the US dollar (i.e., the intervention currency) in advance. Instead, it decided to participate actively in the foreign exchange market, through buying and selling foreign exchange at or near market prices. This provided full freedom to the market to determine the exchange rate, while enabling the authorities to build up the official external reserves, which, in the long run, would bring about stability on both price and exchange rate fronts and help achieve a sustainable high economic growth.

The exchange rate stabilised, restoring stability in the foreign exchange market within a short period after experiencing a minor overshooting during the first few days. This overshooting was not unanticipated and not excessive compared with the experience of many other countries when they moved from a fixed or managed system to a floating system (for more details, see Box 1). The quick restoration of stability was a result of the gradual release of the pressures through the widening of the band and gradual depreciation of the exchange rate earlier.

Developments in the external sector and on the fiscal front had significant implications for monetary management in 2000. Given the pressures on interest rates, exchange rates and external reserves by increased public sector borrowing and a higher balance of payments deficit, monetary policy in 2000 focussed on maintaining stability in the domestic financial markets, while providing adequate liquidity to facilitate economic activity. Monetary policy also sought to prevent the build up of demand fuelled inflationary pressures in the economy. Monetary policy was tightened by raising the Central Bank's short-term interest rates, particularly in the second half of 2000, to ensure financial market stability. Consequently, the Central Bank's repurchase and reverse repurchase rates were raised in several steps from 9.25 per cent and 13.48 per cent at the beginning of 2000 to 17 per cent and 20 per cent, respectively, at the end of year. Tighter monetary policy, together with increased public sector borrowings, caused market interest rates, which were on a falling path until May, to increase sharply in the second half of the year. As the sharp increase in interest rates was considered a temporary phenomenon, short-term rates increased at a

Box 1

Evolution of Exchange Rate Management in Sri Lanka

The Monetary Law Act, under which the Central Bank of Sri Lanka was established, places on the Bank the responsibility of maintaining the stability of the external value of the Sri Lanka rupee in relation to foreign currencies, in line with macro-economic fundamentals. In the past half century, the exchange rate system of Sri Lanka has evolved from a regime of fixed exchange rates to a managed float and finally to an independent float.

Fixed Exchange Rate Regime

When the Central Bank was first set up, Sri Lanka, like most countries at that time adopted a fixed exchange regime. The Sri Lanka rupee was linked to the pound sterling. The fixed exchange rate system was maintained through the 1960's and most of the 1970's, with a rigid system of exchange controls. Throughout most of this period, there was heavy pressure on external reserves. The rupee was first devalued by 20 per cent in 1967 in response to the continued depletion of reserves and devaluation of the pound sterling. The devaluation was supplemented with a system of dual exchange rates introduced in 1968. Under this system, which was known as the Foreign Exchange Entitlement Certificates Scheme (FEECS), there was an 'official' exchange rate applicable to essential imports and traditional exports, and another higher rate, applicable to all other exports and imports. The objective of the scheme was export diversification and import compression by allowing the market mechanism to regulate the flow of 'non-essential' imports. It was designed to bring the rupee cost of a wide range of such imports closer to the realistic value of foreign exchange.

With the suspension of the convertibility of the US dollar for gold in August 1971 by the United States, the rupee was linked to the US dollar at the prevailing parity of Rs. 5.9524 per US dollar, allowing the parities against other currencies to be determined on the basis of their cross rates with the US dollar in international foreign exchange markets. The Sri Lanka rupee was linked to the pound sterling from 10 July 1972, at the prevailing parity of Rs. 14.94, following the flotation of the pound sterling in June 1972. Sri Lanka moved from a hard peg to a single currency, to a basket peg in May 1976, by determining the exchange rate with reference to an appropriately weighted basket of currencies. This step was necessitated by the need to insulate the rupee from random events abroad, which, under the previous regime, tended to be transmitted to Sri Lanka, via the link between the rupee and the pound sterling. With the use of a basket of currencies in the determination of the exchange rate, there was greater scope for the effects of underlying trends in the Sri Lankan economy to be represented in Sri Lanka's exchange rates vis a vis other currencies. The exchange rate was gradually re-adjusted under a crawling peg system between August and mid November 1977, allowing it to reflect changes in macro-economic fundamentals with the intention of finding a more realistic rate of exchange for the rupee.

Managed Float with a Crawling Band

In November 1977, Sri Lanka made a major shift from restrictive policies towards a liberal policy regime with the partial liberalisation of external trade and payments. The dual exchange rate system was abolished by introducing a unified exchange rate, which was initially depreciated by 46 per cent. With unification, the exchange rate was allowed to float, providing scope for the exchange rate to be determined largely on the basis of demand and supply in the market. At the initial stage of floating, the Central Bank's management of the exchange rate was considered essential, as the foreign exchange market was thin and the financial system was not mature enough to operate on its own. Accordingly, the Central Bank announced daily the rates at which it would buy and sell foreign exchange from and to the market within a narrow band.

Under the managed floating system, the Central Bank initially quoted fixed daily rates for six major currencies. However, after 1982, the Bank limited its quotations only to the intervention currency, the US dollar, allowing the commercial banks to determine the cross rates for other currencies based on market conditions. At the beginning, the margin between the buying and selling rates maintained by the Central Bank was Rs. 6.00 per US dollars 100. This was adjusted on several occasions as shown in Table 1 and finally revised to 10 per cent in January 2001, allowing market forces greater scope to determine the exchange rate, with the domestic foreign exchange market gaining a greater degree of maturity. With the liberalisation of the exchange rate under the managed float system, the country also liberalised its payments system and by March 1994, it had removed all restrictions on current external transactions and accepted Article VIII of the Articles of Agreement of the IMF. Capital account

Box 1 (Contd.)

transactions were also largely liberalised, except for restrictions on investment abroad and borrowing abroad by residents, and investment in domestic debt instruments by non-residents.

Changes in 2000

An increased balance of payments deficit, largely due to high oil import prices and security related additional imports, resulted in a reduction in official foreign reserves in 2000 and there were expectations that external reserves would decline further. In this background, there was pressure on the exchange rate and the Central Bank was faced with a major challenge in managing the exchange rate with the crawling band. Since the declaration of the government in May 2000 that the country was on a war footing, the market had expected heavy expenditure by the government, which, together with rising petroleum prices and declining reserves, generated a market expectation of a rupee depreciation. Exporters started to hold onto their foreign exchange earnings and finance their operations through rupee funds, while importers advanced their operations and started forward bookings for imports. In order to cover both spot and forward sales to customers commercial banks too intensified their buying in the spot market. As a result of these developments, the market exchange rate started operating around the Central Bank's selling rate most of the time, requiring the Bank to sell foreign exchange to defend the exchange rate. The Central Bank responded to this by widening the spread between its buying and selling rates and increasing its interest rate on several instances during 2000. Accordingly, the Central Bank widened the margin between its buying and selling rates of foreign exchange from 2 per cent to 5 per cent in June 2000 and further to 6 per cent in November and 8 per cent in December before widening it to 10 per cent in January 2001.

The widening of margins in this manner and regular adjustment of the exchange rate, by taking into account market developments, permitted a reduction of pressure in the foreign exchange market, thus avoiding a financial crisis as experienced in a number of developing countries, particularly in East Asia and Latin America. However, the Central Bank observed that in the current economic environment, regular widening of the intervention band may lead to a formation of market expectations of continuous depreciation of the rupee, thus exerting an unnecessary pressure on the official external reserves of the country. At the same time, the increases in interest rates that were effected to provide stability in the exchange market could not be maintained for a long period, as high interest rates would be detrimental to economic activity in the long run.

New Exchange Rate Regime

On 23 January 2001, Sri Lanka took a major step forward in the liberalisation of foreign exchange transactions by allowing commercial banks to determine the exchange rate freely. The Bank no longer announced its buying and selling rates in advance. Instead, it indicated that it would participate actively in buying and selling at or near market prices. The new system permitted freer transactions in the market, while stabilising the value of the rupee and helping authorities to build up official foreign assets. The experience of other countries that have floated their currencies have highlighted the need for implementing precautionary measures, during the transition period, to help and stabilise the market and promote prudential conduct by commercial banks by restraining speculative activity. Therefore, the Central Bank also implemented the following temporary measures in consultation with commercial banks and foreign exchange dealers.

- Limits on daily working balances maintained by commercial banks in foreign exchange, on the basis of past export-import credit facilities granted by the banks, to prevent banks from building up foreign exchange for unwarranted speculative activities.
- Requesting banks to ensure settlement of export credit by exporters by using export proceeds within 90 days. This period was extended to 120 days in respect of exports, where it was customary to grant 120 days' deferred payment terms to buyers. Higher interest was to be charged, when settlement became overdue.
- Requesting banks to limit their forward market operations only to trade related transactions.
- Requiring forward sales and purchases of foreign exchange to be backed by a rupee deposit of 50 per cent, to discourage speculative forward contracting.
- Advising banks not to permit early or pre-payment of import bills, in anticipation of a depreciation.

As expected, these measures helped to create stability in the foreign exchange market. They are

Box 1 (Contd.)

expected to be relaxed gradually and removed once the foreign exchange market reached a desirable state of stability.

Immediately with the change in the exchange rate regime, an overshooting of the rate was expected and did occur, as experienced in a number of other countries. The rupee depreciated gradually during the first two days, but overshot on the third day, even recording some transactions at Rs.98 per US dollar. However, the market correction process for the overreaction started on the same day and the rate stabilised around Rs.88.90 per US dollar within a week's time. The weighted average exchange rate in the spot market recorded a depreciation of 9.1 per cent on 25 January 2001 compared with the pre-float level, but the rate of depreciation declined to 1 per cent by 7 March 2001. Similarly, the spread between buying and selling rates of foreign currencies has narrowed drastically in the inter-bank foreign exchange market as well as in commercial bank transactions with customers. This was a relatively quick stabilisation of the exchange rate compared with the experience of other countries that floated their exchange rates. For example, Brazil's currency depreciated by 40 per cent on the first day of floating and 21 per cent in the first month of floating in January 1999. The Indian rupee depreciated by 16 per cent in the first month of floating in March 1993, the Korean won by 31 per cent in the first month of floating in December 1997 and the Swedish kroner by 28 per cent in the first five months of floating in 1992.

Chart 1
Inter-bank Rate

The following main factors have contributed to achieving faster stability in the market.

- Release of pressure in the foreign exchange market gradually through regular adjustments of the exchange rate according to changes in macro-economic fundamentals of the country and widening of the band over a longer period to allow more flexibility in the market.
- Timely and effective implementation of precautionary measures with the introduction of the new regime.
- Safeguards provided by high interest rate policy and continuation of capital controls.
- Cordial and close relationship between market participants and the authorities.

The new system has already halted the drain on official foreign reserves and will help to build them to a more comfortable level. In addition, with the restoration of stability in the exchange market, the Central Bank would be in a position to gradually reduce its interest rate, too. As a first step, the Central Bank reduced its repo and reverse repo rates by 1 percentage point on 26 February 2000, and by 50 basis points on 3 April 2001.

It is also encouraging that the market is already developing its own strategies and instruments to settle large import bills, such as petroleum, without resorting to the Central Bank for foreign exchange reserves as under the previous regime. Under the present exchange rate regime, it is not necessary for the Bank to use monetary policy to defend the exchange rate, as the exchange rate is not considered a nominal anchor. The Bank could now well target its monetary policy to achieve the prime objectives of price stability and financial system stability. However, the Central Bank will intervene in the market to prevent excessive fluctuations in the exchange rate but will not attempt to defend any particular level of exchange rate. The new system will also improve market confidence and the country's external competitiveness, encouraging investors, both domestic and foreign, and expanding the capacity of the economy to achieve higher growth and create more employment opportunities in the future.

Box 1 (Contd.)

Table 1 - Exchange Rate Changes

Date	Band Width	Major Changes	Exchange Rate of CBSL			Exchange Rate Regime
			Buying	Middle	Selling	
1949	Rs.0.25/= per 100 US$	Rupee was linked to pound sterling	4.7615	4.7619	4.7640	Fixed
22 Nov. 1967	"	Rupee was depreciated by 20%	5.9510	5.9524	5.9535	Fixed
06 May 1968	"	Introduced Foreign Exchange - Entitlement Certificates Scheme	5.9510	5.9524	5.9535	Dual exchange rate - system
01 Aug. 1971	"	Rupee was linked to the US dollar	5.9510	5.9524	5.9535	"
10 July 1972	"	Rupee was relinked to pound sterling	6.3940	6.3953	6.3965	"
11 July 1972	"	Introduced Convertible Rupee - Account Scheme	6.3940	6.3953	6.3965	"
24 May 1976	"	Rupee was pegged to a weighted - average basket of currencies	8.6440	8.6451	8.6465	"
09 March 1977	"		8.7140	8.7154	8.7165	"
12 March 1977	"	Rupee was revalued by 20%	7.2805	7.2817	7.2830	"
15 Nov. 1977	"	Dual exchange rate system was abolished and a managed floating exchange rate system was introduced	8.5980	8.5990	8.6005	"
16 Nov. 1977	Rs.6.00/= per 100 US$		15.9700	16.0000	16.0300	Managed floating with crawling band
24 Oct. 1978	"		15.6300	15.6600	15.6900	"
25 Oct. 1978	Rs.3.00/= per 100 US$	Band was reduced	15.6300	15.6450	15.6600	"
09 Nov. 1982	"		20.9250	20.9400	20.9550	"
10 Nov. 1982	Rs.1.50/= per 100 US$	Band was reduced	21.0225	21.0300	21.0375	"
06 March 1987	"		28.7325	28.7400	28.7475	"
09 March 1987	Rs.3/= per 100 US$	Band was widened	28.7350	28.7500	28.7650	"
28 Feb. 1992	"		42.9650	42.9800	42.9950	"
23 March 1992	1.0 per cent	Band was changed	42.9840	43.2000	43.4160	"
17 March 1995	"		49.6804	49.9300	50.1797	"
20 March 1995	2.0 per cent	Band was widened	49.4109	49.9100	50.4091	"
19 June 2000	"		73.6907	74.4350	75.1794	"
20 June 2000	5.0 per cent	Band was widened	75.6000	77.5400	79.4700	Managed floating with horizontal band
02 Nov. 2000	"		75.6000	77.5400	79.4700	
03 Nov. 2000	6.0 per cent	Band was widened	75.6000	77.8700	80.1400	Managed floating with crawling band
08 Dec. 2000	"		76.8700	79.1400	81.4100	"
11 Dec. 2000	8.0 per cent	Band was widened	76.8700	79.9448	83.0196	"
11 Jan. 2001	"		77.2750	80.3498	83.4246	"
12 Jan. 2001	10.0 per cent	Band was widened	77.2750	81.1388	85.0025	"
22 Jan. 2001	"		77.4050	81.2688	85.1325	"
23 Jan. 2001	-	CBSL stopped announcing its buying and selling rates in advance				Independent floating

Source: Central Bank of Sri Lanka

Notes: 1. Before 1977, the band width was fixed at about 0.12 cts. below the parity rate but was rounded off to the nearest multiple of 0.05 cts. and the fixed selling rate was 0.25 cts. above the buying rate.

2. During 10 November 1982 to 2 November 2000, the band width was computed symmetrically about the middle rate. After 3 November 2000, it was computed from the buying rate.

faster rate than the medium and long-term rates, thereby flattening the yield curve for government securities.

In order to promote foreign currency deposits and improve liquidity in the foreign exchange market, the statutory reserve requirement (11 per cent) on foreign currency deposits that had not been placed abroad was removed in August 2000. By taking advantage of this measure and responding to rising interest rates in major international markets, commercial banks raised their interest rates on foreign currency deposits to attract deposits.

Monetary expansion remained at around 13 per cent in 2000, despite the sharp rise in public sector bank borrowings, mainly due to a reduction in the net foreign assets of the banking system. High interest rates helped to contain expansion of domestic credit and, hence, to contain monetary expansion in line with the increase in nominal income.

Despite an increase in net credit to the government from the Central Bank by about Rs.45 billion or 96 per cent, reserve money expanded at a moderate rate of 4.7 per cent in 2000 compared with an 8.2 per cent increase in 1999 on account of a sharp decline in the net foreign assets of the monetary authority by Rs.31 billion.

Commercial bank credit to the private sector increased by 12 per cent (Rs.38 billion) mainly catering to the increased demand for credit from the service, commercial and manufacturing sectors. Increased corporate sector liquidity with a declining trend in effective tax rates, resort to new low-cost financing instruments such as commercial paper and the availability of credit facilities from the development banks may have reduced private sector demand for commercial bank credit. According to the financial survey, credit to the private sector rose by Rs.48 billion (11 per cent). Net credit to the government rose significantly by Rs.53 billion (57 per cent), of which Rs.45 billion (84 per cent) came from the Central Bank. Meanwhile, credit extended to public corporations rose by Rs.25 billion, mainly caused by heavy borrowings by the Ceylon Petroleum Corporation (CPC), the Ceylon Electricity Board (CEB) and the Co-operative Wholesale Establishment (CWE). Consequently, the total public sector borrowings rose sharply by Rs.78 billion (73 per cent), accounting for over 142 per cent of the monetary expansion in 2000.

