Chapter 1

ECONOMIC PERFORMANCE, OUTLOOK, ISSUES AND POLICIES

1.1 Introduction

In 2003, Sri Lanka made further progress in its march to economic recovery and stability through a continuation of sound macroeconomic policies and a further deepening of structural reforms. This was supported by a favourable environment resulting from the confidence built by the continuation of the ceasefire, a gradual improvement in the world economy and increased international support for the country. The improved macroeconomic management was basically centred around addressing key policy areas, viz., the continuation of fiscal consolidation, prudent monetary policy and a well functioning independently floating exchange rate system. These were reinforced by a significant headway that was made in broadening and deepening structural reforms. In order to support rehabilitation and reconstruction activity and to facilitate economic reforms and policy adjustments aimed at laying the foundation for long-term economic growth in an atmosphere of peace and harmony, the international community pledged a substantial amount of highly concessional financing facilities for the country. The economy responded to these stimuli positively, firming growth, reducing unemployment, improving price stability and strengthening the economy's resilience in absorbing external shocks. All in all, Sri Lanka is presently at a crossroads, as prospects are high for a durable peace and a move towards a sustainable high quality economic growth[1]*. However, to reach this goal, a national consensus on major political and economic issues should be built through a series of wide and continued public discussions and awareness programmes. This makes it incumbent on all segments of society, such as politicians, bureaucrats, the business community, civil society, academia and the media, to support and pursue the initiative vigorously. Any failure in this regard would cause Sri Lanka to miss another opportunity of achieving the interrelated twin objectives of peace and high quality economic growth.*

On the economic policy front, an overall improvement was observed in 2003. Monetary policy continued to balance judiciously the two objectives, viz., ensuring sustainable low inflation, while facilitating economic recovery. This was further supported by the continuation of the independently floating exchange rate system, which has served well since its introduction in 2001 by absorbing a part of the pressure from larger than expected foreign currency inflows. In the implementation of this policy stance, the Central Bank cut its policy rates cautiously to encourage investments and used active open market operations to sterilise the excess rupee liquidity resulting from the build up of external reserves. The latter helped the Central Bank to contain the expansion of reserve money within the programme targets. Meanwhile, steps were taken to strengthen further the market orientation in implementing monetary policy: active open market operations, permitting the market to determine interest rates by adopting an auction system and enhancing the transparency and predictability of monetary management, by keeping the market informed of changes more regularly. The Central Bank is taking a range of further measures to broaden monetary policy instruments and improve the policy transmission mechanism through improvement in the soundness of the financial system. Steps were also taken to improve the stability, safety and efficiency of the payments and settlements system.

1 An environment friendly, high economic growth, with greater equality, is referred to as a sustainable high quality economic growth.

The success of the monetary policy stance was ensured by a complementary fiscal policy regime, which aimed primarily at fiscal consolidation, compatible with the medium-term sustainable fiscal strategy envisaged in the Fiscal Management (Responsibility) Act (FMRA). Accordingly, measures were taken to enhance government revenue mobilisation through an improvement in tax policy, coupled with a better tax administration. At the same time, on the expenditure side, the growth in recurrent expenditure was contained by checking the expansion in the wage bill, defence expenditure and transfer payments. Action was also taken to check the sharp growth of the unfunded pension liability of the government by bringing new recruits to the government service under a contributory pension scheme. The abuse of welfare programmes by the undeserving, thereby burdening the taxpayers, was to be checked by designing a new overall welfare programme under the Welfare Benefit Law. Public expenditure allocation was improved by minimising low priority rupee funded capital expenditure. In financing the reduced deficit, the main emphasis was placed on concessional foreign borrowing in order to release more domestic financial resources to the private sector, which was identified as the driving force in accelerating economic growth and creating productive employment. The first Mid Year Fiscal Position Report submitted by the Ministry of Finance in terms of the FMRA made a comprehensive evaluation of the progress in fiscal operations and highlighted the additional measures, particularly revenue measures, needed for keeping the budget on track, even though some of them could not be implemented in time due to delays in legislation. Policies improving debt management, such as replacing high cost short-term debt with long-term low-cost debt, extending the maturity of Treasury bonds, and prudent Treasury cash management were continued, helping to reduce interest costs below the original budgetary estimates.

A significant headway was made on various areas in the structural reforms agenda too, e.g., by opening public sector monopolies to market competition (petroleum and telecommunications), amending legislation (particularly laws relating to the labour market and the financial system) and proposing a three year civil service reform linked to a public sector wage increase. Long overdue amendments to the labour laws streamlining settlement of disputes, eliminating restrictions on overtime work by women and increasing penalties for child labour were implemented. Additional labour courts and tribunals were established. A mandatory compensation formula for retrenched workers was announced and an unemployment insurance scheme was being prepared to facilitate the implementation of labour market reforms. The previously mentioned improvements in macroeconomic management and the deepening of structural reforms created a conducive environment for economic recovery, by increasing investor confidence, encouraging foreign inflows and enhancing donor assistance. These measures also helped to lay the foundation for a long-term sustainable high quality economic growth.

There was a widespread positive response from the economy to the measures adopted. On the production side, all major sectors, particularly paddy, manufacturing, trade, telecommunications, financial services, tourism, port and aviation, and construction, contributed to the acceleration of growth, with a 5.9 per cent growth being recorded in Gross Domestic Product (GDP) and a 6.4 per cent growth in Gross National Product (GNP). Meanwhile, on the demand side, a recovery in exports and a pick-up in investments added to the continuing consumer confidence. Capital formation picked up, increasing to 22.3 per cent of GDP, particularly during the second half, recording increases in both public and private investment. The increased economic growth and the recovery in investment created more productive job opportunities in the private sector, reducing unemployment, although it still remains high at 8.4 per cent. National savings grew by 1.8 percentage points to 21.3 per cent of GDP, reducing the domestic resource gap (i.e., investment minus savings), as a result of improved incomes of the people, increased remittances and reduced current account deficit in the budget. It is encouraging that inflation declined at a faster pace than expected to 2.6 – 6.3 per cent, depending on the price index, adjusting, after a long period, inflationary expectations downward, which is necessary to achieve sustainable low inflation.

On the fiscal front, despite a large revenue shortfall, the budget deficit declined to 8.0 per cent of GDP, due to effective expenditure containment measures; the realised deficit however, was higher than budgeted. Increased economic growth and the reduced budget deficit together contained the rising trend in the public debt to GDP ratio. The reduced deficit and increased foreign financing reduced government net domestic borrowing significantly (about Rs. 47 billion), enabling the government to repay some of its existing debt to the banking sector, thereby releasing more resources to the private sector. Meanwhile, public corporations too reduced their borrowings in 2003, reducing the overall public sector borrowing requirement by Rs. 54 billion and hence facilitating the downward adjustment in interest rates. Thus, the fiscal sector achievements clearly indicate favourable movements towards the targets in the FMRA, although they were below expectations.

During 2003, the external sector was further strengthened with a recovery in exports and a continuation of the growth in tourism, port services, worker remittances and private capital inflows. Despite increased petroleum prices, the terms of trade improved by 7.4 per cent in favour of Sri Lanka. The current account deficit in the balance of payments (BOP) as a ratio of GDP declined to 0.6 per cent, while the overall BOP recorded a surplus (US dollars 502 million) for the third consecutive year. Consequently, external reserves of the country improved further, the external debt service ratio declined and the short-

TABLE 1.1
Selected Macroeconomic Indicators

Item	1980-89 Avg.	1990-99 Avg.	2000	2001	2002(a)	2003(b)
GDP (real) growth rate (% change)	4.2	5.1	6.0	-1.5	4.0	5.9
GNP (real) growth rate (% change)	4.0	5.3	5.8	-1.3	4.1	6.4
GDP deflator (% change)	11.8	10.2	6.7	12.4	8.4	5.0
GDP (nominal), per capita, rupees	9,608	37,430	68,102	75,133	83,267	91,434
GDP (nominal), per capita, US dollars	362	669	899	841	870	947
Colombo Consumers' Price Index (% change)	12.8	11.3	6.2	14.2	9.6	6.3
Sri Lanka Consumers' Price Index (% change)	n.a.	n.a.	1.5	12.1	10.2	2.6
All Share Price Index (1985=100)	n.a.	693.2	447.6	621.0	815.1	1,062.1
Unemployment rate, per cent	n.a.	12.4	7.6	7.9	8.8	8.4 (c)
Gross domestic investment (% of GDP)	26.2	24.8	28.0	22.0	21.3	22.3
Gross domestic savings (% of GDP)	12.9	15.9	17.4	15.8	14.5	15.7
Foreign savings (d) (% of GDP)	13.3	9.1	10.6	6.2	6.9	6.6
Gross national savings (% of GDP)	n.a.	n.a.	21.5	20.3	19.5	21.3
Balance of payments, current account (% of GDP)	-8.1	-5.1	-6.4	-1.4	-1.4	-0.6
Budget, current account (% of GDP)	0.9	-2.0	-3.4	-4.9	-4.4	-3.3
Budget, overall balance (% of GDP)	-14.0	-9.3	-9.9	-10.8	-8.9	-8.0
Import coverage of foreign assets, months						
Total foreign reserves (months of imports)	3.4	5.7	3.5	4.5	4.9	5.8
Gross official reserves (months of imports)	1.8	3.8	1.7	2.7	3.3	4.2
Exchange rate (Rs/US$), (% change) (e)	-9.1	-5.7	-9.9	-11.3	-3.7	-0.01
Real Effective Exchange Rate-24 (1999=100) (% change)	-	-	0.7	0.04	0.5	-3.4
Money supply (M_{2b}), (%) change (f)	17.9 (g)	16.8 (g)	12.9	13.6	13.4	15.3
Private sector credit (% change)	20.3 (g)	18.2 (g)	11.8	8.9	12.0	16.9

(a) Revised
(b) Provisional
(c) 3rd quarter 2003
(d) Net imports of goods and non-factor services
(e) Changes in end year exchange rate; negative sign indicates depreciation.
(f) Consolidated money supply including FCBUs
(g) In relation to M_2

Source:- Central Bank of Sri Lanka

term external debt to external reserves decreased, reducing external sector vulnerability and strengthening stability in the foreign exchange market.

On the monetary front, money supply grew (M_{2b} by 15.3 per cent) in line with expectations, despite the high reserve accumulation, which causes it to rise faster. The declining public sector credit utilisation enabled accommodating the expanding private sector demand for credit without raising money supply, thereby supporting the economic recovery. The domestic money market remained liquid and the yield curve shifted gradually downward, reflecting reductions in most interest rates, although some lending rates adjusted relatively slowly. Nevertheless, the interest spread between lending rates and deposit rates remained high, though decreasing marginally during the last quarter, emphasising the necessity for accelerating financial sector reforms, increasing competition in the financial markets and expanding information available to the public. Reflecting increased corporate sector profitability and improved business confidence, the performance of the stock market showed a record improvement. A long-term reference yield curve emerged with the issue of long tenor government debt instruments, facilitating future developments in the domestic debt market.

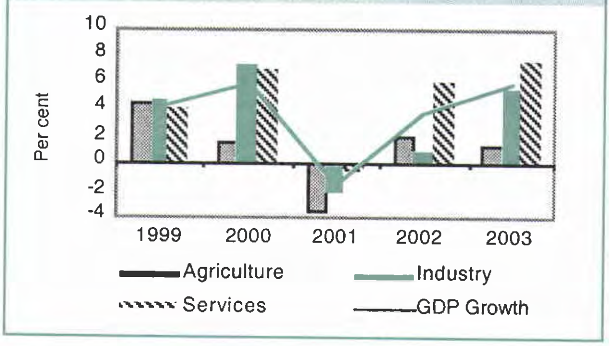
Even though achievements in 2003 are encouraging, much more needs to be done to achieve a sustainable high quality growth, resolving basic economic problems on a more sustainable basis and addressing related issues effectively. Despite recent improvements, major economic problems such as widespread poverty, high structural unemployment, serious under employment and relatively high inflation continue to loom large, throwing up challenges to policy makers. Similarly, some major underlying issues still remain unresolved and without being addressed effectively. These are inadequate and volatile economic growth, inadequate investment and savings, low productivity improvement, the continuation of high fiscal deficits causing a heavy debt burden, inadequate infrastructure facilities and relatively high interest spread with low financial deepening.

Looking ahead, Sri Lanka's future prospects of achieving a sustainable high economic growth appear to be promising, provided the downside risks are mitigated. The risks arise mainly from the failure to pursue the peace initiative and the abrogation midway of the needed structural reforms for laying the foundation for a sustainable high quality long-term growth. With these essential elements in place, it is necessary to continue with the pursuit of sound macroeconomic management, supported by the development of infrastructure facilities, particularly power and transport, improvement in law and order, strengthening of political stability, effective utilisation of foreign donor assistance and harnessing the emerging favourable external environment for the benefit of the country. The last requires that Sri Lanka, as a small open

Chart 1.1
Macroeconomic Indicators

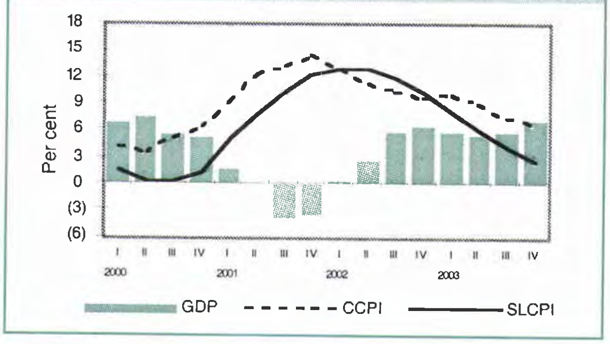
Broad based economic recovery

Chart 1.1.1
Real GDP and Sectoral Growth



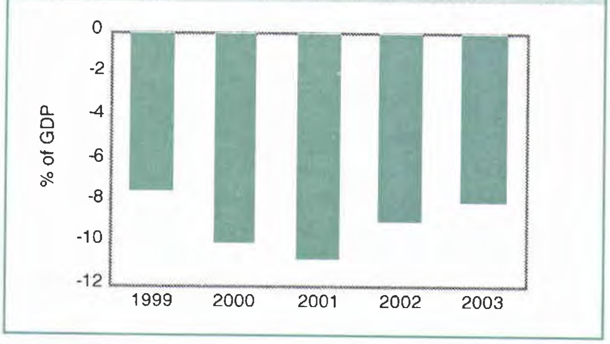
Continuation of growth, with declining inflation

Chart 1.1.2
Real GDP Growth and Inflation



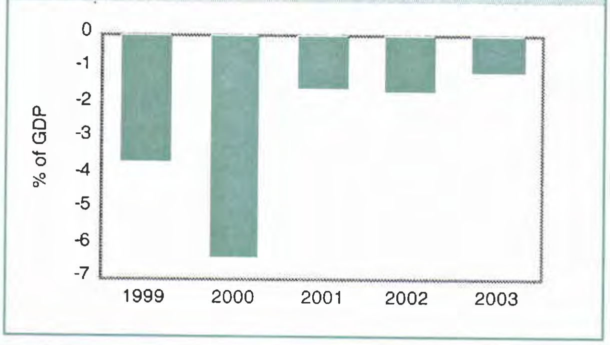
Fiscal deficit declining, but slowly

Chart 1.1.3
Fiscal Deficit



Manageable external balance

Chart 1.1.4
External Current Account Deficit



economy, integrate itself successfully with the world economy to enhance its growth prospects through the realisation of the benefits of increasing globalisation.

The required adjustments and reforms have been clearly identified and discussed in the previous Central Bank Annual Reports. They were also included in Sri Lanka's Poverty Reduction Strategy Paper (PRSP), prepared in consultation with all development partners over a period of more than two years and endorsed by international donors[1]. What is necessary now is to prioritise and sequence them appropriately, while ensuring consistency and compatibility, and take measures for their effective implementation.

In this endeavour, the significance of assuring a strong ownership of the reforms and building a national consensus through an open dialogue and effective public awareness cannot be overemphasised. The favourable world economic prospects and strong international support have offered an ideal opportunity for the country to take major steps in this direction in 2004. If the country misses this opportunity, the cost would be unbearably high.

1.2 International Environment

The recovery in the global economy, which is crucial for Sri Lanka to sustain its economic growth, continued at a faster rate during 2003 than in 2002. World output grew by 3.9 per cent in 2003 in comparison to 3.0 per cent in 2002. A higher growth in the two largest economies, namely, the US and Japan, and the continuation of growth momentum in Asian emerging market economies, largely contributed to this recovery. The US economy grew by 3.1 per cent during 2003 compared to 2.2 per cent in 2002. An accommodative monetary policy, coupled with an expansionary fiscal policy implemented since 2001 against a background of economic

1 For details see Boxes 3 and 4 on pages 8 – 11, in Central Bank Annual Report 2002.

recession, helped the recovery in the US economy. However, the emergence of significantly large twin deficits (i.e., fiscal deficit and external current account deficit) in the US has posed downside risks that might affect the current recovery. Japan also recorded a faster recovery by growing at an estimated 2.7 per cent from a negative 0.3 per cent in 2002. Strong global recovery and low levels of inventories helped the recovery in Japan. However, weaknesses in the Japanese corporate and banking sectors still remain, posing downside risks to a sustainable recovery. Meanwhile, the slowdown in the Euro area continued for the third consecutive year. The Euro area recorded an estimated growth of 0.4 per cent in 2003, down from 0.9 per cent in 2002. Apparently, exports from the Euro area could not grow along with the global recovery, owing to the sharp appreciation of the euro. Investment spending too remained weak owing to weaknesses in corporate balance sheets.

Emerging market economies in Asia continued to be the fastest growing region despite uncertainties related to the Iraq war, surging oil prices at the beginning of the year and subsequently, the impact of the Severe Acute Respiratory Syndrome (SARS) epidemic. Emerging Asia grew by 7.2 per cent in 2003 in comparison to 6.2 per cent growth in 2002. However, newly industrialised Asian economies recorded a lower growth (3.0 per cent), while South Asia grew at a faster rate (7.0 per cent). ASEAN-4[1] also grew at a marginally higher rate of 5.0 per cent in 2003 compared to a 4.3 per cent growth in 2002. While the net external demand continued to play a key role in the economic growth in Asia, domestic demand played a greater role in 2003, as most emerging market economies in Asia adopted domestic demand led growth strategies. A notable feature in Asian economies in 2003 was the rapid build up of external reserves and the effective real depreciation of currencies. This exerted some international pressure for greater flexibility in exchange rate management in the region, particularly on the countries that have been following fixed exchange rate regimes

Inflation bottomed out in 2002 and increased marginally in both advanced economies and developing countries mainly due to the effects of the stimulating macroeconomic policies implemented in recent years and the rise in oil prices. Meanwhile, world trade has also been estimated to have grown at a higher rate at 4.5 per cent in 2003 than in 2002 (3.1 per cent), owing to the recovery in advanced economies, but is still below the annual average growth of 6.9 per cent recorded in the 1990s. Both exports from and imports to advanced countries, and emerging market and developing countries grew at a higher rate in 2003 than in 2002. In the international commodity market, petroleum prices rose sharply by 15.8 per cent in 2003, compared with a 2.5 per cent increase in 2002 and a 13.8 per cent decrease in 2001. Non-fuel commodity prices increased by 7.1 per cent in 2003 compared with a 0.5 per cent increase in 2002. This large difference in commodity price increases raised the trade deficit in oil importing developing countries, resulting in challenges in managing the external sector balance. Terms of trade improved by 0.1 per cent in favour of developing countries during the year. The risk of raising barriers on international trade in advanced countries receded in 2003 with the removal of restrictions on steel imports by the USA, but the failure to reach a consensus at the WTO meetings would limit the potential benefits of liberalisation and integrated markets.

