Chapter 1

ECONOMIC PERFORMANCE, OUTLOOK, ISSUES AND POLICIES

1.1 Introduction

An unfavourable global economic environment, exacerbated by domestic uncertainties, made 2001 a very difficult year for the Sri Lankan economy. The economy was hit by a series of adverse external shocks that negated the expected achievements on the economic front. It also reflected the continuing vulnerability of the economy, despite its recent diversification. Hence, it highlighted the necessity for stronger policy adjustments and bolder structural reforms to enhance the resilience of the economy and achieve sustainable high growth with stability. The slowdown in the global economy, which sharply reduced the demand for Sri Lanka's manufacturing exports and caused a deterioration in external trade activities, deepened following the September 11 terrorist attack in the United States of America. The prolonged drought that was experienced from 2000, continued during 2001 as well, reducing domestic agricultural output, increasing domestic food prices and lowering the hydro electricity generation. The reduction in hydro power generation led to power cuts during the second half of the year, thus disturbing all economic activity. To deepen the crisis, the terrorist attack on the Katunayake International Airport in July sharply curtailed tourist arrivals, weakened business confidence and substantially reduced external trade. The last was the result of the imposition of a high war risk insurance premium on ships and airlines, following the attack. Meanwhile, the political uncertainty that prevailed in the second half of the year further lowered investor confidence, on the one hand, and caused the postponement of structural reforms, on the other. The impact of these negative forces was magnified by existing structural weaknesses, delays in policy responses, inconsistencies in policy action and a reversal of policy strategies during the run-up to the December general election. Against this background, graduating into an independently floating exchange rate regime in January 2001 as a further step in the move towards the market orientation of the exchange rate and entering into a Stand-By Arrangement (SBA) with the International Monetary Fund (IMF), helped the country to ease the burden of the external shocks somewhat by improving financial market stability and enabling a turnaround in the external reserve losses. Thus, early steps were taken to stabilise the economy, which could be a platform for medium-term stability and higher growth.

Frustrating the original expectations of achieving a moderate real growth, containing inflation and strengthening macroeconomic stability, the realisation in 2001 was a negative real growth with increased inflation and worsened macroeconomic imbalances. The economic contraction was widespread, recording negative growth rates in all the major sectors, with higher inflation. It reduced the real per capita income, weakening the ability to save. Investments in real terms declined, thereby limiting the future growth prospects and employment opportunities. A reversal in the previously experienced declining trend in inflation caused inflationary expectations to rise, making the stablisation of the macroeconomy more difficult. Even though a sharper reduction in imports than in exports reduced the external trade deficit as well as the current account deficit significantly, enabling the realisation of a small surplus in the balance of payments, the developments in the external sector and their impact pointed to the continuing vulnerability of the economy to external shocks.

A significant deterioration in the fiscal situation was the other main feature of economic performance during the year. The government fiscal deficit substantially exceeded the original target, leading to higher government borrowing. In fact, the government borrowed the equivalent of 4.9 per cent of GDP to finance its current expenditure, reflecting rigidities in wages, pensions and interest payments. These public sector developments raised concerns about the medium-term fiscal sustainability unless strong fiscal adjustments are taken without *further delay. Despite a sharp increase in domestic bank borrowing by the public sector, monetary expansion remained at a moderate level due to a weak private sector credit demand, thereby containing the potential demand-pull inflationary pressures. The floating of the exchange rate also obviated the need for the Central Bank to maintain very high interest rates. Reflecting this, short-term market interest rates reached a lower level. However, real lending rates remained significantly high, reflecting downward adjustment rigidities in the interest rate adjustment process in the financial system and hence reiterating the necessity for accelerating financial sector reforms to address prevailing structural issues.*

Developments in 2001 clearly demonstrated the vulnerability of the Sri Lankan economy to external shocks and the need for measures to strengthen the resilience of the economy. A fundamental requisite for this is to establish macroeconomic stability as a base for the private sector to perform within a framework of stable and transparent policies. The government's role should be to develop efficient markets and to provide satisfactory infrastructure. In such circumstances, the private sector could respond effectively to adverse external shocks without depending excessively on government assistance and protection.

This has also made clear the urgent need for strong policy adjustments and bold economic reforms in order to ensure an early economic recovery in 2002, strengthen macroeconomic stability, improve future growth prospects and ultimately raise the living conditions of the people, while reducing unemployment and poverty on a sustainable basis. Sri Lanka has been unable to attain its true growth potential in the past due to the non-implementation of appropriate macroeconomic and structural adjustment policies on a consistent basis. Thus, macroeconomic management has become more challenging, while economic reforms have become more urgent. However, with the election of a new government in December 2001, an opportunity has emerged for introducing such policy adjustments, undertaking faster structural reforms, including much needed institutional reforms and deregulation, and addressing governance and accountability issues related to public policies.

The progress, of course, would also depend on the restoration of peace in the country. The continuing war has been an enormous drain on this country, in terms of both human and material resources. In addition, it has significantly suppressed the growth potential of the economy. In economic terms, the country cannot continue to bear the cost of a prolonged war, and hence, a speedy resolution of the conflict is essential. The ongoing peace efforts, with strong and wider domestic and international support, have created optimism with regard to finding a lasting solution. The international community will not only help Sri Lanka in its efforts to find a lasting-peace, but has also pledged to assist in its subsequent rehabilitation, reconstruction and reconciliation efforts. However, it will be up to Sri Lanka, to find long-term solutions to its economic, political and social problems, which it faces at present, and to implement them with conviction. The international community can only be of help.

The economic stabilisation programme introduced with Budget 2001 and endorsed by the international community with the approval of a Stand-By Arrangement (SBA) with the International Monetary Fund (IMF) in April 2001 yielded positive results. This was specifically evident during the first half of the year when the previously experienced external reserve losses were reversed and the economy managed to achieve external adjustment with financial stability. The exchange rate, which overshot immediately after the introduction of the independently floating exchange rate regime on 23 January 2001, stabilised within a very short period, improving the stability in the financial markets. As the market gained experience under the new exchange regime, the Central Bank began to relax the monetary policy stance cautiously. The external current account deficit narrowed significantly because of a sharp contraction of imports, which more than offset the impact of weak exports. Consequently, external reserves increased despite shortfalls in the realisation of expected foreign financing and privatisation proceeds. However, scheduled reviews of the SBA programme in August and December 2001 were not completed as there were delays in the implementation of expected commitments due to adverse economic and political developments during the second half of 2001, delaying the realisation of the full benefits expected under the SBA.

The Gross Domestic Product (GDP), which contracted by 0.9 per cent during the first half of the year, further fell during the second half, recording a negative growth rate of 1.4 per cent for the year as a whole, in contrast to an expected growth rate of 4.5 per cent projected at the beginning of the year. This has been the first annual negative economic growth recorded by Sri Lanka since it regained

Independence in 1948; however, Sri Lanka was not an exception in this regard and many countries in the world recorded negative growth rates in 2001. The global recession, which adversely affected the performance of manufacturing and external trade, accounted for about two thirds of the loss in expected output. The prolonged drought, which had an adverse impact on agricultural output and hydropower generation, was the second major contractionary factor, accounting directly for a reduction in GDP by about 13 per cent. The other factors, including the impact of the terrorist attack, through a reduction in tourist arrivals and the disturbance of port and aviation services, accounted for the balance. The economic slowdown was widespread, reducing the output in all major sectors; agriculture (-3.0 per cent), industry (-2.0 per cent) and services (-0.5 per cent). On the aggregate expenditure side, the investment/GDP ratio declined to 22.0 per cent in 2001 from 26.2 per cent in 2000 (28.0 per cent without adjusting for investment in aircraft) owing to weaker investor confidence and a shortfall in the expected public investment. Meanwhile, the national savings/GDP ratio also declined to 19.5 per cent in 2001 from 21.5 per cent in 2000, reflecting increased government dissavings and the impact of the contraction in income on private sector savings. The slowdown in both economic growth and investment expansion reduced employment creation, compared with previous years, raising the unemployment rate marginally to 7.8 per cent at the end of the third quarter, 2001 from 7.5 per cent at end 2000. Despite the weak aggregate demand, the inflation rate increased, recording 11-14 per cent increases in aggregate price indices in 2001, mainly reflecting the impact of food price increases that resulted from the drought led supply shortages, upward adjustments in administered prices and high import prices.

Budget 2001 was formulated to improve fiscal consolidation, correcting the fiscal slippages of 2000. However, there was a significant deterioration in the fiscal situation. Revenue shortfalls (Rs. 33 billion) and current expenditure overruns (Rs. 19 billion) resulted in a higher overall budget deficit of 10.9 per cent of GDP, compared with 8.5 per cent of GDP in the original budgetary estimates. The increased fiscal deficit, together with the shortfalls in privatisation proceeds (Rs.16 billion) and lower utilisation of foreign financing (Rs. 21 billion), raised the domestic deficit financing to Rs. 124 billion (8.8 per cent of GDP), compared with a budgetary estimate of Rs. 57 billion. Consequently, the government debt has risen to 103.6 per cent of GDP, making the interest bill the largest expenditure component in the Budget.

The external reserve losses experienced in the previous two years started to make a turn around in 2001, but the improvement in the balance of payments (BOP) was below expectations. The trade deficit, as well as the current account deficit, narrowed as import compression (14.9 per cent)

TABLE 1.1
Selected Macroeconomic Indicators

Item	1980-89 Avg.	1990-96 Avg.	1997	1998	1999	2000	2001(a)
GDP (real) growth rate	4.2	5.3	6.3	4.7	4.3	6.0	-1.4
GDP deflator	11.8	11.5	8.6	8.4	4.4	6.7	13.0
GDP (nominal), per capita, rupees	9,608	29,157	50,292	56,760	60,741	68,102	74,760
GDP (nominal), per capita, US dollars	362	579	853	879	863	899	837
Unemployment rate , per cent	n.a.	13.4	10.5	9.2	8.9	7.6	7.8(b)
Import coverage of foreign assets, months							
Gross foreign assets	n.a.	n.a.	6.4	5.9	5.2	3.5	4.5
Gross official reserves	1.8	3.9	4.2	4.0	3.3	1.7	2.7
	Per cent of GDP						
Gross domestic investment	26.2	24.4	24.3	25.1	27.3	28.0	22.0
Gross domestic savings	12.9	14.7	17.3	19.1	19.5	17.4	15.3
Foreign savings (c)	13.3	9.7	7.0	6.0	7.8	10.6	6.7
Balance of payments, current account	-8.1	-6.1	-2.6	-1.4	-3.6	-6.4	-2.4
Budget, current account	2.7	-2.0	-2.2	-2.4	1.0	-3.4	-4.9
Budget, overall balance	-12.4	-9.8	-7.9	-9.2	-7.5	-9.9	-10.9
Money supply (M_{2b}), per cent change (d)	n.a.	n.a.	15.6	13.2	13.4	12.9	13.6
Colombo Consumers' Price Index, percentage change	12.8	12.7	9.6	9.4	4.7	6.2	14.2
Exchange rate (Rs\US$), percentage change (e)	-9.1	-4.8	-7.1	-9.6	-6.0	-12.7	-11.3

(a) Provisional.
(b) 3rd quarter 2001.
(c) Net imports of goods and non-factor services.
(d) Consolidated money supply, including FCBUs. M_{2b} data are available only from 1994.
(e) Changes in end year exchange rate; negative sign indicates depreciation.

Source:- Central Bank of Sri Lanka

outweighed the export slowdown (12.8 per cent). However, foreign investment inflows, realisation of privatisation proceeds and utilisation of foreign assistance fell below expectations. Consequently, the improvement in the BOP was limited to a surplus of US dollars 220 million, compared with the expected surplus of about US dollars 500 million. The country's total external reserves improved to US dollars 2,238 million (i.e.,about 4.5 months import cover), but remained below the desired targets. The exchange rate stabilised under the new regime within a short period, enabling the Central Bank to purchase foreign exchange from the market, thereby helping the Bank to improve official reserves from US dollars 1,049 million to US dollars 1,338 million.

Despite the high public sector bank borrowings that resulted from increased budget deficits and heavy losses in public enterprises, monetary expansion remained moderate at about 13 per cent in 2001, due to a slowdown in private sector credit expansion. The improved financial market stability and the continuation of moderate monetary expansion enabled the Central Bank to reduce its interest rates significantly during the second half of 2001, from the high levels at the beginning of the year. Purchases of foreign exchange by the Central Bank from the market and the government improved rupee liquidity, removing completely the liquidity shortage that continued from 2000. However, monetary management became more challenging due to increased government borrowings, including the overdraft facility with the two state banks which rose to Rs. 38 billion at end 2001. The overall monetary expansion, as well as reserve money expansion, remained within the targets set under the stabilisation programme, preventing the exertion of a demand fuelled inflationary pressure in the economy. Following the slowdown in inflationary pressure and

Chart 1.1
Macroeconomic Indicators

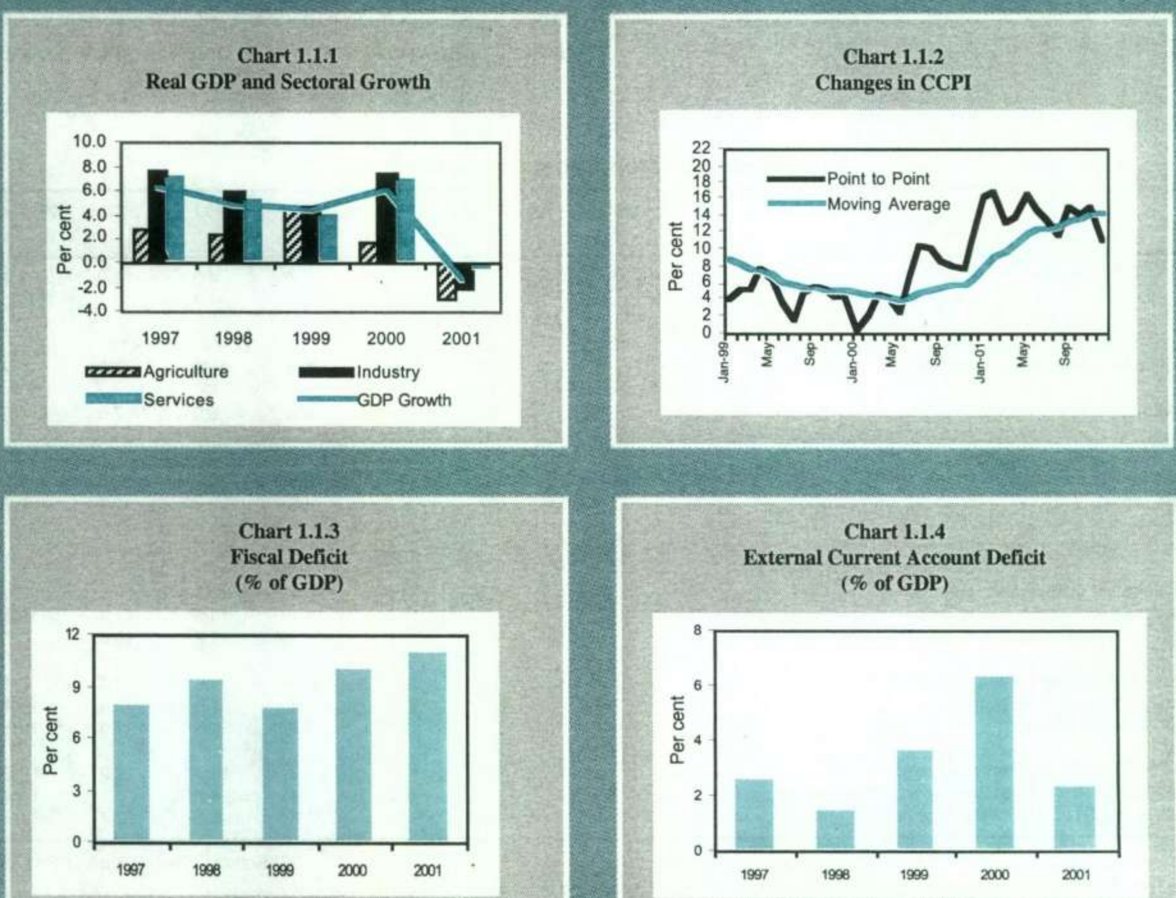


TABLE 1 . 2
Overview of the World Economic Outlook Projections (Annual percentage change)

	Actual		Projections
	2000	2001	2002
World output	4.7	2.5	2.8
Advanced economies	3.9	1.2	1.7
United States	4.1	1.2	2.3
Germany	3.0	0.6	0.9
United Kingdom	3.0	2.2	2.0
Japan	2.2	-0.4	-1.0
Developing countries	5.7	4.0	4.3
Developing Asia	6.7	5.6	5.9
World trade volume (Goods and services)	12.4	-0.2	2.5
Imports			
Advanced economies	11.6	-1.5	2.1
Developing economies	16.0	2.9	6.4
Exports			
Advanced economies	11.7	-1.3	0.9
Developing economies	15.0	3.0	4.8
Consumer prices			
Advanced economies	2.3	2.2	1.3
Developing economies	6.1	5.7	5.8
Six Month LIBOR on US dollar deposits	6.6	3.7	2.8

Source: World Economic Outlook, IMF

improvement in the financial market stability, as well as taking into consideration the contraction in economic growth, the Central Bank gradually reduced its lending rates by 800 – 900 basis points during the year. Financial markets responded positively, reducing all short-term market interest rates, but the reductions effected to general lending rates were smaller and, somewhat belated, reflecting downward rigidities in the interest rates adjustment.

1.2 International Environment

The deceleration in the global economy, which started during the second half of 2000, deepened during 2001 with all major regions of the world recording a widespread slowdown. Consequently, world output expansion declined to 2.5 per cent in 2001 from 4.7 per cent in 2000, implying that technically, the global economy was almost in a recession[a]. This slowdown is considered to be the most widespread among the major countries since World War II. It was also accompanied by a marked decline in the expansion of international trade and services, significantly lower commodity prices, and low international capital flows into emerging market economies and developing countries. These gloomy conditions in the world economy compelled international organisations and most countries to revise downward, from time to time, their annual growth projections during 2001. The International Monetary Fund (IMF) revised downward its growth projections for the global economy in 2001, for the fourth time in December, 2001 from 3.2 per cent (in May 2001) to 2.4 per cent, i.e., half of the growth rate achieved in 2000 (in April 2002 the growth rate for 2001 was estimated to be 2.5 per cent). The G-7 countries repeatedly revised downward their growth projections for 2001 reducing it from 2.7 per cent in the early part of the year to 1.2 per cent at the end of year; USA from 3 to 1.2 per cent, UK from 2.6 to 2.2 per cent, the European Union (EU) countries from 2.7 to 1.7 per cent and Japan from 1.8 to negative 0.4 per cent.

A number of steps were taken to counter this general global economic slowdown. Monetary policy in industrial countries was eased significantly. The US Federal Reserve lowered the Federal Funds rate a record eleven times during 2001 by a total of 475 basis points to its lowest level of 1.75 per cent. Similarly, the EU and the UK lowered their key policy rates by 150 and 200 basis points, respectively, in 2001. Japan also lowered its official discount rate to a near zero level (0.10 per cent) after the September 11 attacks on the US. These measures helped to mitigate the adverse effects to some extent, but were not strong enough to alleviate the continuing economic slowdown and make a turn around in growth.

The impact of the global economic slowdown was manifested in several associated developments: (i) a sharp reduction in world trade volumes, (ii) a risk aversion by investors and a deterioration in the economic fundamentals in some emerging markets, which more than offset the positive effect of declining international interest rates on capital flows to emerging markets, (iii) an accumulation of large scale macroeconomic imbalances among major economies with increasing exchange rate misalignments, and (iv) a deterioration in the terms of trade for developing countries.

In line with the global economic slowdown, world trade also declined substantially in 2001, sharply reducing the expansion in trade volumes (goods and services) to negative 0.2 per cent from 12.4 per cent in 2000. The growth in the import volume of advanced economies declined from 11.6 per cent to a negative 1.5 per cent during the same period, while in developing countries it dropped from 16.0 per cent to 2.9 per cent. Meanwhile, the growth in the volume of exports declined from 11.7 per cent to negative 1.3 per cent in advanced economies, and from 15.0 per cent to 3 per cent in developing countries.

With a decline in global demand, commodity prices declined sharply, seriously affecting those developing countries which were strongly dependent on primary commodity exports. Non-fuel commodity prices declined by 5.5 per cent in 2001 compared with an increase of 1.8 per cent in 2000, while oil prices declined by 14.0 per cent in 2001, reversing their upward trend of nearly 57 per cent experienced in 2000.

These unfavourable developments in the global economy had a strong adverse impact on highly trade

[a] A world annual economic growth of less than 2.5 per cent is considered a recession.

Box 1

Macroeconomic Impact of Shocks

The economy of Sri Lanka was beset by shocks, both internal and external, in 2001. These had significant ill effects on the economy, as detailed elsewhere in this Annual Report. This analysis attempts to disaggregate the impact of the macroeconomic shocks, as such an analysis helps to understand the consequences of external shocks and the vulnerability of different sectors.

Clearly, any disaggregation of this nature would yield only very approximate estimates. Moreover, in addition to the direct impact of the shocks, there would be indirect or second round effects, brought about by the interaction of the shocks. Hence, any conclusions drawn from the numbers should be within the context of such caveats.

Real Sector

In 2001, the economy recorded a contraction of 1.4 per cent in GDP, in contrast to a growth of around 4.5 per cent projected at the beginning of the year, and an average growth rate of about 5.0 per cent over the last decade (i.e., potential growth). The main factors leading to the contraction in growth were the global recession, the severe drought and the terrorist attacks, both in Sri Lanka and the US. The slowing down in the world economy from the early part of the year, which was aggravated into a recession by the September 11 attacks on the US, was estimated to be the major reason. The world recession had highly deleterious effects on the demand for manufactured goods, which, in turn, caused a sharp contraction in Sri Lanka's international trade. Consequently, it is estimated that almost two thirds of the loss in projected output was due to the world recession. Meanwhile, the very severe drought had its direct impact primarily on agriculture and electricity, and is estimated as having been responsible for around 13 per cent of the output decline. The direct impact of the attack on Katunayake is estimated to be marginal (about 2 per cent of the decline in output), although its negative fallout is expected to have had a far greater adverse impact indirectly. The secondary and indirect effect of these shocks had ripple effects on all sectors, and was responsible for a little over one fifth of the output loss. The combined impact of all these shocks is estimated to have resulted in an output loss of around Rs. 56 billion or 6.5 percentage points of GDP in 2001.

Impact of Shocks

Economic Variable/Sector	World Recession	Terrorist Attack	Drought	Secondary Impact	Total
1. Real Sector Output Loss (Rs. Bn.)					
Agriculture			5.0	2.0	7.0
Industry	14.9		2.3	2.7	19.9
Services	20.6	1.0		7.1	28.7
Total	35.5	1.0	7.3	11.8	55.6
Effect on GDP growth (%)	-4.1	-0.1	-0.9	-1.4	-6.4
2. Prices					
Changes in Price Increases(%)					4.1
3. Loss in External Earnings US$ Mn.					
Export US $ Mn	-1,132		-43		-1,175
(%)	(-20.5)		(-0.8)		(-21.3)
Tourist Earnings US $ Mn.	-13	-58			-71
(%)	(-5.2)	(-23.0)			(-28.2)
4. Fiscal					
Revenue loss Rs Bn	20.3	0.1	4.5		25.8
As % of GDP	1.4	0.01	0.3		1.8
Expenditure Increase Rs. Bn	-	5.4	0.2		5.6
As % of GDP	-	0.4	0.0		0.4
Increase in Budget Deficit Rs. Mn	20.3	5.5	4.7		31.4
As % of GDP	1.4	0.4	0.3		2.2
Increase in Govt Domestic Borrowing Rs.Mn	20.3	5.5	4.7		31.4
As of % of GDP	1.4	0.4	0.3		2.2
Increase in Public Debt Rs. Bn.	20.3	5.5	4.7		31.4
As % of GDP	1.4	0.4	0.3		2.2

Source:- Central Bank of Sri Lanka

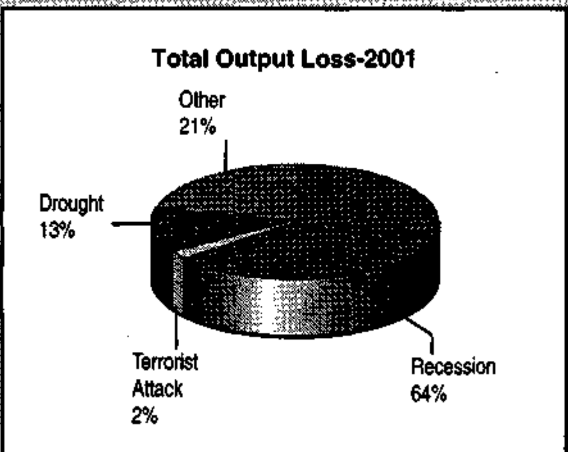
Box 1 (contd.)

Prices

The declining trend seen in prices since 1997 was reversed in 2001. Several factors were responsible, most notably changes in administered prices to adjust for international price changes, supply constraints in domestic food items due to the drought, increases in the prices of imported commodities due to increases in international prices, duties and surcharges on imports, increases in the international prices of goods and the effect of the depreciation of the currency. It is estimated that, had the normal underlying factors prevailed, average inflation based on the CCPI would have been around 7.5 per cent in 2001, as against the realised average inflation of 14.2 per cent. Hence, the difference, i.e., 6.7 percentage points, could broadly be attributed to the direct and indirect effects of the shocks and the impact of increases in administered prices. The average increase in the CCPI, if the administered prices were held at the levels that prevailed at the end of December 1997, was 11.6 per cent (i.e., 2.6 per percentage points below the increase in the average value of the CCPI). Thus, the average increase in the CCPI due to the shocks can be estimated at 4.1 percentage points.

External Earnings

The events of 2001 had a major direct impact on two areas on the external front, namely, export earnings and earnings from tourism. The average growth in exports over the last five years has been around 8 per cent. Even after allowing for the moderation in world economic growth expected at the beginning of the year, exports were expected to grow by around 8.5 per cent in 2001. The expected increase was based on the improved competitiveness following the implementation of the stabilisation programme and the quota-free access to EU markets. The sharp decline in world economic activity, and the reduction in tea production due to the drought, ultimately led to a contraction in exports. In view of the fact that the first half of the year experienced a 10.5 per cent growth in tourist arrivals, tourism was expected to perform extremely well in 2001 and around 450,000 tourist arrivals were expected. However, the July attack at Katunayake and the September 11 attacks in the US virtually brought the tourist industry to a standstill. It is estimated that export earnings were around US dollars 1,175 million below the expected earnings in 2001, while tourist earnings were around US dollars 70 million less than expected, due to these external shocks.



Fiscal Performance

On the fiscal front, the reduction in imports and the contraction in domestic economic activities directly brought down government revenues. In the meantime, the increased expenditure on defence and the relief package given to resuscitate the economy were directly responsible for expenditure overruns. The resulting increase in the budget deficit led to increased borrowings, together with an enhancement in the cost of borrowings. This inevitably raised the level of public debt. It is estimated that the revenue loss due to the three external shocks amounted to about 1.8 percentage points of GDP, while the expenditure increase was around 0.4 percentage points of GDP. Thus, the fiscal outturn would have yielded a fiscal deficit of about 2.2 percentage points of GDP above the budgeted estimate. This was controlled by a significant reduction in capital expenditure, which however, leads to adverse long-run effects of reduction in capital creation and hence, future output potential.