Share prices and the turnover in the Colombo Stock Exchange (CSE) remained depressed, despite healthy earnings by several listed companies and the strong economic recovery. At end 2000, the All Share Price Index was 22 per cent below the value at end 1999. This decline could be attributed mainly to the political uncertainty that prevailed before the General Elections in October 2000, the uncertainty that prevailed in the foreign exchange market and the high interest rates on fixed income securities. However, the continuation of a declining trend in share market activities over a period of 3 years, despite a recovery in the economy and improving corporate sector performance, indicates the necessity for reviewing the market structure and institutional framework of the capital market, which, in the long run, would be crucial for private sector led economic growth.

Financial sector facilities and services continued to improve in a competitive environment. With the expansion of bank branches, banking density improved. The availability of modern services such as automated teller machines (ATM), credit cards and tele-banking facilities expanded. All these encouraged financial intermediation and hence increasing financial deepening in the economy. Further steps were taken to improve rural banking and credit facilities and expand private forward sales contract facilities for agricultural products, introduced in 1999. However, the continuation of high interest spread by banks calls for further improvements in efficiency and reforms in the financial sector.

Structural reforms in the financial sector have been continued even under difficult conditions, but the progress was slow in a number of crucial areas. Limits on foreign ownership in commercial banks and in the insurance business were raised in 2000, to 60 per cent and 90 per cent, respectively, with a view to further improving their capital base and encouraging modernisation of financial services. The Central Bank continued to strengthen its monitoring and supervision of financial sector activities. The capacity of the Central Bank's bank supervision has been improved by increasing the number of qualified supervisors and their ability to process and analyse data collected from banks more speedily and effectively. The risk adjusted capital adequacy ratio for banks was raised to a minimum of 9 per cent from January 2001, with a pre-announced time-plan of raising it further to a minimum of 10 per cent in January 2002, in order to improve the resilience of the banking system. Commercial banks have improved their credit evaluations, recovery processes and loan provisioning. However, despite a recent decline in the ratio of non-performing loans (NPL) to total advances, it is still high (15 per cent), indicating the necessity for adopting more effective measures for loan recovery. Progress has also been made in improving the management in the two state banks and action has been initiated to restructure the Ministry of Finance and to modernise the Central Bank.

During the year, further steps were taken to improve the government debt securities market. The primary dealer network was strengthened by reducing the number of dealers to eight public limited liability companies, with dedicated capital, appointed as Primary Dealers. This is expected to provide a level playing field for primary dealer activity, facilitate dealer surveillance and strengthen public debt management. The infrastructure necessary for a dealer

Box 2

Fifty Years of Central Banking in Sri Lanka

With the regaining of independence in 1948, a need was felt for a monetary regime that would foster stability, growth and development in Sri Lanka. In order to fulfill this need, the Central Bank of Sri Lanka (CBSL) was established and commenced operations on 28 August 1950. During the past fifty years, the Central Bank has evolved and undergone various changes based on the needs of the people and forces of economic growth and development.

Prior to the establishment of the CBSL, the monetary regime that prevailed in Sri Lanka was the Currency Board System, established in 1884 under the Paper Currency Ordinance of 1884. A currency board has some strengths and operates well in an environment of stable balance of payments. However, it has several weaknesses which made the authorities view it as being unsuitable for a country that had become independent and was seeking to develop its economy. Among the weaknesses were the requirement of a 100 per cent reserve base, the automatic link between international reserves and money supply, and the manner in which the exchange rate was determined. Hence, a change in the system was deemed necessary.

In 1949, at the invitation of the government. Mr. John Exter, an economist of the Federal Reserve System of the United States, began preparing a report on the financial and economic conditions of Sri Lanka and the feasibility of establishing a central bank. He recommended the creation of a new independent monetary system and presented a draft Monetary Law Bill incorporating legislation for the setting up of CBSL. The Bill became the Monetary Law Act No. 58 of 1949, and the Central Bank of Ceylon was established under this Act. The newly established Central Bank became the authority responsible for the administration and regulation of the monetary and the banking system of Sri Lanka. The Bank was charged with the duty of regulating the supply, availability, cost and international exchange of money so as to secure, as far as possible, by action authorised by the Act, the following objectives;

(a) the stabilisation of domestic monetary values;

(b) if there has been a determination of the par value of the Sri Lanka rupee, the preservation of the par value of the Sri Lanka rupee and the free use of the rupee for current international transactions; if there has been no determination of the par value of the Sri Lanka rupee, the preservation of the stability of the exchange rate of Sri Lanka rupee in relation to foreign currencies;

c) the promotion and maintenance of a high value of production, employment and real income in Sri Lanka; and,

d) the encouragement and promotion of full development of productive resources of Sri Lanka.

By design, a central bank's activities are unique. Its ability to uniquely influence the money supply in the economy and the financial structure is harnessed in monetary policy to achieve the above objectives. The first objective implies low and stable inflation and the second objective implies stable exchange rates, while the third and fourth objectives ensure economic growth and development.

Exter (1949) further assumed that the establishment of the central bank would greatly strengthen the banking system. CBSL would have the power to examine and supervise banking institutions to avoid bank failures and would stand ready to advance credit as the 'lender of last resort' and thus make the banking system 'almost invulnerable' in times of crises. Strengthening the banking system would encourage the public to make greater use of financial markets as depositories for their savings, thus enabling banks to lend to many.

Apart from fulfilling fundamental objectives, Exter also believed that the Central Bank could do a great deal to introduce more effective management of the public debt and more efficient handling of public finances by acting as the government's fiscal agent, banker and financial adviser. He also emphasised the need for development finance by advocating that the Central Bank should have the authority to lend to institutions other than commercial banks, such as mortgage lending institutions and the co-operative credit movement, as they have made greater credit facilities available to the sectors for which institutional credit is lacking, and also by advocating that the Central Bank should engage in

Box 2 (Contd.)

loan insurance and loan guarantees. He believed that by helping to direct savings, credit and foreign resources into agricultural development and new industries, diversification of the economy could be stimulated, which would make it more resilient and adaptable to changing economic conditions. Over the next five decades, many of these functions became integral parts of the Bank's operations.

The evolution of departments in CBSL kept pace with the evolution of its monetary policy and expansion of other activities (Table 1). At its inception, CBSL had only a few key departments, among which were Banking, Economic Research and the Secretariat. The Economic Research Department provided research inputs and the Banking Department carried out the implementation of the monetary policy, in addition to carrying out functions as the banker to the government and banker to banks. CBSL also inherited several functions as the agent of the government. Those were exchange control and managing the public debt, and two departments were established to carry out these functions.

Financial sector development and stability became a prime function of CBSL with the establishment of the Bank Supervision Department in 1951. Since then, achieving this objective has been further strengthened by establishing the Non-Bank Financial Institutions Supervision Department in 1988 and Financial Markets Department in 1997. With the enactment of the Employees' Provident Fund (EPF) Act in 1958, which required CBSL to be the custodian of EPF funds, the EPF Department was established in 1958.

In the sixties and seventies, as the economic philosophy moved more towards centralisation and direct government intervention, greater emphasis was given to the development objective. Controls and concessions were used to direct credit and resources to priority sectors chosen by the government. In the mid 1970s, CBSL performed a more direct role in economic development. In order to assist in this, the Department of Development Finance was established in 1974 to grant directed and subsidised credit to the industrial and agricultural sectors. CBSL also played a prominent role in the establishing and developing the institutional structure needed to carry out the development finance function in the economy. In this regard, it helped establish a number of independent institutions such as the DFCC Bank and the National Development Bank. In order to strengthen the Bank's activities in the field of rural credit, the Rural Credit Department was established in 1981. This Department, together with the Development Finance Department, served as a national level co-ordinating body for implementing various development programmes. Regional Offices of CBSL were established between 1981 - 1985 to facilitate development finance in rural areas and promote regional growth. As part of this process, the CBSL was instrumental in setting up Regional Rural Development Banks from 1985 onwards.

Fundamental changes were seen after the liberalisation of the economy in 1977 away from direct controls to market based tools. The fixed exchange rate system that had prevailed until then, was changed to a managed float in 1977. The market has been given greater flexibility over the years and in early 2001, Sri Lanka moved to a free float of the rupee. The management of the exchange rate helped to achieve a gradual depreciation which maintained the competitiveness of Sri Lanka's external trade and avoided major exchange crises.

The Central Bank began to reduce gradually its use of direct controls and interventions in the implementation of monetary policy and to move towards more market based, indirect tools of monetary policy. This required the CBSL to involve itself in the development of the financial market and market instruments, particularly in the development of the government securities market.

In the late 1980s and 1990s, the Bank's involvement in development finance and rural credit declined as other institutions developed to deal with these areas. The involvement in directing credit was also phased out, giving greater flexibility to commercial banks and development banks to determine their lending policies. The provision of refinance using CBSL resources was terminated in view of the market distortionary nature of such refinance.

The critical importance of financial sector stability for sustainable economic development and growth has become more evident over the years. CBSL has therefore strengthened its functions as the institution responsible for financial sector stability. A two pronged approach has been adopted in this regard. On the one

Box 2 (Contd.)

Table 1 – Departments and Their Functions

Year of Establishment	Department	Function
1950	Banking Department	Price Stability
1950	Economic Research Department	Price Stability
1950	Exchange Control Department	Other
1950	Public Debt Department	Other
1950	Secretariat Department	Support
1951	Bank Supervision Department	Financial Sector Stability
1958	Employees' Provident Fund Department	Other
1964	Management Audit Department	Support
1967	Establishments Department	Support
1974	Development Finance Department	Development Finance
1977	Currency Department	Other
1978	Statistics Department	Price Stability
1979	Premises Department	Support
1980	Information Department	Support
1981	Rural Credit Department	Development Finance
1981	Centre for Banking Studies	Support
1981	Information Technology	Support
1981-85	Regional Offices	Development Finance
1986	Training	Support
1987	Sri Lanka Automated Clearing House	Other
1988	Department of Supervision of Non-Bank Financial Institutions	Financial Sector Stability
1988	Banking Development Department	Financial Sector Stability
1990	Welfare Department	Support
1992	Security Services Department	Support
1997	Financial Markets Department	Development Finance
1997	New Buildings Department	Support
1999	Legal Department	Support

hand, the Bank reduced its direct controls and encouraged market growth, often being closely involved in the development of new institutions and instruments. On the other, it strengthened its supervisory and regulatory role, both by enhancing its own competence in these areas and by assisting in the creation of a legal framework that would be conducive to orderly development of the financial market.

Over the past fifty years, the Central Bank has occupied a vital place in the financial and economic structure of Sri Lanka. Its role has evolved and changed as the needs of the country and the economic conditions world-wide altered. As it moves into the future further changes are likely. The world-wide experience in the past few decades has been that central banks can best serve their countries by concentrating on maintaining price stability and ensuring stability in the financial sector. Hence, the objectives of the Central Bank will focus more closely on maintaining domestic price stability and the stability of the financial sector, even though the need to have regard to overall economic development will not be ignored. Monetary policy will be more active, and increasingly implemented through market based instruments. As the exchange rate has been floated, monetary policy will be better able to focus on domestic price stability. The supervisory and regulatory framework will be strengthened to ensure that financial sector stability is preserved and Sri Lanka's financial institutions are able to compete at a global level by meeting international prudential norms.

surveillance system also came into being during the year. The surveillance will ensure that these institutions operate in a sound and efficient manner.

With regard to capital market reforms, in terms of administrative changes, some significant changes to the listing rules and internal systems and procedures relating to listings on the Colombo Stock Exchange (CSE) took place in 2000. A major change implemented related to the removal of merit based listing rules in favour of a disclosure-based approach in evaluating listing applications. Steps have also been taken to reduce the cost of listing significantly. These changes are expected to make the CSE more efficient.

Reforms have also been initiated in education and health services. The implementation of reforms in the health sector, based on the recommendations of the Presidential Task Force on Health, commenced in 1998 and progressed well in 2000. Meanwhile, the private sector involvement in providing health care facilities continued to expand in 2000. Out of 17 hospital projects that had been approved by the BOI, 3 major hospital projects have already taken off the ground and are at various stages of development. Educational reforms, encompassing all areas of primary, secondary and tertiary education, have been introduced to improve the quality of education and prepare students to meet emerging new demands in the labour market.

Sri Lanka, like many other developing countries, is progressing on the path of globalisation by gradually removing barriers to trade and investment, while establishing necessary regulatory and supervisory mechanisms and implementing measures required to ensure stability. The process of global integration of product and factor markets is not new and has become an inevitable part of economic development in the modern era. Throughout most of its history, Sri Lanka has been an important part of the international trade network. Globalisation benefits countries mainly by allowing access to a global consumer base and resources. It benefits small countries like Sri Lanka, as they can gain from economies of scale in production, facilitated by access to large markets. It also allows countries to identify inefficient economic activities and replace them with more productive activities. However, to reap the full benefits of globalisation and to avoid its harmful effects, a country should implement a wide range of regulatory and supervisory measures, such as financial sector regulation and supervision, anti-trust legislation incorporating measures against dumping and predatory pricing and other internationally recognised measures such as action against money laundering. At the same time, excessive resistance to the process of globalisation will marginalise countries, retarding economic development and causing them to lag behind countries that have succeeded in integrating themselves with globalisation.

1.2 Output

After slower growth in 1998 and early 1999, GDP, in real terms, grew by 6 per cent in 2000 benefiting from improved resilience in the economy resulting from improved macroeconomic management, structural reforms and a more favourable external economic environment. GNP, defined as GDP adjusted for net factor income from abroad, grew by 5.8 per cent compared with 3.8 per cent in 1999. This growth rate is noteworthy as it was achieved in the midst of several hostile events, which affected economic activity adversely. The first was the sharp rise in international oil prices which raised the import bill of crude oil and petroleum products by about Rs.30 billion (US dollars 400 million), i.e., 12 per cent of the total import bill or 17 per cent of total export earnings. The second was an increase in defence expenditure of Rs.21.9 billion over the original budgetary estimate for 2000 due to the escalation of the war, from the middle of the year. This expanded defence related imports by about Rs.15 billion (US dollars 200 million). Thirdly, unusually low rainfall in the catchment areas reduced the hydropower generation increasing the dependency on costly thermal generation. Fourthly, the delay in the privatisation process due to depressed international market conditions in the telecommunication industry compelled the government to resort to higher domestic borrowing than expected under the original budgetary estimates.

GDP at current market prices rose by 13.5 per cent to Rs.1,256 billion in 2000, while GNP rose to Rs.1,234 billion. With a mid year population of 19.36 million, this indicated an increase of 11.3 per cent in per capita GNP to Rs.63,752 (US dollars 841) in 2000 from Rs.57,256 (US dollars 813) in 1999. When adjustment is made for price increases, per capita national income rose by 4.6 per cent in real terms in 2000, further improving the average living conditions of Sri Lankans.

The economic recovery was reflected in all major sectors, particularly in the expansion in export oriented agricultural and manufacturing sectors and related support services such as trade, transport and utilities. On the production side, the largest growth contribution came from the expansion in Services sector (61 per cent), followed by Manufacturing (26 per cent) and Agriculture (6 per cent). Consequently, the shares of the Services and Manufacturing sectors in GDP rose to 54 per cent and 17 per cent, respectively, while the share of the Agriculture sector declined to 21 per cent.

Agriculture

Agriculture sector output performance was mixed in 2000. Tea and coconut production increased to new record high levels, but the output of rubber, paddy and certain other field crops dropped. Reflecting the net impact of these diverse developments, the overall growth rate of the Agriculture sector decelerated from 4.5 per cent in 1999 to 1.8 per cent in 2000, the lowest since 1996.

Continuing the upward trend since 1993, tea production rose to a new record level of 306 million kg in 2000, surpassing the 300 million kg mark for the first time. This was mainly an outcome of favourable weather conditions, increased fertiliser application and favorable tea prices in the wake of a drop in production in Kenya and recovery in demand from Russia/CIS countries and the Middle Eastern markets. The outcome was encouraged by the improvement in tea prices, the annual average price at the Colombo Auctions improving by 18 per cent to Rs.135.53 per kg, continuing the upward trend started in mid 1999.

Production increases in all three elevational categories contributed to the improved performance, but the main contribution came from the low elevation category. The smallholder sector, accounting for 60 per cent of total output, recorded a 12 per cent growth over 1999, compared with a 2 per cent growth in the production under regional plantation companies. The average yield per hectare in the smallholdings sector (2,216 kg) is almost close to double the average yield in the larger scale plantation sector under management companies. These significant differences indicate the potential for improving productivity in the plantations under the privatised regional management companies, particularly by reinvesting the current surpluses, generated by apparently cyclically high prices in the international market, to improve productivity.

The volume of tea exports in 2000 increased by 7 per cent to 288 million kg, making Sri Lanka the world's largest tea exporter for the fourth consecutive year. Russia continued to be the largest buyer of Sri Lankan tea, while UAE, Syria and Turkey were other leading buyers. Bulk tea exports accounted for 63 per cent of total tea exports, while the share of value added tea exports remained at 37 per cent, indicating the potential for further improvement of export earnings from value added tea exports.

Despite an improvement in prices during the latter half of 2000, rubber output declined by 10 per cent, reaching the lowest production level reported during the last 50 years. The depressed prices that prevailed in the recent past have had a negative impact on maintenance and fertiliser application and even led to the abandoning of tapping in marginal lands, where, as reported, even the cost of tapping could not be recovered. Meanwhile, growing demand for rubber trees as timber and lands for real estate development has reduced the extent under rubber cultivation. However, the domestic consumption of rubber in the industrial sector continued its upward trend, reaching 63 per cent of domestic rubber production in 2000. Rubber exports as intermediate goods declined by 23 per cent in 2000 due both to a production decline and increased domestic demand from the rubber-based manufacturing sector, while the international rubber prices remained low due to poor demand. During the year, there have been some attempts by Thailand, Malaysia and Indonesia to arrest deteriorating international rubber prices.