International financial markets experienced ample liquidity during 2003 in a historically low interest rate environment, which also reduced the margins of lending. Improved US corporate earnings and reduced geopolitical uncertainties led to a strong rebound in mature equity markets. In emerging markets, financial conditions improved further, aided by low interest rates in industrial countries, which facilitated bond issuances by emerging markets. Net capital inflows to emerging market economies have also been estimated to exceed US dollars 131 billion, the highest such inflows since 1997. In the foreign exchange market, the US dollar continued to depreciate sharply in 2003 against other major currencies (e.g., 19.9 per cent, 11.0 per cent and 10.8 per cent, respectively, against the euro, UK pound and Japanese yen, respectively), following similar sharp depreciations in 2002, reflecting the impact of growing

TABLE 1.2

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

	Actual		Projections	
	2002	2003	2004	2005
World output	3.0	3.9	4.6	4.4
Advanced economies	1.7	2.1	3.5	3.1
United States	2.2	3.1	4.6	3.9
Germany	0.2	-0.1	1.6	1.9
United Kingdom	1.7	2.3	3.5	2.5
Japan	-0.3	2.7	3.4	1.9
Developing countries	4.6	6.1	6.0	5.9
Developing Asia	6.4	7.8	7.4	7.0
World trade volume (Goods and services)	3.1	4.5	6.8	6.6
Imports				
Advanced economies	2.3	3.5	5.7	5.4
Developing economies	6.2	8.9	10.2	9.4
Exports				
Advanced economies	1.9	2.7	6.3	6.1
Developing economies	6.5	8.7	8.1	8.7
Consumer prices				
Advanced economies	1.5	1.8	1.7	1.7
Developing economies	6.0	6.1	5.7	5.0
Commodity prices				
Oil	2.5	15.8	3.8	-10.0
Non-fuel	0.5	7.1	7.6	-0.8
Six month LIBOR on US dollar deposits	1.9	1.2	1.3	3.5

Source: World Economic Outlook (April 2004), IMF

1 ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand.

macroeconomic imbalances among industrial countries. The US dollar depreciated by 29.7 per cent against the euro, 18.6 per cent against the UK pound and 18.6 per cent against the Japanese yen during the two year period of 2002-2003. This was a reversal of the appreciation of the US dollar recorded against the same currencies in 2000-2001; 13.9 per cent against the euro, 11.6 per cent against the UK pound and 28.5 per cent against the Japanese yen. Such large fluctuations in the cross rates among major international currencies create difficulties, particularly for developing countries like Sri Lanka which are increasingly integrating to the global economy. This underscored the need for further strengthening macroeconomic policy coordination among major industrial countries and improving surveillance by the IMF.

The recovery in the global economy, in particular in the US and Japan, which are major markets for Sri Lanka's exports, had a direct beneficial impact on Sri Lanka's industrial production and exports. It also helped to swell the inflow of tourists to Sri Lanka to a record level in 2003. In general, international price movements were in Sri Lanka's favour, improving the terms of trade, although the high prices of petroleum products were detrimental to Sri Lanka.

1.3 Output, Demand and Sectoral Performance

Economic recovery in Sri Lanka, which commenced in 2002, continued in 2003 to post a broad based 5.9 per cent real economic growth, benefitting from favourable domestic factors and external environment. All four quarters in 2003 recorded a growth rate of over 5 per cent indicating that the recovery was continuous. Meanwhile, all three production sectors, i.e., Agriculture, Industry and Services, recorded positive growth rates reflecting that the growth was broad based. Similarly, growth was supported by all three demand components, with strong consumer demand, expansion in investment activity and recovery in exports. Increased corporate sector profitability and upward trends in sectoral price indices in the Colombo Stock Exchange also confirmed the broad based economic recovery recorded in 2003. Economic growth, particularly growth in agriculture, trade, tourism and construction, raised the income of a large number of people, distributing the benefits of growth among various segments of society and all parts of the island.

On the production side, the Services sector, accounting for about 55 per cent of the economy, grew by 7.7 per cent in 2003 upgrading its 6.1 per cent growth in 2002, and reflecting its ability to recover fast. As in the previous years, this sector was the largest contributor to annual growth, accounting for about 70 per cent of the growth. The high growth momentum in the trade, transport, telecommunication, tourism and financial subsectors helped the continuation of the recorded high growth in the Services sector. The faster growth of the Services sector, which increased its relative share in the Sri Lankan economy, is in line with the normal trend that has been observed in the development process of a country. With the diversification and modernisation of economic activities, the Services sector expands faster as it has to play a greater role in all three basic economic activities (i.e., production, distribution and consumption), facilitating intermediation among economic agents and flow of resources as well as products within an integrated economic system, and satisfying increased consumer demand for services (Box 6). The Industrial sector, accounting for about 27 per cent of the

TABLE 1.3

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

Item	1990-2000 Avg.	2001	2002(a)	2003(b)
Agriculture Sector	**2.5**	**-3.4**	**2.5**	**1.5**
1. Agriculture, forestry and fishing	2.5	-3.4	2.5	1.5
Agriculture	2.4	-4.3	1.9	3.0
Tea	4.4	-3.5	5.1	-2.2
Rubber	-1.5	-1.5	5.0	1.7
Coconut	2.1	-13.5	-13.6	7.1
Paddy	3.7	-5.7	5.1	7.4
Other	2.5	-2.2	2.9	1.8
Forestry	1.4	5.0	1.9	1.4
Fishing	4.0	-3.9	6.3	-6.9
Industrial Sector	**6.8**	**-2.1**	**1.0**	**5.5**
2. Mining and quarrying	2.8	0.7	-1.1	3.6
3. Manufacturing	8.1	-4.2	2.1	4.4
Processing of tea, rubber and coconuts	2.5	-6.7	-0.9	2.2
Factory industry	9.3	-3.9	2.5	4.6
Small industry	5.9	-3.5	2.1	6.1
4. Construction	5.2	2.5	-0.8	5.5
5. Electricity, gas, water and sanitary services	7.7	-2.9	-0.7	21.7
Electricity	n.a.	-3.7	-1.5	25.3
Water and gas	n.a.	2.1	3.8	1.4
Services Sector	**5.6**	**-0.5**	**6.1**	**7.7**
6. Transport, storage and communication	6.4	3.8	7.6	10.2
Port services	n.a.	0.0	2.4	10.8
Telecommunications	n.a.	23.1	19.3	24.5
Transport	n.a.	-1.8	3.6	3.8
7. Wholesale and retail trade	5.5	-6.7	5.6	7.3
Imports	7.6	-10.7	8.4	11.2
Exports	10.4	-8.0	2.0	3.5
Domestic	2.5	-2.0	3.9	4.4
8. Banking, insurance and real estate	7.7	7.9	11.1	10.6
Banking	n.a	17.4	17.7	15.3
Insurance, real estate and other financial services	n.a	2.4	6.6	7.1
9. Ownership of dwellings	1.3	1.4	1.5	1.3
10. Public administration and defence	3.5	1.0	0.0	0.6
11. Services (n.e.s.)	5.4	2.2	3.4	7.2
Hotels and restaurants	n.a.	-16.1	-1.1	22.0
Other	n.a.	5.9	4.1	4.8
12. Gross domestic product	5.3	-1.5	4.0	5.9
13. Net factor income from abroad	-6.2	12.5	1.4	25.9
14. Gross national product	5.3	-1.3	4.1	6.4

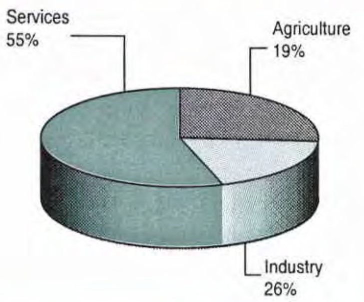
(a) Revised
(b) Provisional.

Source: Central Bank of Sri Lanka

Chart 1.2
GDP - Sectoral Performance

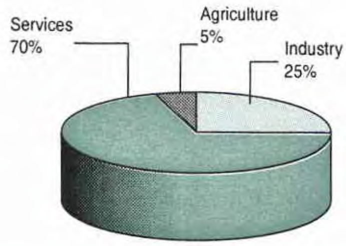
High services sector share reflecting integration and modernisation of the economy

Chart 1.2.1
Sectoral Composition of GDP - 2003



Dynamic services sector contributing the largest share in GDP growth

Chart 1.2.2
Sectoral Contribution to Growth - 2003



economy, grew by 5.5 per cent in 2003, compared with a low growth of 1.0 per cent in 2002. The continuation of the growth momentum in factory industry and the recovery in the power generation and construction subsectors from their negative growth rates in 2002 helped to increase the industrial sector contribution to the annual economic growth from about 7 per cent in 2002 to 25 per cent in 2003. Despite the record paddy harvest and the recovery in coconut production, the Agriculture sector, which accounts for about 19 per cent of the GDP, recorded a lower growth rate of 1.5 per cent in 2003 compared with 2.5 per cent in 2002. It contributed about 5 per cent of the annual economic growth. Negative growth rates in fishing and tea production were mainly responsible for the deceleration of agricultural sector growth. The continuation of a low growth rate clearly reflects the existing structural weaknesses in the agriculture sector and reiterates the necessity for strong reforms to raise productivity and improve its resilience, rather than continuing to rely on unsustainable and distortionary input subsidies, ad hoc tariff protection and inefficient intervention in agricultural marketing activities by the government.

On the demand side, the continuation of domestic consumer confidence and growth momentum in tourism provided the major impetus to economic growth in 2003. The relative share of consumption in the aggregate demand remained high, at about 84 per cent, due to the rising private consumer demand that offset the declining government consumption as demanded by the ongoing fiscal consolidation strategy. Domestic consumption at constant prices rose by 6.1 per cent in 2003 benefitting from rising average per capita real income and increasing tourist arrivals, which rose by 27 per cent. Domestic investment, which displayed a renewed growth momentum towards the end of the year, reflecting the translation of increased investor confidence into real investment activities, grew by 17 per cent in real terms and accounted for about 42 per cent of the growth in domestic aggregate demand. Meanwhile, the recovery in exports, benefitting from high world economic growth and improved trade relations with Sri Lanka's trading partners, particularly with India, EU and USA, added growth impetus to the demand side in 2003. Declining interest rates that resulted from growth supportive monetary policy in a background of decelerating inflation and improving fiscal consolidation, supported economic growth on both the production and the demand sides by reducing the cost of credit.

Despite the increased aggregate demand, inflation decelerated due to increased supply of domestically produced food crops, the continuation of a cautious monetary policy and stability in the exchange rate. On the supply side, both domestic production, and import of goods and non-factor services expanded in 2003, increasing the availability of goods and services in the domestic market and reducing the pressure on prices. The supply of domestically produced goods and services grew by 5.9 per cent and accounted for about 52 per cent of the annual increase in the aggregate supply. The import category grew at 10.4 per cent and accounted for about 48 per cent of the overall supply expansion in 2003.

In 2003, GDP at current market prices rose by 11.2 per cent to Rs.1,760 billion (US dollars 18.2 billion), while GNP rose to Rs.1,737 billion (US dollars 18.0 billion). This increase in nominal terms was a combined outcome of a 5.9 per cent growth in real terms and a 5.0 per cent increase in prices. Thus, GDP in real terms grew at a higher rate than originally projected (5.5 per cent), but the lower increase in prices than expected at the beginning of the year (7.0 per cent), resulted in a lower increase in GDP at current market prices than originally expected (12.8 per cent)[1]. Mid-year population rose by 1.3 per cent to 19.3 million in 2003. Consequently, the average per capita GDP in nominal terms rose by 9.8 per cent to Rs.91,434. Given the lower inflation rate at 5.0 per cent as measured by the increase in the GDP deflator, this indicates an improvement in the average per capita income in real terms by 4.6 per cent. In US dollar terms, per capita GDP rose by 8.8 per cent to US dollars 947, outperforming the previous highest value of US dollars 899 in 2000.

Several factors contributed to increasing economic growth and improving price stability in 2003. The first and the most important factor was the continuation of the ceasefire despite a temporary stalling of the peace process. On the production side, the resulting peaceful environment helped to increase activities in all major production sectors. In the agricultural sector, it helped to expand cultivated areas, and increase yields with the availability of inputs and expanded access to the market. Increased transport and distribution facilities, particularly in the North and the East, helped the growth in the industrial sector as well as in the services sector. On the demand side, it contributed to growth through expanding domestic markets, facilitating movement of goods and people, increasing investment, raising tourist arrivals and expanding rehabilitation and reconstruction work. These gains from the continuation of the ceasefire clearly demonstrate the potentially immense benefits from a sustainable peace and hence, the necessity of achieving a long-term solution to the North-East issue. Secondly, despite the mid-year floods and the dry weather conditions that prevailed towards the end of the year, weather conditions were generally favourable in 2003, contributing to growth in agriculture and electricity generation. Thirdly, recovery in the world economy supported the economic growth through increased demand for Sri Lanka's exports and high growth in tourism. Fourthly, the improvements in macroeconomic management that caused a downward shift in the interest rate structure and an improved liquidity position in the domestic market brought about stability in the financial markets under the floating exchange rate regime. Furthermore, the implementation of structural reforms addressing the deep-rooted weaknesses also had a beneficial impact on the economy. Fifthly, the strong international support for the peace process and the economic reforms helped accelerate the economic growth. The final outcome of the international support was the pledge of a record level of concessionary assistance (about US dollars 4.5 billion for 2003-2006) to develop the whole country, particularly to build the badly needed infrastructure facilities, and implement the rehabilitation and reconstruction activities in the war affected areas.

Agriculture : Despite relatively favourable weather conditions and the continuation of the recovery in the overall economy, the growth rate in the Agriculture sector decelerated in 2003, reflecting the weak dynamism in the sector due to deep-rooted structural weaknesses. Agriculture sector growth has remained significantly lower than the growth in the Industrial and Services sectors over the past decades. During the period 1977 – 2003, its annual average growth was 2.6 per cent, compared with 5.4 per cent in the Services and 5.3 per cent in the Industrial sector. The deteriorating state managed agricultural extension services, inadequate availability of high yielding seed varieties, high post-harvest losses, marketing problems, restrictions in the land market and the continuation of distortionary government interventions are the major issues that need to be addressed urgently. The effective resolution of these issues through a market based sustainable strategy is necessary to ensure a high growth in the Agriculture sector. Such a strategy in the Agricultural sector has to be a major pillar in resolving the high unemployment and widespread poverty in the country, as agriculture still directly accounts for about 35 per cent of employment and is the major economic activity in the rural areas where about 90 per cent of the poor live.

In 2003, the output of paddy, coconut, rubber, sugar, vegetables and fruits increased. However, output in tea, some minor-export crops and a few other field crops declined. Reflecting their combined effect, the value added in the Agriculture sector increased only by 1.5 per cent in 2003. Within the plantation crops, tea production declined from the record output of 310 million kg in 2002 to 303 million kg due to the adverse effect of the mid-year floods and earthslips on low grown tea and the excessive rain on high grown tea producing areas. However, reflecting the built-in resilience of the smallholder tea producers, the low grown tea recovered faster and managed to contain the fall at 0.9 per cent in 2003, compared with a much larger decline of 6.2 per cent in high grown tea. The dry spell experienced at the end of the year affected production in all three elevations. Tea exports increased due to a higher rundown of stocks. Reflecting a favourable trend, the share of bulk tea in total tea exports declined to 59 per cent in 2003 from 64 per cent in 2002 due to the continued efforts to increase the export of value added tea, such as tea packets, tea bags and instant tea. The average price at the Colombo Auction declined marginally, a corollary of increased world tea production and the oversupply due to the interruption of tea exports to the Middle East in early 2003 during the war in Iraq. Meanwhile, the cost of production increased by about 9.3 per cent, mainly due to an increase in the cost of inputs, such as wages, fuel and fertiliser, reducing the producer margin, which was already low at about 15 per cent. In this situation, plantation management companies faced difficulties, particularly in undertaking new investments.

Benefitting from attractive prices, which rose by about 49 per cent at the Colombo Auctions, rubber production increased as producers brought even marginal cultivations under tapping. However, the large number of rainy days and the severe mid-

1 This reduction in GDP at market prices by about Rs. 22 billion from the projected value has some marginal impact on realised economic variables, as ratios of GDP.

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

Sector	2000	2001	2002(a)	2003(b)
Agriculture Sector	**19.9**	**20.1**	**20.5**	**19.0**
1. Agriculture, forestry and fishing	19.9	20.1	20.5	19.0
Agriculture	15.8	16.0	16.6	15.2
Tea	1.4	1.3	1.2	1.1
Rubber	0.2	0.2	0.2	0.3
Coconut	1.2	1.1	1.4	1.2
Paddy	2.8	2.8	3.0	2.6
Other	10.1	10.7	10.7	10.0
Forestry	5.8	6.2	6.1	6.0
Fishing	1.2	1.2	1.2	1.0
Industrial Sector	**27.3**	**26.8**	**26.3**	**26.3**
2. Mining and quarrying	1.9	1.9	1.8	1.7
3. Manufacturing	16.8	16.0	15.8	15.5
Processing of tea, rubber and coconut	2.5	2.3	2.5	2.3
Factory industry	13.1	12.5	12.2	12.0
Small industry	1.2	1.2	1.2	1.2
4. Construction	7.3	7.6	7.2	7.2
5. Electricity, gas, water and sanitary services	1.2	1.3	1.4	1.8
Electricity	1.0	1.1	1.2	1.6
Water and gas	0.2	0.2	0.2	0.2
Services Sector	**52.8**	**53.1**	**53.2**	**54.7**
6. Transport, storage and communication	11.7	12.1	12.4	13.6
Port services	1.0	1.0	0.9	0.9
Telecommunications	2.4	3.0	3.5	4.5
Transport	8.3	8.1	8.0	8.2
7. Wholesale and retail trade	22.6	21.1	20.5	20.1
Imports	10.4	9.4	9.1	9.0
Exports	2.7	2.5	2.3	2.3
Domestic	9.5	9.3	9.2	8.8
8. Banking, insurance and real estate	7.6	8.5	9.6	10.9
Banking	2.3	2.3	2.6	3.1
Insurance, real estate and other financial services	5.3	6.2	7.0	7.8
9. Ownership of dwellings	1.8	1.8	1.7	1.6
10. Public administration and defence	5.2	5.6	4.9	4.4
11. Services (n.e.s.)	4.0	4.1	4.0	4.0
Hotels and restaurants	0.6	0.5	0.5	0.6
12. Gross domestic product	100.0	100.0	100.0	100.0
13. Net factor income from abroad	-2.1	-1.9	-1.8	-1.2
14. Gross national product	97.9	98.1	98.2	98.8

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

year floods limited the output growth to 1.6 per cent in 2003. The average yield remained low at around 911 kg per ha, compared with yields in other major producing countries such as Thailand (1,531 kg/ha) and Malaysia (1,047 kg/ha), mainly due to poor use of rain guards, inadequate application of fertiliser, poor use of high yielding clones, non adherence to systematic infilling and scarcity of tappers. Sheet rubber production grew by 17 per cent, raising its share to 54 per cent in total rubber production, reflecting a shifting away of producers from crepe rubber production due to increasing price differences in favour of sheet rubber. Despite a marginal increase in production, rubber exports declined due to a high domestic demand from the growing rubber based manufacturing industries. In fact, rubber imports increased to meet growing domestic manufacturing sector demand. The continuation of attractive rubber prices since early 2002, resulting in a high producer margin of about 60 per cent, encouraged investment in new rubber cultivation.

Coconut production grew by 7 per cent in 2003, to 2,562 million nuts, a turnaround after two years, reflecting the lagged effect of improved weather conditions in 2002 and the high fertiliser application encouraged by attractive producer margins, over and above the increased production costs. However, the production was well below the peak of 3,096 nuts in 2000. Exports of coconut kernel products increased in 2003 benefitting from the increased nut production. However, coconut oil production, which declined by 53 per cent in 2002, dropped further by 58 per cent in 2003 due to strong competition from imported edible oils. The removal of the import duty surcharge in 2002 and a reduction of tariffs in 2003 increased the competitiveness of imported edible oil prices in the domestic market. A long-term, clear tariff policy would be helpful in encouraging private investment in the coconut sector.

During the 2003 cultivation year, paddy production increased by 7.3 per cent, reaching a record level of 3.07 million metric tons, surpassing the previous peak output of 2.86 million metric tons recorded in 2000 by 7 per cent. Both Maha and Yala seasons reported the best output on record, registering output increases of 6.8 and 8.3 per cent, respectively. This was entirely due to an expansion in cultivation area as the annual average yield declined by 3.4 per cent owing to cultivation of marginal lands. The continuation of the ceasefire enabling the cultivation of paddy land in the war affected areas in the North and the East, and improved water availability, mainly contributed to a 15.3 per cent increase in the cultivated area. It is noteworthy that all the districts in the Northern Province recorded production increases and accounted for about 7 per cent of the total Maha output. Paddy prices dropped during the harvest seasons, but remained at higher levels, well above the cost of production, than in the previous year. In a counter strategy, the specific import duty on rice was raised from Rs.5 to Rs.7 per kilogram in March and further to Rs.9 in August to minimise downward pressure on paddy prices. As the increased domestic production was almost sufficient to meet the total domestic demand, rice imports declined sharply to 35,000 metric tons in 2003.

Despite a decline in 2002 and 2003, the average paddy yield remained at a higher level compared even with some of rice exporting Asian countries such as Thailand, Pakistan, the Philippines and Myanmar (Box 8). Meanwhile, domestic paddy prices remained generally at a higher level than the equivalent import prices. These two factors together indicate that the low income of domestic paddy farmers has been not due to lower yield or uneconomical farmgate prices, but mainly due to other factors such as increasing fragmentation of the land holdings which denies the benefit of economies of scale, high post harvest losses, low output quality and high cost of production mainly due to the scarcity of labour during cultivation and harvesting seasons. Therefore, improvements in the land market, reduction in post-harvest losses, improvement in output quality and mechanisation of cultivation are more important measures in developing paddy cultivation on a long-term sustainable basis, rather than placing heavy reliance on distortionary and unsustainable input subsidies, ad hoc tariff adjustments, inefficient output market interventions by the public sector, and cancellation of agricultural loans.