The above analysis, despite its limitations, demonstrates the vulnerability of the economy to shocks, particularly when several shocks come together in force. Proposals for reducing such vulnerability and developing resilience to face such shocks are given elsewhere in this Report.

Box 2

Global Recession and Implications for Developing Countries

The global economy is estimated to have grown by 2.5 per cent in 2001 from a high growth of 4.7 per cent in 2000. Technically, this would imply the global economy was in recession in 2001[a]. The global slowdown was accompanied by a marked decline in the expansion of international trade and services, significantly lower commodity prices, and low international private capital flows to emerging market economies. The slowdown is also considered to be the most synchronized among countries since World War II. Many attribute this to the external shocks, such as the sharp increase in oil prices in 2000, the bursting of the Information Technology (IT) bubble and the delays in implementing structural reforms by the major industrial economies such as Japan and the the European Union (EU.) While the too tight monetary policies adopted by industrial countries in the face of overheated economic conditions, in particular the United States, would have also helped trigger a sharp global slowdown, the growing integration of financial and corporate sectors in an increasingly globalised environment played its role in spreading the impulses around the globe at a faster speed.

Chart 1
GDP Growth (1995 - 2001)

The United States, which spearheaded the growth in the global economy during the last decade, is estimated to have registered a sharp slowdown from 4.1 per cent in 2000 to 1.2 per cent in 2001. Japan, which is embroiled in a vicious cycle of weakening growth, increasing bankruptcies and a persistently weak financial system, is estimated to have registered a negative growth of 0.4 per cent in 2001. The growth in the EU, which recorded a growth of 3.4 per cent in the previous year, is estimated to have slowed down to 1.7 per cent in 2001. Similar slowdowns have been seen in many other regions.

In line with the global slowdown, world trade is also estimated to have slowed down sharply in 2001. The growth in the volume of imports is estimated to have dropped from 11.6 per cent in 2000 to -1.5 per cent in 2001 in advanced economies, while in developing countries it is estimated to have dropped from 16.0 per cent to 2.9 per cent. Meanwhile, the growth in the volume of exports is estimated to have declined from 11.7 per cent to -1.3 per cent in advanced economies, while developing countries are estimated to have registered a drop from 15.0 per cent to 3.0 per cent in 2001.

The global economic slowdown is now projected to be broader and longer than expected earlier and world economic growth and international trade in goods and services are now expected to recover only in the second half of 2002.

The global economic slowdown had drastic consequences on developing countries, especially on trade dependent countries such as Sri Lanka. In particular countries which are heavily dependent on the USA, EU and Japan as export markets, and on tourism, appear to face severe constraints in maintaining their growth momentum and income levels. Sri Lanka registered its first ever recession since Independence in 1948 with a negative economic growth of 1.4 per cent in 2001. In terms of per capita GDP, this would imply that the average income of a citizen in Sri Lanka in 2001 has dropped below the 1997 level.

Developing economies were adversely affected on several fronts. The sharp drop in global demand, primarily due to the loss of confidence in major international economies, caused a significant slowdown in international trade expansion. This in turn, adversely affected foreign exchange earnings, employment generation, and government tax revenues in developing countries. Sri Lanka, which has a high trade dependency, with a trade/GDP ratio of over 70 per cent, and a concentration of exports in a few markets (the US and EU accounting for 41 per cent and 27 per cent,

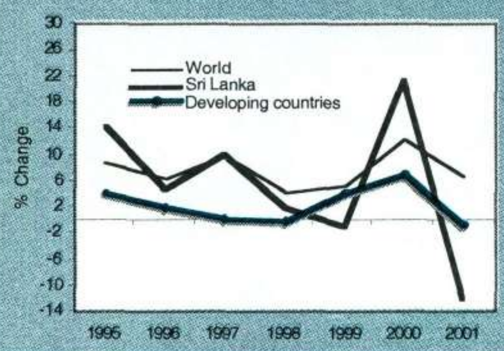
(a) Global recession is defined as a growth below 2.5 per cent per annum, although there is no universally accepted clear-cut definition for global recession.

Box 2 (contd.)

respectively), and a few products, is highly vulnerable to adverse shocks of this nature, as reflected in sharp declines in export volumes (8.0 per cent) and import volumes (10.7 per cent). Another channel through which developing countries are affected is the declining commodity prices in international markets, which reduces their export earnings. Prices of non-fuel commodities, mainly exported by developing countries, are estimated to have dropped by almost 6.5 per cent in 2001 with a corresponding deterioration in the terms of trade by the same magnitude. Reflecting these changes in values and prices, the country's export earnings declined by 12.8 per cent while the expenditure on imports declined by 14.9 per cent.

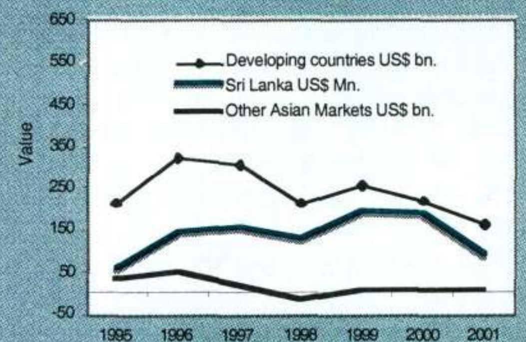
The tourism sector, to which some emerging markets are heavily exposed, has been hard hit, particularly after the September 11 attacks on the US, and a quick recovery in global tourism appears to be very unlikely. Sri Lanka, which had already suffered from the terrorist attacks on the Katunayake Airport in July 2001, was badly affected by these events and experienced a drop of 44 per cent in tourist arrivals during the second half of the year. Similarly, an economic slowdown in countries in the region also had an adverse effect on transhipment and other port related services.

Chart 2
International Trade (1995 - 2001)



Further, significantly increased insurance premia and increasing security concerns, particularly after the September 11 attacks, have already increased transaction costs with a negative impact on the long-term growth potential. Despite the reduction in insurance premia somewhat towards the end of the year, security would remain a concern in many countries for quite some time to come. International investors have become more risk averse, particularly after the September 11 attack, resulting in higher risk premia This would have long-term effects on emerging market economies such as Sri Lanka, which depend heavily on foreign capital for development purposes. The scarcity of foreign capital would reduce domestic investment, affecting future growth prospects.

Chart 3
Capital Flows (1995 - 2001)



The potential disruption to cross border flows of goods and services and financial assets as a result of the above concerns would take the globalisation process, which is regarded as a vehicle providing opportunities for rapid growth, a step backward, unless a collective effort is made to overcome problems and difficulties. In addition, the use of resources for containing terrorism by industrial countries may lead not only to a drop in Official Development Assistance (ODA), on which many developing countries rely as an alternative to raising capital in international capital markets, but also to a decline in resources allocated for Research and Development, which could retard future growth.

The events of 2001 are a severe setback to the global economy, in particular the developing countries, in terms of loss of income, employment and reduced welfare. The slow progress in global economic recovery, in particular, growth in the USA, EU and Japan, would prolong the time taken for recovery in developing countries. This would mean that developing countries, including Sri Lanka, would face a difficult period ahead in bringing their economies back to the normal growth path.

A coordinated and collaborative approach, particularly in major economic blocks such as the USA,

Box 2 (contd.)

EU and Japan, which function as engines of growth in the global economy, is of paramount importance in revitalising the global economy. It would be necessary for industrial countries to pay due attention to the concerns of developing countries, including through opening up their markets for exports of developing countries by eliminating non-tariff barriers and providing additional financial support to activate their economies. This, in turn, would bring rich dividends for developed countries by minimising the risk of further widening the gap between the rich and the poor and potentially creating two 'worlds' within the globe. Developing countries, for their part, could support this by adopting an appropriate, although sometimes difficult, prudent macroeconomic policy mix, and undertaking structural reforms to bolster their economies without jeopardising external and internal stability, thereby strengthening resilience in a highly volatile and uncertain external environment.

dependent developing countries such as Sri Lanka. Almost all Asian countries were affected adversely, except China and India, compelling them to scale down their early growth expectations. Sri Lanka's terms of trade deteriorated by 1.7 per cent in 2001, a deterioration for the third consecutive year, while export volumes declined by 8 per cent, resulting in a severe external trade shock.

Inflation remained low during 2001 in many regions of the world, reflecting the weak global demand and the decline in oil prices. Despite continuous reductions in interest rates and the introduction of fiscal stimulus packages, inflation in advanced countries marginally declined from 2.3 per cen in 2000 to 2.2 per cent in 2001 reflecting more stable macro economic conditions in those countries.

International financial markets remained relatively subdued and stagnant in 2001, even though sharp corrections in overpriced equity markets and the September 11 disruption resulted in some volatility. Despite the slowdown in the US economy, the US dollar strengthened against all major currencies reflecting much greater economic weaknesses in other countries, notably Europe and Japan. Volatility in key international currencies made macroeconomic management in most developing countries more difficult. Private capital inflows to emerging market economies and developing countries continued to be weak since the outbreak of the currency crisis in East Asia followed subsequently by the crises in Russia and Brazil. The Asian and the Middle Eastern regions felt the full brunt of capital outflows due to the prevailing uncertain market conditions, particularly in the crisis affected Asian economies.

1.3 Output Growth and Sectoral Performance

In 2001, GDP in real terms is estimated to have contracted by 1.4 per cent, deviating from its medium-term annual growth trend of around 5 per cent, largely reflecting the severity of the adverse external shocks. The negative effects

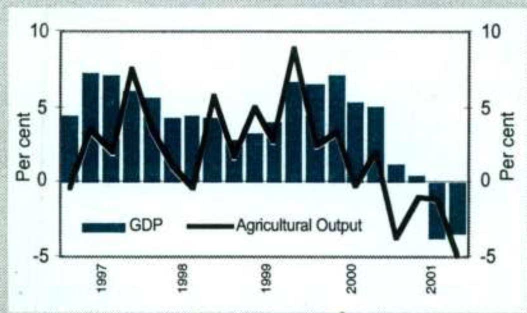
TABLE 1.3

Growth in Gross National Product at Constant (1996) Prices (Annual Percentage Changes)

Item	1990-1999 Avg.	2000	2001(a)
1. Agriculture, forestry and fishing	2.6	1.8	-3.0
1.1 Agriculture	2.5	1.7	-3.7
Tea	4.0	7.8	-3.4
Rubber	-0.7	-9.7	-1.8
Coconut	1.5	8.0	-9.7
Paddy	4.2	-0.3	-5.7
Other	2.6	0.9	-2.0
1.2 Forestry	1.4	1.6	5.0
1.3 Fishing	4.2	2.5	-4.0
2. Mining and quarrying	2.6	4.8	0.7
3. Manufacturing	8.0	9.2	-4.0
3.1 Processing of tea, rubber and coconuts	2.3	4.2	-5.3
3.2 Factory industry	9.3	10.4	-3.9
3.3 Small industry	5.9	5.5	-3.5
4. Construction	5.2	4.8	2.5
5. Electricity, gas, water and sanitary services	8.1	4.5	-2.9
5.1 Electricity	n.a.	4.5	-3.7
5.2 Water and gas	n.a.	4.5	2.1
6. Transport, storage and communication	6.3	7.8	5.2
6.1 Port services	n.a.	0.4	0.0
6.2 Telecommunications	n.a.	25.1	25.5
6.3 Transport	n.a.	4.1	-0.5
7. Wholesale and retail trade	5.2	8.7	-6.5
7.1 Imports	7.1	12.9	-10.7
7.2 Exports	9.6	18.3	-8.0
7.3 Domestic	2.5	2.4	-1.6
8. Banking, insurance and real estate	7.9	6.4	5.0
9. Ownership of dwellings	1.3	1.7	1.4
10. Public administration and defence	3.4	4.2	1.0
11. Services (n.e.s.)	5.7	2.3	2.2
11.1 Hotels & restaurants	n.a.	-1.1	-5.5
12. Gross domestic product	5.2	6.0	-1.4
13. Net factor income from abroad	-6.9	-20.3	8.0
14. Gross national product	5.3	5.8	-1.3

(a) Provisional Source:- Central Bank of Sri Lanka

Chart 1.2
Quarterly Real GDP Growth Rates, 1997-2001



were felt both on aggregate supply and on aggregate demand. The economy commenced slowing down in late 2000. The deceleration started from a peak growth of 7.3 per cent in the second quarter of 2000 and continued into 2001, reflecting the impact of the continuation of the world economic slowdown on the country's exports, and the adverse consequences of the prolonged drought on agriculture and hydro power generation. The situation deteriorated further during the second half due to the adverse impact of power cuts caused by the continuation of the drought, the terrorist attacks on the Katunayake International Airport in July, the September 11 attacks in USA and the political uncertainty in the country after the prorogation of Parliament in August. Reflecting the impact of all these adverse developments, quarterly economic growth declined sharply to a trough of

TABLE 1.4
Gross Domestic Product at Current Factor Cost Prices (Sector Shares in per cent)

Sector	1998	1999	2000	2001(a)
1. Agriculture, forestry and fishing	21.1	20.7	19.4	19.4
2. Industry	27.5	27.3	27.3	26.5
2.1 Mining and quarrying	1.9	1.8	1.9	1.9
2.2 Manufacturing	16.5	16.4	16.8	15.8
2.3 Electricity, gas and water supply	1.5	1.5	1.2	1.3
2.4 Construction	7.6	7.6	7.3	7.5
3. Services	51.4	52.0	53.3	54.1
3.1 Transport, storage and communication	11.1	11.4	11.7	12.3
3.2 Wholesale and retail trade	21.5	21.2	22.6	21.9
3.3 Banking, insurance and real estate	7.6	8.1	8.1	8.4
3.4 Ownership of dwellings	1.9	1.8	1.8	1.8
3.5 Public adminsitration and defence	5.3	5.3	5.2	5.5
3.6 Services (n.e.s.)	4.0	4.1	4.0	4.1
4. Gross domestic product	100.0	100.0	100.0	100.0
5. Net factor income from abroad	-1.3	-1.8	-2.1	-2.0
6. Gross national product	98.7	98.2	97.9	98.0

(a) Provisional Source: Central Bank of Sri Lanka

Chart 1.3
Sectoral Composition of GDP

Chart 1.3.1

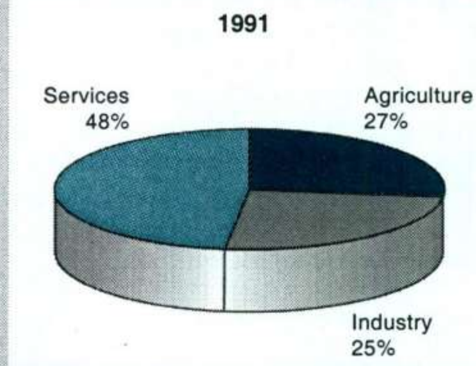
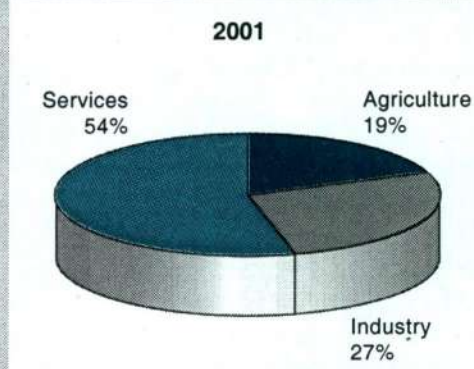


Chart 1.3.2



minus 3.7 in the third quarter and a further negative growth of minus 3.4 per cent in the fourth quarter. Consequently, annual economic growth, as measured by the change in real GDP, contracted by 1.4 per cent in 2001, compared with a 6 per cent growth in 2000. GNP, defined as GDP adjusted for net factor income from abroad, contracted by 1.3 per cent in 2001, compared with a 5.8 per cent increase in 2000.

The economic slowdown was widespread, with the agriculture sector declining by 3 per cent, industry sector declining by 2 per cent and the services sector by half a per cent. Only a few sectors, such as construction, banking, insurance and real estate, storage and transport and communication recorded positive real growth rates in 2001, and even these positive rates were lower than the comparable growth rates in the previous year.

At current market prices, GDP rose by 11.3 per cent to Rs.1,400 billion in 2001, while GNP rose to Rs.1,377 billion. These increases in nominal terms were due to increases in prices, because both real GDP and real GNP recorded negative growth. Meanwhile, the Census of Population and Housing – 2001 conducted by the Department of Census and Statistics after 20 years showed a mid-year 2001 population of 18.73 million[a]. Thus, the average (per capita) GDP in nominal terms increased by 9.8 per cent to Rs.74,760 in 2001. Given the GDP deflator reflecting an inflation in prices of 13 per cent, it is possible that the average living conditions of Sri Lankans would have deteriorated in 2001. In US dollar terms, the per capita GDP showed a decline of 6.9 per cent from US dollars 899 to 837, following a 15.1 per cent depreciation of the average exchange rate.

Agriculture and Allied Activities

The performance of the agriculture sector was affected by the severe drought that prevailed through most of the year. The output of major agricultural products declined in 2001, contracting the value added in agriculture by 3 per cent, in contrast to the 2 per cent growth in the previous year. This sector recorded negative growth rates in 1992 and 1996 too, due to adverse weather conditions reflecting its vulnerability to the vagaries of the weather and underscoring the need for measures to improve its resilience, such as the expansion of modern cultivation practices (drip irrigation and greenhouses), cultivation of less water intensive crops etc.

The monsoons not only failed to bring sufficient rainfall but the distribution of rainfall was also highly concentrated during a very short period, increasing the severity of the drought. The production of even the perennial crops was affected by the prolonged drought. The output of tea, rubber, coconut, paddy and other field crops, except potatoes, declined compared to 2000. However, the livestock sector reported a positive growth, especially in milk, eggs and poultry meat.

The upward trend in tea production, observed since the privatisation of the management of the state plantations in 1992, benefiting from improved agricultural practices and management practices, was reversed in 2001, largely reflecting the adverse impact of the drought. Tea production, which reached a record output level of 306 million kg in 2000, declined by 3.5 per cent to 295 million kg in 2001.

A marginal increase in tea output in the low elevation areas was not sufficient to offset output declines in high and medium elevations. The average yield in the smallholder sector (2,212 kg per ha.) was significantly higher than that in the large plantation sector (1,365 kg per ha.), reflecting the existing potential for increasing the yield by improving agricultural practices and replanting old plantations with high yielding tea plants. Meanwhile, cut, tear and curl (CTC) teas suffered a slight setback, as their prices were not favourable owing to increased global supply.

Despite the reduction in output, the quantity of tea traded at the Colombo auctions and exported showed an increase in 2001, indicating a reduction in stocks. The annual average price at the Colombo auctions increased by 6 per cent in rupee terms to Rs.143.96 per kg. But it declined in US dollar terms by 10 per cent, to US dollars 1.61 per kg, reflecting the decline in tea prices in the international market following a slowdown in global demand and the revival of Kenyan tea production.

The volume of tea exports increased by 2 per cent to 295 million kg, whereby Sri Lanka retained its position as the world's largest tea exporter for the fifth successive year. Russia, UAE and Syria were the three largest buyers. The share of bulk tea exports declined from 63 to 60 per cent in 2001, while the share of value added tea exports rose from 37 to 40 per cent. Thus, there may still be potential to augment tea export earnings by moving to more value added tea.

Rubber production, which has been on a declining trend in the recent past, dropped further by 1.8 per cent to 86 million kg, in 2001, the lowest output ever. This drop was reflected in he smallholder and plantation sectors. The decline in output is due to the abandoning of tapping, attributed to unremunerative prices. Meanwhile, a growing demand for rubber trees as timber and rubber land for real estate development has further reduced the extent under rubber cultivation. A continuation of depressed rubber prices for a long time now has discouraged the application of fertiliser, thereby reducing rubber yields. Sri Lanka is the world's largest industrial tyre manufacturer. In addition, a wide range of rubber based manufacturing products including gloves, pneumatic tyres and tubes too use natural rubber as the major input. Reflecting the weak export demand for manufactured products, the consumption of rubber in the domestic industrial sector declined by 2 per cent in 2001. Similarly, the rubber wood industry too suffered a setback in 2001 due to the weakening demand.

Coconut production, which reached a record output of 3,096 million nuts in 2000, declined sharply by 10 per cent to 2,796 million nuts. The continuation of the drought and the lagged effect of reduced fertiliser application in previous years were the major contributory factors for the decline. The drop caused coconut prices in the domestic market to rise sharply in 2001. However, the average export price of kernel products in US dollar terms, which declined by 31 per cent in 2000, declined further by 19 per cent, reducing the pressure on coconut prices in the domestic market. Nevertheless, a sharp increase in coconut oil production

(a) The per capita GDP series has been revised on the basis of provisional population estimates by the Department of Census and Statistics following the Census of Population and Housing – 2001.

under the protection provided by a high tariff on edible oil imports exerted upward pressures on domestic coconut prices. To meet the domestic supply shortage, the import of copra was allowed during the year to contain rising coconut prices in the domestic market.

Paddy production declined by 5.8 per cent in 2001 as the Maha season was affected by the drought. The extents sown and harvested during both seasons declined due to an inadequate rainfall. However, as cultivation was concentrated in irrigated lands and marginal lands were not cultivated, the average yield increased, reaching a new record level of almost 4 metric tons per hectare. The drop in domestic production and import restrictions through licensing requirements raised rice prices sharply in the domestic market. In the wake of these increasing prices, CWE and the private sector were allowed to import rice on a duty free basis towards the latter part of the year. In order to establish a conducive environment for cultivators as well as millers to develop the paddy sector, the licensing requirements should be abolished and protection, if any, should be provided only through a maximum level of tariff, without adjusting it in an ad hoc manner as has been done in the past.

Other export crops recorded a mixed performance in 2001. This sector has now become a major export earner, exceeding the combined export earnings from both rubber and coconut. Among the major crops within this category, the production of cinnamon and cloves increased, while pepper production declined sharply, reflecting the phenomenon of alternate bearing in pepper.

The other field crop sector also performed poorly in 2001 as the output of all the major crops, except potato, declined. Potato production increased by 19 per cent, owing to the very heavy protection provided by a specific duty on potato imports.

Fish production during the year declined by 6 per cent, reflecting output reductions in both marine and aquaculture. Consequently, fish prices increased in the domestic market. The livestock sector, consisting mainly of the dairy and poultry sub-sectors recorded an improvement in 2001.

Industry

In 2001, the performance in the industrial sector was affected by weak demand, power cuts and increased costs of production. Within Manufacturing, the factory industry sector, which is the largest sub sector, recorded a decline of 3.9 per cent due to a sharp reduction in the output of export oriented industries and a considerable slowing down of industries catering to the domestic market. Manufacturing output, which increased continuously during the last two decades recording an average annual output growth rate of over 7 per cent, declined for the first time in 2001. Among the industrial sub categories, notable contractions were recorded in apparel and textiles (8.5 per cent), ceramic products (11.9 per cent) and petroleum products (11.3 per cent).

The decline in the manufacturing sector was mainly attributed to the poor performance of export oriented industries. The reduction in stock levels by major buyers and supermarkets in USA following the downward revision of consumer spending forecasts reduced the export orders for apparel and textile products. Meanwhile, buyers in the EU markets demanded large price discounts, reducing the average export prices of high value added apparel. The terrorist attack on the Katunayake International Airport and the September 11 attacks in USA further worsened the situation faced by Sri Lankan manufactured exports.

The apparel and textile export sector, the largest sub sector within the Manufacturing sector, faced severe competition in the international market. Special concessions granted by USA to some African and Caribbean countries and increased supply from low-cost manufacturing countries in Eastern Europe and China further aggravated the competition faced by Sri Lankan apparel and textile exporters. China, with its own fabric and accessory manufacturing base, large capacity and relatively cheap labour, entered the international markets strongly, after its accession to the World Trade Organisation (WTO) in 2001, intensifying the competition faced by small countries such as Sri Lanka.

The expansion of industries catering to the domestic market decelerated in 2001 due to weak consumer spending. In the depressed domestic market, some manufacturers introduced various sales promotion activities and incentives, squeezing their profit margins. Weak demand, increased cost of production and rigidity in labour laws affected the profitability in the manufacturing sector in 2001. The industrial survey on the non-BOI industrial sector indicated a decline of profitability from 13.7 per cent in 2000 to 10.4 per cent in 2001.

On the policy front, the government continued with its private sector led export oriented industrial policy. The experience in 2001 indicates the necessity for improving factor productivity to face increasing international competition and diversification of the industrial product base and export market destinations so as to increase resilience to external shocks. Similarly, flexible labour regulations are necessary to facilitate restructuring of industries according to changes in the world market.

The energy sector was in severe crisis in 2001. There was a severe shortage of power supply, with a significant drop in hydropower generation due to poor rainfall received in the catchment areas, delays in repairing power plants and discontinuation of hired power plants. This led to prolonged power cuts in the second half of the year, which disrupted economic activity. The power generation capacity increased by 7 per cent to 1,901 MW in 2001 with the commissioning of the combined cycle power plant (110 MW), reducing hydro dependence to 61 per cent. However, effective generating capacity remained well below its potential capacity due to low water levels in reservoirs.

The electricity consumer network grew by about 7 per cent, increasing the share of households with electricity to 65 per cent. The demand for electricity increased with the expanding consumer network and increasing use of power in the economy at a faster rate than the expansion in power generation capacity. This aggravated the shortage of power already experienced by the country.

The Ceylon Electricity Board (CEB) faced a twin crisis in 2001; a power crisis and a liquidity crisis. The cost of power generation rose rapidly due to high dependence on thermal power and hired power, but power tariffs were not raised adequately to cover the additional cost. The continuation of an average tariff (Rs.5.53 per unit) below the average cost (Rs.7.20 per unit) resulted in severe operational losses of about Rs.12 billion in the CEB, which had to be financed by bank borrowings. The reported management inefficiencies and misuse of resources may have also been contributing factors to the crisis. Meanwhile, the system losses remained high at around 21 per cent, further aggravating its financial crisis.

The power crisis in 2001, which was a repetition of a similar crisis in 1996, clearly demonstrates the continued weakness in power policy and the delay in the implementation of planned power projects. Several measures need to be taken to tackle the power crisis. In the short-term, CEB's power plants under repairs have to be completed as soon as possible, power losses have to be reduced by fixing meters to unmetered consumers and preventing power thefts. A transparent automatic power tariff adjustment system has to be introduced. Meanwhile, the planned power projects, which have been inordinately delayed, have to be expedited. Additional new power projects, which are already in the investment pipeline, have to be commenced without further delay.

In the medium to long term, it is crucial to develop low cost sources of power generation, such as coal power, in order to generate a reliable power supply to meet increasing demand at a reasonable price, as well as to restore the financial viability of the power sector. As it takes more than 4-5 years to fully commission an economically efficient coal power plant, the proposed 300 MW coal power plant should be initiated without further delay, while necessary action has to be taken to build two other 300 MW coal power plants, which are in the power capacity expansion programme. At the same time, CEB needs urgent restructuring to become a viable commerical organisation.

