Chapter 1

ECONOMIC PERFORMANCE, OUTLOOK, ISSUES AND POLICIES

1.1 Introduction

Policy makers faced several major challenges at the beginning of 2002 that required immediate attention to enable the economy to recover from the contraction in 2001. The main challenges were: to find a lasting solution to the conflict that had weakened economic growth for nearly two decades; to accelerate the economy wide reforms sorely needed to improve the efficiency of the economy, optimise use of resources and encourage private sector led growth; and to reduce the high fiscal deficit, thereby bringing the inflation and the growing public debt under control.

Notable progress was made on all fronts during 2002. The cessation of hostilities and the ongoing peace process brought not only a sense of relief throughout the country, but led to a spontaneous increase in economic activity and a containment of non-productive expenditure. Substantial reforms, which would have long-term benefits, were introduced in areas such as labour markets, the fiscal system and the financial sector. The fiscal deficit was reduced significantly and legislation was brought in to strengthen fiscal discipline, transparency and accountability.

These changes would enable the economy to move to a sustainable higher growth path, which would help to reduce unemployment and improve the living standards of all citizens. However, the full benefits would generally be realised only in the medium to long term. Hence, the turnaround of the economy to a growth of 4 per cent in 2002 from a contraction of 1.5 per cent in 2001, can be regarded as an encouraging start.

In 2002, the Sri Lankan economy recovered from the setback it experienced in 2001, benefitting from improved domestic conditions, mainly resulting from the peace process, strong fiscal consolidation efforts, accommodative monetary policy, renewed commitment to structural reforms, and a more favourable international environment. Economic growth rose progressively during the year and recorded an annual growth rate of 4 per cent in 2002, in contrast to a contraction of 1.5 per cent in 2001. Reflecting this, the corporate sector recorded a notable increase in profits. The growth was largely reflected in the services and agricultural sectors on the production side, as the recovery in the industrial sector was constrained by weak export demand. The services sector accounted for about 80 per cent of overall growth in 2002, benefitting mainly from a continuation of growth momentum in the telecommunication and financial sectors, and recovery in trade, transport, port services and tourism. Agriculture and allied activities accounted for about 13 per cent of overall growth, reflecting the recovery in paddy, tea, rubber, other agricultural crops and fishing. On the demand side, the growth was mainly driven by improved domestic consumer demand, stimulated by improved security conditions and distribution facilities, with the progress in the peace process under the ceasefire agreement. The growth impetus from investment expansion and export demand remained weak. The unemployment rate rose marginally due to low expansion in investment. Improvement in macroeconomic management, centred around a medium-term sustainable fiscal strategy and acceleration of structural reforms aimed at unleashing the growth potential of the economy by raising productivity and expanding investment, is essential to increase economic growth on a more sustainable basis, as the growth momentum driven by consumer demand alone is not sustainable.

Despite increases in a number of administered prices, inflation declined throughout the year. This was the combined effect of tight monetary policy since mid-2000 on the demand side, and improved domestic supply conditions, the relative stability of the rupee and easing import prices, on the supply side. The annual average inflation declined in 2002, although inflation is still high. Maintaining this declining trend is critical for adjusting high inflationary expectations downward.

A salient feature of 2002 was the noteworthy improvement on the fiscal front. Despite a large shortfall in revenue, the current account deficit, primary deficit and the overall deficit declined, benefitting from strong expenditure rationalisation and improvements in public debt management. The overall public sector deficit, including public enterprises, declined by about 2 per cent of GDP, reflecting improved fiscal management and public enterprise reforms. A strong commitment to fiscal discipline was demonstrated by the enactment of the Fiscal Management (Responsibility) Act in December 2002 (see Box 5), which makes it obligatory to reduce the fiscal deficit and the public debt burden as a ratio of GDP continuously within the next ten years. Further, the law requires a greater degree of transparency and accountability in fiscal affairs, which would strengthen credibility of fiscal management and commitment to good governance.

Despite the slow recovery of export demand, the external sector benefited from the recovery in the services account and improvements in inward private transfers and capital inflows. The external current account deficit widened but the overall balance of payments was in surplus for the second consecutive year, raising the country's external reserves and reducing pressure on the exchange rate. The floating exchange rate regime continued to serve well, further strengthening stability in the foreign exchange market and improving the external competitiveness.

Monetary expansion remained within the target, compatible with the macroeconomic framework. Declining credit to the government facilitated the accommodation of the expanding demand from the private sector without additional expansionary pressures. Following the declining trend in inflation and decreasing public sector domestic borrowing requirements, the Central Bank reduced its policy rates cautiously. Improved domestic rupee liquidity, mainly on account of purchases of foreign currency by the Central Bank, together with reduced use of the public sector overdraft facility, facilitated the transmission of the policy rate reduction to the economy, shifting the entire interest rate structure downward.

However, interest rate spreads remained high, reflecting the need to further improve competition and accelerate reforms in the financial sector. Financial sector reforms were further strengthened. The law governing the Central Bank was amended to enable the Bank to focus more clearly on its core objectives of economic and price stability, and financial system stability, to improve the flexibility of the Bank's monetary policy, and strengthen its regulatory power. Reforms in state owned financial institutions moved forward but slowly. As part of the ongoing efforts to improve the stability of the financial sector, regulatory and prudential requirements have been further strengthened. The Central Bank began publishing bankwise interest rates, commissions and charges, with a view to encouraging competition in the financial

TABLE 1.1

Selected Macroeconomic Indicators

Item	1980-89 Avg.	1990-97 Avg.	1998	1999	2000	2001	2002(a)
GDP (real) growth rate	4.2	5.2	4.7	4.3	6.0	-1.5	4.0
GDP deflator	11.8	11.1	8.4	4.4	6.7	12.4	8.3
GDP (nominal), per capita, rupees	9,608	32,103	56,760	60,741	68,102	75,133	83,382
GDP (nominal), per capita, US dollars	362	618	879	863	899	841	872
Unemployment rate, per cent	n.a.	13.2	9.2	8.9	7.6	7.9	9.1(b)
Import coverage of foreign assets, months							
Gross foreign assets	n.a.	n.a.	5.9	5.2	3.5	4.5	4.9
Gross official reserves	1.8	3.9	4.0	3.3	1.7	2.7	3.3
Per cent of GDP							
Gross domestic investment	26.2	24.4	25.1	27.3	28.0	22.0	21.5
Gross domestic savings	12.9	15.0	19.1	19.5	17.4	15.7	14.6
Foreign savings (c)	13.3	9.7	6.0	7.8	10.6	6.2	6.7
Balance of payments, current account	-8.1	-5.7	-1.4	-3.6	-6.4	-1.5	-1.6
Budget, current account balance	2.7	-2.1	-2.4	-1.0	-3.4	-4.9	-4.4
Budget, overall balance	-12.4	-9.6	-9.2	-7.5	-9.9	-10.8	-8.9
Money supply (M2b), per cent change (d)	n.a.	n.a.	13.2	13.4	12.9	13.6	13.4
Colombo Consumers' Price Index, per cent change	12.8	12.3	9.4	4.7	6.2	14.2	9.6
Exchange rate (Rs/US$), per cent change (e)	-9.1	-5.2	-9.6	-6.0	-9.9	-11.3	-3.7

(a) Provisional.
(b) 3rd quarter 2002.
(c) Net imports of goods and non-factor services.
(d) Consolidated money supply, including FCBUs.
(e) Changes in end year exchange rate; negative sign indicates depreciation

Source:- Central Bank of Sri Lanka

markets through dissemination of more information to the public. Similarly, awareness campaigns were conducted through the media, cautioning the public regarding the risks of placing funds with unregulated institutions. The licence of a licensed specialised bank, which had become insolvent due to imprudent operations, was revoked, but this had no systemic impact.

A renewed commitment to structural reforms was evident in the reforms of labour markets, public enterprises, the financial sector, the civil service, the tax system, public debt management, administered prices, the regulatory system, trade policy and the legal framework. Benefitting from improved macroeconomic management and structural reforms, the IMF Stand-By Arrangement (SBA) was put back on track in early 2002 and concluded successfully in September, which raised the credibility regarding commitment to policy changes and structural reforms. This facilitated the finalisation of a long-term concessionary financial assistance programmes from the IMF and the World Bank. (see Box 4).

Several factors contributed to these economic achievements in 2002. They are, the progress in the peace process (see Box 2), improvements in macroeconomic management, renewed efforts at structural reforms, favourable weather conditions, removal of the war risk insurance premium, an end to power cuts and finally, slow recovery in the global economy. The most important factor was the restoration of a peaceful environment under the ceasefire agreement, which enabled people to go about freely and engage in economic activity throughout the island. A continuous and steady improvement in business confidence helped. It also helped in reducing internal and external macroeconomic imbalances, particularly by containing security related expenditure and imports. Successful fiscal consolidation efforts and a continuation of cautious monetary management resulted in a macroeconomic environment conducive to economic recovery. Reduced government domestic borrowing made more financial resources available to the private sector and facilitated reductions in interest rates, which supported private sector led economic recovery. Improved weather conditions contributed to a recovery in agriculture and with the ending of power cuts, reactivation of other economic sectors. The removal of the war risk insurance premium facilitated recovery in port services and external trade.

Although the economy recovered in 2002, the performance was below the level required to reduce poverty and raise per capita income levels on a more sustainable basis. Even after a quarter of a century since the introduction of a market oriented economic policy framework, the experience of and prospects for the economy are less encouraging than expected. Low and lacklustre growth, inadequate investment and savings, continuation of macroeconomic imbalances, low productivity, inefficient resource allocation and under-utilisation of resources are still major concerns in the economy. Meanwhile, major economic problems such as widespread poverty, a low per capita income, high structural unemployment, high inflation, a rising public debt burden, continued exchange rate depreciation and vulnerability to external shocks have continued, and in some cases have been aggravated. A close analysis would reveal that Sri Lanka was unable to realise the full benefits of the market friendly economic framework due to three major factors, viz., continuation of costly and destructive civil disturbances, a less favourable macroeconomic environment and slow progress in economic liberalisation and other structural reforms. Civil disturbances, aggravated since 1983, entailed severe political, social and economic costs. It disturbed the smooth functioning of the economy, wasted scarce economic resources, prevented full utilisation of resources and weakened investor confidence. However, continued high fiscal deficits were one of the major causal factors for many of the economic ills. They crowded out the expansion of more productive private sector economic activities by constraining resource availability, and exerted upward pressure on interest rates and inflation and depressed the value of the rupee. Delays in economic reforms slowed down economic growth, inhibiting improvements in productivity and expansion in investment. Continuation of structural rigidities and inefficiencies in the economy limited the trickle down effect of economic growth by not improving adequately, access to markets, resources and public services for a large segment of the population, particularly to people in low income groups.

Therefore, addressing these three issues vigorously is critical to any strategy for accelerating economic growth and improving the distribution of growth benefits to the entire population within a market oriented economic framework. Recent experience has shown again that peace is essential for economic development, since both peace and economic growth are inextricably inter-related. The major challenge faced by the country today is to achieve these two goals simultaneously. It is encouraging that the government has clearly recognised the challenge and is determined to advance on both fronts. In fact, steps in this direction have been initiated already. Serious commitments have been made by the government by mobilising domestic and international support to achieve a durable peace, while building up national consensus for a political solution to the conflict. Any reversal or delay in moving forward in this process would result in large human, social and economic costs. Every effort must be made to move forward fast until a solution acceptable to all ethnic communities in Sri Lanka is reached.

Sri Lanka's economic problems and the necessary economic reforms have been identified and widely debated for a long time. However, their adoption and implementation have been delayed on account of short-term political concerns, which have rendered concerns and commitment somewhat elusive. Hence, an enlightened national consensus and stronger commitment to economic reforms are critical to implementing them effectively. In this endeavour, the value of open and candid discussion and effective public awareness programmes cannot be overestimated. Also, the required policy adjustments and structural reforms are comprehensive and inter-related and require proper sequencing and ensuring policy consistency and continuity to realise their maximum benefit. Meanwhile, improvements in governance, transparency and accountability in public policy would strengthen policy credibility and public support, while minimising abuse. Strengthening law and order in the country is also critically important for the smooth operation of a market based economy. It is important to define clearly the role of the government as the public sector still dominates in a number of economic sectors even after 25 years of economic liberalisation. There is a need for a lean, efficient and dynamic public sector, which facilitates rather than interferes in economic activity. This would enable the development of an efficient and dynamic private sector, which would spearhead economic growth based on its efficiency, productivity, management capabilities and capacity to innovate. Such strong and competitive enterprises would be able to face emerging market challenges effectively without having to rely on subsidies, concessions and protections from the government. The recent economic policy framework, i.e., 'Regaining Sri Lanka: Vision and Strategy for Accelerated Development' (RSL) issued by the government clearly indicates desired economic objectives and necessary policy adjustments, structural reforms and implementation strategies to achieve them.

The required financial resources, human skills and institutional capacity for undertaking reforms are significantly larger than currently available. The additional resources required for relief, reconstruction and rehabilitation under the peace process would exert further pressure on this limited resource supply. Also, slow recovery of the world economy

Chart 1.1
Macroeconomic Indicators

Chart 1.1.1
Real GDP and Sectoral Growth

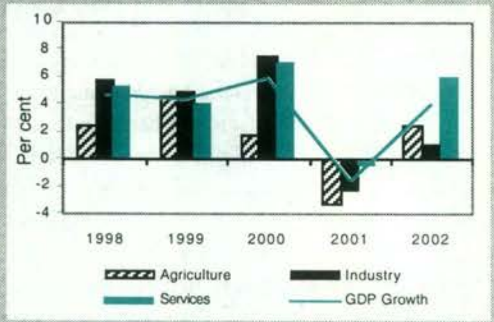


Chart 1.1.2
Changes in CCPI

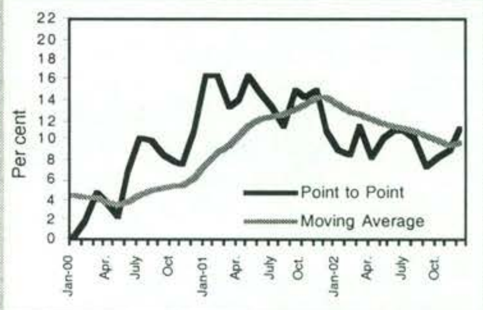


Chart 1.1.3
Fiscal Deficit

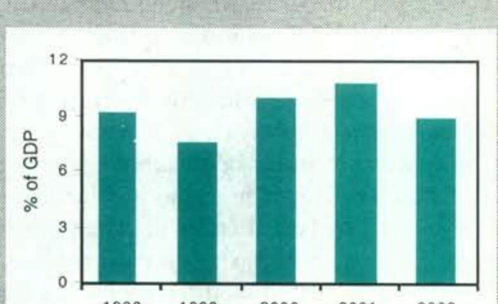
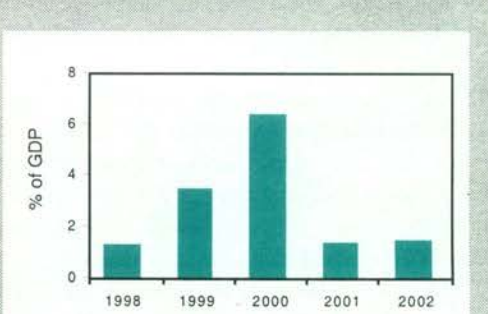


Chart 1.1.4
External Current Account Deficit



Box 1

Progress of the Peace Process [1]

Date	Event
25 Dec 2001	The LTTE declared a unilateral ceasefire, which was positively responded to by the government.
02 Feb 2002	Secretariat for Co-ordinating the Peace Process (SCOPP) was established.
22 Feb 2002	The unofficial ceasefire was followed by a Permanent Ceasefire Agreement signed between the Government and LTTE.
14 Aug 2002	Date set for peace talks in Thailand.
04 Sep 2002	Government of Sri Lanka lifted the ban on the LTTE, ahead of the first round of peace talks
16 Sep 2002	First round of peace talks held in Thailand (Sep. 16-18, 2002) – the first in seven years.
31 Oct 2002	Second round of peace talks held in Thailand (Oct 31-Nov 03, 2002). Three sub committees were formed, namely: 1. Sub-Committee on immediate humanitarian and rehabilitation needs in the North and East 2. Sub-Committee on de-escalation and normalisation 3. Sub-Committee on political matters
25 Nov 2002	At a well-attended donor meeting in Oslo, US $ 70 mn of aid was committed.
02 Dec 2002	Third round of peace talks held in Oslo, Norway (Dec. 2-5, 2002). Parties agreed to explore a solution founded on the principle of internal self-determination.
06 Jan 2003	Fourth round of peace talks held in Thailand (Jan 6-9, 2003).
07 Feb 2003	Fifth round of peace talks held in Germany (Feb 7-8, 2003).
18 Mar 2003	Sixth round of peace talks held in Japan (Mar 18-21, 2003).
Planned Events	
14 Apr 2003	Advance donor consultative meeting to be held in Washington D.C.
29 Apr 2003	Seventh round of peace talks scheduled to be held in Thailand (Apr 29 – May 02, 2003).
6 May 2003	Preparatory Committee, for the donors' meeting to be held in Japan, scheduled to be held in Colombo.
9 - 10 Jun 2003	Donors' meeting scheduled to be held in Japan.
12 Jun 2003	Eighth round of peace talks scheduled to be held in Japan (June 12-15, 2003).
15 Jul 2003	Ninth round of peace talks scheduled to be held in Europe (July 15-18, 2003). (venue to be decided).

1. Information as at end March 2003

Source: Secretariat for Co-ordinating the Peace Process (SCOPP)

Box 2

Economic Benefits of Peace

The first year following the cessation of hostilities between the government and LTTE amply demonstrated the economic benefits of peace. The two decades of civil war hindered Sri Lanka's economic development through inefficient allocation of resources, productivity losses, destruction of infrastructure, under-utilisation of production capacity and weak investor confidence, along with political instability and human suffering. The adverse implications of the war were felt not only in the North and the East, but throughout the country and in all sectors of the economy. With the peace initiative, product, labour and capital markets have been revitalised, supported by productivity gains, opening of access to new markets, improved investor confidence and market friendly policies. Along with these salutary developments, macroeconomic fundamentals also improved. Measures taken for fiscal consolidation, financial sector reforms and labour reforms will further stimulate private investment, promote factor mobility, improve productivity and contain inflation in the medium term, thereby supporting sustained higher economic growth. Though difficult to quantify, the direct and indirect benefits from halting the loss of human life, prevention of dislocation of families and minimising general disruption to social life have significant economic payback. The benefits too are not limited to the North and the East, but spread across the country, promising a better future for all citizens.

Real Sector Growth

The peaceful environment contributed in large measure to the recovery of the Sri Lankan economy in 2002. The improvements were reflected in both demand and supply. The renewed demand for goods and services with the opening of access to the North and the East was translated into increased production activity. Improved security conditions revitalised production activity, particularly in agriculture, including pasddy, other field crops and fishing. Productivity improvements, increased mobility of factors of production, reduced delays at security clearance, releasing lands for cultivation and extended hours of fishing had positive effects on production. Increased utilisation of capacity, both in industries and farm lands, were also helpful in increasing value addition. The paddy harvest in Maha 2002/2003 was the highest on record. Other agricultural field crops also increased in 2002 with a significant contribution from the North and the East.

Peace led to expansion in the services sector. Transportation trade, tourism, telecommunications, port services and financial services were the main areas of growth. Efficiency in the passenger and goods transportation improved significantly with the removal of roadblocks and opening of roads previously closed for security reasons. The opening of the A-9 road for passenger and goods transportation after 12 years fuelled economic activities and facilitated product and factor mobility. The peaceful environment gave a fillip to the tourist industry. Foreign tourist arrivals moved closer to record levels, while domestic tourism also expanded rapidly in 2002, raising the value addition in the services sector. Tourist arrivals increased by 17 per cent, while earnings from tourism increased by 16 per cent. With the increased demand for internal air transportation, particularly between Colombo and Jaffna, three airlines were licensed to operate domestic flights in 2002. The supply of telecommunication facilities in the North and the East expanded. Port services recovered fast in 2002 as the war risk insurance surcharge imposed on ships calling at Sri Lankan ports was completely removed in 2002. Improved external and domestic trade were also helpful in boosting port services. Many financial institutions recommenced or expanded their services in the North and the East. The services sector grew by 6 per cent in 2002.

With the increased production of goods and services supported by effective macroeconomic policies, inflation that had the potential to rise rapidly as pent up demand was released, was contained. Further, the growth in the economy and the better use of resources would help both to increase employment opportunities and to shift employment from less-productive to more-productive areas.

Fiscal Gains

The fiscal sector benefited, particularly from the containment of defence expenditure. Defence expenditure, including public order and safety, amounting to 4.8 per cent of GDP in 2001, declined to 4.0 per cent in 2002. In nominal terms, the actual defence expenditure was Rs.60 billion in 2002, compared with an estimated requirement of Rs.100 billion in the absence of peace. These savings largely contributed to reducing the budget deficit by about 2 percentage points to 8.9 per cent in 2002, while enabling the redistribution of limited resources from unproductive sectors to productive sectors. The secondary beneficial impact of these developments is also being experienced.

Box 2 (contd.)

The rapid increase in government debt was contained. The decline in government demand for domestic resources reduced the crowding out of the private sector, reduced pressure on interest rates and helped monetary management. The yield on 364-day Treasury bills declined to 9.91 per cent at end 2002 from 13.74 per cent at end 2001. Private sector credit expanded by 12 per cent in 2002 in comparison to 9 per cent in 2001.

External Sector and Investor Confidence

On the external front, the impact of the cessation of hostilities felt through reduced defence imports, increased earnings from tourism, increased foreign investment and donor assistance, reduced pressure in the exchange market and improved external reserves. Defence imports declined by 0.7 per cent of GDP in 2002 supporting the BOP. International trade, supported by peace, also recovered significantly in 2002. The international community pledged large amounts of financial resources for rehabilitation work in war torn areas, as well as for development work elsewhere in the country. Substantial amounts of funds are also expected at the donor group meeting to be held in Japan in June 2003.

The ceasefire agreement and commitment of the government to secure permanent peace has promoted business confidence, encouraging private investments. Foreign direct investments (FDI) and portfolio investment grew significantly in 2002. FDI amounting to US dollars 230 million in 2002, was the second highest annual FDI so far received by Sri Lanka. Renewed interest in the share market also signifies improved investor confidence. All Share Price Index (ASPI), which was 562 in January 2002 rose to 815 by December 2002, while Milanka Price Index (MPI) increased from 909 to 1375 during the same period. Portfolio investment turned around to record a net in flow of US dollars 25 million in 2002 from net outflows in four prior years. With these developments, total external assets of the country increased to US dollars 2,495 million by end 2002, which was sufficient to finance 4.9 months of imports.

The peaceful environment prevailing in 2002 brought in significant short-term economic benefits. The North and the South both benefited from the peace. It also helped to accelerate economic reforms and enhance availability of external donor support. Its long-term benefits would be even greater. All these achievements were possible even before agreeing on a permanent resolution to the conflict. Therefore, there will be even more significant economic benefits with the dawn of lasting peace. At the same time the economic implications of any reversal of the peace process would be very serious. Hence, strong commitment of all parties involved is essential to achieving permanent peace.

Box 3

Poverty Reduction Strategy Papers

Despite the steady growth in the world economy in recent decades, a fifth of the people in the world still survive on less than one US dollar a day. To add to this problem, in the next 25 years, the world population is expected to grow by 2 billion people and most of them will be born in developing and emerging economies. If poverty related issues are not addressed effectively, many of these people will be doomed to poverty. Having recognised the serious economic and social implications of widespread poverty, the international community, in particular the World Bank and the International Monetary Fund (IMF), have introduced a new approach to poverty reduction in 1999, which is based on two pillars i.e. the country self help and support from the international community. Under the country self help pillar, the affected countries themselves should make concerted efforts to adopt sound and effective poverty alleviating policies and strategies. Simultaneously, the international community must increase its support to these countries. In brief, in addressing poverty related issues, the need for strengthening domestic policies and institutions and enhancing external assistance is strongly emphasised. The new approach recognised that nationally owned participatory poverty reduction strategies are the most promising means of securing more effective policy making and better partnerships between countries and donors. Accordingly, donors, the World Bank and the IMF requested aid recipients to prepare Poverty Reduction Strategy Papers (PRSP) for their respective countries to ensure that poverty issues are well addressed and that foreign aid is optimally used for poverty reduction. The PRSP would henceforth be the basis of all their concessional lending.

Broadly speaking, a PRSP should contain a country's planned macroeconomic, structural and social policies and public action programmes for a three year or a longer time horizon to promote broad based growth and reduce poverty. Although there are no blueprints for preparing a PRSP, five core principles underlie the PRSP approach. The PRSP should be prepared by the government through a country driven process, including broad participation that promotes country ownership of the strategy and its implementation, as well as partnerships among the government, domestic stakeholders and development partners. Comprehensive diagnosis and recognition of the multi dimensional nature of poverty, a long term perspective, and results orientation are also key elements of a PRSP.

The process of preparing a PRSP should reflect a country's individual circumstances and characteristics. The specific contents of PRSPs will vary widely among countries. However, a full PRSP should include the following main elements.

- **Participatory process:** A description of the country's participatory process that the government conducts to design and to build ownership for the strategy. This should include a participatory process within the government, other stakeholder involvement, bi-lateral and multilateral external development partners' involvement and a mechanism used to consult the poor and their representatives.
- **Poverty diagnosis:** The nature and determinants of poverty outcomes, various dimensions of poverty, identification of economic, social and institutional constraints to poverty reduction, assessment of growth and the distribution impact of past policies should be included.
- **Targets, indicators and monitoring:** The PRSP should define medium and long term goals for poverty reduction outcomes, establish indicators of progress and set annual and medium-term targets.
- **Prioritised public action plan:** The poverty reduction strategy should be supported by a clear prioritised government policy action plan with time horizon targets and estimated cost of the programme.
- **Macroeconomic framework:** The PRSP should clearly spell out the macro economic framework which is conducive for achieving (i) low inflation, (ii) an external position that is sustainable in the medium to long run medium term, (iii) growth which is consistent with the poverty reduction objectives laid out in the PRSP and (iv) an overall fiscal stance that is compatible with poverty reduction and growth objectives.
- **Resource plan:** The PRSP should have an adequate and credible resource plan, including domestic borrowing and projected aid flows.
- **Structural and sectoral policies, policies for social inclusion and equity, governance and public sector management:** The PRSP should estimate the likely impact of its proposed policy measures on the poor and indicate measures to mitigate any negative impacts. Measures and plans for improvements in governance and public sector management, especially in areas that are important for poverty reduction, should be spelt out.

When a PRSP is presented by the government to the Executive Boards of the World Bank and the International Monetary Fund, it will be accompanied by an assessment of

Box 3 (contd.)

that strategy by the Bank and Fund staff, referred to as the "joint staff assessment" (JSA). The JSA must make an overall assessment for the Executive Boards as to whether or not the strategy presented in the PRSP constitutes a sound basis for concessional assistance from the Fund and the Bank. The amounts of assistance and detailed design of the programmes in support of a country's poverty reduction strategy are determined through the Bank's Country Assistance Strategy (CAS) and arrangements under the IMF's Poverty Reduction and Growth Facility (PRGF).

There has been widespread acceptance of the PRSP approach and these processes are taking place in some low income developing countries. Donors and recipient countries have increasingly embraced it, since it is based on the two pillars of country self help and support from the international community. Developing countries require a long time to prepare a full PRSP due to their inadequate human skills and institutional capacity limitations. Hence they are allowed to prepare an Interim PRSP (IPRSP) at the first stage. IPRSP should include a statement of government commitment to poverty reduction, main elements of its existing poverty reduction strategy, existing poverty pattern, macro framework and policy matrix, a timeline and a description of the consultative process by which the full PRSP will be developed etc. Upto end August 2002, 18 full PRSPs and 45 interim PRSPs have been prepared and presented to the Executive Boards. Although the majority of PRSPs were prepared by African countries, progress has been made across all regions.

There are advantages as well as challenges in preparing PRSPs. A growing sense of ownership among most governments of their poverty reduction strategies, a more open dialogue within governments and with at least some parts of civil societies, a more prominent place for poverty reduction in policy debates, extending beyond social sector interventions to focus on reducing income poverty through higher and more broadly shared growth, and more systematic data collection, analysis and monitoring of tangible outcomes. The main challenges identified from the country experiences are the importance of alignment by partners, including the World Bank and Fund, to support PRSP implementation, the importance of greater understanding of the linkages between policies and poverty outcomes, the need for realism in the setting of goals and targets and the desirability of alternative policy choices.

Sri Lanka completed the initial draft of its PRSP in May 2002. The document was revised in December 2002 by incorporating donors comments and amalgamating with the government's economic policy framework 'The Future: Regaining Sri Lanka'. The PRSP was re-titled as 'Regaining Sri Lanka: Vision and Strategy for Accelerated Development'. Primarily the paper describes the vision and strategy for growth and how this growth is connected to the poverty reduction strategy. Six major pillars constitute the foundation for poverty reduction efforts namely, building a supportive macroeconomic environment, reducing conflict related poverty, creating opportunities for poor, investing in people, empowering the poor and strengthening governance, implementing an effective monitoring and evaluation system.

According to Sri Lanka's PRSP, approximately 25-39 per cent of the population is classified as poor. In order to reduce this, the medium-term macroeconomic framework calls for the economy to move towards a moderate growth pace (6 – 7 per cent) and this is expected to pave the way for a sustainable high economic growth path of 8 – 10 per cent per annum in the long run, with per capita income rising to nearly US dollars 2000 by 2010. The government has recognised that peace is vital for higher growth and great emphasis will be placed on the peace process. With a view to revitalising the private sector, an array of reform in areas such as fiscal, financial, trade, investment, labour market and land market are presented in the PRSP. Issues related to conflict related poverty are expected to be addressed through a wide ranging process of stakeholder and community consultation, and identification of strategies to improve relief, rehabilitation and reconciliation efforts. With respect to poverty alleviation, the strategy is to gradually shift from an economy based on low productivity subsistence oriented agriculture, to higher productivity services and industrialisation. One of the main challenges is to effectively connect poor regions to rapidly growing domestic and international markets. This is expected to be accomplished by an integrated strategy that focuses on six main areas: upgrading the port network, building a national highway system and integrated road network, enhancing performance of the bus system, modernisation of railways and improving access to the telecommunication facilities. More stable pricing policies, promoting private land ownership, upgrading agriculture marketing systems, water resource management, deregulation of activities relating to agriculture, promotion of small and medium enterprise activities, increasing employment and mainstreaming poverty reduction in sectoral strategies are some of the strategies, to be adopted. Since Sri Lanka has already shown substantial progress towards some of the millennium development goals (increasing primary school enrolment, reducing infant and child mortality rates and maternal mortality rate, increasing access for all who need reproductive health etc.) more attention will be paid to improving consumption poverty. The measures identified in the PRSP are designed to accelerate GDP growth and simultaneously to draw the poor into the mainstream of economic development. The successful implementation of this strategy is crucial for sustained poverty reduction in Sri Lanka.

Box 4

Poverty Reduction and Growth Facility

The Poverty Reduction and Growth Facility (PRGF) is currently the most concessional lending facility provided by the International Monetary Fund (IMF). It was introduced in September 1999, to integrate the objectives of poverty reduction and growth into the IMF's lending facilities for low income countries. It replaced the IMF's previous concessional lending facility, the Enhanced Structural Adjustment Facility (ESAF).

The PRGF reflects some far-reaching changes in the way the Fund has been working to support low-income member countries. First, the contents of Fund supported programmes have been changed to integrate poverty reduction strategies and economic growth. Second, there is more emphasis on country ownership of PRGF-supported programmes. Third, the role of the Fund and the relationship with other donor agencies has been better defined.

To enhance country ownership of PRGF supported programmes, member countries applying for the Facility are required to prepare a document titled, "Poverty Reduction Strategy Paper" (PRSP) or an Interim PRSP, which sets out the country's medium term strategy to reduce poverty while achieving higher economic growth. The preparation of the PRSP should be based on extensive consultations with all stakeholders, including the poor. The main objective of broader participation is to enhance the country ownership of the programme. The World Bank and the Fund jointly assess the PRSP, in consultation with the authorities, to identify ways and means by which the Bank and Fund can contribute to achieve the objectives set out in the document. The approved PRSP then serves as the basis for concessional lending by both institutions, as well as other official donors. The purpose of joint assessment is to tailor assistance to fit their respective areas of responsibility in supporting strategies in the PRSP. (A more detailed description of the PRSP process is found in Box 3 of this Report.) Based on the PRSP, programmes are prepared by the IMF and the World Bank, and approved by their respective Executive Boards. Specific measures under PRGF supported programs are derived from the PRSP and conditionalities are imposed to ensure efficient and effective implementation of policies in the PRSP.

There is a clear division in conditionalities applied by the World Bank and the IMF, each focussing on its respective areas of expertise and responsibility. IMF conditionality in the programme is focused more on macroeconomic stability, while the Bank focuses on the implementation of structural reforms. The Bank has established a credit line called the Poverty Reduction Support Credit (PRSC) to enable it to link its lending directly to the implementation of PRSPs.

Eligibility for the PRGF is based principally on a country's per capita income, drawing on the cutoff point for eligibility for World Bank concessional lending (currently the cutoff point is per capita gross national income of US dollars 875 at 2001 prices). An exception to the cutoff has been made for small island economies; these countries continue to be eligible for PRGF and World Bank concessional assistance (International Development Assistance -IDA), notwithstanding their relatively high per capita income levels. As of December 31 2002, 77 countries including Sri Lanka were eligible for PRGF assistance and 38 countries were receiving benefits.

PRGF for Sri Lanka

In April 2001, Sri Lanka entered into a Stand-By Arrangement (SBA) with the IMF to obtain SDR 200 million for a macroeconomic stabilisation programme (Details of the SBA is found in Box 3 in the Central Bank's Annual Report of 2001). Main objectives of the SBA were to stabilise the exchange rate, build up official reserves to a comfortable level and improve fiscal balances. This was to be a 14-month programme, to be completed by June 2002. However, adverse political and economic developments in the second half of 2001, including the attack to the airport, sluggish external demand, the prolonged drought and the general elections derailed the SBA programme. Subsequently, Sri Lanka was able to renegotiate the SBA programme and it was successfully completed in September 2002.