In the minor export crop category, except cloves, which was affected by mid-year floods, all major crops recorded increases in output. Cinnamon, the largest crop in this category, recorded an 8 per cent production increase. In the other agriculture sector, catering mainly to the domestic market, output increases were recorded in most varieties of fruits and vegetables. Sugar production increased by 42 per cent due to improvement in efficiency following the privatisation of Sevanagala and Pelwatte sugar factories and cultivations. However, potato, onion and chillie production declined in 2003 despite continuation of high import protection through specific duties. The continued cultivation of potato in the same lands for a number of seasons, without crop rotation, mainly due to the attractive local prices arising from high import protection, adversely affected potato production, reducing yields, reflecting the unexpected cost of high protection in agriculture.

Fish production declined by 5.4 per cent, reversing the moderate growth recorded in 2002. This was entirely due to a decline of 6.8 per cent in marine fish production, which accounts for about 89 per cent of total fish production of the country, as inland and aquaculture fish production recorded an increase of 7.6 per cent. Even though the prohibition of the use of some fishing gear has been identified as a reason for this decline, the fisheries sector growth has been constrained by a series of regulations and restrictions discouraging large scale private investment, particularly in deep sea fishing. Reflecting the combined effect of reduced production and increased domestic demand, fish prices rose in 2003.

In the livestock sector, milk production rose by 2 per cent, but the domestic production was sufficient to meet only 15 per cent of the country's demand, resulting in heavy reliance on imports, mainly powdered milk. Initiatives taken so far to expand the domestic dairy industry have not been successful. Benefitting from the increased demand, particularly with the booming tourist industry, poultry meat production recorded an increase of 3.6 per cent in 2003, compared with the production in 2002.

Industry: The Industry sector[1] , which recorded a slower recovery of 1.0 per cent in 2002 compared with the other two sectors, grew faster in 2003, recording a 5.5 per cent annual growth. The recovery was widespread with an annual growth rate of over 3.5 per cent in all four major sectors (i.e., Mining and quarrying, Manufacturing, Construction and Electricity, gas and water), raising their contribution to the overall GDP growth in 2003. The growth has come from both the private and public sectors, but the private sector, which has an increasing relative share in the Industry sector, contributed more. Increased agricultural production, continuation of the ceasefire, recovery in export demand, booming tourism, favourable weather conditions, declining lending rates and the continuation of structural reforms were identified as major contributory factors for the industrial sector growth. Reversing the negative growth rate recorded in 2002, the Mining and quarrying sector grew by 3.6 per cent in 2003 mainly owing to growth in the quarrying subsector (5.5 per cent), which responded positively to the demand from the Construction sector.

Meanwhile, the Manufacturing sector, which accounts for about 62 per cent of the overall industrial sector, grew by 4.4 per cent, compared with a 2.1 per cent growth in 2002. Within the Manufacturing sector, plantation processing industry turned around its negative growth owing to higher output in coconut and rubber, but remained at a low rate of 2.2 per cent due to a production decline in tea. The annual growth in the small industries sub-group also increased from 2.1 per cent in 2002 to 6.1 per cent in 2003 benefitting from the high domestic demand and booming tourism. Factory industry, the largest subsector accounting for about 81 per cent of the total manufacturing sector, recorded a faster recovery, with a 4.6 per cent growth in 2003 compared with 2.8 per cent in 2002, but was still well below its potential growth. This increase was entirely owing to a growth in the private sector industries (5.2 per cent), which account for about 96 per cent of the factory industries, as the public sector industries recorded a negative growth of 8.0 per cent, reflecting the closure of the petroleum refinery for about one month for routine maintenance work. Both domestic market oriented and export market oriented industries contributed to the private sector led industrial growth. A continuation of the growth momentum in consumer demand, a recovery in investment activity and improvement in transport and distribution in the North helped the growth in domestic market oriented industries. Meanwhile, improved export demand contributed to the growth in export-oriented industries. Despite increased energy costs, manufacturing sector profitability improved by 2.3 percentage points to 14.2 per cent, reflecting the benefits of improved labour productivity, declining interest costs, restructuring measures involving cost economising and moderation of wage increases. Labour productivity, measured as the average value addition per worker, based on the annual industrial survey information, improved by 2.9 per cent in 2003 compared with 0.9 per cent

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

in 2002, mainly owing to the application of modern technology and the modernisation of production processes. Capacity utilisation in the manufacturing sector rose by 4.0 percentage points to 85 per cent, encouraging new investment activity towards the end of the year. Consequently, machinery and equipment imports (volume index) recorded a 33.7 per cent growth in 2003 compared with a 17 per cent increase in 2002.

Textiles, apparel and leather products, accounting for 40 per cent of the total output in factory industries, grew only by 2.6 per cent, despite the recovery in the world economy. This clearly reflected increasing competition in the international markets for these products from low cost producer countries such as China. The food, beverage and tobacco industrial group, catering mainly to the domestic market, recorded a relatively higher growth rate of 6.3 per cent owing to a high growth in liquor (12 per cent) and food processing (7.3 per cent) industries. High growth in rubber based products (21.8 per cent) and plastic and PVC products (8.5 per cent) helped the annual growth rate of the industrial category covering chemical, petroleum, rubber and plastic products increasing to 5.0 per cent in 2003. Special facilities granted to Sri Lankan exports to the EU market and appreciation of the euro contributed to high growth in rubber based products. The recovery in construction activities supported the 6.1 per cent growth in the non-metallic industrial category, consisting of cement, concrete products and ceramics. The fabricated metal industry grew by 6.7 per cent, reflecting mainly the increased demand for agricultural machinery, water pumps, steel furniture and electrical items. The paper and paper product industry grew by 4.5 per cent and was supported by the demand for packing materials, particularly export oriented industries.

The Construction sector, which experienced a setback during the past two years, recovered in 2003, recording a growth rate of 5.5 per cent, and contributed about 6.5 per cent to the overall GDP growth. However, the growth was below the original expectation as government capital expenditure was cut down by Rs.7.6 billion in the efforts to contain the fiscal deficit. The major growth impetus came from the private sector mainly from housing construction. Increased consumer confidence and the availability of financial facilities at lower interest rates encouraged private sector housing construction. Government and public corporation investment expenditure also increased by 46 per cent, adding further impetus to the growth in the sector. Meanwhile, some of the rehabilitation and reconstruction work undertaken in the North and the East, albeit in a limited way, with external assistance, also contributed to the growth. Construction sector growth momentum was also shown by the increase in the building material import volume index, which rose by 21.3 per cent in 2003 compared with 3.9 per cent in 2002.

In the industry sector, the recovery in the Electricity, gas and water sector was notable, recording an annual growth of 21.7 per cent in 2003 compared with a decline of 0.7 per cent in 2002. The recovery in electricity generation after the power cuts of the previous year and increased generation of low-cost hydropower, enhanced the value addition in the power sector. Consequently, power generation increased by 10 per cent in 2003, while the value addition in electricity rose by 25.3 per cent as the relative share of hydro power rose to 43 per cent in 2003 from 39 per cent in 2002. The entire increase came from the CEB as the private sector share in total generation declined to 29 from 35 per cent due to non-renewal of emergency power purchase agreements. Meanwhile, the total installed capacity increased by 15 per cent to 2,223 MW in 2003 with the commissioning of the Kukule Ganga Power Project (70MW) and a combined cycle power plant owned by AES (Kelanitissa) Pvt. Ltd., (165 MW). However, this is still inadequate to meet the fast growing demand for power. The demand for power grew at a high rate of 13 per cent with the economic recovery, increasing power intensity in the economy, and expanding consumer base, particularly under the rural electrification programme, i.e., 'Deepaloka'. The proportion of households with electricity connections increased to 68 per cent in 2003 from 62 per cent in 2002.

Even though there were no power cuts in 2003, serious problems in the power sector continued to loom large, adversely affecting the productivity in the economy and investor confidence. Large fluctuations in power supply and regular supply disruptions not only reduced the productivity of the economy but also caused damage to sensitive modern machinery and equipment. Meanwhile, the significantly lower expansion in power generation capacity in comparison to the demand, which is growing at over 8 per cent annually, and delays in implementing low-cost large scale power projects increase the risks of power shortages, discouraging investment. Despite the availability of power sector restructuring and development plans, including identified capacity expansion projects strongly supported by concessional donor financing, the implementation has been slow and relatively ineffective. Unbundling of the CEB as a part of the restructuring process under the separation of the roles of the government as owner, regulator and operator has been initiated, but noteworthy progress has not been made. The project proposals for large scale low cost power plants have been in the pipeline for more than ten years without even the location for a single project being finalised yet. Similarly, despite the availability of concessional donor financing and technical assistance, the transmission and distribution is not only inadequate, but also inefficient, resulting in system losses still as high as 19 per cent, more than double the international norm. Therefore, an effective implementation of power sector reforms and faster action in implementing power projects are crucial to accelerating economic growth.

Despite significant fluctuations in price, local consumption of LP gas continued to expand in 2003 reflecting the expanding consumer base due to its convenience and price advantage over alternative energy sources. A third player entered the market, expanding the supply capacity and increasing competition. However, the potential benefit for consumers from the competition has not yet materialised, reflecting the necessity for a proper regulatory system.

The total volume of water supplied by the National Water Supply and Drainage Board (NWSDB) increased by 2.0 per cent to 357 million cubic meters in 2003. The existing capacity is inadequate to meet the rising demand, while concerns have been raised regarding the uninterrupted availability and quality of water supply services.

Services: The Services sector continued as the main driving force in the economic recovery. This was enabled by a continuation of the high growth momentum in telecommunications and financial services, and accelerated recovery in trade, tourism and port services. Trade was the largest subsector, accounting for about 22 per cent of GDP and 39 per cent of the Services sector. It grew by 7.3 per cent in 2003, benefitting from expansion in both external trade and domestic trade. The continuation of the ceasefire and economic recovery provided impetus to domestic and external trade services. Meanwhile, increased derived demand for imported intermediate goods and increased demand for capital goods with the recovery in investment, supported the growth in import trade. Improved market access in the North and expanding packaging and trading facilities added additional impetus to domestic trade services. The Consumer Affairs Authority (CAA) has been established to ensure the protection of consumer rights in a liberalised market environment.

The second largest subsector, i.e., Transport, storage and communication, accounting for 13 per cent of the overall GDP and 24 per cent of the Services sector, accelerated its annual growth rate to 10 per cent in 2003 from 7.6 per cent in 2002. Within this sector, telecommunications continued to record double digit growth (24.5 per cent), reflecting dynamism with growing competition among suppliers, expansion of services in the North and the East and increasing demand with changing consumer preference. The subscriber network for fixed access and mobile cellular services increased by 29 per cent in 2003 compared with 21 per cent in 2002. This high growth was bolstered by the fast expansion in the mobile telephone market. The subscriber base of fixed access telephones increased by 6 per cent, while mobile cellular phone connections rose by 462,000 or 50 per cent (on top of the 40 per cent increase in 2002). Improvements in cellular telephone technology, aggressive competition, affordable initial costs, a good supply and expansion of coverage have been the main reasons for the significantly high growth in the mobile phone sector. Internet and e-mail services also expanded rapidly, recording a 22 per cent annual growth in a competitive market environment with 27 service providers. The value addition of the sector has also increased with the expansion of various value added services by telecommunication operators. This high performance was further supported by a continuation of the liberalisation in the telecommunication industry, the e-Sri Lanka initiative by the government and additional demand in the North. The major reforms undertaken in 2003 that supported such growth were the issue of 32 licences ending the monopoly of external gateway operations and finalisation of the tariff rebalancing, removing the cross subsidy pricing against international calls. The benefits of these are clearly indicated by a reduction in charges on international direct dialing (IDD) calls by over 50 per cent in 2003 and increases in subscribers to IDD by 25 per cent and international outgoing calls. Meanwhile, the still low tele-density[1] in Sri Lanka compared with many countries in the Asian region indicates considerable potential for further expansion in this sector. The completion of the project linking Sri Lanka and India by a microwave link between Talaimannar and Rameswaram has further expanded the future prospects of the industry.

Port services continued to expand in 2003 accelerating the growth in value addition in the sector in GDP from 2.4 per cent in 2002 to 10.8 per cent in 2003. Both expansion in domestic container handling by 8 per cent and an increase in transshipment services by 12 per cent contributed this growth. Container volume handled at the Colombo Port rose by 11 per cent to a record level of 1.9 million TEUs. The major contributory factors were the recovery in the domestic economy, high economic growth in India raising demand for transshipment services, attractive promotional schemes offered, capacity expansion and productivity improvement. The number of containers handled per hour increased for main lines from 24 in 2002 to 30 in 2003, while berth efficiency improved with a reduction in waiting hours for container vessels from 1.9 to 0.9 for main lines. These improvements were clearly reflected in the increased profits of the port service industry in 2003. Looking forward, further improvements in productivity, capacity expansion in the Colombo Port and developments in other ports based on economic criteria are essential to harness the full benefits of the strategic location of Sri Lanka on one of the main international sea routes.

Despite the continuation of economic recovery, the value addition in the transport sector (in GDP) recorded only a moderate growth rate of 3.8 per cent, as in the previous year, reflecting deep-rooted structural weaknesses, particularly in public passenger transportation. Passenger and goods transport services provided by the private sector expanded, with an increase in the fleet of vehicles. The number of new buses and lorries registered in 2003 increased by 36 per cent and 39 per cent, respectively, reflecting continuation of private sector investment in the transport sector. The number of buses operated by Regional Transport Companies continued to decline in 2003, and their passenger kilometrage decreased by

1 Tele-density (i.e., number of fixed access telephones per 100 people) : 4.7 in Sri Lanka, 48.9 in South Korea, 46.3 in Singapore.

15 per cent. The operated train kilometres remained at the samee level as in the previous year (i.e., 8 million km) while goods transportation dropped by 2 per cent. However, passenger kilometerage increased by 4 per cent, reflecting the impact of significantly cheaper fares compared with bus fares. The capacity and quality of the public sector transport services, both bus and railway services, further deteriorated in 2003, while their increasing reliance on government transfers emphasises the necessity for bold reforms.

In 2003, the Banking, insurance and real estate sector, accounting for about 9 per cent of overall GDP and 17 per cent of the Services sector, grew by 10.6 per cent following an 11.1 per cent growth in 2002, reflecting the increasing financial intermediation in the economy and profitability of the financial sector. The major contributory factors for this growth were increased business activity, a boom in the Colombo Stock Exchange, wider interest margins, expansion in insurance and leasing activities, and developments in the domestic debt market. Financial sector reforms, particularly in the state banks and strengthening of regulatory and supervisory systems, continued in 2003, even though progress was slow in restructuring state banks.

Meanwhile, the record arrivals of tourists, exceeding 0.5 million, resulted in a high growth of 22 per cent in the hotels and restaurants subsector. The lowest growth of 0.6 per cent among the sub sectors in the Services sector was recorded in 2003 by Public administration and defence, reflecting the impact of the ongoing fiscal consolidation strategy.

Health and education services are still largely provided by the government even though the private sector share has been rising continuously. In the health services, the private sector share has already exceeded more than half with expanding private health service facilities. Private sector investment, including foreign investment, continued to expand health facilities and improve the quality of service. Meanwhile, public sector health services suffered significantly in 2003 from a series of labour disputes resulting in severe inconvenience to the public, particularly to the patients in low income groups who cannot afford to obtain private health services. Even though private sector education services have been expanding continuously in the recent past, archaic restrictions on the opening of university education to the private sector constrained the potential faster expansion in education services in the country.

1.4 Consumption, Savings and Investment

In 2003, on the aggregate demand (AD) side[1], all three demand components, i.e., domestic consumption, investment and exports of good and non-factor services, contributed to the annual growth of 7.5 per cent in real terms (i.e., at constant 1996 prices). Domestic consumer demand continued its growth momentum and accounted for about half (49 per cent) of the overall increase in AD in 2003. Meanwhile, reflecting improved business confidence, reduced interest rates and increased government capital expenditure, investment contributed about 35 per cent compared with 16 per cent in 2002, raising the total contribution of domestic demand (i.e., consumption and investment) to the increase in AD to 84 per cent. The contribution of the external demand (i.e., export of goods and non-factor income) was 16 per cent, reflecting the slow recovery in exports. Reflecting high growth in consumption and investment, domestic demand grew by 8.4 per cent in real terms, while the aggregate demand, including exports, recorded a growth of 7.5 per cent in 2003.

TABLE 1.5

Aggregate Demand - 2003 (a)

	Rs. bn.	Percentage Share	% change	
			Nominal	Real
Domestic demand	1,846.8	106.6	11.0	8.4
Consumption	1,483.2	84.2	9.5	5.9
Gross domestic capital formation	392.9	22.4	16.9	17.8
Net external demand	-115.8	-6.6	-	-
Exports of goods and non-factor services	629.7	35.7	10.3	4.8
Imports of goods and non-factor services	745.5	42.3	9.7	10.4
Total demand	1,760.3	100.0	11.3	5.9

(a) Provisional Source: Central Bank of Sri Lanka

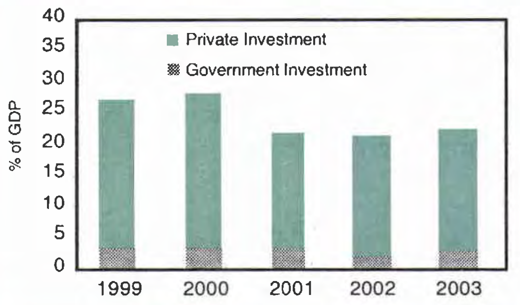
Domestic consumption, in real terms, grew by 6.1 per cent in 2003 following a 6.5 per cent growth in 2002. This growth was mainly supported by the improved consumer confidence and pent up demand in the North with the continuation of the ceasefire, increased per capita income, reduced interest rates and the boom in tourism. The increase was entirely due to an increase in private sector consumption, as government consumption, in real terms, declined under the fiscal consolidation strategy. Within private consumer demand, higher increases were recorded in consumer durables, particularly electronic goods. Meanwhile, the annual growth in investment, in real terms, rose to 17 per cent in 2003 compared with 6.7 per cent in 2002, reflecting improved business confidence, lower lending rates, and increased government investment including reconstruction activities in the North and the East, albeit at a lower level than expected. Investment expansion was mainly recorded in the areas of power, roads, telecommunications and building construction. The recovery in the world economy, improved trade relations with major trading partner countries and improved external competitiveness of the country, as reflected by depreciation in the REER, supported the expansion of the exports of goods and non-factor services, which grew by 4.8 per cent.

1 Aggregate demand for domestic goods and services (AD) is defined as AD= C+I+X-M, where, C= consumption, I= investment, X = exports of goods and non-factor income and M= imports of goods and non-factor income.

Chart 1.3
Invetment and Savings

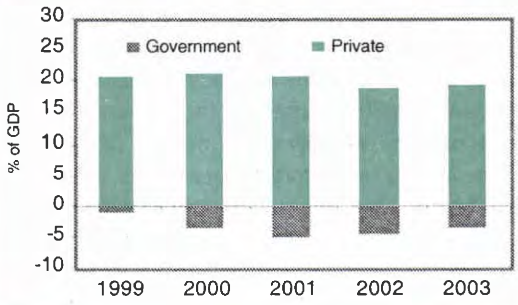
Continuation of low investment/GDP ratio

Chart 1.3.1
Domestic Investment



Continuation of low savings/GDP ratio

Chart 1.3.2
Domestic Savings



The private sector accounted for the larger share in both consumption (91 per cent) and investment (76 per cent). The corresponding share of government recorded declines in the last two years, as government expenditure remained tight under the ongoing fiscal consolidation strategy.

Investment and savings grew, albeit at a lower rate than expected. A higher growth in national savings than in capital accumulation (i.e., investment) reduced the domestic resource gap. The ratio of investment to GDP increased to 22.3 per cent in 2003 from 21.3 per cent in 2002, reflecting a recovery in both private investment and public investment, though they were below expectations. However, as this level of investment is not adequate to support the achievement of economic growth in excess of 8 per cent envisaged in the PRSP, urgent efforts are necessary to raise private investment, as well as public investment. In this context, it is prudent to generate more room in the budget by raising revenue and containing recurrent expenditure to raise government investment to over 6 per cent of GDP, while directing public investment more towards infrastructure development financed mainly with concessional foreign assistance, as this will encourage private investment by playing a catalytic role rather than substituting for it.