The demand for petroleum products, which remained high in the past few years, dropped marginally in 2001, for the first time since 1993. The slowdown in economic activity, increased domestic petroleum prices and a decline in thermal power generation were mainly responsible for this decline. International crude oil prices, which remained high until September, 2001, declined thereafter with the deepening of the economic slowdown in industrial countries following the terrorist attack in USA. Consequently, the average import price of crude oil (c&f) declined by 15 per cent to US dollars 24.47 per barrel in 2001, enabling the Ceylon Petroleum Corporation (CPC) to reduce a part of its outstanding loans, and reducing the burden on the balance of payments (BOP).

Diesel and furnace oil prices were raised in April by Rs.3.00 and Rs.1.80 per litre, respectively, to cover the continuous losses accruing to the CPC. High prices, the discontinuation of CEB hired power purchases and the slowdown in transport activities with the economic slowdown resulted in a 3 per cent decline in diesel consumption, which accounts for about 50 per cent of the total petroleum consumption. Meanwhile, the declining trend in kerosene oil consumption was halted in 2001 due to renewed demand for kerosene along with the power cuts.

The accumulation of heavy losses and the continuing inefficiencies underscore the need for major reforms in the petroleum sector. The CPC introduced a long overdue flexible pricing policy for petroleum products at end 2001. Under the new pricing policy, local prices of major petroleum products are expected to be revised monthly, based on changes in the cost of production. With this pricing system, any gain or loss due to the fluctuation of international crude oil prices, exchange rate or any other input will be passed on to consumers according to a formula. A debt recovery adjustment factor has also been incorporated into the pricing formula in order to settle the existing debt of CPC, amounting to about Rs.19 billion at end 2001. Following the end of the monopoly period, a new local company entered the LP gas market creating competition. Consumers have already benefited from the competition through lower prices and improved services.

In order to create a more competitive market for petroleum products, major reforms are necessary in the sector. The unbundling of refined product imports, bunker and aviation fuel supplies, operations of the refinery and petroleum distribution have to be implemented to improve efficiency and competition in the petroleum sector.

The total volume of water supplied by the National Water Supply and Drainage Board (NWSDB) increased by 3 per cent, while the number of new connections provided grew by 14 per cent. The NWSDB implemented 46 upgrading and rehabilitation projects during the year. As it is difficult to meet the increasing demand for water only through public sector investment programmes, it is desirable to involve the private sector in the development of water supply. For example, the total investment requirements to achieve the targets of NWSDB, i.e., to increase access to safe drinking water from the present level of 67 per cent to 80 per cent, reduce non-revenue earning water from the present high level of 35 per cent and provide a 24 hour uninterrupted pipe borne water to all consumers has been estimated at Rs.85 billion, as against a planned investment allocation of Rs.45 billion for the water sector by the government for the next few years.

Services

The Services sector, which accounts for about 53 per cent of GDP, also recorded a negative growth rate of 0.5 per cent in 2001. Transport, communication and financial services sectors recorded moderate positive growth rates, though they were lower than in 2000. However, the largest sub sector i.e., Wholesale and retail trade, recorded a sharp decline, mainly reflecting the declines in external trade, resulting in a contraction in the Services sector as a whole. Tourism was the hardest hit sub-sector, declining by 16 per cent, reflecting its vulnerability to external shocks.

The telecommunications sub sector, which has been growing vigorously since 1996, recorded a high growth of 25.5 per cent in 2001. This high growth was largely due to a sharp expansion in cellular telephones by 55 per cent. Heavy investment, competitive prices, aggressive advertising campaigns and new facilities helped to achieve this high growth. However, further reforms are necessary in the sector by promoting fair and efficient competition, which could be achieved by efficient regulation.

The overall performance of road and rail transportation showed a marginal improvement in 2001, while air and sea transportation suffered a significant setback following the terrorist attacks of July and September. The public road passenger transport fleet showed an increase, but was still well below the increasing demand for transport services. The weak railway infrastructure led to continued operational losses and poor maintenance led to delays and a number of derailments and several fatal accidents in 2001. These developments underscore the need for urgent railway reforms. As an efficient and high quality transport service is essential for faster economic development, reforms in the transport sector have to be given priority, by removing inefficiencies in the sector and by further increasing private sector participation.

The overall performance of port activities recorded a negative growth in 2001. Port services, which grew during the first half of the year, declined sharply during the second half with the imposition of the war risk insurance surcharge on vessels calling at Sri Lankan ports and the bypassing of Colombo by some major shipping lines subsequent to the terrorist attack at the Katunayake airport in July. The situation eased towards the end of the year with the reduction of the war risk surcharge and the return of major shipping lines to the Colombo Port.

The total cargo handled at the Colombo, Galle and Trincomalee ports declined by 2 per cent in 2001. Containerised cargo has increased, accounting for about 71 per cent of total cargo in 2001. Transshipment container movements, which accounted for about 69 per cent of the total container throughput, increased marginally as the Port of Colombo attracted major shipping lines during the first half of the year.

As a high trade dependent country, the availability of efficient and high quality port services is essential for Sri Lanka's economic development. Failure or delay to develop the Colombo Port as an efficient shipping centre in the region would risk the hub status of the Port, as ports in the neighbouring countries would attract major shipping lines. The improved competition in the Colombo Port with the commencement of operations of the South Asia Gateway Terminal Ltd. (SAGT) has created an enabling environment for improving the efficiency of port services. Productivity indicators such as the number of containers handled per hour and average waiting time for berthing of main line container vessels improved in the past few years, but are still well below the level of other efficient ports such as Singapore. Further improvements in efficiency and productivity are essential in facing future competition, with other regional ports, particularly for transshipment services.

Some improvement was seen in the postal network. However, operational losses which burdened the government budget, delays in delivery and losses of items in the delivery process clearly indicate the necessity for major reforms in the postal services. Realistic pricing is an essential prerequisite to introduction of competition to this sector, while greater diversification of services and performance related incentives may be necessary to make the basic public service more efficient.

Although the repair and maintenance of the road network continued at a satisfactory level, only one fourth of the road network in the country is yet weather paved and a greater part of these roads are inadequately maintained, especially at the provincial level. It is observed that, along with the increasing vehicle fleet, traffic congestion in the cities has increased sharply, resulting in travel delays, loss of manhours and increasing pollution, emphasising the necessity for urgent remedial action. The progress in the construction of major highways, which had already been commenced (Colombo – Katunayake and Colombo – Matara), was also very slow, though foreign funding for those projects had been available.

In 2001, education and health sector activities expanded further, while sectoral reforms continued, though at a slow pace. In addition to 585 government hospitals, 160 private hospitals with a capacity of about 7,000 beds provided health services. This capacity will increase significantly with the opening of a large private sector hospital with modern facilities in 2002. The medical staff in the country increased further in 2001, but both government and private hospitals continued to experience severe shortages of qualified nurses and paramedical staff. The persistent shortage of key medical personnel emphasises the need for raising training opportunities in the country. Recent studies have shown an increasing share of private sector in health expenditure, which is now around 50 per cent. Unlike in developed countries, where a large part of private health expenditure is covered through health insurance schemes, private health expenditure in Sri Lanka is almost entirely borne by the users. This clearly indicates the existing potential for the expansion of health insurance services in the country.

Several steps have been taken to improve the quality and the standards of both general education and university education. An Educational Reforms Implementation Monitoring Unit (ERIMU) was established in order to ensure the implementation of ongoing educational reforms. The significant differences in education facilities available in different districts, a mismatch between the availability and the demand for trained teachers and the continuation of a supply-demand mismatch in the labour market emphasised the need for major reforms at all levels in the education system. Encouraging the private sector participation and facilitating competitiveness are essential for the effective implementation of education reforms given the fiscal limitations and the required efficiency improvements.

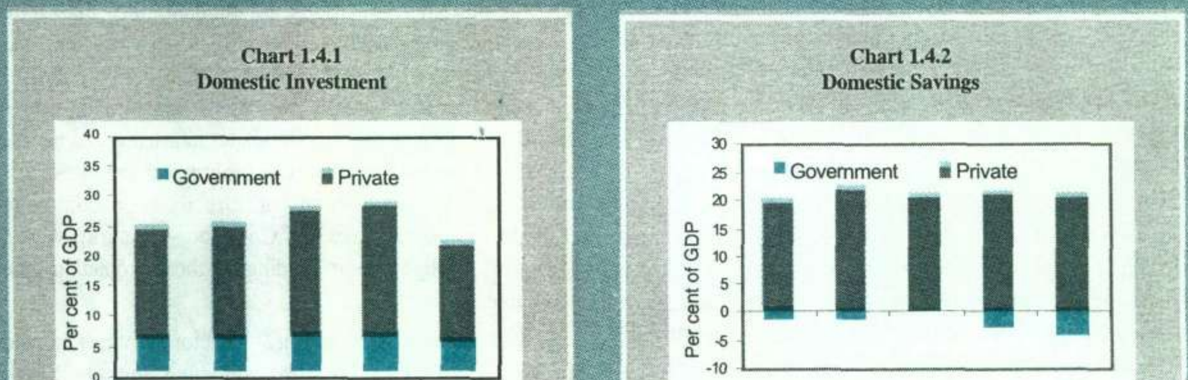
1.4 Consumption, Savings and Investment

On the expenditure side, the relative share of consumption increased and remained high. During a temporary economic slowdown, generally, the consumer adjustment is mainly reflected in savings rather than in consumption. Accordingly, total consumption expenditure at constant prices (1996) rose marginally by 0.4 per cent, raising its share to 79.3 per cent in 2001 from 76 per cent in 2000.

Consequently, the national savings/ GDP ratio, which declined from the recent peak of 23.5 per cent in 1999 to 21.5 per cent in 2000, declined further to 19.5 per cent in 2001, recording the lowest ratio since 1997. A similar declining trend was observed in the domestic savings/GDP ratio. Increased government dissavings reflected in the rising current account deficit was the major contributory factor for this decline, accounting for about 71.6 per cent, in 2001. The private sector savings/GDP ratio declined marginally from 20.9 per cent in 2000 to 20.3 per cent in 2001.

The gross domestic capital formation, which grew by 9.9 per cent (at 1996 prices) in 2000, declined by 17.1 per cent in 2001 reducing the investment/GDP ratio from 28 per cent (26.2 per cent when adjusted for the investment in three aircraft under the refleeting programme of SriLankan Airlines) to 22.0 per cent. Public sector (government and public corporations) investment as a ratio of GDP declined from 6.6 per cent to 5.8 per cent during the same period, as capital expenditure was cut down in an attempt to contain the expanding fiscal deficit, which resulted from the rising current account deficit in the government budget. However, a large reduction was reflected in private investment even after the adjustment made for SriLankan Airlines' refleeting investment in 2000. Private investment decreased from 19.7 to 16.2 per cent of GDP between the two years. The slowdown in economic activity, weak business confidence, a depressed equity market which was not conducive to raising new resources, high interest rates, low foreign investment

Chart 1.4
Investment and Savings



inflows and political uncertainty in the country were the major causal factors for the reduction in private sector investment. This should be reversed and increased to over 25 per cent of GDP in order to achieve the necessary overall investment of about 30 per cent of GDP in the medium term, to achieve an average annual economic growth rate of over 8 per cent.

The savings-investment gap as a ratio of GDP, which increased from 3.8 per cent in 1999 to 6.5 per cent in 2000, narrowed to 2.5 per cent in 2001, reducing the external and internal resource gap. However, this decline has resulted from a reduced private investment/GDP ratio, thereby lowering the future potential for the expansion of output, rather than resulting from an increased national savings/GDP ratio. Therefore, a turnaround in the dissavings of the public sector is necessary to increase the overall domestic savings to finance the high investment requirements needed for accelerating the economic growth rate.

The total resource availability in the economy valued at constant (1996) prices, consisting of GDP (domestic resources) and import of goods and non-factor services (foreign resources), declined by 4.5 per cent in 2001. The negative GDP growth of 1.4 per cent and the contraction in imports and non-factor services by 10.1 per cent were responsible for this reduction. On the resource utilisation side, consumption grew marginally by about 0.4 per cent in real terms, while investments and export of goods and non-factor services declined by 17.1 per cent and 6.5 per cent, respectively. Thus, on the aggregate demand side, a decline in both foreign demand (i.e., export of goods and non-factor services) and domestic investment demand are largely responsible for the weak economic performance in 2001.

1.5 Prices

Despite the weak aggregate demand, the inflation rate increased to a double digit figure in 2001 reflecting the impact of temporary supply shortages of domestically produced major food items caused by the drought, upward adjustments in administered prices, higher import prices, excessive tariff and non-tariff protection for some major food items and import surcharge. The prolonged drought resulted in temporary shortages in many domestically produced food items, raising their prices sharply. The direct impact and passthrough effect of upward revisions in petroleum prices, water tariff and the wheat flour price, and the imposition of a surcharge on electricity tariff were partly responsible for the high price increases observed in 2001. In addition to high international prices for some imported food items, the imposition of a 40 per cent import surcharge, high tariff protection for imported edible oil and potatoes and the licensing restriction on rice imports also contributed to high price increases in 2001. The high tariff on edible oil imports led to the sharp increase in coconut prices with the reduction of domestic coconut production, while restrictions on rice imports resulted in sharp increases in rice prices with the decline in domestic paddy production. Thus, the high price increases in 2001 were mainly caused by supply shortages and cost-push factors. As monetary expansion was contained at a level compatible with the increase in nominal income in 2000 and 2001, there was no pressure for significant demand fuelled inflation.

All measures of aggregate price changes recorded high increases, in a range of 10-14 per cent in 2001 (9-12 per cent when the direct impact of administered price increases is removed), higher than in 2000. The Colombo Consumers' Price Index (CCPI), the official index for consumer price inflation, covering a consumption basket of low income households in the Colombo Municipal area, registered an annual average increase of 14.2 per cent in 2001 compared with an increase of 6.2 per cent in 2000 and 4.7 per cent in 1999. The Greater Colombo Consumers' Price Index (GCPI), an alternative measure of the aggregate consumer price level with a broader geographical coverage than the CCPI, recorded an annual increase of 11 per cent in 2001 compared with 3.2 per cent in the previous year. The Colombo District Consumer Price Index (CDCPI), which has a wider coverage than even the GCPI, recorded an annual average increase of 10.3 per cent in 2001. The Wholesale Price Index (WPI), measuring price changes at the primary market level and covering all three categories of goods (consumer, intermediate and investment) rose by 11.7 per cent in 2001 compared with 1.7 per cent in 2000. The GDP deflator, a broader measure than all the above, covering all economic sectors, rose by 13 per cent in 2001 compared to 6.7 per cent in the previous year.

The Food sub-index, which constitutes the largest weight (over 58 per cent) in all consumer price indices, contributed to about 66-77 per cent of the overall increase in 2001. The Fuel and light sub-index and Miscellaneous items sub-index are the other major sub-indices that contributed to the high increases. The contribution of the clothing sub-index to the overall price increase was negligible at 1 per cent, reflecting increased supply to the domestic market by producers due to weak export demand and excess capacity in the garment industry.

1.6 Wages

Employees in both public and private sectors received wage increases in 2001 but increases in the private sector were restricted by adverse economic conditions experienced in almost all major economic sectors.

The overall wage rate index for central government employees recorded a nominal increase of about 21 per cent in 2001, compared with an 8.3 per cent increase in 2000. The full year's impact of the wage increases granted in August and October 2000, and the increase of Rs.1,200 granted in October 2001 to all government employees, were reflected in the high increase in the public sector annual wage index for 2001. Within the public sector, the wage index for minor employees recorded a higher increase of 23 per cent compared with a 19 per cent increase in the wage index for non-executive officers. As wage increases were higher than the average inflation rate, the real wages for these public sector employees rose between 5 – 9 per cent. These politically motivated ad hoc wage increases, which are not related to improvements in productivity, not only raise the government wage bill, which is already high, but also delays the introduction of a performance based wage adjustment system in the public sector. Such increases could also give wrong signals to job aspirants, leading them to favour public sector employment over the private sector.

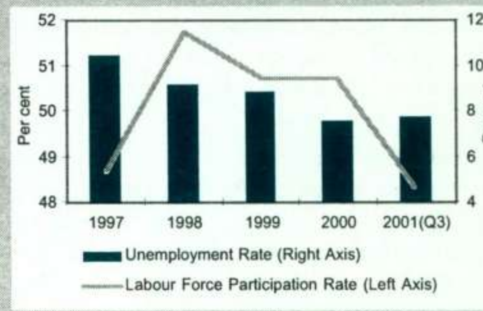
Nominal wages in the formal private sector were raised in 2001 at different rates for different categories. As measured by the changes in minimum wage indices for the private sector employees under the Wages Boards, nominal wages rose by 4.9 per cent in 2001 compared with 2.3 per cent in 2000. Among the sub sectors, the services sector received the highest increase of 17.5 per cent, followed by a 7.3 per cent increase in the industry and commerce sector and a 2.9 per cent increase in the agricultural sector. Thus, the wage increases in agriculture and industry and commerce sectors were lower than the annual inflation rate, thereby reducing their real wages, while employees in the services sector enjoyed a real wage increase.

Employees in the informal sector in agriculture and construction activities received nominal wage increases in 2001, ranging from 6 to 19 per cent, resulting in a mixed impact on their real wages. Within the informal sector, employees in the coconut sector received 11 to 19 per cent increases, while tea sector workers received 13 to 14 per cent wage increases reflecting affordability due to favourable output prices. In the paddy sector the increases ranged from 8 to 13 per cent. The lowest increase of 6 per cent was recorded for the rubber sector reflecting the difficulties in granting wage increases due to a continuation of low rubber prices.

1.7 Population, Labour Force and Employment

In 2001, the Department of Census and Statistics (DCS) completed the Census of Population and Housing after a lapse of 20 years, providing useful demographic information. The total population, as estimated by Census-2001, was 18.7 million persons and the average annual growth rate of population was 1.2 per cent for the 20 year period from 1981 to 2001. The increasing inter-regional mobility, ageing population and changing gender ratio were some of the more pronounced demographic developments evident from the Census results. Higher population increases were recorded in some districts of the Northern and Eastern provinces reflecting migration from the conflict areas. Similarly, high population growth rates were recorded in districts where economic activities are concentrated, such as Gampaha and Colombo, reflecting internal migration for economic reasons. The increasing population in the higher age groups indicates the need for changing the future education and health requirements of society. Similarly, the decreasing gender ratio, defined as the number of males per 100 females in the population, declined from 103.9 in 1981 to 97.9 in 2001, indicating possible changes in the future labour force participation rate and the composition of the workforce.

Chart 1.5
Labour Force Participation and Unemployment Rate



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 2001 was estimated at 6.7 million. The labour force participation rate, which declined gradually from 51.7 per cent in 1998 to 50.3 per cent in 2000, declined further to 48.3 per cent in the third quarter of 2001.

The slowdown in both economic growth and investment activities have resulted in generating fewer employment opportunities, thereby raising the rate of unemployment. Some of the badly affected sectors, such as tourism related services and garment exports, resorted even to temporary employment retrenchment.

According to the Sri Lanka Bureau of Foreign Employment, foreign employment placements rose to 184,000 in 2001 from 181,000 in 2000. The relative share of male and female employees in foreign employment placements remained similar to that in the previous year, at around 32 and 68 per cent, respectively. The categories of foreign employment placements also did not indicate any significant change, with housemaids accounting for the major share (50 – 60 per cent), while skilled employees accounted for only about 20 per cent of the total.

1.8 Fiscal Policy, Budgetary Operations and Public Debt

As the persistently high budget deficit was not sustainable, the fiscal policy outlined in Budget 2001 was expected to consolidate fiscal operations, correcting slippages experienced in 2000 in order to bring the budgetary outturn back to the medium-term sustainable path.

Budgetary measures were aimed at reducing the budget deficit by raising revenue and containing current expenditure, while maintaining a high level of public investment. Public investment was expected to be mainly financed from external sources. The entire fiscal deficit of 8.5 per cent of GDP was planned to be financed from foreign loans, privatisation proceeds and domestic non-bank financing, leaving a sufficient amount of domestic financial resources for the private sector. In fact, the Budget expected a repayment of public debt amounting to Rs.11 billion to the domestic banking system.

On the revenue front, measures were taken to raise both tax and non-tax revenue. Major revenue measures were a 40 per cent surcharge on imports, a 20 per cent surcharge on corporate income tax, and an increase in the National Security Levy (NSL) by one percentage point to 7.5 per cent. Other measures introduced in the Budget were the removal of exemptions given to gems and jewellery, the suspension of import duty concessions for vehicle imports given to public servants and parliamentarians, improvements in tax administration and increases in non-tax charges/fees/levies.

On the expenditure front, major emphasis was placed on reducing wasteful and non-priority recurrent expenditure. Major measures in expenditure control and management were the imposition of limits on expenses relating to personal staff of parliamentarians, use of vehicles, telephones and travelling, a request to curtail recurrent expenditure of public institutions and plans to close down 35 public entities which were economically not viable and/or redundant under the present policy environment, establishment of a Food Procurement and Monitoring Unit, imposition of a minimum 10 per cent cut in all expenditure other than salaries, and further improvement in Treasury cash management.

On the public investment front, the public investment programme was subjected to tight scrutiny with a view to curtailing unproductive and redundant expenditure programmes. Considering the resource constraints faced during the first half of 2001, the Budget proposed the postponement of non-priority construction work by six months.

TABLE 1.5
Summary of Government Fiscal Operations
(As a percentage of GDP)

Item	1980	1985	1990	1995	1999	2000	2001(a)
1 Revenue	19.6	22.3	21.1	20.4	17.7	16.8	16.5
2 Expenditure and net lending	41.8	34.1	31.0	30.5	25.2	26.7	27.4
2.1 Current expenditure	18.5	20.1	22.3	23.1	18.7	20.2	21.5
2.1.1 Security	1.3	4.5	4.1	6.5	4.4	5.6	4.9
2.1.2 Interest	3.4	4.6	6.4	5.7	5.6	5.7	6.7
2.1.3 Wages(b)	4.5	3.6	3.9	3.4	3.0	3.2	3.4
2.1.4 Subsidies and transfers	8.4	5.5	6.5	6.1	4.2	4.2	4.7
2.1.5 Other	0.9	1.9	1.4	1.4	1.4	1.6	1.7
2.2 Capital and net lending	23.3	13.9	8.7	7.4	6.5	6.5	5.9
2.2.1 Public Investment	18.5	13.8	8.3	7.9	6.5	6.4	5.9
Aquisition of real assets	7.9	4.5	3.7	3.4	3.0	2.6	2.6
Capital transfers	9.4	8.6	2.3	2.9	2.5	2.8	2.3
On lending	1.2	0.6	2.2	1.7	1.0	1.0	1.0
2.2.2 Other	4.7	0.2	0.4	-0.5	-	0.1	0.0
Restructuring cost	-	-	-	0.5	0.4	0.3	0.4
Other	4.7	0.2	0.4	-1.0	-0.4	-0.3	-0.3
3 Current account balance	1.1	2.2	-1.2	-2.7	-1.0	-3.4	-4.9
4 Overall deficit before grants and excluding privatisation	-22.2	-11.7	-9.9	-10.1	-7.5	-9.9	-10.9
5 Financing	22.2	11.7	9.9	10.1	7.5	9.9	10.8
5.1 Foreign financing	9.2	6.4	5.7	4.5	0.7	0.4	1.4
5.1.1 Loans	5.3	4.4	3.6	3.2	0.1	0.0	1.0
5.1.2 Grants	3.9	2.0	2.1	1.4	0.6	0.4	0.4
5.2 Domestic financing	13.0	5.3	4.2	5.1	6.8	9.4	8.8
5.2.1 Banks	9.8	2.9	0.1	1.1	2.5	4.5	3.5
5.3 Privatisation	-	-	-	0.4	...	...	0.6
6. Public Debt	77.6	80.2	96.5	95.5	95.1	96.9	103.6
6.1 Domestic	44.2	38.6	41.6	43.2	49.1	53.8	58.3
6.2 Foreign	33.5	41.7	54.9	52.3	45.9	43.1	45.3
Memorandom items :							
Total wage bill	5.0	4.2	4.9	5.2	5.3	5.5	5.6
Gross defence expenditure (c)	1.3	4.5	4.1	6.5	4.9	6.1	5.5

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

Source: Ministry of Finance
Central Bank of Sri Lanka

The Budget also aimed at limiting the use of domestic resources in financing the deficit, relying more on privatisation proceeds (Rs. 25 billion) and foreign financing including a commercial loan of US dollars 200 million from the international market. This was with the objective of reducing the crowding-out impact of budgetary operations and preventing inflationary financing as well as reducing pressure on domestic interest rates.

However, the fiscal situation deteriorated significantly in 2001 with all fiscal aggregates deviating significantly from their targets. A revenue shortfall, recurrent expenditure overruns, lower capital expenditure, a higher budget deficit, shortfall in privatisation proceeds, lower foreign financing, higher domestic borrowing and an increase in public debt were the final realised outcomes.

In comparison to the budgetary targets, a large revenue shortfall (Rs.33 billion) and a significant overrun in recurrent expenditure (Rs.19 billion) increased the current account deficit by about 3.7 percentage points of GDP (Rs. 52 billion) to 4.9 per cent and the overall fiscal deficit by 2.4 percentage points of GDP (Rs.29.2 billion) to 10.9 per cent. The increased fiscal deficit, together with the shortfall in the expected privatisation proceeds (Rs.16.4 billion) and external financing (Rs. 20.6 billion), both concessional and commercial borrowings, compelled the government to borrow heavily from domestic sources. Domestic borrowing amounted to 8.8 per cent of GDP compared with the budgetary target of 4 per cent of GDP. This led to a significant increase in government domestic bank borrowing (Rs.48.5 billion) in contrast to the expected repayment (Rs.11 billion) in the original estimates, as the available domestic non-bank resources were limited. Increased domestic borrowing continued to exert pressure on domestic interest rates and crowded out resources available to the private sector. Consequently, the outstanding public debt increased sharply by Rs.231.9 billion to Rs.1,450.6 billion raising the public debt/GDP ratio to 103.6 per cent at end 2001, giving a warning signal about the worsening of the public debt burden and highlighting the need for strong fiscal adjustments to ensure macroeconomic stability.

The deterioration in the fiscal sector was attributable to three main developments in 2001. First, the contraction of domestic economic activity and a sharp decline in imports adversely affected the achievement of revenue and privatisation targets, reducing government receipts by about Rs. 43.8 billion, while increasing government relief expenditure. Second, some of the fiscal adjustments announced in the Budget were not implemented, thus preventing the realisation of expenditure savings and thereby resulting in an increase in recurrent expenditure by Rs.15.3 billion. Third, the fiscal package announced in October 2001, extending relief to investors and vulnerable groups, by reducing taxes and increasing civil service salaries and pensions resulted in an additional cost of Rs.9 billion, consisting of a revenue loss of about Rs.5.4 billion and an additional expenditure of Rs.3.7 billion.

On the revenue front, total revenue recorded a shortfall of Rs.33 billion. This was due to a substantial reduction in import related tax revenue and revenue losses due to the fiscal package introduced in October 2001. Furthermore, the poor performance in public enterprises reduced non-tax revenue.