Meantime, Sri Lanka initiated negotiations for a PRGF, with an intention to obtain a large concessional financing package to reduce poverty on a more sustainable basis through higher economic growth. To reach consensus on appropriate poverty reduction strategies for Sri Lanka, broad consultations with stakeholders in the country and outside were conducted. Among the stakeholders involved in the formulation of the strategies were government and semi-government agencies, non-governmental organisations representing a broad spectrum of interests, the private sector and donors. The country's approach to the strategy was first elaborated in a document titled " Connecting to Growth: Sri Lanka's Poverty Reduction Strategy". The consultative process also developed views on relief and rehabilitation in the conflict-affected areas through a process called the Framework for Relief, Rehabilitation and Reconciliation (RRR). Based on this consultative process, a poverty reduction strategy (PRS) for

Box 4 (contd.)

Sri Lanka was drafted and discussed at the Sri Lanka Development Forum in June 2002 where development partners strongly endorsed the strategy.

Meanwhile, the government prepared a document in which the economic vision for Sri Lanka was enunciated. The document titled " The Future: Regaining Sri Lanka" (TFRSL) set out a comprehensive economic programme to eliminate factors which inhibit economic growth. This is consistent with the Poverty Reduction Strategy, but demands accelerated growth and a complete implementation framework, and an elaborate monitoring mechanism. Finally, the PRSP titled as 'Regaining Sri Lanka: Vision and Strategy for Accelerated Development' was prepared, combining all three documents; TFRSL, PRS and RRR.

Based on the PRSP, the IMF has approved a three-year PRGF arrangement in the amount of SDR 269 million (65 per cent of the country's IMF quota) and in addition, a concurrent three-year Extended Fund Facility (EFF) arrangement in the amount of SDR 144.4 million (35 per cent of the quota) over the period 2003-2006 (approximately a total sum of US dollars 567 million). Loans under PRGF carry an annual interest rate of 0.5 per cent, with re-payments made semi-annually, beginning five and a half years and ending 10 years after the disbursement. The EFF arrangement carry the IMF's basic interest rate (around 2.27 per cent in April 2003), with re-payments made semi-annually, beginning four and half years and ending 10 years after the disbursement. The total amount will be disbursed in seven tranches over a period of three and half years, subject to meeting performance criteria set out in the programme. The importance of the PRGF-EFF programme lies not only itself, but perhaps more importantly in its catalytic role for mobilising assistance from other donors and encouraging private capital inflows. The total assistance from the World Bank and Asian Development Bank (ADB) alone is expected to be around US dollars 1,500 million in concessional funds. Japan and other donors are also expected to commit a significant amount to support the PRGF-EFF programme at the forthcoming donor conference. While the PRGF –EFF disbursements would be available to strengthen the country's external reserve position to a comfortable level in the medium term, other donor support including PRSC would be available to implement other policies and to undertake structural reforms specified in the PRSP.

While aiming for sustained growth at 8-10 per cent per annum in the long-run, the policy framework incorporated in the PRGF-EFF supported programme has been designed to achieve at least 6.5 per cent growth on average during the period 2003-06. The programme has identified that there is a gap of external financing of about US dollars 400 million per year on average, to achieve the envisaged growth targets. This entire gap is expected to be filled by other donors on concessional terms and conditions, mainly the World Bank, Asian Development Bank and Japan. Policies incorporated in the PRGF-EFF arrangement and commitments under the programme would also help galvanise support from other bilateral donors to fill the required gap. A donor conference has already been scheduled for June 2003 to assess the needs for reconstruction-related spending and to provide assistance for the overall reform agenda.

The World Bank has prepared a Country Assistance Strategy (CAS) to support the economic programme in the PRSP. The CAS proposes a base lending program of US dollars 800 million including US dollars 380 million under Poverty Reduction Support Credit (PRSC) at concessional rates from the IDA facility for the next four years. There is a provision under the CAS, whereby if the poverty reduction strategy is implemented exceptionally well, the base level lending could be raised to as high as US dollars one billion over the period. However, a failure in the implementation of the economic programme or the resumption of hostilities in the ethnic conflict could result in a fall in the base level lending to under US dollars 250 million.

In addition, the ADB has also prepared a country assistance program, which aims to provide US dollars 200 million per year on average to reduce poverty and promote economic growth throughout the country. Other donors, including Japan, the largest bilateral aid donor to Sri Lanka are expected to commit a significant amount of external finance at concessional rates at the forthcoming donor conference to be held in Japan in June 2003. The PRGF-EFF arrangement has laid a strong foundation to build other donor assistance.

Therefore, the PRGF arrangement with the IMF has provided a rare opportunity for Sri Lanka to gain from the good progress so far achieved in finding a long lasting solution to the ethnic conflict and from the government's commitment to speed up economy reforms necessary to achieve higher growth rates, while reducing poverty. Effective and speedy implementation of the PRGF-EFF supported programme would guarantee the availability of external financing at concessional rates. In turn, expediting the relief, rehabilitation, and reconciliation efforts will also help secure long lasting peace in the country. This concessional financing is also helpful in achieving fiscal sustainability while providing more resources for infrastructure and social capital development. Therefore, it is necessary for all stakeholders in the economy to ensure the successful implementation of PRGF-EFF supported programmes. Any slippage could cost the economy dearly.

would make the economic efforts more difficult. This explains the government's determination to mobilise concessionary foreign assistance to fill the large resource gap. An ideal window of opportunity has emerged for such an effort with progress in the peace process, the successful completion of the SBA programme with the IMF, improved macroeconomic management and renewed commitment to structural reforms. The response of multilateral and bilateral donors to these needs are most encouraging. The Poverty Reduction and Growth Facility (PRGF) programme with the IMF and Poverty Reduction Support Credit (PRSC) facility with the World Bank, consisting of large concessional financial support for a longer period from the multilaterals, can play a catalytic role by significantly catalysing other donor support and encouraging foreign private investment inflows with the endorsement of the country's economic policies by the international community. (see Box 4).

Thus, Sri Lanka is at a pivotal point in its history as prospects for a durable peace and commitment to economic policy adjustments and structural reforms remain high. As the international community has expressed its willingness to provide support for both endeavours, Sri Lanka should not miss this unique opportunity to realise the maximum benefits from that goodwill. The speed and the extent to which these benefits will be realised will depend entirely on the commitment of all Sri Lankans to reaching a national consensus on the question of national unity and their determination to pursue sensible economic reforms to achieve rapid economic development. The clear emphasis on poverty alleviation in the economic programme of the government (see Box 3) will ensure that the benefits of economic development are widely shared by all the people.

1.2 International Environment

The global economy recovered during 2002 at a moderate rate benefitting from recoveries in the United States, which spearheaded global growth during the last decade, Canada, newly industrialised Asian economies and developing countries as a whole, aided by fiscal stimulus, accommodative monetary policies and interest rate cuts. World output grew by 3.0 per cent in 2002, up from a dismal 2.3 per cent registered in the previous year[1]. The growth in 2002 was 0.2 percentage points higher than the original estimate of 2.8 per cent reflecting the accelerated growth in the second and third quarters, but was well below the October 2001 estimate of 3.5 per cent. The continuation and strengthening of growth stimulating packages, consisting of accommodative monetary policy and expansionary fiscal measures in industrial countries and improved macroeconomic management with accelerated structural reforms in developing countries, were the major contributory factors for the growth recovery. However, two large economic blocks, the Euro area and Japan, continued to remain weak, stalling a faster global recovery during the year. Continued rigidities in the product and labour markets and strains in the financial sector have prevented a recovery in the Euro area, while problems in corporate and banking sector institutions which have led to a high level of debt, and the dilemma faced by authorities in using monetary policy at zero interest rate to stimulate the economy continued to undermine a recovery in Japan on a sustainable basis. While the Euro area grew only by 0.8 per cent in comparison to a 1.4 per cent growth in 2001, the Japanese economy expanded by 0.3 per cent, against 0.4 per cent in the previous year. Developing countries as a group recorded a growth rate of 4.6 per cent in 2002 compared with 3.9 per cent in 2001, a marginal improvement. Developing Asia registered the highest growth rate of 6.5 per cent, compared with other regions. Inflation remained lower at 1.5 and 5.4 per cent in advanced and developing countries, respectively, in 2002, compared with corresponding values of 2.2 and 5.8 per cent in 2001, facilitating monetary accommodation.

Meanwhile, international trade improved somewhat during the year owing to faster trade growth in developing countries and a recovery in advanced economies. Moderate recovery in consumer demand resulted in an increase in imports by advanced economies by 2 per cent against a drop of 1.2 per cent in 2001, while growth in imports by developing countries more than doubled from 2 per cent to 5.4 per cent, due to both higher consumer and investment demand. Meanwhile, exports by advanced economies recovered from a drop of 1 per cent to a growth of 1.9 per cent reflecting faster recovery in developing countries. Exports by developing

TABLE 1.2
Overview of the World Economic Outlook Projections (Annual percentage change)

	Actual		Projections
	2001	2002	2003
World output	2.3	3.0	3.3
Advanced economies	0.9	1.8	2.0
United States	0.3	2.4	2.4
Germany	0.6	0.2	0.7
United Kingdom	2.0	1.7	2.2
Japan	0.4	0.3	0.5
Developing countries	3.9	4.6	5.0
Developing Asia	5.6	6.5	6.3
World trade volume (Goods and services)	0.0	2.9	4.9
Imports			
Advanced economies	-1.2	2.0	4.9
Developing economies	2.0	5.4	6.3
Exports			
Advanced economies	-1.0	1.9	4.4
Developing economies	3.0	6.3	5.4
Consumer prices			
Advanced economies	2.2	1.5	1.7
Developing economies	5.8	5.4	5.7
Six Month LIBOR on US dollar deposits	3.7	1.9	1.7

Source: World Economic Outlook (February 2003), IMF

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

countries increased by 6.3 per cent in 2002 against an increase of 3 per cent in 2001. Higher oil prices, particularly during the latter part of the year owing to uncertainties in the Middle East and supply disruptions in Venezuela due to political turmoil, and a significant increase in non-fuel commodity prices, caused larger trade deficits in oil importing developing countries. During the year oil prices rose by 2.7 per cent against a drop of 14 per cent in 2001, while non-fuel commodity prices increased by 3.9 per cent against a drop of 5.4 per cent in the previous year. Terms of trade improved by 0.4 per cent in favour of developing countries during the year. However, restrictions on access to industrial country markets continued to limit the potential benefits of globalisation and integrated markets, for developing countries. OECD countries continued to heavily protect their agricultural sectors, spending about US dollars 300 million in 2001, more than 6 times the total official development assistance.

International financial markets recovered partially from the setback caused by the September 11 attack, the bursting of stock market bubbles, and corporate account scandals in 2001. Net capital flows to emerging market economies improved from US dollars 34 billion in 2001 to US dollars 81 billion in 2002, developing Asia benefitting the most. This was mainly due to a faster recovery in Asia, in particular, the robust economy in China and Hong Kong. Private capital to Asia is mainly reflected in foreign direct investments (FDI). The Western Hemisphere registered a sharp drop in private capital due to a fall in FDI, while the Middle East and Turkey as a single region continued to experience net capital outflows due to prevailing uncertainties. The declining trend in Official Development Assistance (ODA) continued. The financial crisis in Argentina was severe but had a limited effect on the rest of the world and contagion was contained.

Interest rates continued to decline in 2002, reflecting the recovery enhancing monetary policy stance facilitated by subdued inflationary trends. Almost all central banks in industrial countries cut their official interest rates, further reducing them to record low levels. In foreign exchange markets, the US dollar depreciated sharply against other major international currencies (i.e., 18.7 per cent, 10.9 per cent, 10.7 per cent against the euro, Japanese yen and UK pound, respectively), reflecting corrections for macroeconomic imbalances. Such sharp fluctuations within a short period create difficulties for trade dependent developing countries such as Sri Lanka. Therefore, further strengthening of macroeconomic coordination among industrial countries is desirable in improving stability in the cross rates among major international currencies.

1.3 Output, Growth and Sectoral Performance

In 2002, Gross Domestic Production (GDP) in real terms grew by 4.0 per cent, a recovery from the contraction of 1.5 per cent experienced in 2001. The recovery was gradual and continuous during the year. After three consecutive quarters of negative growth in 2001, (Q_2 - 0.1%; Q_3 - 3.9%; Q_4 - 3.6%), the economy showed a clear upward trend, recording progressively, increasing growth rates each of the four quarters of 2002 (Q_1 +0.5%; Q_2 +3.0%; Q_3 +5.9%; Q_4 +6.2%).

Chart 1.2
Quarterly Real GDP Growth Rates, 1998-2002

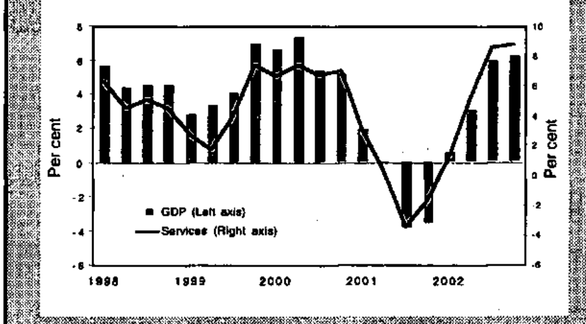


TABLE 1.3

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

Item	1990-2000 Avg.	2001(a)	2002(b)
Agriculture Sector	**2.5**	**-3.4**	**2.5**
1. Agriculture, forestry and fishing	2.5	-3.4	2.5
1.1 Agriculture	2.4	-4.3	1.9
Tea	4.4	-3.5	5.0
Rubber	-1.5	-1.5	5.0
Coconut	2.1	-13.5	-13.6
Paddy	3.7	-5.7	6.1
Other	2.5	-2.2	2.5
1.2 Forestry	1.4	5.0	2.7
1.3 Fishing	4.0	-3.9	5.9
Industrial Sector	**6.8**	**-2.1**	**1.0**
2. Mining and quarrying	2.8	0.7	-1.1
3. Manufacturing	8.1	-4.2	2.2
3.1 Processing of tea, rubber and coconuts	2.5	-6.7	-1.0
3.2 Factory industry	9.3	-3.9	2.8
3.3 Small industry	5.9	-3.5	0.9
4. Construction	5.2	2.5	-0.8
5. Electricity, gas, water and sanitary services	7.7	-2.9	-1.3
5.1 Electricity	n.a.	-3.7	-2.1
5.2 Water and gas	n.a.	2.1	3.8
Services Sector	**5.6**	**-0.5**	**6.0**
6. Transport, storage and communication	6.4	3.8	7.7
6.1 Port Services	n.a.	0.0	2.4
6.2 Telecommunications	n.a.	23.1	19.3
6.3 Transport	n.a.	-1.8	3.7
7. Wholesale and retail trade	5.5	-6.7	5.5
7.1 Imports	7.6	-10.7	8.6
7.2 Exports	10.4	-8.0	2.0
7.3 Domestic	2.5	-2.0	3.4
8. Banking, insurance and real estate	7.7	7.9	11.1
9. Ownership of dwellings	1.3	1.4	1.4
10. Public administration and defence	3.5	1.0	0.0
11. Services (n.e.s.)	5.4	2.2	3.2
11.1 Hotels & Restaurants	2.5	-5.5	0.3
12. Gross domestic product	5.3	-1.5	4.0
13. Net factor income from abroad	-6.2	12.5	5.7
14. Gross national product	5.3	-1.3	4.1

(a) Revised
(b) Provisional

Source:- Central Bank of Sri Lanka

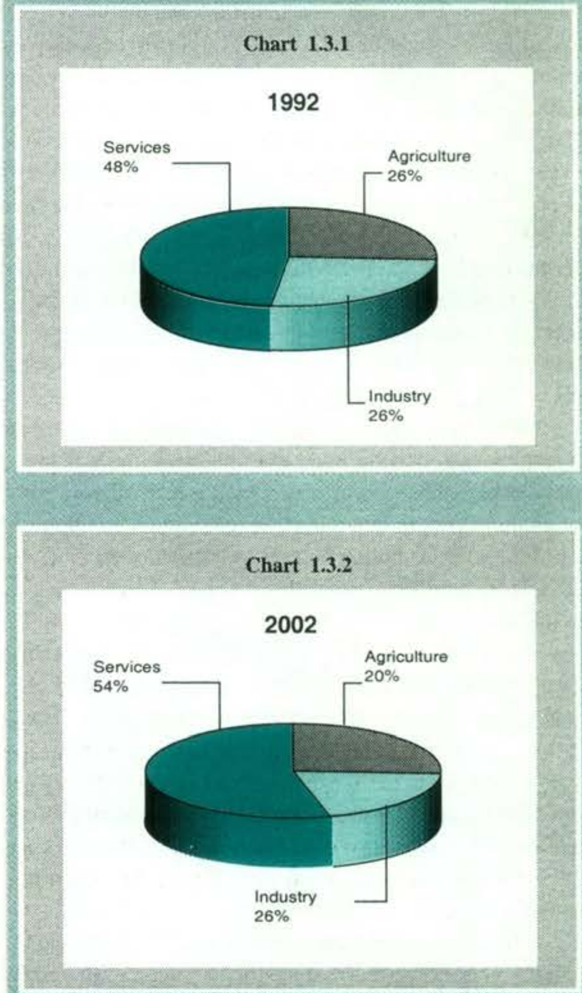
However, the higher increases in the last two quarters were partly because of the low base in the previous year. Economic activities during the second half of 2001 were severely disrupted by the terrorist attacks on the Katunayake International Airport in July 2001 and the September 11 attacks in USA. The political uncertainty in the country after the prorogation of Parliament in August, which continued to prevail till the general election in December 2001, made matters worse. Improved performance in the corporate sector with rising profitability also reflected the benefits of economic recovery. It is important that the economic recovery in 2002 should be further strengthened in the coming years to push it up to a rate above 6 per cent to alleviate the major economic issues confronting the country such as high unemployment and incidence of poverty.

The recovery process was continuous, but comparatively less broadbased. The services sector, the largest sector accounting for over 50 per cent of GDP, recovered strongly, because of its resilience and flexibility to adjust faster to external shocks. It grew by 6 per cent, accounting for about 80 per cent of overall growth in 2002. Production in agriculture and allied activities recovered partially in 2002, benefiting from improved weather conditions and progress in the peace process, recording an annual growth rate of 2.5 per cent and contributing 12.6 per cent to overall GDP growth. The industrial sector, which recorded a negative growth rate until the third quarter of 2002 largely due to weak export demand, grew the slowest at 1 per cent in 2002, contributing only 7.1 per cent to the overall growth. These developments clearly indicate the necessity for strong structural reforms to improve flexibility in the economy, particularly in the agricultural and industrial sectors, and strengthen its resilience to external shocks, so that the country could maintain a sustainable high growth rate.

Similarly, on the demand side, domestic demand contributed about 75 per cent to the aggregate demand, while the export (both goods and services) sector accounted for only 25 per cent, reflecting the poor performance in merchandise exports. Within domestic demand, consumer demand, the largest expenditure category accounting for over 80 per cent of the total expenditure, grew by 14 per cent and accounted for 69 per cent of overall demand growth. The contribution to overall growth from investment was only 12 per cent in 2002, partly because of a slow recovery in private investment and partly an underperformance in public sector investment. The latter was caused by low realisation that was 19 per cent below the budgetary estimates for the year.

On the supply side, both GDP and imports of goods and non-factor services expanded in 2002, increasing the availability of goods and services. However, the domestic supply grew at 13 per cent and accounted for 73 per cent of the annual increase in the aggregate supply. The import category grew by 11 per cent and accounted for 27 per cent of the overall supply expansion in 2002.

Chart 1.3
Sectoral Composition of GDP



At current market prices, GDP rose by 12.6 per cent to Rs.1,585 billion (US dollars 16.5 billion) in 2002, while GNP rose to Rs.1,560 billion (US dollars 16.2 billion). These increases in nominal terms were a combined outcome of a 4 per cent growth in real terms and 8.3 per cent increase in prices. Mid-year population rose by 1.5 per cent to 19.0 million in 2002. Consequently, the average per capita GDP in nominal terms rose by 11 per cent to Rs.83,382 in 2002. Given the lower increase in the GDP deflator (by 8.3 per cent) this indicates an improvement in the average income in real terms by about 3 per cent in 2002, reversing the drop observed in 2001. In US dollar terms, per capita GDP rose by 3.7 per cent to US dollars 872 from US dollars 841 in 2001, but yet below the level of US dollars 899 in 2000.

Several factors contributed to the economic recovery in 2002. The first and most important was the improvement in the security situation in the country with progress in peace process. The resultant peaceful environment raised consumer and investor confidence and encouraged the expansion of economic activity. This favourable impact is reflected in all major production sectors, i.e., agriculture, fisheries, industry and services. Secondly, the break in drought conditions in the second half of 2002 helped increase agricultural production and restore hydro-power generation, thereby ending the prolonged power cuts. This last factor had a clear positive impact on both industry and services. Thirdly, the removal of the war risk premium in March 2002 on insurance on vessels arriving in Sri Lanka assisted recovery in both trade and tourism. Fourthly, even though the recovery in the world economy was slow and below expectations, the expansion in international trade was better in 2002 than in 2001. Finally, the improvement in macroeconomic management, resulting in a downward shift in the interest rates structure and improving liquidity in the domestic market, the continuation of structural reforms and improved stability in financial markets under the floating exchange rate regime, have had a beneficial impact on the economy in 2002.

Agriculture

The Agriculture sector recovered partially in 2002, benefiting from more favourable weather conditions, the improved security situation and attractive prices for most major crops. The output of paddy, tea, rubber and a number of minor export crops and other field crops increased. However, output in coconut and a few other field crops decreased. Reflecting these developments, the value added in the Agriculture sector increased by 2.5 per cent in 2002 compared with a 3.4 per cent decline in 2001.

TABLE 1.4

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

Sector	1998	1999	2000	2001(a)	2002(b)
1. Agriculture, forestry and fishing	21.1	20.7	19.9	20.1	20.1
2. Industry	27.5	27.3	27.3	26.8	26.3
2.1 Mining and Quarrying	1.9	1.8	1.9	1.9	1.8
2.2 Manufacturing	16.5	16.4	16.8	16.0	15.9
2.3 Construction	7.6	7.6	7.3	7.6	7.2
2.4 Electricity, gas and water supply	1.5	1.5	1.2	1.3	1.4
3. Services	51.4	52.0	52.8	53.1	53.6
3.1 Transport, storage and communication	11.1	11.4	11.7	12.1	12.4
3.2 Wholesale and retail trade	21.5	21.2	22.6	21.1	20.5
3.3 Banking, insurance and real estate	7.6	8.1	7.6	8.5	9.2
3.4 Ownership of dwellings	1.9	1.8	1.8	1.8	1.7
3.5 Public administration and defence	5.3	5.3	5.2	5.6	5.8
3.6 Services (n.e.s)	4.0	4.1	4.0	4.1	4.0
4. Gross domestic product	100.0	100.0	100.0	100.0	100.0
5. Net factor income from abroad	-1.3	-1.8	-2.1	-1.9	-1.7
6. Gross national product	98.7	98.2	97.9	98.1	98.3

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Registering a strong recovery from the drought affected output in 2001, tea production rose by 5 per cent in 2002 to a new record level of 310 million kg. Both favourable weather and improved management practices contributed to this growth. Output increased in all three elevation categories. High grown teas, which accounted for 28 per cent of total output, recorded a high growth rate of 16 per cent, resulting in the highest output in this category since 1966. Low grown tea output, which accounted for 54 per cent of total output, rose by 2 per cent, the output of medium grown teas increased marginally (0.4 per cent). The production of orthodox tea continued to dominate. Production of cut, tear and curl (CTC) tea rose by 4 per cent to 17.8 million kg (i.e., 5.7 per cent of total output) in 2002. Auction volumes increased marginally by 0.4 per cent, while the export volume declined slightly (1.1 per cent) in 2002. The annual average Colombo Auction price increased to Rs.149.30 per kg from Rs.143.96 per kg in 2001. However, in dollar terms there was a marginal decline. Despite the production increase, the export volume declined by 1 per cent, while the average export price in US dollar terms dropped by 3.3 per cent. Reflecting these trends, total tea export earnings decreased by 4.3 per cent in 2002. The share of bulk tea exports remained high, over 60 per cent, indicating the potential to increase export earnings by expanding value added tea exports.

The smallholder sector continued to play a dominant role in the tea industry, accounting for about 61 per cent of the national output. The yield of 2,286 kg per hectare in smallholdings was significantly higher than the average yield of 1,462 kg per hectare in the estate sector. The lower national average yield (1,875 kg per ha in 2002), compared with Kenya (2,239 kg per ha in 2001) and India (2,000 kg per ha in 2000), indicates the potential for further increases in output by improving productivity. In this context, it is crucial to pay attention to three major issues. First, it is time to review the present management arrangement system in privatised plantations in order to improve the profitability of the plantations. It has been observed that no funds could be raised by plantation companies from the market for new investments due to low profitability, which has been brought about by the management fee structure, which is inflexible even in a downturn in market conditions. Second, measures need to be identified to resolve the current scarcity of labour, especially tea pluckers in the low grown areas, as irregular plucking adversely affects the quality, price and productivity of tea. Thirdly, the present high post-harvest damage in green tea leaf in the bought leaf industry has to be brought down significantly by improving packing methods and transportation facilities.

Reversing the declining trend observed in the recent past, rubber production rose by 5.2 per cent to 91 million kg in 2002. The increase was attributed to an increase in the number of tapping days and a sharp price increase, which encouraged tapping in some marginal rubber lands, which had been abandoned in the past because of unattractive prices. Rubber prices rose over 20 per cent as global demand increased, driven mainly by the demand from China. This is clear evidence that the fast growing Chinese economy not only present challenges to Sri Lankan exports, but also provides opportunities for them. However, the annual average rubber export price declined by 2.7 per cent due to very low prices that prevailed in the early months of 2002. Despite this, the rubber export volume rose by 14 per cent, thus raising exports earnings by 11 per cent. The average yield increased by 11 per cent to 724 kg per hectare through some low productive marginal lands being brought under production. Nevertheless, the average yield in Sri Lanka is well below other countries such as Thailand (1,418 kg/ha) and Malaysia (950 kg/ha). Improvements in management practices, adequate fertiliser application, use of rain guards and replanting with high yielding varieties are crucial in improving productivity in the rubber sector.

Coconut production, which declined in 2001 from peak output in 2000, further declined by 14 per cent to 2,392 million nuts in 2002. This was attributed to the lagged effect of the drought in 2000/2001 and mite infestation in certain areas of the coconut triangle. Consequently, the average retail price of coconut (Rs.10.50 per nut) rose sharply by 36 per cent to Rs.14.20 per nut, and the production of coconut oil and desiccated coconut (DC) declined by 53 per cent and 40 per cent, respectively. In order to contain sharply rising domestic coconut prices, the government reduced the surcharge on the import of edible oil from Rs.20 to Rs.5 per kg and allowed imports of copra. These ad hoc measures may provide short-term relief to the consumer but they discourage long-term investment in coconut cultivation and processing industries. A well designed long-term trade policy, yield enhancing cultivation practices and replanting with high yielding varieties are critical in developing the coconut sector in the long run. Despite a sharp increase in export prices by 59 per cent, the volume of coconut exports declined by 36 per cent due to the poor crop, limiting growth in export earnings to about 2 per cent in 2002.

Paddy production in 2002 increased by 6 per cent to 2.8 million metric tons, benefitting from the expanded cultivation area under favourable weather conditions and the improved security situation. This is marginally below the peak annual output in 2000. Production in the Maha season rose by 10 per cent due to a 6 per cent increase in the extent sown and a 3 per cent improvement in yield. Production increased in all major producing areas and the highest increase was in Uda Walawe, a fifteen-fold growth, recovering from the effects of the severe drought in the previous Maha season. The sown area and output increased in the Yala season too. However, the average yield declined by 9 per cent as marginal lands were cultivated. Consequently, the average annual yield, which had increased continuously during the last few years, dropped by 1.5 per cent in 2002 to 3,895 kg per hectare.

The farmgate price for paddy remained above the government purchase price of Rs.13.00 per kg throughout the year, except for two short spells during the peak harvesting periods in Maha and Yala. The 35 per cent import duty on rice imports was changed to a specific duty of Rs.7 per kg (effective rate of about 38.4 per cent in 2002) with effect from 21 January 2002. However, CWE was allowed to import 30,000 metric tons of rice at a reduced duty of Rs.4 per kg to contain increasing rice prices during the pre-Maha harvest period. Subsequently, the licensing requirement for rice imports was removed in March 2002, as the high tariff protection was considered sufficient. The removal of the import licensing requirement, coupled with the depleted stock at the beginning of the year due to the poor crop in 2001, led to an increase in rice imports in 2002. A consistent and transparent tariff policy is essential to develop a market based system to stabilise prices and the quality of rice. Similarly, increasing the availability of high yielding seeds and expansion of forward purchasing arrangements will help to increase output and quality in the paddy sector.

Output in the other agriculture category, consisting of minor export crops and other field crops, including vegetables and fruits, increased, recording a 2.5 per cent growth in value added terms. The export volume of minor crops rose by 23 per cent in 2002, continuing the recent upward trend. Within the sub-category, cloves, nutmeg, and pepper output increased, while cinnamon output declined marginally (4.4 per cent), though cinnamon exports increased in 2002. Even with a marginal price increase of 0.2 per cent, the total export earnings from minor export crops rose by 23 per cent in 2002 due to a sharp increase in volume.

The performance in other crops was mixed. Potato and soya bean production increased, while the output of chillies, maize, and black gram declined. The recent decline in areas cultivated and rise in yields in chillie and onion cultivation indicate that farmers have been shifting low productive lands away from these crops to alternative crops. The ad valorem tariff of 35 per cent was replaced with specific duties of Rs.30, Rs.6 and Rs.5 per kg for chillies, big onions and red onions, respectively, raising their level of protection. The government also took steps to establish more marketing centres to improve marketing facilities. The establishment of dedicated wholesale marketing centres with basic facilities would help to determine more competitive prices for agricultural products that are acceptable to producers and buyers and also to minimise the present high wastage between the producer and the consumer by developing storage and packing industries. Provision of marketing facilities through infrastructure development and promotion of forward purchase/sale contract systems are steps in the right direction. They are preferable to any expansion of the public sector's direct involvement in agriculture marketing activity.

Within the livestock sector, the poultry industry continued its upward trend, and production increased by 26 per cent. The revival of tourism and the resumption of a reliable supply of power helped the expansion, by providing attractive prices and undisrupted product storage facilities. A rebate scheme for export of poultry (Rs.20 per kg) was introduced following a proposal in Budget 2002, in order to promote poultry exports and address the temporary excess supply before the revival of the tourist industry.

Fish production increased by 5.8 per cent to 301,460 MT in 2002 benefitting mainly from the improved security situation and transport facilities following the ceasefire agreement. Output in the marine sector increased by 7.2 per cent with increased fishing activity in the Northern and the Eastern coastal areas. However, aquaculture production declined by 5.8 per cent mainly because of the drop in prawn production due to weak export demand. The overall production increase contained upward pressure on domestic fish prices in 2002.

Industry

In 2002, the industrial sector[1] recorded the lowest growth among the major sectors, reducing its share from 27.4 in 2001 to 26.6 per cent of total GDP in 2002. Increased domestic demand with progress in the peace process, resumption of regular power supply in May and a moderate growth in export demand during the second half of the year contributed to the positive growth of 1 per cent in 2002 in contrast to a decline of 2.1 per cent in 2001. However, the power cuts during the early part of the year, continued weak export demand and increased costs of production adversely affected the early recovery in industrial production.

Within the Industrial sector, output in the Manufacturing sector, which is the largest sub-sector accounting for about 63 per cent of value added in the Industrial sector, grew moderately by 2.2 per cent compared with a decline of 4.2 per cent in 2001. Within the Manufacturing sector, the factory industry sector, the largest sub sector, grew by 2.8 per cent, benefiting from increased domestic demand (13 per cent) and a moderate recovery in export demand (2 per cent). However, output in the plantation processing sub-sector declined for the second consecutive year (-1.0 per cent), albeit lower than the contraction (-6.7 per cent) in 2001, due to sharp contraction in the coconut processing industry.

The increased demand for the products of industries catering mainly to the domestic market, particularly food, beverage and tobacco (4.6 per cent) and chemicals, petroleum, rubber and plastic industries (5.7 per cent) contributed to this relatively higher output growth rates, recovering from the slow growth or contraction in 2001. However, the major export oriented industries (i.e., textiles and apparel, rubber based products and ceramics) recorded weak performance, reflecting a slow recovery in the world economy and increased competition in international markets. The largest export oriented industry, i.e., textiles and wearing apparel, grew only by 1.4 per cent, a recovery of less than one fourth from the sharp decline of 8.6 per cent in 2001. Weak consumer demand in major export markets, i.e., USA and Euro area countries, and increased competition from low cost producing countries (e.g., China, Vietnam and Bangladesh) and other exporting countries which are eligible for special trade concession (sub-Saharan and Caribbean countries) not only limited the growth in the export volume of the textile and apparel industry to 1.4 per cent, but also reduced the price (i.e. unit value) by 6 per cent. Lower export prices, together with increased domestic cost of production, squeezed the profit margins of export oriented industries and delayed the further expansion and new investment activity. A few sub-sectors such as leather products recorded a negative growth for the second consecutive year due to loss of export market competitiveness to low cost export countries, such as China.

However, the ability of major manufacturers to create an up-market image in international markets through design, price, on-time delivery and the reputation of the country as a supplier of high quality products helped to mitigate to a certain extent the impact of unfavourable developments. Manufacturers paid greater attention to quality improvement, better order placement, efficient material sourcing, effective marketing, low cost trade financing, utilisation of information technology, and logistical arrangement to face increasing global competition. The Free Trade Agreement (FTA) with India was helpful to some industries such as rubber based products, and soap and plastic products to penetrate the Indian market. Nevertheless, the recent worrisome trends in the export oriented industries, emerging challenges in international markets and potential difficulties with the scheduled end of the Multi-Fibre Arrangement (MFA) in 2005 indicate the necessity for a comprehensive programme to strengthen prospects of the industrial exports sector. Such a package should include, among other things, the expediting of the establishment of new trade agreements with USA and other major trading partner countries, removal of barriers retarding trade expansion under the FTA with India, implementation of structural reforms conducive to productivity growth and the development of infrastructure facilities.