It is encouraging that both the domestic savings to GDP and national savings to GDP ratios increased about marginally in 2003 making available more domestic resources for investment. The domestic savings to GDP ratio rose by 1.2 percentage points to 15.7 per cent, mainly reflecting a reduction in government dis-savings (i.e., current account deficit in the budget), by 1.1 percentage points of GDP. Meanwhile, national savings to GDP rose by a higher value (1.8 percentage points) reflecting increased private foreign transfers, mainly private remittances. Benefitting from growth in private remittances, the private national savings to GDP ratio rose to 25.7 per cent, compared with the domestic private savings to GDP ratio at 19.0 per cent. Thus, private foreign transfers have become a major contributor to national savings, accounting for about 31 per cent. However, Sri Lanka's savings to GDP ratio has remained significantly lower than the comparable ratios in a number of Asian countries[1]. This was due to both continuation of dis-savings by the public sector and relatively low savings habits in the private sector. The medium-term fiscal adjustment strategy already envisages turning around the government from a negative saver to a positive saver. Measures are also necessary to raise private savings as improvements in public savings alone would not be sufficient to raise the national savings to GDP ratio to an adequate level to cover the high investment (over 30 per cent of GDP) required to achieve the desirable growth rate over 8 per cent, envisaged under the poverty reduction strategy agreed with the main donors.

1.5 Income Distribution and Poverty

The average family income in Sri Lanka is significantly different among the three major sectors, i.e., urban, rural, and estate, while the income distribution is skewed more towards the high income categories as indicated in the Household Income and Expenditure Surveys undertaken by the Department of Census and Statistics[2]. Nevertheless, poverty

1 The national savings to GDP ratio in selected Asian countries are: 23.4 per cent in India, 22.4 per cent in Bangladesh, 29.4 per cent in Malaysia, 26 per cent in the Philippines, 30 per cent in Thailand and 42 per cent in Singapore.

2 These data are from the preliminary report on the Household Income and Expenditure Survey (HIES) 2002 of the Department of Census and Statistics.

Box 1

Have Living Conditions Improved in Sri Lanka?

1. Background

The Statistics Department of the Central Bank commenced field work on the Consumer Finances and Socio Economic Survey 2003/04 (CFS 2003/04) in early October 2003. This is the eighth survey in the series that began in 1953. The main objective of the survey series is to collect comprehensive data on demographic characteristics, housing conditions, income, expenditure, consumption, indebtedness, savings and investment patterns of households in the country. These surveys have been a key source of information on socio-economic conditions and consumption patterns in the country for planners, decision makers, researchers, the business community, international organisations and the general public. The current CFS 2003/04 is being conducted after a lapse of seven years and covers four districts of the North and East, Batticaloa, Jaffna, Trincomalee and Vavuniya, after a gap of 20 years. During this period, the security situation, as well as the lack of a population frame from which to select a sample, did not enable the conduct of the survey in those areas. However, with the conduct of the Census of Population and Housing 2001 (Census 2001) by the Department of Census and Statistics (DCS), a population frame became available for sample selection. Further, with the ceasefire that came into operation in early 2002, field work in those four districts was made possible. As the Census 2001 could not be completed in three districts of Killinochchi, Mannar and Mullativu, there was no population frame from which to select a sample in those three districts and hence, they had to be excluded from the current survey, which covers the other 22 districts. However, according to the DCS, this omission excludes only around 6 per cent of the entire population of the country. This survey, therefore, would provide critically important information on socioeconomic conditions in all parts of the country, including the North and East, that would help in the rehabilitation, reconstruction and development of Sri Lanka as a whole.

2. Coverage

CFS 2003/04 is being conducted in 4 rounds of three months each over an entire calendar year, with the sample being distributed evenly across calendar quarters, districts and sectors (rural, urban and estate) to ensure representativeness of the sample. The sample consists of around 12,000 households. This is a larger sample than the 8,663 households selected for the previous survey conducted in 1996/97. The sample size was increased to accommodate inclusion of the four new districts of the North and East, while ensuring reliability of estimates at the district level for key variables of analysis. The findings reported here are based on preliminary information from Round 1 of the survey that was conducted from early October to late December 2003 and covered 2,897 households. The distribution of households among the rural, urban and estate sectors was 82 per cent, 13 per cent and 5 per cent, respectively, consistent with the population distribution across these sectors in the Census 2001.

3. Preliminary Findings

Household Size : Preliminary findings indicated that household size has continued to decline. This was seen in all three sectors, with the lowest decline in the estate sector (Table 1). On average, household size had reduced significantly from around 5 persons 20 years ago to around 4 persons now. There were 1.6 income receivers per household on average and this had not changed in 20 years. However, trends were mixed across sectors. The number of income receivers in a household in the estate sector had continuously declined over this period, while in the urban and rural sectors, there had been marginal increases between 1981/82 and 1996/97, although this trend had not continued thereafter. This may have been due to the fact that during this 20 year period, household members in the estate sector may have sought higher educational attainment, following improved opportunities, or moved

TABLE 1
Household Characteristics

Number

Year	Household size				Income receivers per household			
	Urban	Rural	Estate	All	Urban	Rural	Estate	All
1981/82	5.5	5.2	4.8	5.2	1.6	1.5	2.5	1.6
1986/87	5.2	5.1	5.0	5.1	1.8	1.5	2.3	1.6
1996/97	4.9	4.6	4.7	4.6	1.8	1.6	2.1	1.6
2003/04 [1/]	4.3	4.3	4.6	4.3	1.8	1.5	1.7	1.6

1/ Round 1 October to December 2003

Box 1 (contd.)

TABLE 2

Dependency Ratio [1]

Year	Urban	Rural	Estate	All
1981/82	2.3	2.6	1.0	2.4
1986/87	1.9	2.4	1.2	2.1
1996/97	1.7	1.9	1.3	1.8
2003/04 [2]	1.4	1.8	1.6	1.7

1 Ratio of non income receivers to income receivers.
2 Round 1 October to December 2003.

out of that sector in search of alternate employment which may have arisen as a result of avenues for employment in services and industry increasing during this period, as well as rationalisation of employment in this sector following privatisation of the plantations.

The fall in household size with the number of income receivers remaining constant reflects a decline in the dependency level [1] of households. The trends indicated that the urban sector had gained the most and that the estate sector actually deteriorated in household welfare in this regard during these 20 years (Table 2).

Housing Conditions and Household Amenities : The improving trends in housing conditions and access to household amenities that had been seen in previous surveys was clear in this survey as well (Table 3). The share of houses with permanent structures in terms of wall material, flooring and roofing had risen. The percentage of households with brick or cement walls had increased to 75 per cent from 62.5 per cent in the previous survey 7 years ago, and tripled compared with 20 years ago. Similarly, the share of housing with permanent flooring and roofing materials had risen in this 20 year period from around half to around 80 per cent. The share of houses with safe water had also risen to 62 per cent from below 50 per cent in the previous survey. Sanitary latrine facilities had also improved, although at a slower pace to 78 per cent, but around 5 per cent of households continued to be without latrine facilities. Households with access to electricity for lighting was almost three quarter of the population, a significant increase from 57 per cent in the previous survey. The percentage of households that could afford and were using LP gas for cooking had also arisen, but at a slower pace, and accounted for around 15 per cent. Firewood continued to be the main source of fuel, with 83 per cent of households continuing to use this source. In view of the increase in population and dwindling resources for firewood, a much more significant switch to alternate sources of fuel for cooking would be required in the near future.

With increased access to electricity, household amenities had also improved. Households with radios had risen to over three quarter of the population and televisions were available with nearly 70 per cent. The increase in

1 Dependency level = ratio of non-income receivers to income receivers.

TABLE 3

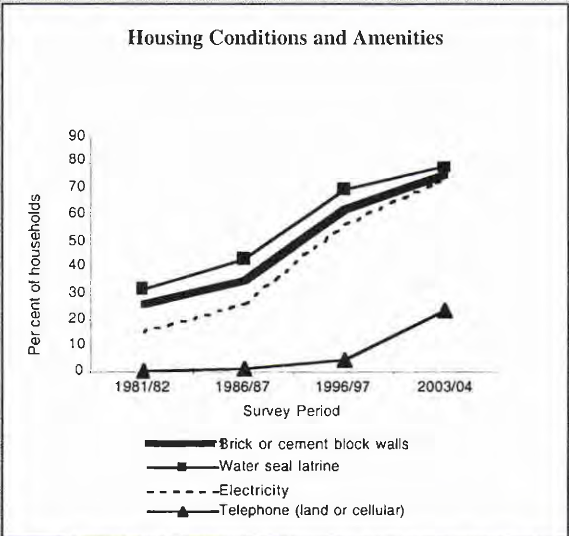
Housing Conditions and Amenities

Percentage of households

Category	1981/82	1986/87	1996/97	2003/04 [1]
Brick or cement block walls	26.2	35.1	62.5	75.3
Cement, tiled or better flooring	52.6	58.8	74.1	81.5
Tiled or asbestos roofing	46.5	54.7	73.2	78.8
Own well or pipeborne water inside home	38.7	32.6	46.9	62.2
Water seal latrine	31.9	43.7	70.1	78.4
Without latrine	29.9	16.9	6.5	5.4
Electricity	15.8	26.5	56.8	73.9
LP gas for cooking	1.1	2.6	10.8	14.5
Firewood for cooking	n.a.	95.1	86.6	83.1
Radio	60.7	67.2	73.6	77.2
TV	3.8	19.6	50.6	68.2
Sewing machine	30.7	37.2	41.5	44.9
Refrigerator	2.9	8.1	16.8	28.7
Telephone (land or cellular)	0.9	1.4	4.5	23.9
Motorised transport [2]	4.4	8.5	15.4	25.4

Source: Reports of the CFS Surveys, Parts 1 and 2

1 Preliminary findings from Round 1 October to December 2003.
2 Scooters, motorcycles, three wheelers or cars.



Box 1 (contd.)

households with sewing machines was far less dramatic and probably the outcome of less need for this amenity with easy access to readymade clothing at affordable prices all over Sri Lanka today. The use of refrigerators in homes had also increased to over a quarter of households from just 17 per cent in the previous survey. Similarly, motorised transport for households had also risen from 15 per cent to 25 per cent during this period. The increased use of telephones was far more dramatic, from less than 5 per cent during the 1996/97 survey to nearly one quarter now. It was clear from these preliminary findings that living conditions had improved significantly in the last 7 years in all aspects. These achievements in the quality of housing construction, availability of utilities and other amenities are commendable, especially since they have been achieved against a background of a civil war that created economic uncertainty and adversely affected economic development during this entire period.

4. Summary

Observations of the field staff were consistent with the statistical findings from Round 1 that confirmed the following general observations:

- Housing conditions in the country have improved since the previous CFS survey conducted in 1996/97, in particular, materials used for walls, flooring and roofing, access to electricity and safe water and latrine facilities.
- The telecommunication sector was a leading growth sector in the national economy during the past few years. The rising telephone usage seen from the household survey data confirm this.
- Differences in the living conditions of households that had existed between the three sectors, urban, rural and estate, continued. Although the size of the sample from Round 1 of the survey was too small to obtain reliable estimates of the same, indications are that the improvements in living conditions and access to amenities are more significant in the urban sector than in the other two. Access to better infrastructure, in the form of delivery of utilities, road network, education and health facilities, was better in urban areas of the country than in others. These discrepancies need to be reduced over time, if the quality of life available to urban communities is to be made available to other sectors as well.
- Communities that have had access to new economic opportunities because of industrial activities in their areas (e.g. sugar factory in Sevanagala, export processing factories in Katunayake and garment factories in Kegalle) appeared to have relatively better living conditions (quality of housing etc) than elsewhere.
- Access to better infrastructure in terms of roads, electricity and communication systems appeared to be a key ingredient for improvement in living conditions through better economic opportunities. The main hindrances in areas that had difficulties in marketing their products was inadequate access in the form of poor roads, transport and communication facilities.
- In some communities that had adhered to traditional occupations such as paddy farming that yielded low and uncertain incomes, there appeared to be very little incentive to innovate and attempt other economic activities to improve their incomes, even where opportunities were available through improved infrastructure over time. This may be one reason why differences in living conditions and income levels between the urban and rural sectors continued. The lack of initiative towards moving away from tradition and making the effort to improve their own living conditions in some of these areas was incomprehensible and indicated the need for raising general awareness of such opportunities.
- Survey areas of the North and the East that were visited after 20 years provided evidence that economic opportunities were slowly becoming available, with the return of people, the replacement of damaged infrastructure and revival of hitherto abandoned agricultural lands. Although reconstruction and rehabilitation will take time, it was clear that economic conditions were slowly limping back to normal in those areas.

Box 2

Millennium Development Goals

In September 2000, at the United Nations Millennium Summit, world leaders agreed to a set of time bound and measurable goals and targets for combating poverty, hunger, disease, illiteracy, environmental degradation and discrimination against women. These were named the Millennium Development Goals (MDGs).

There are eighteen targets grouped under eight goals. These leaders have recognised that the goals for eradicating poverty could be achieved only through stronger partnerships among developing countries and through increased action by rich countries, expanding trade, debt relief, transferring technology and providing aid for development.

Developing countries have pursued policies to achieve the underlying objectives of the MDGs for decades with only limited success. Renewed effort and strong political commitment are needed for faster progress towards these ends. As governments assess how the goals will be achieved by 2015, they assess policy priorities and develop national strategies.

Each goal is a specific commitment to reverse the spread of poverty and disease, in most cases by 2015. The eradication of poverty and hunger is the overarching goal. The first seven goals indicate what poor countries must do to achieve human development targets by way of adopting pro-poor policies. The eighth goal is aimed at rich countries and their commitment to respond to developing countries with more aid, fairer terms of trade, and meaningful debt relief.

Sri Lanka, a member state of the United Nations, committed itself to achieve MDGs. Given the various welfare programmes, free health and education facilities that have been provided since the mid 1930s, Sri Lanka ranks quite high in meeting most human development targets, in comparison to other developing nations. However, levels of poverty vary widely in the country, and there are many areas where conditions are at unacceptable levels. The main challenges for Sri Lanka in meeting the MDGs will be lack of data in respect of some of the poorest areas, particularly in the North and the East, the scarcity of financial and human resources, and inefficiencies witnessed in project implementation.

After the adoption of the United Nations Millennium Declaration, international agencies worked together to identify targets and quantifiable indicators that enable the assessment of progress in meeting the MDGs. The table below summarises Sri Lanka's situation in respect of the eighteen targets under the eight goals. The Ministry of Policy Planning and Implementation monitors the progress of MDGs in Sri Lanka with the assistance of UNDP.

TABLE I

MDGs, Targets and Sri Lanka's Situation

Goals and Targets	Sri Lanka Score Card
Goal 1: Eradicate extreme poverty and hunger	
Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than one US dollar a day.	The proportion of the population living on less than one US dollar per day in Sri Lanka was 4 per cent in 1990 and 6.6 per cent in 1995.
Target 2: Halve, between 1990 and 2015, the proportion of people who suffer from hunger.	According to the Household Income and Expenditure Survey – 2002, in terms of the adequacy of energy intake, the percentage of poor population in Sri Lanka was 28.1 per cent in 2002. The high prevalence of underweight children (below 5 years) is a matter for concern, although it decreased from 38% in 1993 to 29% in 2000.
Goal 2: Achieve universal primary education	
Target 3: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.	The net enrolment ratio in primary education was 97% in 2000-2001. The literacy rate of 15-24 year olds was 96.9 per cent in 2001. Though not strictly enforced, schooling till 14 years of age is mandatory.
Goal 3: Promote gender equality and empower women	
Target 4: Eliminate gender disparity in primary and secondary education, preferably by 2005, and to all levels of education no later than 2015.	The ratio of girls to boys in primary education was 0.94 and in secondary education was 1.03 in 2000-2001. The ratio of literate females to males of age 15-24 year was 1.00 in 2001.

Box 2 (Contd.)

Goal 4: Reduce child mortality

Target 5: Reduce by two-thirds, between 1990 and 2015, the under five mortality rate.	The under five child mortality rate was 23 (per 1,000 live births) in 1990. It decreased to in 2001. Infant mortality rate (per 1,000 live births) declined from 19 to 17 between 1990 and 2001.

Goal 5: Improve maternal health

Target 6: Reduce by three quarters between 1990 and 2015 maternal mortality.	The maternal mortality rate was 2.3 per 100,000 live births in 1996. The proportion of births attended by skilled health personnel was 97 per cent during 1995 - 2001.

Goal 6: Combat HIV/AIDS, malaria and other diseases

Target 7: Have halted by 2015, and begun to reverse, the spread of HIV/AIDs.	Official rates of HIV/AIDS prevalence are still relatively low in Sri Lanka. However, there are indications that actual infection rates are higher.
Target 8: Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.	The number of deaths associated with malaria was 9 in 2000. Malaria cases per 100,000 people was 1,110 in 2000. The incidence of new tuberculosis cases increased from 6,174 in 1991 to 8,639 in 2001, but a treatment schedule introduced in the late 1990s is expected to reverse this trend.

Goal 7 : Ensure environmental sustainability

Target 9: Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources.	The proportion of land area covered by forest shrank by more than five percentage points during the 1990s, indicating rapid deforestation. Carbon dioxide emissions per capita increased to 0.5 MT in 1999 from 0.2 MT in 1990. However, total production in the economy per unit of energy used rose during the 1990s, which meant better use of resources. The overall consumption of substances harmful to the ozone layer has fallen.
Target 10: Halve, by 2015, the proportion of people without sustainable access to safe drinking water.	The share of households with access to safe water increased from 62 per cent in 1990 to 70 per cent in 2000.
Target 11: Have achieved by 2020, a significant improvement in the lives of at least 100 million slum dwellers.	The percentage of households with access to safe sanitation has increased from 85.6 per cent in 1994 to 93.6 per cent in 2000.

Goal 8: Develop a global partnership for development

Target 12: Develop further an open, rule based, predictable, non-discriminatory trading and financial system.	Openness as measured by the exports and imports to GDP was 67 per cent in 2002.
Target 13: Address the special needs of the least developed countries.	Sri Lanka committed itself to support UN initiatives to help the least developed countries.
Target 14: Address the special needs of land locked countries and small island developing states.	Sri Lanka committed itself to support UN initiatives to help these countries.
Target 15: Deal comprehensively with the debt problems of developing countries through national and international measures.	Total debt service payments as a percentage of exports of goods and services declined to 9.2 per cent in 2001 from 14.8 per cent in 1990.
Target 16: Development and implementation of strategies for decent and productive work for youth.	The unemployment rate was 8.1 per cent (excluding North and East) in 2002.
Target 17: Provide access to affordable, essential drugs in developing countries.	The proportion of population with access to affordable essential drugs was estimated to be 95-100% in 1999.
Target 18: Make available the benefits of new technologies, especially information and communication technologies.	Telephone mainlines and cellular subscribers per 100 people increased to 9.5 in 2002 from 0.7 in 1990. Personal computers in use per 100 people was 0.9 in 2001.

Sources: Human Development Report 2003
Millennium Development Goals in Sri Lanka/
Ministry of Policy Planning & Implementation

has declined during the last twenty years though it is still high, according to the information in the same surveys. The preliminary findings of the Consumer Finance and Socio Economic Survey 2003/2004, undertaken by the Central Bank of Sri Lanka also confirm the overall improvement in real income and widening income inequality in the country (Box 1).

In 2002, the average household income per month in the urban area, at Rs.23,436, was almost twice the average income in the rural area (Rs.11,819) and three times the average income in the estate sector (Rs.7,346). Similarly, significant differences are seen in the average income per income receiver among the three sectors. The skewness in income distribution towards high income groups was clearly seen in the comparison of relative income shares of different income

TABLE 1.6

Per Capita Income, Housing Conditions and Amenities

As a % of total households

	1981/82	1986/87	1996/97	2003/04(a)
Housing				
Brick or cement block walls	26.2	35.1	62.5	75.3
Cement, tiled and better flooring	52.6	58.8	74.1	81.5
Tiled or asbestos roofing	46.5	54.7	73.2	78.8
Own well or pipeborne water	38.7	32.6	46.9	62.2
Water seal latrine	31.9	43.7	70.1	78.4
Without latrine	29.9	16.9	6.5	5.4
Utilities				
Electricity	15.8	26.5	56.8	73.9
Telephones (land or cellular)	0.9	1.4	4.5	23.9
Refrigerators	2.9	8.1	16.8	28.7
Motorised transport (b)	4.4	8.5	15.4	25.4
Other Amenities				
Radios	60.7	67.1	73.6	77.2
Televisions	3.8	19.6	50.6	68.2
	1981	1986	1996	2003
Income				
Per capita GDP US $	297	397	795	947
Per capita GNP US $	296	358	783	935

(a) Preliminary results - CFS 2003/2004
(b) Scooters, motorcycles, three wheelers or cars.