On the expenditure front, current expenditure overshot the original budget estimate by about Rs.19 billion, mainly due to overruns in defence expenditure, pension payments, increased interest costs and transfer payments to the Samurdhi programme, the fertiliser subsidy scheme and Sri Lanka Railways which incurred high operational losses. However, a significant under expenditure in the capital account of Rs. 22.9 billion offset the increase in recurrent expenditure, reducing total expenditure by Rs. 3.9 billion.

The combined outcome of lower revenue mobilisation and higher current expenditure resulted in a current account deficit of 4.9 per cent of GDP compared with a budgetary target of 1.2 per cent. Increased government dissavings reduced the country's overall savings/GDP ratio in 2001. The primary deficit (revenue minus expenditure excluding interest payments) rose by about 2 percentage points of GDP in comparison to the budgetary target of 2.2 per cent to 4.1 per cent of GDP in 2001. Finally, the overall deficit increased by 2.4 per cent of GDP to 10.9 per cent compared with a budgetary target of 8.5 per cent of GDP, and 9.9 per cent of GDP in 2000.

Financing of the deficit from foreign grants and loans in 2001 was only 1.4 per cent of GDP (Rs. 20 billion) compared with the budgetary target of 2.8 per cent of GDP (Rs.40.6 billion) mainly reflecting the postponement of expected commercial borrowings from the international market and delays in the utilisation of concessionary foreign assistance. Privatisation proceeds realised for deficit financing were Rs.8.6 billion compared with the target of Rs.25 billion. This large shortfall was due to the non-sale of the shares of Sri Lanka Telecom due to unfavourable market conditions.

Consequently, domestic deficit financing rose from the original target of Rs.57 billion (4 per cent of GDP) to Rs.123.6 billion (8.8 per cent of GDP), accounting for about 80 per cent of the financing of the total deficit. Given the limited availability of domestic non-bank resources, a large part of the increased domestic borrowing was reflected in bank financing, i.e., 3.5 per cent of GDP. This included US dollars 158.5 million borrowed through the issue of dollar denominated bonds (Sri Lanka Development Bonds). However, the expansionary impact of government deficit financing was not as grave as it could have been as the entire

Chart 1.6
Fiscal Sector Indicators

Chart 1.6.1
Expenditure, Revenue, Current A/C and Overall Balance

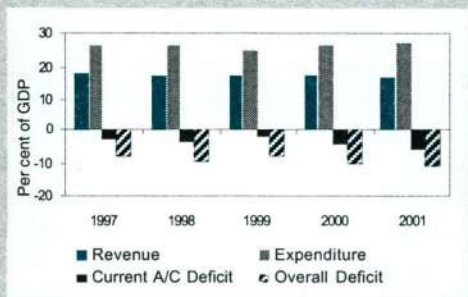


Chart 1.6.2
Financing the Deficit

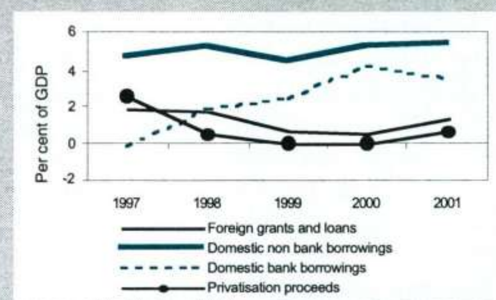


Chart 1.6.3
How a Rupee Was Earned - 2001

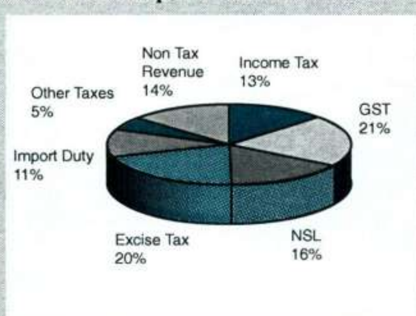
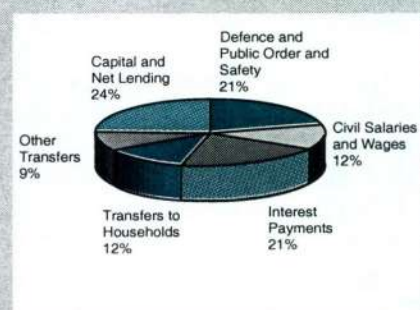


Chart 1.6.4
How a Rupee Was Spent- 2001



bank borrowings were made from commercial banks and not from the Central Bank which would have created high-powered money. In fact, there was a repayment of Rs.6.4 billion to the Central Bank in 2001. In mobilising domestic resources for deficit financing, the government relied more on less market oriented debt instruments such as Rupee loans, in order to contain the adverse impact on market interest rates. This was a deviation from the government's borrowing strategy, which is to gradually move towards more market oriented debt instruments. Furthermore, even in the mobilisation of funds through marketable instruments such as Treasury bonds, the government resorted to issuing instruments with relatively short-term maturities to avoid locking into high interest bearing long-term debt instruments. Consequently, the government raised Rs.28.9 billion through Rupee loans and Rs. 21 billion through Treasury bonds in 2001, compared with corresponding values of Rs.1.8 billion and Rs. 90 billion, respectively, in 2000. Similarly, the government relied heavily on Treasury bills to finance the resource gap, raising the outstanding Treasury bill level by Rs.36 billion to Rs. 171 billion. In addition, the government resorted to using its overdraft facilities with the two state banks raising the outstanding level from Rs.19 billion at the beginning of the year to Rs. 38 billion at end 2001. This is not only a high cost borrowing instrument, but is also recorded outside the normal public debt programme, thereby adversely affecting effective monetary management.

In view of the higher than anticipated resource requirement and the postponement of the expected foreign commercial borrowings of US dollars 200 million, the government issued US dollar denominated bonds (Sri Lanka Development Bonds) to the value of US dollars 158.5 million at variable interest rates to minimise the pressure of the increased deficit financing on the rupee markets.

The level of the government debt stock (Rs.1,450.6 billion) exceeded the national income in 2001, reflecting a faster growth in the debt stock than nominal GDP. The debt/GDP ratio, which declined in the mid-1990s, has increased continuously since 1997, reaching 103.6 per cent at end 2001. The sharp expansion in domestic borrowing, due to the widening fiscal deficit and the increase in the rupee value of foreign debt, due to the depreciation of the exchange rate were the major causal factors for this rise in the debt stock. Within the overall government debt stock, domestic debt increased by 4.5 percentage points to 58.3 per cent of GDP, while foreign debt increased by 2.2 percentage points to 45.3 per cent of GDP during 2001. The sharp increase in government debt with an escalating debt service burden and a continuation of high fiscal deficits raised the issue of medium-term fiscal sustainability, even though a large part (about 95 per cent) of foreign debt is on highly concessional terms. Therefore, containing the fiscal deficit, improving government debt management and a cautious approach to foreign commercial borrowing are necessary and should be adopted, without further delay, in order to move towards a sustainable fiscal path in the medium term.

The overall public sector deficit was higher than the fiscal deficit due to loss making public enterprises. In 2001, the entire public sector deficit was more than 11 per cent of GDP. Similarly, the total outstanding public sector debt, including debt held by public corporations, amounting to Rs.40.8 billion, was Rs.1,491.4 billion, (106.5 per cent of GDP). Therefore, in addressing the public sector debt issue effectively, it is also necessary to give due attention to improving the financial position of public corporations, thereby reducing their existing high debt stock. A strong public enterprise reform programme, including an automatic pricing system, unbundling of large entities and privatisation is essential to resolve the public sector debt issue.

1.9 Exchange Rate and External Sector

The global economic slow down, security concerns worldwide following the September attack, prolonged drought in the country, the terrorist attack on the Katunayake International Airport in July and domestic political turmoil in the second half of the year significantly affected Sri Lanka's balance of payments (BOP) in 2001. Both exports and imports declined sharply while tourism was badly affected. However, the external current account deficit narrowed as imports declined faster. The external capital account and financial account recorded surpluses. Reflecting these changes, the overall balance in the BOP registered a surplus following deficits recorded in the last two consecutive years, but it was well below the original target. Consequently, the external official reserves, as well as the total country reserves, increased, reversing their declining trend and reducing the pressure on the exchange rate. The exchange rate which stabilised after an initial overshooting under the independently floating exchange rate regime introduced in January 2001, improved gradually and forward market activities increased with the removal of precautionary measures. Nevertheless, the BOP for 2001 showed worrisome developments as export proceeds and tourist earnings declined sharply, reflecting the vulnerability of the economy to external shocks, while private capital inflows declined, indicating weak foreign investor sentiment.

The external environment deteriorated significantly in 2001 as the world economy weakened after a strong recovery in 2000. The slowdown was marked by a sharp weakening in USA, a moderate growth in the EU and a still fragile economy in Japan. The drop in demand in advanced countries, particularly in major export markets for developing countries, had adverse repercussions on international trade and the growth prospects of trade dependent developing countries including Sri Lanka. The impact of favourable international developments on the Sri Lankan economy, such as lower oil prices and the reduction in international interest rates, was more than offset by the adverse impact of sharp reductions in export demand, the drop in tourist arrivals and the decline in private capital inflows. The move to an independently floating exchange rate regime and entering into a Stand-By Arrangement with the IMF helped to ease the adverse impact of external developments.

A sharp reduction in international trade in goods and services, significantly lower external trade and current account deficits, a surplus in the overall balance in the BOP resulting in a corresponding increase in official external

TABLE 1.6

External Sector Indicators

Item	1997	1998	1999	2000	2001(a)
Annual changes (%)					
Export volume	10.6	0.1	5.0	18.3	-8.0
Import volume	12.3	12.4	0.2	12.9	-10.7
Export unit value	9.3	11.6	-8.5	1.5	-5.2
Import unit value	2.4	-2.2	-3.5	8.1	-3.6
Terms of trade	6.8	14.2	-5.0	-6.1	-1.7
As a percentage of GDP					
Trade deficit/GDP	-8.1	-6.9	-8.7	-10.8	-7.4
Current account deficit/GDP	-2.6	-1.4	-3.6	-6.4	-2.4
Overall BOP/GDP	1.1	0.2	-1.7	-3.2	1.4
External reserves US$ mn.					
Gross official reserves	2,029	1,984	1,639	1,049	1,338
Total reserves	3,132	2,907	2,582	2,131	2,238
External debt service payments (US $ mn)					
Amortisation payments	430	469	550	621	558
Interest payments	303	289	296	332	253
Exchange rate index (End of period) (b)					
Nominal effective exchange rate index	126.1	111.6	110.4	111.8	112.1

(a) Provisional Source: Central Bank of Sri Lanka
(b) 24 currency basket, 1995 = 100

Chart 1.7
Selected External Sector Indicators

Chart 1.7.1
Balance of Payments

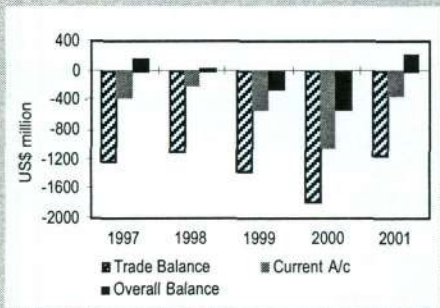


Chart 1.7.2
Effective Exchange Rates (1995=100)

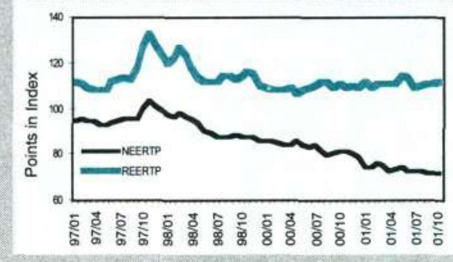


Chart 1.7.3
External Assets

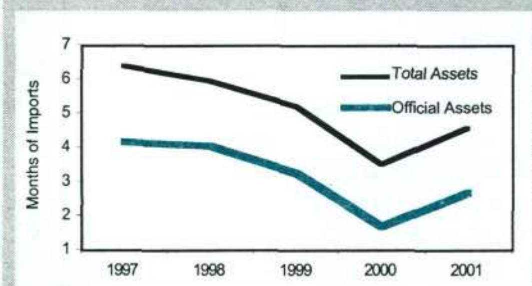
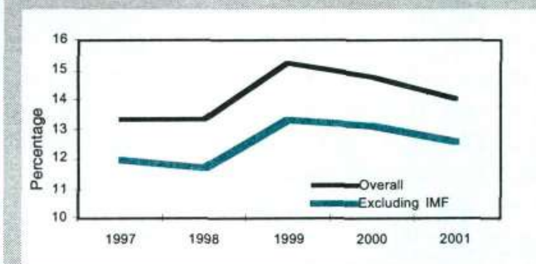


Chart 1.7.4
External Debt Service Ratio (as a% of Exports of Goods and Services)



reserves, an improvement in total external reserves of the country and a depreciation of the rupee are the highlights in external sector developments of Sri Lanka in 2001.

Sri Lanka's external trade (both exports and imports) suffered a major setback in 2001, declining by 16 per cent in US dollar terms, due to a sharp drop in export demand and deteriorating terms of trade. However, the trade deficit declined significantly to 7.4 per cent of GDP in 2001 from 10.8 per cent of GDP in 2000, due to a substantial contraction in imports by 14.9 per cent (18.4 per cent without the adjustment for the three aircraft imported in 2000), than in exports, by 12.8 per cent. The decline in export earnings was a combined outcome of a reduction of volume by 8 per cent and a drop in export prices by 5.2 per cent. The drop in exports was mainly reflected in textiles and garment (14.7 per cent), other industrial products (10.3 per cent) and agricultural products (7.2 per cent). The drop in textiles and garment exports alone accounted for over 62 per cent of the decline in total exports.

The composition of Sri Lanka's exports and distribution of their destinations exhibit the vulnerability of the country to adverse external shocks and impels a re-examination of the country's export development strategy on two dimensions. First, the over dependence on textiles and garment exports which accounts for over 50 per cent of total exports, makes it highly vulnerable to adverse changes in that sector in the international market. This concern is particularly relevant in the face of the phasing out of the Multi-Fiber Arrangement (MFA) by 2005. Second, high concentration of exports on a small number of major export markets makes Sri Lanka highly vulnerable to fluctuations in those markets. The US, the largest destination for Sri Lanka's exports, accounts for about 41 per cent, while the EU, the second largest destination, accounts for about 27 per cent, exposing Sri

Lanka to adverse developments in these two markets. In a highly trade dependent country like Sri Lanka[a], the risk of over exposure, commodity-wise, as well as market destination wise would need to be minimised through diversification not only to strengthen the resilience of the economy but also to exploit its comparative advantages, while keeping in line with changing global trends.

The sharp drop in imports was mainly due to a slowdown in economic activity, low derived demand for intermediate imports from weak export demand, the surcharge imposed on imports and lower petroleum prices. The reduction in import value is a composite result of a 4 per cent drop in average import prices and an 11 per cent decline in volumes. The lower international prices for petroleum, textiles and some investment goods contributed to the reduction in average import price. Lower import volumes of food and consumer durables (sugar, wheat, milk products, motor vehicles, radios and television sets), intermediate goods (textiles, petroleum products, diamonds, chemicals and plastic) and investment goods (building materials and machinery) were the major reasons for a reduction in import volume. Thus, the decline was reflected in all three major import categories. The largest drop, 37.8 per cent, was in the investment category (24.9 per cent when adjusted for aircraft), while intermediate and consumer goods categories declined by 12.3 per cent and 11 per cent, respectively. The sharp drop in investment goods throughout the year was a major concern, as it retards the future economic growth prospects of the country. One of the favourable developments in international commodity prices was the drop in petroleum prices by about 15 per cent during the year, which alone saved about US dollars 125 million in Sri Lanka's import bill. The drop in consumer goods imports was partly due to the import surcharge imposed on non-essential consumer goods. The drop in motor vehicle imports was due to the suspension of the facility given to public servants and parliamentarians for the import of motor vehicles on concessionary terms.

India became the largest single exporter to Sri Lanka (11 per cent) followed by Hong Kong (9 per cent) and Singapore (8 per cent). Asian countries as a group accounted for about 56 per cent of Sri Lanka's imports, while absorbing only 8 per cent of the country's exports. Improvements even under the Free Trade Agreement with India have been very slow.

The surplus in the services account improved, mainly reflecting the impact of the net inflow of US dollars 90 million as an insurance compensation payment to SriLankan Airlines. Excluding this specific inflow, the surplus in the services account dropped, from US dollars 38 million in 2000 to US dollars 18 million. This was mainly due to a decline of 18 per cent (US dollars 39 million) in receipts from tourism and a slowdown in earnings from port and aviation related services following the terrorist attacks in July and September. Despite an increase in the external debt stock, net income payments declined by 8 per cent as the sharp drop in international interest rates reduced interest payments on external debt.

Meanwhile, net current transfers declined by 4 per cent to US dollars 960 million, reflecting a reduction in net private transfers due to the completion of the compensation payments to workers affected by the Gulf War. Excluding this special item, net private transfer receipts increased by about 1 per cent in 2001. These changes in the trade, services, income and transfers accounts sharply narrowed the current account deficit from 6.4 per cent of GDP (US dollars 1,065 million) to 2.4 per cent of GDP (US dollars 371 million) in 2001, enabling a surplus to be recorded in the overall BOP and reducing pressure on the exchange rate.

The capital and financial accounts reflected some improvements due to an increase in loan capital to the government and a significant improvement in short-term capital flows over the previous year, but was below expectations. Foreign direct investment (net) declined sharply due to weak investor confidence and the moving of international investors to high quality investments to minimise their risk exposure. Portfolio investments recorded a net outflow (US dollars 11 million) for the fourth consecutive year, but the outflow was much less than in the previous year (US dollars 45 million). Privatisation proceeds amounted to US dollars 90 million, the sum of receipts of US dollars 65 million for the Prima Flour Mill transaction and US dollars 25 million on account of the balance payment on the Air Lanka transaction. This was a significant improvement compared with the last two years, but was still well below the expectation of US dollars 275 million. The delay in sale of a further share of Sri Lanka Telecom due to unfavourable international market conditions was the major reason for this shortfall. The developments in the current account and the financial and capital accounts resulted in a surplus of US dollars 220 million in the overall balance in the BOP, reversing the deficits seen in the previous two years. However, the realised surplus was below the original target of US dollars 340 million (with the programme financing, of about US dollars 525 million).

Consequently, gross official external reserves rose by 28 per cent to US dollars 1,338 million, sufficient to finance 2.7 months of imports at end 2001 reversing the declining trend observed in the two previous years. The Central Bank purchased US dollars 126 million (net) from the market, more than expected at the beginning of the year. Nevertheless, the improvement in the gross official reserves was below the target of US dollars 1,500 million mainly due to the shortfall in the privatisation programme and the delay in the

(a) The sum of export and import trade/GDP ratio is over 70 per cent completion of the expected reviews and disbursement of financial support under the IMF supported SBA programme. The total gross external assets of the country also improved by 5 per cent to US dollars 2,238 million at end 2001 sufficient to finance 4.5 months of imports.

The total external debt stock of Sri Lanka declined by 5 per cent to US dollars 8,566 million due to a drop in private sector debt (settlement of SriLankan Airlines loans), slow disbursements of foreign loans and cross-exchange rate effects. However, the external debt/GDP ratio increased from 54.5 per cent in 2000 to 54.7 per cent in 2001 due to a contraction of GDP in US dollar terms. The bulk of the debt stock (74 per cent) consisted of concessional long-term debt. Despite the decline in total receipts from goods, services, income and current private transfers, the external debt service ratio of the country decreased from 12.2 per cent to 11.1 per cent, reflecting the drop in international interest rates.

The move to an independently floating exchange rate regime on 23 January 2001 from the crawling band system was a major policy change in 2001. The exchange rate stabilised within a short period after a moderate and temporary overshooting during the first few days under the new exchange rate regime. The overshooting was very moderate compared with the experience in other countries, mainly due to a release of pressure in the exchange rate market through continuous adjustments made under the crawling regime and widening of the intervention band. The new system allows the exchange rate to be determined by market demand and supply forces, with occasional interventions by the Central Bank to minimise excessive fluctuations in the rate. The Central Bank also participates in the forex market to build up its official reserves by purchasing foreign exchange from the market at the prevailing market rates. The Central Bank was able to purchase actively under the new exchange rate policy regime, building up official external reserves, which had been depleted during the previous two years.

A number of precautionary measures were taken to ensure the orderly operations of the foreign exchange market. These measures, which aimed at maintaining an orderly behaviour in the foreign exchange market and encouraging exporters to repatriate export proceeds, helped faster stabilisation in the foreign exchange market. All these measures were removed or relaxed with the improvement of stability in the foreign exchange market. With the removal of these measures activities in the forward market increased gradually while the forward premium declined to be compatible with the interest rate differential between the domestic short-term interest rates and international rates for the dollar and a risk premium. Similarly, reflecting the improved forex market stability, the spread between the buying and selling rates of foreign exchange in the inter bank market and between banks and customers dropped during the year.

Against this backdrop, the Sri Lankan rupee depreciated against all major currencies, except the yen during 2001. It depreciated by 11.3 per cent against the US dollar during the year as a whole and 8.6 per cent after the introduction of the new exchange rate system. In 2001, it also depreciated against the euro (6.7 per cent) the pound sterling (8.7 per cent) and the Indian rupee (8.3 per cent), while appreciating against the Japanese yen by 1.5 per cent. The rupee depreciated against the SDR by 7.9 per cent during the year as a whole and 5.5 per cent since 23 January 2001. Consequently, the nominal effective exchange rate of the Sri Lanka rupee against a five currency basket recorded a depreciation of 7.1 per cent, while against a twenty four currency basket, which includes both trading partner and competitor countries, it depreciated by 7.3 per cent. Meanwhile, the real effective exchange rate against the five currency basket indicated an appreciation of 1.4 per cent, while against the twenty four currency basket it indicated an appreciation of 2 per cent in 2001, indicating that the market based exchange rate system minimised the adverse impact of high domestic inflation on the country's external competitiveness.

1.10 Financial Sector

Monetary Policy

The change in the exchange rate regime to an independently floating system facilitated monetary policy to concentrate more on price stability, but monetary management became more challenging in 2001 due to the conflicting demands arising from the adverse developments in the economy and also having to let go one of the anchors (i.e., the exchange rate) for monetary management. The economic slowdown, and the increase in interest rates to prevent pressure on the exchange rate under the previous crawling exchange band system, required the relaxation of monetary policy, while the prevailing inflationary trend and higher public sector borrowings required a tight monetary policy stance. While balancing these conflicting requirements, the emphasis of monetary policy was placed on promoting future price stability, and maintaining stability in the financial markets and assisting the domestic economy to face the severe internal and external difficulties encountered in 2001. Accordingly, the Central Bank cautiously reduced its key interest rates, which had been raised during the second half of 2000 and in January 2001, gradually but consistently. Provision of adequate liquidity was further supported by the reduction of the Statutory Reserve Requirements (SRR) and the Central Bank of Sri Lanka's (CBSL) purchases of foreign currency from the government and foreign exchange market, without adding pressure on the exchange rate. Consequently, the high rupee liquidity shortfall, which had continued from the previous year, declined sharply, reaching a balanced situation by end 2001. All market interest rates declined, but lending rates adjusted at a slower pace, reflecting existing rigidities in the interest rate adjustment process. The reserve money programme remained on track as envisaged under the macroeconomic stabilisation programme announced at the beginning of 2001, while overall monetary expansion remained moderate, maintaining compatibility with the increase in nominal income, without building demand fuelled inflationary pressure in the economy.

The Central Bank raised its Repurchase (Repo) and Reverse Repurchase (Reverse Repo) rates by 300 basis points each to 20 and 23 per cent, respectively, a few days before moving to an idependantly floating exchange rate on 23 January 2001. However, with the improving financial market stability, these rates were reduced on six occasions by 800 – 900 basis points. A large part of this reduction was made during the second half of the year following the developments in the financial market as well as on the inflationary front. The Bank Rate was also reduced from 25 per cent to 18 per cent to adjust it in line with the reductions in other market rates. CBSL reduced the SRR on commercial bank deposits by 1 percentage point to 10 per cent with the intention of increasing market rupee liquidity, which also increased the commercial banks' lending capacity. With this reduction it was also intended to reduce intermediation costs of the banking sector, thereby enabling banks to reduce their lending rates.

The temporary precautionary measures that were introduced along with the change in the exchange rate regime in January were also phased out gradually with the gaining of experience under the new exchange rate regime, and the consequent improvement in financial market stability. The period allowed for the settlement of export credit without incurring penalties on interest was extended in cases where it was customary to grant credit for a longer period; limits on commercial bank foreign currency overbought positions were converted to a prudential regulation by rebasing the limit on the capital and reserves of banks instead of trade credit; the 50 per cent margin requirements imposed on forward transactions was removed in two equal steps; and the prevention of prepayment of import bills was withdrawn.

With the shift to a floating exchange rate regime, the role of the exchange rate as a nominal anchor has diminished. Consequently, the Central Bank placed greater emphasis on reserve money, which is an intermediate target in the overall monetary programme, in promoting the price stability objective. The Central Bank continued to rely on several measures in assessing monetary conditions, including monetary and credit aggregates, changes in market interest rates and the monetary conditions index. On the selection of policy instruments, more emphasis was given to open market operations (OMO) through changes in the Repo, Reverse Repo, discount and rediscount rates. The Bank also took measures to widen discussions on monetary policy issues, by creating a Monetary Policy Committee (MPC) within the Bank, to further improve dissemination of information on monetary projections and policy decisions.

With a view to closely tracking price movements in order to move towards medium to long term inflation targetting, the CBSL set-up an Inflation Targetting Group which commenced work in analysing the behaviour of 'headline inflation' and 'underlying inflation' and their causal factors.

A turnaround in inter-bank liquidity conditions from a large deficit to a marginal surplus took place in 2001. The purchase of foreign exchange by commercial banks from the Central Bank, the settlement of foreign public debt and large borrowings by the public sector from the banking system had resulted in a liquidity shortfall of around Rs.30 billion towards the end of 2000 and this continued into early 2001. Commercial banks, in particular the two state banks, met the liquidity shortfall through the reverse repurchase window on a rollover basis. However, the injection of rupee liquidity by the Central Bank through the purchase of foreign currency from the market (US dollars 126 million, i.e., Rs.11.3 billion) and the purchase of the dollar proceeds of the Sri Lanka Development Bonds (US dollars 158.5 million, i.e., Rs.14.3 billion) and privatisation proceeds (US dollars 90 million, i.e., Rs.8.1 billion) from the government, improved domestic market liquidity. The reduction of SRR too contributed to improving liquidity by reducing the required deposits of commercial banks with the CBSL by about Rs.3.7 billion. These liquidity injections, after offsetting the liquidity contractionary impact of foreign public debt repayments, increased market liquidity, turning the deficit into a surplus of about Rs.1 billion by end 2001.