Coconut production, which increased by 8 per cent to reach 3,055 million nuts in 2000, was the best output ever on record. Apparently, favorable weather conditions and high price expectations led to increased fertiliser application in 1999, which caused this record output. Predictably, however, the increased supply and a decline in world edible oil prices, together with the capacity limitation of domestic coconut oil and desiccated coconut (DC) industries, caused a steep drop in prices. Almost all DC mills operated at full capacity recording a 32 per cent increase in production, while coconut oil production rose by 27 per cent in 2000. However, export earnings in dollar terms declined by 9 per cent, despite an overall increase in export volume by 31 per cent.

Paddy production decreased marginally in 2000, despite an increase in yield, due to a decline in extents sown and harvested. The increasing trend in the average paddy yield continued for the fourth consecutive year, largely due to an increase in extent sown and harvested in irrigated areas where the average yield is higher. Farmers continued to face difficulties in marketing their paddy not only due to seasonal price declines, but also as a result of the rice imports under a lower tariff that prevailed during the latter part of 1999. The seasonal paddy prices threatened to decline sharply, compelling the government to intervene in the market through purchases by semi-government co-operative organisations. Evidently, the depressed prices that prevailed during the Maha harvest (early 1999) discouraged the application of fertiliser.

Other agricultural crops displayed a mixed performance. Of the export oriented crops, pepper, cocoa and cinnamon recorded increases in output 2000, while others such as coffee and cloves, recorded production declines. The production of these minor export crops has increased considerably in recent years and their export earnings have exceeded the combined earnings from coconut and rubber exports since 1999.

Meanwhile, among subsidiary food crops, potatoes and ground nuts showed higher output levels while the production of big onions, chillies, black gram, green gram, sesame and maize decreased. However, vegetable and fruit production increased by about 5 per cent in 2000, considerably moderating the pressures on the cost of living. Exports of vegetables and fruits have been expanding in the recent past, encouraged by the emergence of new wholesale markets and widespread price dissemination, which enable producers to obtain more remunerative prices. Commercial scale cultivation is at present limited to a few varieties such as gherkins, pineapple, banana and rambutan. Exports may be encouraged by efficient forward contracting. Schemes for forward selling produce have been introduced and are reported to be gaining in popularity. A major problem is the high percentage of losses during post harvest handling (as high as 40 – 50 per cent in the case of vegetables and fruits). The government has set up an Institute called the Institute of Post Harvest Technology (IPHT) at Anuradhapura to carry out research and develop new technologies to minimise such losses. However, it may be useful to encourage the private sector to engage itself in developing good practices of post harvest handling of produce. Another serious problem is the relative scarcity of high quality seed for almost all crops. The discontinuance of the government regulation of the seed industry and the privatisation of government seed farms are welcome, but the nascent private activity may need to access high cost modern technology of commercial seed production.

Manufacturing

The output of the Manufacturing sector grew by 9.2 per cent in 2000, compared with 4.4 per cent in 1999, benefiting from favorable external sector demand, conducive domestic economic conditions and policies, application of modern technology and improved management. The growth of industrial output during the first three-quarters of the year was as high as 12.5 per cent, but moderated to 6.7 per cent in the last quarter of the year. It is noteworthy that the output of factory industries, which grew by 11 per cent, accounted for 81 per cent of the manufacturing sector output and for 23 per cent of the overall economic growth in 2000. The processing of tea, rubber and coconut recorded a modest growth of 4.2 per cent, despite a record output of tea and coconut, owing to a contraction in the rubber processing industry and capacity limitation in coconut processing. It is tentatively estimated that the small industries sector recorded an expansion of 5.5 per cent during the year.

The main contributors to the healthy industrial sector growth were the export-oriented industries led by the apparel and textile industry, which grew by 16.2 per cent in volume terms and contributed 59 per cent of the industrial sector growth in 2000. The export prices of garments, as reflected in the average customs values, have increased by 5.3 per cent, reflecting the increasing share of high value added non-quota exports. Exporters were able to expand their customer base in international markets and obtain more orders with improvements in information technology, modernised equipment and streamlined quota allocation.

Industries catering mainly to the domestic market showed a mixed performance with higher output in soft drinks, milk products, processed meat, biscuits, hard liquor, petroleum, chemicals, fabricated metals, building materials, and soap and detergents. Meanwhile, increased consumer spending, together with active advertising, attractive packaging, improved quality and improved distribution and marketing increased the domestic demand for these products. However, the output of sugar, tobacco products, PVC products, batteries and metal products declined in 2000, owing to a variety of causes. High taxation and growth of unofficial competing markets dampened prospects for beer and tobacco products. Many others were adjusting to increased foreign and local competition.

In an increasingly competitive environment, adoption of modern technology appears to have improved the competitive edge of many local industries. The fiscal incentives offered under the Advanced Technology Programme have encouraged industrialists to modernise their production processes. A lower incidence of strikes and work stoppages, uninterrupted electricity supply and improvement of industrial infrastructure also helped manufacturers to expand their output and reduce costs. They also benefited from sub-contracting, out-sourcing parts of production, improved management of working capital under high interest costs, reduction of wastage, re-use of waste materials and use of energy saving methods.

On the policy front, the government continued to encourage private sector export oriented industries by widening access to foreign markets and developing infrastructure facilities. The removal of quota restrictions for apparel exports to the European market from January 2001 and the Indo-Lanka Free Trade Agreement have opened up vast markets, which await exploitation.

Infrastructure and Services

Government continued to invest heavily in economic infrastructure such as transport, energy, and communication, although the investment fell short of expectations during 2000, owing to a curtailment of capital expenditure to accommodate increased security related expenditure. Meanwhile, the government encouraged private sector participation in infrastructure projects. The private sector has been responding favourably, expanding its involvement in infrastructure development, particularly in the areas of power generation, port development, telecommunications, transportation, health and housing construction. The possibility of private sector participation in the water sector is also under consideration.

Passenger transport mileage increased with the help of an increase in the fleet of buses and 15 new diesel multiple units added to the railways in 2000. With the acquisition of three new aircraft, the performance of the SriLankan Airlines continued to improve, despite the slowdown in tourist arrivals. Sri Lanka Railways improved its scale of operations, but continued to incur large losses, exacerbating the fiscal deficit. This clearly indicates the necessity of implementing the long overdue railway reforms, including a fare increase, which is linked to service improvement. Longer term reforms will have to consider the viability of service lines, which may be facilitated by private sector participation. The construction of the long awaited Colombo-Katunayake expressway commenced in 2000. The government is keen to commence the construction of several key expressways such as the Southern highway (Colombo – Matara) and the Colombo – Kandy highway. Completion of the proposed circular by-pass highway around Colombo could greatly ease the growing road congestion in the capital city.

Electricity generation grew by 11 per cent, consequent on increased investment in the power sector and an annual average increase in demand of about 10 per cent. Capacity in power generation expanded by 5 per cent to 1,779 MW with the commissioning of the first 60 MW barge mounted power plant and installation of the 21 MW Lakdhanavi II thermal power plant. Consequently, dependence on hydro-power dropped further to 65 per cent, reducing the vulnerability of power generation to vagaries of the weather, but raising the cost of generation. Growing system losses, which are now as high as 22 per cent, heavy losses of the

CEB, risks of power cuts due to poor rainfall and distortionary cross-price subsidisation indicate the need for urgent power sector reforms. In this context, the envisaged reforms consisting of unbundling of power generation, transmission and distribution, improvements in procurement systems, introduction of an automatic price (tariff) adjustment system and the development of efficient regulatory systems would be helpful. The resolution of conflicts between power generation and protecting the environment, on the basis of an acceptable level of pollution, could also help prevent power shortages.

Large losses in the Petroleum Corporation has raised its outstanding debt to about Rs.25 billion at the end of 2000. This indicates the necessity of introducing petroleum sector reforms, including the introduction of an automatic price adjustment mechanism in order to respond to international oil price changes in a timely manner. The liberalisation of the petroleum industry to improve competition and minimise waste and costs would not only help consumers but also encourage new investment in areas such as bunkering.

A massive improvement has taken place in telecommunication services since the liberalisation of the telecommunications sector. The strong growth in the telecommunications sector was supported by the competition from private sector operators and the partnership of Sri Lanka Telecom with Nippon Telegraph and Telephone (NTT) of Japan. The subscriber base of telephone services, including mobile telephones, exceeded one million in 2000, further increasing the telephone density in the country to 6.3 per 100 persons. Meanwhile, improvement and modernisation of telecommunication technologies and introduction and expansion of new services such as Internet, e-mail and video-conference facilities not only increased available services to customers, but also improved the quality of communication services. By end 2000, there were 37 telecommunication system operators, including 3 companies providing fixed access telephone facilities and 4 companies providing mobile services, enhancing competition in the sector.

In view of tremendous developments in international communications in recent years, it is of paramount importance for Sri Lanka to modernise its systems to the best international standards, if it wishes to develop a service centre for the region, in the country. Hence, national operators should enter into partnership with big international players in the field. The regulatory system should establish a level playing field for investors and users, and protect the consumers.

The supply of pipe borne water by the National Water Supply and Drainage Board expanded further in 2000, when several new water supply schemes were completed, increasing the number of connections by 77,574 (29 per cent) to 582,600 and the total volume of water produced by 5 per cent to 331 million cubic meters. However, there still exists a large unmet demand for pipe borne water as demand increases with population expansion, urbanisation and expansion of industries and commercial activities. The central objective of the national policy on water supply is to ensure access to safe drinking water for all residents by 2010, at present available only to two thirds of the population. This requires an investment of about Rs.85 billion. Therefore, in order to mobilise adequate financial resources, measures are necessary to attract long-term multilateral funds, encourage private sector investment in the water sector and reduce the proportion of non-revenue earning water (water unaccounted for) production, which is presently as high as 35 per cent.

The post office network expanded further in 2000, with special attention paid to providing new services and development of services in the plantation sector. The postal shop concept, to sell other consumer products as well in post offices, which commenced in 1999 as a pilot project, appears to have succeeded and could be further expanded to improve financial viability. Continuing operational losses of the postal service, competition emerging from new developments in telecommunications and the well known inefficiencies in the postal service clearly indicate the need for early reforms.

Growth in port services slackened in 2000 in the face of stiff competition from neighbouring ports, which resulted in decreased vessel traffic arriving at the Port of Colombo and reduced transshipment activities. The total number of vessels that arrived at Colombo, Galle and Trincomalee ports declined by 2 per cent to 4,232 in 2000, while transshipment handling also dropped at the same rate. However, container handling at the Colombo Port increased slightly due to expansion in domestic container handling with increased external trade. Several port development projects under the public investment programme were in progress during 2000 to expand capacity and facilities at the Colombo, Galle and Trincomalee ports. Meanwhile, rehabilitation of the Queen Elizabeth Quay (QEQ) by South Asia Gateway Terminal (Pvt) Ltd. was in progress and two berths are yet to be completed in 2001. Improvement in efficiency and quality of port services is not only necessary to retain existing customers and attract more ships, but also to reduce delays and costs to producers and exporters.

Education and health sector activities expanded further in 2000, while sectoral reforms continued. The number of government hospitals increased by 20 to 578, mainly due to acquisition of plantation hospitals during the year, while 14 more hospitals were improved under the regional hospitals development programme. New recruitment of doctors and nursing staff further strengthened the public health sector. Private sector involvement in providing health

Box 3

Tertiary Education in Sri Lanka : Issues, Reforms and Prospects

The promotion of tertiary education to explore new frontiers of knowledge and match labour market requirements is essential in achieving long-term development and social objectives such as economic growth, employment opportunities, higher income and overall improvement of quality of life. The direction and outcome of the tertiary education system in Sri Lanka over the years has not kept pace with the open market economic policies initiated in late 1970s. The antiquated education system, in the context of new needs posed by rapid globalisation, has further eroded the competitiveness of the country's labour force. As such, Sri Lanka's tertiary education system has to be re-oriented to meet the challenges of knowledge based future economic development. Knowledge, skills and talent will be crucial factors for growth in the future, while innovation and willingness to change will be the driving forces. The tertiary education system, therefore, needs to be re-structured, incorporating modern quality standards, improving access to modern learning techniques, introducing market oriented study programmes and expanding opportunities available, in line with labour market requirements.

The tertiary education sector in Sri Lanka consists of university education and technical education and vocational training (TEVT). The university education system, a monopoly of the government, consists of 13 universities inclusive of an open university. A regulatory authority set up by the government, the University Grants Commission (UGC), selects students for entry into each university, and sets academic standards and policy with respect to university education in the country. Admission to university education is severely competitive. Annually, out of the total number of students (about 183,000) who sit for the G.C.E.(A/L) examination, about 50 per cent become eligible to enter a university. However, no more than 16 per cent of the students, who become eligible, are admitted. From Year 1 entrants to schools of any age cohort, no more than 2 per cent enter a university 13 years later. The competitiveness has adversely affected the expectations of average students.

The TEVT sector consists of technical colleges and vocational training institutions owned and operated by the government and fee levying private sector institutions. Training institutions under the purview of the government provide specialised training in sector specific skills, while private sector institutions cater to market needs by fulfilling training requirements in demand driven fields. A considerable number of early school leavers and students, who do not gain admission to universities, seek training in the TEVT sector.

The existing university education system in Sri Lanka has not been able to provide the country with a work force ready to face the challenges of a dynamic, market oriented economy. The inability to match modern industry skills and trends in economic and industrial development have shut off job and income opportunities for a substantial number of persons. Courses and programmes directed at government employment, which is being downsized at present, have exacerbated the problem. A high unemployment and under employment rate among university graduates points to a mismatch between supply and demand conditions for graduate employment, reflecting a supply driven education system with little relevance to labour market conditions.

A number of reasons can be cited for the deficiencies in the present tertiary education system. With regard to university education, full-time degree courses still remain a highly restricted and centralised public sector monopoly. The transmission of knowledge is mainly by traditional teaching methods and courses. The uniform curricula, syllabi and teaching materials used do not cater to present day industrial requirements while lagging behind international developments in science and technology. Standards demanded by industry are gradually increasing both here and abroad. Moreover, as prices have played a very minor role in the provision of tertiary public education services, the resort to budgetary financing as a means of funding university education has resulted in restricting opportunities and reducing the quality of the service provided. The intense competition for scarce government resources has led to the under-financing of this sector. The quality of the TEVT education sector is also being questioned with regard to the relevance of the curricula for demand driven courses.

The government has initiated far-reaching reforms in university education with a view to restructuring and developing the existing public sector tertiary education system. On going reforms aimed at improving the quality of teaching and research include curricula reform and staff development. Curriculum reforms include the introduction of course units and modular systems with a view to giving more flexibility in the choice of courses for students, and the introduction of new degree courses which are demand oriented. Moreover, the mode of assessment is also being changed from end year examinations to continuous assessment. Improvements to staff development are being met with the provision of orientation courses in teaching and learning methodologies to probationary lecturers and refresher courses for other teachers. Meanwhile, facilities for career guidance and counseling are being encouraged

Box 3 (Contd.)

with a view to developing university - industry linkages. Reforms with respect to university financing centre around fund raising activities and revenue generation from non-government sources. Reforms in the area of expansion of university education focus on increasing the number of universities and expanding intakes to universities. Meanwhile, universities are also expected to come up with corporate plans indicating the way forward. Reforms in the TEVT sector are also being implemented with a view to improving the quality of courses and the training provided. Private sector participation in TEVT has been emphasised in the reform agenda.

The most recent initiatives announced by the government in its proposed 'Tertiary Education Strategy' give a further impetus to reforming the tertiary education system.[1] As part of its unfinished agenda for policy reform, the government is expected to give passage to a new Universities Act. In its broadest terms, the new Universities Act envisions the ultimate goal of producing a well-informed graduate equipped with problem solving capabilities required by the changing environment and new skills demands.[2] More specifically, the objectives of the proposed new Universities Act revolve around improving the quality of education, decentralising admissions policy, increasing access to information technology, reducing the reliance on state funding to incorporate other non-government sources of financing and further strengthening industry - university linkages by providing incentives for private sector participation in post-secondary education and encouraging industry participation in almost all aspects of tertiary education. It is also proposed to develop a master plan for university reforms incorporating a shared vision and mission between stakeholders to tertiary education reform i.e., students, faculty, administrators, government and industry.

Budgetary constraints in the future will necessitate extensive changes to the tertiary education system. New avenues of financing university education on a cost recovery basis should be sought to replace traditional sources of financing. A key area in this regard would be to harness and encourage the private sector to mobilise resources for development of the tertiary education system. However, opportunities for private sector participation in university education are still minimal. Although there are provisions in the existing Universities Act No. 16 of 1978 to recognise degree courses conducted by private sector institutions, the process involved is tedious and procedures not clear. So far, only a few private institutions have been given degree awarding status for the conduct of some particular courses. In the circumstances, several private institutions at present conduct courses in collaboration with foreign universities for students to earn degrees from foreign universities. Such private post-secondary education institutions are growing at a rapid pace without any clear policies or incentives from the government. This situation suggests that there is an unfulfilled compelling demand for private sector tertiary educational institutions.