Source: Consumer Finance and Socio Economic Surveys (CFS), Central Bank of Sri Lanka

deciles. For example, the share of the highest income decile in total income, at 38.6 per cent, is about twenty three times as high as the share of the lowest income decile (1.7 per cent) indicating a highly unequal income distribution. Similarly, the highest two income deciles together account for more than half of the total income (53.7 per cent), while the lowest five deciles (i.e., the lower half of the total income deciles) account only for about one fifth (19.6 per cent) of the total income. In other words, the relative share of the lowest five deciles in total income is only about half of the income share of the top decile. When considering nominal values, the average monthly household income in the highest income decile, at Rs.50,490, is twenty three times the corresponding value for the lowest income decile (Rs.2,237). The average income per income receiver indicates an even higher difference. The average monthly income per income receiver in the highest income decile, at Rs.29,875, is almost seventy five times the corresponding value for the lowest income decile (Rs.395).

The estimated Gini coefficient, which measures the inequality in income distribution, increased from 0.43 in 1980/81 to 0.46 in 1995/96 and further to 0.48 in 2002, demonstrating an increase in the inequality in income distribution[1], indicating a low trickledown effect of the benefits of economic growth.

The average nominal household income per month rose from Rs.881 in 1980/81 to Rs.13,038 in 2002, about a 15 fold increase. However, in real terms (at constant 1980/81 prices) it rose only by 63 per cent during the same 21-year period, reflecting that a large part of the increase in nominal terms was due to the high inflation observed during the period. In US dollar terms, it rose from 49 dollars to 140 dollars during the same period, recording only a 5.1 per cent annual growth.

Apart from the average household real income, other selected indicators such as housing conditions and access to amenities indicate a continuous improvement in average living conditions since 1980 though the achievements are below expectations (Table 1.6). Housing conditions have been improving significantly, while access to electricity and use of electronic items have been expanding continuously.

Poverty has been a major economic problem in Sri Lanka, despite various poverty alleviation programmes implemented since Independence in 1948. About 7 per cent of Sri Lanka's population are poor according to the lower poverty line (one US dollar per day), and about 45 per cent according to the higher poverty line (US dollars 2 per day). Based on the Household Income and Expenditure Survey data of the Department of Census and Statistics, poverty[2] (i.e., percentage of poor households below the estimated poverty line) has declined from 30.4 per cent in 1990/91 to 26.7 per cent in 1995/96 and further to 23.9 per cent in 2002. This declining trend indicates that the average income rose in low income groups, lifting some of the poor over the poverty line, though the income inequality increased according to the Gini coefficient.

Poverty in the rural areas (31.3 per cent of people) is more than three times that in the urban areas (8.6 per cent). Over 90 per cent of the poor live in rural areas. Therefore,

1 The Gini coefficient is a measure of income inequality and is defined as the ratio of the area between the diagonal and Lorenz curve of the distribution, to the area of the triangular region beneath the diagonal. A Gini coefficient equal to zero indicates a perfect equal income distribution and a coefficient equal to one implies perfect inequality.

2 Defining poverty in terms of adequacy in energy intake, those households spending more than 50 per cent of their expenditure on food and average adult equivalent food expenditure is less than Rs.1,338.48 per adult per month are considered as poor households in the HIES Report-2002.

poverty in Sri Lanka is overwhelmingly a rural issue, especially where access to physical and social infrastructure is least developed. Analyses indicate that, apart from the two decade long conflict, inadequate growth, particularly a low growth in agriculture, lack of opportunities and access to resources and markets, and isolation of the poor, are the main causes of poverty. It is encouraging that the poverty reduction strategy (PRS) outlined in PRSP envisages reducing poverty by accelerating economic growth, improving productivity and removing barriers, rather than depending on redistribution as attempted in the past. The intended measures include increasing access to basic services (health and quality education), connecting to input and output markets through transport, communication and information services, reforming land and labour markets, reducing high protectionism towards improving competitiveness, improving infrastructure, and strengthening governance, as well as law and order.

1.6 Prices

Inflation and inflationary expectations declined at a faster rate than expected throughout 2003, benefitting from factors on the demand as well as the supply side. On the aggregate demand side, continuation of cautious monetary policy by the Central Bank, supported by fiscal consolidation, was successful in checking the excess growth in the nominal aggregate demand and hence, contained upward pressures on the general price level. On the supply side, increased domestic agricultural production, improvement in transportation and distribution of goods, benefitting from the ceasefire, stability in the exchange rate and easing of import prices for some food items, reduced the pressure on domestic prices.

All consumer price indices registered a continuous downward trend in 2003, despite increases in administered prices of transport fares and petroleum prices, reflecting changes in international petroleum prices. The average annualised inflation rate, which decelerated from 10 - 14 per cent at end 2001, depending on the price index, to 7 - 10 per cent at end 2002, further declined to 2 - 6 per cent at end 2003. The Sri Lanka Consumers' Price Index (SLCPI), the new index with recent weights and broader geographical and income group coverage, registered an annual increase of 2.6 per cent in 2003, compared with 10.2 per cent in 2002 and 12.1 per cent in 2001. In the commodity wise classification all sub-indices recorded similar decelerations, reflecting a widespread moderation in price increases. The food, beverage and tobacco category, having the largest relative weight of 71.2 per cent, recorded price increases of only 1 per cent in 2003, benefitting mainly from the record paddy harvest, recovery in the coconut crop and production increases in other domestic food crops. This sharp deceleration in food price increases moderated the impact of relatively high price increases of 6 - 8 per cent recorded in the sub-indices covering petroleum products, transport, and miscellaneous goods and services. The Colombo Consumers' Price Index (CCPI), the official price index for consumer price inflation, covering a consumption basket of low-income households in the Colombo Municipal area, registered similar reductions, with its annual average increase declining from 9.6 per cent in 2002 to 6.3 per cent in 2003. Sectorwise analysis of commodities in its basket indicates that the inflation reflected by prices of domestically produced goods and services decelerated faster, decreasing from 8.4 per cent in 2002 to 4.7 per cent in 2003, compared with a deceleration in import price increases from 14.5 per cent to 12.2 per cent, during the same period. Consequently, the relative contributory share of domestic prices in the overall inflation declined from 76 per cent in 2002 to 60 per cent in 2003, while the contribution of import prices rose from 24 to 40 per cent, during the same period.

Meanwhile, the underlying inflationary expectations as implied by interest rates at government bond auctions and forward premia in the foreign exchange market declined, indicating a downward adjustment in market inflationary expectations. In addition to the continuing downward trend in realised inflation, a number of other factors influenced this reduction. The proven commitment of the government to strong fiscal consolidation preventing inflationary deficit financing and an improvement in market confidence in a monetary policy stance aimed at containing inflation helped in reducing high inflationary expectations, which have remained high over a long period in the country. This downward adjustment was also supported by the continuation of the independently floating exchange rate system and automatic regular adjustments in administered prices such as domestic petroleum prices and transport fares, accelerating the pass-through of the impact of international price changes and hence preventing accumulation of inflationary pressures in the economy.

Despite the recent declining trend, inflation and inflationary expectations in Sri Lanka are still high, compared with inflation rates of 1 - 3 per cent in the country's trading partner and competitor countries. Reducing the country's inflation and maintaining it at a comparably low level will reduce the pressure on the exchange rate and contain excessive wage demands, thereby breaking down the vicious circle between inflation and wage increases, as well as between inflation and exchange rate depreciation. In this context, continuation of prudent monetary policy, supported by an appropriate fiscal policy stance, implementation of productivity improving structural reforms and productivity based wage settlements as a national policy, and improvement in exchange rate stability are crucial in ensuring the achievement of sustainable low inflation.

Similarly, the availability of a representative and widely accepted consumer price index having recent weights and covering a large income segment of the society and geographical area in the country is critical in containing actual inflation as well as inflationary expectations. The current official consumer price index, the CCPI, has a number of well known weaknesses due to its old base year of 1952 and limited

Box 3

Using the SLCPI for Informed Decision Making Relating to the Cost of Living in Sri Lanka

1. Introduction

Information on price movements is vital for economic decision-making, as price changes impact on economic activities in various ways and to different degrees. Such information is critical for policy makers to maintain price stability, and thereby consumer and investor confidence, that ultimately generate economic expansion and development. Price movements also influence wage revisions and vice versa. Movements in prices are captured statistically through price indices. Among them, Consumer Price Indices (CPIs) which measure changes in the cost of living are the most important for wage indexation and payment of cost of living allowances (COLA) to workers.

A CPI is a weighted average of the prices of consumer items in a selected consumption basket. It records the aggregate movements of prices and enables comparison with the aggregate price level during a benchmark or base period. Since market conditions and consumption habits change, the consumption basket as well as the base period have to be revised over time, so that the CPI is representative of such changes and remains relevant. Usually, information from household income and expenditure surveys are used to make such revisions.

2. A General Comparison of the CCPI and SLCPI

At present, many different CPIs with different base years and consumption baskets covering different geographical regions and income/expenditure groups measure consumer price movements in Sri Lanka. Currently, the oldest index, the Colombo Consumer Price Index (CCPI), which is confined to the consumption basket of the lowest 40 per cent of households, ranked by their monthly income, within the Colombo Municipality, with a 1952 base year, is used as the official measure of consumer price movements in the country. The Department of Census and Statistics (DCS) computes the CCPI monthly. This index is now older than half a century and lacks all the vital characteristics required in a representative CPI.

In order to address these shortcomings, the DCS developed a new CPI, the Sri Lanka Consumer Price Index (SLCPI), to replace the CCPI. The SLCPI is based on the consumption basket reflected in the Household Income and Expenditure Survey (HIES) conducted by the DCS in 1995/96. It has a much more recent (1995-1997) base period for prices than the CCPI and a far wider geographical and income/expenditure group coverage, as its consumption basket covers the lowest 80 per cent of households ranked by expenditure in the entire country, excluding only the Eastern and the Northern Provinces. The SLCPI covers prices in the Eastern province as well.

The SLCPI also provides a wider spectrum of information than the CCPI for detailed analysis of price movements. It contains 9 sub indices, compared to 5 sub indices in the CCPI (Table 1). These 9 sub indices are based on the Classification of Individual Consumption by Purpose (COICOP) as specified in the System of National Accounts (SNA) Manual 1993, facilitating international comparison of price movements, which was not possible with the CCPI. The sub-indices also enable monitoring of price movements of specific services, such as health, education, transport and entertainment, (Table 1) of which consumption has risen recently with improvements in living standards. This was not possible with the limited sub classification in the CCPI.

TABLE 1
Sub Indices under CCPI and SLCPI

CCPI	SLCPI
Food	Food, beverages and tobacco
Clothing	Clothing and footwear
Fuel and Light	Housing, water, electricity, gas and other fuels
Rent	Furnishing, household equipment and routine maintenance of the house
Miscellaneous	Health Transport Leisure, entertainment and culture Education Miscellaneous goods and services (including communication)

Further, non-food consumption items such as LP gas have been increasing in importance in the consumption basket of the average household, even in rural areas. Prices of these items have been rising significantly in the recent past. However, they are not represented in the CCPI, since they did not exist at that time. Weights of others in the CCPI, such as electricity and telecommunication facilities, underrepresent their use among households today, as the lowest income groups 50 years ago had little or no access

Box 3 (contd.)

to such utilities. Similarly, weights in the CCPI for modern and popular food items such as prepared foods do not reflect improvements in quality, processing and packetting that have taken place over the past 50 years. These items and changes are covered in the SLCPI, making it more representative of changes in the current cost of living than the CCPI. Moreover, the proposal to revise the weights in the SLCPI every 5 years using the HIES data series would ensure that the SLCPI would always represent current consumption patterns.

Meanwhile, the movement of both indices, as well as their annual average changes, indicate similar trends over this period, with differences moving in both directions, depending on weight and price differences at points in time for consumption items, between the Colombo Municipality and the country as a whole (Charts 1, 2 and 3). Hence, there is no evidence to indicate either one or the other records a constantly higher or lower rate of price change.

Chart 1
Colombo Consumers' Price Index
(1952=100)

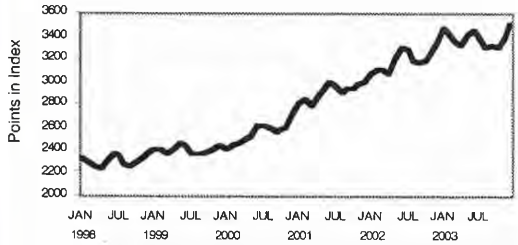
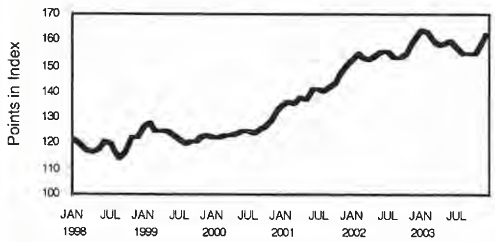


Chart 2
Sri Lanka Consumers' Price Index
(1995-1997=100)



Indexation of wages to a CPI enables nominal wages to be adjusted by a COLA to ensure that the consumption basket represented in the CPI is affordable to the wage earner, despite fluctuations in consumer prices over time.

Chart 3
Comparison of Annual Average Change of CCPI and SLCPI

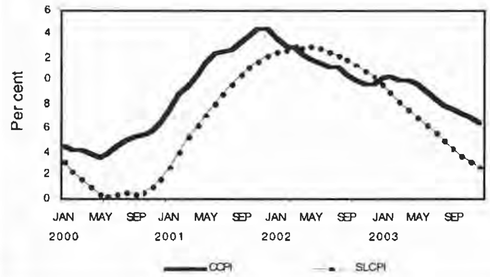
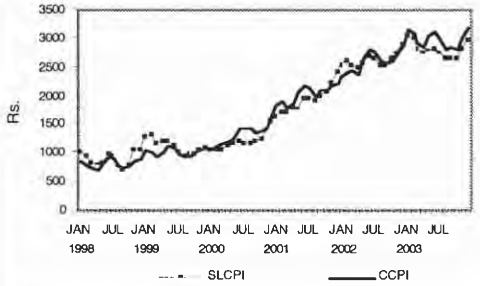


Chart 4
COLA Payment
Based on CCPI and SLCPI



Since the value of the representative basket at its base period is equated to 100 in the CPI, the rupee value of the representative basket during its base period divided by 100 represents the unit COLA that corresponds to one percentage point or unit increase in the CPI.

TABLE 2
Comparison of COLA Payment Based on SLCPI and CCPI

Period	Index Value		Change in Index		COLA Payment	
	SLCPI	CCPI	SLCPI	CCPI	SLCPI (Rs.48 per unit)	CCPI (Rs.2 per unit)
1995-1997	100.0	1,880.1				
1998 January	120.8	2,311.9	20.8	431.8	998.4	863.5
1999 January	126.8	2,400.2	26.8	520.1	1,286.4	1,040.1
2000 January	122.1	2,408.1	22.1	528.0	1,060.8	1,055.9
2001 January	134.1	2,797.5	34.1	917.4	1,636.8	1,834.7
2002 January	152.4	3,046.4	52.4	1166.3	2,515.2	2,332.5
2003 January	163.4	3,461.5	63.4	1581.4	3,043.2	3,162.7

Box 3 (contd.)

Currently, the COLA for public sector employees is computed on the basis of changes in the CCPI, at the rate of Rs.2 per index point, as per Administration Circular No.1111E. 29 DA of 18 November 1981. As the CCPI basket was valued at Rs. 202 in the base year, the unit COLA per percentage point increase in the CCPI was recommended as Rs. 2 at that time. The total value of the SLCPI basket for its base period was Rs. 4,785.96, which indicates that the unit COLA per percentage point increase of the SLCPI would be around Rs. 48. It is seen that a one percentage point increase of the SLCPI should be approximately equal to a 24 percentage point increase of the CCPI (48/2). Assuming that both CPIs are comparable measures of changes in the cost of living, payment of the COLA under wage indexation to either CPI should provide for similar payments, although not identical, over time. However, it could be expected that the more representative CPI would provide for a more realistic measure of such changes.

Certain trade unions have expressed concerns that converting from one CPI to another would be detrimental to their COLA. These concerns are unjustified. Table 2 and Chart 4 provide a comparison of hypothetical COLA payments using the CCPI and SLCPI series from the time of inception of the SLCPI (base 1995-1997). The changes in index points and the corresponding payments that would have been made since the base period, at different points in time during the last 6 years were relatively close, varying by around 0 per cent - 20 per cent in both directions at different points in time. It is clear that there is no bias in either direction for COLA payments, whichever CPI is used. Thus, a careful comparison of the CCPI and SLCPI indicates that there is no advantage to the workers in the calculation of the COLA in favour of the CCPI. In fact, use of the SLCPI would better reflect the impact of price movements on actual current consumption patterns than the CCPI.

3. Conclusion

A comparison of the COLA calculation is one of many examples to emphasise that formal adoption of the SLCPI in place of the CCPI as the official measure of the cost of living in Sri Lanka would ensure a more up-to-date, relevant and representative measure of aggregate consumer price movements in Sri Lanka that would be beneficial for all stake holders.

coverage confined to only 40 per cent of the expenditure group within the Colombo Municipality. Furthermore, the continued computation of a number of consumer price indices reflecting significantly different inflation rates confuses the public understanding of the changes in inflation and distorts inflationary expectations, thereby creating difficulties in macroeconomic management, particularly containing inflation. The SLCPI has the most recent base year (1995-97), the largest coverage of expenditure groups (excluding only the upper 20 per cent), and the widest geographical coverage in the estimation of weights and collection of prices (excluding only the North), compared with other consumer price indices presently available. Therefore, the early adoption of the SLCPI as the official consumer price index and discontinuation of other less representative consumer price indices would facilitate efforts to reduce inflation in the country (Box 3).

1.7 Wages

Actual wage increases were moderate in 2003 despite strong pressures for high wage increases. Public sector wage indices remained unchanged at the 2002 levels, as there were no general wage increases in 2003, after two wage increases given in 2001 and 2002. The average wage in the organised private sector, as measured by the minimum wages under the Wages Boards, rose by 7 per cent in 2003, compared with 7.4 per cent in 2002. Among the sub-sectors, agriculture recorded the highest increase of 9 per cent, mainly reflecting strong union pressure, followed by a 2 per cent increase in industry and no increase in the services sector. Wages in the informal sector, which are determined by demand and supply forces in the market, had increases ranging from 3 per cent to 19 per cent. The highest wage increase of about 19 per cent was recorded in the rubber tapping category for the second consecutive year, reflecting the increased demand for labour and the ability to pay higher wages benefitting from the continuation of high rubber prices. Relatively higher wage increases, ranging from 4 to 13 per cent, were also recorded in the paddy sector, mainly reflecting high demand for labour with the increased extent cultivated and record paddy harvest. Reflecting the impact of increased construction activities, daily wages in the construction sector rose within a range of 7 to 9 per cent. Given the annual inflation of 2.6 to 6.3 per cent, depending on the price index, changes in real wages were mixed in 2003, but all workers benefited from disinflation.

Wages in the public sector were raised by 10 per cent with effect from January 2004 in Budget 2004. However, it is important to note that this wage increase was given as a part of a medium-term civil service reform programme proposed in Budget 2004. The three-year reform programme will provide a 25 per cent increase in the wage structure phased out over

2004 – 2006, conditional on a 30 per cent reduction in public sector employment. It is expected to cut employment by 10 per cent through a targeted voluntary retirement scheme in 2004. Wages in the subsequent two years will be raised if the previous year's employment reduction target is met. This proposed system will provide an opportunity to raise public sector wages by a reasonable rate over a 3 year period, while keeping the wage bill constant as a ratio of GDP. It will also enable the size of civil service, which is considered significantly over staffed, to be reduced. However, the benefits of this reform programme will depend mainly on the proper targetting to those sections of the cadre where redundancy is largest and containing the compensation package at an affordable level.

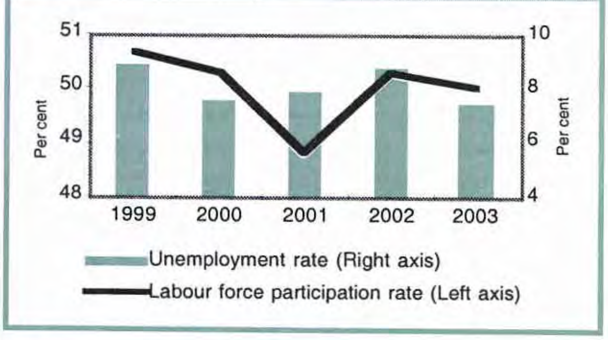
As explained in the National Employment Policy issued in 2002 by the Government and emphasised in the previous issues of the Central Bank Annual Report, linking wage increases to productivity improvement will help to prevent the vicious circle between price increases and wage increases and encourage labour intensive investment creating more employment opportunities. In this context, accelerating structural reforms that improve productivity, particularly labour market reforms, has a significant role to play.

1.8 Population, Labour Force and Employment

Population growth fell marginally to 1.3 per cent in 2003, following a temporary increase to 1.5 per cent in 2002 caused by the return of a large number of Sri Lankans with the progress on the peace process. The annual average population growth in Sri Lanka has been well below that of most countries in the South Asian region, reflecting the effect of high literacy rates, successful family planning and improvements in other socio-economic conditions. Nevertheless, a net addition of about 250,000 persons annually to the existing population raises the burden on the limited resources in the country and indicates the desirability of further reduction in population growth. The mid-year population in 2003 is estimated to be 19.3 million. District-wise estimates indicate that people have been moving from Mullaitivu, Kilinochchi, Vavuniya and Mannar to Jaffna, Trincomalee and Batticaloa, reflecting the return of internally displaced people to their original homes, with improving civil conditions under the continuing ceasefire.