Money Supply

Despite the sharp increase in public sector bank borrowings, monetary expansion in 2001 remained stable at around 13 per cent due to a moderation of credit expansion to the private sector and a smaller improvement in the net foreign assets (NFA) of the banking system than expected under the annual monetary programme. Thus, the overall growth in broad money supply (M_{2b}), as well as reserve money expansion, remained compatible with initial projections. However, the contributions of causal factors to monetary growth changed significantly. The realised increase in NFA of Rs.7.5 billion and private sector credit of Rs. 32.4 billion were significantly lower than the corresponding values envisaged under the monetary programme for 2001 i.e., Rs. 62.3 billion and Rs. 35.4 billion respectively, while the actual increase in public sector credit of Rs. 56.7 billion was much higher than the projected repayment of Rs. 22 billion.

The expansion of narrow money (M_1) declined sharply to 3.2 per cent in 2001 from 9.1 per cent in 2000. This was largely due to the low transactions demand for money resulting from the widespread economic contraction and a shifting to interest earning monetary assets in view of the high opportunity cost of holding non-interest bearing financial assets. Furthermore, an increasing use of technology orientation in financial transactions and the consequent increase in the utilisation of Automated Teller Machines (ATMs) and credit cards reduced the demand for narrow money. Meanwhile, a broader money supply (M_4) based on the financial survey, which includes the operations of licensed specialised banks and finance companies, in addition to licensed commercial banks, grew by 13.6 per cent at end 2001 compared with 12.7 per cent at end 2000. Both reserve money expansion and an increased money multiplier (from 4.60 in 2000 to 4.88 in 2001) contributed to the monetary expansion in 2001. Reserve money expanded by Rs. 7.4 billion compared with a Rs.4.7 billion increase in 2000, reflecting the improvement in NFA of the Central Bank with the building up of external reserves, reversing the developments in the previous two years. Effectively, a further Rs.3.7 billion of high-powered money was made available to the market with the reduction in the SRR, which had previously been sterilised by the Central Bank. Meanwhile, the money multiplier rose, reflecting the impact of the reduction of SRR by 1 percentage point and the decline in the currency to deposit ratio reflecting the high opportunity cost of holding currency. Meanwhile, the average velocity of money decreased marginally from 2.79 to 2.76 indicating no significant changes in the inflationary expectations of the public even though cost push factors dominated in increasing the inflation rate in 2001.

Although the major contribution to the monetary expansion (89 per cent) came from an increase in net domestic assets reflecting the large credit expansion to the public sector, an increase in net foreign assets (NFA) also accounted for about 11 per cent of the increase in 2001, in contrast to a significant contractionary impact in the previous year. The NFA of the banking system increased by Rs.7.5 billion as a composite outcome of an increase of Rs.29.3 billion in the Central Bank's NFA, and a decline of Rs. 21.8 billion in the NFA of the commercial banks, partly reflecting dollar denominated loans extended to the government.

A high credit expansion to the government (36.8 per cent) along with moderate credit expansion to public corporations and private sector (by 6.7 and 8.9 per cent, respectively) resulted in an overall domestic credit expansion of 16.2 per cent. The public sector absorbed Rs.56.7 billion, i.e. 64 per cent, of the total domestic credit increase in 2001 in comparison with an expected repayment of Rs.22 billion in the original estimates for 2001.

TABLE 1.7
Financial Statistics

Item	End 2001 Rs.bn.	Change			
		2000 Amount Rs.bn.	%	2001 Amount Rs.bn.	%
Monetary aggregates:					
Narrow money supply (M_1)	122.2	9.9	9.1	3.7	3.2
Broad money supply (M_2)	450.7	46.6	13.0	46.1	11.4
Consolidated broad money supply (M_{2b})	549.1	55.1	12.9	65.7	13.6
Underlying factors (a)					
Domestic credit to :	639.0	117.0	27.0	89.1	16.2
Government (net)	201.4	53.4	56.8	54.1	36.8
Public corporations	40.8	25.2	193.2	2.6	6.7
Private sector	396.8	38.4	11.8	32.4	8.9
External assets (net)	77.1	-32.6	-31.9	7.5	10.9
Other items (net)	-166.9	-29.4	-27.5	-30.9	-22.7
Reserve money	112.5	4.7	4.7	7.4	7.0
Government (net)	84.7	44.8	96.1	-6.9	-7.5
Commercial banks	0.2	-0.2	-30.5	-0.4	-71.2
External assets (net)	87.3	-31.3	-35.1	29.3	50.6
Other items (net)	-59.6	-8.6	-23.6	-14.7	-32.8
	End 2000	End 2001			
Interest rates (end year)					
3-Month Treasury bills (%)	17.77	12.92			
Commercial banks' weighted average prime lending rate (%)	21.46	14.31			
Share Market					
All Share Price Index (1985=100)	447.6	621.0			
Market capitalisation (Rs. bn)	88.8	124.0			

(a) In relation to M_{2b}

Source: Central Bank of Sri Lanka.

The increased budget deficit, with large shortfalls in privatisation proceeds and foreign financing, turned around the expected government repayment to a high net additional domestic bank borrowing, causing difficulties in monetary management. Meanwhile, the expected repayment to the banking sector from public corporations, estimated at Rs.7 billion, also turned into a new additional borrowing of Rs. 2.6 billion due to a smaller than expected improvement in CPC's cash flow, increasing losses in CEB due to delays in adjusting power tariffs at least to recover its operational costs, and increased borrowing by the Co-operative Wholesale Establishment (CWE). These three major pubic enterprises accounted for 91 per cent of the outstanding bank credit to public corporations, which amounted to Rs.40.8 billion at end 2001, indicating the need for strong restructuring programmes in these enterprises.

Growth in credit to the private sector was moderate, reflecting the impact of the slowdown in economic activity, a decline in business confidence, high real lending rates and the commercial banks' cautious approach to their risk management due to the high non performing loans (NPL) in their portfolios. Annual credit expansion to the private sector, which decelerated from 12 per cent in 1998 to 11.8 in 2000, declined further to 8.9 per cent at end 2001. In absolute terms, credit to the private sector increased by Rs.32 billion in 2001 against Rs.38 billion in 2000. Total credit facilities provided to the private sector by the financial system as a whole increased by Rs. 40 billion or 8.3 per cent in 2001. The purpose-wise breakdown of credit expansion to the private sector reveals that credit for consumption, housing and property development and services grew while credit to industries and trade declined.

Interest Rates

Interest rates moved down significantly during 2001 in contrast to the rising trend in 2000, shifting the yield curve downwards, particularly during the second half. This was a result of downward adjustments in policy interest rates, increased rupee liquidity and reductions in international interest rates.

Following the improvement in financial market stability, moderation in inflationary pressure and the decline in international interest rates, the Central Bank reduced its Reverse Repo rate by 900 basis points, Repo rate by 800 basis points and the Bank Rate by 700 basis points in a number of steps. These reductions, assisted by an increase in market liquidity, resulted in further reductions in short-term market interest rates. The average inter-bank call money market rates recorded the largest reduction, declining from 25.9 per cent at end 2000 to 12.7 per cent at end 2001, i.e., a reduction of about 1,320 basis points. The prime lending rates of commercial banks and the yield on market oriented government securities fell, commensurate with the reductions

Chart 1.8
Financial Sector Indicators

Chart 1.8.1
Expansion of Monetary Aggregates

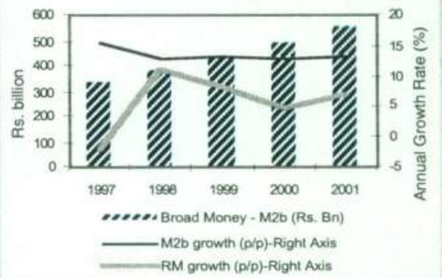


Chart 1.8.2
Interest Rates

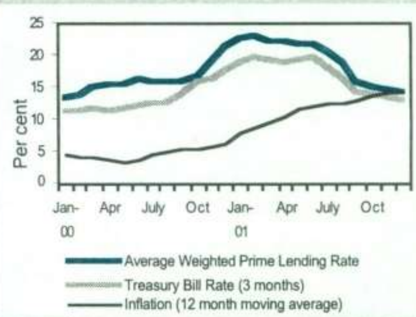
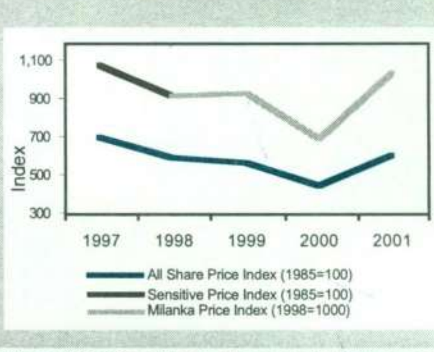


Chart 1.8.3
Share Market Indices



in policy rates by about 800-900 basis points. However, the general lending rates of commercial banks declined less and at a slower pace, resulting in high lending rates in real terms. Some reductions in deposit rates were also recorded. Reflecting all these changes, the yield curve on government paper shifted downward, re-establishing an upward sloping yield curve towards the end of the year.

In addition to monetary policy changes, fiscal measures, i.e., the withdrawal of the turnover tax of 1 per cent on banking and financial products, the reduction of NSL rate from 7.5 to 6.5 per cent and reduction of stamp duty rate from 2 to 1 per cent, had some impact on reducing effective lending rates of commercial banks. Meanwhile, the high level of borrowing by the public sector acted against a larger and faster decline in market rates than what was to be realised.

Despite large reductions in policy oriented interest rates and interbank interest rates, the slow and small adjustments in general lending rates with a continuation of relatively high interest rate spreads, reflect some of the rigidities characterising nominal market interest rates. First, the relatively high level of non-performing assets at around 17 per cent of the total portfolio, coupled with high non-operating costs imposed a stickiness to the downward adjustment of the banks' lending rates. Second, household preference for fixed rate deposits restricted the banks' flexibility to reduce interest rates in the short run reducing their adjustment speed. Third, persistent and large volumes of market borrowings required by the public sector, which are generally less interest sensitive, also prevented faster and large declines in lending rates. Furthermore, market expectations were less sensitive to announced fiscal consolidations and government borrowing targets, as actual public sector borrowings have been significantly higher than the original targets, creating pressure on interest rates. The Central Bank has been continuously reducing the SRR, placing more reliance on OMOs and reducing policy induced intermediation costs, in the composition of the interest rate spread. Furthermore, the Central Bank has started to publish information on interest rates, by institution and instrument with a view to promoting competition in the financial market.

Share market activity, which declined in 2000, continued to be subdued until well into the fourth quarter of 2001, reflecting the slowdown in economic activity, weakened business confidence and weak foreign investor demand. The imposition of a 20 per cent surcharge on corporate income tax with effect from April 2001, continuation of high interest rates, even though they declined during the second half of the year and weaknesses in the institutional structure of capital markets were also factors that affected the performance in share market activity. A reversal in the trend in share market activity was recorded in the last quarter, with renewed market expectations of political change, and decreased returns on fixed income securities following the downward movement in interest rates. Meanwhile, the Colombo Stock Exchange introduced 'Stock Borrowing and Lending' in September 2001, which could stimulate trading in otherwise dormant assets. The corporate bond market further expanded during the year as three companies issued debentures, with one of them obtaining a listing. However, the debt market is still dominated by public debt instruments and corporate debt is very small. It is essential to develop the domestic private debt market and to create an efficient and competitive equity market enabling the private sector to raise its long-term capital requirements through market instruments. In this regard, the establishment of a reference yield curve, popularisation of obtaining credit ratings for institutions as well as instruments and the reorganisation of the institutional structure of the capital market to make it more conducive to market development would be necessary.

1.11 Structural Reform

Structural reforms were continued in 2001 although progress was slow. More attention was paid more to the reforms in education, tax administration, closing down of redundant public sector institutions and an adjustment in prices and charges of the products and services provided by public corporations. In view of the losses and the high debt burden of CPC, the local prices of petroleum products were raised in April 2001, with increases in diesel, kerosene and furnace oil prices, even though kerosene and diesel prices were reduced towards the end of 2001 following the declining crude oil prices. The long overdue automatic petroleum pricing formula was introduced at end 2001, preventing ad hoc price changes and accumulation of losses, allowing a passthrough of changes in petroleum import prices more regularly to the domestic market. However, the full impact of petroleum price changes cannot be realised until transport fares are allowed to reflect the market cost, enabling passthrough of the impact. CEB imposed a fuel adjustment charge of 25 per cent in March 2001, although this falls short of what is adequate to cover the increasing cost. Measures taken to reform the two state banks by reconstituting their Boards of Directors with experienced private sector members and the recruitment of new, experienced staff to key management positions are already showing favourable results. The government has closed down 28 out of 35 identified public sector institutions listed in Budget 2001. Furthermore, privatisation of the National Insurance Corporation by selling a 51 per cent share and the transfer of the Prima Flour Mill agreement to a build-operate-own (BOO) status from a build-operate-transfer (BOT) status by selling the government ownership, improved investor confidence and provided resources for deficit financing. Meanwhile, the Central Bank has approved and recommended to the Cabinet the removal of the remaining restrictions on foreign direct investment (FDI) in the areas of construction, financial and utilities sectors, enabling these sectors to attract further foreign investment. The imposition of high specific import tariff rates instead of ad valorem duties and changes of import licences on an ad hoc basis had an adverse impact on the agricultural sector as well as development and domestic prices.

However, the structural reform programme should be continued with more vigor. In particular, reforms relating to the strengthening of public sector financial institutions, improving the flexibility of the labour market, restructuring CEB and CPC, improving efficiency in ports and land registration, introducing automatic and transparent price adjustment systems in public sector corporations, commercialising railway and postal services, facilitating the operation of private pension funds and improving efficiency in civil service need to be implemented without further delay. Similarly, due attention has to be given to expedite long overdue institutional reforms and deregulation/reregulation in order to improve the efficiency and the flexibility of the economy.

1.12 Economic Outlook for 2002 and Medium-Term Prospects

Overview

The economic prospects of Sri Lanka in 2002 will depend on changes in the external environment, weather conditions, domestic macroeconomic policies, implementation of economic reforms, the political situation and developments in the ongoing peace process. Thus, except for the first two factors all others are under the direct control of the Sri Lankan policy makers and the public. Even assuming that normal weather conditions prevail during the second half of the year and there is an improvement in the international economic environment, strong improvement in macroeconomic management, implementation of bold structural reforms, development of a national consensus on major economic and political issues, the assurance of support from the international community and advances in the peace process are essential to ensure faster economic recovery in 2002 and to lay the necessary basis for a medium-term high, sustainable economic growth, by strengthening investor confidence and improving the resilience and efficiency of the economy.

Finding a lasting solution to the ongoing ethnic conflict through a negotiated settlement will improve economic prospects significantly, by reducing the destructive expenditure, creating a conducive environment and avoiding immeasurable human suffering and social destruction. Therefore, every effort must be made to end the conflict by finding a political solution by arriving at a consensus as soon as possible. Political stability is essential to develop such a consensus.

Similarly, building up a national consensus and improving transparency and accountability are critical in implementing macroeconomic adjustments and bold economic reforms, which could be painful in the short run but are essential.

Global Economic Prospects for 2002

Despite the more than anticipated slowdown in the global economy in 2001, global economic prospects for 2002 and 2003 are becoming more favourable, thus creating a conducive external environment for trade dependent countries. Global economic growth, which declined sharply in 2001, is expected to recover during the second half of 2002 and improve further in 2003. Aggressive macroeconomic policy responses by major industrial economies, in particular the United States, including several rounds of interest rate cuts and fiscal stimulus measures, appear to have arrested the slowdown, as consumer and business confidence improved and uncertainties eased somewhat towards the end of 2001. The increasing signs of the bottoming out of the global slowdown is reflected in many leading indicators in most industrial countries and emerging market economies. Industrial production in most advanced economies has reflected a turn-around while international trade flows have improved. The information technology sector appears to have leveled off indicating prospects of a turn-around in the immediate future. The latter, in particular, is expected to stimulate economic activity in emerging market economies in East Asia which depend heavily on the information technology sector. The signs of economic recovery are also reflected in the financial markets with reduced risk spreads in both mature and emerging markets. The expected stabilisation of oil prices at the current levels would also provide ample support for a gradual recovery in the global economy.

Against this backdrop, the global economy is projected to recover during the second half of 2002. World output is estimated to grow by 2.8 per cent, in 2002. While advanced economies are expected to grow by 1.7 per cent, developing countries are estimated to grow by 4.3 per cent reflecting a marginal increase over the 4 per cent growth registered in 2001. The economic recovery in industrial countries is expected to be led by a strong upturn in the United States stemming from the exhaustion of inventories, increase in domestic demand and the fiscal stimulation introduced in 2001. According to the latest forecasts, the US economy is expected to expand by 2.3 per cent in 2002 and 3.4 per cent in 2003. Meanwhile, economic growth in the EU is also projected to improve from 1.5 per cent in 2002 to 2.9 per cent in 2003 while the economic contraction in Japan (-1.0 per cent) is expected to turn around to a positive growth rate of 0.8 per cent in 2003. Thus, most of Sri Lanka's major export markets are expected to improve towards the second half of 2002, strengthening further in 2003.

The countries in transition are expected to slow down from 5.0 per cent to 3.9 per cent in 2002 and recover only to 4.4 per cent in 2003, due to a host of factors including lower oil prices and production, lagged effects of the real appreciation of currencies, and delays in structural reform.

Developing countries in Asia are expected to recover with a growth of 5.9 per cent in 2002 and 6.4 per cent in 2003 against 5.6 per cent in 2001, reflecting continued resilience in China and India and a partial recovery in the ASEAN-4. With the expected recovery in the information technology sector and improved global demand, economic growth in the Newly Industrialised Asian Economies are projected to increase to 3.6 per cent in 2002 and 5.1 per cent in 2003, in comparison to 0.8 per cent in 2001.

Reflecting the expected improvement in global demand, international trade in goods and services, which suffered a severe setback in 2001, is expected to recover partially in 2002 and improve significantly in 2003 with a growth of 2.5 and 5.6 per cent, respectively in trade volume. While both advanced economies and developing countries are expected to benefit from this trade expansion, trade in countries in transition is expected to slow down due to the low demand expected from that region in 2002. Consumer price inflation in all regions is expected to remain subdued during 2002. Non-fuel commodity prices are also expected to improve during 2002 and 2003 improving the terms of trade for commodity exporting countries.

Stable oil prices at around US dollars 20 per barrel are expected to be beneficial for oil importing countries. However, any significant increase as observed at end March 2002 would create difficulties for oil importing developing countries. The tension in the Middle East might drive up oil prices, which would exert significant adverse effects on oil importing countries.

Short-term interest rates would remain at low levels indicating the need for relaxed monetary policies to support the improvement in economic activities. Accordingly, the average six month LIBOR is expected to drop from 3.7 per cent in 2001 to 2.8 per cent in 2002. This drop in global interest rates would ease the debt service burden of most emerging market economies to some extent as at least part of their external debt is on concessional terms. With these expected improvements in the external front, net private capital flows to emerging market economies are expected to improve substantially from US dollar 49 billion in 2001 to US dollars 68 billion in 2002.

Despite the increasing signs of a bottoming out of the global economic slow down, there are many downside risks. The subdued inflationary conditions, particularly the deflationary condition in Japan, remains a serious concern. In most major industrial countries excess capacity has become a concern which warrants the continuation of supportive macroeconomic policies to stimulate economic activity. Lack of flexibility in the implementation of macro economic policies in many countries would prolong the time taken for recovery in their economies. Substantial imbalances in growth patterns, current account balances and exchange rate movements among major industrial countries could adversely affect the stability in financial and exchange markets in developing countries, inhibiting their growth prospects. Current projections also depend on the assumption of stable oil prices at around the prices prevailing at the beginning of 2002. Current prices are already higher due to the instability in the Middle East. Policy flexibility is vital to ensure prompt responses to external shocks, thereby reducing vulnerabilities. The pace of global economic recovery depends heavily on collaborative and coordinated policies aimed at reducing global macroeconomic imbalances, particularly among major industrial countries.

Sri Lanka's Economic Outlook for 2002

The present projections made for 2002, on the expectations of improvement in the external environment and weather conditions in the second half of the year, and macroeconomic policy adjustments and economic reforms outlined in the Budget 2002, indicate an economic recovery from the low base in 2001. Higher investment and savings are expected, with more employment opportunities, lower inflation and improving macroeconomic stability with a sharp reduction in the public sector deficit and a consequent decline in public sector credit demand. Improvements are also projected in the balance of payments, which would record an overall surplus, while monetary expansion would provide adequate credit expansion to the private sector. However, the achievement of the fiscal targets given in Budget 2002, and implementation of policy adjustments and economic reforms as already announced, would be critical to ensuring the realisation of the expected economic recovery and the projected improvements in macroeconomic stability.

Real output is expected to grow by 3.7 per cent in 2002, with a strong improvement in the second half of the year with the global economic recovery gathering momentum, business confidence growing and weather conditions improving. The recovery is expected to be widespread recording positive growth rates in all major sectors. Even though rainfall during the first half of the year is expected to be less than optimal, the drought affected Agriculture sector is expected to recover, recording a growth rate of 2.2 per cent with increasing production in all major crops, except coconut, which is expected to record a further decline due to the long lagged effect of poor rainfall in 2000/2001. Tea production is projected to improve by 3.7 per cent as weather conditions improve, while rubber output is expected to grow by 2 per cent, benefiting from the anticipated increase in international rubber prices. Paddy output in 2002 is projected to improve by 7 per cent recording only a partial recovery of the drop in 2001. Other agricultural products are expected to record positive growth rates compared with negative growth rates recorded for most crops in 2001. Improvement in the peace process, facilitating normalisation of economic activity in the North and East, will provide further impetus to growth in agriculture and fishing.

The Industrial sector is expected to recover, recording a growth rate of 4.5 per cent in 2002 benefiting from the expected recovery in industrial countries, particularly in the largest export market, i.e. USA, and a high domestic demand for products aimed at the domestic market with the expected improvement in business confidence. The agriculture processing industry would record a positive growth benefiting from rising agricultural output. The projected growth in the export oriented manufacturing sector is expected to be positive at around 3.6 per cent but would be lower than the growth rate in 2000, mainly reflecting late recovery in industrial countries and increasing competition from low-cost export producing countries as well as from countries enjoying special concessions for their exports to USA. Reflecting an improvement in investor confidence, the Construction sector is projected to show a high growth spurt in 2002, which would, in turn, lead to a similar growth in the mining and quarrying sector. The expected increase in rainfall and the present efforts to address power sector issues would enable a high growth to be recorded in power generation, even though power cuts are likely to remain during the first half of the year.

The recovery in the basic economic sectors, i.e., agriculture and industry, and expected expansion in international trade are projected to have a positive impact on the Transport, storage and communication and the Trade sectors. The telecommunications sector is expected to continue its high growth rate of over 20 per cent with increasing demand and expanding new facilities, particularly related to improvements in information technology. The scheduled opening of the refurbished container terminal of the South Asia Gateway Terminal Ltd (SAGT) and expected improvement in transshipment handling with improving regional economic activities are expected to improve growth prospects in port services. The expected recovery in tourism would not only increase tourist earnings but also improve the growth prospects for aviation services. Similarly, the expected economic recovery and improved business sentiments would increase the growth rate in the financial sector. In summary, the Services sector, the largest sector in the economy accounting for more than half of GDP, is projected to record a growth rate of 4.4 per cent in 2002.

On the aggregate demand side, the expected recovery in exports, reflecting expansion in world trade, increasing investment with improving business confidence and increasing consumer demand benefiting from improving purchasing power, are expected to support achieving the projected growth of 3.7 per cent in 2002. As government capital expenditure is planned to be contained at about 5.4 per cent of GDP, the projected increase in investment demand is expected to come entirely from the private sector. However, early political settlement of the ethnic issue and the improving security situation may increase public sector investment more than expected, with additional donor support.

In line with the expected increase in domestic food supply and a moderate increase in import prices, annual inflation is expected to be about 9 per cent, with a lower rate of 7 – 8 per cent on a 12-month point-to-point basis. This is still high compared with the medium-term tolerable inflation rate of 4 – 5 per cent, but the scope for further declines in 2002 is limited due to necessary adjustments in administered prices, particularly in the electricity tariff, which has already been implemented with effect from April 2002, transport fares and postal charges. Given the slower private sector wage adjustments in 2001 compared with price increases, there could be increasing pressure for wage increases in 2002. In this context, it is essential to contain the accommodation of excessive wage increases in order to prevent moving towards a vicious wage-price circle. As any wage increase based on productivity improvement would not have an inflationary impact, it is essential to encourage linking wage adjustments to productivity changes.

In 2002, further strengthening of the external sector is expected, with a containment of the current account deficit at a manageable level, generating a surplus in the overall balance and hence enabling the build up of external reserves. Export earnings are projected to increase by 3.2 per cent, benefiting from the increasing supply of agricultural exports and recovery in export demand for manufactured products. The improvement is expected to come mainly from volume increases, as the projected improvement in the export unit price index is marginal. However, imports are estimated to recover faster with improvement in investor confidence and recovery in industries depending on imported inputs. The consequent increase in the trade deficit is expected to be offset partly by improving tourist earnings and private transfers, and declining foreign interest payments due to low international interest rates. Therefore, the current account deficit is projected to remain at around 2.3 per cent of GDP, containing the pressure on the exchange rate.

Capital inflows are expected to increase significantly, benefiting from improving investor confidence and an accelerating privatisation process. Privatisation proceeds and programme loans delayed in 2001 are expected to materialise in 2002. Meanwhile, foreign direct and portfolio investments are projected to increase reflecting the impact of improving investor confidence and expanding private sector participation in the development of infrastructure and utilities. These developments in the external current and capital accounts are estimated to generate an overall surplus in the BOP in 2002 for the second consecutive year. The projected BOP surplus is about US dollars 489 million with expected programme support under the SBA, while it would be US dollars 256 million without them. Therefore, the successful completion of the present SBA and entering into a Poverty Reduction and Growth Facility (PRGF), which provides larger assistance at a lower interest rate than the SBA facility in 2002 is critical to strengthening the external sector position.

With a projected surplus in the overall BOP, the total external reserve level of the country is expected to increase to an import coverage of 5.6 months, while the official external reserve level would be enough to cover 3 months of imports. External debt service, as a ratio of current receipts including private transfers is estimated to decline to 11.0 per cent in 2002 from 12.9 per cent in 2001, benefiting from increasing external earnings as well as low international interest rates. The floating exchange rate regime would safeguard the country's external competitiveness while enabling the Central Bank to build up external reserves as expected under the present stabilisation programme. Given the moderation in inflation and improvement in external assets, the pressure on the exchange rate is expected to be moderate. The expansion in forward market activities would minimise excessive fluctuations in the foreign exchange rate, particularly when settling large import bills in a thin market.

Recognising the serious deterioration of the fiscal performance in the recent past, Budget 2002 has been formulated to consolidate the fiscal operations, reducing the overall deficit and domestic financing requirement, while introducing a series of measures to address long over due structural issues on the fiscal front. A major overhaul of the tax policy package, comprising abolition of some taxes, adoption of new taxes and changes in the existing tax rates and their coverage was announced in the Budget. The tax system has become increasingly complex and less transparent due to the existence of widespread exemptions and waivers granted on an ad hoc basis. Consequently, the revenue mobilisation ability of the tax system has weakened, while tax evasion has increased, reducing the tax revenue to GDP ratio in recent years.