Gains from allowing private sector institutions in tertiary education are many. International experience with university education suggests that competition among public and private sector universities leads to the development of the entire education system. The quality of education and training will be improved through competition between private and public institutions. Labor market requirements will be met through a demand driven education system. Opportunities for under privileged groups could be increased with savings generated from private sector participation being used to increase assistance to the most needy students. The government should decide on a maximum number of universities that would be in the public sector and allocate resources to maintain such institutions at an optimum level. In addition, performance based financial assistance could be obtained from international funding agencies to develop such institutions, making Sri Lanka an important learning centre in South Asia.

Changing state ownership of the tertiary education system is not an easy task. Private sector universities have been the cause of wide ranging disputes between the government and several interest groups. These differences could be minimised with awareness programmes, continuous dialogue and compromise. Ongoing discussions in the media on this issue are an excellent move to understand the importance of private sector institutions in the provision of tertiary education in the country. New policies should be presented for public discussion within and out of Parliament. Such open debate will help form public opinion on this issue and provide confidence to the general public on the proposed reforms.

The way forward therefore would be for the government to open up tertiary education to the private sector by gradually relaxing existing rigid regulations and offering an appropriate incentive package. At the same time, a regulatory framework should be established to ensure standards, quality and accountability in the new entities and to promote a competitive environment between government and private sector institutions. The existing public tertiary education system should also be improved with ongoing and proposed reforms aimed at quality improvements, expanding the availability of opportunities for higher education and ensuring that labour market demands are met by the education system.

1 Advancing Knowledge and Skills for Development and Competitiveness: The Tertiary Education Strategy, Development Forum - Paris 2000.

2 Presidential Task Force on University Education (1998)

Chart 1.3
Investment and Savings

Chart 1.3.1
Domestic Investment

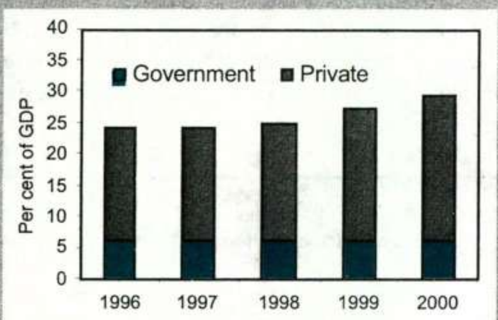
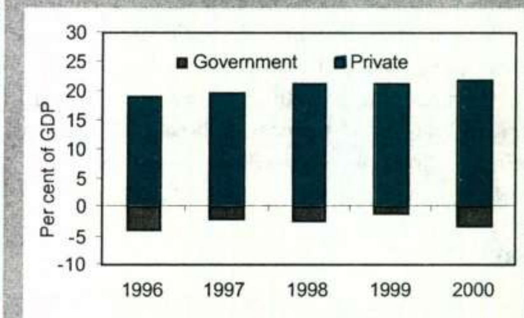


Chart 1.3.2
Domestic Savings



care facilities continued to expand. Completion of 3 private hospital projects in 2000, out of 17 BOI approved hospital projects, which are in the construction stage, will further augment private sector health facilities.

The construction sector recorded a 4.8 per cent growth rate in 2000, the same rate as in 1999, mainly attributed to the increase in investment on infrastructure development. The performance of the state sector housing programme indicated a slowdown in 2000 when compared with the previous year, while housing construction undertaken by the private sector expanded. Supported by the demand stimulated by construction activities, the quarrying sector grew by 5 per cent, increasing the growth rate of the Mining and quarrying sector from 4.1 per cent in 1999 to 4.8 per cent in 2000.

1.3 Investment and Savings

The savings-investment gap as a ratio of GDP, which increased from 1.8 per cent in 1998 to 3.8 per cent in 1999, widened further to 6.6 per cent in 2000. This was a net outcome of increased investment by 0.8 per cent of GDP by the private sector and a decline in national savings by 2.1 per cent of GDP due to increased dissavings by the government.

Gross domestic capital formation, which grew by 6.4 per cent in real terms in 1999, increased further by 9.5 per cent (at 1996 prices) in 2000, raising investment as a ratio of GDP to 28 per cent. Private sector investment, including public corporations, which accounted for 89 per cent of total investment, recorded a high growth rate of 11 per cent (in real terms) compared with 2.5 per cent growth in government investment in 2000. Both private sector and public sector major investment projects focussed mainly on the expansion of infrastructure facilities such as energy, telecommunications, ports and transport. Net foreign private direct investment inflows continued to support expansion of domestic investment.

Developments in savings were mixed in 2000. Private savings increased, benefitting from high disposable income and attractive real interest rates. However, public sector dissavings increased due to fiscal slippages and delays in adjustment of administered prices to cover the cost of products in major public corporations. Consequently, domestic savings as a percentage of GDP, declined from 19.5 per cent in 1999 to 17.3 per cent in 2000. National savings amounted to 21.4 per cent of GDP in 2000, mainly due to high inflows of private remittances. A turning around of public sector dissavings into savings is necessary to increase overall domestic savings to finance the high investment required to accelerate economic growth.

1.4 Prices

Despite increased domestic production of many varieties of food items, the inflation rate, which decelerated in 1998 and 1999, increased in 2000, mainly due to high import prices and increased administered prices. Both CCPI and GDP deflator registered higher increases in 2000, than in 1999. The annual average increase of CCPI rose from 4.7 per cent in 1999 to 6.2 per cent in 2000, while the 12-month increase, on a point-to-point basis, rose to 10.8 per cent by December 2000, reflecting higher price increases during the second half of the year. Similarly, the change in the GNP deflator increased from 4.4 per cent in 1999 to 6.7 per cent in 2000.

As monetary expansion was contained at a level compatible with the increase in nominal income in 1999 and 2000, there was no pressure for significant demand fuelled inflation. Sharp increases in domestic petroleum product prices as a response to high international prices, subsequent upward adjustments in electricity and transport prices and higher prices of imported food items were the major contributory factors for the high increase in CCPI. All domestic petroleum prices were raised in a number of steps in 2000 in order to adjust domestic prices for high international prices; diesel by 86 per cent, kerosene by 77 per cent, furnace oil by 100 per cent and liquified petroleum (LP) gas by 52 per cent. Consequently, bus fares and electricity tariffs were raised by 15 and 6 per cent, respectively, to cover high fuel costs.

1.5 Wages

Wages in both public and private sectors were raised in 2000, partly as a response to the increasing inflation rate. In the public sector, employees earning less than Rs.12, 000 per month received an interim allowance of Rs.600 per month with effect from August 2000. A non-pensionable interim allowance of 10 per cent of the salary for all public officers, subject to a minimum of Rs.1,000, was granted with effect from October 2000. The interim allowance of Rs.600 was incorporated into this 10 per cent increase. These revisions resulted in nominal wage increases ranging from about 7.4 per cent to 9.4 per cent and real wage increases of between 1.0 to 2.8 per cent in the public sector in 2000.

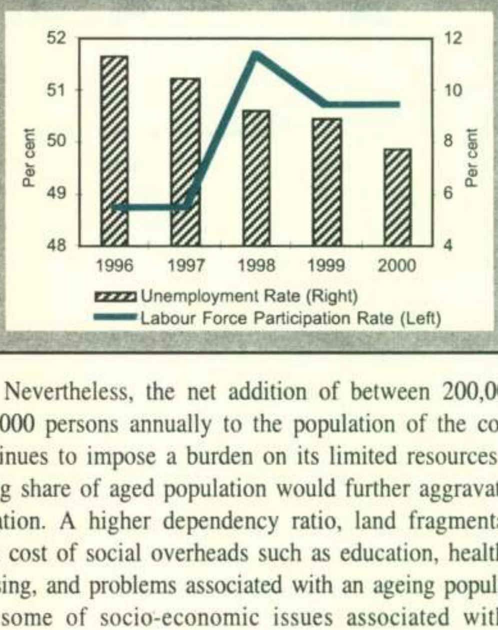
Nominal wages in the formal private sector were revised upward in 2000 at different rates for different employee categories. Consequently, as measured by the changes in minimum wages for private sector employees under the Wages Boards, nominal wages rose by 2.3 per cent, which is lower than the annual average inflation rate of 6.2 per cent. Real wages under the Wages Boards deteriorated in 2000 at a rate between 2.7 to 5.7 per cent for different categories. However, changes in minimum wages alone may not necessarily represent changes in total wages accurately, as adjustments are also made in other allowances. In contrast, in the informal sector, wages increased in real terms, as nominal wages increased at higher rates than the inflation rate.

The rising inflation rate, coupled with recent upward adjustments of prices for certain essential food and non-food consumer items, could encourage labour unions to press for wage hikes. However, restraining full accommodation of price increases, i.e., avoiding allowing their full pass-through, is crucial to prevent the country entering into a potential vicious circle of wage-price increases.

1.6 Population, Labour Force and Employment

The mid year population in 2000 is estimated to be 19.36 million showing an increase of 1.7 per cent compared with a 1.4 per cent increase in 1999. This increase was due to both natural increase and net migration in 2000. However, according to the World Development Report 2000, the average annual population growth in Sri Lanka was well below that of most countries in the South Asian region due to the demographic transition, and improvements in other socio-economic conditions that have taken place in recent years.

Chart 1.4
Labour Force Participation and Unemployment Rate



Nevertheless, the net addition of between 200,000 to 300,000 persons annually to the population of the country continues to impose a burden on its limited resources. The rising share of aged population would further aggravate the situation. A higher dependency ratio, land fragmentation, high cost of social overheads such as education, health and housing, and problems associated with an ageing population, are some of socio-economic issues associated with the current structure and trend in population, which need the attention of policy makers.

According to the Quarterly Labour Force Survey conducted by the Department of Census and Statistics, the labour force at the end of the third quarter of 2000 was estimated at 6.7 million, showing a labour force participation rate of 49 per cent. The share of employment in labour force continued to increase, reaching 92 per cent in 2000 compared with 84 per cent in 1990. The private sector remained the major contributor to employment generation as its economic activity grew faster. Manufacturing, agriculture, trade and hotels, finance, insurance and real estate and construction were the major areas of employment generation. According to the Board of Investment of Sri Lanka (BOI), about 41,000 new employment opportunities were generated through BOI approved projects in 2000.

Employment in the public sector increased in 2000 by about 36,000 (3.2 per cent) mainly due to recruitment of university graduates and increases in Samurdhi workers, defence personnel and teachers. Meanwhile, employment in semi-government institutions increased marginally by about 1 per cent to around 300,000 in 2000. However, the share of public sector employment in total employment further decreased to 13.6 per cent in 2000 from 14.4 per cent in 1999. This declining trend in public sector employment is attributed to faster growth in employment opportunities in the private sector and on-going restructuring programmes in public sector institutions.

The unemployment rate, which had declined from 15.9 per cent in 1990 to 8.9 per cent in 1999, further declined to 7.7 per cent in 2000. The female unemployment rate still remains higher than the male unemployment rate, but it is declining at a somewhat faster rate. Unemployment was high among youth with higher education, reflecting the need for educational reforms.

Foreign employment placements secured through registered sources were around 166,000 in 2000 compared with around 178,000 in 1999, reflecting a temporary slow down due to two Ramazan festival periods in 2000. The Sri Lanka Bureau of Foreign Employment (SLBFE) has continued to provide a number of support facilities for registered migrant workers and their families. The share of employment placements through licensed agents increased to 76 per cent in 2000 compared with 68 per cent in 1999.

1.7 Fiscal Policy, Budgetary Operations and Public Debt

In line with the recent fiscal policy strategy aimed at improving macroeconomic stability, increasing investment and savings in the economy, promoting employment and alleviating poverty, the Budget 2000 was designed to further consolidate the fiscal improvements achieved in the recent past. Accordingly, it was envisaged that the current account

TABLE 1.4
Summary of Government Fiscal Operations
(As a percentage of GDP)

Item	1980	1985	1990	1995	1998	1999	2000(a)
1 Revenue	19.6	22.3	21.1	20.4	17.2	17.7	16.8
2 Expenditure and net lending	41.8	34.1	31	30.5	26.3	25.2	26.7
Current expenditure	18.5	20.1	22.3	23.1	19.6	18.7	20.3
Security	1.3	4.5	4.1	6.5	5.0	4.4	5.6
Interest	3.4	4.6	6.4	5.7	5.4	5.6	5.7
Wages(b)	4.5	3.6	3.9	3.4	3.0	3.0	3.2
Subsidies and transfers	8.4	5.5	6.5	6.1	4.6	4.2	4.2
Other	0.9	1.9	1.4	1.4	1.6	1.4	1.6
Capital and net lending	23.3	13.9	8.7	7.4	6.7	6.5	6.5
Public investment	18.5	13.8	8.3	7.9	6.7	6.5	6.4
Aquisition of real assets	7.9	4.5	3.7	3.4	3.2	3.0	2.6
Capital transfers	9.4	8.6	2.3	2.9	2.2	2.5	2.6
On lending	1.2	0.6	2.2	1.7	1.4	1.0	1.1
Other	4.7	0.2	0.4	-0.5	-	-	0.1
Restructuring cost	0.0	0.0	0.0	0.5	0.4	0.4	0.3
Other	4.7	0.2	0.4	-1.0	-0.3	-0.4	-0.2
3 Current account balance	1.1	2.2	-1.2	-2.7	-2.4	-1.0	-3.4
4 Overall deficit before grants and excluding privatisation	-22.2	-11.7	-9.9	-10.1	-9.2	-7.5	-9.9
5 Financing	22.2	11.7	9.9	10.1	9.2	7.5	9.9
Foreign financing	9.2	6.4	5.7	4.5	1.7	0.7	0.4
Loans	5.3	4.4	3.6	3.2	1.0	0.1	0.0
Grants	3.9	2.0	2.1	1.4	0.7	0.6	0.4
Domestic financing	13.0	5.3	4.2	5.1	7.1	6.8	9.4
Banks	9.8	2.9	0.1	1.1	1.9	2.4	4.3
Privatisation	0.0	0.0	0.0	0.4	0.4	-	[illegible]
Memorandum items :							
Total wage bill	5.0	4.2	4.9	5.2	5.3	5.3	5.5
Gross defence expenditure (c)	1.3	4.5	4.1	6.5	5.6	4.9	6.1

Source: Ministry of Finance and Planning

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

deficit would be turned around to a surplus and the overall fiscal deficit would be contained by augmenting revenue and containing expenditure, with a view to reducing domestic borrowing.

However, the achievement of fiscal targets expected in the Budget 2000 was made extremely difficult by an increase in defence expenditure due to the unexpected escalation of the war, unfavourable conditions in the international market for the telecommunications industry and high oil prices in the international market. Consequently, despite some additional corrective measures being taken, a marked deterioration in the fiscal situation was witnessed in 2000. A revenue shortfall, expenditure overruns, lower capital expenditure, higher deficit, lower privatisation proceeds, lower foreign financing, high domestic borrowing and an increase in public debt were recorded. Increased government demand for domestic financing, together with the enhanced borrowing requirement by public corporations affected by high oil prices, exerted pressure on domestic interest rates. If the resulting high interest rates remain over a long period, not only would the government interest bill be increased but private sector investment and business activities would also be adversely affected. Therefore, the Budget 2001 was designed to reduce the fiscal deficit and domestic borrowing significantly, by raising revenue efforts and containing recurrent expenditure, demonstrating the government's firm commitment to put back the budgetary outturn on the medium-term fiscal consolidation path.

The significant fiscal slippages recorded in 2000 were due to revenue shortfalls, increased defence expenditure, higher interest payments, a public sector wage increase, shortfalls in expected foreign financing and delays in the privatisation process. The overall budget deficit rose to 9.9 per cent of GDP in 2000 from 7.5 per cent in 1999, in

Chart 1.5
Fiscal Sector Indicators

Chart 1.5.1
Expenditure, Revenue, Current A/C and Overall Balance

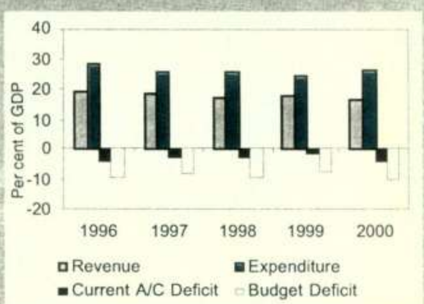


Chart 1.5.2
Financing the Deficit

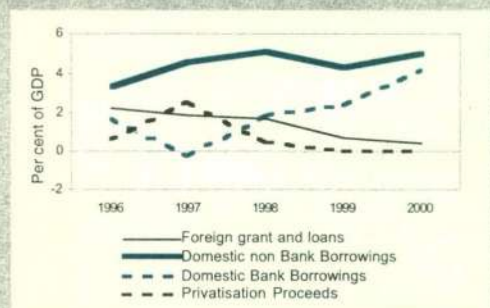


Chart 1.5.3
How a Rupee Was Earned - 2000

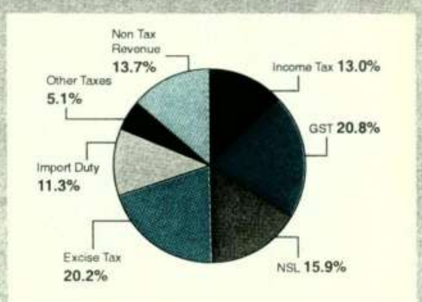
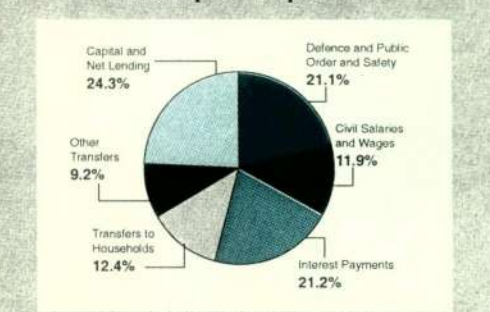


Chart 1.5.4
How a Rupee Was Spent- 2000



contrast to a decline of 1.7 percentage points of GDP achieved in the previous year. This increase was a combined outcome of declining revenue from 17.7 per cent of GDP in 1999 to 16.8 per cent in 2000, and an increase in current expenditure from 18.7 per cent of GDP to 20.2 per cent. Capital expenditure marginally declined to 6.4 per cent of GDP in 2000 from 6.5 per cent of GDP in the previous year.