Continuation of high unemployment

Chart 1.4
Labour Force Participation and Unemployment Rate



According to the Quarterly Labour Force Survey (QLFS)[1] conducted by the Department of Census and Statistics (DCS), the labour force at the end of the third quarter of 2003 (Q3/2003) was estimated at 7.6 million, an increase of 559,000 (7.9 per cent) over the third quarter in 2002 (Q3/2002). The labour force participation rate declined to 48.6 from 49.4 per cent during the same period. This decline was entirely due to the inclusion of the Eastern Province in 2003, which had a lower participation rate. The male participation ratio continued to remain at around 67 per cent. This was more than double the female participation rate, which was around 31 per cent.

The estimated total number of employees rose[2] to 6.58 million in Q3/2003 (excluding Eastern Province) from 6.41 million in Q3/2002, an increase of 175,000 jobs during a period of twelve months. The share of employment in the agricultural sector rose to 35 per cent, while the shares of the services and industrial sectors declined to 43.3 per cent and 21.7 per cent, respectively. This could be due to the larger relative shares in agricultural employment in the new province added to this survey, i.e., the Eastern Province, in 2003. It is noteworthy that the relative share of public sector employees continued to decline, from 23 per cent in 1991 to 13 per cent in 2003, while the shares of private sector employees and the self-employed increased to about 44 and 29 per cent, respectively, reflecting the impact of the private sector led economic development strategy.

The share of employed persons in the labour force rose to 91.6 per cent in Q3/2003 from 90.9 in Q3/2002, indicating that the number of new jobs created in the economy was greater than the number of net additions to the labour force. Consequently, the unemployment rate declined to 8.4 per cent from 9.1 per cent during the same period. Unemployment continued to be high among youth with higher education, albeit with some marginal declines recorded in 2003, reflecting the continuation of the mismatch in the labour market. This clearly indicates the necessity of urgent reforms in education and training.

Employment in the public sector continued to decline for the second consecutive year, decreasing by about 18,200 or 1.7 per cent to 1.043 million at end 2003. This reduction was reflected in both government and semi-government sectors. The reduction was higher in the semi-government category (5

1 A break in the series of labour force statistics occurred at the beginning of 2003 with the inclusion of the Eastern Province in the QLFS in the 15-year QLFS series.

2 In the QLFS, an employed person is defined as one who worked for pay, profit or unpaid family gain for one or more days during the week preceding the survey.

per cent). This was the outcome of the continuation of the freeze on recruitment to the public sector unless there was a clear and strong justification for recruitment. A higher reduction was recorded in the semi-government sector due to the continuation of the privatisation programme, retirement without extension after 55-57 years of age and successful voluntary retirement schemes (VRS). VRS schemes were implemented successfully at the Sri Lanka Ports Authority, Ceylon Petroleum Corporation and Sri Lanka Telecom Ltd., reducing employees by about 7,000 in 2003. Nevertheless, the total employment in the public sector remained high at 1.043 million or 15 per cent of total estimated employment in the country, even after a quarter of a century since the introduction of a market oriented economic policy framework.

Migration for foreign employment continued to increase in 2003. The registered number of annual departures for foreign employment increased by 2.3 per cent, reaching 208,439. This was an increase compared with 203,773 departures in 2002, but was below the annual forecast of 210,000 for 2003. Increasing competition from other labour supplying developing countries and concerns about the safety of migrant female workers were the major contributory factors for this deceleration. The share of female workers declined marginally to 64 per cent in 2003 from 65 per cent in 2002, but is still high. Similarly, the share of housemaids declined to 48 per cent, although they still have the highest share. Meanwhile, the share of skilled migrants rose slowly but gradually.

Major steps were initiated in 2003 to address long over due labour market reforms. Accordingly, amendments to the Termination of Employment of Workmen Act (TEWA), Industrial Dispute Act (IDA), Industrial Disputes – Hearing and Determination Proceedings Act (IDA-Hearing) and Employment of Women, Young Persons, and Children Act (EWYPCA) were passed in 2003, enhancing flexibility and predictability in the labour market. IDA and IDA-Hearing Acts were amended, fixing the time limits to complete hearings of labour disputes in order to end the long delays in dispute settlement. EWYPCA was amended to strengthen penalties for violation of requirements under the Act. The TEWA was amended to enable the introduction of a mandatory formula for payment of compensation to retrenched employees. The formula was announced at end 2003 after a series of consultations with trade unions. These amendments were long overdue requirements. However, the benefits of these amendments to the economy would depend heavily on their effective implementation.

TABLE 1.7

Government Fiscal Operations (As a percentage of GDP)

Item	1995	2000	2002	2003(a)
Revenue	20.4	16.8	16.5	15.7
Tax	17.8	14.5	14.0	13.2
Non-tax	2.7	2.3	2.5	2.5
Expenditure and net lending	30.5	26.7	25.4	23.4
Current expenditure	23.1	20.2	20.9	19.0
Security (b)	6.5	5.6	4.0	3.5
Interest	5.7	5.7	7.4	7.1
Wages (c)	3.4	3.2	3.3	3.2
Subsidies and transfers	6.1	4.2	4.7	4.0
Others	1.4	1.6	1.5	1.2
Capital and net lending	7.4	6.5	4.6	4.7
Public investment	7.9	6.4	4.6	5.0
Aquisition of real assets	3.4	2.6	1.7	2.1
Capital transfers	2.9	2.8	2.0	2.2
On lending	1.7	1.0	0.9	0.7
Other	-0.5	0.1	....	-0.3
Restructuring cost	0.5	0.3	0.3	0.3
Others	-1.0	-0.2	-0.4	-0.6
Current account balance	-2.7	-3.4	-4.4	-3.3
Overall deficit before grants and excluding privatisation	-10.1	-9.9	-8.9	-8.0
Financing	10.1	9.9	8.9	8.0
Foreign financing	4.5	0.4	0.6	2.9
Loans	3.2	...	0.1	2.4
Grants	1.4	0.4	0.4	0.5
Domestic financing	5.1	9.4	8.0	4.5
Banks	1.1	4.5	-0.3	-1.2
Privatisation	0.4	...	0.4	0.6
Public Debt	95.2	96.9	105.4	105.9
Domestic	43.3	53.8	59.8	57.9
Foreign	51.9	43.1	45.6	47.9
Memorandum items :				
Total wage bill	5.2	5.5	5.6	5.2
Gross defence expenditure (d)	5.3	4.5	3.1	2.7

(a) Provisional
(b) Consisting of defence and public order and safety
(c) Excluding those paid to security staff
(d) Excluding public order and safety

Source: Ministry of Finance
Central Bank of Sri Lanka

1.9 Fiscal Policy, Budgetary Operations and Public Debt

Given the high public debt, which is larger than annual GDP, and government debt service payments exceeding government total revenue, fiscal policy in 2003, aimed primarily at fiscal consolidation in a manner compatible with the medium-term fiscal sustainable strategy announced in the Fiscal Management (Responsibility) Act (FMRA). It also aimed at supporting economic growth, implementing structural reforms and creating productive employment in the economy. In this context, Budget 2003 proposed a series of measures to enhance government revenue, contain recurrent expenditure, raise public investment, foster private investment and increase productivity in the economy.

Accordingly, in the original budgetary estimates for 2003, the fiscal deficit was expected to be reduced by 1.4 percentage points to 7.5 per cent of GDP, through raising revenue by 0.6 per cent of GDP and reducing expenditure by 0.8 per cent of GDP. Similarly, it was expected to reduce the current account deficit, which measures the level of government dis-savings, and the primary deficit, which reflects the impact of the current year's fiscal operation on the macro economy. The entire effort to raise revenue was placed on increasing tax revenue, given the limitations on mobilisation of additional non-tax revenue. To contain expenditure, the full adjustment was placed on a reduction of recurrent expenditure, since capital expenditure was raised by 0.7 per cent of GDP to 5.3 per cent of GDP in order to accelerate infrastructure development. In financing the deficit, reliance on foreign financing and privatisation proceeds was raised significantly in order to contain net domestic borrowing at 4.9 per cent of GDP in 2003, compared with 8.8 and 8.0 per cent of GDP in 2001 and 2002, respectively. It is important to note that the domestic net borrowing level was expected to decrease from Rs.126.4 billion in 2002 to Rs.87.3 billion, resulting in a 31 per cent decline. This was intended to reduce the pressure on domestic interest rates and release more domestic financial resources to the private sector, and thereby to accelerate economic recovery.

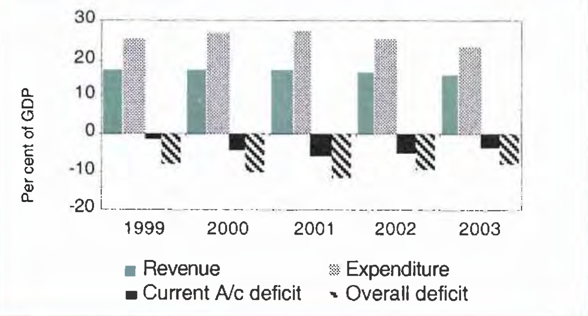
As a means of raising additional tax revenue in 2003, the budget proposals placed major emphasis on expanding the tax base under the Value Added Tax (VAT) and import tariff, and strengthening tax administration. VAT has become the main tax source and was estimated to generate 45 per cent of total tax revenue. Therefore, a number of measures were proposed to expand the VAT base and improve VAT collection. Among them were extending VAT to financial services and the retail and wholesale business, correcting the weaknesses in the VAT structure, including the refund mechanism, and improving tax administration. On the import tariff front, a new tariff rate of 2 per cent was imposed on most exempted imports, as increasing the number of items under the tariff exemption list was the main cause for a significant reduction in the average import duty rate (i.e., total duty in relation to the value of imports), which hampered the overall tax collection[1]. Similarly, the coverage of the debit tax was extended to savings deposits, expanding the tax base. Excise duty rates on

1 The average import duty (i.e., the ratio of total import duty collected, excluding the import surcharge, to total imports) declined continuously from 14.7 per cent in 1991 to 4.6 per cent in 2003.

Chart 1.5
Fiscal Sector Indicators

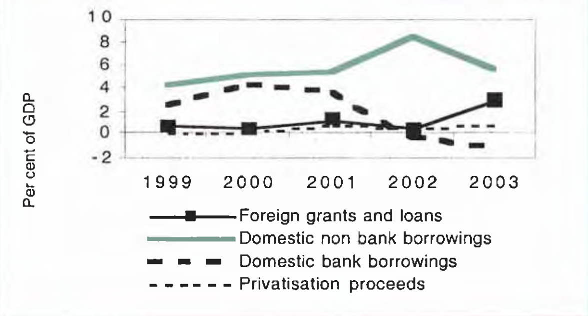
Declining deficit, but at a slower pace than expected

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



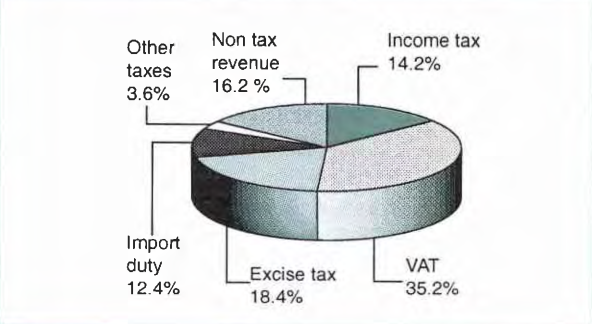
Declining domestic bank financing

Chart 1.5.2
Financing the Deficit



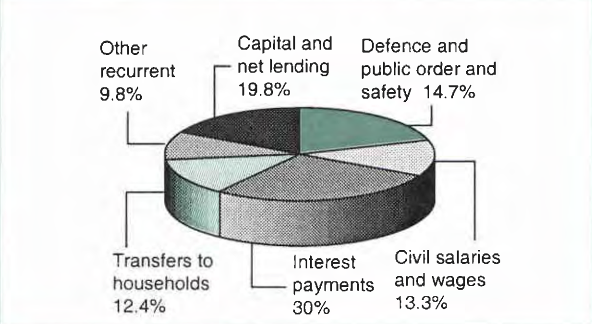
Indirect taxes contributing more than two thirds of revenue

Chart 1.5.3
How a Rupee Was Earned - 2003



Interest and wage payments accounting for more than half of expenditure

Chart 1.5.4
How a Rupee Was Spent- 2003



liquor and cigarettes were raised, while the excise tax on liquor was streamlined by consolidating total tax liabilities under the Excise Ordinance. As tax evasion has become a major factor weakening revenue mobilisation, a new tax amnesty was granted in order to expand the tax base by bringing tax evaders into the tax net.

Continuing the expenditure containment measures introduced in 2002, Budget 2003 placed major emphasis on suspending recruitment to the public sector, avoiding general wage and pension increases, reducing the provision for defence expenditure, better targetting of welfare programmes, limiting resource allocation for unforeseen and unclassified expenses and controlling provision of funds for rupee funded non-priority capital expenditure. Meanwhile, policies introduced to rationalise expenditure in the medium term included the imposition of limits on government guarantees under the FMRA. Additional policies were the establishment of an independent debt management office, continuing the contributory pension scheme for new public sector employees, designing an overall welfare programme under the Welfare Benefit Law and reforms in public enterprises in order to reduce, and if possible to eliminate, their dependence on the budget. In financing the deficit, emphasis was placed on low-cost long-term borrowing, while reducing high cost debt with commercial banks and retiring high cost debt with optional maturities. These measures are expected to help to improve the short-term stabilisation process, while enabling the achievement of a sustainable deficit reduction in the medium to long-run.

Measures were also taken to strengthen the implementation of fiscal measures. Accordingly, a high level committee, namely, the PRGF Monitoring Committee, comprising senior officials from the public sector, was appointed to ensure the implementation of fiscal policies and maintenance of fiscal targets in the Poverty Reduction and Growth Facility (PRGF) programme in 2003. The first Mid Year Fiscal Position Report required under the FMRA provided an opportunity for a comprehensive evaluation of the progress in budgetary operations and to take additional measures if necessary. The Report, presented to Parliament on 30 June 2003, indicated the possibility of deviating from the fiscal targets, mainly due to the slippages on the revenue front. Therefore, a series of additional tax policy measures and tax administrative improvements were put in place during the second half of 2003 to arrest the deviations and keep the deficit on track. These include extension of VAT coverage to any persons providing financial services, increasing the corporate income tax rate applicable to the foreign currency banking units (FCBUs) of commercial banks from 15 to 30 per cent, restriction of input tax claims to 10 per cent and increase of excise duty on cigarettes and liquor. Finally, to limit the expansion of the fiscal deficit, rupee funded non-priority capital expenditures were curtailed.

The realised budget outturn indicates that the fiscal consolidation process made further progress in 2003, moving towards the medium-term fiscal stabilisation targets envisaged under the FMRA though the pace was slower than expected. These favourable developments include reductions (as a per cent of GDP) in recurrent expenditure, the budget deficit and net domestic borrowing for deficit financing; increases in capital expenditure and utilisation of foreign financing and containing the rising trend in debt to GDP ratio. Meanwhile, the public sector deficit (as a percentage of GDP), including deficits in public corporations, declined by a larger value than the reduction in the budget deficit, reflecting the benefits of reforms in public enterprises. However, a large revenue shortfall not only limited the fiscal improvements expected in the budget, but also compelled the government to cut capital expenditure, adversely affecting the expansion in potential economic capacity.

Despite a revenue shortfall of about 0.8 per cent of GDP in 2003, the overall fiscal deficit to GDP declined by about 0.9 percentage points due to a reduction in expenditure by 1.7 per cent of GDP. However, the reduction in the overall deficit was about 0.5 per cent of GDP, less than expected in the budget. The large reduction in expenditure was entirely due to a reduction in recurrent expenditure by 1.9 per cent of GDP as the capital expenditure to GDP ratio increased by 0.2 per cent. Consequently, the current account deficit recorded a larger reduction by about 1.1 per cent of GDP, reflecting a favourable fiscal adjustment. Meanwhile, foreign financing increased sharply, exceeding even the budget estimate and thus reducing the net domestic deficit financing requirement by 3.5 per cent of GDP (Rs.46.7 billion), reducing pressure on the domestic interest rate and releasing more resources to the private sector. As the total available domestic non-bank resources, at Rs.110 billion, were higher than the government's net domestic borrowing requirement of about Rs.79.7 billion, the government took this opportunity to reduce its liabilities to the banking sector. Consequently, net credit to the government from the banking system declined for the second consecutive year, recording a Rs.4.8 billion (0.3 per cent of GDP) decline in 2002 and a Rs.20.9 billion (1.2 per cent of GDP) decline in 2003, reversing the rising trend observed before 2002. Despite the reduction of budget deficit and domestic debt/GDP ratio in 2003 depreciation of rupee against SDR and Yen towards the end of 2003 resulted an increase in total outstanding debt/GDP ratio to 105.9 per cent at end 2003.

The benefits of these fiscal improvements are already reflected in the economy. First, they facilitated pursuing growth supportive monetary policy without increasing inflationary pressure and helped to reduce inflationary expectations. Second, they reduced the pressure on domestic interest rates, contributing to shifting the entire yield curve downward. The declining domestic interest rates, in turn, reduced the government's interest burden by about Rs.2.2 billion in 2003 alone. The reduction in the interest burden is significantly larger, when the benefits in the future years are considered, as the government was able to issue long-term Treasury bonds at significantly lower rates and to replace some high-cost debt with low-cost new bonds. Thirdly, they facilitated economic recovery by making available more domestic financial resources to the private sector at lower rates.

However, still there is a long way to go in order to ensure the medium-term fiscal sustainability expected in the FMRA, as revenue mobilisation and capital expenditure are very low, while the deficit and debt burden are significantly higher than the desired levels. The major challenge in moving forward is reversing the declining trend in the revenue to GDP ratio. This has declined continuously, from about 19 per cent in early the 1990s to 13.2 per cent in 2003. The reduction is about 6 per cent of GDP or Rs.106 billion in relation to GDP in 2003, which is even larger than the government's annual wage bill or total capital expenditure. Reversing this trend will require changes in both tax policy and tax administration. In tax policy reforms, major emphasis has to be placed on expanding the tax base, reducing or if possible eliminating tax exemptions, waivers and tax holidays. In tax administration reforms, attention needs to be given to strengthening management, improving human skills, reforming incentive structures, improving accountability, strengthening the legal structure and improving coordination among major revenue mobilising institutions. The proposed Revenue Authority will provide an ideal opportunity to address these issues effectively.

On the revenue side, a large shortfall was recorded entirely due to poor performance in tax revenue, as non-tax revenue exceeded the budget target in 2003. The tax/GDP ratio continued its decline reaching 13.2 per cent in 2003, the lowest recorded level, in contrast to the expected improvement in Budget 2003. The shortfall was Rs.33.1 billion or 12.5 per cent of expected tax revenue. This shortfall was mainly due to delays in implementing some revenue proposals, poor tax compliance and weak tax administration. Slippages in VAT (Rs.23.2 billion) and income tax (Rs.9.1 billion) were the major causes as collections under excise duty and taxes on international trade marginally exceeded the annual budget estimates. The lagged effect of investment allowances and Advanced Company Tax (ACT) abolished in 2002, poor tax compliance, weak tax administration and an effective incentive system were the major factors that resulted in the large shortfall of 19 per cent in income tax. Consequently, the income tax to GDP ratio declined from 2.4 per cent in 2002 to 2.2 per cent in 2003, despite continuation of economic recovery and improved corporate sector profitability. The corporate income tax to GDP ratio declined below one per cent, reflecting a 33 per cent reduction during the five-year period 1997-2003[1]. The shortfall in VAT was mainly attributed to the postponement of some measures to expand the tax base (such as expansion to wholesale and retail trade), leakages under the refund mechanism under dual VAT rates, and weaknesses in the VAT audit system and administration. Meanwhile, a higher profit transfer of Rs.1.7 billion and dividend from Sri Lanka Insurance Corporation (Rs.750 million) and collection of Rs.2 billion from the Strike, Riot, Civil Commotion and Terrorism Fund helped the non-tax revenue collection to exceed its target by Rs.5.7 billion or about 12 per cent in 2003 compared with 2002.