Despite production increases in tea and rubber, output in the plantation processing sub-sector declined for the second consecutive year due to a sharp drop in the coconut processing industry, which was affected by the lowest crop in the recent past. The diversification of tea production towards high value added products, reviewing and making corrective modifications to the existing plantations management system, depoliticising wage settlements in the plantation sector and a long-term tariff policy for import of substitutes for coconut products are critical in enhancing the future growth prospects in the plantation processing industry.

1 The Industrial sector is defined to include Mining and quarrying, Manufacturing, Construction and Electricity, gas, water and sanitary services.

Benefiting from the increased domestic demand stimulated by the improving consumer confidence with the ceasefire and economic recovery, expanding market access in the North and the East of the country, falling interest rates and revisions or reductions of excise duties, industrial categories producing mainly for the domestic market grew at relatively high rates in 2002. Many manufacturers improved their distribution networks in the North and the East by appointing new agents in those areas. Furthermore, marketing strategies such as aggressive advertising campaigns and improved packaging and distribution methods helped to expand the domestic demand for industrial products. However, manufacturers were not able to reap the full benefits of favourable developments in the domestic market because of issues and problems related to infrastructure facilities, labour markets and inefficient regulations.

Reflecting the flexibility to adjust to external shocks, the small industries sector recovered partially in 2002 growing at 0.9 per cent, compared with a drop of 3.5 per cent in 2001. Increased domestic demand and the recovery in tourism helped largely to turn around the growth rate in small industries. Despite a sharp increase in mineral exports by 15.9 per cent in volume terms, output in the mining and quarrying sector declined by 1.1 per cent due to weak derived demand from the construction industry. Value addition in the construction sector declined by 0.8 per cent in 2002, largely reflecting the delay in translating improved investor confidence into actual private investment activity, significant under utilisation in the government capital budget and delays in implementing major infrastructure development projects. Some restrictions imposed on environmental grounds, such as the ban on obtaining river sand without transitionary and alternative arrangements, also adversely affected the construction industry.

The severe energy crisis experienced in 2001 was resolved in 2002 with temporary measures and a series of corrective measures were taken to increase power generating capacity, and improve efficiency and profitability in the energy sector. However, existing inefficiencies, weaknesses and capacity inadequacy, together with energy demand growing at a faster rate than economic growth, clearly indicate the necessity of implementing the already initiated and identified major power projects and announced reforms, as well as the necessity for comprehensive reforms and a sharp capacity expansion programme to ensure an uninterrupted supply of energy, at a competitive price.

The power cuts imposed in July 2001 because of an acute shortage of power caused by limited capacity and low water levels in reservoirs continued into 2002. The power supply was fully restored in May with the corrective actions taken, such as the acquisition of 290 MW of short-term emergency power plants from the private sector and repairing of some power plants that were not in operation. Meanwhile, the water storage level, which was around 30 per cent at the beginning of the year dropped to 12 per cent by April 2002, but improved to 31 per cent in May and further to 62 per cent by the end of 2002. Consequently, power generation rose by 326 Gwh or 4.9 per cent to 6,951 Gwh in 2002, against a 3 per cent drop in the previous year.

The private sector largely contributed to this increase. Its share of electricity generation, including emergency power and self generation, rose to 35 per cent and hydro dependency fell to about 39 per cent, thereby reducing the vulnerability of the country to the weather. However, power generation from CEB owned plants dropped by 8 per cent as hydro-power generation dropped by 15 per cent to 2,589 Gwh, the lowest level since 1992. The dip in hydro-power generation compelled CEB to resort to expensive thermal power and emergency hired power to meet the demand, causing heavy financial losses (around Rs.7.5 billion) to CEB as the average power tariff (Rs.7.21 per unit) was below the average cost of electricity supplied by CEB (Rs.8.85 per unit). Consequently, banking credit to CEB rose to Rs.15 billion raising its debt burden sharply. This sharp financial deterioration of CEB took place despite substantial increases in the power tariff, on average of about 37 per cent in April 2002. This is the highest power tariff in the region [1]. This underlines the necessity for developing large scale and low cost power sources such as coal power plants in order to guarantee a reliable power supply, at competitive prices, while restoring the financial viability of the power sector and strengthening the country's external competitiveness. Further postponement of two low cost power generation projects selected for implementation, namely, the coal power plant and the Upper Kotmale hydro-power plant, for non-economic reasons, can only worsen the present critical situation in the power sector, leading to an economic crisis, if alternative power plants are not developed without any further delay.

Continuing recent trends, capacity in the power sector expanded only by 29 MW or 2 per cent to 1,930 MW in 2002 against an average annual increase in demand of around 8 per cent in the recent past. In the context of a desired future annual economic growth rate of over 6 per cent and expanding power intensity in the economy, demand for power will increase annually by over 10 per cent, requiring an annual expansion in installed power generating capacity of over 100 MW. Even though there were a number of projects planned to expand power capacity, only one major power generation project (i.e., the Kukule Ganga hydro plant) with a capacity of 70 MW, was in progress for targeted completion at end 2003. It is essential to strictly pursue a carefully drawn power expansion plan to meet increasing demand to achieve faster economic growth. Meanwhile, system losses of CEB continued to decline slowly, reaching 19.5 per cent in 2002. This still remains significantly high, indicating the need for aggressive corrective measures.

A series of reforms were initiated in 2002 for creating competitive energy markets and addressing the issue of supply

1 Average power tariff in US cents; Sri Lanka 7.5; Singapore 5.30, Malaysia 5.08, and Bangladesh 6.86.

shortages, capacity limits, poor quality, inefficiencies and irrational pricing policies. An Energy Supply Committee (ESC) was set up in early 2002 with a two year mandate to find immediate solutions to the existing power shortage. Though commendable action was taken to end power cuts successfully by May 2002, no steps have been taken to commence the implementation of the already identified major power projects. As past experience has clearly shown the colossal economic and social costs of power shortages, taking early effective action is critical for an aggressive power sector development programme. A new Electricity Reform Act was promulgated, enabling the restructuring of the power sector in the country with the objective of ensuring a stable and reliable power supply in the future. Under the envisaged reforms, changes are expected in both electricity and petroleum sectors. In the electricity sector, the main activities of the Ceylon Electricity Board (CEB) will be unbundled, while paving the way for a greater level of private sector participation, particularly in the areas of power generation and distribution. As the availability of a reliable and uninterrupted power supply has been indicated as one of the critical factors in determining private investment, it is necessary to accelerate the implementation of these reforms and major power projects.

The demand for petroleum products grew moderately by about 4 per cent in 2002, compared with the marginal contraction in 2001. The recent slowdown in the growth in demand for petroleum products despite the increasing dependence on thermal power generation, compared with the annual average growth rate of 12 per cent under the previously prevailing highly subsidised petroleum pricing regime, clearly demonstrates the compulsive economy in resource utilisation when prices are allowed to reflect their true market costs. Auto diesel consumption, which accounts for about 51 per cent of total domestic petroleum consumption, has slowed down its growth to 5 per cent since the removal of the heavy price subsidy, as against an annual average growth of 12 per cent recorded during the period 1990-1999, when diesel prices were heavily subsidised. In response to significant narrowing in the difference between diesel and petrol prices, petrol consumption increased by 14 per cent in 2002.

Petroleum prices in international markets fluctuated between US dollars 20 to US dollars 30 per barrel in 2002. The increasing threat of a war against Iraq and political turmoil in Venezuela, the fifth largest petroleum exporter in the world, which led to a cessation of oil exports from that country, were largely responsible for high oil prices. The average import price paid by Sri Lanka increased from US dollars 23 per barrel during the first half of the year to US dollars 27 per barrel during the second half, resulting in an annual average price of US dollars 25.13 per barrel. Domestic petroleum prices were adjusted in terms of the transparent automatic price adjustment formula, permitting a pass through of the fluctuations in international petroleum prices to the consumers. Under this pricing system, the financial condition of the Ceylon Petroleum Corporation (CPC) improved substantially in 2002 as it earned a profit of Rs.5 billion, thereby reducing its high bank credit to Rs.16 billion at end of the year. However, CPC was unable to reduce its accumulated debt burden resulting from previous losses, as envisaged, because the debt recovery component was dropped from the pricing formula from July 2002. The government's decision to withdraw this component was not accompanied by an alternative debt reduction plan. The automatic price adjustment mechanism for petroleum products needs to be continued without ad hoc interference, to ensure the commercial viability of the petroleum industry. Furthermore, the extension of an automatic price adjustment mechanism into the major industries/services using petroleum products as an input, such as thermal power and transport, is also critical to complete the passthrough process of petroleum price changes to the economy. Restructuring CPC and allowing more suppliers, as already announced by the government, are critical to improving efficiency, increasing quality and expanding the capacity through competition in the domestic petroleum industry.

In addition to the introduction of the automatic price adjustment system, several other initiatives have also been taken to restructure the petroleum industry and open it for competition. The liberalisation of the supply of bunker fuel in August with the privatisation of Lanka Marine Services Ltd. (LMS) was a major step in developing a competitive bunkering service, which is essential for developing Sri Lanka as a transshipment and air travel hub in the South Asian region. To open up petroleum product imports, storage and distribution to competition, the Petroleum Products (Special Provisions) Act No. 33 was enacted in 2002. The government reached an agreement with the Indian Oil Corporation (IOC) to import and distribute petroleum products in Sri Lanka. IOC has also agreed to lease oil tanks at Trincomalee for storage purposes. The government is planning to invite another petroleum supplier into the domestic market as a third player to enhance competition in the petroleum sector.

Despite a significant price increase, LP gas consumption rose by 11 per cent in 2002, reflecting the expanding consumer base specifically in urban and suburban areas due to its convenience and price advantage over alternative energy sources such as firewood and kerosene. Arrangements have been made to increase the number of players in the domestic LP gas industry from the present two, to further improve market competition and thereby to establish a competitive price system to benefit the consumers.

Measures have been taken to develop the necessary regulatory system, which is essential to ensure maximum benefits from the liberalisation of sectors providing public utilities. The enactment of the Public Utilities Commission (PUC) of Sri Lanka Act in October was a major step in this endeavour to develop a consistent national regulatory policy. PUC is initially expected to regulate the electricity and water sectors with provisions to add on other utilities such as petroleum, transportation, ports and civil aviation as the reform process progresses. The PUC system would enhance economies of regulation and reduce diseconomies of political interference.

The total volume of water supplied by the National Water Supply and Drainage Board (NWSDB) increased by 2 per cent to 350 million cubic metres, while the number of water connections increased by 62,388 or 9 per cent to reach 727,554. NWSDB operated 275 water supply schemes and continued its development activity upgrading and rehabilitating 82 projects during the year. However, NWSDB has been able to meet only a fraction of the existing demand for pipe borne water. This has been confirmed in recent surveys, which revealed that the proportion of households with access to safe drinking water was about 70 per cent, of which, only 35 per cent had access to pipe borne water. The demand for pipe borne water is continuously increasing with population growth, urbanisation, industrial expansion and commercialisation, as well as due to pollution and drying up of natural water sources. Meanwhile, existing customers are facing problems of low pressure, limited supply hours, frequent water cuts and quality concerns. Poor quality water supply heightens the risk of water borne diseases and other public health hazards, while an inadequate water supply acts as a barrier to faster economic growth.

The national water supply policy intends to address these issues and to ensure that all residents will have access to safe drinking water by 2010. Accordingly, NWSDB has targeted to expand water supply coverage to 80 per cent by 2005, while providing uninterrupted water supply to all customers. They also plan to reduce non-revenue earning water from the present high level of 31 per cent. In order to meet the higher estimated requirements, annual investments of about Rs.10-12 billion is required, compared with the planned annual average public investment of Rs.5 billion. There is a clear need for private sector to participate in the development of water supply. To finance the envisaged public investments, the government has to make every effort to mobilise concessional donor financing, given the tight fiscal situation and the small size of surpluses generated by NWDBS. For example, despite sharp increases in water tariff (i.e. from 12.5 to 87.5 per cent) and a reduction in non-revenue earning water supply from 35 per cent to 31 per cent in 2002, the operating profit was only Rs.112 million for the year, compared to Rs.389 million in 2001.

Services

The Service sector is the largest contributor to GDP, accounting for 54 per cent of output. The Service sector grew at 6 per cent in 2002, recovering strongly from a drop of 0.5 per cent in 2001. A continuation of the high growth momentum in telecommunications and financial services and faster recovery in trade, tourism and port services enabled this recovery. Reflecting the continuation of the high growth trend in the information and telecommunications industry, the sub-sector covering transport, storage and communication increased its annual growth rate to 7.7 per cent in 2002 from 3.8 per cent in 2001. The largest sub-sector, i.e., Wholesale and retail trade, turned around its growth rate to 5.5 per cent from a decline of 6.7 per cent in 2001, despite weak export demand, benefitting from increased opportunities coming out of the progress in the peace process. Recovery in imports and domestic trade enabled this achievement, as the value addition in export trade grew by only 2 per cent. Despite the continuing downward trend in lending rates during the year, the sub-sector covering Banking, insurance and real estate activity grew at 11 per cent in 2002 higher than any other of the sub sector in, benefitting from the economic recovery and an increased interest spread. The only sub-sector in services whose output did not increase in 2002 was Public administration and defence, which is actually a positive outcome. This reflects the effects of the government's determined efforts to prevent expansion in public sector employment, as a part of ongoing fiscal consolidation efforts, and the benefits from the peace process in containing defence expenditure.

The telecommunications sub sector recorded a growth rate of 19 per cent in 2002 continuing its double digit growth path. This high growth was made possible by the expansion in capacity, introduction of new services/facilities, improvements in quality of services, increases in consumer choices, competitive prices and aggressive advertising campaigns. Although expansion in the fixed access telephone network was limited to 7 per cent due to the non-availability of new capacity expanding projects, the mobile telephone network expanded by 36 per cent. Reforms and policy measures introduced in 2002 would further strengthen the growth prospects of this sector under a competitive market environment. The entire telecommunications sector became open to competition with the end of the monopoly status enjoyed by Sri Lanka Telecom (SLT) for international voice services and wire line operations in August 2002. The government took action to license additional external gateway operators with a view to increasing competition and expanding capacity. Similarly, to establish a fair tariff system, a decision was taken to move for a Calling Party Pays (CPP) System from July 2003. SLT became a listed company on the Colombo Stock Exchange (CSE) with the issue of 12 per cent of its share capital at an initial offer for sale in November 2002, increasing the private sector share holding and expanding access to new capital avenues. Concurrently, the Telecommunications Regulatory Commission of Sri Lanka (TRCSL) brought forward a new telecommunications policy with a view to strengthening competition and regulation. Meanwhile, SLT continued its tariff re-balancing process, reducing the relatively high cost to large users and for international calls. The stagnation in outgoing telecom traffic, as incoming traffic increased by 19 per cent, indicates the need for improving the external competitiveness of the telecom industry. The effective implementation of the reforms and measures would further augment the growth potential of the sector, enabling it to satisfy still unmet demand. The low telephone density (9.5 per 100 people including cellular phones), Internet and e-mail access (3.7 per 1,000 people) and international direct dialling (IDD) facilities (4.7 per 1,000 people) clearly indicate potential demand for future expansion.

Some attempts were made to improve postal services by expanding the use of information technology and providing new services. However, the major problems and issues continued to remain, burdening the already worrisome fiscal deficit and undermining faster growth in postal services. The continuing high operational losses and poor quality services clearly indicate a need for fundamental reforms, including expenditure rationalisation, a rational pricing mechanism, introduction of new services based on modern information and communication technology and competition through public-private partnership arrangements. It is important to identify the strengths and weaknesses of the existing island-wide postal network. The postal system has one of the largest networks of service delivery systems, spreading even into remote areas in the island. It includes more than 4,600 post offices, i.e., on average, a post office for every 14.2 sq.km. or for 4,102 people, with close personal contacts with the public. However, this capacity has not been utilised effectively yet, as necessary reforms and changes have been delayed. It is important that the postal authorities take a forward view of the future of the postal services in the light of the development and spread of faster and cheaper communication systems in the future, requiring new approaches to providing postal services. This calls for early action to restructure the postal service system. A forward looking corporate plan is, therefore, a must for the postal services to maintain its usefulness in a future world. The acceleration of postal reforms would, therefore, not only enable the utilisation of the existing network more effectively, but also help it to continue to make its contribution to economic and social development in a completely different future world.

Overall performance in road and rail transportation improved marginally in 2002, while air and sea transportation recovered strongly from the setback following the terrorist attacks of July and September in 2001. Although the number of buses operated by the private sector increased, the average number of buses operated daily declined in 2002 due to reduced operations of buses under Regional Transport Companies (RTC). Under-utilisation of the existing bus fleet, as reflected in the low average running distance of 132 kilometres per bus per day in the case of the private sector, and the increasing inadequacies in service experienced by passengers indicate existing weaknesses in the road passenger transport system. The quality of service remains poor. Private bus operations come under frequent and strong public criticism, mainly because of careless driving, unruly behaviour of crews, use of technically unfit vehicles and violation of traffic rules and regulations. The deteriorating railway infrastructure has led to increasing derailments (104), locomotive failures (543), and significant delays, not only resulting in losses to Sri Lanka Railways (SLR), but also imposing a heavy cost on the whole economy through reduced effective working hours. RTCs and SLR made operational losses of about Rs.4 billion, resulting in a heavy fiscal burden. Some corrective measures were taken in 2002. These included the introduction of the long awaited formula based bus fare policy, steps to encourage public-private partnership, the privatisation programme of RTCs and proposals to establish a Road Fund. However, comprehensive reforms in the passenger transport system and accelerated implementation of the development of the road network in the country, including the already identified highways, are crucial to developing an efficient and dynamic transport sector, which is necessary to achieve high economic growth.

Port activities recovered strongly in 2002 reversing the setback in 2001. The removal of the war risk surcharge (WRS) in March 2002, improved efficiency and productivity in the Colombo Port in a competitive environment and recovery in the external trade of the country contributed to this recovery. Arrivals of ships at the Colombo Port increased by 6 per cent to 3,787 during the year, while container handling expanded by 2 per cent to 1.8 million of TEUs, the highest level ever handled. Improved productivity, such as an increase in gantry crane movements per hour and a reduction in the delay in berthing, encouraged more ships to arrive in Colombo. Productivity improvements in Sri Lanka Ports Authority (SLPA), the public sector enterprise, brought it close to the levels of South Asia Gateway Terminals Pvt. (SAGT), a private sector company with an international partnership. This was the result of a major reform programme providing new work incentives, a voluntary retirement scheme and an aggressive marketing campaign by SLPA. Looking forward, further improvement in productivity and capacity expansion, including the proposed port in Hambantota and by further development of the port in Trincomalee, are essential to harness the full benefits of the strategic location of Sri Lanka on one of the main international sea routes.

Civil aviation activity recovered gradually with the recommencement of operations by airlines which moved away following the terrorist attack in July 2001. There were 32 airlines, including 3 domestic airlines, operating in 2002 compared with 27 at end 2001. The number of passengers passing through the Katunayake International Airport rose by 6 per cent to 2.9 million in 2002. The strategic location of the country and expanding market potential in international air travel indicate that the civil aviation industry has vast potential to expand and increase substantially its contribution to economic growth. Air cargo handling is also an important area to expand in the future, with faster economic growth in the

Asian region. However, productivity improvements and capacity expansion, ideally with a second international airport, are necessary to harness this potential. A noteworthy achievement in 2002 was the enactment of the Civil Aviation Authority of Sri Lanka Act and the subsequent establishment of the Civil Aviation Authority of Sri Lanka (CAASL) replacing the Department of Civil Aviation, enabling it to make commercial decisions more independently.

The Wholesale and retail trade services sector, which contributed about 21 per cent to overall growth in GDP in 2002, turned around from a contraction of 6.7 per cent in 2001 to grow at 5.5 per cent in 2002. Recovery in both domestic and external trade contributed to this growth. . Imports expanded at a faster rate than exports with increasing domestic demand following the ceasefire agreement and the reduction in the surcharge on import duty from 40 to 20 per cent in April. The ongoing peace initiative provided an impetus to the domestic and import trade services. However, because of the weak recovery in export demand, value addition in export services recovered in 2002 by only about one fourth of its drop in 2001. Value added in domestic trade continued to increase with expansion of packaging and improvements in trading facilities.

Financial services expanded with the economic recovery and improved business confidence, and grew at 11 per cent in 2002 compared with 7.9 per cent in the previous year. Increased business activity, wider interest rate margins, recovery in the Colombo Stock Exchange, the expansion of insurance and leasing activities, and developments in the domestic debt market contributed to growth in the financial services sector. A strengthening of financial sector stability, reforms to the legal framework to be compatible with developments in financial markets, increased competition, introduction of new products and services, extension of business hours and improved commercial court facilities are essential to raise the future growth prospects in the financial services sector. Some steps have been taken to improve the legal framework, the regulatory and supervisory systems and reforms in public sector financial institutions, to create an environment more conducive to faster growth in financial services.

The tourist industry, which is highly sensitive to external shocks, recovered strongly in 2002. Tourist arrivals, which declined by 15.9 per cent in 2001 and 24 per cent in the first half of 2002, recovered in the second half to grow at 101 per cent. This remarkable growth, of course was on a lower base in the second half of 2001. The major factors that contributed to this recovery were the improved security situation following the ceasefire agreement, the consequent relaxation of both travel advisories and travel warnings by many countries against travel to Sri Lanka, the acceptance of Sri Lanka as an official tourist destination by China, removal of the war risk surcharge, and an aggressive marketing campaign with attractive packages offered by the tourist industry in collaboration with the Tourist Board in the aftermath of the terrorist attack in July 2001. The expansion of tourist destinations to the Eastern coast and longer stay by tourists, enhanced the benefits of the recovery in tourism. Nevertheless, there was a significant change in the composition of tourist arrivals. Even though Western Europe accounted for the largest share (51 per cent) of arrivals in 2002, its share declined from (61 per cent) 2001. This was due to a 2 per cent decline in arrivals from Western Europe. However, increased arrivals from the other regions, particularly from Asia and the Middle East, were more than sufficient to cover this decline. The largest increase in tourist arrivals (i.e., 106 per cent) was from India. A serious bottleneck developed in 2002 as seating capacity became scarce with the limited number of airlines coming to Sri Lanka. The government has already taken an initiative to sign agreements with seven countries to increase flying frequency to resolve this issue as soon as possible. Prospects for growth in the tourist industry seem bright given the potential of the country, including the expansion in eco-tourism and culture tourism, if the peace process continues. Acceptance of Sri Lanka as an official destination by the Chinese government enables the industry to launch official promotion campaigns in China, which is the fastest growing large economy in the world today. It may be also helpful to request Russia to include Sri Lanka in their official destinations list. Continuing the promotion of tourism under bilateral and regional co-operation would further increase and diversify tourist arrivals.

Activities in education and health services expanded in 2002, particularly with increasing private sector participation, while sectoral reforms continued, albeit at a very slow pace. The total number of government hospitals increased by 20 to 605 and private hospitals by 15 to 175 in 2002 respectively. Foreign investment entered the expanding health services in Sri Lanka with the establishment of a branch of a reputed foreign hospital with modern equipment and high quality facilities. The medical staff in the country increased further in 2002, but the severe shortage of qualified nurses and para medical staff continued. Consequently, the newly established private hospital had to recruit some of its staff from India. Despite the country's high literacy rate, the persistent shortages of key medical personnel clearly demonstrate the inadequate capacity of the public sector to provide sufficient specialised training facilities and hence, underscores the need for permitting the private sector to enter the field with an adequate regulatory system to maintain the required standards.

Public health services have been deteriorating quantitatively and qualitatively due to limitations in available resources. Meanwhile, the private sector has been aggressively expanding the supply of curative health services, satisfying demand unmet in the public sector. Currently, over 50 per cent of curative health care services is provided in the private sector. But the private sector has not shown interest in expanding preventive health care facilities. As the potential national benefits from preventive health care are higher than from curative health, it is time for policy makers to reconsider priorities in determining resource allocation in the public sector. The resurgence of communicable diseases such as malaria and dengue fever also reemphasises the necessity for expanding preventive health care facilities. Therefore, a greater involvement of the public health sector in the provision of preventive health care services with adequate attention to the health needs of vulnerable groups, would be useful, while encouraging the private sector to provide curative health care services. As shown by a recent study, a large part of health expenditure is still paid for by the government (48 per cent) and households (46 per cent). Private health insurance schemes covered only about 1 per cent of total expenditure and the balance 5 per cent was paid by employers and other organisations. Encouraging the promotion of private health insurance systems and social insurance would help expand private sector health facilities.

The public sector continued to be the major supplier of education at all three levels, i.e., primary, secondary and tertiary, accounting for about 96 per cent of school students. However, the number of public schools, as well as students in them, further declined in 2002. During the year, 65 government schools had to be closed due to a lack of sufficient students to operate them on a cost-effective and efficient basis. It would be a waste of the scarce resources of the country to continue to run such schools which cannot attract a sufficient number of students. Hence, the appropriate policy would be to amalgamate such schools with larger schools in the neighbouring areas as a measure to pool resources for greater efficiency. Similarly, the student population in government schools declined by 4 per cent, continuing the recent downward trend, which reflects both a drop in the school going age population and an increase in enrolment in private and international schools. The school density at one school per 7 sq. km. and a pupil/teach ratio at 21 indicate the availability of adequate educational facilities and a wide dispersion over the island. However, the deteriorating quality of the public school education has drawn much attention in the recent past. Several programmes were implemented in 2002 to improve the quality of education. In order to strengthen school management, School Boards were established under a School Based Management (SBM) System by involving both teachers and parents. Zonal Monitoring Boards were established to solve the implementation problems within Zones. Teacher training activities continued. More equipment and other facilities were provided to schools. These activities were supported by concessional donor assistance.

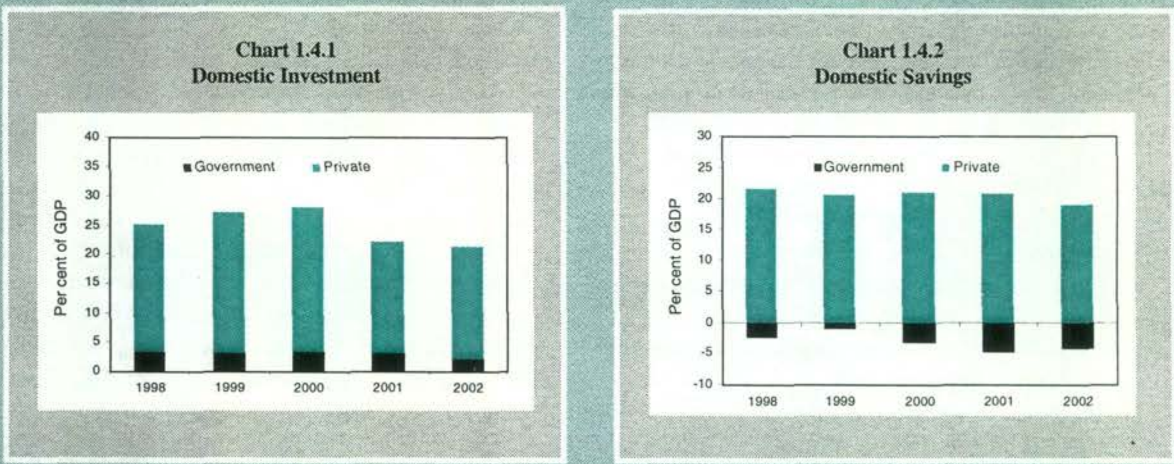
The number of admissions to universities excluding the open university, increased by 2 per cent to 12,144 in 2002. However, only 13 per cent of the total number of students qualifying for admission to universities were able to secure places in universities. This is mainly due to the continued public sector monopoly in the university education system, despite the pressure from both parents and the community for standard private sector based universities. Other countries in the region such as Singapore and Malaysia were successful in building a high quality private university system accredited to reputed seats of learning in developed countries. Despite continuing efforts to improve university education, as well as technical education and vocational training, concerns remain high about the quality of tertiary education. The government's recent policy framework document, i.e., Regaining Sri Lanka: Vision and Strategy for Accelerated Development, highlights a number of constraints in the present educational system and the need for urgent reforms to address them. These constraints have been identified as quality constraints, institutional constraints, language constraints and tertiary education constraints. The recently issued labour market policy document has also emphasised the necessity for reforms in the education sector with a view to developing Sri Lanka as a centre for providing high quality services in South Asia. The continuing high structural unemployment among educated youth, deteriorating social conditions and growing youth unrest, even among school students, clearly demonstrate the need for bold reforms without further delay. Given the tight fiscal situation and the increasing demand for high quality education, opening education services, particularly tertiary education, to the private sector, while continuing the public education system in a competitive market environment, has to be a major component in educational reforms.

1.4 Consumption, Savings and Investment

On the expenditure side, consumption expenditure at constant prices (1996) grew faster (7.5 per cent) than investment (3.1 per cent), raising the share of consumption in total expenditure to 80.1 per cent in 2002 from 79.4 per cent in 2001. This was entirely accounted for by an increase in private consumption, which accounted for about 90 per cent of total consumption as government consumption expenditure in terms of GDP declined by 0.8 percentage points with successful fiscal consolidation. Increased consumer confidence with the economic recovery and satisfying of pent up demand in the North and the East with the progress in the peace process were the major contributory factors. Improved security and transport facilities in the areas, which were not under the control of the government, helped the distribution of goods and services in those areas. On the purpose-wise classification, expenditure on durable consumer goods grew faster than the other consumer expenditure categories, largely reflecting the impact of the release of the pent up demand in war affected areas. Similarly, domestic tourism rose sharply following the signing of the ceasefire, further stimulating private consumption.

The national savings/GDP ratio, which declined from 21.5 per cent in 2000 to 20.3 per cent in 2001 declined further to 19.7 per cent in 2002. This decline was entirely due to a decline in private savings as a percentage of GDP by 1.7 percentage points to 19 per cent. Government dis-savings fell by 0.6 per cent of GDP in 2002. The domestic savings/GDP

Chart 1.4
Investment and Savings



ratio dropped by 1.2 percentage point to 14.6 per cent. However, an increase in foreign savings by 0.5 per cent of GDP, reflecting higher net foreign private transfers, contained the decline in the national savings/GDP ratio to 0.6 percentage points. The declining trend in the savings/GDP ratio should be reversed and increased to over 25 per cent to ensure the availability of domestic resources adequately to accelerate economic growth.

Gross domestic capital formation at constant prices (1996), which declined sharply by 17.5 per cent in 2001, improved by 3.1 per cent in 2002, although yet below expectations. The drop in investment below expectations was reflected in the moderate increases in the private sector initial public offerings (IPOs) in the capital market and lending by development financial institutions (DFIs). The increase in investment was solely due to higher investment by the private sector as government investment declined even in nominal terms by Rs. 10.4 billion in 2002. On a sectoral basis, relatively large increases were recorded in transport sector investment, in response to increased demand for trade and transport with the improving security situation.

The investment/GDP ratio declined to 21.3 per cent of GDP in 2002 from 22 per cent in 2001, reflecting slower expansion in investment than the GDP growth. This low investment ratio, which was lower than the average value of 25.4 per cent of GDP recorded during the last five years (1997-2001), was far below the investment of about over 30 per cent of GDP required to achieve a desirable annual growth of over 8 per cent. Therefore, an aggressive investment programme and improvements in the quality of investment are necessary to achieving higher economic growth.

Reflecting the faster reduction in the domestic savings/GDP ratio than investment/GDP, the savings investment gap as a ratio of GDP rose to 6.7 per cent in 2002 from 6.2 per cent in 2001, increasing the dependence on foreign savings to cover the existing low investment/GDP. Furthermore, a continuous savings-investment gap is reflected in persistent external sector current account deficits, which vary largely with the trade deficit. Therefore, more private savings and a turnaround in dissavings in the public savings are necessary to raise the availability of domestic savings. The acceleration of pension reforms allowing private sector involvement in pension fund management to ensure availability of market rates of returns to contributors and developing a pension regulatory system are critical to facilitate growth in long-term savings. Similarly, reforms in the financial system are necessary to improve domestic savings mobilisation. Continuing large intermediation costs in the financial system of over 4 per cent points discourage expansion of savings as well as investment, adversely affecting economic growth.[1] Financial sector reforms have to be accelerated to reduce high intermediation costs by strengthening stability, raising efficiency and improving competition in the financial system of the country.

Total resource availability in the economy valued at constant prices (1996), consisting of GDP (domestic resources) and import of goods and non-factor services (foreign resources) grew by 6.3 per cent in 2002 compared with a decline of 4.3 per cent in 2001. Both the recovery in domestic growth (4 per cent) and a sharp increase in imports and non-factor services (11.2 per cent) contributed to this turnaround in resource availability in 2002. On the resource utilisation side, consumption recorded the highest growth of

1 Comparable intermediation costs: India (2.8 per cent), Malaysia (3.3 per cent), Thailand (1.4 per cent), Korea (2.6 per cent), Singapore (2.3 per cent), Hong Kong (2 per cent).

7.5 per cent, followed by exports of goods and non-factors services by 5.6 per cent and investment 3.1 per cent. Given the limits in domestic demand in a small island economy, major emphasis has to be placed on export expansion to accelerate economic growth.

1.5 Prices

Despite increases in administered prices of a number of goods and services, inflation, even though still high, declined throughout 2002, reflecting the impact of a tight monetary policy stance on the demand side and improved domestic supply conditions, deceleration in exchange rate depreciation and declines in import prices on the supply side. The tight demand management policies pursued by the Central Bank since the second half of 2000, resulting in high positive real interest rates, were successful in checking the excess growth in the nominal demand and hence containing upward pressures on the general price level. On the supply side, increased domestic agricultural and fish production, benefiting from favourable weather conditions, implementation of the ceasefire and consequent relaxation of transport barriers, reduced the pressure on domestic consumer prices. The slower depreciation of the rupee on a trade weighted average nominal exchange rate basis, from 9.8 per cent in 2001 to 7.3 per cent in 2002, helped to contain price increases in imported goods as well as exportable domestic products. Because of weak commodity prices in international markets, prices of major imported consumer products declined by 13 per cent in contrast to a 4 per cent increase in 2001, reducing imported inflationary pressure in the economy. The reduction of the surcharge on imports from 40 to 20 per cent in April and the removal of the War Risk Surcharge in March also helped contain price increases for imported goods. Finally, upward pressure on prices was neutralised by restraining increases in nominal wages in excess of growth in productivity.