On the revenue side, collections from tax as well as non-tax sources were lower than expected. Tax revenue shortfalls were registered in corporate income tax due to reduced profits in major public enterprises, while import duty revenue collections were low due to reduced tariff rates, a shift of the import duty on petroleum products to an excise tax and changes in the composition of imports towards more low tariff items. Non-tax revenue was poor due to lower profits and dividends obtained from public enterprises as their profitability deteriorated mainly due to high oil prices and delays in necessary adjustments in their product prices.

On the expenditure front, current expenditure overshot the original budget estimate significantly because of security related expenditure, increased interest payments resulting from high interest rates and increased debt stock and a higher wage bill, following the pay rise to government employees in August. However, the savings achieved in non-wage recurrent cost through a 5 per cent cut of non-essential supplies offset part of these expenditure increases. The government also attempted to mitigate the fiscal pressure by slowing down the public investment programme. Consequently, realised public investment, at 6.4 per cent of GDP, was lower than the original budgetary estimate of 8.1 per cent of GDP.

The combined outcome of lower revenue mobilisation and higher current expenditure resulted in a current account deficit of 3.4 per cent of GDP compared with the original budgetary target of a surplus of 0.6 per cent of GDP. Higher dis-savings by the government were seen in 2000 than in 1999. The primary deficit (revenue minus expenditure excluding interest payments) worsened by 2.3 percentage points of GDP to 4.2 per cent of GDP, in 2000 compared to 1.9 per cent of GDP in 1999.

Financing of the deficit from foreign grants and loans in 2000 was only 0.4 per cent of GDP, compared with the original budgetary estimate of 1.7 per cent of GDP, partly reflecting delays and slowdown in public investment activities. Privatisation proceeds realised for deficit financing were only Rs.401 million compared with an expected amount of Rs.30,000 million. This shortfall arose primarily from the non-sale of Sri Lanka Telecom shares due to depressed prices for the telecommunications sector in international markets.

The increased budget deficit, together with the shortfalls in privatisation and foreign financing proceeds, compelled the government to increase its borrowings from the domestic market significantly. Consequently, domestic financing of the deficit increased from 6.8 per cent of GDP in 1999 to 9.4 per cent in 2000, compared with 3.5 per cent of GDP in the original budgetary estimates. Given the limited availability of domestic non-bank resources, a large part of the increased domestic borrowing was reflected in bank financing. This included the borrowing of US dollars 100 million as a foreign syndicated bank loan through the foreign currency banking unit of a domestic bank. Government borrowings for deficit financing from the banking sector rose to 4.3 per cent of GDP in 2000, from 2.4 per cent in 1999.

A large part of this domestic market borrowing was mobilised through Treasury bonds, which is a more market oriented borrowing instrument. Reflecting the increasing resort to domestic sources in deficit financing, the share of domestic debt in total public debt increased to 56 per cent in 2000 from 52 per cent in 1999. Medium and long-term debt stock increased at a faster rate in 2000 as Treasury bonds, the major borrowing instrument, were issued with maturity periods of over 2 years, lengthening the average maturity of the public debt. For the first time, the government issued callable Treasury bonds (i.e., two year bonds with a call option) as the high interest rates were considered a temporary phenomenon.

1.8 Exchange Rate and External Sector

International Developments Affecting Sri Lanka

World trade, which started to recover after mid 1999, strengthened further during 2000. World trade volume is estimated to have grown by 12.4 per cent in 2000, up from 5.3 per cent recorded in the previous year. This is attributed mainly to a sharp increase in the volume of exports by both advanced economies and developing countries, with the volume of exports in advanced economies increasing from 5.0 per cent to 11.4 per cent and in developing countries, from 4.1 per cent to 15.7 per cent. While the export volume increased by 9.2 per cent in the US against 2.9 per cent in the previous year, Japan registered a growth of 12.2 per cent, in comparison with 1.9 per cent in 1999. Meanwhile, in EU, growth in exports more than doubled from 4.9 per cent in 1999 to 11.3 per cent in 2000. The major impetus for the growth in imports came from the US with a growth of 13.7 per cent, while Japan and the EU countries also played a catalytic role with growth rates of 7.7 per cent and 10.5 per cent, respectively. The newly industrialised Asian economies continued to maintain their high growth momentum in international trade with exports and imports growing at 16.4 per cent and 15.2 per cent, respectively. Terms of trade reflected an improvement of 6.4 per cent in favour of developing countries, while those in advanced economies deteriorated by 2.2 per cent. The improvement in the terms of trade in developing countries reflected mainly the sharp increase in oil prices. Only a marginal improvement in export prices of non-fuel primary products (1.8 per cent) of developing countries was seen in 2000. Developing countries, as a whole, benefited more from international trade in 2000 than the advanced economies, with current accounts of their balance of payments changing to a surplus for the first time in a decade. However, Sri Lanka, being an oil importer, experienced a deterioration of its terms of trade by 6 per cent in 2000.

International exchange markets remained relatively stable, although some volatility in key currencies was witnessed during the year. The continued robust economic performance in the United States strengthened the dollar against all major currencies during the year. The Japanese yen, which appreciated by about 9 per cent in 1999 in response to signs of economic recovery, continued to depreciate owing to growing economic and financial woes in the economy. The yen depreciated at a faster rate towards the end of the year, with an overall depreciation of 11 per cent against the US dollar in 2000. Meanwhile, despite several attempts by the European Central Bank (ECB), with the support of USA and Japan, to intervene in the exchange market to stabilise the exchange rate, the euro continued to slide throughout the year, though with some improvement towards the end of the year, resulting in a depreciation of 8 per cent against the US dollar. Meanwhile, exchange markets in East Asia, except in Indonesia and the Philippines, reflected relative stability. While the Indonesian rupiah depreciated by 26 per cent against the US dollar, reflecting the continuing financial sector problems and political uncertainties, the Philippine peso depreciated by 20 per cent due to an unsettled political environment. The Thai bhat depreciated by 14 per cent, showing a faster depreciation towards the end of the year while the Korean won weakened by 10 per cent after an appreciation during the first half of the year. The Singapore dollar depreciated by 4 per cent in 2000, though it remained stable during the second half of the year. Meanwhile, Malaysia continued with its fixed exchange rate policy during the year. Since the currencies of these competitor countries depreciated in the market improving their competitiveness, a similar depreciation was necessary in the Sri Lankan rupee to maintain competitiveness in the world market.

Sri Lanka's External Sector Developments

Despite continued strong recovery in exports and continued of inflows of private remittances, the balance of payments position deteriorated in 2000 mainly due to increased oil prices, enhanced defence imports, slowdown in tourist arrivals, lower utilisation of foreign assistance and net outflows in foreign portfolio investments from the Colombo Stock Exchange. Consequently, deficits in the external current account and the overall balance of payments increased, reducing external reserves and exerting pressure on the exchange rate. In order to arrest the situation, several changes were introduced in the exchange rate regime by widening the band on several occasions. Similarly, the monetary policy stance was tightened to reduce pressure on the exchange rate and external reserves.

In line with the strong recovery in the domestic economy and the favourable external environment, Sri Lanka's external trade registered a notable upturn, with both exports and imports growing at faster rates in 2000. Exports registered a high growth of 20 per cent in 2000 against a drop of 4 per cent in 1999, mainly reflecting a sharp increase in the volume of exports by 18 per cent; the price index rose by only 2 per cent. The high growth was generated mainly by the continued expansion in textiles and garments, tea, machinery, electrical equipment, rubber based products, gems, diamonds and jewellery. Diversification of exports continued, reducing the relative share of plantation agricultural commodities in total exports to 15 per cent in 2000, while raising the share of industrial exports to 78 per cent. Within industrial exports, textiles and garments accounted for the largest share of about 70 per cent.

The total import bill increased at an even higher rate of 22 per cent in 2000, reflecting both increased volumes and higher international prices. As a result, the trade deficit widened to 10.8 per cent of GDP in 2000 from 8.7 per cent in 1999. Imports of intermediate goods recorded the highest

TABLE 1.5

External Sector Indicators

Item	1996	1997	1998	1999	2000(a)
Annual changes (%)					
Export volumes	4.1	10.6	0.1	5.0	18.3
Import volumes	0.4	12.3	12.4	0.2	12.9
Export unit value	11.6	9.3	11.6	-8.5	1.5
Import unit value	12.0	2.4	-2.2	-3.5	8.1
Terms of trade	-0.5	6.8	14.2	-5.0	-6.1
As per cent of GDP					
Trade deficit/GDP	-9.7	-8.1	-6.9	-8.7	-10.8
Current account deficit/GDP	-4.9	-2.6	-1.4	-3.6	-6.4
Overall BOP/GDP	-0.5	1.1	0.2	-1.7	3.1
External reserves US$ Mn.					
Gross official reserves	1,957	2,029	1,984	1,639	1,043
Total reserves	2,717	3,132	2,907	2,582	2,126
Exchange rate index (End of period) (b)					
Nominal effective exchange rate index	111.3	126.1	111.5	110.2	111.6

Source: Central Bank of Sri Lanka

(a) Provisional

(b) 24 currency basket, 1995 = 100

Chart 1.6
Selected External Sector Indicators

Chart 1.6.1
Balance of Payments

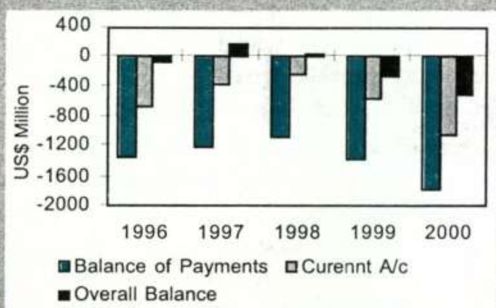


Chart 1.6.2
Effective Exchange Rates
(1995=100)

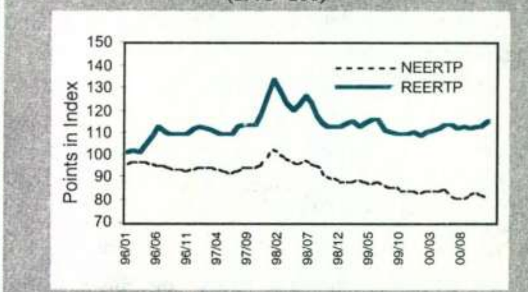


Chart 1.6.3
External Assets

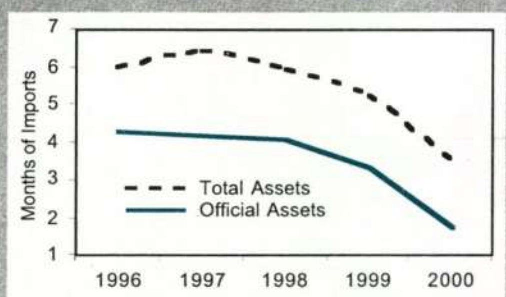
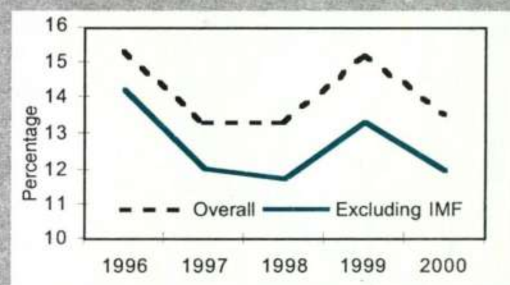


Chart 1.6.4
External Debt Service Ratio
(as % of Exports of Goods and Services)



increase, growing by 24 per cent, while consumer goods and investment goods grew by 12 and 11 per cent, respectively. The terms of trade deteriorated for the second consecutive year as import prices rose by 8 per cent, while export prices rose only by 2 per cent in 2000. The surplus in the service account declined due to a slowdown in the tourism sector and a marginal drop in transshipment cargo handling. The deficit in the interest income widened further, mainly due to higher interest payments on external debt. Total net current transfers registered a notable improvement due to high private transfers amounting to US dollars 974 million in 2000, reducing the pressure on the balance of payments.

As a result of these developments, the deficit in the current account widened significantly to US dollars 1,065 million or 6.4 per cent of GDP in 2000. This is an unsustainable high deficit in the long-run, indicating the need for strong adjustments to contain it. In the capital account, government's long-term disbursements remained low due to delays in project implementation, which requires due attention. As the increase in net capital and financial flows were not adequate to cover the sharp increase in the current account deficit, the overall deficit in the balance of payments reflected a further deterioration, increasing to US dollars 516 million or 3.1 per cent of GDP.

The total external debt stock of the country declined by 2.5 per cent in 2000 reflecting slow disbursements of foreign loans, increased debt repayments and the effect of cross currency movements. The external debt/GDP ratio declined from 57.8 per cent in 1999 to 53.5 per cent in 2000, while the external debt service ratio declined from 12.4 per cent to 12.2 per cent, reflecting increased export earnings improving the debt repayment capacity of the country.

Total gross external assets of the country declined by 18 per cent to US dollars 2,126 million at the end of 2000 and were sufficient to finance 3.5 months of imports. Meanwhile, gross official reserves declined by 36 per cent to US dollars 1,043 million and were sufficient to finance 1.7 months of imports for 2000.

International foreign exchange markets continued to remain stable even though the US dollar strengthened further in 2000. However, despite a relatively low rate of domestic inflation, the deteriorating balance of payments continued to exert pressure on the Sri Lanka rupee. The flexibility in the foreign exchange market was increased by widening the band in a number of steps. The widening of the band and regular adjustments for market developments under the crawling band managed system released the pressure in the foreign exchange market. As a result, the rupee depreciated at a faster rate of 12.5 per cent in 2000.

The real effective exchange rate of the rupee against a 24 currency basket reflected a marginal appreciation of 0.6 per cent in 2000, reflecting maintenance of the country's external competitiveness.

1.9 Financial Sector

Monetary Policy

Monetary management became challenging in 2000 as recovery in economic activities required increasing domestic liquidity but the enhanced public sector domestic borrowings, pressure on the rupee in the foreign exchange market and increasing inflation rate, required a tightening of monetary policy. Accordingly, monetary policy in 2000 focussed on maintaining stability in the money and foreign exchange markets, while preventing the build up of demand fuelled inflationary pressure in the economy.

Increased borrowing requirements of the public sector to finance a larger budget deficit and operational losses of oil-hit public enterprises, competed with the private sector for domestic financial resources, pushing up market interest rates. Meanwhile, the increased deficit in the balance of payments, which exerted pressure on the official external reserves and the rupee in the foreign exchange market, had a considerable influence on monetary management in the second half of 2000. Consequently, the monetary policy was tightened, particularly during the second half of the year.

TABLE 1.6
Financial Statistics

Item	End 2000 Rs.bn.	Change			
		1999 Amount Rs.bn.	%	2000 Amount Rs.bn.	%
Monetary aggregates:					
Narrow money supply (M1)	118.5	12.3	12.8	9.9	9.1
Broad money supply (M2)	404.7	41.9	13.3	46.6	13.0
Consolidated broad money supply (M2b)	483.4	50.6	13.4	55.1	12.9
Underlying factors (a)					
Domestic credit to :	549.9	63.4	17.1	117.0	27.0
Government (net)	147.3	29.3	45.3	53.4	56.8
Public corporations	38.3	3.0	30.1	25.2	193.2
Private sector	364.4	31.1	10.5	38.4	11.8
External assets (net)	69.5	-3.6	-3.4	-32.6	-31.9
Other items (net)	-136.0	-9.2	-9.5	-29.4	-27.5
Reserve money	105.2	7.6	8.2	4.7	4.7
Government (net)	91.6	20.8	80.3	44.8	96.1
Commercial banks	0.5	-0.4	-33.3	-0.2	-30.5
External assets (net)	57.9	-12.5	-12.2	-31.4	-35.2
Other items (net)	-44.9	-0.4	-1.1	-8.6	-23.7
	End 1999	End 2000			
Interest rates (end year)					
3-month Treasury bills (%)	11.79	17.77			
Commercial banks weighted avg.prime lending rate (%)	15.90	21.46			
Share Market					
All Share Price Index (1985=100)	572.5	447.6			
Market capitalisation (Rs. bn)	112.8	88.8			

Source: Central Bank of Sri Lanka.