On the expenditure side, a saving in the current expenditure of about Rs.10 billion and a cut in capital expenditure by Rs.10.8 billion resulted in a lower total expenditure by about Rs.20.7 billion or 4.7 per cent less than the budget estimate. The key measures that enabled expenditure consolidation were the streamlining of defence expenditure, benefits of continuation of the ceasefire, the freeze on recruitment to the public sector, avoidance of ad hoc wage increases, strict control on transfer payments to sub-national levels of government and public institutions and rationalisation of current payments on other goods and services. The savings in current expenditure were reflected mainly in interest payments (Rs.5.1 billion) and current transfers and subsidies (Rs.5.7 billion), as expenditure on goods and services remained almost on target. The reduction in interest payment was mainly due to a decline in domestic market interest rates, replacing of high cost borrowing with low cost new issues of debt instruments, and improvements in Treasury cash management and public debt management. Despite additional expenditure pressures and unexpected expenditure on flood relief, total expenditure in 2003 was below the level in 2002, as well as the budget estimate. Meanwhile, all major items that recorded expenditure overruns in the past, such as transfers to public institutions and Samurdhi, were maintained well within the budgetary allocations. These outcomes clearly indicate the government's strong commitment to fiscal consolidation. Reflecting the benefit of the continuing ceasefire, defence expenditure was contained at Rs.47 billion, a 4.4 per cent reduction in nominal terms. As a ratio of GDP too, it declined, reaching 2.7 per cent in 2003 compared with 4.5 per cent in 2000. Continuation of this favourable declining trend in recurrent expenditure to GDP is crucial for realising the medium-term fiscal stabilisation targets envisaged in the FMRA.

The public investment programme recorded a marginal improvement, increasing only to 5 per cent of GDP in 2003 from 4.6 per cent of GDP in 2002. This was lower than expected in the budget (5.3 per cent of GDP), as well as the medium-term desirable level of over 6 per cent. The low increase was mainly due to restrictions on releasing funds to low priority capital expenditure projects in the attempt to arrest the deviation in the fiscal deficit.

The overall budget deficit declined from 8.9 per cent in 2002 to 8.0 per cent in 2003, continuing the downward trend observed in 2003. In nominal terms, the deficit was at the level (Rs.141 billion) that prevailed in 2002. However, the current

1 Sri Lanka has the lowest corporate income tax to GDP ratio (1.3 per cent in 2001) compared with other countries in the Asian region: India (1.6 per cent), the Philippines (2.7 per cent), Thailand (2.9 per cent), Vietnam (5.6 per cent), Malaysia (6.2 per cent). The ratio for Sri Lanka declined further to 0.9 per cent of GDP in 2003.

account deficit and primary deficit declined, not only in terms of GDP, but also in nominal terms. The primary account deficit declined by Rs.8.6 billion to Rs.16 billion, continuing its declining trend. The current account deficit declined by a larger value of Rs.11 billion, reflecting the benefits of savings in interest payments. In GDP terms, the primary deficit declined to below 1 per cent of GDP, while the current account deficit declined to 3.3 per cent of GDP, recording a larger reduction than the decline in overall deficit. However, all these realised deficit values were higher than the budget targets. The largest deviation of 1 per cent of GDP was recorded in the current account deficit.

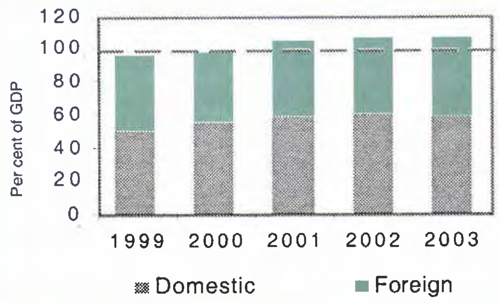
In financing the fiscal deficit, the burden on domestic financing declined due to increased foreign resource mobilisation and realisation of privatisation proceeds. Foreign financing rose sharply to Rs.51 billion, compared with Rs.9 billion in 2002 exceeding even the budget estimate of Rs.34 billion. Improvements in foreign aid utilisation to US dollar 895 million and borrowing of US dollar 100 million (about Rs.9.5 billion) from foreign banks under a Japanese government guarantee (through NEXI) were the two contributory factors for the increase. Meanwhile, the receipt of privatisation proceeds for deficit financing increased to Rs.10.2 billion in 2003, from Rs.5.7 billion in 2002, but it was below the budget estimate of Rs.13.5 billion. Privatisation of Sri Lanka Insurance Corporation (Rs.6 billion) and sale of 100 gas stations and one third of the common user facility in the petroleum sector to the second player (receipts for budget Rs.2.7 billion) were the main sources of privatisation proceeds. Consequently, net domestic financing declined by 37 per cent to Rs.79.7 billion, compared with Rs.126.4 billion in 2002, even lower than the budget estimate of Rs.87.3 billion. The entire domestic borrowing was mobilised from the non-bank sector through the issue of market based instruments, i.e., Treasury bills and bonds.

The government's overdrafts with commercial banks, which declined from Rs.38 billion at end 2001 to Rs.3.6 billion at end 2002, declined further to about Rs.2 billion at end 2003. Similarly, government import bills payable to commercial banks decreased by Rs.12.6 billion in 2003. Government also repaid maturing dollar denominated Sri Lanka Development Bonds amounting to US dollars 158.5 million. Thus, the fiscal operations in 2003 helped to improve the liquidity in the banking system significantly, thereby supporting the declining trend in domestic interest rates. This was further supported by the repayment of some outstanding banking sector liabilities by public corporations.

Three major favourable developments were observed in the government debt stock in 2003; a containment of the rise in the public debt to GDP ratio, reduction of high-cost debt and an increase in the average debt maturity with the issue of long maturing debt instruments upto 20 years. The rise in the government debt to GDP ratio was contained in 2003, moving only from 105.4 per cent in 2002 to 105.9 per cent in 2003. The total outstanding government debt rose by 12 per cent to Rs.1,863 billion at end 2003. The increase of Rs.194 billion was mainly the outcome of the net borrowing (Rs.123 billion) and impact of the depreciation of the exchange rate on debt denominated in foreign currencies (Rs.68 billion), reflecting the sensitivity of the debt burden to exchange rate variations. Although the Sri Lankan rupee remained virtually unchanged against the US dollar in 2003, it depreciated against the Japanese yen (12.7 per cent) and the Special Drawing Rights (SDR) (10.1 per cent), which account for about 75 per cent (34 and 41 per cent, respectively) of total foreign debt. In the debt composition, domestic debt at end 2003 accounted for 57.9 per cent, while the share of foreign debt was 47.9 per cent, of which 99 per cent was in the concessional category.

Containing rising trend in Debt/GDP ratio

Chart 1.6
Composition of Government Debt



The public sector deficit, consisting of the fiscal deficit and the deficit of non-financial public corporations, also continued to decline in 2003. With the improvements in the performance of public corporations, their deficit declined by about 0.1 per cent of GDP, reducing the total public sector deficit by about 1.1 per cent of GDP to 7.9 per cent of GDP in 2003.

The outstanding debt stock of the public sector, consisting of government debt and debt of the non-financial public corporations, amounted to Rs.1,905 billion, of which Rs.40.6 billion (2.3 per cent of GDP) was held by the public corporations. The public sector debt to GDP marginally increased from 108.1 per cent in 2002 to 108.2 per cent in 2003. This marginal increase was the outcome of reductions in public corporation debt (0.4 per cent of GDP) and increase of central government debt (0.5 per cent of GDP).

In 2003, improvements in budgetary operations of provincial councils (PCs) also helped the fiscal consolidation efforts of the central government. Their revenue collection increased by 24 per cent to 0.7 per cent of GDP, benefitting from the economic recovery. Increases in turnover tax and stamp duty collection mainly contributed to the increase. Meanwhile, their expenditure was contained at 2.8 per cent of

GDP as in 2002. These developments helped to contain their transfer requirements from the central government. However, their dependence on central government transfers is still high as their income is sufficient to cover only 13 per cent of their total expenditure. Similarly, concerns have been raised about the potential duplication of work and high operational costs under the existing PC system.

1.10 Trade, Tourism and Balance of Payments

The external sector, where a better performance was observed in 2002, improved further in 2003, strengthening the resilience of the economy, benefiting from the world economic recovery, continuation of the ceasefire, improvement in economic management and acceleration of structural reforms. A recovery in exports, increased inflows from services and an improvement in the income account, reduced the deficit in the goods, services and income account, neutralising the impact of an increase in imports. Meanwhile, increased private remittances helped to reduce the external current account deficit to a significantly lower level of US dollars 101 million (0.6 per cent of GDP) compared with US dollars 237 million (1.4 per cent of GDP) in 2002. Net inflows through the financial and capital accounts increased sharply by 58 per cent to US dollars 702 million, offsetting the current account deficit and resulting in a substantial surplus (US dollars 502 million) in the overall balance of payments for the third consecutive year. Consequently, the foreign reserves of the country rose further to comfortable levels, while pressure on the exchange rate decreased significantly; in fact, the rupee appreciated against the US dollar, which is the major trading currency, before the political uncertainty in the last quarter of 2003. Finally, the country's external vulnerability declined as the import coverage and coverage of short-term external liabilities by external reserves rose, and the external debt service ratio decreased. Nevertheless still heavy dependence on only two export products (tea and garments, accounting for 63 per cent of exports) and a few export markets (USA and EU accounting for 93 per cent of garment exports), high costs of power and doing business, excessive rigidities in the labour market and political uncertainty have to be addressed effectively to improve the resilience of the country to external shocks on a more sustainable basis.

Several factors contributed to the achievements in 2003. On the domestic front, the benefits of the ceasefire were reflected clearly in increased tourist arrivals, capital inflows and foreign assistance, as well as in reduced defence imports. Improved macroeconomic management and continuation of structural reforms not only increased exports but also encouraged foreign investment and concessional foreign financing inflows. These policy reforms and the peace process also led to the approval of the long overdue Poverty Reduction and Growth Facility and the Extended Fund Facility (PRGF-EFF) by the IMF, and enhanced assistance from the World Bank group, ADB, Japan and other donors, including the Poverty Reduction Support Credit (PRSC) facility from the World Bank. The approval of the PRGF-EFF and PRSC was also considered an endorsement of the country's economic policies envisaged in the poverty reduction strategy paper (PRSP). This endorsement helped to enhance concessional assistance from other donors and encourage foreign investors. This was clearly reflected at the Tokyo meeting in June 2003 at which donors pledged total assistance of about US dollars 4.5 billion for the period of 2003 - 2006. Sri Lanka's improved economic relations with major trading partner countries, particularly with India, USA and EU, helped the expansion in exports. Favourable domestic weather conditions also contributed to improvements in the external sector, raising agricultural exports and containing demand for oil for power generation. On the external front, a faster than expected growth in the world economy helped the recovery in Sri Lanka's exports and booming tourism. Adverse developments in some Asian countries, particularly the SARS epidemic and terrorist attacks, also contributed to the sharp increase in tourist arrivals in Sri Lanka.

Exports recovered in 2003, recording a 9 per cent annual growth rate in US dollar terms compared with a decline of 2 per cent in 2002 benefitting from both a volume increase (3.5 per cent) and a price increase (5.5 per cent). The recovery was broad based, with industrial exports growing at about 10 per cent and agricultural exports at 3 per cent. Industrial exports,

TABLE 1.8

External Sector Indicators

Item	2000	2001	2002	2003(a)
Annual change (%)				
Export volume	18.3	-8.0	2.2	3.5
Import volume	12.9	-10.7	11.4	11.2
Export unit value	1.5	-5.2	-4.1	5.5
Import unit value	8.1	-3.6	-8.3	-1.8
Terms of trade	-6.1	-1.7	4.6	7.4
Tourist arrivals	-8.2	-15.9	16.7	27.3
Private remitances	9.8	-0.4	11.4	9.9
As a percentage of GDP				
Trade deficit/GDP	-10.8	-7.4	-8.5	-8.4
Current account deficit/GDP	-6.4	-1.4	-1.4	-0.6
Overall BOP/GDP	-3.2	1.4	2.0	2.8
External reserves (b)				
Gross official reserves (US $ mn)	1,049	1,338	1,700	2,329
(Months of imports)	1.7	2.7	3.3	4.2
Total reserves (US $ mn)	2,131	2,238	2,495	3,218
(Months of imports)	3.5	4.5	4.9	5.8
External debt service payments				
Amortisation payments (US $ mn)	621	558	572	527
Interest payments (US $ mn)	332	254	216	229
Overall debt service ratio				
(As a percentage of X,G and S)	14.7	13.2	13.2	11.6
Exchange rate index (end of period) (c)				
Real effective exchange rate index	99.6	99.6	100.1	96.7
Nominal effective exchange rate index	90.9	82.7	76.1	71.6

(a) Provisional   Source: Central Bank of Sri Lanka
(b) Reserves are calculated at market value from 2002.
(c) 24 currency basket, 1999 = 100

dominated by garment exports (65 per cent), contributed about 80 per cent of the increase in total exports, while agricultural exports, dominated by tea (71 per cent), contributed only 6 per cent[1]. However, earnings from mineral exports declined by 7 per cent mainly due to a decline in gem exports. Within the industrial category, all sub-groups except petroleum and leather, travel goods and footwear, recorded increases in export earnings. The textile and garments sector recorded a moderate growth of 6.3 per cent, while all other industrial groups together grew by 16.2 per cent, mainly benefiting from high growth in rubber based products (27 per cent), diamonds and jewellery (14 per cent) and machinery and equipment (9 per cent), reflecting diversification in industrial exports. Another noteworthy improvement was the higher growth in net export earnings of textile and garments (9 per cent) than in the gross export value (6.3 per cent), reflecting the movement towards high value added products in the garment industry. All three plantation crops contributed to the growth in agricultural exports, while other agricultural exports dropped by about 10 per cent due to decreases in un-manufactured tobacco exports, reflecting high domestic demand, and a decline in earnings from pepper exports due to lower prices and volume.

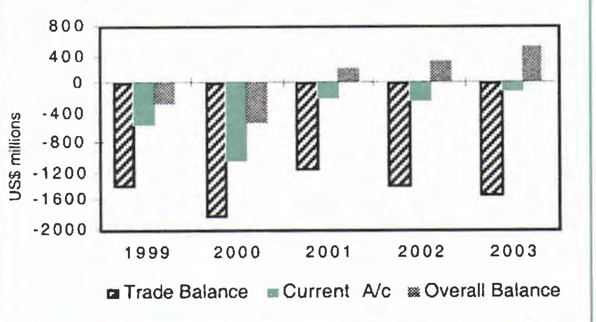
Imports grew by 9 per cent in 2003, compared with a 2 per cent growth in 2002, reflecting the impact of the recovery in the domestic economy, derived demand for imported inputs from the growth in export and the reduction of the import surcharge from 40 to 20 per cent. This was the combined outcome of a volume increase by 11 per cent and a price decline of about 2 per cent. Intermediate imports, the largest import category (57 per cent), grew by about 9 in 2003

1 The balance 15 per cent of the increase in total exports was reflected under the category 'Unclassified'.

Chart 1.7
Selected External Sector Indicators

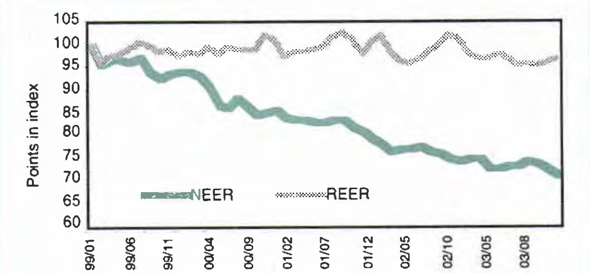
Continuing low current account deficit and a BOP surplus

Chart 1.7.1
Balance of Payments



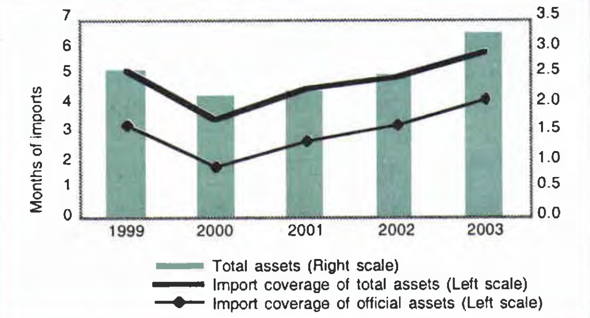
Marginally improving external competitiveness

Chart 1.7.2
Effective Exchange Rates
(1999=100)



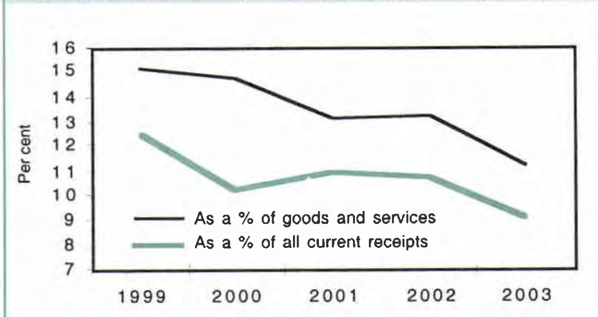
Improving external assets

Chart 1.7.3
External Assets



Declining debt service ratio

Chart 1.7.4
External Debt Service Ratio



compared with 5 per cent in 2002, mainly reflecting increased input demand from the manufacturing sector. The Intermediate category accounted for more than half (56 per cent) of the increase in total imports. Despite a sharp increase in petroleum prices (21 per cent), the petroleum import bill declined by about 6 per cent due to a reduction in import volume, reflecting the reduced demand for fuel for thermal power generation. The second largest import category (22 per cent), consumer goods, expanded by 12 per cent, mainly reflecting a sharp increase in the import of non-food and drink and contributed 29 per cent of the increase in the total import value. Reflecting the impact of improved consumer confidence, all major categories of consumer durable imports increased significantly. With increased domestic agricultural production, the import volume of food items decreased by 2 per cent in 2003 from an increase of 21 per cent in 2002. Imports of investment goods, accounting for about 20 per cent of the total import bill, rose by 13 per cent and accounted for 26 per cent of the increase in total import value. Reflecting recovery in investment, all sub categories in capital goods imports increased in 2003; transport equipment by 37 per cent, building materials by 21 per cent and machinery and equipment by 9 per cent.

In 2003, international prices moved in favour of Sri Lanka, improving the terms of trade by 7.4 per cent, compared with a 4.6 per cent improvement in 2002. This was a combined outcome of an increase in the export unit price index and a decline in the import unit price index. The export price index rose by 5.5 per cent, compared with a decline of 4.1 per cent in 2002, solely benefitting from price increases in manufacturing exports. Even though textile and garment exports recorded a moderate price increase (3.6 per cent), non-garment exports experienced a relatively high price increase of 11.9 per cent. The unit price index for overall imports declined about 1.8 per cent following an 8.3 per cent decrease in 2002. This was entirely due to a decline in the investment goods prices (-12.3 per cent), as import prices for intermediate (4.6 per cent) and consumer goods (0.5 per cent) recorded increases. The impact of the sharp increase in petroleum prices (18 per cent) in intermediate goods was moderated by a decline in the import prices of textiles (-0.3 per cent).

The direction of external trade continued to change, increasing the relative share of developing countries, albeit slowly. The share of developing countries as Sri Lanka's export destinations increased from 22 per cent in 1995 to 25 per cent in 2003, while their share in the country's imports increased from 64 to 68 per cent during the same period. The government continued its efforts to improve trade relations with major trading partners in order to accelerate export diversification. In this context, special emphasis has been placed on negotiations with India, USA and EU as the latter two are the largest buyers of Sri Lanka's exports, while India is the largest source of imports.

The services account recorded a significant improvement owing to increased earnings from tourism and transportation, and recorded an increase of 34 per cent in net inflows in 2003. Tourist earning rose by 30 per cent, at a higher rate than arrivals, (27 per cent) reflecting an increase in average tourist spending. Net transportation services, which included passenger fares, freight services and port related services, increased by 10 per cent owing mainly to increased transshipment cargo handling and the country's external trade, in addition to booming tourist arrivals. Meanwhile, the deficit in the income account contracted notably, owing to increased income earnings from the country's international reserves. Despite continuation of low interest rates in international financial markets, increased external reserves and improvements in official reserve management raised the receipts in the income account, reversing the declining trend recorded in the previous years. Income generated from the official external reserves more than doubled, rising from US dollars 41 million in 2002, to US dollars 110 million in 2003, which was sufficient to cover 75 per cent of the interest payments on government external debt.

Current transfers continued to grow steadily, recording a 9 per cent growth in 2003. This was mainly due to increasing remittances by migrant workers, who remitted US dollars 1,414 million, an increase of 10 per cent in 2003. The higher annual increase than in previous years was due to an increase in the number of migrant workers and higher transfers in the first quarter of 2003 caused by the uncertainties that prevailed in the Middle East region prior to the war in Iraq. The ongoing efforts for peace and the improved security situation in the North and the East also contributed to channelling more funds through the formal financial sector. Despite a recent decline, West Asia accounted for the largest share (57 per cent) of remittances, while the share of the second largest source, Europe, rose to 18 per cent. Other major contributors were North America (6 per cent) and the Far East (5 per cent). Remittances have become the most steady and largest single net foreign exchange source to Sri Lanka, and were sufficient to cover 92 per cent of the trade deficit in 2003. Similarly, worker remittances have a greater distributional impact as their benefits are spread among a large number of low income families scattered all over the country.