However, inflation remained high in 2002. The drop in the inflation rate was slowed down by increases in administered prices and low productivity in domestic production. Administered prices of kerosene (38 per cent), diesel (13 per cent), electricity tariffs (37 per cent on average), water tariffs (over 25 per cent), private bus fares (15 per cent), postal stamps (29 per cent) and cigarettes (7 per cent) rose in 2002. Similarly, the removal of the subsidy raised domestic wheat flour prices, while the fixing of the fertiliser subsidy affected the cost of agricultural production. Even though these administered price increases exerted upward pressure on the aggregate price level in 2002, they have only a one-time effect and bring other long-term economic benefits, which help to achieve price stability in the long run. The temporary inflationary pressures caused mainly by these administered price increases prompted the government to provide some relief measures in July 2002. These included a decision to exclude the imposition of the Value Added Tax (VAT) on a selected list of consumer items and on pharmaceutical products. They also included a reversal of pricing policy with regard to the loss recovery charges on petroleum products. Although these measures may have marginally reduced upward pressures on prices in the short term, their long-term macroeconomic effect may be to build up inflationary pressure in the economy. Targeted income transfers to vulnerable groups to relieve temporary pressures from structural reforms are preferable to ad hoc tax adjustments, as they would not adversely affect resource allocation efficiency and long-term price stability. Increased incomes consequent on the economic recovery and a strong growth in tourist arrivals also worked against a faster deceleration in inflation in the short run through their impact on aggregate demand. However, their other direct and indirect effects on the macroeconomic system as a whole could have downward pressure on price increases.

All measures of aggregate price changes showed lower price increases, in a range of 7 to 11 per cent in 2002, depending on the price index, (6 to 9 per cent when the direct impact of administered price increases is removed), in comparison to a range of 10 to 14 per cent (10 to 14 per cent adjusted for administered price increases) observed in 2001. The Sri Lanka Consumers' Price Index (SLCPI), the new index with recent weights and broader geographical and income group coverage, registered an annual average increase of 10.2 per cent in 2002 compared with an increase of 12.1 per cent in 2001. The Colombo Consumers' Price Index (CCPI), the official price index for consumer price inflation[1], covering a consumption basket of low-income households in the Colombo Municipal area, registered a faster reduction with its annual average increase declining from 14.2 per cent in 2001 to 9.6 per cent in 2002. The annual average increase in the Greater Colombo Consumers' Price Index (GCPI), which has a broader geographical coverage than the CCPI, declined marginally from 11 per cent in 2001 to 10.6 per cent in 2002. The Colombo District Consumer Price Index (CDCPI), which has a wider coverage than even the GCPI, recorded the lowest annual average increase of 6.8 per cent in 2002, declining from 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) recorded a similar trend, increasing by 10.7 per cent in 2002 compared with 11.7 per cent in 2001. The GDP deflator, the broadest measure of all price indices, covering all economic sectors, rose by 8.3 per cent in 2002 compared with 12.4 per cent in the previous year. All major sub indices also recorded a similar deceleration in price increases in 2002. The major sub indices of food, fuel and light, and transport decelerated faster, while only some categories such as personal care and medicine, which have smaller weights, registered faster increases in 2002, than in 2001.

The food sub-category, which has the largest weight (over 59 per cent) in all consumer price indices, contributed to

1 SLCPI will be the official price index after April 2003.

about 80 per cent of the overall increase in the aggregate price level in 2002. The fuel and light, and the miscellaneous sub-categories accounted for about 7 and 11 per cent of the increase in the aggregate price index, respectively. The contribution from the clothing sub-category to overall price increase was low at 1 per cent, reflecting stable import prices and increased supply to the domestic market by producers due to weak export demand.

1.6 Wages

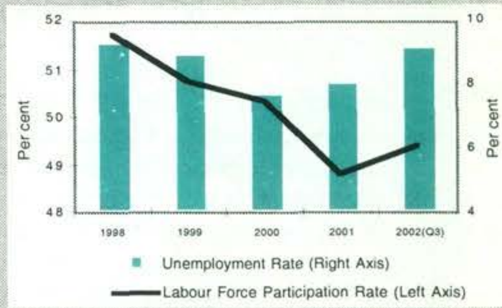
In 2002, there were no general wage increases in the public sector or in the formal private sector coming under the Wages Boards, except an increase in the daily wage for workers in the plantation sector in July. However, the overall annual wage rate index for government employees rose in 2002 by 16 per cent, reflecting the impact of public sector wage increases of between 19 – 24 per cent in October 2001. This followed an annual increase of 21 per cent in 2001. Public sector real wages, defined as nominal wages adjusted for increases in the consumer price index, rose sharply by 5.9 per cent in 2001 followed by another 6.4 per cent rise in 2002.

The extremely tight fiscal situation did not provide any fiscal space for a further wage increase in the public sector in 2002. Government's determined efforts to resist ad hoc wage increases helped the ongoing fiscal consolidation process, containing unsustainable increases in government's total wage bill. That wage bill rose by 17 per cent in 2000, 14 per cent in 2001 and by another 13 per cent in 2002, even without any wage increase during the year. During the five year period from 1998 – 2002, the wage index for government employees rose by 68 per cent, more than twice the increase of 37 per cent in wages under the Wages Boards.

Nominal annual average wages in the formal private sector also increased in 2002, even though there was only one wage increase recorded under the Wages Boards during the year, reflecting the impact of wage increases granted during the second half of 2001. The wage index covering all Wages Boards rose by 7.4 per cent in 2002, compared with 4.9 per cent in 2001. Among the sub-sectors, the highest increase in 2002 was 7.9 per cent in the agriculture sector, followed by 7.3 per cent in industry and commerce and 3.1 per cent in services, which recorded a very high increase of 17.5 per cent in 2001. In contrast to the experience of public sector employees, workers in the private sector governed by the Wages Boards suffered real wage losses ranging from 2 per cent to 6 per cent in 2002. However, it is important to note that most of the private sector industries have been granting increasing amounts of incentive payments based on productivity related indicators, and that such payments are not represented in the minimum wage indices. Consequently, the deterioration of real wages in the private sector may be not be as high as reflected by estimates based on minimum wage indices.

Wages in the informal sector covering a large number of daily paid workers are mainly determined by demand and supply forces in the market. In 2002, wages in the informal sector rose by 4-16 per cent, resulting in a mixed impact on real wages. Increases in the nominal daily wages in the construction sector were 8 to 9 per cent, a marginal deterioration in real terms in 2002. In the agricultural sector, nominal wage increases were between 4 to 16 per cent. The highest nominal wage increase was in the rubber tapping category, reflecting the increased demand for labour and an ability to offer higher wages in the sector because of higher rubber prices. In the paddy sector, increases ranged from 9 to 10 per cent, marginally improving the real wages.

Chart 1.5
Labour Force Participation and Unemployment Rate



As emphasised in the previous issues of the Central Bank Annual Report and the recently issued draft National Employment Policy – 2002 by the government, every effort has to be made to base wage adjustments on increases in productivity in order to prevent the vicious circle of wage-price-wage increases.

1.7 Population, Labour Force and Employment

The mid-year population in 2002 is estimated to be 19 million, an increase of 1.5 per cent compared with a 1.4 per cent increase in 2001. This marginally higher increase in the rate of growth could be due to a significant number of returnees who had fled the country on account of civil disturbances. The average annual population increase in Sri Lanka has been well below that of most countries in the South Asian region in the recent past due to the demographic transition, successful family planning, high literacy rates and improvements in other socio-economic conditions. Nevertheless, a net addition of about 300,000 persons annually to the existing population in the country continues to impose a burden on its resources. Therefore, a further reduction in population expansion is desirable, while giving due attention to the age structure too, as a faster growing ageing population share could lead to complex economic issues. Provisional district-wise estimates indicate a significant increase in internal migration as annual population increased significantly in Jaffna, Kilinochchi, Mulaitivu, Batticaloa and Trincomalee, while population decreased noticeably in Mannar and Vauniya.

In 2002, the labour market showed a mixed performance, reflecting the lagged impact of the economic contraction experienced in the previous year. Progress was made to complete a number of important amendments to labour laws (see Box 13). The labour force participation rate and available job opportunities increased with the progress in the peace process over the year but unemployment rose as the recovery in the economy and investment expansion were lower than required to fully absorb the new additions to the labour force.

According to the Quarterly Labour Force Survey (QLFS) conducted by the Department of Census and Statistics (DCS), the labour force at the end of the third quarter of 2002 (Q3/2002) was estimated at 7.1 million, an increase of 4.8 per cent over the third quarter of 2001 (Q3/2001). The labour force participation rate rose from 48.3 per cent to 49.4 per cent during the same period, reflecting increases in both male and female participation rates. However, the labour force participation rate peaked at 51.7 per cent in the first quarter of 2002 (Q1/2002), reflecting a high female participation rate during a successful Maha harvest.

The estimated total number of employees rose from 6.3 million at end 2001 to 6.4 million in Q3/2002, an increase of 117,000 jobs or 1.9 per cent during a 9 month period. The recovery in agriculture and services increased their relative shares in total employment in 2002. However, the share of employment in the industrial sector declined because of weak performance in export oriented industries and the construction sector. Trade and hotel service sectors recorded the largest increase in employment, benefitting from expanding trading activity and recovery in tourism. The share of employed persons in the labour force declined from 92.2 per cent in Q3/2001 to 90.9 per cent in Q3/2002 indicating that the number of new jobs created in the economy was less than the number of net additions to the labour force. Consequently, the unemployment rate increased in 2002 and remained at 9.1 per cent in Q3/2002 compared with 7.8 per cent in Q3/2001. Unemployment continued to be high among youth with higher education, reflecting the existing mismatch in the labour market. It pointed to the need for urgent reforms in education and training.

Employment in the public sector declined by 0.9 per cent to 1.09 million at end 2002. This was the combined outcome of a 0.5 per cent increase in the government sector and a 5.2 per cent reduction in the semi-government sector. This was an outcome of the government's decision to freeze the recruitment to the public sector unless there was a clear and strong justification for recruitment. The large reduction in employment in the semi-government sector was due to privatisation, successful voluntary retirement schemes (VRS), laying off unproductive casual workers employed on an ad hoc basis and retirement without extension after 55 years of age. Successful VRS schemes were offered by the Central Bank of Sri Lanka and Salu Sala. Meanwhile, SLPA, CPC and the Co-operative Wholesale Establishment (CWE) reduced mainly their unproductive casual employees, while People's Bank strictly adhered to the official retirement age. Continuation of these measures is critical in moving the civil service reforms forward.

Foreign employment placements rose by about 20,000 (11 per cent) to about 204,000 in 2002, recording the highest annual increase in the recent past. Increased demand, normalisation of air travel facilities and aggressive promotional campaigns undertaken by government institutions and private licensed agents contributed to this increase. The relative share of females remained high (65 per cent), while housemaids continued to be the largest category, accounting for 53 per cent of all placements. Steps were taken to provide training to prospective employees with a view to improving the competitiveness of Sri Lankan workers. Similarly, measures were initiated to resolve numerous difficulties faced by people going abroad for employment.

On the policy front, a number of major steps were taken to address some long standing labour market issues. The Factory Ordinance of 1942 was amended in August raising the number of overtime hours from 100 hours per annum to 60 hours per month for female employees. The Industrial Disputes Act of 1950 and the Termination of Employment Act of 1971 were amended in January 2003, specifying time periods for dispute settlement and enabling the commencement of a clear compensation formula for terminated workers. The Employment of Women, Young Persons and Children Act of 1956 was amended, increasing penalties for employers violating the conditions set out in the Act. The Ministry of Labour and Employment (MLE) prepared the Draft National Employment Policy – 2002 to harness the educated unemployed youth not only for the domestic labour market, but also for the international labour market, by providing them with appropriate training with the support of the private sector. The government has initiated the proposed Youth Corps to provide employment oriented training programmes. Steps were taken to expedite the implementation of the 'Tharuna Aruna' programme to resolve the graduate unemployment problem. Meanwhile, the MLE took steps to establish employment service outlets throughout the country to provide information. The MLE worked with the Sri Lanka Bureau of Foreign Employment and the private sector to broaden training facilities for migrant workers. Similarly, discussions were initiated with other countries to improve the protection of migrant workers and to help them in resolving their problems. Thus, the government's policy direction is to provide facilities for and encourage training activities, enable workers to obtain private sector employment with high incomes, rather than attempting to absorb them into the public sector, which cannot be done without raising the fiscal burden and causing a deterioration in productivity in the economy.

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

Item	1980	1985	1990	1995	2000	2001	2002(a)
1 Revenue	19.6	22.3	21.1	20.4	16.8	16.7	16.5
2 Expenditure and net lending	41.8	34.1	31	30.5	26.7	27.5	25.4
2.1 Current expenditure	18.5	20.1	22.3	23.1	20.2	21.6	20.8
Security	1.3	4.5	4.1	6.5	5.6	4.8	4.0
Interest	3.4	4.6	6.4	5.7	5.7	6.7	7.4
Wages (b)	4.5	3.6	3.9	3.4	3.2	3.4	3.4
Subsidies and transfers	8.4	5.5	6.5	6.1	4.2	4.6	4.7
Others	0.9	1.9	1.4	1.4	1.6	2.1	1.3
2.2 Capital and net lending	23.3	13.9	8.7	7.4	6.5	5.9	4.5
Public investment	18.5	13.8	8.3	7.9	6.4	5.9	4.6
Aquisition of real assets	7.9	4.5	3.7	3.4	2.6	2.6	1.7
Capital transfers	9.4	8.6	2.3	2.9	2.8	2.3	2.0
On lending	1.2	0.6	2.2	1.7	1.0	1.0	0.9
Other	4.7	0.2	0.4	-0.5	0.1	....	....
Restructuring cost	0.0	0.0	0.0	0.5	0.3	0.4	0.3
Others	4.7	0.2	0.4	-1.0	-0.2	-0.3	-0.3
3 Current account balance	1.1	2.2	-1.2	-2.7	-3.4	-4.9	-4.4
4 Overall deficit before grants and excluding privatisation	-22.2	-11.7	-9.9	-10.1	-9.9	-10.8	-8.9
5 Financing	22.2	11.7	9.9	10.1	9.9	10.8	8.9
5.1 Foreign financing	9.2	6.4	5.7	4.5	0.4	1.4	0.5
Loans	5.3	4.4	3.6	3.2	0.0	1.0	0.1
Grants	3.9	2.0	2.1	1.4	0.4	0.4	0.4
5.2 Domestic financing	13.0	5.3	4.2	5.1	9.4	8.8	8.0
Banks	9.8	2.9	0.1	1.1	4.5	3.5	-0.3
5.3 Privatisation	0.0	0.0	0.0	0.4	...	0.6	0.4
6. Public Debt	77.6	80.2	96.6	95.5	96.9	103.2	105.1
6.1 Domestic	44.2	38.6	41.6	43.2	53.8	58.0	59.8
6.2 Foreign	33.5	41.7	55.0	52.3	43.1	45.3	45.3
Memorandum items :							
Total wage bill	5.0	4.2	4.9	5.2	5.5	5.5	5.6
Gross defence expenditure (c)	1.3	4.5	4.1	6.5	6.1	5.5	4.9

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

Source: Ministry of Finance
Central Bank of Sri Lanka

1.8 Fiscal Policy, Budgetary Operations and Public Debt

The fiscal policy strategy in 2002 aimed to achieve fiscal consolidation compatible with medium-term fiscal sustainability, strengthen fiscal policy credibility and stimulate economic growth by encouraging private sector initiatives, with the government playing mainly the role of a facilitator in the development process. Within this broad framework, the policies in Budget 2002 were formulated based on well-structured fiscal measures for ensuring fiscal consolidation to attain fiscal sustainability supporting macroeconomic stability, strengthen policy implementation to minimise fiscal deviations, create an environment conducive to reviving investor confidence, remove bureaucratic and regulatory constraints to attract investment and accelerate structural reforms and improve efficiency in resource allocation and productivity growth. Despite internal and external difficulties, there were significant improvements achieved, albeit with some slippages, which supported economic recovery, improved investor confidence, reduced macroeconomic imbalances and laid a foundation for a medium-term fiscal sustainability path. Strong policy commitments by the government, effective implementation and progress in the peace process under the ceasefire agreement were the major factors that made possible these achievements.

The reduction of the public sector deficit has become a major policy objective, as weak fiscal performance, including activities of the public enterprises, has been the principal cause of many of the economic ills in the recent past. On the fiscal front, persistently high budget deficits, financed largely by domestic borrowing, high current expenditure, sluggish revenue collection, under-utilisation of concessional foreign assistance, significant shortfalls in realisation of privatisation proceeds, and rising public debt were the major reasons for the deterioration in fiscal sector performance during the last few years. Continuing massive losses resulting from inefficiency, irrational pricing, high debt burden, overstaffing and delays in reforms were the major reasons for the losses in public enterprises. Budget 2002 proposed policy changes and reforms in all key areas, namely, taxation, government expenditure, deficit financing, public debt management and public enterprise reforms, required for immediate fiscal consolidation and improving performance of public enterprises. It also emphasised the necessity for structural reforms to create a growing economy with greater participation of the private sector and proposed a series of measures necessary for this purpose. The reform measures focussed on improving good governance, freeing the economy from excessive bureaucratic controls, further liberalising output and input markets, revitalising the rural economy, developing infrastructure, encouraging public-private partnerships, developing human skills and creating opportunities for productive employment. It was expected that these measures would increase investment and improve productivity leading to accelerated economic growth, employment generation and raising income, enabling to address basic economic issues such as inflation, unemployment, poverty and vulnerability of the economy to external shocks on a sustainable basis.

Budgetary measures in 2002 were expected to contain the primary deficit, as well as the overall deficit, by augmenting revenue efforts, controlling expenditure and improving debt management. It was also expected to set more realistic fiscal targets and achieve them by closely monitoring and implementing policy measures effectively. Accordingly, the overall deficit was expected to be reduced from 10.8 per cent of GDP in 2001 to 8.5 per cent of GDP in 2002 by raising revenue by about 1 per cent of GDP and reducing expenditure by about 1.4 per cent of GDP. As a surplus in the primary deficit is necessary to turn around the rising public debt, the primary deficit was expected to be reduced faster from 4.1 per cent to 1.2 per cent of GDP. The reduced fiscal deficit target was planned to be financed from concessionary foreign loans, privatisation proceeds and domestic non-bank borrowing, without creating inflationary pressure and reducing the crowding-out of resources from the private sector. Public

Chart 1.6
Fiscal Sector Indicators

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

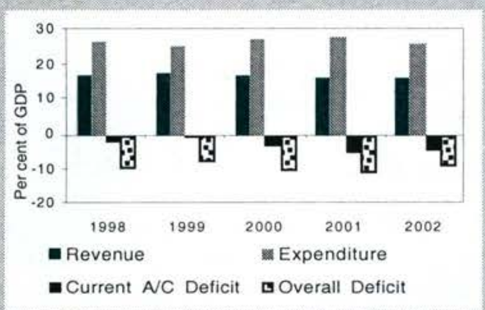


Chart 1.6.2
Financing the Deficit

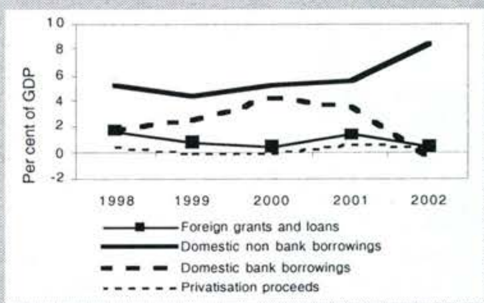


Chart 1.6.3
How a Rupee Was Earned - 2002

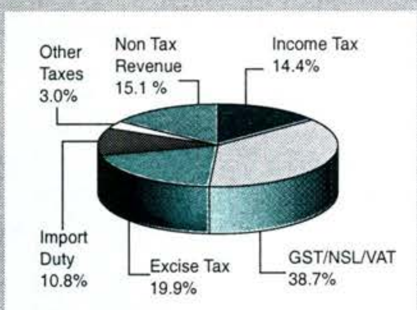
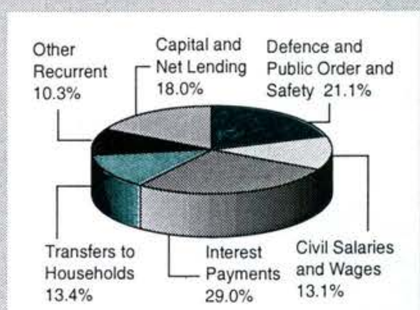


Chart 1.6.4
How a Rupee Was Spent- 2002



investments, mainly allocated for infrastructure development, were expected to be financed mainly from external concessionary financing. Deviating from the recent trend of increasing reliance on expansionary bank financing, it was expected to reduce the existing debt to the banking system.

Because of a persistent decline in revenue mobilisation, as indicated by the decline in the revenue to GDP ratio from around 21 per cent of GDP in the early 1990s to below 17 per cent in recent years, revenue enhancing measures received strong emphasis. As the reduction was mainly in tax revenue, which declined from 19 per cent of GDP in 1990 to 14.8 per cent of GDP in 2001, the government gave the highest priority to reforming the tax system by simplifying the tax structure, eliminating ad hoc tax concessions, broadening the tax base, and strengthening tax administration, thereby improving tax collection. Accordingly, four taxes, i.e., stamp duties collected by central government, the capital gains tax, advance company tax (ACT) and the transfer tax on non-residents, were abolished. Similarly, the 20 per cent surcharge on corporate taxation was abolished, and the 40 per cent surcharge on dutiable imports was reduced to 20 per cent. The consolidation of the Goods and Services Tax (GST) and the National Security Levy (NSL) into a single Value Added Tax (VAT) was a major tax reform undertaken in 2002. The replacement of the NSL, which was a turnover type tax with a cascading effect, by a value added type tax was a long felt need. Two new taxes, the debits tax on current account transactions of the banking system and the Ports and Airports Development Levy (PAL) on imports, were introduced to recoup revenue losses arising from the abolition of stamp duties. It is not desirable to use the debits tax as a long-term tax measure as it will not only have cascading effects, but could also discourage financial deepening and intermediation, affecting the efficiency in the economy. The withholding tax on interest and dividend income was made a final tax for non-corporate investors in order to broaden the tax base. The change to charge a withholding tax on interest earnings of marketable debt securities upfront on the basis of the yield to maturity will increase the current year tax revenue at the cost of future tax revenue. In another step to move towards a tax system with a broader base and lower tax rates, the maximum income tax rate on both personal and corporate income and the number of tax slabs were reduced to three (10, 20, 35 per cent) from four (10, 15, 25, 35 per cent), while broadening the slab size. Budget 2002 also indicated the government's desire to reduce the maximum income tax rate in the medium term to 20 per cent.

Measures were also taken to streamline the existing tax incentives, minimise distortions and improve tax administration. A permanent Tariff Commission was proposed and a Tariff Advisory Council (TAC) was established to minimise the distortionary impact of taxation on the external competitiveness of domestic producers. As there has been a continuously declining trend in the ratio of import duties to the value of total imports (i.e., average duty rate), it was decided to prevent granting ad hoc duty waivers and impose new tariff rates ranging from 2-10 per cent on items previously exempted from the tariffs. The tax administration on liquor was simplified by unifying excise tax liabilities under the Excise Ordinance and the Excise (Special Provisions) Act. Meanwhile, steps were taken to reform the Large Taxpayers Unit (LTU) in the Inland Revenue Department by bringing the income tax and VAT files of the large taxpayers under one administrative unit. To improve tax administration, it was proposed to establish a Revenue Authority (RA) bringing the administration of the Inland Revenue Department, the Customs Department and the Excise Department under one authority.

On the expenditure side, Budget 2002 proposed long overdue measures to rationalise current as well as capital expenditure in order to ensure a sustainable reduction in the fiscal deficit over the medium term. The suspension on hiring in the public sector, except to technical and professional grades, the introduction of better targetting mechanisms in welfare programmes, such as the Samurdhi and school uniforms distribution, streamlining the provision for defence services and restrictions on resource allocation for unclassified and unforeseen expenses were major measures taken to contain recurrent expenditure. Strict control on the provision of funds for rupee funded non-priority and less productive investments and efforts to raise foreign concessional financing for investment projects were proposed to contain the burden of capital expenditure on the budget. Among other major measures to rationalise government expenditure in the medium-term were the proposals to reform the civil service, including the introduction of a non-contributory pension scheme, a strong welfare targetting system through the Welfare Benefit Act, implementation of a zero based budgeting system in public sector institutions and the rationalisation of government institutions with amalgamations to reduce duplication and closure, if their activities were redundant.

Meanwhile, proposals were made to reform public enterprises to improve their efficiency and through it, their profitability, enabling them to pay taxes, levies and debt service payments to the government. Shortfalls in such payments have been one of the major reasons for rising budget deficits in the past. In this regard, reforms in CEB, CPC, SLPA and CWE were important. Reforms in other public enterprises were expected to reduce their required budgetary transfers significantly.

Budget proposals in 2002 put much emphasis on improving the deficit financing and debt management by establishing transparency and accountability. Until 2001, borrowing through various non-instruments such as bank overdrafts and import bill financing was not accounted for under the formal overall borrowing limit. At end 2001, government borrowings from the two state banks through such

Box 5

Fiscal Management (Responsibility) Act

Introduction

The application of legislative measures to improve fiscal management, transparency and accountability thereby compelling governments to strictly observe their commitments to improve public finances, has become increasingly popular, over the last few decades. In the wake of persistently high budget deficits and mounting public debt, several developed and developing countries, have adopted statutory restrictions on the size of fiscal indicators such as the budget deficit, public debt and government guarantees.

In Sri Lanka, there has been a significant deterioration in the fiscal situation, leading to high fiscal deficits and rising public debt. Persistently high budget deficits have been a major cause of the main economic ills during the past two decades. These high budget deficits not funded with concessional foreign resources compelled the government to borrow heavily from domestic sources to bridge the resources gap. The heavy reliance on domestic deficit financing on average about 6.5 per cent of GDP during the 1980 - 2001 period, and around 8 per cent during the last five years, has resulted in high market interest rates, crowding out of private investments and generating inflationary pressure. The large amount of short-term domestic borrowing, at high interest rates, increased the debt service burden sharply. This lead to an undesirable outcome of total debt service payments exceeding government revenue in 2002. The interest cost alone was more than one third of the current expenditure of the government. With these developments, the debt stock of the country climbed to over 100 per cent of GDP in 2002, clearly raising concerns regarding the sustainability of both high deficits and the public debt. The government attempted to address this serious issue in two ways. First, a series of discretionary measures were introduced to reduce the primary deficit and improve debt management. Second, considering the gravity of the issue, the government enacted the Fiscal Management (Responsibility) Act (FMRA), which makes fiscal discipline mandatory. This Act was passed in Parliament on 10 December 2002 and will be effective from the fiscal year 2003. The Act is laudable not only because it brings a formal discipline to the fiscal process, but also because it increases the transparency and accountability in government fiscal operations.

The Fiscal Targets in the FMRA

The major feature in the FMRA is the stipulation of medium-term fiscal strategy targets. Under the Act, the budget deficit has to be reduced to 5 per cent of GDP by 2006 and maintained at that level thereafter. Total liabilities of the government should not exceed 85 per cent of GDP at the end of the fiscal year 2006 and 60 per cent of GDP at the end of 2013. The Act further, specifies that government guarantees as a percentage of GDP, for the current year and the proceeding two years should not in the aggregate exceed 4.5 per cent of GDP. Although the targets set out in the FMRA are challenging, they are achievable with commitment and determination on the part of the government to adopt a disciplined monetary and fiscal policy stance. Government's policies would need to be directed to restoring fiscal sustainability by raising the economic growth rate and by a combination of revenue augmenting and expenditure compression and debt reducing measures.

To fulfil the objective of accountability and transparency, the Act specifies several reports to be presented to Parliament and to the general public by the Finance Minister, within a given time frame. Details of these reports are given in Table 1.

FMRA is meant to improve discipline and credibility of a government's fiscal activities in several ways. First, it ensures that the fiscal strategy of a government is based on responsible fiscal management and facilitates for public scrutiny of fiscal performance. The Act compels the government to follow a prudent fiscal policy strategy to strengthen public confidence. Second, under the Act the government is required to adopt policies relating to fiscal consolidation with a degree of sustainability and predictability. The ultimate target of these measures is to reduce the budget deficit and the government debt to prudent levels to ensure fiscal sustainability. Third, the Act legislates principles of responsible fiscal management and design measures to improve the flow of information on the public finances. Fourth, it imposes responsibility on a government to ensure inter- generational equity arising from the financial impact of decisions taken in respect of the fiscal operations. Finally, the Act includes provisions aimed at insulating public spending from populist pre-election spending impulses. Prior to an election, a government will be obliged to report on the fiscal consequences of all new policies that are to be introduced.

International Experience

The Fiscal Responsibility Act (FRA) in New Zealand adopted in 1994 presented an innovative approach to the promotion of prudent fiscal management. It explicitly emphasised transparency, thereby opening the structure and functions of the government, public sector accounts and fiscal intentions and projections to the public, was implemented. The legislation in Australia (Charter for

Box 5 (contd.)

Budget Honesty-1998) and the United Kingdom (Code of Fiscal Stability-1998) adopted similar approaches requiring fiscal reporting to the public. Countries seeking to participate in the European Economic and Monetary Union under the Maastricht Treaty had to achieve general government deficits not exceeding 3 per cent of GDP, the government debt was not to be in excess of 60 per cent of GDP. Under the subsequent Stability and Growth Pact in 1997, countries in the European Union were required to reach these targets. Several developing countries also have adopted statutory commitments recently to improve the fiscal framework. South American countries such as Argentina (FRA-1999) Brazil (FRA-2000) and Peru (FRA-1999) have committed themselves to prudent fiscal management through FRAs and by setting ceilings on the budget deficit, expenditure and indebtedness, while adopting measures to improve accountability and transparency of government fiscal policy. In the two neighboring countries, i.e. India (Fiscal Responsibility and Budget Management Bill-2000) and Pakistan (Fiscal Responsibility and Debt Limitation-2002), legislation has been presented setting targets on similar lines to achieve fiscal consolidation and to gain public confidence in general fiscal matters.

The FMRA has been a voluntary commitment on the part of government in the direction of fiscal consolidation. Although the commitment is voluntary, it is important to conduct the fiscal policy based on a clear set of principles aiming to achieve the targets stipulated in the Act. Any slippage from the anticipated targets will lead to a loss of credibility in policy makers and the government as a whole. Further, any deviation from expected targets would have a detrimental effect on debt management and the reinforcement of economic stability. Therefore, the government's commitment is essential for the successful implementation of this Act, which would reinforce the ongoing fiscal consolidating process and improve overall economic management in the country.

TABLE 1
Reports to be Presented under the FMRA

Name of Report	Date of Submission	Objectives	Major Contents
Fiscal Strategy Statement	With the Budget Speech (second reading).	Increase public awareness and establish standards for evaluating the government's conduct of fiscal policy.	Government's medium term fiscal policy. Broad strategic priorities on which the budget is based. Key fiscal measures relevant for the implementation of the fiscal strategy. Fiscal objectives and targets related to fiscal indicators, especially government debt.
Mid-Year Fiscal Position Report	End June or lapse of 6 months from the date of the passing of the Appropriation Act, whichever is later.	Providing updated information on the government's fiscal performance in the first four months to enable the public to evaluate it with the government's fiscal strategy.	Estimated and actual expenditure, revenue and cash flow for the first four months of the year. Estimated and actual government borrowing, and any other statements reflecting the government's financial position for the first four months of the year.
Final Budget Position Report	End May of the year following the budget.	Providing updated information on the government's fiscal performance for the whole year to enable the public to evaluate it with the government's fiscal strategy.	Estimated and actual expenditure, revenue and cash flow for the year. Estimated and actual government borrowing, and any other statement reflecting the government's financial position during the year. Reasons for shortfalls in the estimated revenue and overruns in expenditure and borrowings.
Pre-election Budgetary Position Report (submitted by the Secretary to the Ministry of Finance)	Within 3 weeks of the announcement of a general election.	Announcing the current fiscal position of the government to the public to avoid election handouts.	Estimates of revenue and expenditures and economic and other assumptions used for these estimates.
Statements of Responsibility	With the Pre-election Budgetary Position Report	Stating the responsibilities of the Minister and the Secretary in preparing the pre-election budgetary position report.	Statement signed by the Minister to the effect that the Minister has disclosed all the known information required for the preparation of the pre-election budgetary report, within one week of an announcement of an election. Statement by the Secretary stating that the pre-election report contains information to the fullest extent possible.

facilities were as high as Rs.50.5 billion, consisting of Rs.38 billion as overdrafts and Rs.12.5 billion as import bills. A proposal was made to extend the coverage of the overall government annual borrowing limit to cover all borrowing including the bank overdrafts and unpaid import bills. Furthermore, as the impact of such large overdrafts on the cost of government borrowing, and on overall economic management was high, it was proposed to reduce the outstanding overdraft facility by about Rs.30 billion by securitising that debt with marketable public debt instruments. Similarly, borrowing through administrative arrangements was suspended and it was decided to settle existing administrative debt as soon as possible.

On financing of the deficit, Budget 2002 proposed to rely more on external financing (Rs.26 billion) and privatisation proceeds (Rs.21 billion), limiting the use of domestic resources (Rs.88 billion). The objective was to reduce the crowding-out impact of deficit financing, avoid inflationary financing and reduce pressure on domestic interest rates.