Budget 2002 has taken a bold step in addressing these structural weaknesses in the government revenue mobilisation efforts by introducing a series of major tax reforms. Accordingly, seven taxes (i.e., the Goods and Services Tax (GST), National Security Levy (NSL), 20 per cent surcharge on corporate income tax, advance company tax, tax on capital gains, government stamp duty, and 100 per cent transfer tax on purchase of immovable property by non-resident citizens) were abolished, four with effect from April 2002, one with effect from May 2002 (stamp duty) and two (GST and NSL) with effect from July 2002. A new Value Added Tax (VAT) with two rates, i.e., a lower rate of 10 per cent on essential goods and services and a standard rate of 20 per cent on other goods and services has been proposed with effect from July 2002, abolishing the GST and NSL simultaneously. The base for the VAT system has been broadened by bringing in some of the items exempted under the GST as well as adjusting exemption levels. It is also proposed to bring in the retail trade into the VAT system in 2003, further expanding the VAT base. The import duty surcharge was reduced from 40 per cent to 20 per cent. The exemption thresholds for personal income tax and retirement benefits were raised, while a graded corporate tax structure has been introduced for corporate income tax. Stamp duty on imports was converted to a Port and Airport Development Levy while a debit tax has been introduced as a temporary measure. The tax rate applicable to dividend and interest income was restricted to 10 per cent and such earnings were excluded from the computation of income tax. Tax incentives have been rationalised, limiting new exemptions only to essential areas, while selective incentives have been given for the garments, IT, housing and livestock sectors.

On the expenditure side, measures have been introduced to curtail transfers to public institutions and to rationalise payments under subsidy schemes through limiting benefits only to truly needy people. Improvements in targetting under welfare and subsidy schemes are expected through an enactment of a Welfare Benefit Law and reorganising the fertiliser subsidy programme as a Farm Input Support Scheme. With the cessation of hostilities, defence spending is expected to be reduced, while the existing hiring freeze in the public sector including government agencies, will be continued, except for recruitment for technical and some professional categories. In order to ensure the viability of the public sector pension payment system, a contributory system consisting of 8 per cent by employees and 12 per cent by the government has been proposed for new public sector employees. Capital expenditure has been limited to 5.4 per cent of GDP, mainly by limiting foreign finance to priority investment projects while rationalising transfer payments to public sector institutions under the capital account. Similarly, measures have been proposed to improve public debt management with a view to containing the sharply rising debt service payments.

With these measures, Budget 2002 attempts to reduce the primary balance (which reflects the impact of the current fiscal policy stance) by increasing revenue efforts and containing expenditure; to lower the current account deficit in order to reduced government dissavings and to reduce government borrowings and hence to contain expansion in public debt. Accordingly, the primary deficit in 2002 is targeted to be reduced to 1.2 per cent of GDP from 4.1 per cent in 2001, and the current account deficit to 3.4 per cent from 4.9 per cent of GDP. These improvements in the primary and current account balances are a combined outcome of increasing revenue efforts by 1 per cent of GDP to 17.5 per cent and reduction in current expenditure by 0.5 per cent of GDP to 21.0 per cent. Considering the constraints in the resource availability in the domestic market, capital expenditure is to be limited to 5.4 of GDP, of which about 80 per cent is expected to be covered from foreign concessional sources. Thus, the decline in the current account deficit by 1.5 per cent of GDP and a reduction of capital expenditure by 0.9 per cent of GDP is expected to reduce the overall fiscal deficit from 10.9 per cent of GDP in 2001 to 8.5 per cent of GDP in 2002.

In financing the deficit, more reliance has been placed on foreign concessional sources and asset sales. Net foreign financing expected in 2002 is estimated at Rs.26.5 billion, while privatisation proceeds are expected to generate Rs. 21 billion. The balance resource gap of Rs.88 billion is expected to be raised from the domestic sector, reflecting a reduction of Rs. 35.6 billion compared with Rs.123.6 billion in 2001. Thus, domestic financing of the fiscal deficit is targetted to decrease by Rs.35.6 billion, higher than the reduction targetted in the overall fiscal deficit (Rs.16.8 billion) because of the expected increases in foreign financing by Rs.6.4 billion and privatisation proceeds by Rs.12.4 billion in 2002. The Budget also announced plans to contain the borrowings of public corporations from the banking system and address their fundamental weaknesses. However, it is important to note that the government domestic borrowing would pre-empt almost all the resources available in the domestic non-bank sector in 2002. Therefore, a strict budget monitoring mechanism should be in place to avoid any deviation from the announced fiscal targets in order to identify any potential deviations and take necessary corrective measures early.

Budget 2002 has also proposed a series of economic reforms, including the establishment of a Revenue Authority to improve and coordinate revenue mobilisation policies, a Permanent Tariff Commission and enactment of a Welfare Benefit Law to improve targeting, Land Titles Registration Law to simplify land registration and legislative reforms covering the financial sector and introduction of enforceable time limits on the hearing and decision of labour disputes by tribunals and arbitration panels dealing with such disputes, and a schedule of specified compensation payable on termination of employment.

Similarly, the achievements of BOP and monetary targets are also subject to the realisation of expected foreign financing and privatisation proceeds by the government. Furthermore, maintaining the envisaged monetary targets would also be subject to realisation of improvement in the financial positions of public corporations. Any significant increases in public sector borrowing over the expected level would require curtailing private sector credit in order to ensure reduction in inflation or allowing an increase in inflationary pressure without crowding out the private sector credit. As both these options are not conducive to achieving high economic growth with stability, every effort has to be made to minimise these potential risks, particularly in fiscal adjustments and improvements in public corporations.

Monetary management will be a challenging task in 2002 under the floating exchange rate regime, given the potential conflict between the necessity of a tight monetary policy stance to contain inflationary pressures and the more relaxed monetary policy stance required to support economic recovery. However, on balance, monetary policy would need to remain tight at least until fiscal consolidation starts to take effect and inflationary pressures abate further. This is necessary to prevent the present cost-push inflation turning into a demand fuelled inflation. Therefore, the policy interest rates, which were reduced by about 800 – 900 basis points in six adjustments made since February 2001, have to be decided cautiously. Once the public sector adjustments take effect with improved market rupee liquidity and downward adjustment in inflationary expectations, the Central Bank would be able to reduce its interest rates (i.e. Repo and Reverse Repo rates) gradually, but over the year. However, there is a large space in general lending rates to adjust downward, as they have not been reduced to reflect the full impact of reductions in policy interest rates and taxes.

Based on the overall macroeconomic outlook, monetary expansion in 2002 is projected to be around 12.5 per cent to be compatible with the increase in nominal income growth. Given the expected reduction in the public sector domestic credit demand, monetary expansion is projected to come from the improvement in net foreign assets of the banking system and expected private sector credit demand. Out of the projected increase in money supply of Rs.69 billion, Rs.59 billion (i.e., 86 per cent) is expected from an increase in NFA while only Rs.10 billion is expected from an increase in net domestic assets (NDA). The projected increase in the NDA is low due to the expected reduction in public sector credit in the banking sector by Rs.34 billion consisting of Rs.29 billion from the government and Rs. 5 billion from public corporations. These estimates would permit accommodating private sector credit expansion of about Rs.46 billion in 2002, compared with the realised increase of Rs.32 billion in 2001. Thus, given the projected increase in NFA, the increase in private sector credit demand expected along with economic recovery could be accommodated, avoiding pressure on prices only if the public sector could adhere to its borrowing targets. Therefore, the realisation of fiscal targets envisaged in the 2002 Budget and expected improvements in the financial position of public corporations are critical to achieving these monetary targets and expected downward adjustments in inflationary expectations and hence interest rates.

Early finalisation of a settlement to the ethnic issue, strong recovery in the world economy and faster

Box 3

Stand By Arrangement

The International Monetary Fund's (IMF) most important purposes include the promotion of exchange rate stability and the provision of confidence to its members. In order to achieve these the IMF provides facilities to countries experiencing balance of payments difficulties so that they can restore external and internal stability required for sustainable economic growth. The financial assistance provided by the IMF enables countries to rebuild their international reserves, stabilise their currencies, and continue paying for imports without having to impose trade restrictions or capital controls. The IMF provides financial assistance to member countries under a variety of facilities and conditions. The amounts available, the interest rate charged, and the periods of repayment of IMF credits vary with different facilities and the conditions laid down are those best suited to address the types of balance of payments problems facing a given member in need of external financing. IMF loans are usually provided under an 'arrangement', which stipulates the conditions that the country must meet in order to gain access to the loan facility. The government of the country engages in a dialogue with the IMF and formulates an economic programme based on its future economic policies, which is referred to as the Letter of Intent. If these policies are considered to be sensible and viable, the IMF Executive Board, whose 24 directors represent the IMF's 183 countries, approves financial support. Loans are then released in phased instalments as the programme is carried out.

The IMF maintains a large pool of resources, from which to help finance temporary imbalances in the balance of payments of its members. These resources are of a revolving character and are primarily derived from currencies deposited by its members. The IMF may supplement these resources by borrowing. To use IMF resources, a member must justify the need for such resources, usually either due to balance of payments difficulties or the depletion of its external reserves.

Short-term balance of payments needs of a member country are customarily supported by a one to two year Stand By Arrangement (SBA), which is the most widely used facility of the IMF. The length of an SBA is typically 12 to 18 months. Loans under an SBA have to be repaid within a maximum of 5 years, but countries are expected to repay within 2 to 4 years. Longer term balance of payments support, usually requiring more extensive structural reforms, can be addressed by a three year programme under an Extended Fund Facility (EFF). Financial support under the EFF is subject to repayment over 4 to 10 years from the date of drawing. However, it is expected to be repaid within 7 years. The amount that can be borrowed under these arrangements is normally up to 100 per cent of the member's quota annually and 300 per cent cumulatively, although access to larger amounts is granted in exceptional circumstances.

Interest payable on these credits is the basic General Resource Account (GRA) rate of charge which is set as a proportion of the weekly SDR interest rate. The SBA and EFF carry a surcharge of 100 basis points above the basic rate of charge for credit exceeding 200 per cent of a member's quota, and 200 basis points for credit exceeding 300 per cent of quota.

There are other loan facilities offered by the IMF, tailored to address specific circumstances of its diverse membership. Other such non-concessional facilities offered by the IMF include the Supplemental Reserve Facility (SRF), the Contingent Credit Lines (CCL), Compensatory Financing Facility (CFF) and Emergency Assistance (EA). The IMF also offers concessional long-term financing to low income members under its Poverty Reduction and Growth Facility (PRGF), formerly known as the Structural Adjustment Facility (SAF), with the twin objectives of poverty reduction and promoting high growth on a sustainable basis.

There are several advantages that an SBA offers over other facilities. Financial assistance provided under SBA allows member countries to correct their temporary balance of payments imbalances without having to resort to trade and payments restrictions. It assists in building up market confidence, locally and internationally, through an increased build up of reserves. Having adequate reserves is important as it helps the member country to meet unexpected increases in demand for imports and encourages private foreign capital inflows. Unlike other loans from bilateral and multilateral donors, where the parties must go through a time consuming negotiation process, under the SBA, the eligible amount, or a part of it is disbursed immediately upon obtaining Board approval from the IMF. Therefore, it has a very quick impact on the member country. Unlike other multilateral and bilateral loans, which are lent to the government, SBA funds are lent to the central banks of the countries. Hence, it does not affect the domestic money supply of the country. A further advantage is that undertaking an IMF supported programme acts as a catalyst to generate additional financial assistance from other sources such as official and private creditors.

Box 3 (contd.)

Sri Lanka, which became a member of the IMF in 1950, has obtained assistance from the IMF on several occasions since 1961, twice under SBA facilities. Sri Lanka obtained an SBA facility of SDR 93 million (94.9 per cent of the quota at the time) in December 1977 in view of the economic reforms the government undertook at the time. In September 1983, the IMF extended SDR 100 million (44.8 per cent of the quota at the time) under an SBA facility to undertake further reforms, of which only SDR 50 million was drawn; SDR 30 million in 1983 and SDR 20 million in 1984.

The present SBA programme for Sri Lanka was approved by the IMF Board on 20 April 2001. As on previous occasions, the Government decided to use the Stand By facilities of the IMF at this time, because of a decline in external reserves arising from a sharp increase in payments for oil imports and unanticipated increases in budget expenditure. The IMF's stamp of approval at the time was crucial in softening the negative impact on the country flowing from the attitude of the international community to the ethnic conflict, and in getting the support of the international community to face the expected global economic slowdown in 2001. Under this arrangement, the country was granted a 14 month credit facility of SDR 200 million (approximately US dollars 250 million) (48.4 per cent of the country's IMF quota) to support the government's economic adjustment programme for 2001-2002. Sri Lanka drew SDR 103.4 million (equivalent to 25 per cent of the country's IMF quota) on 21 April 2001. The remaining SDR 96.6 million was to be disbursed in four equal tranches of SDR 24.1 million each on 30 August 2001, 30 November 2001, 28 February 2002, and 15 May 2002 after the completion of scheduled reviews. The facility was subject to an interest rate equivalent to the SDR rate, which stood at 4.38 per cent per annum at the time of the disbursement of the first tranche. The loan was payable in 5 years and the Government of Sri Lanka could settle the loan earlier if the country's external position improved faster than expected. The second and third tranches were not drawn, as the reviews required prior to disbursement could not be completed due to internal and external difficulties facing the country. The reviews are expected to be completed before March 2002.

The SBA is a part of a broader financial package, which includes contributions from other multilateral lending institutions such as the World Bank and the Asian Development Bank, official bilateral donors and the private sector. A total of approximately US dollars 520 million is expected. The programme aims to restore macroeconomic stability through an improvement in the financial position of the public sector and the rebuilding of official reserves, supported by a flexible exchange rate. Thus, the government is expected to achieve specific targets in certain areas, and implement certain reforms. The disbursement of the remainder of the facility is subject to the achievement of the performance targets, which is assessed in reviews.

Sri Lanka is required to achieve 11 targets, relating to economic indicators on a quarterly basis, six of which were performance criteria[a] and five indicative targets. At end June 2001, all targets except one indicative target had been met, while at end December, five of the six performance criteria and one indicative target had been met. However, the IMF will grant a waiver for the non-compliance of the performance criteria enabling the release of due financing under the SBA as it was largely due to external adverse factors which were beyond the control of the Sri Lankan authorities.

It is expected that once the SBA is completed, Sri Lanka would move to a programme of substantial structural reform, which could be supported under a PRGF. Loans under the PRGF are based on a Poverty Reduction Strategy Paper (PRSP), which is prepared by the country in cooperation with civil society and other stakeholders, in particular, the World Bank. The interest rate levied on PRGF loans is 0.5 per cent per annum and loans may be repaid over a maximum period of 10 years. Under a PRGF, a wider range of reforms will be undertaken. Such reforms would include continued fiscal consolidation, labor market reforms, public enterprise restructuring and privatisation, reform of the public administration, the removal of impediments to foreign direct investment, and a substantial increase in public expenditure on infrastructure development. The PRGF aims at making poverty reduction efforts a key element of a renewed growth oriented economic strategy, which would foster sustainable high quality growth, leading to higher living standards and a reduction in poverty on a more sustainable basis.

(a) Performance criteria (PCs) are targets that would determine whether a country would automatically qualify for subsequent disbursements under the SBA. Failure to adhere to the PCs would disqualify the country from drawing further under the facility. However, the borrowing country could request for a waiver, if failure of achieving PCs could be justified and such justification is accepted by the Executive Board of the IMF. Indicative targets (ITs) are desirable targets but are not as critical as PCs. Failure to meet ITs would not have an impact on the continuation of the programme.

improvement in weather conditions may improve the macroeconomic situation more than expected at present, facilitating realisation of the envisaged fiscal targets in Budget 2002. However, the potential downside risks in achieving some fiscal targets, particularly containing current expenditure and realisation of privatisation proceeds, cannot be underestimated. Similarly, early preparation is essential to prevent potential revenue losses when introducing the VAT system by abolishing the GST and NSL in July 2002. Similarly, there could be strong pressure from various interest groups to delay and weaken the reforms outlined in the Budget. Meanwhile, the achievement of the envisaged fiscal targets and implementation of reforms outlined, are critical to improving macroeconomic stability and ensuring faster economic recovery and preparing the necessary basis for a high growth in future by improving investor confidence and releasing more domestic financial resources to the private sector.

Medium-Term Macroeconomic Prospects

In addition to finding a lasting solution to the ethnic issue, the medium-term macroeconomic prospects of Sri Lanka will depend mainly on the magnitude and speed of policy adjustments and implementation of economic reforms. Since a macroeconomic framework with weak policy adjustments and slow economic reforms is not sustainable, a medium-term economic scenario based on strong policy adjustments and faster economic reforms is considered and estimates are given in Table 1.8. This scenario is based on the assumptions of continuation of fiscal consolidation and civil service reforms compatible with a medium-term fiscal sustainability strategy, public enterprise reforms, financial sector reform, strengthening the stability of the financial system and reducing high intermediation cost, labour market reforms increasing flexibility, land market reforms creating an efficient land market, increasing investment in infrastructure developments, ensuring availability of quality infrastructure facilities adequately, undertaking institutional reforms increasing transparency and accountability and reforming regulatory systems, simplifying the necessary ones while eliminating those which are not compatible with the market oriented macroeconomic policy framework. These adjustments and reforms are not only necessary to improve the medium-term growth prospects of the country, but also to strengthen the resilience of the economy which is essential given the potential risks of external shocks in an increasingly globalising, high trade dependent country.

The floating exchange rate regime, supported by prudent fiscal and monetary policy, and continuation of structural reforms would enable Sri Lanka to maximise benefits from an increasingly integrated world economy, utilising the country's resources more effectively. Medium-term world

TABLE 1.8
Medium-Term Macroeconomic Indicators

Item	Provisional 2001	Projections 2002	Projections 2003	Projections 2004	Projections 2005	Projections 2006
Mid year population (million)	18.7	18.9	19.0	19.2	19.4	19.6
GDP growth (%)	-1.4	3.7	5.5	6.0	6.5	6.5
Investment (% of GDP)	22.0	24.0	26.0	28.0	29.0	30.0
Private	19.0	18.9	18.9	20.5	21.0	21.0
Public	3.0	5.1	7.1	7.5	8.0	9.0
Domestic savings (% of GDP)	15.3	16.8	19.5	20.8	21.3	22.8
Private	20.3	20.2	20.1	19.7	19.2	19.3
Public	-4.9	-3.4	-0.5	1.1	2.1	3.5
CCPI annual average (% change)	14.2	9.0	6.0	5.5	4.5	3.8
Export volume (% change)	-8.0	5.0	16.3	13.0	13.1	12.3
Import volume, without aircraft (% change)	-10.7	5.6	12.9	14.4	13.8	10.5
External current account deficit (% of GDP)	-2.3	-2.4	-1.5	-2.2	-2.9	-2.6
Official reserves (months of imports)	2.7	3.4	3.5	3.6	3.6	3.8
Government revenue (% of GDP)	16.5	17.5(a)	19.1	19.4	19.8	20.1
Government expenditure (% of GDP)	27.4	26.1(a)	26.6	25.9	25.8	25.6
Budget deficit (% of GDP)	-10.9	-8.5(a)	-7.5	-6.5	-6.0	-5.5
Broad money (% change)	13.6	12.5	11.8	11.9	11.3	10.5

(a) Budget 2002

Source: Central Bank of Sri Lanka

economic growth projections indicate a conducive environment for Sri Lanka to achieve sustainable, high quality growth, if it elects to follow growth oriented policy adjustments and structural reforms.

Under this scenario, GDP growth is projected to be higher than 6.5 per cent in the medium-term, primarily led by investment and exports. Inflation is targetted to decline gradually to 3.8 per cent, reducing pressure on the exchange rate. Public sector adjustment is the major pillar in this scenario. Internal, as well as external macroeconomic imbalances, are expected to decline in the medium term. Reduction in the fiscal deficit is expected to play a key role in reducing the national investment-savings gap, while increasing exports are expected to reduce the external current account deficit. High growth with increasing savings is expected to reduce the domestic debt to GDP ratio, as well as external debt to GDP ratio, ensuring medium-term debt sustainability.

Faster growth in investment, attracting even more foreign investment, would increase domestic output and improve the external situation, raising external reserves, thus enabling the achievement of stability in the exchange rate and domestic prices under the given scenario. Such achievements would have the salutary effect of encouraging people to adjust downward their inflationary expectations, which have been continuously high in Sri Lanka. Such a reduction in inflationary expectations would facilitate monetary management and gradually improve market confidence.

Reduction of the fiscal deficit in the medium term to about 3 – 4 per cent of GDP, while increasing public investment to about 7 – 8 per cent is critical in raising necessary investment, and generating sufficient domestic savings in achieving a sustainable growth rate over 6.5 per cent. The present investment, at around 22 – 24 per cent of GDP, is not sufficient to generate a growth rate over 5 per cent in the medium term. Therefore, investment has to be increased to about 30 per cent of GDP in the medium-term to raise the growth rate to over 6 per cent. On the investment front, public investment has to play a catalytic role by selecting investments having a crowding-in effect on private investment instead of selecting crowding-out investment. In a developing country like Sri Lanka, public investment in infrastructure development would have a crowding-in impact on private investment raising the overall investment of the country, as private investment responds positively to the availability of infrastructure facilities.

However, a larger share of about 75 per cent of total investment or 22 – 23 per cent of GDP is still expected from the private sector. To what extent the private sector would take up the challenge is not known, although there are some signs of private sector resurgence. In financing this high investment, more emphasis has to be placed on national savings as the availability of concessionary financing is declining gradually. The required increase in national savings by 5 – 6 per cent of GDP to finance the required high investment is difficult to achieve only by encouraging private savings in Sri Lanka, as in most developing countries. Therefore, it is essential to turn around the present current account deficit (i.e., government dissavings) to a surplus (i.e., government savings) in order to generate sufficient national savings in the medium- term as indicated in the medium term scenario. Similarly, the government has to reduce the overall fiscal deficit to about 3 – 4 per cent of GDP from the present high level of over 8 per cent in the medium-term in order to ensure availability of domestic financial resources to meet increasing private sector investment. Thus, fiscal consolidation is critical in achieving the high investment, savings and growth targets envisaged under the given medium-term scenario.

Similarly, reforms in public corporations are essential to reduce the overall public sector deficit and hence the public sector borrowing requirements, in order to make available sufficient resources to the private sector. In this context, introduction of automatic price adjustment systems and implementation of cost minimisation measures are helpful in reducing the borrowing requirement of public corporations.

Even with all these adjustments it would be difficult to generate the required financial resources from national savings, particularly at the early stage of the growth acceleration programme to meet high investment demand. Therefore, it is essential to encourage foreign investment, which is very low at present. Foreign investors not only bring financial resources but also new technology and market access generating externalities and improving competitiveness.

In addition to the expected growth from capacity expansion through high investment growth, contribution to the growth increase is also expected from efficiency improvements, i.e., raising productivity. In this context, structural reforms addressing issues affecting resource allocation efficiency and productivity improvements could play a key role. Thus, acceleration in implementing structural reforms should be a major integral part of the policy strategy in achieving a medium-term, high, sustainable growth.

1.13 Economic Issues and Policies

The performance of the Sri Lankan economy since the introduction of a market-oriented policy framework in 1977 has been encouraging, although there were temporary setbacks from time to time. The annual average economic growth accelerated to 4.5 per cent for the period 1977-2001 from 3.5 per cent for 1950-1977. The higher growth rate, coupled with decelerating population growth, raised per capita income from US dollars 106 in 1950 to US dollars 294 in 1977 and further to US dollars 838 in 2001. Thus, annual average per capita income growth rose to 4.3 per cent for the period 1977-2001 from 3.7 per cent for 1950 -1977. Even though some vulnerabilities still seemed to continue, the resilience of the economy has strengthened with a diversification and modernisation of production as well as exports, while increasing the link with the global economy. The share of the private sector in economic activity has increased gradually, raising efficiency in the economy. The unemployment rate declined, albeit slowly.

However, despite positive economic achievements on many fronts, Sri Lanka's economic development has been far behind East Asian countries. Furthermore, the country's performance was even overtaken by a number of other Asian developing countries, which started economic reforms much later, largely owing to weak policy adjustments and slow economic reforms. Consequently, major economic problems such as slow growth and low productivity, coupled with inadequate savings and investment, persistent high inflation, unemployment, under-employment and poverty, serious macroeconomic imbalances and vulnerability to external shocks not only still continue to remain, but have been aggravated in some instances, posing greater challenges to macroeconomic management. There is no doubt that some factors, which are beyond the country's control, may also have contributed to such developments; but that should not be an excuse for weak performance. In fact, such factors should be taken as challenges for prudent macroeconomic management by pursuing timely and adequate remedial measures to minimise their repercussions. Given the fast changing global events and the potential for rapid growth following peace, managing the inevitable change with least cost to the economy and social life would be an uphill task for policy makers in the short to medium term. This would require changes not only on the economic front but also in cultural, social and attitudinal areas.

Developments in 2001 have clearly demonstrated the economy's vulnerability to external shocks and the limited availability of policy options in the short-term, reflecting the necessity for strong policy adjustments and faster economic reforms without further delay. The difficulties, painfulness and political cost of such reforms are clear, but those would be short term and could be minimised by improving co-ordination and building up consensus among all development partners with proper public awareness programmes. Furthermore, the available room for accommodating any further policy slippages is very limited and postponement of necessary policy adjustments and structural reforms is economically very costly, as it could lead the country towards an economic crisis. The economic outlook for 2002 and the medium-term economic prospects of Sri Lanka discussed above also emphasise the need for strong policy adjustments as soon as possible in order to ensure faster economic recovery with macroeconomic stability in 2002 and high quality sustainable growth in the medium-term.

Peace: Everyone agrees that peace is essential for economic development, minimising non-productive expenditure and creating a business environment conducive to investors. In this context, finding a lasting solution to the North-East conflict, acceptable to most Sri Lankans, if not all, is essential. Building up trust and reaching consensus among all partners involved in the conflict and addressing its deep-rooted causes are essential steps in the process of moving towards the final goal. In this endeavour, the progress under the ongoing peace process, supported domestically and internationally, is encouraging. Finding a political solution acceptable to all for this complicated issue will not be easy, but is essential to ensure the future prosperity of the country. Experiences in other countries have also shown that it is possible to find a lasting solution to this type of issue if all partners are genuinely committed and prepared to move forward along a difficult path trusting each other. The international community will not only help Sri Lanka to find a lasting solution, but will also assist the country in its subsequent rehabilitation, reconstruction and reconciliation efforts. However, the ability to find and responsibility for finding such a solution depends on none other than the Sri Lankans themselves.