(a) In relation to M_{2b}

Chart 1.7
Financial Sector Indicators

Chart 1.7.1
Contribution to Broad Money Growth

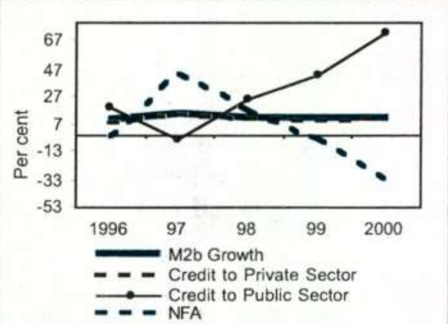


Chart 1.7.2
Interest Rates

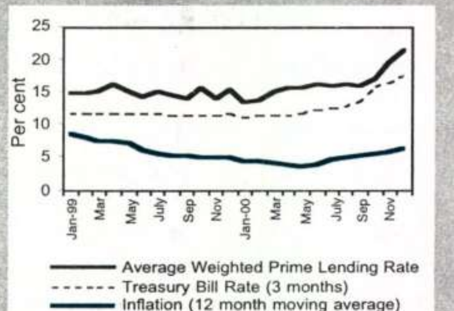
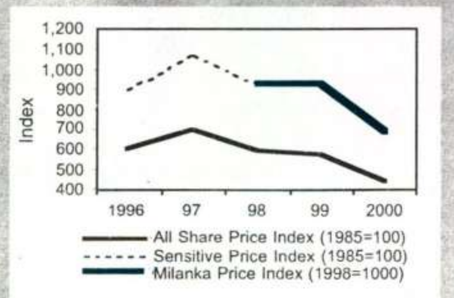


Chart 1.7.3
Share Market Indices



This was achieved by raising the Bank Rate, repurchase rate and the reverse repurchase rate on several occasions. The Central Bank utilised a range of indirect monetary policy instruments to influence interbank interest rates and broad money growth.

Monetary management was based on a monetary targeting framework with reserve money being an intermediate target. The Central Bank continued to rely on several measures in assessing the monetary conditions, including growth in monetary aggregates, monetary conditions index and changes in market interest rates. Open market operations through changes in repurchase and reverse repurchase rates continued to be the major policy instrument.

The monetary policy stance was relaxed at the beginning of 2000 by reducing the repurchase rate by 25 basis points to 9 per cent in view of the continued downward trend in inflation, improvement in market liquidity and strong recovery in economic activities without inflationary pressure. However, during the second half of the year, in the context of increasing inflation, increased pressure on domestic interest rates by enhanced public sector borrowings and pressure on the foreign exchange market by deteriorating external sector conditions, monetary policy was tightened. This was achieved by raising the repurchase and reverse repurchase rates on several occasions, to 17 and 20 per cent, respectively, by end 2000, while the Bank Rate was raised from 16 to 25 per cent in three steps. However, the Central Bank continued to make available liquidity to the market through its reverse repurchase window, preventing a liquidity shortage arising due to declining international reserves.

The statutory reserve ratio (SRR) in respect of rupee deposit liabilities was maintained at 11 per cent. However, the SRR on foreign currency deposits not placed abroad was removed in August with a view to improving the foreign currency liquidity of the commercial banks and encouraging foreign currency depositors by enabling the banks to pay attractive interest rates.

Money Supply

Despite the sharp increase in bank credit to the public sector, monetary growth in 2000 remained stable at around 13 per cent due to reduction in the net foreign assets of the banking system. The annual growth of consolidated broad money (M_{2b}), which includes the operations of domestic banking units and foreign currency banking units, declined slightly to 12.9 per cent in December 2000 from 13.4 per cent in December 1999, containing potential demand fuelled inflationary pressure in the economy. The growth in narrow money (M_1) moved in a wider range 4.0 – 11.7 per cent, but recorded a relatively low growth of 9.1 per cent at the end of 2000. Reserve money expanded by an even lower rate of 4.7 per cent due to a sharp decline in the net foreign assets (NFA) of the Central Bank. The money multiplier rose from 4.26 per cent in 1999 to 4.60 per cent in 2000, reflecting the impact of the removal of the SRR on foreign currency deposits and the decline in the currency to deposits ratio. The velocity of money remained at around 2.6 per cent, indicating no significant changes in inflationary expectations of the public.

The major contributory factor that contained monetary expansion was the decline in NFA of the banking system. In 2000, NFA of the banking system declined by 32 per cent to Rs.69.5 billion, reflecting the significant deficit in the balance of payments. A large part, about 96 per cent of this, was in NFA of the Central Bank due to sale of foreign exchange to commercial banks and settlement of foreign public debt. The decline in NFA of commercial banks was marginal (about Rs.1.2 billion).

A sharp increase in credit to the public sector together with a moderate credit expansion to the private sector resulted in a 27 per cent expansion in overall domestic credit. Government borrowing from domestic banks increased significantly due to the wider deficit and shortfall in foreign financing and privatisation proceeds. Out of the increase in net credit to the government, a large part (about 84 per cent) was from the Central Bank. This was reflected mainly in the increased holdings of government securities by the Central Bank, as commercial banks used government securities in their portfolio to obtain liquidity under the reverse repurchase facility to meet their liquidity needs.

Credit to public corporations rose by Rs.25 billion (193 per cent) in 2000 in comparison to a much lower increase of Rs.3 billion in 1999. Three major public enterpirses viz., CPC, CEB and CWE, accounted for the bulk (97 per cent) of this credit increase. A sharp increase in international prices for oil and wheat, inadequate and delayed adjustments in the corresponding domestic prices and increased use of thermal power due to lack of rainfall, led to public corporations increasing their bank borrowings.

Credit to the private sector increased by Rs.38 billion or 12 per cent in 2000. The moderate credit demand by the private sector despite increased economic recovery could be due to increased retained earnings with the corporate sector and a move towards new borrowing instruments such as commercial paper. In addition to the commercial banks, development banks and finance companies also provided financial facilities to the private sector. Total credit facilities provided to the private sector by the financial system as a whole increased by Rs.47.7 billion or 11.2 per cent in 2000.

Interest Rates

A general rise in the interest structure was observed in 2000, particularly during the second half. This was a result of increased public sector borrowings, reduction of liquidity as a consequence of a large balance of payments deficit and tighter monetary policy. Despite the upward trend in the inflation rate during the second half, real interest rates increased due to higher increases in nominal interest rates. However, larger increases in short-term rates than in medium and long-term rates flattened the yield curve, reflecting a market perception that high interest rates were a short-term phenomenon.

Interbank call market rates exhibited considerable instability, reflecting sharp changes in repurchase and reverse repurchase rates and developments in the foreign exchange market. Following rising interest rates, commercial banks raised their deposit rates as well as lending rates. However, slower adjustment in their deposit rates compared with increases in lending rates, further increased the interest spread.

Despite the economic recovery and improved corporate sector performance, share prices and turnover in the Colombo Stock Market remained depressed in 2000, as foreign investors were net sellers. The All Share Price Index declined by 22 per cent, while the market capitalisation declined by 21 per cent. There were only a few new share issues in 2000 as most companies postponed issues due to depressed market conditions.

1.10 Economic Outlook for 2001 and Medium-term Prospects

Global Prospects for 2001

The global economy is expected to slow down somewhat during 2001, after a high growth of 4.8 per cent in 2000. This is mainly due to the effect of high oil prices in 2000, a sharp fall in equity prices in major international markets and the lagged effects of high interest rates that prevailed in 2000, as a result of tighter monetary policies pursued to arrest high inflationary pressures in the major economies. The estimated world output growth of 3.2 per cent for 2001 assumes a smooth adjustment in imbalances in major industrial economies and a drop in international prices of crude oil. Economic growth in advanced economies is expected to decline from 4.1 per cent in 2000 to 1.9 per cent in 2001, while that in developing countries is projected to decline from 5.8 per cent to 5.0 per cent. Growth in the United States, Sri Lanka's major export destination, is expected to drop from 5.0 per cent in 2000 to 1.5 per cent in 2001. The Euro area and the United Kingdom, the other two major destinations for Sri Lanka's exports, are expected to grow moderately, with estimated growth rates of 2.4 per cent and 2.6 per cent, respectively.

World trade, which reflected a sharp recovery in 2000, is expected to remain buoyant with an expansion of 6.7 per cent in 2001. With the expected decline in international prices of crude oil, the terms of trade are expected to move in favour of advanced economies with an improvement of 0.5 per cent. However, non-fuel exporting developing countries would benefit from an improvement in terms of trade by 0.9 per cent during 2001. The current account balances of developing countries are expected to deteriorate to a deficit of US dollars 30 billion as a result of a higher growth in imports.

With the expected drop in crude oil prices, the rate of inflation is projected to moderate during the year. Consumer price inflation in advanced economies is estimated to decline from 2.3 per cent in 2000 to 2.1 per cent in 2001, while in developing countries it is expected to decelerate from 6.1 to 5.7 per cent.

TABLE 1.7
Overview of the World Economic Outlook Projections (Annual percentage change)

	Actual		Projections	
	1999	2000	2001	2002
World output	3.5	4.8	3.2	3.9
Advanced economies	3.4	4.1	1.9	2.7
United States	4.2	5.0	1.5	2.5
Germany	1.6	3.0	1.9	2.6
United Kingdom	2.3	3.0	2.6	2.8
Japan	0.8	1.7	0.6	1.5
Developing countries	3.8	5.8	5.0	5.6
Developing Asia	6.1	6.9	5.9	6.3
World trade volume (Goods and services)	5.3	12.4	6.7	6.5
Imports				
Advanced economies	7.9	11.4	6.7	6.5
Developing economies	1.6	16.9	8.8	7.9
Exports				
Advanced economies	5.0	11.4	6.2	6.2
Developing economies	4.1	15.7	7.1	7.0
Consumer prices				
Advanced economies	1.4	2.3	2.1	1.8
Developing economies	6.7	6.1	5.7	4.8
Six month LIBOR on US dollar deposits	5.5	6.7	4.5	4.3

Source: World Economic Outlook, IMF

Major industrial economies are expected to relax their monetary policy by gradually reducing interest rates. Developing countries, in particular emerging market economies, would benefit from increased financial flows in a low interest rate environment. In the global financial markets, the US dollar may come under pressure against other major currencies due to increasing signs of a slowdown in economic activity, the prospect of lower interest rates, a weaker US stock market and concerns about the size of the US current account deficit.

With the restoration of market stability, together with an orderly correction in equity markets in advanced economies, private foreign capital flows to developing countries are expected to improve substantially from US dollars 36 billion to US dollars 116 billion in 2001. Asia could expect a turnaround in private capital flows with a net inflow of US dollars 11 billion against a net outflow of US dollars 22 billion in 2000. The improvement in the capital and financial flows to developing countries would help to offset the deterioration in the current account.

The global outlook for 2001, however, faces significant further downside risks and uncertainties. The world economic outlook for 2001 depends heavily on a smooth and orderly adjustment in imbalances in the output growth pattern in major industrial economies and also in equity and exchange markets. The threat of a resurgence in crude oil prices is a major concern for the stability in money and exchange markets throughout the global economy. Any such increase would have adverse effects, particularly on developing countries. The growth projections also depend heavily on how the US economy behaves during the year. A hard landing of the US economy, against the projected moderate slowdown, would have drastic effects on developing countries, including Sri Lanka, as demand for their exports could fall significantly.

Sri Lanka's Economic Outlook for 2001

In this background, the present projections made for 2001 indicate a lower growth and somewhat higher inflation, but greater macroeconomic stability, with improvements in the balance of payments reducing the current account deficit and leading to an overall surplus, a reduction in public sector credit demand and non inflationary monetary expansion. However, the achievement of the fiscal targets given in Budget 2001 and implementation of the economic reforms and adjustments that have been announced would be crucial in ensuring the realisation of the projected improvements in macroeconomic stability.

The Sri Lankan economy is projected to grow by around 4.5 per cent in 2001, as compared to 6 per cent in 2000. A slow growth in agriculture due to adverse weather conditions, the moderation of the manufacturing sector growth rate after achieving a high capacity output in 2000, and an associated reduction in the growth rates in trade and other services are expected to be the major causal factors for the lower growth. Tea production is projected to continue its growth momentum in 2001, while rubber production is expected to recover from the decline in 2000. However, the effect of adverse weather on 2000/2001 Maha paddy cultivation and the projected decline in coconut production from its peak in 2000, will moderate overall agricultural growth in 2001. The net effect of the projected slowdown in world economic growth and the enhanced market access for Sri Lankan garment exports to EU countries following the recent removal of quota restrictions, indicate a moderate growth potential in the Sri Lankan export manufacturing sector in 2001. Meanwhile, the new surcharge on imports and depreciated exchange rate will slow down the demand for imports. The slowdown in growth rates in agriculture, manufacturing and external trade will result in a moderate growth in other related services. However, the growth momentum is expected to continue at a high level in the telecommunications, power and construction sectors as a result of the envisaged new investment, while a recovery is projected in tourism.

Inflation is expected to be higher in 2001 due to cost push factors such as increased import prices and full pass-through of increases in administered prices in 2000. It is likely to rise and remain at a high level during the early months of the year. However, prices are expected to stabilise in the latter part of the 2001. Accordingly, the annual average inflation rate is projected to increase from 6.2 per cent in 2000 to about 9.5 per cent in 2001.

Budget 2001, which contains both short-term economic stabilisation measures and those which are necessary to correct some of the structural weaknesses in the fiscal area, has been formulated to return to a medium-term fiscal adjustment path. The fiscal position is expected to be consolidated by reducing public dis-saving (i.e., current expenditure in excess of revenue), containing the overall fiscal deficit and reducing borrowings from the domestic market. On the revenue side, new revenue measures, raising direct and indirect tax rates, and steps to improve tax administration, have been proposed. A reduction in non-productive expenditure and the rationalisation of public spending, while focusing on the acceleration of infrastructure development, will be the main theme on the expenditure side. Proposals have also been made to encourage the remittance of foreign currency earnings and boost earnings from apparel and software and information technology related exports. These measures are expected to reduce the budget deficit by 2.9 percentage points of GDP from a projected deficit of 11.4 per cent of GDP in a baseline scenario, without measures as announced in the budget presentation.

Accordingly, the government's current account deficit in 2001 is expected to decline to 1.2 per cent of GDP from a deficit of 3.4 per cent in 2000. This improvement in the current account, is planned to be achieved by the twin strategy of raising the revenue/GDP ratio to 18.3 per cent and reducing the current expenditure/GDP ratio to 19.5 per cent in 2001. With enhanced public investment at 7.4 per cent of GDP in comparison to 6.4 per cent in 2000, the overall budget deficit is expected to be contained at 8.5 per cent of GDP. After adjusting for envisaged foreign financing and privatisation proceeds, the domestic financing is projected to be 4.8 per cent of GDP (Rs.69 billion) in 2001, significantly lower than the realised figure of 9.4 per cent of GDP (Rs.118.5 billion) in 2000.

However, the potential downside risks to achieving some fiscal targets, particularly containing recurrent expenditure and realisation of privatisation proceeds, cannot be underestimated. The achievement of the envisaged fiscal targets is necessary to improve macroeconomic stability and release more resources for private sector investment, while reducing pressure on interest rates. As the leeway in the budgetary outturn for any unexpected change is very limited, every effort would need to be made to take prompt corrective measures to adjust for any revenue shortfall or expenditure increase.

In 2001, a significant turnaround is expected in the balance of payments with a lower current account deficit of US dollars 463 million and an overall surplus of US dollars 140 million. A continuation of the growth momentum in exports, though at a slower pace than the high rate in 2000, lower international prices for petroleum products, reduced expenditure on defence imports, continued increase in private transfer inflows, net foreign inflows through portfolio investments, an expected increase in foreign direct investments, improvement in utilisation of foreign assistance by the government, expected government medium-term foreign borrowing of US dollars 200 million and a projected inflow of US dollars 275 million on account of privatisation proceeds underpin the achievement of this surplus. The current account deficit is expected to decline from 6.4 per cent of GDP in 2000 to 2.9 per cent in 2001, reducing external sector imbalances significantly. Total international reserves, as well as the official international reserves, are expected to improve in 2001, raising the country's import capacity.

Based on the above mentioned macroeconomic developments, monetary expansion is targeted to be contained at around 13 per cent in 2001. The expected fiscal improvements and a reduction in credit demand by public corporations will permit the accommodation of higher credit expansion to the private sector proper (by about 10 per cent) in 2001 without exerting pressures on interest rates and contributing to inflation. The expected improvement in the net foreign assets of the Central Bank will enhance market liquidity, while enabling the Bank to reduce a part of its holdings of government paper, which increased significantly in 2000. New credit requirements of public corporations are expected to be low in 2001. In fact, some of them may even be able to repay a part of their existing bank loans due to improvements in cash flows following increases in administered prices.

Monetary management will be a challenging task in 2001 under the new exchange rate system introduced in January 2001. Monetary policy has to remain tight, at least during the initial part of 2001, until the fiscal adjustments take effect, inflationary pressures abate and reserves start to increase. This is necessary to prevent cost-push inflation resulting from administered price increases and exchange rate depreciation turning into a demand fuelled inflation. Subsequently, with improved rupee liquidity in the market, reduced public sector borrowing requirements, improved stability in the financial market and reduced inflationary pressures in the economy, the Central Bank would be able to reduce its interest rates (repurchase and reverse repurchase rates) gradually over the year, without creating the risks of demand fuelled inflationary pressure.

However, the realisation of the fiscal targets envisaged in the 2001 Budget and expected improvements in the financial position of public corporations are necessary conditions to ensure the achievement of these monetary targets and the expected reduction in interest rates in 2001. Any significant deviation in achieving the planned public sector borrowing reductions would not only make it difficult to reach these desirable monetary targets and reduction in interest rates, but could also exert pressure on the exchange rate. Thus, under the new exchange rate system, fiscal policy has an important role to play in achieving macroeconomic stability.