The determination to push ahead with the fiscal consolidation process was clearly shown by the enactment of a Fiscal Management (Responsibility) Act (FMRA) towards the end of 2002. The FMRA spelled out the accountability of the Finance Minister to Parliament and fiscal targets to be achieved in the medium-term. Accordingly, the budget deficit is targeted to be reduced to 5 per cent of GDP by 2006 and maintained below that level thereafter. The outstanding government debt is targeted to be reduced to 85 per cent of GDP by 2006 and further to 60 per cent by end of 2013. The Act has also placed a ceiling on government guarantees (at 4.5 per cent of GDP for three consecutive years) to contain contingent liabilities. Provisions were also made in the Act to ensure the achievement of the annual approved budgetary targets and to prevent politically motivated pre-election expenditure as seen in the past.

Reversing the recent deteriorating trends, the fiscal performance in 2002 showed marked improvements, despite a shortfall in the expected revenue, by reducing expenditure, the deficit and financing requirements significantly. Realised revenue was 1 per cent of GDP below the original estimate, but its impact on the budget deficit was offset to a large extent by a reduction in expenditure by 0.7 per cent of GDP, including a decrease in current expenditure. The realised overall fiscal deficit of 8.9 per cent of GDP exceeded the original target of 8.5 per cent, but was well below the deficit of 10.8 per cent of GDP in 2001 and 9.9 per cent in 2000.

Similarly, the primary balance, which reflects the impact of the current year's fiscal operations on the macro-economy, as well as the current account deficit, which indicates the level of government dissaving, also declined, recording a favourable development. These deficit reductions were entirely a result of expenditure reductions as revenue/GDP ratio remained unchanged from the previous year. Nevertheless, all three realised deficits were higher than the original budget targets, although the margins were lower than in previous years. These deficit increases were entirely due to a shortfall in tax revenue (Rs.15 billion) as the realised non-tax revenue was very close to the original budgetary target, while the realised expenditure was significantly lower (Rs.11 billion) than the original target. However, the full benefit of the reduced deficits were not reflected in the domestic borrowing for deficit financing, as there were significant shortfalls in realisation of foreign borrowings and privatisation proceeds. As a result, realised government domestic borrowing was Rs.38 billion higher than the original estimate. Nevertheless, the government's net domestic borrowing in 2002 as a percentage of GDP was less than in 2001. Furthermore, it was less than the financial resources available in the domestic market, thereby making available financial resources to the private sector and reducing pressure on domestic interest rates.

In 2002, the consolidated public sector deficit, which comprises the general government and the operations of public non-financial corporations, also registered a significant improvement, decreasing to 9 per cent of GDP from 11 per cent of GDP in 2001. The improved financial performance of CPC with the adoption of an automatic pricing formula was the major reason which helped to maintain the performance of public corporations at the same level as in 2001. The improvement in the deficit would have been larger had the debt recovery charge not been removed from the petroleum pricing formula in July 2002. Improvements in operational efficiency of public enterprises and the introduction of automatic pricing formulae for their products/services seem to be a rational way to improve their commercial viability.

On the revenue side, the tax/GDP ratio continued its decline reaching 14 per cent in 2002, the lowest recorded level, notwithstanding the proposals in Budget 2002 to improve revenue mobilisation by expanding the revenue base, introducing new taxes and improving tax administration. This decline was due largely to the grant of various tax concessions, delays in implementing additional revenue generating measures, slow progress in improving tax administration, weak performance in public enterprises and the tax amnesty granted to tax evaders. The sharp increase in non-tax revenue helped to offset the decline in tax revenue, thereby enabling the maintenance of the total revenue/GDP ratio in 2002 at the same level as 2001. An increased profit transfer from the Central Bank, higher interest payments by public enterprises and timely collection of revenue from other non-tax sources helped to raise the non-tax/GDP ratio to 2.5 per cent in 2002 from 2.0 per cent in 2001. As high profit transfers from the Central Bank cannot be expected in the future under the proposed macroeconomic framework consisting of strong fiscal consolidation and declining nominal interest rates, every effort has to be made to increase other non-tax revenue sources by adjusting prices/charges to reflect at least the cost of goods and services provided by the public sector, and by reforming public enterprises to improve their profitability.

On the expenditure side, significant progress was made in containing non-interest expenditure below the budgetary target. The key measures that enabled expenditure consolidation were the streamlining of defence expenditure, benefits from the cessation of hostilities, improved targetting in household welfare programmes, the freeze on recruitment to the public sector, avoidance of ad hoc wage increases, strict controls on transfer payments to sub-national levels of government and public institutions and the rationalisation of current payments on other goods and services. Consequently, non-interest current expenditure as a percentage of GDP declined from 14.9 per cent in 2001 to 13.5 per cent, reversing the upward trend in the recent past. However, interest expenditure rose to 7.4 per cent of GDP from 6.7 per cent in 2001, partly offsetting gains from the reduction in other current outlays. Increased domestic borrowing reflecting the slippages in the overall deficit and large shortfalls in foreign financing and privatisation proceeds, was the major factor that contributed to this increase. However, improved debt management and deficit financing by replacing high cost debt with low cost long maturity debt helped reduce the increasing debt service burden to some extent. Reflecting these developments, the realised current expenditure in 2002 was Rs.2 billion lower than the original budget estimate reducing the current expenditure/GDP ratio to 20.8 per cent in 2002 from 21.6 per cent in 2001. This favourable declining trend needs to be continued to realise the medium term fiscal stabilisation targets envisaged in the FMRA

The public investment programme in 2002 suffered a major setback, declining from 5.9 per cent of GDP in 2001 to 4.6 per cent in 2002. This was the combined result of strict controls on expenditure on rupee funded projects and delays in the implementation of foreign funded projects. The three month delay in presenting the budget also affected the shortfall in the utilisation of capital expenditure. Even though this expenditure shortfall helped contain expansion in the fiscal deficit in 2002, it was at the expense of the future growth potential. As a large proportion of public investment has been allocated for infrastructure development with concessional foreign financing, it is essential to ensure its realisation in order to expand the future economic growth capacity and encourage mobilisation of more concessional foreign donor assistance. Reflecting the benefits of efforts in improving utilisation of donor assistance, the foreign aid utilisation ratio, which rose from 15 per cent in 1999 to 17 per cent in 2001, increased further to 23 per cent in 2002. Further improvements in this utilisation ratio is essential to mitigate the burden of deficit financing from domestic resources and to encourage mobilisation of additional foreign concessional assistance.

Reflecting the benefit of expenditure containment, the realised overall deficit financing requirement declined sharply from Rs.152 billion in 2001 to Rs.141 billion in 2002, exceeding the original target only by Rs.6 billion. However, the realised domestic borrowing exceeded the target sharply by Rs.38 billion (i.e., 2.4 per cent of GDP), reflecting significant shortfalls in expected foreign financing by Rs.18 billion and privatisation proceeds by Rs.15 billion.

As a ratio of GDP, the realised total domestic borrowing for deficit financing was 8 per cent compared with the budget target of 5.5 per cent. However, it was lower than the 8.8 per cent in 2001 and 9.4 per cent in 2000. The composition of government domestic borrowing changed significantly in 2002. The government was able not only to mobilise its entire domestic borrowing requirement from non-bank sources but also to repay some debt to the banking sector, reversing the increasing trend in government bank credit in the recent past, and consequently reducing pressures on interest rates. The repayment to the banking system, at Rs.5 billion in 2002, albeit lower than the budgetary target of Rs.19.5 billion, was a major improvement compared with net bank borrowing of Rs.57 billion in 2000 and Rs.49 billion in 2001. Within the domestic bank financing, repayment to the Central Bank rose from Rs.6 billion in 2001 to Rs.13 billion in 2002 reducing high inflationary deficit financing and facilitating monetary management. Government borrowing through dollar denominated bonds (i.e., Sri Lanka Development Bonds) and the foreign currency loans from state banks (US dollars 50 million), and renewals of its foreign currency loan (US dollars 250 million) at a lower interest rate with a longer maturity also eased the pressure from deficit financing on domestic rupee funds market and hence on interest rates.

Public debt management improved in 2002 by reducing government non-transparent borrowings, relying on more market oriented debt instruments and extending the maturity of debt instruments. The absorption of funds from two state banks was one way used to finance the increased resource gap outside the normal borrowing programme, before 2002. Consequently, the accumulation of such bank liabilities rose sharply to Rs.51 billion at end 2001. As proposed in Budget 2002, the overdrafts were reduced sharply from Rs.38 billion at end 2001 to Rs.3.6 billion at end 2002. This reduction of Rs.34 billion was more than the envisaged target of Rs.30 billion. Meanwhile, progress was made under proposals selected to reduce import bills with foreign borrowings. These measures reduced the cost of government borrowing and improved transparency in government financing. They also helped monetary management and facilitated domestic money market operations. However, public debt as high as 105 per cent of GDP, debt service payments (Rs.284 billion) exceeding the government revenue (Rs.261 billion) in 2002 and the medium-term fiscal targets envisaged in the Fiscal Management (Responsibility) Act, clearly emphasise the necessity of greater attention to further improving public debt management.

In 2002, provincial councils (PC) continued to experience difficulties because of slow growth in revenue, rising recurrent expenditure, increasing capital expenditure requirements and heavy dependence on the central government for financial resources. As the total revenue of PCs was sufficient to cover

TABLE 1.6
External Sector Indicators

Item	1998	1999	2000	2001	2002(a)
Annual changes (%)					
Export volume	0.1	5.0	18.3	-8.0	2.0
Import volume	12.4	0.2	12.9	-10.7	11.0
Export unit value	11.6	-8.5	1.5	-5.2	-4.3
Import unit value	-2.2	-3.5	8.1	-3.6	-7.9
Terms of trade	14.2	-5.0	-6.1	-1.7	3.9
As a percentage of GDP					
Trade deficit/GDP	-6.9	-8.7	-10.8	-7.4	-8.5
Current account deficit/GDP	-1.4	-3.6	-6.4	-1.5	-1.6
Overall BOP/GDP	0.2	-1.7	-3.1	1.3	2.0
External reserves US$ mn.(b)					
Gross official reserves	1,984	1,639	1,049	1,338	1,700
Total reserves	2,907	2,582	2,131	2,238	2,495
External debt service payments (US $ mn)					
Amortisation payments	469	550	621	559	574
Interest payments	289	296	332	254	214
Exchange rate index (End of period) (c)					
Real effective exchange rate index	111.5	110.2	111.6	112.8	110.9

(a) Provisional Source: Central Bank of Sri Lanka
(b) In 2002, reserves are calculated at market value.
(c) 24 currency basket, 1995 = 100

only one fifth of their expenditure, the central government continued to transfer funds through capital and current grants to fill the resource gap. Therefore, improving revenue enhancing measures of PCs and rationalising their expenditure by minimising duplication of work are crucial in reducing their high financing gap. With the on-going peace process, special emphasis has to be paid to the financial activity of sub-national governments, as fiscal devolution will be a major issue to be resolved when finalising a lasting political solution.

1.9 Trade, Tourism and Balance of Payments

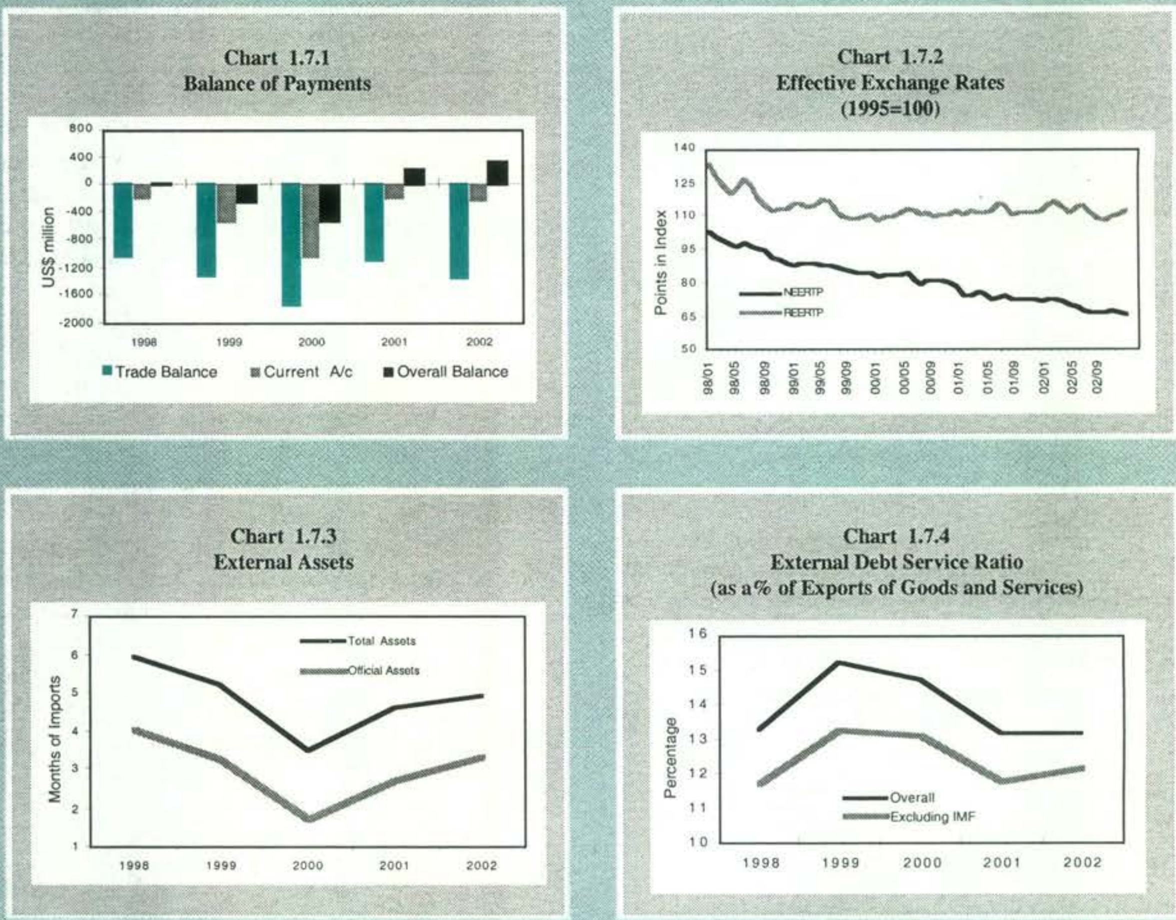
The developments in the domestic and global economy, both favourable and unfavourable, affected Sri Lanka's external sector. Improvements in security conditions following the ceasefire, macroeconomic policy adjustments, including those under the Stand By Arrangement (SBA) with the IMF, and the recovery in the world economy impacted favourably. However, the uncertainty in the Middle East and disruptions to oil production in Venezuela, a major exporter, kept oil prices high, even though the terms of trade of the country improved due to a sharp decline in the overall import price index. As economic recovery in the US and in the Euro area, which are major markets for Sri Lankan exports was sluggish, the demand for exports was below initial expectations. The overall balance of payments was in surplus, for the second year in succession, with a corresponding increase in official external reserves. International trade recovered partially, as did port activity. The tourist industry recovered significantly; net portfolio inflows were positive after four successive years of net outflows; capital inflows and private transfers increased as well.

The government took further steps to liberalise the capital account in the balance of payments. Restrictions on foreign direct investments in banking, insurance, stock broking, financial services, mass transport, telecommunications and professional services were relaxed. External trade and tariff policy sought to stimulate the economy through increased openness. The surcharge on import duty was reduced from 40 per cent to 20 per cent. However, in a step back, specific duties were introduced on some agricultural produce early in 2002 and items under zero tariff were brought under 2 per cent and 10 per cent tariff bands. Although this would generate additional revenue for the government, it represents a setback in the move to a more simplified two band tariff regime. Nevertheless, distortions to the tariff regime by way of ad hoc duty exemptions, waivers and surcharges were kept to a minimum. A permanent Tariff Advisory Council was established to examine and correct anomalies in the tariff structure and address the concerns of importers and industrialists. With these revisions to the tariff structure, the average import duty, i.e., the ratio of import duty collected to total adjusted imports, declined marginally to 4.8 per cent in 2002 from 4.9 per cent in 2001.

Further welcome steps with regard to the relaxation of controls were the removal from January 2002 of requirements to obtain licences for the import of rice, other than paddy, and the simplification of procedures for importing low value items by the removal of duties, surcharges and other levies. A Ports and Airports Development Levy (PAL) of 1 per cent of the CIF value of imports (0.75 per cent for imports for processing and re-export) was introduced from April 2002, with the abolishing of stamp duty. Several incentive schemes, including tax advantages, were introduced by the government in 2002 and strengthened in Budget 2003, to reinvigorate the export sector, which was badly affected in 2001. A significant feature of some of these schemes is that concessions will be provided on the basis of the location of an enterprise to promote dispersion of enterprises to other parts of the country from the Western Province, where there is a concentration of economic activity.

The changes in the international and domestic economies, with the policy changes implemented, led to an improvement in Sri Lanka's external trade in 2002, even though the recovery was not as strong as initially projected. The value of exports, in US dollar terms, decreased by 2.4 per cent to US dollars 4,699 million as export prices declined. The volume of exports increased by 2 per cent, which in value terms, was offset by a decline of 4.3 per cent in export prices. The value of imports increased by 2.2 per cent to US dollars 6,105 million in 2002 from US dollars 5,974 million in 2001, the composite effect of an 11 per cent increase in volume an 8 per cent decrease in import prices. As import prices declined at a faster rate than export prices, despite the increase in oil prices, Sri Lanka benefited, with a 3.9 per cent improvement from 2001 in the terms of trade.

Chart 1.7
Selected External Sector Indicators



As a result of the faster increase in imports, the trade deficit widened to US dollars 1,406 million (8.5 per cent of GDP) in 2002, from US dollars 1,157 million in 2001 (7.4 per cent of GDP). The services account, however, improved markedly with increased receipts from tourism. Similarly, declining international interest rates reduced the deficit in the income account in 2002. Net current transfers increased by 11.7 per cent as private transfers significantly increased, perhaps due to tensions in the Middle East. These improvements were sufficient to cover the increase in the trade deficit. However, the deficit in the current account increased to US dollars 264 million from US dollars 244 million in 2001. The deficit on the current account was more than offset by increased inflows in the capital and financial accounts. Higher net foreign direct investment (US dollars 230 million), a positive net inflow in portfolio investments (US dollars 25 million) and increased long-term borrowings contributed to the increase. As a result, the Balance of Payments (BOP) recorded a surplus of US dollars 338 million, in comparison to a surplus of US dollars 220 million in 2001. Consequently, gross official reserves rose to US dollars 1,700 million at end 2002, from US dollars 1,338 million at end 2001. This level of reserves was sufficient to cover 3.3 months of merchandise goods imports. The total reserves of the country amounted to US dollars 2,495 million, sufficient to cover 4.9 months of imports. The external debt of the country increased by 8.7 per cent, to US dollars 9,291 million (56 per cent of GDP) due to increased borrowing by the government, increased liabilities to the IMF and the exchange rate effect resulting from changes in major cross rates. On the exchange rate front, the foreign exchange market has been more stable and has deepened since the flotation of the rupee in January 2001. The rupee depreciated by only 3.7 per cent against the US dollar in 2002, in comparison to a depreciation of 11.3 per cent in 2001. The lower depreciation against the dollar was partly due to the weakness of the dollar in international markets. The rupee depreciated at a higher rate against other major international currencies. The international competitiveness of Sri Lanka improved, as seen by a depreciation of the real effective exchange rate of the rupee.

The demand for exports was affected by slow recovery in Sri Lanka's major export markets, i.e., USA and the Euro area. A gradual improvement in export demand took place during the year, with the cumulative decline in exports decreasing from 17 per cent at the end of the second quarter, to 2.4 per cent at end year. Although agricultural and mineral exports increased in 2002, industrial exports, which accounted for 77 per cent of all exports, decreased by 2.1 per cent. This was, in a large measure, due to a 6 per cent decline in the average price of textiles and garments, which account for two thirds of the value of industrial exports. Increased competition from low cost producers and sluggish growth in the major export markets depressed prices. The weak export performance highlights the vulnerability of Sri Lanka's economy and clearly demonstrates the need for diversification of export products and markets.

The composition of exports has substantially changed during the last 25 years, with industrial exports displacing agricultural exports, but little change was seen in the composition from 2001 to 2002. Within industrial exports, the other important categories besides textiles and garments are machinery, mechanical and electrical equipment, diamonds and jewellery, rubber products, leather products and footwear, and food beverages and tobacco. All of these, other than the last category, recorded higher exports in 2002. Among agricultural exports, tea still accounts for 70 per cent. Although the output of tea increased in 2002, both the volume and average price of exports declined. The decline is attributed to larger stocks in the world market in the first half of 2002. Of tea exports, 64 per cent are still in bulk form. Middle Eastern countries, led by the United Arab Emirates, purchased 44 per cent of Sri Lanka's tea exports, the Commonwealth of Independent States (CIS) bought 24 per cent and European Union (EU) 10 per cent. Earnings from the export of coconut products increased by 1.5 per cent in contrast to a 47 per cent decline in 2001. Similarly, the value of rubber exports increased by 11 per cent in contrast to a decline in 2001. Sri Lanka's export earnings were also boosted by an increase in minor agricultural exports such as cinnamon, cloves, unmanufactured tobacco and pepper, after three consecutive years of decline. Mineral exports too, of which gem exports comprise 95 per cent, increased by 4 per cent.

Increased economic activity, and the reduction in the import duty surcharge helped to increase imports by 2.2 per cent to US dollars 6,105 million in 2002. Increases were seen in all three sub categories, i.e., consumer (7 per cent), intermediate (5 per cent), and investment (8 per cent) goods. In 2002, imports of both food and consumer durables in the consumer group increased. In the intermediate goods category, the higher price of oil and increased volumes of wheat, crude oil and fertiliser imports pushed up the value of imports. An encouraging feature was the increase in the investment category, where transport equipment, machinery and building material imports expanded. Industrial countries continued to be the main destinations for exports from Sri Lanka (74 per cent), followed by developing countries (22 per cent) and Eastern Europe (4 per cent). USA was the single largest export destination (38 per cent) as it has been since 1979. The main source of imports was developing countries (70 per cent) with India being the single largest source. The SAARC region accounted for 5 per cent of exports and 15 per cent of imports.

The effects of the improved security situation was clearly evident in the services account, which recorded a surplus of US dollars 271 million, an increase of 55 per cent over 2001. Earnings from tourism increased by 16 per cent to US dollars 248 million, while receipts from non-resident Sri Lankans travelling to Sri Lanka is estimated at US dollars 115 million. The peace dividend was felt strongly in tourism. Tourist arrivals increased by 16.7 per cent in 2002, in contrast to a decline of 15.9 per cent in 2001, the improvement in the year under reference being seen in the second half of the year. Western Europe continued to be the main source of tourists, although a special promotional campaign by SriLankan Airlines, the tourist industry and the Tourist Board led to a substantial increase in tourists from India. Sri Lanka needs to capitalise on the positive news emanating from the country to build up the tourist industry. The acceptance of Sri Lanka as an official tourist destination by the Chinese government, following representations made by the Sri Lankan government, is a welcome step. A constraint currently faced by the industry, which needs to be addressed urgently, is the severe shortage of airline seats to major European markets. Moreover, commensurate improvements in infrastructure are essential to attract more high spending tourists.

Net receipts from telecommunications services increased by 79 per cent to US dollars 61 million. This is regarded as being far below potential. The lack of gateway capacity is a bottleneck. As the government has identified in the Regaining Sri Lanka initiative, the liberalisation of the international telecommunications market is vital and this process commenced under the National Telecommunications Policy. Receipts from information technology exports are estimated to have decreased by 24 per cent to US dollars 50 million, mainly due to the slow global recovery, particularly in the United States. Declining international interest rates had a beneficial impact on the income account through a reduction in net interest payments.

Current transfers, comprising private transfers and official transfers, continue to increase. Gross private transfers increased by 11 per cent to US dollars 1,287 million. This is attributed to several factors - an increase in the number of Sri Lankans employed abroad, an increase in incomes in oil exporting Middle East countries due to rising oil prices, and uncertainty in the Middle East encouraging expatriate workers to remit their savings to Sri Lanka. Although the West Asian region accounted for over 60 per cent of total private transfers, with increasing levels of employment elsewhere, particularly in Europe, its share has declined. The efforts by the Sri Lankan authorities to promote employment in countries other than those in the Middle East have assisted in this change. Private transfers, the second largest foreign exchange earner after net garment exports, were sufficient to cover over 90 per cent of the trade deficit. Given the importance of these inflows to the economy of Sri Lanka, the hardships faced by migrant workers, particularly, in West Asia, warrants the special attention of the authorities.

In the capital account, foreign direct investment, private long-term borrowing and portfolio investments increased. Nevertheless, following an increase in the net foreign assets of commercial banks and a reduction in privatisation receipts, net capital and financial flows decreased by 10 per cent in 2002. Private long-term capital flows increased from US dollars 45 million to US dollars 139 million, mainly on account of long term trade credits. No significant foreign borrowing was made by the private sector. Foreign direct investment increased significantly to US dollars 242 million from US dollars 82 million on 2001, following increased political stability. The major areas of investments were power, communications, port services and manufacturing. Sri Lanka needs to continue attracting significant amounts of foreign investment, which is vital to ensure sustained economic growth. It is essential to ensure uninterrupted power supplies, flexible labour markets, adequate infrastructure facilities and excellent telecommunications facilities, as well as improved productivity, which requires significant improvements in education and labour reforms. Privatisation receipts amounted to only US dollars 5 million, from a fraction of the sale of Sri Lanka Telecom shares, reflecting the gloomy global investment conditions. The proposed privatisation of Sri Lanka Insurance Corporation was postponed to 2003. Long-term capital received by the government decreased by 6 per cent, of which nearly 89 per cent was on concessional terms. This decrease was a positive feature, as it reflected a decrease in long-term credit for defence related imports. Non-defence related long-term credit, in contrast, increased by 12 per cent. The bulk of the funds received by the government was for power generation, private sector development, small and medium enterprise development, water supply, education and irrigation. Short-term capital inflows decreased, mainly as commercial banks improved their net foreign assets. A notable feature of short-term capital movements was the net inflow of US dollars 25 million to the Colombo stock market in contrast to the net outflow since 1998.

It is important to ensure the optimal use of concessional assistance, particularly in areas such as health, education and infrastructure development, minimising the use of non-concessional sources of financing. There has been a persistent low utilisation of funds received on concessional terms. The government has appointed a committee to assist in the monitoring of projects and to streamline processes to ensure that the country reaps maximum benefit from scarce concessionary assistance.

The foreign exchange market stabillised and deepened after the flotation of the rupee in January 2001. The rupee depreciated by 3.7 per cent against the US dollar in 2002, in comparison to 11.3 per cent in 2001, due to the weakness of the dollar in international markets, increased capital flows and attractive real interest rates in the domestic market. The rupee depreciated by 11-19 per cent against other major currencies such as the euro, the Japanese yen, the pound sterling and SDR. The real effective exchange rate (REER) of the rupee depreciated by about 0.5 per cent and 2 per cent against a basket of five major currencies and a broader 24-currency basket of trading partners and competitors, respectively, indicating an improvement in Sri Lanka's international trade competitiveness. The forward foreign exchange market deepened with an increase in the volume of transactions, as well as an increase in the maturity periods of transactions. A substantial decline in the forward premium was also seen, with the market expecting a weakening of the dollar and a reduction in domestic interest rates.

The external assets of the country improved significantly for the second consecutive year. The successful completion of the SBA with IMF not only led to a direct increase in gross external assets, but also increased confidence in the economy. The government issued the balance amount of Sri Lanka Development Bonds (US dollars 91.5 million), bringing the total issued amount to the originally proposed US dollars 250 million. Gross external reserves increased to US dollars 2,495, sufficient to cover 4.9 months of imports, while gross official reserves increased to US dollars, 1,700 million (3.3 months import cover) by end 2002.

The total external debt of Sri Lanka increased by US dollars 747 million to US dollars 9,291 million by end 2002. Of the increase, 31 per cent was the result of cross currency rate changes. Medium and long-term debt account for about 93 per cent of outstanding external debt, while 86 per cent was on concessional terms. Total debt service payments, including amortisation and interest payments, as a percentage of receipts from merchandise exports and services, remained at 13.2 per cent in 2002. It was lower, at 10.7 per cent, of total receipts from exports of goods, services, income and private transfers. Hitherto, Sri Lanka has had the benefit of obtaining the bulk of its debt on highly concessional terms. However, as the per capita income increases, Sri Lanka will automatically become ineligible to access highly concessional assistance from multilateral donors such as the IDA and ADB. Hence, it is vital that maximum use is made of available concessional assistance. Extreme caution and high professionalism need to be exercised when negotiating non-concessional loans.

TABLE 1.7
Financial Statistics

Item	End 2002 Rs.bn.	Change 2001 Amount Rs.bn.	%	2002 Amount Rs.bn.	%
Monetary aggregates:					
Narrow money supply (M_1)	139.4	3.7	3.2	17.2	14.0
Broad money supply (M_2)	510.4	46.0	11.4	59.7	13.2
Consolidated broad money supply (M_{2b})	622.5	65.7	13.6	73.4	13.4
Underlying factors (a)					
Domestic credit to :	680.4	89.0	16.2	41.5	6.5
Government (net)	193.0	54.0	36.7	-8.3	-4.1
Public corporations	43.0	2.6	6.7	2.2	5.4
Private sector	444.4	32.4	8.9	47.6	12.0
External assets (net)	110.6	4.6	6.6	36.5	49.3
Other items (net)	-168.5	-27.9	-20.5	-4.7	-2.9
Reserve money	126.4	7.3	7.0	13.9	12.3
Government (net)	70.9	-6.9	-7.7	-13.6	-16.1
Commercial bank	...	-0.4	-71.2	-0.1	-80
External assets (net)	117.4	26.4	45.6	33.0	39.2
Other items (net)	-61.9	-11.8	-25.9	-5.4	-9.6
	End 2001	End 2002			
Interest rates					
91-day Treasury bills (%)	12.92	9.92			
Commercial banks' weighted avg.prime lending rate (%)	14.31	12.24			
Share Market					
All Share Price Index (1985=100)	621.0	815.1			
Market capitalisation (Rs. bn)	124.0	162.6			

(a) In relation to M_{2b}

Source: Central Bank of Sri Lanka.

1.10 Financial Sector

The financial sector was characterised by greater stability and improved performance in 2002. Money and foreign exchange markets were liquid and stable. Monetary policy focussed on price stability, while supporting the economic recovery. Domestic interest rates fell, assisted by declining inflation, greater fiscal discipline, the availability of rupee liquidity and decreasing international interest rates.

Monetary growth was moderate, in keeping with projections, avoiding the build up of demand fuelled inflationary pressure, all helping to reduce inflation in the future. Improved fiscal performance reduced the absorption of funds by the government from the banking system. Private sector credit expanded, although moderately, responding to lower interest rates and slow recovery in the economy. Interest margins of financial intermediaries, particularly banks, rose, increasing their profitability. The foreign exchange market was stable, while activity increased, deepening the market. The rupee depreciated by a relatively small amount against the US dollar, reflecting both the weakness of the dollar internationally and the inflow of foreign funds to Sri Lanka.

After several years, the Colombo stock market performed well, boosted by the ongoing peace process and gradual recovery in the economy. Foreigners were net investors, following four years of net outflows.

With gradual recovery in the economy, other sub sectors in the financial sector, for example finance companies, insurance companies and unit trusts, also improved their performance. There are ongoing reforms to increase efficiency and stability in the sector. In order to improve the regulatory framework and financial system stability, banks were notified of the proposed increase in the capital adequacy ratio and the consolidated supervision of domestic and foreign currency units.

Monetary Policy

Monetary policy in 2002 concentrated mainly on avoiding the creation of demand fuelled inflationary pressure, while providing adequate liquidity to support recovery in the economy. Declining inflation, more stable money and foreign exchange markets and greater fiscal discipline assisted the process of monetary management. As announced to the market at the beginning of the year, the Central Bank cautiously reduced its key policy rates, i.e., the Repurchase (Repo) rate and the Reverse Repurchase (Reverse Repo) rate. In contrast to the previous year, the domestic rupee market remained liquid throughout most of the year, the result of the conversion of foreign inflows and reduced absorption of funds by the public sector. Stimulated by the reduced interest rates, private sector demand for credit improved moderately with the relatively slow economic recovery.

Box 6

Amendments to the Monetary Law Act

The Monetary Law Act (MLA) No. 58 of 1949, which established the Central Bank of Sri Lanka (CBSL) and governs the activities of the Bank, was based on a Sessional Paper (No. XIV – 1949) titled 'Report on the Establishment of a Central Bank for Ceylon', prepared by Mr. John Exter, then a Senior Vice President of the Federal Reserve Bank of New York, whose services were obtained by the government for this purposes. Although amendments to the MLA have been made from time to time in the past half a century, it has essentially retained its original form. After several years of discussion and deliberation, some major changes were introduced by amendments to the Act, passed in Parliament in December 2002. These amendments are designed to enable the Central Bank to deal more effectively with the current economic structure and its needs.

The amendments focussed on the under-mentioned areas.

a. Changing the focus of the Bank's objectives.
b. Increasing the Bank's expertise and efficiency by expanding its governing Board and the powers of delegation.
c. Increasing the flexibility and effectiveness of monetary policy and exchange rate policy.
d. Improving the payment and settlement system.
e. Strengthening the regulatory role of the Bank.

a. Changing the focus of the Central Bank

Prior to the amendment, the Bank had multiple objectives relating to the stabilisation of domestic monetary values; preserving the stability of the exchange rate; the promotion of a high level of production, employment and real income, and the encouragement and promotion of the full development of the productive resources of Sri Lanka. It was not uncommon for central banks established half a century ago, to have multiple objectives which could sometimes be in conflict or be inconsistent. Hence, a consensus has developed internationally, that a central bank's most effective principal object should be the maintenance of price stability. As price stability is crucially dependent on stable macroeconomic conditions, the core objective of CBSL was designated as 'economic and price stability'.

Further, as experience in other countries has demonstrated, the stability of the financial system is crucial in preventing economic crises in a country. Hence this too was recognised as a core objective of CBSL.