The need for high quality economic growth to improve the living conditions of Sri Lankans on a sustainable basis is also accepted. Similarly, almost all political parties in the country have accepted the market oriented economic policy strategy as the most suitable macroeconomic framework for achieving the necessary high growth. Such acceptability minimises significantly the political risk of reversing the overall economic policy framework with every successive change in government. Furthermore, all major political parties, the private sector and the international community supporting Sri Lanka, have also repeatedly emphasised the need for strong policy adjustments and economic reforms in order to ensure high economic growth. Nevertheless, there are some differences among them on the degree and speed of such policy changes and reforms, as well as in their sequencing and timing. However, consensus could be developed through open discussions with wider participation on such issues. Furthermore, it is not practically possible to achieve the maximum benefits of policy adjustments and reforms without adequate support from all the affected segments of the economy. Therefore, it is most important to outline explicitly the necessary major policy adjustments and reforms with their sequence, speed and intended timetable for implementation, in order to build up the required national consensus on such critical decisions. The public at large, particularly interested groups affected by such policy changes previously, have repeatedly expressed their concern on the transparency and accountability of the decision making and policy implementation process. Therefore, the need for an open discussion before making major economic policy decisions and accommodating constructive criticism cannot be underestimated in the process of building up public support for economic reforms and improving the transparency in public policy formulation and implementation.

High Growth: One of the major economic issues being debated at present in various fora is the ways and means of generating sustainable high economic growth, as its necessity is universally accepted. Basic economic principles explain that economic growth could be accelerated by improving efficiency in resource allocation, particularly in the short run, by moving towards the boundary of the production possibility frontier, i.e., the line indicating the various combinations of the maximum possible production of different goods and services for a given set of inputs and technology. Similarly, these principles indicate that achieving a sustainable high growth over the medium-term depends on the ability to shift the production possibility frontier outward (i.e., an expansion of the production capacity in the economy) through factor accumulation and/or technological improvements. Therefore, it is essential to undertake policy adjustments and reforms helpful in improving resource allocation efficiency, as well as augmenting the availability of inputs and improving technology.

In other words, the achievement of a sustainable medium-term, high growth objective requires a continuous factor accumulation and/or an improvement in total factor productivity. The expansion in investments (i.e., capital formation) and discovery or acquisition of new primary resources are the means for the augmentation of available production inputs in the economy. Meanwhile, improving resource allocation efficiency, minimising wastage in the production process and improving technology are the major avenues available for raising productivity in the economy. Therefore, it is essential to undertake policy measures to encourage and facilitate improvement of resource allocation efficiency, technological improvement, investment and participation in the workforce, while removing the hindrances affecting them, in order to ensure achieving a sustainable high growth.

The relationship between investment (i.e., capital formation) and output assumes special importance in the case of a capital-deficient developing country like Sri Lanka, especially in reinvigorating economic growth. Studies have typically shown that capital accumulation contributes upto 60-70 per cent of growth in per capita output (IMF, 2000) and continues to be the primary engine of growth. The present investment/GDP ratio in Sri Lanka, at around 22 per cent, is totally inadequate for achieving the desired growth rate of over 8 per cent in the medium-term. Hence, it has to be raised at least to about 30 per cent of GDP. In raising investment, reliance has to be placed on encouraging both domestic investment and foreign investment. Foreign investors would not only bring in investment and increase external market access, but would also create beneficial externalities on domestic production through making available modern technology and managerial skills.

In raising domestic investments, both private and public investment should play an important role. However, public investment has become a 'soft target' of fiscal consolidation efforts. This has to be turned around by rationalising current expenditure, while making adequate allocation for public investment and taking measures to realise the same. An important issue in raising total domestic investment is the relationship between public and private investment, particularly in the context of the vacation of public investment from several areas to create space for private investment as part of the ongoing economic reforms. In order to ensure the maximum benefits from public investments, they have to be concentrated in areas where 'crowding-in' of private investment would occur, rather than in areas where 'crowding-out' would result. The general acceptance is that the public investment in infrastructure development would not have a crowding-out impact on private investment. In fact, such public investment could have a crowding-in impact, encouraging private investors, as the inadequacy of infrastructure facilities prevailing in the country is a major hindrance discouraging expansion of private investment.

Even though public sector investment has stimulating and complementary effects on private investment, the expansion in the fiscal deficit consequent on raising public investment can cause financial crowding out, raising real interest rates via increases in nominal interest rates. This, in turn, can induce a downturn in aggregate demand including private investments. Accordingly, public investment stimuli in raising growth prospects must rely on a compositional shift in fiscal expenditures in favour of public investment in infrastructure without an unbridled expansion of the fiscal deficit.

In financing large investments, the major emphasis has to be placed on domestic savings given the declining trend in the availability of concessionary foreign financing and increasing volatility in the international capital markets. However, the present national savings/GDP ratio, at around 20 per cent, is woefully inadequate in meeting the required high investment demand of over 30 per cent of GDP. Therefore, turning around the dissavings in the public sector, currently about 5 per cent of GDP, into a positive savings of over 5 per cent of GDP, while encouraging private savings is essential in raising national savings to an adequate level. Therefore, every effort must be made to encourage private savings, while removing the hindrances affecting private savers. In this context, the new tax proposal on interest income could have an unexpected adverse impact on the efforts to encourage national savings if adequate safeguards are not put in place at the implementation stage.

In raising productivity, the main reliance has to be placed on research and development (R&D), transferring of modern technology and factor market mobility and flexibility. However, the allocation for R&D is minimal in Sri Lanka (0.08 per cent of GNP in 1999) compared with an average spending by developing countries as a group (0.64 per cent of GNP in 1990).[a] A sustainable solution lies in providing incentives to the private sector to engage in R&D by protecting their property rights, enforcing patent rights and promoting the free play of the market demand and supply forces rather than attempting to depend entirely on the public sector for R&D. Meanwhile, foreign investment could be used as a conduit for transferring modern technology.

On the aggregate demand side, more reliance has to be placed on export demand, given the limited size of the domestic market as well as limitations on expanding the same. Of course, increasing domestic investment and growing consumer demand, benefiting from rising income with high growth, will provide demand stimulus, but that will not be sufficient to support high sustainable growth. Accordingly, the importance of investment in favour of export oriented industries and strengthening the country's external competitiveness cannot be overstated. The present floating exchange rate regime is very helpful in strengthening external competitiveness, but it alone will not be sufficient unless it is supported by productivity improvements. In this regard, improvement in human skills, linking wage increases to productivity increases, flexibility in labour markets, modernisation of technology, availability of efficient high quality infrastructure facilities at competitive market prices, removal of cross-price subsidies prevalent in utility pricing and the removal of unnecessary regulations and replacing of inefficient regulations with efficient ones are essential to improve the country's external competitiveness.

Potential Growth Sectors: A similar issue under consideration is the identification of potential high growth sectors in the economy. Given the existing inefficiencies, low productivity and investment opportunities, contribution to high growth can be expected from all three major sectors, i.e., agriculture including allied activities, industry and services. However, given the limitation in the availability of arable land, more emphasis has to be placed on the services and industry sectors in the acceleration of economic growth.

Services: The phenomenal expansion of services world-wide has led to services being regarded as an engine of growth and even as a necessary concomitant of economic growth. The share of the services sector is well over 70 per cent in advanced countries and it is about 54 per cent even in Sri Lanka. Furthermore, as a highly trade dependent island economy, the future growth prospects of Sri Lanka will largely depend on expanding as an internationally competitive service centre. As the services sector provides various kinds of services to the agricultural and manufacturing sectors, such improvement in services will raise the productivity of the entire economy. Thus, the services sector with the highest potential for growth has to be the leading sector well integrated with the industrial and agricultural sectors in achieving high future economic growth in Sri Lanka.

Efficiency in transport and ports services is essential in maintaining the country's external competitiveness. Despite the recent improvements, the efficiency in the Colombo Port is well below other competitive ports, such as Singapore and Salalah in the region. A large part of the present income of the Colombo Port is derived from transshipment services and the future growth of port services depends on attracting transshipment business. Thus, improvement of efficiency in the Colombo Port is crucial for strengthening its regional competitiveness as well as supporting development in the country's external trade. Given the limitation for capacity expansion in the Colombo Port, and the proximity of Hambantota to one of the most busy sea transport routes in the Indian Ocean, the development of the proposed Hambantota Port would provide strong impetus to the expansion of port services in the country. Similarly, the achievement of peace will facilitate the development of the Trincomalee Port, one of the largest natural harbours in the world, particularly to provide transshipment facilities and ship repair and maintenance services, further augmenting significantly port services and hence, its sectoral contribution to GDP.

An efficient, low cost, high quality reliable transport service is essential in achieving high economic growth. The present inefficient, low quality and unreliable passenger transport service adversely affects the productivity of the whole economy. The long time taken even for short-distance travel by public passenger transport operated by both the private and public sectors significantly affects labour productivity in other sectors. The existing administered fare system for public passenger transport services, based on ad hoc adjustments, affects the viability of the sector, discourages new investment and reduces the quality of the services. Therefore, introducing an automatic and transparent transport fare adjustment system is necessary to ensure the viability of the transport industry and to attract more investment, expanding the capacity and improving the quality of passenger transport.

An efficient passenger railway system not only provides a convenient and cheap public transport service, particularly in Colombo and suburban areas, but also helps to control the increasing traffic congestion in road passenger transport.

(a) Research and Implementation Systems for Non-Aligned and Other Developing Countries, Biotechnology and Development Review, Vol. 4, No.1, April 2001.

However, the reliability and quality of the railway services have deteriorated significantly. Furthermore, railway accidents have increased sharply due to poor maintenance. These inefficiencies and weaknesses, with highly subsidised fares, result in a heavy fiscal burden. A comprehensive restructuring programme with private sector participation and automatic fare adjustment system is essential to improve the viability, and future prospects of the railway service for both passenger and goods transport.

A continuously increasing demand, existing capacity limitations and vulnerability to weather clearly indicate the increasing gap between the supply of and the demand for electricity and, hence, the existing potential for future expansion in the power sector. With the increasing electricity intensity in production activities and expanding consumer network with increasing use of electrical appliances, the demand for electricity indicates the necessity for a double digit growth rate in electricity supply. Provisional estimates indicate that a 1 per cent increase in economic growth would raise electricity demand by about 2 per cent. Thus, in order to ensure the realisation of a desirable high economic growth, electricity generation has to be expanded not only to eliminate the existing excess demand, but also to meet increasing new demand. Furthermore, dependence on hydropower has to be further reduced by diversifying power generation to other sources such as coal, thermal, solar and wind to minimise the vulnerability of the electricity supply to rainfall variation.

The existing crisis situation in electricity supply has an adverse impact on the country's productivity and expansion of production capacity. The present power tariffs in Sri Lanka are the highest in the region, significantly weakening the country's external competitiveness. A comprehensive reform package including unbundling of generation, transmission and distribution activities of the CEB, introduction of an automatic, transparent tariff adjustment system correcting biases against production activities through cross-subsidy, reducing system losses, which are as high as 20 per cent, involving private sector participation and removing political interference in power sector expansion activities is essential to improve the viability and future prospects of the power sector.

An efficient financial sector is essential for faster economic growth in a modern economy. Despite opening the financial sector to the private sector, including foreign banks, and strengthening the regulatory and supervisory system, the financial sector reflects a number of concerns. Some of them are high interest spreads, high non-performing loan ratios, subdued development in capital market activities, an undeveloped bond market and slow expansion in insurance activities. The two state banks, having high intermediation costs and operating with a number of loss making branches and a high NPL ratio, dominate the commercial banking system, still accounting for more than 50 per cent of total deposits and loans in the banking system. Similarly, the Sri Lanka Insurance Corporation accounts for more than 70 per cent of the insurance business in the country. The two largest retirement benefit funds, i.e., EPF and ETF, are directly under public sector management, not releasing long-term savings adequately to the private sector to finance their long-term investment activities. The low financial deepening of the country compared with other developing countries in the region clearly indicates the future growth potential in the sector. Commercialisation of state sector financial institutions, amendments of legislation affecting the financial sector to be more compatible with modern financial services, improving efficiency in the payments and settlements system and strengthening the supervisory and regulatory system and ensuring systemic stability in the financial sector will facilitate faster growth and efficiency of the financial system, increasing its sectoral contribution to GDP.

As an island, one of Sri Lanka's largest and best natural resources is the sea. However, the country has not been able to tap the full benefits from this most valuable natural resource. Despite various incentives provided by successive governments, the country's fish production is still well below domestic demand. A proper development strategy, involving the private sector, would not only increase fish production to meet the domestic demand, but would also generate export earnings. Even though the country has a number of natural ports very close to a busy international sea route, only the Colombo Port has expanded and improved, attracting transshipment business. In accelerating future growth of the country there is large growth potential to be tapped in sea based economic activities if necessary regulatory reforms are made.

The tourism industry in Sri Lanka has experienced lacklustre developments, particularly due to the adverse impact of terrorist attacks. Given the country's location, natural resources, cultural attractions and historical sites, there is a great potential for future developments. Development of sea based sports and recreation activities will further improve the potential in the tourist industry. With the achievement of peace, an effective promotional campaign would increase growth in the tourist industry increasing its contribution to GDP and creating new employment opportunities. Similarly, developments in tourism will have an indirect contribution to growth through encouraging activities in other related services and in the small industry sectors. It is essential to target high value-added tourism in promotional campaigns in order to ensure obtaining the maximum benefits to the country.

Industry: The private sector led export-oriented industrialisation strategy adopted in Sri Lanka since 1977 has encouraged the diversification of the industrial sector over the last two decades providing more employment opportunities and contributing to overall economic growth and expansion in export earnings. However, at present, the industrial sector is highly vulnerable to changes in the external environment as it is not only highly concentrated on a few products but also depends on a few external markets. At present, the garment manufacturing sector accounts for 45 per cent of domestic manufacturing production and 69 per cent of total industrial exports. Furthermore, USA accounts for 64 per cent of the country's garments export market while UK and the EU account for another 19 and 30 per cent, respectively. Changes in economic conditions in these countries and granting of special concessions to other developing countries exporting to these countries have had an adverse impact on Sri Lanka's manufacturing sector. This concern is particularly relevant in the face of the phasing out of the Multi-Fiber Arrangement (MFA) by 2005. Therefore, a diversification programme for the industrial sector, product-wise as well as export market destination-wise, is critical to improving the resilience and future growth prospects of the manufacturing sector.

Meanwhile, moving into high value added industries is necessary to accelerate future industrial growth. Similarly, achieving increasing access to the Indian market under the Free Trade Agreement will not only expand export market opportunities but would also lead to attracting foreign investors to the country.

The share of bulk tea exports in Sri Lanka is still as high as 60 per cent, reflecting the potential for improvement in value addition in the tea industry. In this context, expansion of the tea blending industry could make a major contribution. Liberalisation of tea imports, while giving due consideration to concerns expressed by some tea industry participants will encourage further development of the blending industry in the country. Similarly, modernisation of the Colombo tea auction, the world's largest tea auction, with the help of modern computer technology would not only facilitate competitive price discovery through a more competitive auctioning system, but also save the time of exporters (i.e., buyers), which could facilitate value addition of tea exports.

Given the international market prospects and high literacy rate in the country, every effort must be made to expand the information technology (IT) industry. Expansion of the IT industry will have spillover impacts on all other economic sectors, thereby improving their productivity. Some of the major constraints to IT industry expansion are capacity limitation in the telecommunications sector and a low level of computer literacy. Therefore, measures to expand computer literacy and expand telecommunication facilities under a competitive market system are essential.

In generating a balanced high growth and creating more employment opportunities, small and medium industries (SMI) could play a prominent role. Development of infrastructure facilities and popularisation of subcontracting of production activities will encourage the expansion of the SMI sector.

The construction industry, which has high potential domestic value addition and more employment creation capabilities, faces a number of issues. First, public sector institutions such as the Road Development Authority and the existing regulations are not conducive to a faster growth in the construction industry. Regular delays in payments to contractors undertaking public sector construction activities as a part of the budgetary management strategy, result in liquidity problems, adversely affecting the viability and efficiency of the industry. Resolving these issues will help to improve the efficiency and contribution of the construction sector to GDP.

Agriculture: Agriculture still plays a dominant role in the Sri Lankan economy, accounting directly for nearly 20 per cent of GDP as well as in export earnings, while employing directly more than one third of the labour force (36 per cent), providing inputs for the agricultural processing industry and supplying a large share of domestic food requirements. Despite the continuation of various assistance schemes provided by successive governments since independence, the growth in the agricultural sector has remained low reducing its relative share in GDP. Similarly, agricultural productivity has remained low, resulting in a high average cost of production in comparison with some other developing countries. Consequently, there has been growing concern in recent years about the constraints on growth of the country on account of the high vulnerability of agricultural output to the vagaries of the weather, as well as the stagnation, in some cases even decline, of sectoral output. Policy inconsistencies with ad hoc tariff and non-tariff changes, non-availability of high yielding seed varieties in adequate quantities and in time, greater dependence on traditional cultivation practices without shifting to modern high-tech cultivation methods, weaknesses in marketing systems and high post-harvest losses are some of factors that have affected the poor performance of the sector.

However, the recent successful experiences in a number of predominantly agriculture based countries (i.e., Chile, Indonesia, Malaysia, Mauritius and Thailand) indicate that a high growth in agriculture could be achieved with consistent and conducive policies and a proper institutional system. Given the limitations in the availability of arable land, almost all output increases in agriculture have to come from increasing yield, i.e., productivity increases. A comprehensive policy package, compatible with the overall market oriented policy framework, is essential to revitalise the growth in agricultural output. In this context, liberalisation of input markets such as seed and fertiliser, while improving land markets would facilitate achieving a high yield. Similarly, encouraging the private sector to become involved in R&D,

as well as in the supply of extension services would accelerate moving towards modern cultivation practices. Furthermore, encouraging the private sector to improve transportation, packaging, storage and marketing will improve farmer income by reducing post-harvest losses and ensuring reasonable prices for their products. The development of the road network in rural areas is essential, not only to facilitate transportation of output, but also to supply agricultural inputs efficiently.

Another important factor adversely affecting the efficiency of agricultural markets is the lack of effective forward markets, the absence of a competitive price discovery system and the failure of the market in providing proper price signals. In the absence of proper price signals, farmers' decisions to cultivate any crop may depend on less efficient criteria such as administered prices rather than demand and supply, leading obviously to an inefficient resource allocation. Furthermore, the existence of fragmented and non-competitive markets prevents discovery of appropriate prices for farmers' products. Therefore, the development of forward markets, derivative products and commodity exchanges, and dissemination of market information regularly would ensure the discovery of competitive prices for agricultural products and minimise excessive price fluctuations. The lack of such marketing facilities at the rural level results in distress sales, particularly by small and marginal farmers. Such low prices have a direct bearing on their ability to invest in agriculture and hence, on the yield.

Thus, Sri Lankan agriculture calls for a comprehensive reform package encompassing technology upgradation, improvement of infrastructure facilities and development of a competitive marketing system. Agricultural yields can be increased through improving infrastructure facilities instead of welfare payment distribution among farmers, and making available high quality inputs through a competitive market system rather than providing input subsidies. Similarly, tools of emerging bio-technology, such as genetic engineering, seem to offer significant possibilities of increasing yields.

Thus, in a sector-wise analysis, the services sector, the export oriented manufacturing sector and infrastructure development activities have large growth potential necessary to accelerate future economic growth of the country.

Resilience of the Economy: The experience in 2001 demonstrates the vulnerability of the Sri Lankan economy to external shocks and the necessity of measures to strengthen the resilience of the economy as such external shocks are unavoidable in an increasingly globalising economy. The largest economic contractionary impact resulted in 2001 from weak export demand, accounting for about 64 per cent of total GDP growth reduction, compared with the share of the prolonged drought at 13 per cent and terrorist attacks at 2 per cent. As such, large fluctuations in the international economic environment are entirely beyond the control of a small country like Sri Lanka, the only available solution is the diversification of export products as well as export markets. In this context, expanding existing non-garment export categories and entering into new export industries such as electronics, IT products and agro-based products are essential. Similarly, export promotion campaigns and trade negotiation strategies could play a critical role in diversifying export markets. Promotion of vertical integration among regional industries, i.e., textiles in India and garments in Sri Lanka, is another alternative for market diversification.

Shortfalls in rainfall have been another major source of external shocks adversely affecting domestic agriculture and hydro power generation. Sri Lankan agriculture continues to depend on highly water intensive cultivation practices, largely due to a fully subsidised irrigation water supply system and inadequate encouragement to use less water intensive new agricultural practices. Developing a proper pricing system for irrigated water by taking into account concerns of farmers and dissemination of information on modern cultivation practices, while encouraging application of them, are necessary steps to minimise the vulnerability of the agricultural sector to rainfall variations.

Similarly, high dependence on hydro power generation, despite the recent reduction, is another area of vulnerability of the economy to rainfall variations. Further reduction in hydro dependence alone is not sufficient, as only expanding to thermal power increases the country's vulnerability to excessive volatility in the international oil market. In this context, expanding to other energy sources such as coal power generation, and gradually to other developing energy sources such as solar and wind power, is essential in improving the resilience of the economy.

Similarly, improvements in the flexibility of the economy, increases the passthrough impact of external shocks, facilitating faster adjustments in the economy by distributing the impact across a larger part of the economy. For example, the delay in the introduction of an automatic price adjustment system for domestic petroleum products and other related products and services such as power and transport services prevented a quick passthrough of the impact of high oil import prices in 1999-2001, resulting in serious problems in the petroleum industry and power sector and increasing adverse imbalances in the economy. Similarly, stringent labour laws, regulations and the slow implementation process of labour regulations prevented the passthrough impact of the sharp drop in export demand for garments in 2001, excessively burdening investors in the industry. Thus, improving flexibility, particularly in pricing systems and industry restructuring, and reducing delays in decision making are also useful in strengthening the resilience of the economy against external shocks.

Inflation: Another major macroeconomic issue under discussion is the continuation of high inflation with some fluctuations. It is generally accepted that high inflation is not conducive to realising sustainable high growth as it wastes valuable productive resources for inflation hedging activities and discourages productive investment due to increasing uncertainties and unfavorable speculative activities. Similarly, at the operational level, there is a recognition that the growth-inflation trade-off curve has a nonlinear segment i.e, inflation at some low level has positive effects on growth by 'greasing the wheel' of the economy, but there is a point beyond which inflation can be harmful to growth. The turning point in this tradeoff curve varies among countries, as well as for a particular country over different time periods, depending on other macroeconomic factors. Therefore, it is not easy to find such as inflationary turning point exactly for any country, but it is estimated to be around 4-5 per cent for most developing countries, according to some empirical studies.

With the move of the country to a floating exchange rate system, the focus of monetary policy has become concentrated mainly on promoting price stability. As continuation of high public sector borrowings is the major causal factor for monetary expansion in Sri Lanka, a significant reduction in the public sector deficit is essential to facilitate monetary management in achieving its price stability objective. However, monetary policy alone cannot contain inflation, particularly in the short run. In the short run, price changes result not only by changes in aggregate demand caused by monetary policy stimuli, but also cost push factors and temporary supply shortages, as well as changes in inflationary expectations. Similarly, wage determination practices have a significant impact on inflation determination, as wage increases higher than productivity increases create inflationary pressures. Therefore, while monetary policy places more emphasis on promoting price stability, taking measures to increase domestic factor productivity and relating wage increases to productivity increases would be helpful in containing inflation. Strengthening policy credibility and reducing the presently high inflation on a consistant basis would encourage the downward adjustment in inflationary expectation which is critical to achieving price stability on a sustainable basis.

Unemployment: Unemployment has been one of the major economic issues under discussion during the last few decades. Despite a continuously declining trend in recent years, except for a marginal increase in 2001, unemployment is still high, at over 7 per cent of the labour force. It is also highly concentrated among educated youth. The continuation of inadequate investments and the consequential low economic growth, which have resulted in an inability to create sufficient job opportunities to all employment aspirants in the labour force, were the major reasons for the continuation of high unemployment. Nevertheless, the coexistence of high unemployment with unfilled vacancies in some economic sectors such as in BOI industries, and labour shortages in some plantation areas, indicate that a labour market mismatch has also contributed to the high unemployment. This has been further demonstrated by the continuation of a high level of underemployment, in addition to unemployment. Similarly, the concentration of high unemployment among educated youth underlines the existing mismatch between the education system and the demand for labour skills. Therefore, addressing hindrances relating to the labour demand side as well the labour supply side is essential to reduce unemployment and underemployment on a sustainable basis.

On the demand front, the expansion of investment and acceleration of economic growth are essential developments to reduce unemployment and underemployment on a sustainable basis. Furthermore, potential employment creation could be further accelerated by encouraging labour intensive industries and the production process. However, the potential to create employment of given investment and/or economic growth varies according to the existing incentive and disincentive structure for labour intensity in the economy. It is unfortunate that most existing labour laws, regulations and practices are biased against labour intensification in production. As it is difficult to restructure industries by reducing employment under the present labour laws, even when an industry faces severe difficulties due to reasons beyond the employer's control, investors prefer to select less labour intensive production processes. Similarly, delays in labour dispute settlements, often caused by politically motivated mushrooming unions, result in difficulties in negotiating labour issues. The non-availability of a confidential voting system for major labour union decisions such as strikes, and the violent behaviour of unions in sometimes even damaging property and threatening lives of the management discourage investment in labour intensive investment. Similarly, recruitment to the public sector on an ad hoc basis and the availability non-performance based benefits in the public sector also discourage labour intensive private industries through high threshold wage levels for the unemployed in the waiting queue. Corrective measures to resolve these hindrances against labour intensive investment are critical in resolving unemployment through creation of more employment opportunities. In this context, the recent decision to expedite settlement of labour disputes, define clear guidelines for compensation payments, rationalise public sector cardre, introduce a contributory pension scheme for new public sector employees and expand income tax coverage to civil service incomes excluding their salaries, are useful measures in the right direction.

On the supply side, major weaknesses are the inadequacy of skills and vocational training and attitudes in favour of white-collar jobs. Even though the literacy rate in Sri Lanka is high, at around 90 per cent, there are weaknesses in the labour force of the country with regard to the availability of required technical skills for modern economic activities and proficiency in international languages. Encouraging the learning of at least one international language at the secondary and tertiary education levels, facilitating computer education, and reorganisation of the supply-driven technical and vocational training programmes to be demand-driven programmes are also necessary measures in reducing the high unemployment and underemployment among educated youth. Such policies not only contribute to reducing unemployment, but also improve labour productivity of the country through building up human capital and reducing underemployment, where productivity is relatively low.

The increasing globalising of the world, where national barriers are gradually becoming less effective, thus facilitating the free movement of labour, and increasing foreign demand for Sri Lankan labour, is also useful in resolving the country's unemployment issue. Provisional estimates indicate that about one million Sri Lankans are already working in foreign countries. They not only bring valuable foreign earnings to the country, but also serve as a safety valve in releasing excess supply pressure in the domestic labour market. So far, foreign employment opportunities have been concentrated mainly in unskilled and low wage categories such as housemaids. However, well coordinated training programmes to improve the skills demanded by advanced countries and increasing proficiency in information technology and an international language such as English, will open the doors even in advanced countries for skilled Sri Lankan workers. Such a programme would also facilitate the country to maximise benefits from a labour force already equipped with a high literacy rate. This could be incorporated as a major and integral part in the proposed youth training programme, as well as in reforms planned under technical and vocational programmes.