Medium-term Economic Prospects for Sri Lanka

The medium-term growth projections for Sri Lanka can be considered under two scenarios: one with strong policy adjustments and accelerated reform implementation and the other with moderate policy adjustments and a very slow implementation of reforms. The scenario with strong adjustments and faster reforms includes continued fiscal consolidation, public enterprise reforms, civil service reforms, labour market reforms and a substantial increase in public expenditure on infrastructure development. The new exchange rate regime, supported by prudent fiscal and monetary policy, would encourage the country's exports, strengthening external sector stability. Medium-term expectations under the World Economic Outlook projections by the IMF indicate a reasonable growth for partner country imports from Sri Lanka, despite the expected slowdown in the US economy.

Fiscal consolidation efforts outlined by the government under the medium-term policy framework would lead to improved macroeconomic stability, reducing pressure on interest rates and releasing more resources to the private sector for investment. A declining budget deficit, with lower interest rates, would reduce the government debt service burden, thereby ensuring medium-term fiscal sustainability.

TABLE 1.8
Medium Term Macroeconomic Indicators

Item	Actual	Provisional	Projections with Strong Adjustments and Fast Reforms					Projections with Moderate Adjustments and Slow Reforms				
	1999	2000	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
Mid Year Population (million)	19.0	19.4	19.4	19.6	19.8	20.0	20.2	19.4	19.6	19.8	20.0	20.2
GDP Growth (%)	4.3	6.0	4.5	5.5	6.5	6.8	7.0	4.5	5.0	5.0	5.0	5.0
Investment (% of GDP)	27.3	28.0	27.6	28.9	31.0	31.5	32.0	26.0	24.8	24.4	24.4	24.4
Private	20.8	21.4	20.2	20.9	22.5	23.5	24.0	19.9	18.4	17.9	17.9	17.9
Public	6.5	6.6	7.4	8.0	8.5	8.0	8.0	6.1	6.4	6.5	6.5	6.5
Domestic Savings (% of GDP)	19.5	17.3	20.3	22.6	24.0	25.1	26.2	18.2	16.7	15.8	15.3	15.3
Private	20.5	20.7	21.4	22.0	22.5	22.6	22.7	22.9	19.8	17.9	16.7	16.4
Public	-1.0	-3.4	-1.1	0.6	1.5	2.5	3.5	-4.7	-3.1	-2.1	-1.4	-1.1
CCPI annual average (% change)	4.7	6.2	9.5	6.0	5.5	5.0	4.0	11.0	8.5	7.5	7.0	6.5
Export volume (% change)	5.0	18.3	6.8	8.8	8.5	8.8	9.2	6.7	8.6	6.5	6.3	6.2
Import volume, without aircraft (% change)	2.8	12.9	5.0	7.1	7.6	8.7	9.1	4.6	8.9	7.6	7.5	6.3
External current account deficit (% of GDP)	-3.7	-6.6	-3.1	-2.1	-2.3	-2.6	-3.2	-3.7	-3.5	-4.0	-4.5	-4.5
Official reserves (months of imports)	3.0	1.5	2.5	3.1	3.5	3.6	3.7	1.2	0.9	0.8	0.7	0.5
Government revenue (% of GDP)	17.6	16.8	18.3	19.5	20.0	20.1	20.2	17.3	17.1	17.1	17.2	17.2
Government expenditure (% of GDP)	25.1	26.7	26.8	26.0	25.5	25.1	24.7	27.8	26.6	25.6	25.3	25.1
Budget deficit (% of GDP)	-7.5	-9.9	-8.5	-6.5	-5.5	-5.0	-4.5	-10.5	-9.5	-8.5	-8.1	-7.9
Broad money (% change)	13.4	12.9	13.0	10.8	11.3	11.1	10.7	16.0	13.9	12.9	12.4	11.8

Source: Central Bank of Sri Lanka

Frequent price adjustments and continued public enterprise reforms would reduce the burden on the budget and demand for credit by public corporations. Low public sector demand for domestic financial resources, with an accelerated implementation of structural reforms, would create an environment conducive to private sector investment, improve the country's external competitiveness, expand potential output and enable further reduction of unemployment and poverty on a sustainable basis.

The moves to expand private sector economic activities will encourage exports and attract foreign direct investment, improving the balance of payments position. The planned fiscal consolidation and achieving a favourable balance of payments position will facilitate prudent monetary management and enable the country to achieve a low inflation regime on a sustainable basis. This will have the salutary effect of encouraging people to adjust their inflationary expectations downward.

However, the alternative scenario with moderate macroeconomic adjustments, consisting of a high fiscal deficit and delays in economic reforms indicates some pessimistic medium-term economic prospects. The continuation of high fiscal deficits with weak economic reforms would result in a high public debt burden, pressures on interest rates, lower investment and savings, low growth, increasing external sector imbalances, high inflation and unemployment, and an increase in poverty levels. The continuation of civil conflict with high defence expenditure under this scenario would cause a further deterioration in the medium-term economic prospects and may even lead eventually to an economic crisis.

The two scenarios shown above illustrate the necessity for improving macroeconomic adjustments, while accelerating economic reforms without delay.

1.11 Economic Issues and Policies

A little over two decades ago, Sri Lanka, became the first country in the South Asian region to adopt an open market economy policy framework, placing emphasis on an outward looking and liberal economic policy regime, moving away from the inward looking and control oriented economic policies and strategies followed by most developing countries since the second World War. The results of this policy change have been encouraging. Since then, all major political parties in Sri Lanka have come to accept the virtues of market oriented policies, even though they may have differences with regard to the manner, sequencing and the speed of implementing the necessary reforms. This has greatly reduced potential risks arising from changes in direction of the overall economic policy regime.

However, despite positive economic achievements on many fronts, Sri Lanka seems to have found itself overtaken by other developing countries in Asia who started reforms much later owing to slower progress in implementing reforms, due to various internal and external factors. Consequently, major economic problems such as slow growth, inadequate savings and investment, persistently high inflation, unemployment and poverty, and serious macroeconomic imbalances still continue to jeopardise progress. In fact, some of these problems have been aggravated in the recent past, posing greater challenges to policy makers. These may be due to factors beyond the country's control, but that should not be an excuse for weak performance. It should be a challenge to fashion alternative remedial policies. The time lost in making excuses may prove costly and the country runs the risk of being marginalised in a rapidly progressing world outside.

The economic outlook for 2001 and the medium-term economic prospects discussed earlier, indicate that the situation could change from bad to worse, unless corrective measures are taken without further delay and necessary reforms are implemented consistently and effectively. The need to have a clear vision, definite objectives, set targets and an outline of the necessary policy strategies to address comprehensive and interrelated economic issues on a sustainable basis, cannot be underestimated. The government has clearly elaborated its objectives, targets and policy strategy in 'Vision 21' issued in November 1999. As stated there and in previous policy documents, the medium-term economic policy objective of the government is to promote sustainable non-inflationary high quality economic growth in a market friendly policy framework, while ensuring long-term external (balance of payments) viability and providing reasonable protection for vulnerable groups which would not dampen initiative. As in all policy statements, Vision 21 and the recent budget speeches emphasised the need for accelerating the annual economic growth rate to 7-8 per cent by removing existing bottlenecks and creating an environment conducive to accelerate domestic investment and increase savings. There are many areas which need urgent attention and early action.

Most importantly, the country needs a more peaceful environment in order to create a helpful business environment for domestic and foreign investors. This can only be achieved by resolving the ongoing armed conflict in a part of the country. As the country cannot afford to continue this conflict, all persons and political parties should extend their fullest co-operation to find a lasting solution by addressing its deep-rooted causes. It appears that ordinary people who have suffered considerably by the conflict, are quite willing to live together and work in peace and amity. The international community has not only backed the government's peace initiatives, but also generously offered help to undo the damage. The governments of countries and the international community have no sympathy for countries that let internal differences lead to armed conflict and break up of countries. It is natural that they would rather help and invest in countries that put their house in order. It is therefore, the overriding and paramount responsibility of Sri Lankan leaders to forge a consensus to restore peace, law and order in Sri Lanka. In fact, many current economic problems would, to a large degree, be resolved with the restoration of peace.

Despite improvements.seen in some years, Sri Lanka's fiscal deficit has remained high, which has retarded private investment, raised inflation and increased the debt burden. The ratio of government debt to GDP is high at 97 per cent, while the annual interest payment has reached 34 per cent of government revenue and 32 per cent of current expenditure. Further delays in arresting the expanding fiscal deficit would require more painful and difficult adjustments in the future. Therefore, it is necessary to take strong corrective measures now to contain the fiscal deficit within a sustainable medium-term framework, outlined in numerous government policy statements. As the required fiscal adjustment is as high as 4-5 per cent of GDP, both revenue enhancing and expenditure containing measures are required.

On the revenue side, it would be necessary to include changes in the Goods and Services Tax (GST), in order to strengthen revenue mobilisation efforts. This tax was introduced in 1998, replacing the Turnover Tax (TT) with a view to removing the cascading tax effect and broad-basing the tax system. While streamlining the system of taxation is important, any significant reduction in tax revenue is counterproductive. If GST is to be more revenue generating, it is essential that the existing exemptions be pruned further to cover a bare minimum of goods and services. The contribution of personal income tax to government revenue is not only low (less than1 per cent of GDP), but has also declined gradually as a ratio of GDP. It is necessary to effect further improvements in tax administration and improve compliance by reducing tax rates, while expanding the coverage, to increase revenue generation under the income tax system. Lower tax rates will encourage tax compliance, while the expansion of the coverage to public sector employees and the elected representatives of the people would remove the existing inequalities in the treatment of various groups for income tax purposes. The present salaries of the public sector may be well below the threshold specified for income tax, but the extension of the coverage would result in a requirement to disclose other taxable incomes, if any, thereby improving the tax compliance culture in the country and removing the unequal treatment, about which the private sector has been agitating for a long period of time. With regard to import tariffs, the lower average tariff rate (4.5 per cent) compared with the average effective tariff rate (15 per cent), clearly indicates further possibility of improving revenue collection by removing duty waivers and reducing duty exemptions.[1] Similarly, the unification of the BOI customs regime with the Customs Department has to be implemented, while ensuring an efficient service to enterprises. Further strengthening of the tax administration system would also be useful to raise revenue collection.

On the expenditure side, every effort must be made to contain increasing recurrent expenditure. Controlling the size of the public service as well as wage increases is necessary to contain the rising government wage bill. The unjustifiably large number of families receiving benefits under the government's social safety programmes, particularly under the Samurdhi programme, indicates potential savings by improving targeting and introducing an effective exit mechanism to eliminate ineligible recipients. This would not only reduce subsidies to the undeserving but would also permit an improvement in the assistance to the most vulnerable groups. Frequent and realistic adjustment of prices of public enterprises and minimisation of their operational costs, improving procurement systems, reducing waste and increasing productivity are necessary to reduce transfer payments to public enterprises. As the interest cost on public debt has become the largest expenditure item under recurrent expenditure, improving cash management by minimising idle cash balances of government departments and institutions and minimising government borrowing costs by prudent public debt management are necessary to contain the interest bill. The rising cost of borrowing also highlights the need to bring down the budget deficit to a more sustainable level of about 3-4 per cent of GDP in the medium term.

Sri Lanka has moved far ahead of her neighbours in the area of trade and tariff reforms, by simplifying and reducing the tariff structure and removing non-tariff barriers. However, ad hoc changes in tariffs and intervention to provide short-term relief when temporary problems emerge have made the policy environment highly unpredictable. This has discouraged market participants from developing sustainable long-term solutions to such problems. For example, the reduction of the tariff on rice imports as a temporary measure in 1999 to reduce prices not only gave inconsistent policy signals to farmers, rice millers and stock holders, but also necessitated further rounds of ineffective intervention by the government in the paddy market through the CWE and Co-operative Societies, creating more market distortions. As the state enterprises are usually compelled to buy at uneconomic prices, the ultimate result would be the weakening of their financial position, necessitating government subsidies to cover losses, the cost of which has to be borne by the taxpayers. Similarly, changes to tariffs applicable on edible oil caused significant distortions in the

1 Average tariff rate = Total tariff collected/Value of total imports
Average effective tariff rate = Total tariff collected/Value of tariff applicable imports

coconut oil industry and resulted in creating an uncertain environment for coconut growers and traders. Similar distortions have also been seen in the case of potato imports. Such sudden policy changes have become a constraint to efficient functioning of markets, weakening policy credibility and harming producers as well as consumers in the long run.

As a majority of people in Sri Lanka still earn their living from agriculture, there could be a need to protect their interests, in general. However, this should not be sought through excessively high import duties or their ad hoc changes, which would only hide inefficiency and burden the consumers. The government needs to define clearly the degree of protection that should be afforded to the domestic agricultural sector through tariffs. Such a consistent and predictable policy environment will lead to efficient resource allocation and encourage producers, traders, stock holders and manufacturers using domestic agricultural products as their inputs, to develop long-term market strategies and encourage more investment in the sector. This would benefit all parties in a competitive market environment.

One of the major factors affecting farmers in domestic agriculture is low productivity. This reduces their competitiveness in relation to imports by raising their average costs of production. Various studies have shown that timely availability of high yielding seed varieties is a crucial factor affecting agricultural sector productivity. In this context, the government's recent efforts to move away from direct involvement in seed producing and distributing industries and to encourage private sector participation in producing quality seeds, while supporting research and development activities to develop new high yielding seed varieties, is a move in the right direction. It is also essential to change the price fixing strategies for seed varieties adopted by public sector institutions, which are based on non-market criteria, in order to ensure an effective private sector participation in the agricultural seeds industry. There is also the long standing problem of sharp seasonal volatility of farmgate prices, which discourage farmers from undertaking production and adopting good agricultural practices. The government should encourage the development and use of market based instruments such as private forward sales contracts to resolve such seasonal price fluctuations, rather than attempting to involve itself directly in market activities, where its record has not been a success.

The government has gradually moved away from setting prices for a large number of goods and services, allowing market forces to determine them. However, it still continues to set prices for some goods and services which are considered essential, and in the production and distribution of which there is government involvement. These include petroleum products, electricity, bus and rail transport services, water services, postal services and wheat flour. Very often, these government managed enterprises become impervious and insensitive to market realities, as evident by heavy overstaffing and lack of professionalism in management, especially when granted monopoly powers. When prices require timely adjustment due to increases in input costs, they are reluctant to adjust prices, in the expectation of government subsidisation, and run up large overdrafts with state banks, which add further costs. Ultimately, they have to be bailed out by the taxpayer. The weakness of finances discourages necessary investment. It is important to note that the losses so financed through subsidies have to be borne by the general public at large, not by the users of their products or services. The reluctance of some of these enterprises to adjust prices appears to be dictated by their failure to provide quality and adequate services to customers, commensurate with technological improvements in the rest of the world. The subsidies to public enterprises have also exerted pressure on the fiscal deficit, while their heavy bank borrowings have created pressures on market interest rates. The recent upward adjustment of prices to better reflect their costs is salutary, but they need to convince the public of their efforts to keep their costs to a minimum.

Furthermore, some subsidies have led to inefficient pricing, resulting in misallocation of resources, with long-term adverse implications on the country's external competitiveness. For example, the continuation of the cross-subsidy on diesel over a long period has led to a concentration on more heavy engine capacities. Similarly, a significant cross-subsidy in the electricity tariff structure and water charges, which places a higher burden on producers of goods and services, to subsidise domestic consumption has an adverse impact on Sri Lanka's external competitiveness. Benefits of such subsidised prices are available only to the households who have access to these facilities, while their costs have to be borne indirectly by the entire population, including those who have no access to such facilities. Only 58 per cent of households have access to electricity, while only 30 per cent have water connections, but both electricity and water are provided to households at prices, a part of which is paid for by non-users or other users. The present wheat flour price setting system provides an untargeted subsidy, which has an unequal distributional impact in that all flour consumers, irrespective of their income or wealth, receive a subsidy from non-consumers. It also imposes a heavy fiscal burden and distorts relative prices of domestic substitutes such as rice.

It is important to note that major infrastructure facilities such as power, transport and water are under less flexible and often distortionary price setting systems. The introduction of a flexible pricing system with automatic adjustment for changes in market conditions for these sectors is essential if they are to expand their production capacity and improve product-quality by reinvesting their surplus funds and attracting new investors. The introduction of an automatic and transparent price adjustment mechanism for imported goods presently under an administered pricing system, such as petroleum products and wheat flour, will allow a faster pass-through of changes in international prices and minimise price distortions, inefficiencies in resource allocation and the burden on the budget. Such automatic price adjustment systems should be simple and transparent, allowing adjustments both ways in order to ensure consumer confidence and public acceptance of high prices when world prices rise and lower prices when they decline.

It would therefore appear necessary to adjust prices of these items to reflect their real market costs and introduce transparent automatic price determination mechanisms as soon as possible, allowing prices to adjust according to changing market conditions. Simultaneously, corrective measures have to be taken to reduce their local cost of production by minimising system losses, upgrading procurement methods and improving efficiency. As the country needs to expand infrastructure facilities adequately, these price setting reforms and production cost minimisation measures require priority on the policy agenda in order to prepare the environment necessary for sustainable economic growth.