Therefore, these two objectives, which are in harmony and would enable CBSL to perform its core functions effectively, replaced the existing multiple objectives.

b. Increasing the Central Bank's expertise and efficiency

Hitherto, CBSL has had a three member governing Board (the Monetary Board) consisting of the Governor (Chairman), the Secretary to the Ministry of Finance (Official Member) and a third member appointed by the President. The rationale behind a small Board was that it would be more effective than a larger one on the grounds of (a) practicability of summoning board meetings; (b) ability to reach consensus in decision making; and (c) ability to go deep into issues. However, the developments in the economy within the last few years and the complexities of the matters that have to be dealt with by the Board, have necessitated increased expertise and knowledge in a wide area of activity. Hence, the size has now been expanded to include two additional non executive members with the ability to contribute to the deliberations of the Board. In fact, such an expansion had been initially recommended by the Presidential Commission on Banking and Finance in 1992.

The Monetary Board would now consist of the Governor, the Secretary of the Ministry of Finance and three members appointed by the President on the recommendation of the Minister of Finance, with the concurrence of the Constitutional Council.

A further amendment has been brought in to permit the Monetary Board to enable it to delegate its administrative powers, functions and duties to the Governor, or an officer or a committee of officers. This would free the Board from having to deal with day to day administrative issues and enable it to devote more of its time and energy to key central banking issues.

c. Improving the flexibility and effectiveness of monetary and exchange rate policy

Monetary and exchange rate management evolves over time with the increasing complexity of both the domestic and international economies. Hence, it becomes necessary to review continuously the framework in which these policies are formulated and implemented. With this intent, several amendments were made to sections in the MLA to improve the effectiveness of such policies.

(i) The MLA had defined 'money supply' very narrowly as the currency and demand deposits owned by persons other then commercial banks and the government. Although this definition was adequate in the past, with the development of the financial system, in terms of both institutions and instruments, a wider definition

Box 6 (contd.)

is required. Hence the amendment gives the flexibility to the Monetary Board to amend the definition, taking into account the developments in the economy that warrant revisions in the definition of money stock.

(ii) The requirement for banks to maintain statutory reserves is a monetary tool provided to the CBSL under the MLA to limit the volume of money created by credit operations. The statutory reserve requirement (SRR) was imposed only on commercial banks and that too, only in respect of their deposit liabilities. Moreover, the MLA specified fixed upper and lower limits on different types of deposit liabilities.

With the developments in the economy, as in the case of the definition of 'money supply', it became necessary to revise the list of institutions and instruments that affect the money supply in the economy. Furthermore, although the Central Bank has been moving away from non-market oriented tools, such as SRR, in implementing monetary policy, the limits imposed by the MLA constrained this shift. Hence, a removal of the limits became necessary. Similarly, there were no provisions for the payment of interest on statutory reserves, other than in exceptional instances. Therefore, the amendments brought in the following changes:

a. Enabled the Monetary Board, by Gazette order, to impose reserve requirements on financial institutions other than commercial banks and on financial liabilities other than deposits.
b. Removed the maximum and minimum limits imposed by law in required reserves, thereby giving the Board the freedom of determining the appropriate ratio.
c. Enabled the payment of interest on statutory reserves, if the Board feels such payment is warranted.
d. Provided greater flexibility to the CBSL to determine and stipulate the manner in which reserves are calculated and the rate at which the penalty for non –compliance should be calculated.

(iii) The MLA was drawn up in an era when fixed exchange rate regimes were the international norm. Therefore, it imposed certain rigid obligations on the Central Bank regarding the purchase from and sales to commercial banks of foreign currency to ensure the free use of the Sri Lankan rupee for current international transactions. These rigid conditions, however, are not applicable in the current context of floating exchange rate regimes. Thus, the amendments grant greater flexibility to CBSL, while still indicating the responsibility of the Bank to ensure the free use of the rupee for current international transactions.

d. **Improving the payment and settlement system**

Presently, the Central Bank provides settlement facilities for the transfer of funds among commercial banks and primary dealers through current accounts maintained with CBSL. Automated systems are now being introduced for such high value transfers and settlements on a 'real time basis', i.e. with no time lag between transaction and settlement, to bring Sri Lanka's settlement system on par with developed international systems. Systems are also being introduced for the issuance of government securities and of Central Bank securities in book entry form and for the recording of holdings of such securities in a central depository and for transfers of such securities electronically. Transactions in such securities among banks and primary dealers would also be effected electronically through the automated settlement system. In order to facilitate the operation of these systems, amendments were made to the MLA to achieve the following.

- establish the systems and provide for selected rights and responsibilities;
- enable the provision of intra-day liquidity by CBSL to ensure smooth functioning of systems;
- establish finality and irrevocability of transactions;
- grant validity and enforceability to electronic records and transactions;
- provide for the outsourcing of functions related to payments and settlements.

e. **Strengthening the regulatory role of the Central Bank**

The provisions contained in the MLA in respect of insolvent banks did not apply to licensed specialised banks as that category of banks was recognised by the Banking Act only in 1995. The amendments, therefore, extend the applicability of these provisions to licensed specialised banks. The amendments also enable the more expeditious winding up procedures laid down in the Banking Act to be applied to a liquidation of an insolvent bank.

The above are amendments introduced to address urgent issues. At a more fundamental level, as part of the ongoing programme to modernise Sri Lanka's financial legislation and financial institutions to meet the challenges of the current international financial system, a complete overhaul of the MLA is expected in the next year or two.

Chart 1.8
Financial Sector Indicators

Chart 1.8.1
Broad Money, Reserve Money and Monetary Growth

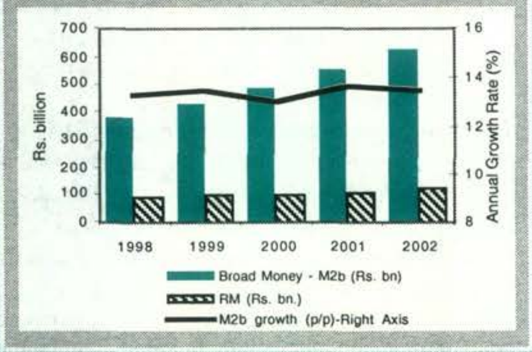


Chart 1.8.2
Distribution of Domestic Credit

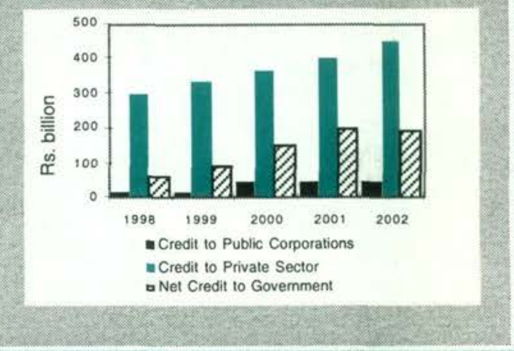


Chart 1.8.3
Interest Rates

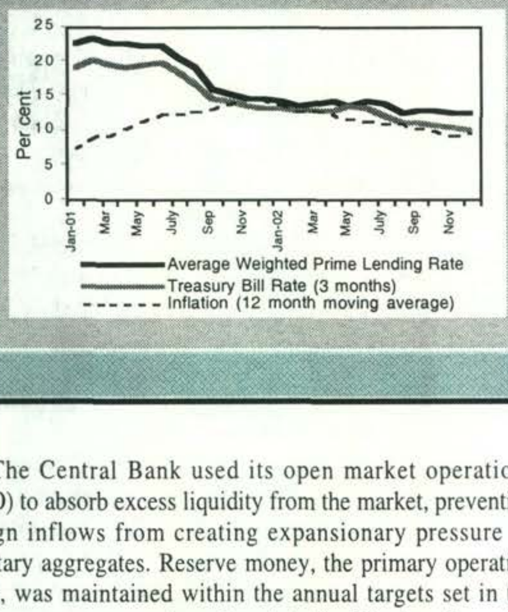
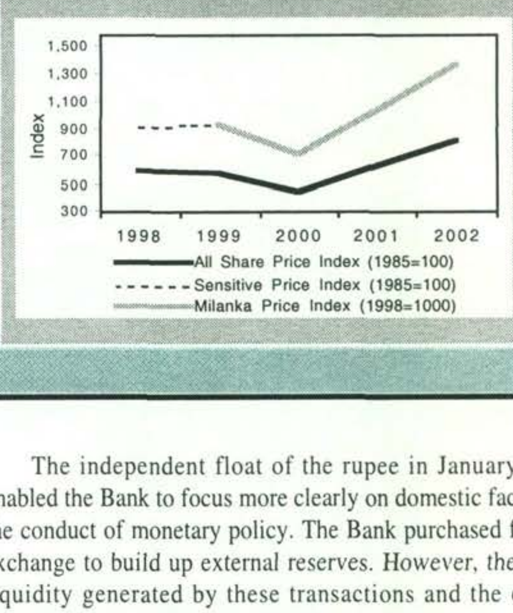


Chart 1.8.4
Share Market Indices



The Central Bank used its open market operations (OMO) to absorb excess liquidity from the market, preventing foreign inflows from creating expansionary pressure on monetary aggregates. Reserve money, the primary operating target, was maintained within the annual targets set in the monetary programme. Amendments to the Monetary Law Act, were passed in Parliament in December 2002 (for details see Box 6). The core objectives of the Central Bank were redefined to focus on economic and price stability, and financial system stability. In addition, the amendments increased the flexibility in conducting monetary policy.

The Central Bank's Repo and Reverse Repo rates were reduced by 225 basis points during the year, in several steps. During the first half, the rates were reduced by 25-50 basis points. Thereafter, as inflation continued its downward trend, the market remained liquid, international interest rates decreased and the economy required support to sustain its recovery, rates were further reduced by 175-200 basis points. Market rates moved down.

The independent float of the rupee in January 2001 enabled the Bank to focus more clearly on domestic factors in the conduct of monetary policy. The Bank purchased foreign exchange to build up external reserves. However, the rupee liquidity generated by these transactions and the excess liquidity arising from other factors was mopped up to contain their expansionary impact. The foreign exchange market remained stable, permitting the Central Bank to enhance the limits on the net open position of commercial banks, giving them greater flexibility in their operations.

As a further step in making the process of monetary management more transparent, the overall monetary policy framework and the projections for the year were announced to the market and posted on the Bank's website. Changes in policy were swiftly communicated to the market, while action was also taken to provide more information to the markets. The Monetary Policy Committee met at least once a month to consider monetary developments and made recommendations to the Monetary Board. The Central Bank announced plans to move to more active OMO in early 2003 (for details see Box 20) and mock operations in this regard commenced, in consultation with market participants.

Money Supply

Growth in the money supply, though slightly above initial projections, was in line with revised projections. Monetary (M_{2b}) growth at end 2002 was 13.4 per cent in comparison to the projection of 13.5 per cent announced in early 2002. The monthly point to point growth peaked at 17.9 per cent in June 2002, primarily due to a low base in the middle of 2001, and then declined steadily.

Unlike in 2001, a substantial portion of the increase in the money supply was caused by a growth in net foreign assets, reflecting a higher inflow of foreign currency into the country during 2002. The improved fiscal performance of the government also had an impact on monetary aggregates, with the government reducing its net liabilities to the banking system (by Rs.8 billion), even though the reduction was not as large as expected initially. The composition of net credit to the government (NCG) also changed. The Central Bank's holdings of government paper declined through its OMO, whereas in contrast, commercial banks increased their holdings. Another notable feature was that within NCG from the commercial banks, the overdraft facilities to the government from the two state banks declined drastically (from Rs.38 billion at end 2001 to Rs.3.6 billion at end 2002).

Credit to public corporations increased by Rs.2.2 billion, slightly less than the increase of Rs.2.6 billion in 2001. This increase was caused primarily by the CEB resorting to bank finance to fund the purchases of emergency power to ensure an uninterrupted supply of electricity. CPC was able to reduce its borrowings by around Rs.2.4 billion, improving its financial viability. The repayment would have been even higher if the debt recovery component in the automatic pricing formula had not been removed mid-year. Private sector credit increased gradually, as the economic recovery strengthened. The point to point growth in private sector credit increased from 8.9 per cent at end 2001 to 12 per cent at end 2002. In absolute terms, private sector credit grew by Rs.48 billion in 2002, in comparison to an increase of Rs.32 billion in 2001. Growth in private sector credit, however, was below initial expectations, mainly due to the weaker than expected recovery in international trade.

Reserve money grew by Rs.14 billion in 2002, in comparison to Rs.7.4 billion in 2001. The Central Bank conducted OMO to maintain reserve money growth within the targets envisaged in the monetary programme. The growth came entirely through an increase in the net foreign assets of the Central Bank; in fact, net domestic assets declined by about Rs.19 billion. A major part of the increase in reserve money (Rs.12 billion) was in currency in circulation, partly on account of increased economic activity, particularly in the North and the East, following the peace process. The imposition of a debits tax on withdrawals from demand deposits may also have increased currency holdings to some degree. The money multiplier (M_{2b} multiplier) increased slightly from 4.88 at end 2002 to 4.92 at the end of 2002. The money multiplier was higher than the end year value throughout 2002, except in two months in the early part of the year. A decline in the currency to deposit ratio brought about by innovations in the payments system and a decrease in the effective statutory reserve ratio (SRR) due to an increase in foreign currency deposits (on which no SRR is applicable) were the major factors that contributed to the increases in the multiplier.

The realised monetary aggregates were in line with the original projections, although some compositional changes occurred. Realised monetary growth was 13.4 per cent, in comparison to an original projection of 12.5 per cent made at the end of 2001 and a revised projection of 13.5 per cent, made in the first quarter of 2002 to accommodate the increasing demand for money associated with expanding economic activity in the North and the East. Reserve money growth was within the expected target. The non-realisation of the planned privatisation process and government's foreign borrowing programme affected the composition of monetary expansion. Net foreign asset growth in the system was lower than expected. Correspondingly, the decrease in the government's liabilities to the banking system was below initial projections. Similarly, public corporations were unable to reduce their liabilities to the banking sector as planned. These developments, however, did not lead to a crowding out of private sector credit. Although private sector credit growth was higher than initially expected (12 per cent, in comparison to 10.4 per cent), the increase was comfortably funded with resources in the banking system, as made evident by the availability of excess liquidity in the market.

Interest Rates

The declining trend in market interest rates experienced from early 2001 continued during 2002. The reduction in the Central Bank's policy rates, greater fiscal discipline that reduced the demand for domestic rupee funds, increased foreign inflows converted to rupees and a relatively slow growth in the demand for credit in the private sector were all factors that assisted this downward movement in market interest rates. The reduction was also evident in the yield on government paper, with the yield curve for government securities shifting further downward. In fact, this yield curve was inverted, indicating market perceptions of a decline in inflation in the medium-term. Interest rate volatility was low in 2002, reflecting the greater stability in the market. Although both deposit and lending rates of banks decreased, the decrease in lending rates was slower, increasing the spread. The relatively high spreads are symptomatic of inadequate competition and structural weaknesses in the commercial banking sector.

As the rupee market was liquid throughout most of the year, short-term rates, particularly interest rates in the call money market, closely followed the movements of the Central Bank's Repo rate. Average call market rates decreased by about 225 basis points (bps) in 2002, in comparison to the decrease of 225 bps in the Repo rate. Similar decreases were seen in the overnight Sri Lanka Inter Bank Offered Rate (SLIBOR) (221 bps) and the average weighted prime lending rate (AWPR) (207 bps). The availability of market liquidity ensured that all Treasury bill auctions were oversubscribed. The yield on 91-day bills decreased by 300 bps and on 364-day bills by 383 bps, resulting in a virtually flat yield curve for Treasury bills at end 2002. In general, the lending rates of commercial banks came down by about 125-175 bps, whereas rates on 1 year fixed deposits decreased by around 330 bps and on savings deposits by around 175 bps. The increasing spreads clearly increased the profitability of the banking sector in 2002. The issue of longer-term Treasury bonds (4-6 years) recommenced in 2002 and in line with other market rates, yields declined, particularly in the second half. The availability of a market determined yield curve for government securities that could be used as a benchmark by the private sector is essential for financial market development. Hence, the Central Bank plans to issue Treasury bonds with even longer maturities in 2003, which would serve the twofold purpose of extending the yield curve and giving the government greater flexibility in managing its debt.

Internationally too, interest rates decreased, as major economies eased monetary policy to assist recovery of their economies. For example, the benchmark United States Fed Funds rate was at a 40-year low in 2002.

Capital Market

Significant improvements were evident in activity at the Colombo Stock Exchange (CSE) in 2002, especially in the first three quarters. Key market indicators such as share price indices, turnover and price earnings ratios all increased substantially. The Sri Lankan stock market was noted as one of the best performing markets in the world in 2002. Further, for the first time since 1998, non-nationals were net investors, resulting in a net inflow of around US dollars 25 million through the stock market. Improved confidence in the country with the progress in the peace process, strategic purchases by non-national investors and an expected improvement in corporate profitability with economic recovery have been cited as factors that pushed up the market. In addition, the decreasing interest rates and proposals in Budget 2002 to tax dividends at a flat 10 per cent and remove the 20 per cent surcharge on corporate profits were also regarded as beneficial to stock market activity. Primary market activity revived as several companies launched initial public offerings (IPOs). A landmark event was the offer for sale by the government of 12 per cent of the shares of Sri Lanka Telecom. This offer for sale, with a market value of Rs.3.2 billion, was the largest on the CSE thus far. However, some dampening of activity was witnessed in the last quarter. Among the factors regarded as causing this was the proposal in Budget 2003 to impose VAT on financial institutions.

Some increase in activity in the listed corporate debt market was also seen during the year. HNB issued 10 year debentures to build its Tier II capital, thus extending the tenor of listed debentures. Prior to that, the longest tenor for listed debentures was seven years. The proposed extension of the yield curve for government securities should assist the listed bond market. Furthermore, the proposal in Budget 2003 requiring a credit rating for publicly issued debt instruments should enable investors to make more informed investment decisions and help better run companies to access medium and long-term funds directly from the market at lower cost.

Other Developments

With the recovery in the economy, performance in other sub-sectors of the financial sector also improved. Assets and liabilities of finance companies grew and more finance companies applied for registration. The insurance industry also grew, with the private sector making a strong presence. The government divested its balance holdings in the National Insurance Corporation (39 per cent). The proposed privatisation of the Sri Lanka Insurance Corporation had to be postponed to 2003, in view of the global investment climate. Once this is completed, the major portion of the industry would be in the hands of the private sector. This sector has much potential for growth in Sri Lanka as insurance penetration is limited in the country. With the international collaboration that exists, it can make a significant contribution to economic activity. The performance of Unit Trusts improved significantly following the upturn in the stock market.

Amendments to the Monetary Law Act effected in December, 2002 have now explicitly indicated that financial system stability is one of the two core objectives of the Central Bank. In keeping with this, the Bank strengthened its supervisory role. Awareness campaigns were conducted through the media to caution the general public regarding the risks of placing funds with unregulated institutions. The licence of a licensed specialised bank, whose imprudent operations had led to insolvency, was revoked. This institution, however, had little systemic importance. In order to strengthen the stability of the banking system, banks have been informed that the required risk weighted capital adequacy ratio would be raised to 10 per cent from 2003. Furthermore, the operations of domestic banking units and foreign currency banking units (FCBUs) will be evaluated on a consolidated basis, and many prudential norms earlier applicable only to domestic units would be applicable to FCBUs as well. The Central Bank initiated the publication of bank wise information on interest rates and charges/commissions to promote competition through wider dissemination of information.

There are ongoing reforms in the financial sector designed to remove bottlenecks and increase its efficiency, in keeping with the vision to make Sri Lanka a financial hub in the region. Restructuring of the two state banks, streamlining operations of the Central Bank, divesting of government holdings in financial institutions to the private sector, facilitating mergers and amalgamation of financial institutions, liberalisation of foreign investment in the financial sector and revamping of the legislative framework to bring it into line with current international norms, are all measures that were taken in 2002 to achieve these goals.

1.11 Economic Outlook for 2003 and Medium-Term Prospects

Future economic prospects of Sri Lanka are favourable, but concerns remain on some downside risks. The country's economic prospects will depend mainly on the progress in the ongoing peace process, strengthening macroeconomic management, speed and effectiveness of implementing structural reforms, finalisation and implementation of the long overdue long term concessional financial assistance programmes i.e., PRGF with the IMF, PRSC with the World Bank, enhanced country assistance programme with the ADB and other donors, improvement in the external environment and favourable weather conditions. Except the last two factors, all others are directly under the control of the country, if necessary measures are implemented effectively and in time. Given the severe effects of a ballooning public debt, strengthening macro-economic management has to be centred around a medium-term fiscal sustainability strategy consisting of a faster reduction in the budget deficit and a consequent reduction in public debt. A time-bound comprehensive structural reform programme consisting of reforms in all major areas, i.e., input markets, public enterprises, civil service, financial sector, pensions, utilities, regulatory systems and judicial system, would not only reinforce the macroeconomic management but also improve investor confidence and increase productivity, enabling the achievement of high economic growth with economic stability.

Lasting peace is essential to ensure economic recovery in 2003 and achieve a high, sustainable growth in the medium term. An early political solution to the North and East issue would increase growth prospects significantly, while any reversal in the peace process would have huge economic, political and social costs. Therefore, every effort must be made to accelerate the ongoing peace process and to complete it successfully by finding a lasting political solution through consensus building as soon as possible. Political stability and national consensus on key political and economic issues among the major political parties, segments of society and institutions are essential, as a national priority, in achieving the twin major objectives of peace and sustainable high economic growth.

Global Economic Prospects for 2003

The pace of the global economic recovery has slowed since late 2002, amid continuation of the adverse effects of the bursting of the equity market bubble, rising geopolitical uncertainties, low market confidence and increased oil prices. Assuming the issue in Iraq is resolved quickly, the revised world economic outlook by the IMF in February 2003 adjusted downward the global growth forecast for 2003 by 0.4 percentage points to 3.3 per cent under the baseline scenario. The advanced economies are projected to grow by 2 per cent, 0.5 percentage points lower than the September 2002 projections. A downward adjustment has been made for all three major economies. The reduction in the US economy was marginal, while larger downward revisions were made for the Euro area and Japan, as policy reforms, in particular labour market reforms, are delayed in the Euro area and financial sector woes in Japan continue unabated. Developing countries are expected to grow at a high rate at 5 per cent even after a downward adjustment of 0.3 percentage points. This will be mainly driven by high growth centres in developing Asia, mainly China, India and the ASEAN-4.

The projected recovery in world trade has been also adjusted downwards correspondingly. The world trade volume in goods and services is projected to grow by 4.9 per cent in 2003 down from earlier projection of 6.1 per cent, but still higher than the 2.9 per cent in 2002. Growth in imports by advanced countries was adjusted downward to 4.9 per cent in 2003 but is still better than the 2 per cent in 2002 and –1.2 in 2001 indicating prospects for export expansion from developing countries, which is projected to grow by 6.3 per cent. Commodity prices are projected to increase at higher rates in 2003 compared with the moderate recovery in 2002 and declines in 2001. Oil prices, which rose by 2.7 per cent in 2002, are estimated to rise by 12.3 per cent in 2003, aggravating difficulties faced by oil importing developing countries. Non-oil commodity prices are projected to grow by 9.3 per cent.

Reflecting commodity price increases, world inflation is expected to be higher in 2003 but still remain low compared with historical levels. Inflation in industrial countries is projected to be about 1.7 per cent, while it is expected to be 5.7 per cent in developing countries. Given the subdued inflationary pressure and the need for a growth stimulus, interest rates are expected to remain low in 2003.

However, downward risks remain high on these projections given under the baseline scenario. The first and most important one is the intensity and duration of the war in Iraq. Any spread to the Middle East region and/or protraction would have serious implications on the global economy, in particular on developing countries. It would stall the expected recovery in the global economy with a likelihood of reverting to recession, as global trade growth slows down and investment dries up. Disruption to the supply of oil would result in a sharp increase in oil prices from the already high levels, exerting pressure on the balance of payments of oil importing developing countries and consequently on their exchange rates. The Gulf region being a large source of employment for developing Asian economies, a protracted war in the region would result in a sharp drop in private remittances further worsening BOP problems and increasing unemployment in those countries.

Second, the continuation of growth imbalances in major world economic centres increases the risk of sudden and abrupt corrections disturbing stability in the international financial system. The sluggish conditions in the second largest economy, Japan, and the Euro area, which have made the global economy heavily dependent on the fortunes of the US economy, would result in the continuation of growth imbalances in major economic blocks. Reflecting these imbalances, heavy fluctuations in major currencies, in particular the US dollar, the yen and the euro, could have destabilising effects in exchange markets resulting in difficulties for developing countries in macroeconomic management.

Third, the continuation of restrictions on entering the markets in advanced countries prevents the maximisation of benefits of globalising economic activities for developing countries.

Therefore, an early resolution to the conflict in Iraq is necessary to ensure the recovery in the global economy. Meanwhile, further strengthening of co-ordination in macroeconomic management among advanced countries would minimise growing imbalances among them. Similarly, opening of markets in advanced countries enhances the opportunities for developing countries to expand their exports and to integrate into the world economy successfully. Nevertheless, improving discipline in fiscal and monetary management and advancing in structural reforms are necessary in developing countries to improve their growth potential and strengthen resilience to withstand external shocks.

Sri Lanka's Economic Outlook 2003

The present macroeconomic prospects for 2003 are favourable, if correct measures are implemented, even though some high downside risks remain. The projections under the baseline scenario consist of a continuation of economic recovery, higher investment expansion, greater stability in prices and exchange rate, lower unemployment, improvement in external reserves, greater macroeconomic stability and strengthening resilience of the economy. Nevertheless, the realisation of these desirable results depends on four major factors : (a) forward movement in the on going peace process, (b) strong policy adjustments, particularly containing the public sector deficit and domestic deficit financing as envisaged in Budget 2003 to be compatible with the medium-term sustainable fiscal strategy, (c) continuation of structural reforms without delays and reversals to remove constraints on productivity improvement and investment expansion and (d) mobilisation of adequate external concessional assistance, including financing under the PRGF/PRSC augmenting other external donor support necessary mainly for economic reforms, infrastructure development, rehabilitation and reconstruction.

Real output is expected to grow by about 5.5 per cent in 2003 benefitting from a recovery in all major sectors; Agriculture (2.9 per cent), Industry (5.3 per cent) and Services (6.6 per cent). The Agriculture sector growth will be mainly driven by the expected monsoon rains, expanding economic activity in the North and the East and continuing strong export demand for minor agricultural crops. The Industrial sector growth will be generated by the momentum in manufacturing industry and construction activity. Expanding activities in trade and transport, recovery in tourism and port services, and the continuation of a high growth momentum in the telecommunications and financial sectors will mainly drive the high growth in the Services sector, which is the largest sector in GDP, accounting for more than half of the total value addition. On the aggregate demand side, both domestic demand driven mainly by the investment expansion and consumer confidence, and increased export demand with the expected expansion in the world trade, would enable the realisation of high growth. Envisaged growth enhancing structural reforms not only raise the growth potential of the economy, but also improve the external competitiveness of the country by increasing productivity and strengthen resilience of the country by diversifying the economy.

Inflationary pressures will further decline in 2003 with continuation of prudential monetary policy aimed at containing monetary expansion consistent with macroeconomic fundamentals. This will also be supported by increasing domestic agricultural production, rising productivity, increasing competition, greater stability in the exchange rate and lower pressure on the interest rates from fiscal deficit financing. Accordingly, annual inflation is expected to decrease to about 7.5 per cent in 2003, reducing inflationary expectations, which are still high. Decelerating inflation would reduce the pressure on excessive wage increases, while the expected productivity increasing reforms would enable workers to realise higher wages without resulting in cost-push inflationary pressures. It will also improve the country's external competitiveness without adding pressure on the exchange rate. Increasing economic activity and high investment expansion would create more productive job opportunities, particularly in the private sector, enabling a reduction in unemployment and underemployment. Increasing income opportunities and widespread economic recovery would improve the living standards of the country, supporting the poverty reduction drive.

Further strengthening of the external sector is expected in 2003, containing the current account deficit at a manageable level, generating a surplus in the overall balance, building up external reserves and reducing external debt service payments. Despite the expected recovery in exports, the current account deficit is projected to increase to 3.3 per cent of GDP, mainly reflecting a higher increase in imports driven by increasing investor and consumer confidence. Export earnings are projected to grow, benefitting from both increasing volumes and rising prices. Meanwhile, imports are expected to grow faster, reflecting increasing demand for all three categories, i.e., consumer, intermediary and capital goods. However, the consequent increase in the trade deficit is expected to be offset partly by improved earnings from tourism and port services, telecommunication services and private transfers.

The capital and financial accounts are expected to improve significantly benefitting from increasing external donor support, improving foreign investor confidence and expected privatisation proceeds. Government's external borrowings under concessional terms and conditions are estimated to be higher in 2003 with the progress in the peace process and the firm commitment to implement economic reforms under the PRGF with the IMF, PRSC with the World Bank and the country assistant programme with the ADB. The endorsement of the medium-term policy framework in the PRSP by the IMF and the World Bank would facilitate the government to obtain substantial financial support from other donors, particularly at the forthcoming donor conference in Japan in mid-2003. Consequently, the government will be able to keep its external commercial borrowings to a minimum to ensure long-term external debt sustainability. FDI and portfolio investment inflows are expected to improve with the continuation of political stability and peace process and improving investor confidence with the endorsement of policies by the Bretton Woods Institutions. The proposed measures to further liberalise the capital account in 2003 would help the private sector to attract more medium and long-term external financing. Meanwhile, obtaining sovereign ratings for the country early would expand access to the international capital market not only for the government, but also for the private sector, which is particularly necessary for infrastructure investment.

Consequently, it is expected to realise an overall surplus in the BOP for the third consecutive year, reducing pressure on the exchange rate and enabling to build up the country's external reserves to a more comfortable level. The estimated BOP surplus for 2003 is about US dollars 389 million including expected programme supports under the PRGF, while it would be a deficit of US dollars 37 million without them. With the projected surplus in the BOP, the total external reserve level is expected to increase to an import coverage of 4.7 months by end 2003, while the official external reserve level would be enough to cover 3.5 months of imports. The external debt service, as a ratio of current receipts including private transfers, is estimated to decline to 9.6 per cent in 2003 from 10.7 per cent in 2002, benefitting from increasing external earnings as well as low international interest rates.

The floating exchange rate regime is expected to safeguard the country's external competitiveness by adjusting according to market forces, reflecting developments in macroeconomic fundamentals of the country. The Central Bank will continue its intervention in the foreign exchange market only to prevent undue excessive volatility and to build up official external reserves by purchasing at market rates. Further deepening and expansion in the foreign exchange market are expected through expansion in forward market activity.

Recognising the burden of an already very high public debt and the need for achieving medium-term fiscal sustainability, Budget 2003 has been formulated to further consolidate fiscal operations, reducing the overall deficit and domestic financing requirement, while introducing more measures to address structural issues on the fiscal front. Accordingly, measures have been proposed for enhancing revenue, rationalising expenditure and improving debt management as continuation of efforts initiated in the previous year's budget. Furthermore, measures have been proposed to improve transparency and accountability of fiscal management.

In line with the medium-term fiscal consolidation path, the overall deficit in 2003 has been targeted to be reduced to 7.5 per cent of GDP. Concomitantly, the current account deficit and the primary deficit are expected to be reduced to 2.3 per cent and 0.2 per cent of GDP, respectively. These are compatible with the medium-term fiscal strategy consisting of reducing the overall deficit to below 5 per cent of GDP by 2006 and turning around the primary deficit to a surplus and reducing the current account deficit sharply, while maintaining an adequate level of public investment. The improvements in fiscal aggregates are expected to be achieved through a reduction of current expenditure (by 1.5 percentage points to 19.3 per cent of GDP) and an increase of revenue (by 0.6 percentage points to 17.1 per cent of GDP), while raising public investment (by 0.7 percentage points to 5.3 per cent of GDP) in 2003.

On the revenue front, the entire increase in 2003 is expected through higher tax revenue collection. New revenue augmenting measures, particularly expanding the revenue base, improving tax administration and the expected economic recovery, would contribute towards achieving the high tax revenue expected in Budget 2003. On the revenue front, major emphasis has been placed on VAT. It is estimated to account for 47 per cent of total tax revenue with the implementation of proposals for extending its coverage. Similarly, the coverage of the debits tax has also been expanded. As a further step in moving towards a tax system with low rates and a large base, the maximum income tax rate was reduced to 30 per cent from 35 per cent, while the public service employees' exemption from income tax was limited only to employment income. Tax administration is expected to improve by expediting the establishment of a well-structured Revenue Authority, and expanding the coverage of the Large Taxpayers Unit (LTU). Timely implementation of these measures is critical to realising the expected improvement in revenue mobilisation. However, concerns have already been raised about the potential revenue losses due to the proposed tax amnesty.

Therefore, every effort must be made to minimise such revenue losses during the implementation of the tax amnesty.

On the expenditure side, improvements are envisaged through strict controls over and streamlining of recurrent expenditure. In this context, major emphasis has been placed on the suspension of hiring to the public service, except for technical and professional categories, better targetting of welfare programmes and curtailing of non-priority expenses. Effective implementation of the Welfare Benefit Act will help in improving targetting of welfare beneficiaries. Meanwhile, improvement in public debt management by replacing high cost short-term debt with low cost long-term debt and reducing reliance on domestic financing would help to contain the interest cost, which has become the largest recurrent cost item. In the preparation of capital expenditure, priority was given to more growth supportive investment for which largely concessional external financing is available.

In financing the resource gap in Budget 2003, heavy reliance has been placed on concessional external financing and privatisation proceeds. Accordingly, domestic net borrowing is estimated to decrease to Rs.87.3 billion in 2003 from Rs.126.4 billion in 2002, leaving more resources to the private sector and reducing pressure on domestic interest rates. In fact, a repayment to the banking system of about Rs.14 billion is expected to reduce the inflationary impact of fiscal operations significantly. Nevertheless, realisation of expected foreign financing and privatisation proceeds are critical to achieve these improvements in deficit financing as large slippages of such estimates will directly raise the domestic borrowing requirement as seen in the past. Realisation of foreign financing and privatisation proceeds will be not only critical in achieving fiscal targets, but also in realising targets expected in the BOP and monetary survey.