Reforms in Primary Input Markets: Even though Sri Lanka has made significant reforms in output markets, it has not made much progress in reforming the primary input markets such as land and labour. Delays and inefficiency in land registration, lengthy delays in settling land disputes, non-marketability of government lands held under permit by the present occupants, and the large extents of land owned by the public sector, including idle land in prime centres such as major cities, hinder the development of an efficient and active land market. In this context, the proposed measures to improve the efficiency and simplicity of land registration procedures and vest absolute title with those presently in occupation of state lands under permits, are useful steps in the right direction. Similarly, in the case of state land, which is not required for state purposes at present but is commercially viable, it is more prudent to release them to the private sector under long-term lease arrangements at commercial prices. Furthermore, the recent removal of the 100 per cent transfer tax on foreigners acquiring immovable property would also encourage the development of the land market.

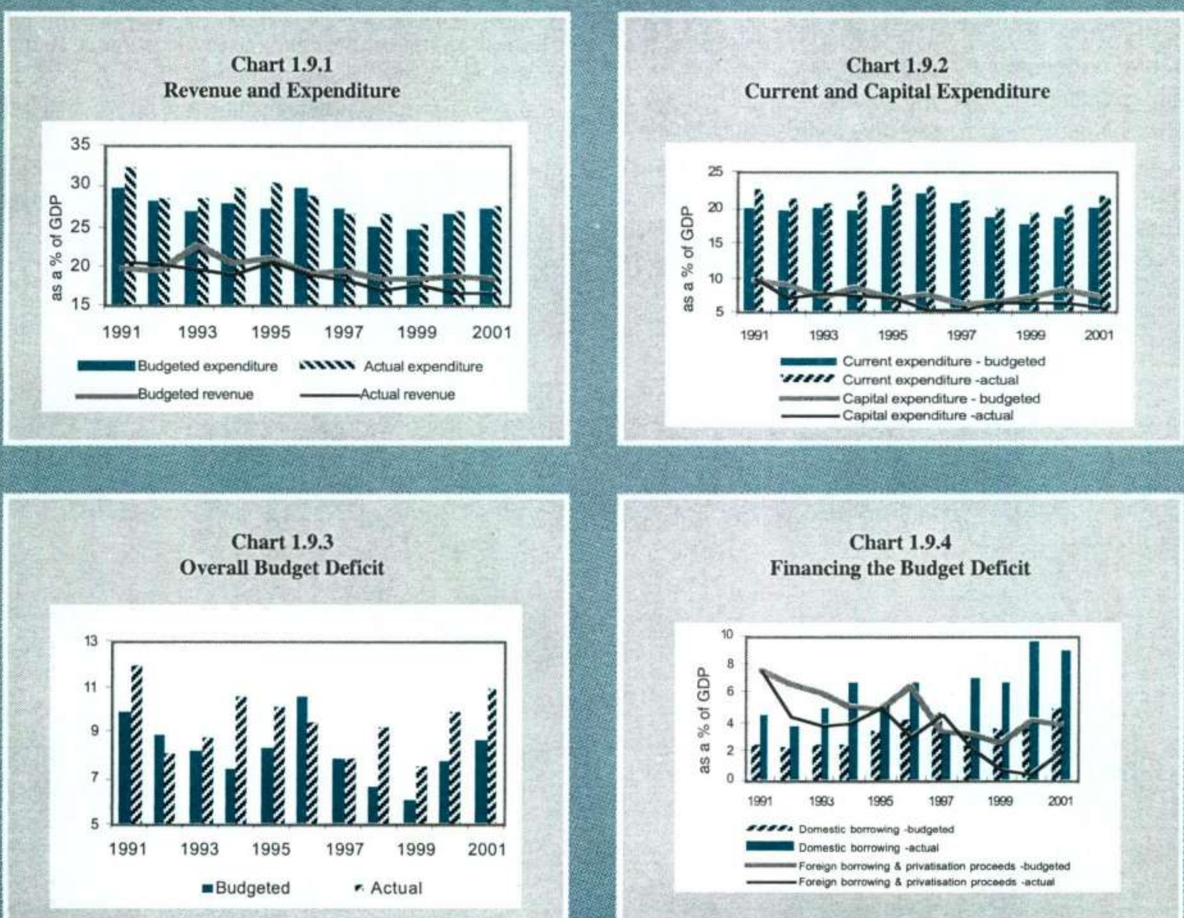
As already mentioned, some existing labour laws have proved to be inefficient, causing significant damage to employment creation and the economic progress of the country over the years. Such labour laws cater only to a small segment of the labour market, while the majority has suffered due to the lack of a dynamic labour market. Due to these rigid laws, low wage, unskilled labour finds it difficult to enter the competitive labour market. In fact, such rigid laws do not even protect the job security of existing employees, who are supposed to be the only beneficiaries of those laws. Changing these conditions would be unavoidable as industries facing difficulties, may be wound up due to existing rigidity in the labour laws. Many of these industries could be continued successfully with restructuring, if labour laws were more flexible. Therefore, reforms for improving the labour market and making it more flexible are essential not only in the interest of future employees and employers, but also in the interest of employees who are already in the work force. Such reforms would also encourage development of a productive and technologically advanced society, enabling Sri Lanka to become a human resource centre in the region.

Fiscal Sustainability: Deterioration in the fiscal situation due to continuation of high fiscal deficits over a long period and significant increases in public debt have raised concerns regarding the medium-term fiscal sustainability of the country. A declining government revenue/GDP ratio and an increasing current expenditure/GDP ratio have raised the current account deficit, despite successive governments repeatedly announcing their desire to achieve a current account surplus in the budget in policy statements as well as in budget speeches. The increasing current account deficit, together with public capital expenditure, has resulted in high fiscal deficits. A large part of expenditure has been allocated to growth-retarding activities and in fact, even the allocated investment expenditure (growth inducing) has been curtailed very often in an attempt to contain the fiscal deficit from exceeding the original budgetary estimates. Finally, the government has resorted to financing a large part of the deficit through domestic borrowing as there have been continuously large shortfalls in the realisation of foreign financing and privatisation proceeds expected for deficit financing. Consequently, the public debt has increased, exceeding even the annual GDP, thereby raising the interest cost in the budget to about 31 per cent of total current expenditure or 41 per cent of total government revenue in 2001.

These fiscal developments have serious adverse impacts on the country's economy by causing a worsening macroeconomic imbalance, crowding out private investment and hence retarding the growth prospects and employment expansion. They also raise domestic interest rates, increase inflationary pressure and result in additional pressure on the external current account deficit, which exerts pressure on the exchange rate to depreciate. Furthermore, the frequent significant deviation of realised fiscal values from the original budgetary estimates has led to an erosion of the reliability of budgetary estimates and the credibility of fiscal policy. Meanwhile, some non-productive, large items of current expenditure had unintended, indirect growth-retarding impacts on the economy. For example, the continuation of the untargetted, high household subsidy schemes raised the threshold reference wage for unskilled workers discouraging them from participating actively in the work force; the generalised wheat flour subsidy not only provided benefits to foreign wheat farmers at the expense of domestic taxpayers but also had an adverse impact on domestic paddy farmers producing a very close substitute (i.e., rice); an excessive public sector labour force reduced the efficiency of the civil service; and the continuation of transfer payments to public enterprises to cover their large operational losses not only prevented the implementation of corrective measures, which would have improved their efficiency, but also retarded their capacity expansion and quality improvement.

Therefore, it is universally agreed that the continuation of the current fiscal situation is not desirable, as well as not sustainable, in the medium term. Hence, the necessity of adopting a strong fiscal adjustment strategy urgently in order to ensure medium-term fiscal sustainability and ensure

Chart 1.9
Fiscal Operations 1991 - 2001
(Budgeted and Actual)



achievement of sustainable high growth is also accepted. This strategy has to consist of measures under all four pillars; revenue enhancement, expenditure containment, efficient deficit financing and prudent debt management.

Under the revenue enhancement measures, it is essential to expand the tax base, placing less reliance on raising tax rates in order to encourage tax compliance and minimise distortionary effects. All tax concessions and waivers need to be discontinued as soon as possible in order to safeguard an adequate tax base. Improvement of tax administration is essential to realise revenue targets. Similarly, regular adjustments in charges for government services, at least to cover their market cost, are essential. On the expenditure side, emphasis has to be placed on containing growth-retarding expenditure levels as well as improving the quality of expenditure. All subsidy schemes should be targeted only to provide benefits to the genuinely deserving segments of the population. All current transfer payments to public sector enterprises, which have revenue sources, should be phased out, requiring them to adhere to at least a balanced budget (operational) principle. A civil service reform programme has to be implemented to contain the increasing wage bill and pension payments as well as to improve the efficiency of public service. In deficit financing, every effort must be made to mobilise targeted foreign financing and privatisation proceeds. In domestic financing, all resources have to be mobilised through market oriented instruments rather than placing the burden on captive type sources, such as EPF, ETF and insurance companies, which have already been burdened by financial repression due to the strategy in deficit financing implemented during the last few decades. Debt management has to be improved, not only by considering the present cost, but also by taking into consideration the long-term impact, and debt sustainability issues. Finally, all these measures have to be implemented effectively under a regular monitoring system in order to ensure achieving the intended fiscal targets, if necessary, by taking additional corrective measures during the fiscal year. This is essential to strengthen the reliability of budgetary estimates and the credibility of fiscal policies.

Provisional simulation experiments indicate that the achievement of fiscal sustainability is highly sensitive to growth. Even strong adjustments, which lower the overall fiscal deficit to about 4 per cent of GDP, in the medium-term, could lead to a rising debt/GDP ratio if at least 2 per cent annual GDP growth is not maintained. Therefore, implementation of growth enhancing structural reforms is equally important in achieving medium-term fiscal sustainability. Thus, both strong fiscal consolidation efforts and measures and growth accelerating structural reforms are the key to rapid growth. Hence, early attempts should be made to ensure the attainment of medium-term fiscal sustainability in Sri Lanka.

Fiscal adjustments alone are not adequate to reduce the overall public sector deficit and borrowings. Such efforts have to be complemented with a strong public enterprise reform programme, including the introduction of automatic price adjustment mechanisms and cost minimisation measures. In order to increase public support for such reform it is essential to convince the public that all Sri Lankans, not only the users of subsidised goods/services, have to pay, now or later, for losses, with interest costs in public enterprises, caused by maintaining their product prices below the corresponding cost of production.

Box 4

Deregulation Process in Sri Lanka

Regulation is deemed necessary when a market is not sufficiently competitive, when there are prudential norms to meet, and when the private or public sector activities produce serious externalities on social life, environment etc. As Gibbons (1992) explains, since at least Hume (1739), political philosophers and economists have understood that if citizens respond only to private incentives, public goods will be under-provided and public resources over utilised.[a] An illustration shows that if common grazing lands are opened to farmers, cattle could have a healthy growth, and grazing land is not hurt, if only a few cattle are sent for grazing. However, unregulated access to common grazing land will result in excessive use of the land and cattle being underfed. Thus, well placed and a right degree of regulation may protect the rights and resolve conflicting interests of diverse groups in society, accelerate economic growth, increase social welfare, ensure equitable distribution and protect natural resources and environment. Still, such regulation needs revision from time to time, and especially when the market players feel hindered or inhibited in a manner that restricts growth and development. However, it should be noted that Ronald Coase later showed that this should not necessarily happen if externalities can be internalised through agreements when the cost of such agreements is not prohibitively high.

Need for Deregulation

Effective regulation should always accomplish its intended tasks at the least cost and minimal disruption to the economy. It should not unnecessarily delay the decision making process of economic agents. In contrast to this, it has been observed in Sri Lanka that numerous regulations have increased the cost of doing business, while hindering innovation and economic growth. Existing regulations increase firms' overhead and operating costs, and slow down their decision-making processes. It also locks up resources, which will otherwise be available for productive purposes. Excessive regulation tends to cause job losses and low employment generation in the economy, while paving the way for increased political interference and patronage. The numerous and complex regulations encourage those involved in administering and implementing these regulations to indulge in rent-seeking activities leading to corruption, delays, low productivity, inefficiency, waste of resources and revenue losses to government. The government, and hence the taxpayers, also incur undue expenditure in implementing and administering regulations. Even more seriously, excessive regulation discourages capital inflows and encourages outflows.

Deregulation in Sri Lanka

The deregulation strategy of Sri Lanka should review existing regulations and laws to make them business friendly, while preserving a clearly defined set of regulations. The required minimum regulation in this set up should perform important functions including maintaining prudential norms and public interest goals. The regulations should allow the government to perform the role of a facilitator of economic activities, encourage and ensure delegation and empowerment of officials to take decisions, and ensure fair and equal play by the competing forces in the economy.

Sri Lanka has undertaken economic and trade liberalisation, structural adjustments and public sector restructuring programmes including privatisation since 1977. Most of the existing regulations governing sectors such as telecommunications, transportation, insurance, banking, trade and energy etc., have been either partly removed or relaxed to promote competition. However, it has been increasingly recognised that some of the existing regulations are not effective, not appropriate at all or not appropriate in the current form to the present domestic and global economic environments, increase the cost of setting up and carrying on any businesses or industries and hinder investment flows and economic growth. Therefore, it is necessary to evaluate critically the effectiveness, and costs and benefits of the existing regulations to identify the regulations that need to be either repealed or reformed to make them effective and less costly. In this regard, a De-Regulation Committee was set up on 19 January 2001 under the Industrial Promotion Act No. 46 of 1990 to study and promote de-regulation with a view to improving the country's competitive position to attract investment, especially in competition with several deregulated countries such as Dubai, Singapore and Hong Kong.

The main tasks assigned to this Committee include reviewing laws and regulations constraining competition and imposing high and unnecessary compliance costs,

(a) Hume, D., 1739, A Treatise of Human Nature, Reprint. London: J. M. Dent, 1952.

Box 4 (contd.)

removing impediments to setting up businesses or making investments in Sri Lanka, reducing the public-private interface on activities such as reporting requirements, permission, record keeping, discretionary authority of public officials in granting approvals, etc. to a minimum, reviewing markets and market development in Sri Lanka to streamline regulations and facilitating market development, identifying and removing entry barriers, ensuring smooth and timely exit for firms, identifying and making recommendations to remove pricing cartels, controls and monopolies where they exist and identifying and removing policy or procedural restrictions hindering Sri Lanka's entry into the global market.

As a first step in this endeavour, the Committee commissioned a programme of work in four core areas, viz., assessment of experiences with regulatory arrangements and processes of regulation reform in other countries and lessons for Sri Lanka, identification and measurement of impediments faced by businesses in Sri Lanka, review of two overarching regulatory arrangements impacting on all businesses and most individuals in Sri Lanka namely, customs and taxation, and reviews of regulatory arrangements in the tea and energy sectors. The work programme has generated several important findings. Some of the important findings are as follows. Countries like Singapore, Hong Kong, Dubai and Mauritius perform very well with much less regulation. Outdated regulations and rigid administrative procedures imposed by public sector institutions raise costs and discourage dynamism in trade and industry. The time and monetary costs for firms to comply with Sri Lanka's regulatory system on average raise costs by 9 per cent and reduce profits by 30 per cent. Poorly operating land and labour markets are two of the biggest barriers to investment and income generation in Sri Lanka. Besides land and labour market regulations, other causes of unnecessarily high compliance costs are tax-related regulations, customs regulations, banking and financial regulations and environmental regulations. In the case of electricity, restrictions on entry and ad hoc supplementary intervention by the government have resulted in large budget transfers, shortages and limited incentives for further private investment. The tea sector faces compulsory levies for research and development and promotion activities.

The Committee organised a conference in February 2002 to discuss the above findings and, after discussions, was able to draw the following major recommendations. However, the recommendations have been made by evaluating only a few regulations relating to few specific areas and do not cover all existing regulations relating to the entire economy.

Regulatory review process

- The government should establish an ongoing programmme of regulatory review involving independent and transparent tests of all regulation to ensure it is in the public interest.

Customs

- An electronic data information system compatible across Customs, Inland Revenue and ports, suited to electronic lodgement by traders and services by an external service provider should be implemented as a matter of urgency.
- The Customs Act should be completely reviewed and re-written.

Land laws

- Land that is commercially viable should be unlocked and sold at commercial prices.
- The Titling Act of 1997 should be made operational.
- The Rent Act of 1972 should be abolished.

Labour laws

- Labour laws should be amended to allow lay-off with specified compensation without going to a labour tribunal.
- Retraining and retooling provisions should be strengthened to help people back into the workforce.
- Sri Lanka's mandated holidays should be brought into line with other countries.

Taxation

- The National Security Levy and other turnover taxes should be eliminated and shifted into the Value Added Tax even at an increased rate.
- The tax return for an individual should be cut down to one page like Singapore's.
- Recommendations of the Diagnostic Task Force should be implemented, especially bringing

Box 4 (contd.)

taxable profit in line with commercial profit and fostering a culture which sees taxpayers as clients and not enemies.

Energy

- Remove cross subsidies, price controls and budget transfers.
- Remove restrictions on entry into electricity generation, distribution, and transmission.
- Establish a regulatory framework to oversee investment and competition.
- Dismantle restrictions on private sector activity in petroleum sector.
- Immediately commence proposed coal-fired power plants and preparation of environmental impact studies for three more locations.

Tea

- Liberalise tea imports to allow trade in different kinds of tea, subject to conditions of careful monitoring of impacts on tea smallholders and on the marketing of pure Ceylon tea.
- Tea promotion activities should not be restricted to the Tea Board.
- Tea research and development activities should not be restricted to the Tea Research Institute.
- Taxpayers should be free to commission research from a wide range of providers.

Guidelines for Deregulation in Sri Lanka

In the absence of regulations or any force that may compel economic agents to behave rationally, each economic agent will try to fulfil his self-interests, which may sometimes cause severe disruption and injuries to other economic agents and the environment. Therefore, benefits of regulations in these extreme cases should not be overlooked in favour of complete deregulation. However, regulations promulgated at one point in time to handle a particular situation may not necessarily suit the same situation at a different point in time, as the prevailing conditions may not be the same. Therefore, policy makers should recognise the fact that, while it is impossible to dispense with all regulations, they could still reform some of the existing regulations to make them more effective and repeal unnecessary, superfluous or redundant regulations. They should also recognise that it is possible to re-introduce a regulation that was previously repealed if any future situation warrants the re-introduction of repealed regulation to re-regulate a particular industry. All existing regulations should be periodically evaluated to assess the effectiveness of such regulations and their direct and indirect impact on the economy, businesses and competition. Based on these evaluations, unnecessary and redundant regulations should be repealed, ineffective and costly regulations should be either reformed or repealed depending on the need for them, while continuing with only the effective and essential regulations. Successful deregulation should eventually result in government shifting its resources away from ineffective regulations to more efficient ones and businesses to shift their scarce resources to more productive and innovative purposes to attain economic efficiency.

If there is a need for the introduction of new regulations to achieve a particular goal, which could not be achieved by other means, the policy makers should first assess the impact of the proposed regulations on the economy in terms of costs and benefits. Once the declared goal is achieved or, if the regulations are not effective in achieving such goals, those regulations should either be repealed or reformed depending on the circumstances. It is necessary that those administering such regulations be aware of the intended objectives of such regulations and competent enough to take bold and correct decisions at the right time. All decisions should be made by them independently purely on the basis of economic considerations and not on political or any other considerations.

An effective process of regulation should also go hand in hand with civil service reforms. Recommendations for deregulation cannot be implemented unless civil servants are properly incentivised. This is specially so, as deregulation generates an asymmetric first round of benefits, where the industry is the first beneficiary of civil servants adjusting to a lesser degree of authority. The country and the population at large may benefit in the second round, once industry benefits effectively trickle down to the economy.

Box 5

Reforming and Strengthening the Financial Sector

Currently, over one half of Sri Lanka's GDP is derived from the services sector. It is also the sector with the highest potential for growth. Within this sector, a critical area is the financial sector. The financial sector is important not only for its own sake, but also for the strong influence it can have in facilitating the functions of other sectors of the economy. Being one of the earliest sectors in which relaxation of controls was instituted, the financial sector benefited from the liberalisation policies and has expanded steadily over the last 20 – 25 years. Deregulation has led to sector expansion, with both foreign and domestic investors entering the field (as highlighted in the Box article 'Reforms for Financial Stability and Efficiency' in Part I of Annual Report 2000). Currently, the financial sector accounts for about 8 per cent of GDP, while the sector's annual average growth rate in the last ten years has been 7.2 per cent. Despite the progress that has been made, there still remain weaknesses and areas that require urgent attention if the sector is to reach its full potential and facilitate overall growth.

Banking Sector

The banking sector has been, and is, clearly the largest segment in the financial sector. The presence of foreign banks and locally incorporated private banks has helped to improve the efficiency and dynamism of the banking sector. However, the two state banks still dominate the market, accounting for over half the deposits base and credit provided. In the past, the operations of the state banks have not always been based on commercial criteria and this has resulted in certain inefficiencies in their operations, which affect the entire banking industry. Hence there is an urgent need to improve the operations of these two banks. An important step in this process would be to ensure that their future dealings with the government are at arm's length and their business activities are based on commercial criteria.

Weaknesses in the financial sector, however, are not concentrated solely in the two state banks. The non performing loan (NPL) ratio is relatively high for most banks. Several of the smaller banks' contribution to the sector is marginal or insufficient. The information systems in many banks, which are of critical importance in managing risks in today's fast moving banking world, are inadequate.

Banks should draw up realistic debt recovery plans or in the alternative, get their shareholders to put in more capital to provide for non-recoverable debt. Although one-size does not fit all, banks in Sri Lanka should acquire more effective risk analysis and risk management packages and adopt them to suit their own requirements.

In order to be able to deliver financial services effectively, the banks should be sound and solvent. In that context, it would, be advisable to increase the minimum capital adequacy requirement for banks to strengthen their ability to withstand shocks. In the future, it is likely that consolidation will take place among banks, as is happening globally, resulting in the emergence of larger, stronger and more viable entities.

Debt Market

The debt, or fixed income securities market forms an important part of most developed financial markets. It provides an alternative to banks, both as a source of funds and as an avenue of investment, thereby increasing competition in the financial system and increasing returns to both investors and savers. Sri Lanka's debt market is relatively underdeveloped. Although a comparatively active market exists for government paper, the private debt market is miniscule. It has often been argued that a primary cause for this condition is the continuously large fiscal deficit, which results in the state pre-empting funds, in particular, long-term funds. It has also been argued that the development of the fixed income securities market requires a medium to long-term default risk free yield curve to serve as a benchmark for other securities. Therefore, the issue of longer-term, market oriented government paper and reduction in the fiscal deficit are items that need to be high on the reform agenda.

A further reason for the retardation in the development of the debt market is perhaps the lack of investor awareness, outside urban centres. Bank branches have spread to all parts of the country and are a familiar feature to most citizens. Yet, debt instruments are usually regarded as exotic inventions by most people and enterprises. Thus, heavy responsibility lies on market participants to popularise this segment of the financial market. In this regard, credit rating can play an important role, as highlighted in the Box article on 'The

Box 5 (contd.)

Role of Credit Rating in Developing the Private Debt Securities Market' in Part I of this Annual Report.

In addition, a drawback to the development of the market in government securities is that currently, these securities are issued and transacted in the form of physical paper (scrip). Plans are under way to transform this paper based system into a much more efficient scripless securities trading system (SSTS) by mid 2003. The SSTS would include a Central Depository for government securities, which would be integrated with the Real Time Gross Settlements (RTGS) system to facilitate delivery versus payments.

A related issue that affects both the government debt securities market and other fund transfers in the entire financial system, is the payments and settlements system in the country. As an economy becomes more complex and attuned to the use of modern technology, it becomes essential to develop safe and efficient payments and settlement systems congruent with such technology and capable of facilitating financial transactions. Hence, the Central Bank has begun establishing an RTGS system to process large and time critical value payments. Arrangements are also being made to procure an automated general ledger system within the Bank (details in Box article 'Payments System Reforms' in Part II of this Annual Report) with interfaces to the RTGS and SSTS systems. These measures would, inter alia, eliminate payments and settlements risks in the current end of day settlement system and enhance the integrity and tradability of government debt.

Regulation

Events in this country and worldwide have amply demonstrated the importance of regulation and supervision in ensuring the stability of the financial sector. Confidence is the key to the survival of the financial sector. However, there is also a considerable body of evidence to indicate that over regulation can effectively kill financial markets. Thus, a 'via media' is required to have a well balanced regulatory system. The financial sector in Sri Lanka has several regulators e.g., the Central Bank, the Securities and Exchange Commission and the Insurance Board. It is important that these institutions work in cohesion, both to ensure adequate regulation and to avoid unnecessary duplication of work, which would impose additional burdens on the regulatees and thereby increase inefficiency. It is also of extreme importance to recognise the fact that external regulations are but a part of the process. An orderly and well functioning market is a sine qua non for financial sector development. Thus, issues of self regulation and internal governance are central to the modern philosophy of regulation. Market players must institute their own systems of effective internal control and the management of the enterprises must be held accountable. Recent events worldwide have also highlighted the responsibility cast on external auditors.

In the context of regulation, the provision of information and the observance of internationally accepted standards and codes are assuming ever greater importance. Many countries have realised that requiring public disclosure of information in standard formats and the adoption of universally accepted codes of good practice can go a long way in promoting transparency and accountability, and thereby financial sector stability. Sri Lanka must follow these principles and adopt international standards, but with suitable modifications, where relevant.

A further area where action is urgently needed is in the legislation relating to the financial sector. Although there have been changes implemented over the years, it is necessary that important pieces of legislation such as the Banking Act, the Monetary Law Act and the Exchange Control Act be amended to reflect current conditions, trends, practices and user group requirements, and perhaps making provision for future needs.

The Central Bank

By virtue of the statutory responsibilities vested in it, the Central Bank of Sri Lanka has been called upon to play a leading role in the financial market in Sri Lanka. It is a regulator, an advisor, a market developer and a market player, roles that can sometimes be in conflict. If the Central Bank is to discharge its responsibilities effectively, it has also to evolve with the financial market and accept changes in its role. Over the past half a century and more, changes have certainly occurred in the operations of the Bank. However, there is perhaps greater need for reform in the current context of rapid globalisation and changing needs of the financial sector. Conscious of this need, the Central Bank has commenced internal reforms to modernise itself. Some of these measures were highlighted in the article 'Modernisation of the Bank' in Part II of Annual Report 2000 and are further detailed in the Box article

Box 5 (contd.)

'Modernisation of the Central Bank' in Part II of this Annual Report.

The Bank is focussing more on its core functions of achieving price stability and financial sector stability. In this regard, a Monetary Policy Committee and a Financial Stability Committee have been appointed within the Bank. These committees will examine and generate greater debate on relevant issues, and will provide policy advice to the Governor and the Monetary Board. In the medium term, there is a plan to increase the size of the Monetary Board from its present three members to five. This will bring in greater expertise and experience, and help to improve further the policy making process in the Bank. In the longer term, it would be necessary for the Bank to divest itself of non-core activities. In April 2002 the Bank divested the cheque clearing process to 'LankaClear (Pvt) Ltd.', a company managed by commercial banks themselves. The Central Bank retains a 20 per cent shareholding of the company. The other, most prominent of these non-core activities are managing the public debt, implementing exchange control regulations and managing the funds of the Employees' Provident Fund. These functions were statutorily vested in the Central Bank in a different milieu. Given the changes that have taken place in the economy, there do not appear to be over-riding reasons why they should continue to be carried out by the Bank in the future.