As a highly trade-dependent country, the need for efficient and adequate port services cannot be overlooked in Sri Lanka's move to strengthen its external competitiveness, as well as reduce costs of production in the domestic manufacturing sector based on imported raw materials. The efficiency in the Colombo Port has improved recently with the containers handled per hour rising from 12 to 15, and the average delay in berthing time being reduced, but its overall efficiency appears to be lower than comparable international levels. The involvement of the private sector in providing port services in Colombo will help in improving efficiency and promoting competition. It may be necessary to restructure the publicly owned component of the Colombo Port as an efficient competitor to the private component, which would be fully functional soon. Furthermore, changing to a piece-based payment system for port employees could be helpful in improving their productivity. As private sector involvement in port development would take time, public sector investment has to play a greater role. However, given the resource limitations, prioritising public investment in the port sector is necessary to ensure maximum benefits.

An efficient and dynamic public service is required to improve performance of the public sector and enhance prospects for private business. Many countries have taken steps to modernise and streamline their public administration. Sri Lanka has yet to progress beyond the policy formulation stage, after an abortive attempt in the early nineties. It is widely accepted that the public sector could be made more productive and efficient by closing down redundant institutions, introducing performance based promotional and remuneration systems and improving staff mobility and recruitment procedures. It may be necessary to make the government pension schemes more sustainable by moving away from the current pay as you go (PAYG) defined benefit system to a more affordable defined contribution system.

The large number of public holidays could be reduced to levels in other countries by providing a special quota of short leave to those who wish to engage in religious observances. It is encouraging to note that the government has announced the closure of a number of redundant institutions and its desire to reduce the number of public holidays. In August 2000, the President appointed a committee to consider pension reforms. Recommendations are due in 2001. Similarly, recommendations are expected from the Salaries Commission to resolve a number of issues in the public sector salary structure, with a view to attracting efficient people to the public service. The government has also established the Public Service Management Development Authority (PSMDA) to review the procedures of ministries and departments. The Central Bank has started a modernisation scheme with a view to further improving its efficiency, while the restructuring of the Ministry of Finance has been initiated. The government has also appointed a number of task forces to make recommendations for reforms in key sectors such as labour, telecommunications, apparel, taxation and capital market development. Moving to a high, sustainable growth path will require an efficient, productive and skilled workforce and a flexible labor market. Sri Lanka has nearly 50 labour laws, some of which are not operational. Some elements of the present labour regulations are completely out of date, impeding business expansion and investment, inhibiting job creation and leading to the creation of short-term jobs, as evidenced by the large increase in casual and temporary employment. It appears that the Termination of Employment Workmen Act (TEWA), which requires government permission to discontinue labour by the private sector, has reduced labour market flexibility considerably because the procedures are time consuming. The application of labour law privileges to sub-contractors of firms appears to discourage the growth of the practise of contracting out parts of business activities. Similarly, the development of many small trade unions creates unjustifiable and costly labour disputes. It is encouraging that measures for expediting procedures for labour dispute settlement and arbitration are under consideration. It is also essential that all three parties (employees, employers and regulators) work together to create a culture where the labour force works in partnership with management and owners of institutions and jointly promote growth and productivity for their mutual benefit. It is also extremely important to link wage increases to productivity improvements because unreasonable wage increases could affect the competitiveness and the survival of firms in a highly competitive world. A comprehensive review of the labour laws would be helpful with a view to promoting new employment, because current laws seems to discourage new employment. It is irreconcilable that a country which has an unemployment rate of over 7 per cent should have laws which discourage new employment and labour mobility.

Similarly, a flexible and efficient land market is crucial in strengthening efficiency in land utilisation, particularly in the agricultural sector. A clear, single legal system, an efficient land registration service, market based pricing mechanisms and competitive market structures are more effective in improving land utilisation efficiency and productivity than direct non-market and control oriented rules and regulations such as the recent attempt to acquire unutilised lands by the state as a punitive measure.

Recent experience has shown that a sound banking system is not only crucial to providing efficient intermediation services in the effort to accelerate economic growth, but also to prevent vulnerability to financial crises. Despite recent improvements, the ratio of non-performing loans to total advances in Sri Lanka still remains high (15 per cent) while the interest spread (i.e., intermediation cost) is relatively high (5-6 per cent) compared with that in most neighboring countries (2-3 per cent). The Central Bank has been continuously strengthening its regulatory and supervisory activities but it should be clearly accepted that no amount of Central Bank supervision would help to make the banking system better and safer, unless the banks themselves operate in a prudent manner. It is heartening to note that some progress has been made in reforming the two state banks. Steps have been taken to strengthen their management and boards of directors. Management teams have already commenced rationalising non-commercial operations and have halted some loss making activities. Further strengthening of the two state banks which account for about 55 per cent of the assets and liabilities of the banking sector, is necessary to reduce intermediation costs and strengthen financial sector stability by increasing their capital base. These banks have twice been assisted by taxpayers to meet their emerging deficits arising largely by directed lending and it may not be fair to call upon the taxpayers to do so again. Hence, alternative methods of capital enhancement such as issuing new shares to employees and customers, has the merit of raising the commitment of the staff to their bank.

In developing necessary financing facilities in the country, a greater focus and emphasis have to be given to the development of local debt and equity markets. The current relatively high transactions costs in the Colombo Stock Exchange (CSE) and declining trend in such costs in other international markets indicate the necessity for cost reduction to encourage market activities. Similarly, there is scope for many more financial instruments to be listed on the Stock Exchange. For instance, listing commercial paper and convertible bonds will boost the activities of the CSE. Moreover, commodity futures (such as for tea and rubber) could be developed, further expanding activities in the market. The domestic debt market has shown some improvements recently, but more remains to be done. Further development of the primary dealer system, introduction of a real time gross settlement system and a scripless trading system for securities, trading facilities for debt instruments and opening of the domestic debt market gradually to foreign investors are some of major areas that may need policy attention.

Efficient and effective regulatory systems are crucial in promoting sound and efficient markets, particularly when financial services and utilities are liberalised. However, an introduction of a regulatory system should not harm the development of the market but should contribute to greater competition and protection of consumers' interest. They should not lapse into being mere price controllers. The general consensus today is that the regulatory body should not be a government organisation, but an organic part of the market with complete independence.

The government has successfully completed a number of privatisation programmes whereby the private sector has been encouraged to participate in government run activities. Results are encouraging, except in a few cases. This has strengthened the support of employees and the general public for such a process. The authorities are already working on 'second generation' reforms, involving large scale public utilities which have traditionally been the preserve of the public sector. Deregulation of these sectors is more complex and needs thorough preparation. The successful completion of reforms in the power, port, telecommunications, transport and water sectors is crucial in developing the efficient infrastructure required for achieving sustainable economic growth.

Business failures resulting from internal and external factors are a common phenomenon in a dynamic market economy. If business failures are beyond the control of a firm and cannot be corrected within a reasonable time frame, a legal framework should be in place to transfer capital locked in these ventures to productive activities. However if the reasons for failure are temporary in nature and can be corrected with the assistance of an outside organisation, such enterprises should be given an opportunity to restructure themselves by removing the legal

Box 4

Redefining Objectives of the Central Bank

When a new central bank is being established it is impossible to predict the course of its development. John Exter, 1949

Introduction

At first there was no clearly defined concept of central banking. In earlier periods, one bank gradually came to assume more and more the position of a central bank due to its involvement in the note issue and acting as a government's banker and agent. The Riksbank of Sweden is the first central bank to be established (1897), but the Bank of England, established in 1694, was the first bank of issue to assume the position of a central bank and to develop fundamentals of the art of central banking.

The Bank of England also came to accept 'the lender of last resort' position forced on it by the banking crises in Britain in 1847, 1857 and 1866.[1] Financial panic, a leading cause of crises, could be allayed by the assurance that Bank of England would meet all legitimate requirements of finance. Similar crises occurred in the United States in 1837, 1857, 1873, 1884, 1893 and 1907 and led to the establishment of the Federal Reserve System, consisting of twelve Regional Reserve Banks, in 1914.

Following the example of the Bank of England, during the course of nineteenth century, many countries either endowed an existing bank with the sole or principle right of note issue, or caused a new bank of issue to be established with special powers and privileges of a central bank. However, many developing economies, which were under colonial rule, did not have central banks in the early years. Instead, currency boards with limited independence carried out monetary operations.[2]

The Central Bank of Sri Lanka (CBSL) was established on 28 August 1950 as the alternative to the then existing monetary regime of currency board, based on the Monetary Law Act authored by John Exter.[3] The currency board system as was established at the time had several shortcomings such as the inability to increase or decrease money supply whenever needed, and the rigid linkage it had to maintain between domestic currency and foreign currency (the Indian rupee). The Central Bank was established partly due to the shortcomings of the currency board system and also due to the symbolic importance of economic independence that followed the political independence of 1948. The primary objectives of CBSL at the time of the establishment were regarded as domestic price stability; exchange rate stability; the promotion and maintenance of a high value of production, employment and real income in Sri Lanka; and, the encouragement and promotion of full development of productive resources of Sri Lanka.

Exter (1949) assumed that the establishment of the Central Bank would greatly strengthen the banking

1 Kock, M. H. de, 1973, Central Banking, Fourth Edition (Reprint 1997), Universal Book Stall, New Delhi

2 A currency board is a monetary regime where the domestic currency is linked to a chosen foreign currency. Thus, the domestic money supply could fluctuate only in response to the inflow and outflow of foreign currency to the economy.

3 Exter, John, 1949, Report on the Establishment of a Central Bank for Ceylon, Government of Ceylon, Colombo, Ceylon

(Contd.)

impediments to reorganisation. As the existing legal framework in Sri Lanka does not facilitate such speedy closing down or restructuring activities, attention has to be given to develop the legal framework necessary for such activities, rather than attempting to have direct government involvement in restructuring or acquiring failing enterprises.

Most of the structural reforms outlined above are necessary for the rapid development of the economy. However, in view of their sensitivity, building national consensus through open debate and education of all parties involved, is of fundamental importance in implementing these reforms. Further delays in making these reforms are extremely costly to the economy and could jeopardise many of the hard earned gains achieved during the first phase of reforms. It would also cause the country to lag behind its competitors, who are forging ahead with reforms and successfully integrating themselves with the on-going globalisation process. Recognising Sri Lanka's achievements in the past, the international community has often expressed its willingness to support the next generation of economic reforms in Sri Lanka on highly concessional terms. It is vital that the country should not miss this opportunity. Sri Lanka managed to survive many recent crises thanks to the resilience built up by the first phase of reforms initiated 24 years ago. There is no assurance that the future world economic outlook will always be hospitable. Hence, it is imperative that Sri Lanka should intensify its reform efforts to create a stronger and more resilient economy.

Box 4 (Contd.)

system. It should have the power to examine and supervise banking institutions to avoid bank failures and should stand ready to advance credit as the 'lender of last resort' and thus make the banking system 'almost invulnerable' in times of crisis. Strengthening the banking system would encourage the public to make greater use of markets as depositories for their savings, thus enabling banks to lend to many. The Bank could assist in the development of the broadest possible market for government securities by providing, through judicious market support, the price stability and liquidity that were necessary to attract investment funds.

Exter believed that the Central Bank could also do a great deal to introduce more effective management of the public debt and more efficient handling of public finances by acting as the government's fiscal agent, banker and financial adviser. He emphasised the need for development finance by advocating that the Central Bank should have the authority to lend to institutions other than commercial banks, such as mortgage lending institutions and the co-operative credit movement, as they made more credit facilities available to the small farmer, and also by advocating that the Central Bank should engage in loan insurance and loan guarantees. He believed that by helping to direct savings, credit and foreign resources into new agricultural development and new industries, a diversification of the economy could be stimulated, which would make it more resilient and adaptable to changing economic conditions abroad.

CBSL was regarded as the most trustworthy and capable agent of the government at the time of establishment. Thus, many, somewhat non-central banking functions, were assigned to the Bank, both at the time of establishment and later on. Among those were the implementation of exchange control regulations and the maintenance of the Employees' Provident Fund (EPF).

Evolution of Central Bank Objectives

The ultimate objective of any central bank is to foster economic growth by promoting factors of production, promoting full utilisation of resources, avoiding harmful effects of business cycles and economic crises, and minimising the risk premium in a country. In the early years the US Federal Reserve made loans for productive purposes to support the production of goods and services under the assumption that providing reserves to the banking sector to make these loans would not be inflationary. This theory, which is now discredited, is known as the 'real bills doctrine'. The inflationary pressure of the real bills doctrine was augmented during World War I as interest rates had to be kept low to help the government finance the War. The Federal Reserve then decided that the real bills doctrine was inconsistent with the goal of price stability.

Price stability assumes priority among goals of central banks. As historical evidence suggests, high inflation rates are detrimental to economic growth, are socially disruptive and are associated with political and social disorder.[4] Therefore, inflation should be eliminated to an extent at which, as Alan Greenspan states, economic agents do not take account of inflation in making their decisions. Although there is no agreement on the extent of inflation targeted by central banks, research indicates that growth maximising inflation rates are usually low single digit inflation rates.

Associated with price stability is the stability in the external value of currency, or stable exchange rates. There is little evidence that unstable exchange rates could cause greater damage to economies than high inflation. Therefore, countries are increasingly concentrating more on domestic price stability than exchange rate stability. The choice is further facilitated by the world experience on the failure of managed exchange rate regimes. The Bretton Woods system of fixed exchange rates lasted only from 1944 to 1971. The system collapsed as efforts of countries to maintain fixed exchange rates led to instability in domestic economies. Recently, central banks committed to maintaining both domestic price stability and exchange rate stability faced severe financial crises. Examples are the Swedish crisis in 1992, Mexican crisis in 1994 and East Asian crisis in 1997. Countries have realised that a central bank cannot maintain both domestic price stability and exchange rate stability simultaneously on a sustainable basis. Furthermore, they have realised that the design of the central bank or the monetary authority affects the ability to maintain exchange rate stability. A central bank committed to maintaining domestic price stability has to allow considerable volatility in the exchange rate, and should also avoid direct intervention in the exchange market to manage the exchange rate.

Monetary regimes that maintain rigid exchange rates are essentially currency boards. In the process of

4 Fischer, Stanley, 1996, Why Are Central Banks Pursuing Long-Run Price Stability?, Paper Presented at Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.

Box 4 (Contd.)

maintaining rigid exchange rates, they loose control over the money supply. At the other extreme, central banks that have chosen to target inflation explicitly, have allowed free flotation of their currency, but are in control of their money supply. In both cases, whenever internal (or external) balance is achieved, in the economy, external (or internal) balance is also usually achieved, leading to the acceptance of both regimes as sound regimes.

Both domestic price stability and exchange rate stability rely on a sound financial system, making it a pre-requisite for achieving primary objectives. Stability is maintained through financial sector supervision and regulation, and through the implied guarantee of the 'lender of last resort'. However, financial sector supervision and regulation are not always conducted by central banks. In many countries, supervision and regulation are conducted by a separate institution. Those with an English influence generally combine monetary policy and supervision. Countries with more German influence prefer separation. In part, these different traditions reflect different historical circumstances. Early in the century, the German banking system used few cheques (people preferred cash) and encouraged high levels of capital. Consequently, bank runs were rare, and the Bundesbank played little role in bank regulation. English-style banking systems were more prone to bank runs. In response, the clearinghouse emerged, an organisation that cleared cheques, supervised banks, and at times issued its own currency. Central banks in these countries were modeled quite explicitly on clearinghouses and naturally took on the responsibility of bank rescues, whether as a lender of last resort or as a coordinator of bank consortia. Although many English style banks have combined functions, the supervisory function was separated from the Bank of England in 1998 believing that separation would lead to increased independence and flexibility in using monetary policy tools to hit its explicit inflation target.

Restructuring Objectives of CBSL

Achieving domestic price stability has always remained the primary objective of CBSL. However, while focusing on the primary objective, CBSL has been attempting to achieve the other three objectives of exchange rate stability; the promotion and maintenance of high value of production, employment and real income; and, the encouragement and promotion of full development of productive resources. Financial sector stability has not been explicitly stated as an objective, but has been assigned to CBSL as a function. Similarly, managing public debt, exchange control, EPF, issuing currency and other agency functions have also been assigned as functions.

The new evidence, and the need to continue CBSL as a central bank, have bolstered the primary position of the objective of maintaining domestic price stability. Achieving exchange rate stability, therefore, is limited to the extent that it is required for price stability, and is warranted by price stability. Thus, the exchange rate may float freely responding to market sentiments.

Similarly, with the refutation of the real bills doctrine, and its own experience in the eighties, direct involvement in promoting economic growth and development has been subdued. A low inflation regime may promote economic growth and development, as in many countries.

Financial sector stability emerges as a strong secondary objective, as stability facilitates the transmission of monetary policy. Monetary policy tools are increasingly market oriented. Thus, a sound financial system is necessary for the propagation of policy. Thus, until the need for separating the bank supervision function from CBSL is greatly felt, financial sector stability will remain an important objective of CBSL.

There is a need for phasing out some functions of CBSL if the activities involved contradict the operations needed for achieving the primary objective. For example, managing the public debt involves interfering in the interest rate structure and the money supply. Monetary policy is also conducted using interest rate as a policy tool. Thus, the two activities often conflict. Similarly, managing the EPF could yield conflicting activities to monetary policy operations. Thus, there is a need for gradual phasing out of the management of these two activities from CBSL. In the new central bank, other functions could also be carried out as long as the activities involved are not in conflict with the primary objective of price stability.