The challenges in monetary management in 2003 will largely come from the fallout from international geopolitical developments and delays in the global economic recovery, as both will have adverse implications on price levels, the domestic foreign exchange market and aggregate demand. It is essential to strike a balance between curtailment of inflationary pressures in the domestic market arising from external shocks and the need to improve economic recovery. Similarly, a close monitoring of the expected large inflows of foreign assistance is critical to minimising their potential inflationary pressures and impact on the country's external competitiveness. Increasing reliance on open market operations in monetary management will facilitate facing these challenges without creating economic distortions.

The expected decline in inflationary pressures would enable the Central Bank to reduce its policy rates cautiously and would gradually shift the yield curve further down. The expected surplus in the BOP, raising domestic liquidity and reducing public sector borrowings, would further facilitate reductions in market interest rates.

Based on the overall macroeconomic outlook, monetary expansion (i.e., growth in broad money supply (M_{2b})) has been targeted to be around 13.5 per cent to be compatible with the expected economic growth of 5.5 per cent and the reduction of inflation to 7.5 per cent. Improvements in both net foreign assets (NFA) and net domestic assets (NDA) are expected to contribute to monetary growth. NFA of the banking system is estimated to increase by 33 per cent in 2003, benefitting from the overall surplus expected in the BOP. The entire expansion in NDA is expected to come through credit expansion in the private sector, as the public sector is expected to make a substantial repayment of liabilities to the banking system. This credit growth would help increase private sector economic activity including investment and hence support the achievement of high economic growth. The expected reduction in the fiscal deficit and increase in surplus funds in the domestic non-banking sector would help to reduce government liabilities to the banking sector. Similarly, liabilities of public corporations to the commercial banks are expected to decline, particularly due to expected repayments by CPC in 2003 using proceeds from the privatisation of some of its activities. Accordingly, the outstanding credit of the public sector is expected to decline by about Rs. 27 billion. Meanwhile, the private sector credit level is estimated to rise by Rs.77 billion (17 per cent) in 2003, compared with the realised increase of Rs.48 billion (12 per cent) in 2002. However, realisation of fiscal targets envisaged in Budget 2003 and expected improvements in the financial position of public corporations are critical to achieving these monetary targets.

Faster progress in the peace process, acceleration of structural reforms and a stronger than expected recovery in the world economy may improve the macroeconomic situation more than expected under the baseline scenario described above. However, existing downside risks cannot be underestimated. Any slowdown or reversal of the peace process, protraction of the war in Iraq, delays in recovery of the world economy, large fiscal slippages and delays in envisaged structural reforms could worsen the macroeconomic situation causing severe difficulties for economic management. Therefore, every effort must be made to move forward in the peace process, achieve the envisaged fiscal targets, implement structural reforms and take corrective measures to absorb external shocks in time.

Medium-Term Macroeconomic Prospects

The medium-term macroeconomic prospects of Sri Lanka will depend on a host of factors including political stability, finding a lasting solution to the issue of the North and the East and the intensity and speed of economic policy adjustments and structural reforms, including long overdue institutional reforms, and changes in the international economic environment. As a highly trade dependent economy, as well as the most liberalised country in the South Asian region, developments in the international economy have a significant impact on the economic prospects in Sri Lanka. The global economic recovery and international trade expansion are expected to continue in the medium-term, creating greater opportunities for more liberalised economies such as Sri Lanka. Similarly, increasing competition in international markets and growing preferential trade arrangements result in more challenges to export oriented developing countries. Meanwhile, availability of ODA, which is already low, is expected to decline continuously increasing the relative importance of private capital flows even into developing countries. However, private flows are highly sensitive to market sentiments reflecting country risks including political, economic and social uncertainties. Thus, Sri Lanka can maximise realisation of benefits from the emerging international trends only if necessary macroeconomic policy adjustments and structural reforms are implemented effectively and a lasting political solution is found to the issues of the North and the East, strengthening the country's external competitiveness, improving resilience of the economy and minimising overall country risks for investors.

As the medium-term outlook is highly sensitive to the basic assumptions on the above mentioned critical factors, four medium-term scenarios could be considered under alternative assumptions – viz. a baseline scenario, a high growth scenario, a low growth scenario and a worst case scenario. Summary results for the baseline scenario are given in Table 1.8.

Baseline Scenario: This is based on the assumption that the peace process will progress, leading to a restoration of a lasting peace within another year or two and the government will implement policy adjustments and structural reforms effectively. Under this scenario, economic growth is projected to accelerate to 5.5 per cent in 2003, and exceed 6 per cent after 2004. A gradual but continuous decline is estimated in inflation and unemployment, while investments would increase as confidence builds up, supporting growth. A steady decline in the budget deficit is expected with the implementation of a medium-term fiscal consolidation strategy to more towards achieving the targets set out in the Fiscal Management (Responsibility) Act. Consequently, public debt would decline, avoiding any debt crisis. The external current account deficit would be around 4 per cent of GDP, a sustainable level, particularly in view of the increased imports of capital goods and inflows of concessional foreign financing and FDI. Official foreign reserves would rise to a comfortable level improving exchange rate stability. Money supply would grow at a rate, which would avoid the build up of inflationary pressure and provide adequate liquidity required for accelerating economic growth. Consequently, a gradual decline would be seen in inflationary expectations and hence, in interest rates. However, a positive real interest rate would remain, encouraging domestic savings.

High Growth Scenario: This scenario envisages a very early achievement of a lasting peace and the accelerated implementation of policy adjustments and deeper structural reforms. Economic growth would accelerate at a faster rate and be over 8 per cent in 2006, benefitting from increasing productivity and expanding investment. Increasing growth and investment would reduce the unemployment rate faster, while rising productivity would decelerate inflation. Achievement of

TABLE 1.8
Medium-Term Macroeconomic Indicators

	Provisional	Projections			
	2002	2003	2004	2005	2006
Mid year population (million)	19.0	19.0	19.2	19.4	19.6
GDP growth (%)	4.0	5.5	6.5	6.8	7.0
Investment (% of GDP)	21.5	24.0	26.5	27.6	28.7
Private	16.9	18.8	20.3	20.7	21.5
Public	4.6	5.3	6.3	7.0	7.3
Domestic savings (% of GDP)	14.8	15.9	18.1	19.1	20.9
Private	19.2	18.2	18.0	17.3	18.0
Public	-4.4	-2.3	0.0	1.8	2.9
CCPI annual average (% change)	9.6	7.5	7.0	6.0	5.0
Export volume (% change)	2.0	3.2	20.7	20.9	21.7
Imports volume (% change)	11.0	9.4	25.1	21.6	19.0
External current account deficit (% of GDP)	-1.6	-3.3	-4.1	-4.3	-3.7
Official reserves (months of imports)	3.3	3.5	3.7	4.1	4.4
Government revenue (% of GDP)	16.5	17.1	17.9	18.7	19.1
Government expenditure (% of GDP)	25.4	24.6	24.2	23.7	23.4
Budget deficit (% of GDP)	-8.9	-7.5	-6.3	-5.1	-4.3
Broad money (% change)	13.2	13.5	13.9	13.2	12.4

Source: Central Bank of Sri Lanka

medium-term fiscal targets envisaged in the Fiscal Management (Responsibility) Act would be faster than the baseline scenario, while improvements in the external sector and resilience of the economy would be stronger.

Low Growth Scenario: It is assumed that the cessation of hostilities remains, but the peace process drags on with no finality, and only a few policy adjustments and structural reforms are implemented. Under this scenario, although some economic growth takes place, the growth would be below the historical average of 5 per cent for the period since 1977 and totally inadequate to bring about the expected improvement in the quality of life of the people. Inflation would gradually creep up, eroding the incomes of vulnerable groups. Investment would still take place, but not in the magnitude required to boost growth to desired levels. Unemployment would increase as the slow pace in economic growth and investment expansion could create a smaller number of job opportunities than the increases in the labour force. The budget deficit and public debt would continue to increase, preventing achievement of the envisaged sustained medium-term fiscal targets. Consequently, the risk of a debt crisis would increase. High monetary expansion and low productivity growth would raise inflationary expectations, exerting pressure on the exchange rate and dampening investor confidence. The present market oriented policy framework would be difficult to continue under this scenario and policy makers would be compelled to resort to controls, including import controls and foreign exchange controls.

Worst Case Scenario: This scenario is based on the unfortunate possibility of a resumption of hostilities and a reversal of economic policy adjustments and structural reforms. It clearly highlights the imperative need for peace. Economic growth would decline to very low levels and the economy may, in fact, suffer a contraction. Investment would decline sharply with the weakening investor confidence. Inflation would increase rapidly, as would unemployment, increasing risk of social unrest within the country. The budget deficit and public debt would increase to levels which would make a debt crisis almost inevitable in the near future. Monetary expansion resulting from the high fiscal deficits would be rapid, further aggravating inflationary pressure in the economy. Interest rates would rise commensurately. The widening external sector deficit and decreasing capital inflows would reduce significantly the country's external resources. Official external reserves would deplete to a critical level, exerting tremendous pressure on the exchange rate compelling a reintroduction of strict exchange control measures. Consequently, policy makers would be compelled to resort to a controlled economic regime, introducing rationing for goods and services, and strong controls on imports and foreign exchange transactions within a very short period.

These scenarios, although tentative projections that are sensitive to changes in the assumptions, show clearly the need to achieve a lasting peace early and implement strong policy adjustments and structural reforms faster, to ensure achieving a sustainable high growth in the economy.

1.12 Economic Issues and Policies

Developments under the market oriented economic policy framework introduced in 1977, indicate that the Sri Lankan economy responded positively to economic liberalisation and macroeconomic policy adjustments, aimed at creating a conducive environment for investment and output expansion. The liberalisation of economic activity increased the availability of goods and services to consumers, expanded investment opportunities to entrepreneurs and thus job opportunities to employment seekers. Increased investment and improved market competition raised the potential for economic growth in the country, through both capacity expansion and productivity improvement. Consequently, compared to the previous period, the average annual economic growth rate increased, albeit marginally by about 1 per cent, raising per capita income and hence the living conditions of the people. Increased growth and investment activities helped to increase productive employment, mainly in the private sector, reducing unemployment to a large extent. Strong market competition and expanded investment with modern technology improved the quality of products and raised factor productivity. The diversification of exports, by reducing dependence on primary agricultural exports, increased the resilience of the economy to fluctuations in international terms of trade.

Despite these positive achievements on many fronts, major economic problems such as poverty, unemployment, inflation, macroeconomic imbalances and vulnerability to external shocks continued to threaten the country's ability to move along a long-term sustainable growth path. In fact, some economic problems, such as macroeconomic imbalances and the consequent public debt burden, have worsened, raising concerns on fiscal sustainability in the medium term. However, experience in other countries, particularly in East Asia and recently China, have demonstrated that it is possible to achieve fast economic development in a short period following economic liberalisation and structural reforms. A closer analysis reveals that three major factors held back the performance of the Sri Lankan economy operating under a market oriented macroeconomic policy framework during the last quarter of the twentieth century.

Civil Disturbances: The first and the most important factor was the continuation of civil disturbances, first started as a guerrilla war, but which soon developed into a conventional civil war in the country threatening political stability, worsening social conditions and hindering economic development. It brought in its own cost to the economy by preventing the economy from operating at full capacity, hindering improvements in productivity, disturbing the resource allocation efficiency and interfering with the free mobility of both inputs and finished products throughout the country. Its adverse impact on economic activity was not limited to the North and the East, but was also evident in other parts of the country. The resultant deterioration of market confidence constrained investment expansion, particularly discouraging much needed foreign investment inflows. Meanwhile, increased defence expenditure widened the fiscal deficit, reducing resources available for economic development and raising the burden of public debt. It also exerted pressure on domestic interest rates and the exchange rate through high government borrowing and higher defence imports. Estimates in some studies indicate that civil disturbances contributed to the loss of at least two percentage points of annual economic growth, i.e., over 40 percentage points, during the last twenty years.

Macroeconomic Imbalances: Secondly, the emerging macroeconomic imbalances that continued throughout the period prevented the economy from realising the full benefits of economic liberalisation. Even though private sector led economic growth was the major strategy envisaged in the market oriented economic framework that was pursued, almost all long-term savings in the economy were absorbed by the government, largely for deficit financing of less productive or sometimes non-productive activities. The continuation of financial repression in deficit financing, i.e., absorbing financial resources at lower than market rates of interest, helped not only to continue a fiscal policy with high deficits over a long period, but also discouraged the improvement in domestic savings. The continuation of high fiscal deficits, together with financial repression, reduced resources available to the private sector, thereby weakening private sector initiatives for investment and enterprise, which were essential for sustainable economic growth. Meanwhile, the existence of high current account deficits in the government budget (i.e., dissavings) prevented an improvement in domestic savings, despite the fact that financial repression has been greatly relaxed since the late 1980s. Consequently, Sri Lanka's savings ratio has not only been below the high savings ratios in East Asian countries, but also below those in most neighbouring South Asian countries, where per capita income is lower than Sri Lanka. The impact of domestic macroeconomic imbalances resulting from high fiscal deficits was extended to the external sector as well, engendering high current account deficits and thereby exerting pressure on the exchange rate. The depreciation of the rupee significantly fuelled domestic inflation, reflecting the high external trade dependence of the country (around 77 per cent). Thus, the continuation of macroeconomic imbalances resulted in a vicious circle of inflation-depreciation, raising inflationary and depreciation expectations in the economy, creating difficulties for monetary management as well.

Economic Reforms: Thirdly, the slow progress in economic liberalisation and other structural reforms prevented the realisation of the full benefits available under the market oriented economic policy framework. The share of the public sector in economic activity increased sharply during the first decade, following the introduction of the new economic framework in 1977, as existing public enterprises expanded and new public enterprises were established. This was not compatible with the basic principle of private sector led growth envisaged under the new policy framework. Even though the removal of trade restrictions and the opening of sectors to private investment have been continued since 1977, the public sector still dominates a large number of major economic sectors, such as power and energy, transport, ports and aviation, water, telecommunications, financial services, education, health and trade. The continued operation of inefficient and loss making public enterprises has been one of the major causal factors for many economic problems faced by the country today. Their losses added to pressure on the fiscal deficit or increased public sector bank borrowings, exerting pressure on interest rates and crowding out private investment. Their inefficiency reduced growth in productivity in the economy and raised costs of production, exerting cost-push inflationary pressures. The adverse impact of continuing their functioning has been clearly shown up in the poor performance in infrastructure facilities, weakening the country's external competitiveness and investor confidence. For example, the power sector has been in crisis for long, resulting in an inadequate and unreliable supply of electricity and the highest energy costs in the region. The present average cost of power per kWh in Sri Lanka is US cents 7.5, when compared to 5.8 cents in Malaysia, 5.3 cents in Singapore and 6.9 cents in Bangladesh. Furthermore, the risk in the availability of an adequate and reliable power supply has become one of the major concerns that stands in the way of building investor confidence about Sri Lanka. Similarly, weaknesses in the public transport sector have not only resulted in a heavy fiscal burden, but also, reduced productivity in almost all sectors in the economy because of delays, long travel time even over short distances and inconvenience to passengers. Similarly, public sector monopolies, although opened recently to the private sector, retarded the potential expansion in port and aviation services in the country, compared with achievements in some of the ports in the region. Efficiency in the ports and aviation sector is critical in overall economic development for a heavily trade dependent island economy.

On top of the above inefficiencies, economic reforms too have been very slow and inadequate in major input markets. Labour market flexibility, which is one of the preconditions for realising maximum benefits from a market oriented economic system, has been seriously limited by archaic labour laws and regulations. Their negative impact on labour intensive investments has adverse consequences on employment expansion. Similarly, delay and uncertainty in reforms have a serious negative impact on labour productivity and investor confidence. Large public sector holdings, delays in registration and transfer, and inefficiency in the land market have prevented the development of an efficient market and maximising land productivity. The continuing public sector involvement in agricultural seed markets and extension services has become a barrier to improve agricultural yields. The present yields of all major agricultural crops (i.e., paddy, tea, rubber, coconut) are significantly lower in Sri Lanka than in many other emerging economies. Delays in education reforms, particularly the opening of tertiary education to the private sector, and changing skills and vocational training facilities from a supply driven system to a demand driven system resulted in not only a mismatch in the labour market and high structural unemployment among educated youth, but have also led to social and political unrest in the country.

Delays in liberalising input and output markets prevented faster economic diversification, which is essential to strengthen the resilience of the economy. Continuing high dependence on hydro power, which is sensitive to the vagaries of the weather, and high concentration of exports in two products (garments and tea) and a few markets (USA and EU for garments and the Middle East for tea) resulted in the country being exposed and vulnerable to the fluctuations in terms of trade.

An efficient and dynamic public sector is critical for the effective functioning of a market economy. Slow progress in civil service reforms has resulted in a continuation of inefficiency in the public sector, retarding the realisation of benefits under the market oriented economic framework. Frequent complaints by private sector investors about public sector inefficiencies and delays in the implementation of policy changes and reforms clearly demonstrate the cost of delaying civil service reforms for accelerated economic growth. Furthermore, delays in judicial reforms and the deteriorating law and order situation in the country, which are essential for the successful functioning of a market economy, also adversely affected the realisation of full benefits from economic liberalisation in Sri Lanka.

Addressing these three major critical issues effectively is essential to accelerate economic growth. The continuation of the ongoing peace process aimed at finding a lasting political solution is necessary to remove the first barrier discussed above. The effective implementation of a comprehensive macroeconomic adjustment programme, particularly containing a medium-term sustainable fiscal strategy, will address the second issue. Finally, the acceleration of further liberalisation and other economic reforms will address effectively the third barrier mentioned above.

The required macroeconomic policy adjustments and structural reforms have been discussed extensively in previous issues of the Central Bank Annual Report, government policy documents (Vision 2020 and Regaining Sri Lanka:Vision and Strategy for Accelerated Development), special reports prepared by trade chambers and country papers prepared by international organisations. A summary of these adjustments is given below.

The most important macroeconomic policy adjustment is a continuous and sharp reduction in the fiscal deficit by rationalising current expenditure while maintaining adequate public capital expenditure and increasing revenue mobilisation to ensure medium-term fiscal sustainability. Major structural reforms necessary in the public sector to support these fiscal adjustments include the simplification of the tax system, expansion of the tax base, discontinuation of tax concessions, improvement in tax administration, introduction of cost recovery prices/charges for public services, reforming the civil service, introducing zero budgeting for public institutions at least in their current account wherever possible, improvement of procurement procedures, closing down redundant public institutions, consolidating remuneration for ministers and parliamentarians as a package, diversifying public debt instruments and improving public debt management. Similarly, a structural reform programme consisting of privatisation, commercialisation, introduction of automatic and transparent price adjustments in public enterprises, improvements in labour market flexibility and land market efficiency, application of performance based wage increases and increased private sector participation in economic activity including infrastructure and human resource development is necessary to revitalise public enterprises.

Financial sector reforms, consisting of legal reforms, commercialisation of public sector financial institutions, increased private sector participation in insurance and pension activities, and introducing competitive market regulations for capital and debt markets have been identified to strengthen financial sector stability, improve efficiency in domestic resource mobilisation and reduce intermediation costs. Meanwhile, ongoing reforms in the Central Bank have been envisaged to enable it to concentrate more on its primary objectives of economic and price stability, and financial system stability.

On the trade front, identified reforms consist of the implementation of a consistent tariff policy, rationalisation of non-tariff barriers (NTBs), simplification of government approval procedures, developing competitive markets for agricultural inputs and outputs, encouraging forward/futures markets for agricultural outputs to minimise seasonal price fluctuations, and developing independent regulatory systems.

Amendments to labour laws, expansion of performance based wage determination, rationalisation of public holidays and demand-driven skills development have been identified as necessary labour market reforms. The proposed land reforms consist of the development of an efficient land registration and transfer system and release of unutilised public sector lands. Similarly, relaxation of controls on the utilisation of the sea for fishing, recreation and transport is essential to harness fully the resources of the sea, one of the largest natural resources of the country.

In the health sector, restructuring the public health sector to concentrate more on preventive and primary health care and opening health training to the private sector are identified as major reforms. With the expansion of private sector health care services, it is essential to promote health insurance schemes to ensure the self-sustainability of the sector and its future growth. With regard to public sector health services, urgent action needs to be taken to address organisational and administrative weaknesses to minimise labour disputes that surface frequently, as they lead to great inconvenience to the public, losses in productivity and waste of scarce resources. Maintenance of a proper distribution of available limited resources and establishment of an appropriate referral system would help to reduce congestion in major hospitals.

Educational reforms, consisting of teacher training, appropriate teacher deployment, updating curricula to include new subjects such as computer and information technology, teaching major international languages, opening tertiary education to the private sector, and devolving management of schools to the local community are necessary to develop a competitive and skilled labour force and make Sri Lanka a regional service centre.

Sri Lanka's public university system, which has failed to provide opportunities for all those who aspire to receive a university education, is severely constrained by a chronic shortage of funding, an ailment emanating from the wider budgetary difficulties of the country. The consequence has been disastrous: a gradual deterioration in the educational standards compelling prospective employers to suspect whether to hire the throughput of the university system; continuous agitations by both students and staff for better facilities and failure to attract and retain quality staff to maintain the educational standards. Valuable lessons could be learned by Sri Lanka in this regard from the experiences of the California State Public University System in the 1960s and the British University system in 1980s when there was a general cut in public funding due to similar budgetary constraints. The university systems in both cases, responded positively to the new problem by competitively restructuring their universities, as private companies would do in similar situations, by progressively reducing their reliance on public funding. Income sources were diversified, new income sources were identified and exploited, substantive ancillary products such as research output were developed and marketed and a competitive environment within the universities was created using entrepreneurial, rather than academic skills. Courses were rated and then rationalised on the basis of demand for same. It appears that university authorities in Sri Lanka are sitting idly on a vast resource base, which could be developed for the betterment of the university system. Both students and staff must appreciate this need and work together towards saving the system as otherwise a critical stage would be reached when the entire system would face the threat of a general collapse. It is of utmost importance to infuse entrepreneurial skills into the running of public universities.

Existing economic problems, necessary economic policy adjustments and structural reforms mentioned above have been discussed in the government's recent policy document 'Regaining Sri Lanka: Vision and Strategy for Accelrated Development' (RSL). It enunciates the government's strategy to meet the economic challenges facing the country and to put the economy on a high growth path, so that the people could reap the benefits emanating from a vibrant economy. In order to achieve these objectives, four key challenges have been identified in the document: increasing employment opportunities immediately by creating 2 million jobs, overcoming the public debt crisis, finding resources for reconstruction of the economy and increasing income levels. These challenges are expected to be met by increasing growth through both raising productivity and expanding investment. The need for further liberalisation by removing growth retarding restrictions and regulations, correcting distortions in the way of productivity growth, accelerating the privatisation process, encouraging public-private partnerships, reforming the legal foundations of the economy and improved public sector efficiency have been emphasised as necessary measures for achieving the objectives. The need for strengthening export expansion through improved external competitiveness, a cost effective trade policy, efficient customs administration and expanding market access under identified bilateral and regional trade agreements has also been emphasised, since achieving a high growth will depend critically on increasing exports, as an island economy. The need to reduce direct government involvement in economic activity allowing an increasing role to the private sector has been reiterated. Accordingly, the government's primary responsibility in economic activity is expected to be to develop and maintain policies and rules necessary to ensure market competitiveness and to implement them efficiently, minimising the burden on the economy. An extensive action plan, consisting of detailed policy measures and reforms is given as an Annexure to the RSL document. As efficient implementation of this action plan is critical in achieving these objectives, a close monitoring and progress reporting system have also been proposed in the document.

The RSL has been submitted as Sri Lanka's Poverty Reduction Strategy Paper (PRSP) to the IMF, World Bank and other donors. It identifies causal factors for multi-faceted, high poverty in Sri Lanka. They are: insufficient economic growth, civil conflict, geographical isolation, limited access to markets/resources/public services, low agricultural productivity, and governance problems. Accordingly, it envisages a multi-pronged poverty reduction strategy consisting of enhancing the economic growth potential, revitilising the rural economy, enhancing rural infrastructure, improving the quality of education, prioritising health expenditure and depoliticising social welfare programmes.

Peace: Everyone agrees that peace is essential for economic development and that the war creates a huge economic burden. The costs of the war have been very clear during the last twenty years. It was manifested by an economic growth rate that was persistently well below the country's potential, resulting in a low per capita income, lower employment opportunities, high inflation, low productivity, destruction of infrastructure facilities, weakening of market confidence, discouraging investment including foreign investment inflows, increased fiscal deficits and pressure on interest rates and the exchange rate. Economic gains under the ongoing ceasefire clearly indicate the potential benefits from peace. First, it has helped the ongoing economic recovery, provided a peaceful environment conducive for economic activity and improved market confidence. The growth momentum in 2002 in trade and transport, agriculture, fishing, tourism and port activity gave evidence of these benefits. Secondly, it has stopped the escalating cost of the war, reduced pressures on the fiscal deficit and hence on interest rates and the exchange rate. Thirdly, it improved market confidence encouraging investors, including foreign investors. These benefits that were under the ceasefire which was only the first step in the ongoing peace process, clearly indicate the potential for huge benefits one can expect under a lasting peace, the ultimate objective of the peace process.

Experience has shown that economic growth and peace are highly interrelated. High economic growth needs a lasting peace, a lasting peace can only be maintained with a strong vibrant economy offering widening opportunities for all. Sri Lanka's future economic performance would depend heavily on whether the country would achieve peace. The gains would be completely different if the country continues a no war/no peace situation or reverts to war. Attaining a durable peace within a sustainable constitutional arrangement is essential to achieve the high growth necessary to alleviate poverty on a more sustainable basis. Strong commitments from all involved parties and building up consensus gradually on difficult and complex issues are essential in achieving it. In this endeavour, progress made under the ongoing peace process is encouraging. Increased domestic and international support has further strengthened the peace process, indicating that it is moving in the right direction. At the same time, the acceleration of rehabilitation and reconstruction activity is critical to further strengthen domestic support. An aggressive mobilisation of external concessional donor assistance in time is necessary for these expensive activities, as available domestic resources are not adequate. The proposed donor group meeting in Japan in mid-2003 will provide an ideal opportunity for mobilising such external financing. Therefore, every effort must be made to mobilise the maximum amount of resources at the forthcoming donor group meeting not only for reconstruction and rehabilitation in the North and the East, but also to develop infrastructure facilities in other parts of the country, which have been neglected in the past. The subsequent, fast utilisation of such assistance will further strengthen the growing support for peace.

The country at present is at a crossroads. The major challenge facing the country is moving on all three fronts simultaneously; i.e., moving forward in the peace process, providing relief, implementing rehabilitation and reconstruction activity and accelerating economic growth through productivity improvement and capacity expansion by implementing structural reforms effectively.

On the economic policy front, most of the appropriate policies have been known. The need is to implement them, in time and effectively. The required policy adjustments and reforms are comprehensive and painful. Therefore, their successful implementation requires strong political commitment, building up consensus, maintaining policy consistency, proper sequencing, demonstrating transparency and accountability, developing a dynamic private sector, and mobilising adequate concessionary financial resources.

Commitment: The required economic policy adjustments and structural reforms have been known over a long period. However, they were not implemented because of short-term political concerns, resistance from interest groups and weaknesses in implementation processes. Therefore, a strong political commitment is essential for the implementation of reforms effectively and in time. It is essential to build up a national consensus on major economic policies. It is encouraging that almost all major political parties have accepted a market oriented economic framework as most appropriate to achieve economic development. That acceptance minimises significantly the political risk of reversals in the overall economic framework with every successive change of government. However, an unfortunate feature in economic policymaking in the country is that often, politicians who strongly support desirable economic policy changes and structural reforms when in power, vehemently oppose the very same changes usually without any alternative measures, when they are in opposition. Inevitably, such action creates suspicion and distrust among the general public about the efficacy of policies and the suitability of reforms. This has mainly been due to the lack of a national consensus on major economic policies and structural reforms. Therefore, it is critical to have open and transparent discussions on national economic issues among political parties to build consensus, strengthen policy ownership and a firm political commitment to implement them. This process can be encouraged and facilitated by private sector organisations such as trade chambers and professional associations.

Consensus among political parties alone is not sufficient for the effective implementation of difficult economic reforms to resolve deeply rooted problems. A consensus on the economic policies among all major stakeholders, i.e., politicians, bureaucrats, academics, media, trade unions and the public, is essential. Such efforts will establish the policy ownership and increase commitment of the civil service in the implementation of reforms, while the private sector, media and public can provide the necessary support to mitigate potential resistance from powerful interest groups who benefit from existing economic distortions, at the cost of the entire nation.

In this endeavour, the need for effective public awareness programmes cannot be over-estimated. The costs of continuing economic distortions and rigidities and potential benefits from their removal have to be explained and quantified, as often as possible. Justification for reforms should be supported with recent successful experience in Sri Lanka and in other countries. Measures to address potential temporary difficulties faced by vulnerable groups during the implementation of some reforms need to be adopted early to minimise their resistance and to broaden public support.

Sequence: Since the list of required economic adjustments and reforms is comprehensive and long, proper sequencing is essential[1]. In particular, given the limitations in available institutional capacity, skills and financial resources, it is essential to prioritise reforms, in order of impact on growth. The establishment of such prioritises would facilitate the mobilisation of required concessionary external assistance for their implementation.

Continuity: Another important element of effective economic reforms is continuity. In the context of increasing globalisation, reform will be an ongoing endeavour. Changing technology, discovery of new resources, changes in demand reflecting human desires and increasing international competition would call for a dynamic economic policy framework to ensure sustained high economic growth. In such circumstances, policy changes and structural reforms will also need to become a part of the continuing policy making process. Thus, any discontinuity or reversal in implementation of reforms can result in high opportunity costs to the economy. The impressive achievements in East Asian countries compared with other developing countries is clearly evidence of the benefits of an unabated continuation of economic reforms.

Consistency : Similarly, ensuring policy consistency is vital to economic management and structural reforms. Inconsistency in economic policies, reversing already implemented policies without acceptable justification, postponing the implementation of policies or changing them in an ad hoc manner can lead to loss of policy credibility and market confidence. Past experience in Sri Lanka emphasises the need for paying high attention to this issue. The continuation of a market oriented economic policy framework, with expanding public sector involvement in economic activity, not only retarded the realisation of economic benefits, but has also resulted in an unsustainable debt burden in Sri Lanka. Similarly, liberalisation of the financial sector and reduction of financial repression, without the required corresponding fiscal consolidation efforts, has increased the debt service burden in the budget significantly during the last two decades. Meanwhile, ad hoc and inconsistent policy changes not only discouraged investment, but also lead to a waste of valuable scarce economic resources. For example, ad hoc tariff changes on edible oil imports caused significant difficulties to the coconut oil and desiccated coconut (DC) industries, resulting in a waste of economic resources and the loss of valuable export markets for DC products built up over a long period. Similarly, high agricultural protection for some products, sometimes over 100 per cent, has been incompatible with policies for improving efficient resource allocation and containing inflationary pressures. Further, although the recently introduced Debits Tax could be justified on the grounds of improving the government's revenue mobilisation efforts, it is not consistent with developing and deepening the financial sector to develop Colombo as a regional financial hub, which is one of the major policies under the present economic development programme. Such inconsistency creates confusion and uncertainty with regard to policy direction, and retards economic growth. Therefore, every effort must be made to maintain policy consistency in implementing economic policy changes and structural reforms, as they could result in large economic costs in a system where economic activities are highly interrelated.

Governance and Transparency: A primary cause for poor economic performance in the country has been the inferior governance principles pursued specifically by the public sector. Effective governance can be established only if the role of government is clearly defined, including the responsibilities of sub-national governments. The recent policy document 'Regaining Sri Lanka: Vision and Strategy for Accelerated Development' has clearly defined the role of the government in economic activity, as a facilitator providing a conducive policy environment, rather than an active major player directly involved in economic activity. It has emphasised the need for a lean and efficient government. Similarly, improving transparency and accountability in economic management is critical to minimising misuse, strengthening public support and implementing policies effectively. This is very important as the public at large, particularly interested groups affected by policies/reforms previously, have repeatedly expressed their concerns regarding transparency and accountability in the decision making process, as well as in the implementation of decisions.

The continued coverage of a large number of non-eligible beneficiaries under major welfare schemes, while keeping out some truly deserving people from receiving such benefits, high waste in public expenditure, inordinate delays in the provision of services to the public, continuous recruitment of staff to public sector institutions already overstaffed and persistent underutilisation of concessional foreign assistance clearly demonstrate the weakness in transparency and accountability in the public sector. The adherence to best international practices and codes is essential in strengthening accountability and transparency. In this context, the recently enacted Fiscal Management (Responsibility) Act and the Welfare Benefits Act are major steps in the right direction. However, their final impact will depend heavily on effective implementation. Meanwhile, the Central Bank has improved its transparency in monetary management by increasing information dissemination. It is equally important that the private sector adheres to transparency and accountability in their own actions.

Role of the Government: A clear definition of the role and the responsibility of the government is essential, as mentioned above, for successful economic management. The most important role of the government is to maintain effectively the law and order in the country, ensuring protection of property rights, which is essential for the successful functioning of a market economy. The necessity of a legal framework compatible with the market oriented

1 The action plan attached to 'Regaining Sri Lanka: Vision and Strategy for Accelerated Development' runs into 80 pages.

economic system and an efficient judicial system cannot be overestimated. Limitations to available commercial court facilities and trained judges experienced in commercial matters, as well as long delays and inefficiencies, rampant in the current judicial system, all impose heavy economic costs, clearly indicating the need for major legal and judicial reforms to support faster economic growth.

The ideal government for a successful market economy is a lean and efficient one. Such a government plays only the role of a facilitator in the economy, and is not a major producer or distributor of goods and services, which can be done more efficiently by the private sector. However, even after a quarter of a century since the introduction of a market oriented economic framework, the government is still involved directly in both the production and distribution of a large number of economic sectors. Furthermore, the public sector continues to exercise monopoly power in some sectors in the economy. The continuation of this high government direct engagement in economic activity is not conducive to the realisation of benefits under market oriented economic reforms. Therefore, as envisaged in the RSL, a faster reduction of the government's direct involvement in economic activity is needed to accelerate economic growth.

Despite the continued liberalisation of the external sector and the eligibility for concessionary donor assistance, foreign investment inflows to Sri Lanka have remained low, constraining the economic growth of the country. Foreign investment inflows under official assistance has remained low, even though donors have regularly pledged large amounts of concessional financial assistance to the country. Delays and inefficiencies in implementation were the major reasons for the underutilisation of foreign aid. The inflow of foreign private investment also remained relatively low despite continuous opening of economic sectors to foreign investors and offering of attractive concessions, including tax holidays. Continued civil disturbances, slow progress in structural reforms, inefficiency in the civil service and policy inconsistency are some of the major causal factors for low foreign private investment inflows. Addressing these problems is essential to encourage larger inflows, which are critical for accelerating economic growth.

Role of the Private Sector: The private sector has to play an active role in accelerating economic development in the market economic framework where the major emphasis is on private sector led growth. Changes in attitudes, development of business ethics, and improving transparency and accountability are critical to developing a dynamic private sector, which can effectively take the challenges in a globalised economy. The need for changing attitudes is clear, in that even twenty five years after the introduction of economic liberalisation, some entrepreneurs in the private sector depend on government subsidies, concessions and protection for the continuation of their business activities. Instead, the need is to improve the commercial viability of their businesses through improved management and production efficiency. Furthermore, they have to be prepared to face challenges emanating from external competition by improving productivity and expanding research and development activity rather than continuing to depend on undesirable subsidies, concessions and market protection. Similarly, an improvement in business ethics, transparency and accountability of the private sector will help to improve the confidence of the public in structural reforms, which aim at transferring more and more economic activity from the public sector to the private sector.

Financing: The availability of sufficient financial resources in time is essential to achieve the two primary objectives discussed above, i.e., peace and economic growth. The early commencement of rehabilitation and reconstruction work in the North and the East, as well as accelerating the development of infrastructure facilities in the entire island are critical to strengthening further domestic support for the peace process and increasing economic growth. The comprehensive reform programme presented as an action plan in the RSL, and provisional estimates made for rehabilitation and reconstruction work, indicate the need for a significantly large amount of additional resources (i.e., more than US dollars one billion annually) over the medium-term (3 – 5 years) on a front loaded basis. However, available domestic resources are very limited due to the low savings/GDP ratio of below 20 per cent, which is not sufficient even to cover the existing normal investment demand of around 25 per cent of GDP. Therefore, an aggressive programme for mobilisation of foreign assistance is essential to ensure the availability of necessary resources.

An ideal window of opportunity has emerged with the progress in the peace process, successful completion of the Stand-By Arrangement (SBA) with the IMF, and improved macroeconomic management and commitment to economic reforms. Increasing international support for the peace process will facilitate the mobilisation of much of the required resources as grants rather than loans, if a well thought out strategy is followed. The successful completion of the SBA has strongly established the government's policy credibility, enabling a move to long-term assistance programmes from international financial organisations and increasing available assistance from bilateral donors. An improved macroeconomic management and a commitment to structural reforms have further strengthened the country's eligibility for external concessional assistance.

In this context, progress in the government's efforts is encouraging. The Oslo meeting in November 2002 was used to mobilise foreign assistance to address immediate humanitarian needs. Even though the amount committed was small, about US dollars 70 million, compared with the large amount of assistance required, the commitment of donors to provide financial assistance to support the peace process was established. Similarly, the proposed donor group meeting in June, 2003 in Japan provides an opportunity to raise the necessary foreign assistance. It will also provide an excellent opportunity to mobilise additional concessional assistance required for economic development, particularly infrastructure

TABLE 1.9
IDA Base Case Lending Programme, FY03-FY06

(US $ millions)

FY03	**205.0**
PRSC I: Factors of Production	110.0
Economic Reform Technical Assistance	15.0
Second Community Water	40.0
National HIV/AIDS Prevention	10.0
Improving Relevance & Quality of Undergraduate Education	30.0
FY04	**230.0**
PRSC II: Welfare Reform & Rural Development	90.0
e-Lanka	50.0
Rural Poverty Reduction Initiative	40.0
Health Sector Operation	50.0
FY05	**195.0**
PRSC III: Public Sector Reform	90.0
NE-Infrastructure Rehabilitation/Capacity Building	40.0
Public Sector Reform Technical Assistance	15.0
Education Sector Operation	50.0
FY06	**170.0**
PRSC IV (to be determined)	90.0
Land and Water Administration	40.0
Services for Urban Poor	40.0

Source: World Bank

developments in the whole island and to undertake costly economic reforms. It is essential to mobilise this assistance on highly concessional terms, preferably as grants rather than loans.

Almost all donors have indicated their willingness, and some of them have even begun to enhance their concessional assistance to Sri Lanka, by taking into account the policy credibility, improved macroeconomic management, strong commitment to structural reforms and excellent loan repayment record of the country, Sri Lanka has never rescheduled or failed to honour its debt service obligations. The Poverty Reduction and Growth Facility (PRGF) with the Extended Fund Facility (EFF) assistance approved by the IMF for Sri Lanka in April 2003 is a major achievement in this regard. The total package from the IMF alone is SDR 413.4 million, i.e., about US dollars 567 million (100 per cent of the country quota), consisting of SDR 269 million, i.e., about US dollars 369 million (65 per cent of quota) under the three-year PRGF and SDR 144.4 million, i.e., about US dollars 198 million (35 per cent of quota) under a three-year EFF. The PRGF programme provides a number of benefits. First, it provides a large amount of financial assistance at a low interest rate (0.5 per cent per annum) for a long period (repayment period of 10 years) with a long grace period (5 1/2 years)[1]. Second, it will encourage mobilisation of additional donor assistance. Third, it provides an international endorsement of the country's economic management, encouraging not only donor financing, but also private capital inflows. Fourth, the availability of financial assistance from the IMF, which is entirely as balance of payments support, will improve the macroeconomic environment by increasing the country's external reserves that will improve the resilience of the economy to external shocks and the stability of the exchange rate. Every effort must be made to complete the PRGF programme successfully, thereby strengthening the country's economy and policy credibility.

Similarly the new Country Assistance Strategy (CAS) for Sri Lanka, approved by the World Bank in March 2003, proposes to disburse an increased amount of long-term concessional financing from the World Bank group. The base case lending programme in the CAS consists of a total of US dollars 800 million (US dollars one billion under a high-case scenario) of IDA resources for the period FY 2003 to FY 2006 at a concessionary rate (0.5 per cent per annum) with a long repayment period (over 30 years) and a grace period (10 years). These resources will be available as budgetary support for financing economic reforms and infrastructure development. In each year, the lending programme would be anchored in a Poverty Reduction Support Credit (PRSC) programme, providing support for the implementation of the poverty reduction strategy. This would be complimented by two to four investment/sectoral operations per year to support key programmes in the focus areas as in Table 1.9. The World Bank has made preparations to obtain Board approval for the PRSC facility for Sri Lanka in mid 2003. The PRSC, which is in the form of programme financing, alone will provide (US dollars 380 million) during the programme period.

Similarly, ADB, which provides about US dollars 200 million annually as assistance to Sri Lanka, has already initiated work necessary to further enhance its country assistance. Meanwhile, other donor organisations and bilateral donors, including Japan, Sri Lanka's largest donor, have

1 The component under the EFF is available at the basic rate (2.27 per cent in April 2003) with a grace period of 4 years and repayment period of 10 years

clearly expressed their commitment to increase concessional assistance to Sri Lanka.

This new donor assistance will provide benefits to a large part of the population, particularly to low income groups, as they will be provided based on the Poverty Reduction Strategy Paper (PRSP) prepared by Sri Lanka, and endorsed by the IMF, the World Bank, ADB and other donors (see Box 3). This creates a faster trickle down effect, which would strengthen public support for economic adjustments and structural reforms envisaged under these assistance programmes.

Furthermore, the endorsement of the country's economic policies and reforms by international organisations will improve international investor confidence, and encouraging foreign private investment inflows. Private inflows should be encouraged as concessional assistance to the country will decline with the continuing downward trend in official donor assistance (ODA) and as Sri Lanka will not be eligible for concessional financing from multilateral organisations when its per capita income increases over the eligibility threshold level, within the next few years. In this context, obtaining sovereign debt ratings as soon as possible from reputed international rating agencies will be a forward looking step, as it will further strengthen foreign investor confidence and greatly enhance the resource base available to Sri Lanka. Furthermore, it will improve policy discipline in the country, as such ratings will be upgraded with policy improvements, and downgraded with policy weaknesses and slippages.

Sri Lanka should not miss this unique opportunity, where the international community has indicated its willingness to support strongly the peace process and provide a large amount of concessional financial assistance for rehabilitation, reconstruction and development of the whole country. However, the realisation of maximum benefits from this goodwill will depend entirely on the commitment, unity and ability of all Sri Lankans, i.e. politicians (both government and opposition), civil servants, civil society and the private sector.

Summary and Conclusions : Even though Sri Lanka was the first country in South Asia to adopt open economic policies, it cannot be complacent about its achievements over the past 25 years. The growth momentum maintained during this period has been below the country's long term growth potential. While the destructive civil war contributed substantially to less-than-the potential economic performance, the failure to pursue the economic reform programme vigorously too was a major cause for such an undesired outcome. The correct identification of the past mistakes would, therefore, help the country to map out suitable strategies for accelerating economic growth in the future. Lasting peace, strict fiscal discipline and vigorous policy reforms are the key to the success of such a strategy.

Box 7

Major Economic Policy Measures: 2002-2003[1]

Policy Measures Taken in 2002

	Effective Date	Policy Measures
Monetary Policy	20 Mar 2002	- Central Bank's Repo and Reverse Repo rates reduced by 50 basis points to 11.50 per cent per annum and 13.50 per cent per annum, respectively.
	21 Mar 2002	- Central Bank's Reverse Repo rate increased by 10 basis points to 13.60 per cent per annum.
	22 Mar 2002	- Central Bank's Reverse Repo rate increased by 5 basis points to 13.65 per cent per annum
	04 Apr 2002	- Central Bank's Reverse Repo rate increased by 20 basis points to 13.85 per cent per annum.
	04 Jun 2002	- Central Bank's Reverse Repo rate reduced by 10 basis points to 13.75 per cent per annum.
	25 Jun 2002	- Margin between the discount (outright sales) rate for Treasury bills at the secondary window of the Central Bank and the primary market weighted average yield rate (PMYR) increased from 5 basis points to 15 basis points.
	11 Jul 2002	- Margin between the discount (outright sales) rate for Treasury bills at the secondary window of the Central Bank and the PMYR increased from 15 basis points to 50 basis points.
	26 Jul 2002	- Central Bank's Repo and Reverse Repo rates reduced by100 basis points each to 10.50 per cent per annum and 12.75 per cent per annum, respectively.
	29 Jul 2002	- Margin between the discount (outright sales) rate for Treasury bills at the secondary window of the Central Bank and the PMYR increased from 50 basis points to 125 basis points.
	22 Nov 2002	- Central Bank's Repo and Reverse Repo rates reduced by 75 basis points and 100 basis points to 9.75 per cent per annum and 11.75 per cent per annum, respectively.
	17 Dec 2002	- Monetary Law (Amendment) Act No. 32 of 2002 was enacted.
		- Statutory limits on the Statutory Reserve Ratio (SRR) was removed with the amendments to the Monetary Law Act (MLA).
Financial Sector	01 Feb 2002	- Local Treasury Bills Ordinance (Primary Dealers) Regulations No.1 of 2002 and Registered Stocks and Securities Ordinance (Primary Dealers) Regulations No.1 of 2002 issued to expand the Primary Dealer (PD) system to permit Licensed Commercial Banks (LCBs) to become PDs and to strengthen the supervisory framework.
	01 Mar 2002	- Daily foreign currency net open position (NOP) limits of commercial banks was raised.
		- Maximum positive net open foreign exchange position of commercial banks was increased to 15 per cent from 10 per cent of a bank's capital funds and reserves.
	25 Mar 2002	- Financial Sector Reform Committee, consisting of members from the government, the Central Bank and banking and other financial institutions was formed.
	1 Apr 2002	- Sri Lanka Automated Clearing House (SLACH) divested by the Central Bank to a new limited liability company (LankaClear Ltd.) managed by commercial banks.
	02 May 2002	- Capital Adequacy Ratio for PDs was introduced (3 per cent).
	02 Jul 2002	- Requirement of bidding a minimum of 15 per cent of the amount offered at Treasury bond auctions was imposed on PDs.
	15 Aug 2002	- Permission was granted to consider the daily market value of investments made by commercial banks in Sri Lanka Development Bonds (SLDB) as liquid assets for calculation of statutory liquid assets ratio.
	13 Sep 2002	- In terms of Finance Companies (Deposits) Direction No. 1 of 2002, issued by the Monetary Board of the Central Bank, finance companies were allowed to accept deposits for a minimum of one month. Prior to this change, the minimum maturity period was three months.
	24 Dec 2002	- Prudential norms hitherto applicable to the domestic banking operations of commercial banks were made applicable to the off-shore banking units.

1 This includes major economic policy measures implemented during 2002 and the first four months in 2003. In addition, policy measures that have already been announced and are to be implemented in 2003, are also included.

Box 7 (contd.)

	Effective Date	Policy Measures
External Sector	31 Jan 2002	- Payment of interest on accounts held by foreign passport holders resident in Sri Lanka on resident visas was permitted.
	16 Mar 2002	- Sri Lankans were permitted to export Sri Lanka currency notes up to a limit of Rs. 5,000 per person when they travel abroad and import the same on their return to Sri Lanka.
		- Persons resident in Sri Lanka were permitted to retain in their possession foreign currency in the form of travellers cheques and currency notes purchased from an authorised dealer for travel abroad but unutilised for such travel up to a limit of US dollars 2,000 or its equivalent in other convertible foreign currency for the purpose of utilising for future travel abroad, provided that the currency notes so retained do not exceed US dollars 500 or its equivalent in other foreign currency.
	22 Mar 2002	- Payment of sea and airfreight in foreign currency was permitted.
		- Foreign currency account facilities for shipping/airlines were permitted.
	19 Apr 2002	- Restrictions placed on non-resident investments in the areas of banking, finance, insurance, stock broking, construction of residential buildings and roads, supply of water, mass transportation, telecommunication, production and distribution of power and energy, professional services and setting up of branches/liaison offices of companies incorporated overseas were completely relaxed.
	12 Jun 2002	- Registered insurers were permitted to hold more than one special foreign currency account.
	04 Sep 2002	- Granting of housing loans in foreign currency to Sri Lankans employed abroad by authorised dealers was permitted.
	22 Nov 2002	- Import of gold on consignment account basis by limited liability companies, approved by the Controller of Exchange, was permitted.
Trade and Tariff Policy	1 Jan 2002	- Full duty waiver for import of petroleum products was granted (from 1 January 2002 to 07 November 2002).
	21 Jan 2002	- Licensing requirement on the import of rice removed and a specific duty of Rs. 7.00 per kg on rice introduced instead of 35 per cent import duty.
		- Surcharge of 40 per cent on import duty on rice and paddy removed.
	01 Mar 2002	- Tariff provisions of the Indo-Lanka Free Trade Agreement came into effect.
	22 Mar 2002	- A fee of 0.1 per cent was imposed on import licences subject to a minimum of Rs 100.
		- A levy of Rs. 100 was imposed on export control licences.
	22 Mar 2002	- Specific duties on red onions (Rs.5.00 per kg), big onions (Rs.6.00 per kg), potatoes and chillies (Rs.30.00 per kg) were imposed. Maize was made duty free.
	01 Apr 2002	- Specific surcharge of Rs. 20 per kg on soya bean oil, palm oil, sunflower oil and coconut oil reduced to Rs. 5 per kg.
		- Fabric imports exempted from GST.
	15 April 2002	- Surcharge of 40 per cent on import duty reduced to 20 per cent.
	03 May 2002	- Tariff Advisory Council was set up.
	26 Sep 2002	- Specific surcharge of Rs. 5 per kg on soya bean oil, palm oil, sunflower oil, coconut oil and other vegetable oil withdrawn.
		- Masoor red dhal and yellow dhal exempted from 20 per cent import duty surcharge.
		- Import of Sprats, canned fish and dried prawns made duty free.
	01 Oct 2002	- Export rebate scheme for poultry sector was implemented (subsidy of Rs. 20 per kg for chicken exported to any country for first six million kg).
	06 Nov 2002	- Duty rates between 2 and 10 per cent imposed on items hitherto exempted from customs duty, excluding crude oil, wheat flour, pharmaceuticals and books.
		- Specific duty on import of rice reduced to Rs. 5 per kg.
		- Specific duty of Rs. 5 per kg. imposed on import of green gram, cowpea, tur dhal, rice flour and jaggery.
	18 Nov 2002	- Waste and scrap of copper, nickel, aluminium, lead, zinc, tin and tungsten etc. were brought under export licensing.

Box 7 (contd.)

	Effective Date	Policy Measures
Fiscal Sector	01 Feb 2002	- Ad valorem excise of 35 per cent on petrol, diesel and kerosene replaced by specific duties of Rs. 24 per litre on petrol and Rs. 4 per litre on diesel.
	14 Feb 2002	- Excise duty rates on selected categories of cigarettes revised (reduced for below 60 mm length brands and increased for brands in 72-84 mm length).
	22 Feb 2002	- NSL on wheat, wheat flour and bread removed.
		- Subsidy payment on wheat flour to Prima Ceylon Ltd. withdrawn.
	22 Mar 2002	- Excise duty under Excise (Special Provisions) Act on beer (10%) and on hard liquor (30%) removed and all excise taxes on liquor brought under the Excise Ordinance. In order to recoup the revenue loss, excise duty rates adjusted upward.
		- Excise duty of Rs.4 per litre imposed on all aerated waters under Excise (Special Provisions) Act.
	01 Apr 2002	- 10 per cent withholding tax on interest income imposed (with a tax free limit of Rs. 72,000 per annum).
		- Personal income tax exemption threshold raised to Rs.240,000 per annum and rate bands changed to the following: First Rs. 180,000 10% Second Rs. 180,000 20% Balance 35%
		- Corporate income tax rate reduced to 20 per cent if taxable annual income does not exceed Rs.5 million.
		- 20 per cent surcharge on corporate taxation abolished.
		- Advance Company Taxation (ACT) abolished.
		- Tax on capital gains abolished.
		- A tax amnesty to persons who have not declared their income up to 31 March 2002 was introduced under the Inland Revenue (Special Provisions) Act No. 7 of 2002.
	10 Apr 2002	- Statutory limit applied to government borrowings made through Treasury bills increased to Rs. 250 billion.
	29 Apr 2002	- Duty free allowance for migrant workers increased from US dollars 1,250 to US dollars 1,500.
	30 Apr 2002	- Stamp duties, imposed under the central government, abolished.
	01 May 2002	- Ports and Airports Development Levy (PAL) of 1 per cent was imposed on all imports with a concessionary rate of 0.75 per cent on imports into export processing industries.
	23 May 2002	- Revenue Management Advisory Council (RMAC) was set up.
	01 Jun 2002	- Debits Tax, at a rate of 0.1 per cent, introduced on all debit transactions, proceeds realised by the encashment of certificates of deposits and travellers cheques under Debits Tax Act No. 16 of 2002.
	01 Aug 2002	- Goods and Services Tax (GST) and National Security Levy (NSL) abolished and consolidated into a Value Added Tax (VAT).
		- Excise duties on cigarettes, petrol, diesel and kerosene revised.
	10 Oct 2002	- Fertiliser subsidy scheme for urea revised from a fixed price subsidy (Rs. 350 per 50 kg.) to a fixed cost subsidy scheme (Rs. 6,000 per MT).
	12 Oct 2002	- Diesel tax imposed by Finance Act No. 16 of 1995 abolished.
	18 Oct 2002	- Excise duties on cigarettes revised.
	22 Oct 2002	- Welfare Benefits Act No. 24 of 2002 was enacted (Box No. 16).
	17 Dec 2002	- RMAC was restructured to a Revenue Steering Committee (RSC).

Box 7 (contd.)

	Effective Date		Policy Measures
Other Policies	15 Jan 2002	-	An Automatic Petroleum Price Adjustment Formula (APPAF) was introduced.
	06 Mar 2002	-	A new insurance scheme for potato farming was introduced under the Agricultural and Agrarian Insurance Act No. 20 of 1999.
	20 Mar 2002	-	Debt recovery charge on diesel in the APPAF was reduced to Rs. 2.50 per litre from Rs. 3.50 per litre.
	01 Apr 2002	-	A flat fee of Rs.25/- per garment sold in the local market by BOI enterprises, was imposed.
	15 Apr 2002	-	Electricity tariffs raised by an average rate of 37 per cent.
	01 May 2002	-	Telecom tariffs raised by an average rate of 15 per cent.
	04 May 2002	-	Sri Lanka Consumers' Price Index (SLCPI) was introduced on a trial basis.
	01 Jun 2002	-	Water tariffs raised in the range of 12.5 per cent to 87.5 per cent.
	01 Jul 2002	-	A Bus Fare Policy for road passenger transportation was introduced to revise bus fares, preferably annually, according to a formula.
	15 Jul 2002	-	Debt recovery component in the APPAF (Rs. 6.00 per litre of petrol and Rs. 2.50 per litre of diesel) was withdrawn.
	06 Aug 2002	-	Factories Ordinance Act of 1942 amended.
	01 Oct 2002	-	Recruitment to the public sector suspended.
		-	Existing vacant posts in the public sector abolished.
	22 Oct 2002	-	Rural Economy Resuscitation Fund was established.
	07 Nov 2002	-	Upper limit of credit of the New Comprehensive Rural Credit Scheme (NCRCS) increased from Rs. 2.7 million to Rs. 5 million for production of seed and planting material and purchase and storage of agricultural produce under the Forward Sales Contract System.
	11 Dec 2002	-	Board of Investment Bill was passed by Parliament.
		-	Electricity Reform Act No. 28 of 2002 was enacted.
	17 Dec 2002	-	Petroleum Products (Special Provisions) Act No. 33 of 2002 was enacted.
	18 Dec 2002	-	Civil Aviation Authority of Sri Lanka Act No. 34 of 2002 was enacted.
	20 Dec 2002	-	Public Utilities Commission of Sri Lanka Act No. 35 of 2002 was enacted.

Policy Measures Taken in 2003

	Effective Date		Policy Measures
Monetary Policy	07 Jan 2003	-	Central Bank's Repo and Reverse Repo rates reduced by 75 basis points to 9.00 per cent per annum and 11.00 per cent per annum, respectively.
	28 Jan 2003	-	Margin between the discount (outright sales) rate for Treasury bills at the secondary window of the Central Bank and the PMYR reduced from 125 basis points to 25 basis points.
	11 Feb 2003	-	Margin between the discount (outright sales) rate for Treasury bills at the secondary window of the Central Bank and the PMYR further reduced from 25 basis points to 5 basis points.
	03 Mar 2003	-	Active Open Market Operations commenced.
	03 Apr 2003	-	Computing Statutory Reserve Requirement (SRR) of commercial banks on the basis of daily average balances of deposit liabilities and vault cash during the week ending the preceding Tuesday of the reserve week was commenced.

Box 7 (contd.)

	Effective Date	Policy Measures
Financial Sector	01 Jan 2003	- Capital Adequacy Ratio (CAR) applicable to Domestic Banking Units of commercial banks and specialised banks increased. Accordingly, commercial banks and specialised banks were required to maintain a minimum CAR of 10 per cent in relation to Risk Weighted Assets with core capital constituting not less than 5 per cent. - Classification of all fixed income assets in the Foreign Investment Portfolio as 'trading', 'held to maturity' and 'available for sale' as per International Accounting Standard (IAS) commenced.
	15 Jan 2003	- Treasury bonds with a maturity period of 10 years were issued, extending the yield curve.
	01 Feb 2003	- Treasury bonds with a maturity period of 15 years were issued further extending the yield curve.
	01 Apr 2003	- CAR for PDs increased to 5 per cent from 3 per cent. - Minimum Capital Requirement of PDs increased to Rs.200 million, with Tier 1 capital of at least Rs.150 million.
External Sector	21 Jan 2003	- Restrictions on Rupee lending to foreign controlled companies approved under Section 17 of the Board of Investment Act were removed. - Forward purchases of foreign currency for repayment of foreign loans were extended up to 720 days. - Forward purchase of foreign currency for imports, from banks other than those handling import documents, was permitted. - Conversion into foreign currency of rupee proceeds realised on the sale of assets mortgaged for foreign currency loans, was permitted in the event of default of such loans. - Issue of bid bonds and performance bonds in favour of persons resident outside Sri Lanka was permitted without a limit in respect of exports and other service contracts. - The limit applicable to letters of guarantee for purposes other than exports and other service contracts, was enhanced up to a value of US dollars 500,000 from Rs. 200,000. - Payment of interest at a rate not higher than the prevailing interest rate for the respective currencies, to suppliers for imports made on deferred payment basis, was permitted.
Trade and Tariff Policy	01 Jan 2003	- Ports & Airports Development Levy was reduced from 0.75 per cent to 0.5 per cent for imports solely used for export purposes.
Fiscal Sector	01 Jan 2003	- Fiscal Management (Responsibility) Act No. 3 of 2003 came in to effect (Box 5). - Tax free limit on interest, under 10 per cent withholding tax, raised from Rs.72,000 to Rs.108,000 per annum. - Coverage of the Debits Tax extended to savings deposits with commercial and licensed specialised banks at the rate of 0.1 per cent. Exemption of the Debits Tax on withdrawal increased to Rs.20,000 per mensem. - Coverage of VAT extended to banks and other financial sector organisations. - Services provided by professional conference organisers registered with the Sri Lanka Convention Bureau, import and supply of textiles and handloom products, jewellery, maize, medical and dental equipment and surgical dressings, which were exempt from the VAT, brought under the 10 per cent rate. - Tree Tax on Kitul tapping for toddy reintroduced. - Licence fees paid by super markets, grocery stores etc. that sell alcoholic beverages with an annual turnover in excess of Rs.72 million increased. - An annual fee was imposed on motor vehicles, which will be credited to a Road Fund.
	19 Feb 2003	- Contributory Pension Fund Bill was passed by the Parliament as an amendment to the Employees' Provident Fund (EPF) Act No. 15 of 1958. Consequently, the title of the Employees' Provident Fund Act was changed to Employees' Provident Fund and Contributory Pension Fund Act.

Box 7 (contd.)

	Effective Date	Policy Measures
	01 Apr 2003	- Personal income tax rate and corporate tax for companies with a taxable income of over Rs. 5 million per annum reduced to 30 per cent. The 5 per cent deduction given to public quoted companies from taxable income before computing tax liability withdrawn. - The current system of taxation of remittances of non-resident companies replaced with a remittance tax of 10 per cent. - Public service employees' exemption from income tax limited to employment income. - Duty free allowance for migrant workers increased from US dollars 1,500 to US dollars 1,750.
Other Policies	07 Jan 2003	- Termination of Employment of Workmen Act of 1971 amended. - Industrial Disputes Act of 1950 was amended. - Employment of Women, Young Persons and Children Act of 1956 amended.
	09 Jan 2003	- Consumer Affairs Authority Bill was passed by Parliament.
	10 Jan 2003	- A new insurance scheme for greenhouses and protected crops introduced under the Agricultural and Agrarian Insurance Act No. 20 of 1999.

Policy Measures Proposed to be Implemented in 2003

- Relaxing of payment terms stipulated for imports to permit the release of all imports by Sri Lanka Customs without referring to Exchange Control.
- Liberalisation of opening of branch or liaison offices by non-residents, subject to bringing in a minimum capital of US dollars 100,000.
- Repeal of the Exchange Control Act and enactment of the new Foreign Exchange Management Act.
- Amending the Local Treasury Bills Ordinance and Registered Stocks and Securities Ordinance to provide for a Scripless Securities Settlement (SSS) System & Central Securities Depository (CSD).
- Introduction of Real Time Gross Settlement (RTGS) System and SSS System.
- Setting up the CSD in the Public Debt Department of the Central Bank.
- Establishment of a Revenue Authority.
- Enactment of the Public Debt Management Law.
- Establishment of the Public Debt Management Office.
- Establishment of the Human Resources Endowment Fund.
- Establishment of the Infrastructure and Corporate Restructuring Fund.
- Establishment of an Agro-Enterprise Development Fund.
- Establishment of a Road Fund.
- Establishment of a Jaggery Palm Development Body.
- Establishment of a Gem and Jewellery Trade Promotion Council.
- Establishment of the Private-Public Partnership Forum of the Sri Lanka Apparel Association to overcome challenges posed by the phasing out of the Multi-Fibre Arrangement on quotas.
- Creation of a new Tea Sector Association with representatives from the government and all stakeholders in the sector.

Box 8

Calendar of Data Dissemination to the General Public

Type of Information	Frequency	Dissemination Form	Approximate Date of Release
Real Sector			
1. GDP	Quarterly	Press Conference, Press Releases CBSL Website, Weekly Economic Indicator (WEI), Monthly Economic Indicator (MEI)	For the first three quarters, at the end of the following quarter, for the 4th quarter on the 1st working day of May in the following year
	Annually	Annual Report, CBSL Website	Annual: 1st working day of May of the following year
2. Index of Industrial Production, CBSL	Monthly	MEI, WEI, Annual Report	With a lag of six weeks
3. Agricultural Production (Tea, Rubber, Coconut)	Monthly	MEI, WEI, Monthly Bulletin, Annual Report,	With a lag of six weeks
4. Energy	Monthly	MEI, WEI, Monthly Bulletin	With a lag of four weeks
5. Telecommunications	Monthly	MEI	With a lag of six weeks
6. Port services	Monthly	MEI	With a lag of four weeks
7. Tourism	Monthly	Monthly Bulletin	With a lag of six weeks
8. Transport	Monthly	MEI	With a lag of three months
Prices and Wages			
9. CCPI	Monthly	Press Releases, CBSL Website, MEI, WEI, (Gazette Notification by DCS), Monthly Bulletin, Annual Report	On the 1st working day of the following month
10. CDCPI	Monthly	Press Releases, CBSL Website, MEI, WEI,	On the 1st working day of the following month
11. WPI	Monthly	Monthly Bulletin, MEI, WEI, CBSL Website	With a lag of two months
12. SLCPI	Monthly	Press Releases, CBSL Website, MEI, WEI, (Gazette Notification by DCS), Monthly Bulletin, Annual Report	With a lag of six weeks
13. GCPI	Monthly	Press Releases, CBSL Website, MEI, WEI, (Gazette Notification by DCS), Monthly Bulletin, Annual Report	With a lag of one month

Box 8 (contd.)

Type of Information	Frequency	Dissemination Form	Approximate Date of Release
14. Nominal Wage Rate Index for workers in wages boards [1/]	Monthly	Monthly Bulletin, MEI, WEI, CBSL Website	With a lag of two months
15. Nominal Wage Rate Index for employees in the government sector [2/]	Monthly	Monthly Bulletin, MEI, WEI, CBSL Website	With a lag of one month
Fiscal Sector [3/]			
16. Revenue Expenditure Financing	Monthly	Monthly Bulletin, MEI, WEI (except financing), Monthly Bulletin, CBSL Website	With a lag of two months (Revenue data are available with a lag of one month)
17. Total debt	Monthly	MEI, WEI, Monthly Bulletin	With a lag of two months
Domestic	Monthly	CBSL Website	With a lag of one month
Foreign	Monthly		With a lag of two months
Financial Sector			
18. Interest Rates			
CBSL Policy Rates [4/]	Daily	CBSL Website, WEI. MEI	On the same day
Repo Rate	Daily	CBSL Website, WEI. MEI	On the same day
Reverse Repo Rate	Daily	CBSL Website, WEI	On the same day
Bank Rate	Daily	CBSL Website, WEI	On the same day
Sri Lanka Inter Bank Offered Rate (SLIBOR)	Daily	CBSL Website, WEI	On the same day
Call Market Rates	Daily	CBSL Website, WEI	On the following day
Average Weighted Prime Lending Rate (AWPR)	Weekly	CBSL Website, WEI	Last working day of each week
Average Weighted Deposit Rates (AWDR)	Monthly	CBSL Website, WEI, MEI	With a lag of one week
Treasury Bills	Weekly	CBSL Website, Newspaper, WEI, MEI	Every Thursday
Treasury Bonds	Depending on the auction	CBSL Website, WEI, MEI	On the following day
Rupee Securities	Depending on the issue	CBSL Website, WEI, MEI	On the following day

Box 8 (contd.)

Type of Information	Frequency	Dissemination Form	Approximate Date of Release
19. Banking System Liquidity Indicators			
Repo/Reverse Repo Volumes	Daily	CBSL Website, MEI, WEI	On the following day
Reserve Money	Weekly	CBSL Website, MEI, WEI	With a lag of one week
Monetary Survey	Monthly	CBSL Website, MEI, WEI	With a lag of 5 weeks
Financial Survey	Monthly	Monthly Bulletin	With a lag of 8 weeks
20. Stock Market Indicators	Daily	CBSL Website, WEI	On the same day (evening)
External Sector			
21. Trade Balance	Monthly	MEI, WEI, Monthly Bulletin	With a lag of one month
22. Balance of Payments	Quarterly	MEI, Monthly Bulletin	With a lag of three months
23. Exchange Rate	Daily	CBSL Website, MEI, WEI Monthly Bulletin	On the same day
24. External Debt	Monthly	Annual Report	With a lag of three months
25. External Reserves			
Official	Monthly	MEI, WEI, Monthly Bulletin	With a lag of two weeks
Total	Monthly	MEI, WEI, Monthly Bulletin	With a lag of 5 weeks

1/ Currently there is a lag of two months in publishing the Nominal Wage Rate Index for workers in wages boards. Action has been taken to reduce the lag.

2/ The index is adjusted only when there is a change in the wages of government employees. The adjusted index can be made available immediately after receiving the relevant circular on such wage changes.

3/ Includes only Central Government Operations

4/ Changes in policy rates are announced on the same day

Agencies Responsible for preparing data
1. CBSL - Central Bank of Sri Lanka
2. DCS - Department of Census and Statistics
3. ERD - External Resources Dept.

Energy : Ceylon Electricity Board (CEB), Ceylon Petroleum Cooperation (CPC)

Telecommunications:- Sri Lanka Telecom Ltd., Telecommunications Regulatory Commission of Sri Lanka

Port services:- Sri Lanka Ports Authority (SLPA)

Tea production:- Sri Lanka Tea Board

Rubber production:- Rubber Development Department

Coconut production:- Coconut Development Authority