In the capital and financial accounts, inflows to the government through loans and privatisation proceeds, and continuation of foreign direct investment helped to record a large net inflow. Increased donor assistance as a strong support for the peace process, improvement in economic management, implementation of structural reforms, and improvements in aid utilisation resulted in a significant increase in long-term inflows to the government. The gross long-term inflows to the government increased by 68 per cent to US dollars 908 million, while the net value rose by more than three times, reaching US dollars 548 million, compared with US dollars 162 million in 2002. The utilisation ratio of foreign assistance, which rose from 13 per cent in 2001 to 15 per cent in 2002, rose further to 21 per cent in 2003, reflecting the benefits of steps taken by the government to improve disbursements[1]. This improvement was partly due to a larger amount of programme financing being available for budgetary purposes. Disbursements of US dollars 556 million (17 per cent increase) under project loans and US dollars 244 million under programme financing (269 per cent increase) and the raising of a commercial loan of US dollars 100 million under a NEXI guarantee were the major contributory factors for a record level of foreign aid disbursement in 2003. Meanwhile, the repayment of government long-term loans declined to US dollars 359 million from US dollars 380 million in 2002 owing to a decline in repayment of defence related loans from US dollars 144 million to US dollars 92 million during the same period.

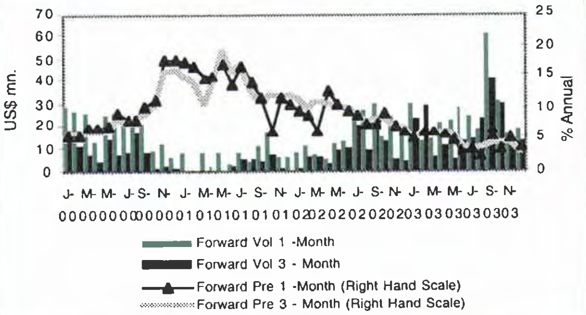
However, net private inflows declined from US dollars 185 million in 2002 to US dollars 140 million, largely due to a decline in private sector foreign loans. The decline in the private sector foreign borrowings was mainly due to the investors' 'wait and see' approach, lower domestic interest rates and increased liquidity. Privatisation proceeds from foreign sources were lower than expected, mainly due to the purchase of the Sri Lanka Insurance Corporation (SLIC) by a local entity and delays in the receipt of the proceeds from the Indian Oil Company (IOC). The lower net inflow in portfolio investment was owing to a large outflow of US dollars 40 million, resulting from the strategic purchase of the controlling interest of a large hotel company by a local blue chip company from foreign investors. Net foreign assets of commercial banks improved by US dollars 96 million in 2003 in comparison to the increase of US dollars 40 million in 2002. This was mainly due to the repayment of US dollars 158.5 million of dollar denominated Sri Lanka Development Bonds (SLDBs), held by commercial banks.

The reduced current account deficit and increased surplus in the capital and financing accounts resulted in a record surplus in the overall BOP, amounting to US dollars 502 million in 2003, the second highest surplus ever recorded[2]. Consequently, the country's gross official external reserves rose by US dollars 629 million to US dollars 2,329 million (4.2 months import cover) in 2003, while the total gross external reserves increased by US dollars 723 million to US dollars 3,218 million (5.8 months import cover). The ratio of gross official reserves to short-term liabilities (on the basis of remaining period to maturity) increased from 76 per cent in 2002 to 100 per cent in 2003, reducing the external vulnerability of the country[3].

The independently floating exchange rate regime continued to serve well, strengthening the exchange rate stability, deepening the foreign exchange market and improving the country's external competitiveness. The exchange rate of rupee against US dollar, which depreciated slowly by 0.6 per cent, reaching Rs.97.28 in June, appreciated thereafter reaching Rs.94.02 on 17 September. However, it depreciated with relatively high volatility during the last quarter due to uncertainty caused by political developments, to Rs.96.74 at end 2003. This implied an annual depreciation of only 0.01 per cent, compared with 3.7 per cent and 11.3 per cent depreciations in 2002 and 2001, respectively. However, the rupee depreciated at a higher rate against the euro (16.6 per cent), the pound sterling (9.9 per cent), Japanese yen (9.7 per cent), the SDR (8.5 per cent) and the Indian rupee (5.1 per cent), reflecting a sharp weakening of the US dollar against other international currencies. Reflecting these changes, the nominal effective exchange rate (NEER) of the rupee based on 5-currency and 24-currency baskets depreciated by 5.0 per cent and 5.9 per cent, respectively[4]. These nominal depreciations and the deceleration of the domestic inflation improved Sri Lanka's external competitiveness measured in terms of the real effective exchange rate (REER), namely, the 5-currency REER and the 24-currency REER, depreciating by 2.8 per cent and 3.4 per cent, respectively.

Forward market volume increasing, while premia decreasing

Chart 1.8
Forward Volumes and Premia



The domestic foreign exchange market continued to expand and deepen both in terms of volume of transactions and in terms of the duration of forward transactions, further strengthening the stability in the exchange rate. The annual volume of forward transactions rose by 48.4 per cent to US dollars 1.4 billion, which was 38 per cent of the total transactions in the interbank market. Forward premia were

1 Foreign assistance utilisation ratio is defined as total disbursements during the year as a percentage of total current undisbursed balance at the end of the previous year and new commitments during the year.

2 The highest BOP surplus of US dollars 661 million was recorded in 1993.

3 Short-term liabilities include short-term debt of the government, the private sector and banking sector external liabilities.

4 The five-currency basket includes the US dollar, euro, sterling pound, Japanese yen and the Indian rupee. The twenty four-currency basket includes 12 trading partner and 12 export competitor countries.

below interest rate differentials throughout the year except for a few days during the last quarter. Exporters were more active than importers in the forward market.

The total external debt of the country as a ratio of GDP increased slightly to 58.4 per cent in 2003 from 56.3 per cent in 2002, reflecting higher foreign loan disbursement to the government. The faster economic recovery helped contain the expansion of external debt as a ratio of GDP. However, total external debt in US dollar terms rose by 14 per cent to US dollars 10,644 million at end 2003. The increase was entirely due to an increase of US dollars 1,159 million in government external debt as the private sector external debt declined marginally. It has been estimated that more than 50 per cent of the increase in dollar terms was due to the sharp depreciation of the US dollar against other major currencies, as about 43 and 31 per cent of the debts were denominated in SDR and yen, respectively. This clearly indicates the sensitivity of external debt to sharp variations in cross rates among major international currencies. A large part, about 95 per cent of total debt, is medium and long-term debt, mainly consisting of concessional debt of the government (85 per cent). The government's non-concessional external debt remained almost unchanged at US dollars 219 million. Containing non-concessional external debt is crucial for ensuring external debt sustainability, as well as for encouraging concessional foreign assistance. Foreign debt service payments as a ratio of receipts from export of goods and services, income and private transfers declined to 9.3 per cent in 2003 from 10.8 per cent in 2002, reflecting an improved debt repayment capacity of the country.

1.11 Financial Sector

In 2003, the financial sector was characterised by cautious monetary management, greater financial market stability, improved performance, and continuation of reforms and modernisation of facilities and services. Monetary policy continued to focus on ensuring sustainable low inflation, while facilitating economic recovery. Money and foreign exchange markets widened and deepened, while remaining liquid and stable. Policy rates were reduced further by the Central Bank, taking into account the macroeconomic developments, particularly the steady decline in inflation, at a faster rate than expected and containment in public sector borrowing requirements. In the foreign exchange market the Central Bank limited its interventions to preventing excessive short-term volatility. It took advantage of higher than expected foreign exchange inflows to build up official reserves through purchases in the market, while keeping to the target reserve money path through sterilisation, using government and Central Bank securities. In the implementation of monetary policy the Central Bank placed increasing reliance on more market oriented instruments and strategy by moving to more active open market operations. The CBSL also continued its efforts to make monetary policy operations more transparent helping to improve credibility and predictability of the monetary policy stance.

The market responded positively by reducing interest rates. There was also a decrease in volatility in market rates, an increase in credit utilisation by the private sector and expansion in foreign exchange market activity. Overall monetary and credit expansion remained in line with the programme targets, even though the year ended with slightly higher monetary growth reflecting the impact of the continuation of economic recovery. Profitability in the financial sector increased with increased interest spread and enhanced volume of business, enabling an increase in the capital base of financial institutions. Improvements in financial system soundness were further supported by the strengthening of prudential regulations, reduction in non-performing assets, resolution of difficulties in weaker banks, and enhancement of disclosure and dissemination of more information. Stock market performance increased significantly with several key market indicators reaching record levels in 2003 though some reversals were seen towards the end of the year due to uncertainty caused by political developments. The domestic debt market expanded with increasing reliance on market oriented instruments in mobilising resources for government deficit financing and developing a long-term benchmark yield curve for government securities.

Meanwhile, reforms aimed at improving efficiency, competition, stability and resilience of the financial sector were continued in 2003. Progress was made in enacting new legislation and making necessary amendment to the existing legislation with a view to developing a supportive legal framework compatible with the requirements of a modern, sound financial system. Measures were also taken to improve the stability, safety and efficiency of the payments and settlement system with the establishment of a Real Time Gross Settlement (RTGS) system and moving to a Scripless Securities Settlement (SSS) system in government securities.

Nevertheless continuation of concerted efforts is necessary to further strengthen the monetary policy transmission mechanism and the resilience of the financial system and to develop the domestic debt market, particularly by reducing non-performing loans, through better risk management and credit culture, narrowing the high interest rate spread through strong competition, and developing the long-term benchmark yield curve through improvements in public debt management.

Monetary Policy: The monetary policy stance of balancing the focus on achieving sustainable low inflation while supporting the economic recovery continued in 2003. The high inflation, coupled with negative economic growth, experienced in 2001 was reversed to some extent in 2002 with a deceleration in inflation and a positive economic growth, although the achievements were below expectations as well as desirable levels. Therefore, the challenge to monetary management in 2003 was to consolidate achievements in the previous year with a further reduction in inflation to a low level, while providing necessary support to strengthen the economic recovery. The monetary policy stance aimed at achieving this goal led to reductions in policy rates cautiously and gradually. Accordingly, key policy rates (i.e., Repurchase Rate, Reverse Repurchase Rate and Bank Rate) were cut, broadly in line with the pace of disinflation, while keeping real interest rates positive. Meanwhile, the independently floating exchange rate regime was continued, which served well in building external reserves and absorbing some of the pressure from large inflows, particularly under the services, and capital and financial accounts in the balance of payments. The excess part of the resulting rupee liquidity from the purchase of foreign currency by the Central Bank was sterilised through open market operations in order to contain reserve money expansion within the inflation containing target envisaged in the annual monetary programme. In absorbing the excess liquidity, the Central Bank issued its own securities as its holdings of government securities became inadequate in the second half of the year, demonstrating its commitment to containing excessive monetary expansion and hence potential inflation in the future.

The Central Bank reduced in four steps (January, May, August and October) its Repurchase (Repo) and Reverse Repurchase (Reverse Repo) rates by a total of 275 and 325 basis points, respectively, and narrowed the margin between the two policy rates by 50 basis points. This was on top of the reduction of 225 basis points in these rates effected in 2002, facilitating the downward shift in the yield curve. The Bank Rate was also reduced from 18.0 per cent to 15.0 per cent in order to keep it with the trends in the Central Bank's other policy rates. A number of factors justified and supported these reductions in policy rates: the continuing decline in inflation and market inflationary expectations, monetary expansion remaining in line with the desired levels despite excess market liquidity, successful containment of public sector borrowings, non-excessive expansion in private sector credit, increased relative stability in the foreign exchange market, continuation of output gap, albeit decreasing gradually, and the downward movements in some international interest rates. The spread between the Central Bank's Repo and Reverse Repo was reduced to 150 basis points from 200 basis points by taking into account the reduced volatility in money market rates, the low spread between bid and offer rates in the market and the downward shifting of Repo and Reverse Repo rates to single digit levels. These reductions in policy rates and continuation of liquidity in the market resulted in gradual reductions in all market interest rates, though some lending rates were slow to adjust. Nevertheless, a faster decline in inflation than reductions in some nominal interest rates resulted in a rise in the corresponding real interest rates.

In the implementation of monetary policy, a monetary targetting framework, with reserve money as the main operating target, broad money supply as the intermediate target, and economic and price stability as the ultimate target, was continued in 2003[1]. The Monetary Policy Committee (MPC) met at least once a month to consider monetary developments and to make recommendations to the Monetary Board. A series of economic variables representing developments in the monetary and financial sector as well as in external, fiscal and real sectors were monitored closely and analysed thoroughly in the process of monetary policy determination. Steps were taken in 2003 to further strengthen the market orientation in the implementation of monetary policy and enhance the transparency, predictability and credibility of monetary management. The Central Bank moved to a system of more active open market operations (OMO) in March 2003 allowing market forces to play a greater role in the determination of interest rates. Under the new system, the Bank would decide the quantum involved in OMO, while allowing the market to determine the interest rates through an auctioning system. Meanwhile, an interest rate corridor formed by the Bank's Repo and Reverse Repo rates with the availability of stand-by facilities at these boundary rates, is used to prevent potential excessive volatility in the short-term market interest rates, given the stage of development of the money market in the country. This corridor is reviewed continuously and revised whenever necessary, signalling to the market the monetary policy stance and the desired direction of interest rate movements.

The new OMO system worked smoothly, enabling the Central Bank to contain reserve money expansion within the desirable path with improved liquidity management and reduced volatility in the market rates. It provided an opportunity to the money market participants to participate in the determination of effective interest rates in OMO, while encouraging them to improve their own liquidity management and rate of return. The basis for computing the statutory reserve requirement (SRR) to be maintained by the commercial banks with the Central Bank was changed in April 2003 from the deposit and vault cash balances related to a single working day to the corresponding weekly average values. This change not only enabled to improve the accuracy of daily market liquidity estimates, which are vital for the efficient working of OMO, but also improved the effectiveness of SRR as a monetary policy instrument. Monetary projections, along with explanatory notes, were posted on the Central Bank's website, increasing the availability of information on monetary management. The Central Bank also started to release an advance release calendar announcing the dates of monthly press releases on monetary policy decisions. Under this, the Bank commenced releasing a monthly monetary policy statement giving reasons behind the policy decisions in order to increase the market's awareness, which is necessary for improving market stability.

1 Details of the current monetary policy framework and programme are available on the Central Bank's website (www.centralbanklanka.org).

Box 4

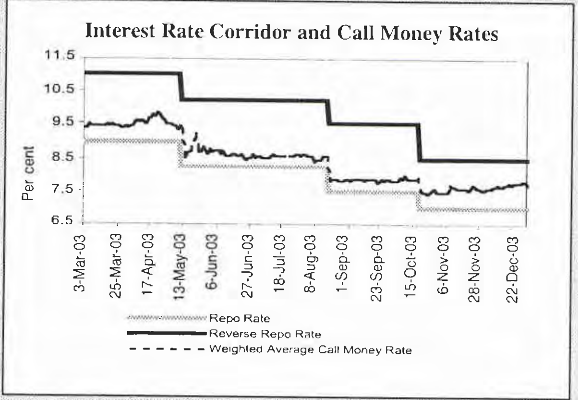
Initial Experiences and Challenges under Active Open Market Operations

In March 2003, the Central Bank of Sri Lanka introduced a system of active Open Market Operations (OMO) to enhance the effectiveness and the market orientation of monetary policy operations[1]. The Central Bank conducts its monetary policy operations within a monetary policy framework of targeting money supply through the maintenance of reserve money at appropriate levels, while maintaining as far as possible, the stability in short term interest rates, mainly the inter bank call money rates. The main features of the new system are as follows:

i. establishment of an interest rate corridor as the instrument of maintaining reserve money at targeted levels;
ii. absorption or enhancement of liquidity through daily repurchase or reverse repurchase auctions, coupled with standing facilities to maintain interest rate stability within the corridor; and
iii. outright sales/purchases of government securities, mainly Treasury bills, primarily to deal with structural/long-term liquidity imbalances.

Interest Rate Corridor and Reserve Money Targets

The interest rate corridor, formed by the key policy rates of the Central Bank, i.e., the overnight Repurchase (Repo) rate and Reverse Repurchase (Reverse Repo) rate, was reviewed on a monthly basis and a statement on the outcome of the each review was released on pre-announced dates. The salient feature of the market during 2003 was the continued excess liquidity and the tendency of the market rates to remain low, close to the floor of the corridor. In some periods during the year, the reserve money remained well below the target, indicating a need to change the corridor to maintain the reserve money target. This view was further supported by the continued downward trend in inflation and lower than expected growth in credit to private sector. Therefore, the corridor was revised downward in three steps (Chart). At the last revision, the width of the corridor was also narrowed by 50 basis points (bps) to 150 bps, as the spread between market bid and offer rates declined, reflecting a reduction in the volatility of the rates and the decrease in the absolute level of the market rates. The impact of the reduction in market rates was clearly reflected in monetary aggregates towards the end of the year with credit to the private sector and reserve money reaching the targets.



Daily Operations and Interest Rate Stability

As expected under the present system, the stability of inter bank call money rates was maintained within the corridor (Chart). However, market rates moved near the Repurchase rate, as the market formed a perception of a continued downward trend in rates, due to the downward trend in inflation and the persistent excess liquidity. On average, excess liquidity was around Rs. 9 billion, though a significant variation was observed at times. The Bank conducted repurchase auctions on every working day to absorb excess liquidity, except on one day on which market liquidity was in balance. However, the amount offered at the auction was lower than the estimated excess liquidity. This was on account of several considerations including (a) possible errors in liquidity assessment (b) the leeway between the actual reserve money and target and (c) the views of market participants that a certain level of excess liquidity should be maintained in the market in view of certain rigidities, such as lending limits imposed by banks on each other. On average, the amount offered was about Rs. 3.7 billion less than the estimated liquidity surplus. The balance was absorbed under the standing facilities.

Under the present system of monetary operations, as the Central Bank actively manages market liquidity, there has never been a shortage of liquidity except on one occasion when the surplus was closer to zero. Nevertheless, reverse repurchase facilities under standing facilities were utilised on two days in April and three days in May (on average less than Rs. 2 billion per day). This was a reflection of rigidities in the market. When the liquidity surplus is concentrated in a few banks, some banks find it

1 For details, see Box Article No. 20 of the Annual Report of the Central Bank of Sri Lanka 2002

Box 4 (contd.)

difficult to raise funds in the inter bank market due to the limits some banks have on lending to others. Such limits impose a constraint on the smooth operations of banks when there are banks with unsustainably high deficit, which are funded on an overnight basis.

One of the challenges successfully faced by the Central Bank was maintaining interest rate stability during the festive seasons in March/April and December. A common experience, before the introduction of the present system, was a sharp increase in interbank rates during this period due to seasonal demand for liquidity. This was avoided in 2003 by appropriate actions by the CBSL under the new system. The standard deviation of the weighted average call money rate in April 2003, was 0.14 per cent, while it was 0.52 per cent in 2002 and 0.65 per cent in 2001. Similarly, it was 0.07 per cent in December 2003 while it was 0.33 per cent in December 2001. The standard deviation in December 2002 was comparable with that in 2003 as liquidity management in a proactive manner was commenced during the second half of that year in preparation for the launching of the present system of monetary operations.

Assessment of Market Liquidity

The assessment of market liquidity which plays a major role in the determination of the Central Bank daily operations in the market has been reasonably accurate. On average, about 3 times out of 4, the error margin of the assessment was less than 10 per cent, while 4 times out of 5, it was less than 15 per cent. Another measure of the error margin, the RMSE (Root Mean Squared Percentage Error) was around 12 per cent. A certain level of error is unavoidable, as banks are not required to maintain 100 per cent of reserves on a daily basis. They could maintain a short position at the beginning of the reserve week and cover the deficit during the rest of the week. The behaviour of banks in this regard cannot be predicted with certainty though errors were minimised through a persuasive dialogue with banks. Another factor which contributed to the error margin was the difficulty in estimating net currency withdrawals from the Central Bank. However, this estimation has gradually been improved by contacting major banks every morning to obtain information on their planned currency transactions with the Central Bank. In addition, the method of computing the statutory reserve requirements and reporting dates of deposits liabilities for the same were changed to improve the accuracy of liquidity assessment. However, there is still scope for further improving the estimation of liquidity. Commercial banks too could contribute by improving their own liquidity assessments submitted to the Central Bank, which would be mutually beneficial.

Management of Excess Liquidity

Another challenge faced by the Central Bank under the present system was to absorb a part of the excess liquidity on a permanent basis, rather than on a daily basis. Excess liquidity increased from around Rs. 10 billion to Rs. 13 billion by mid March 2003. Except during the New Year season from late March to April and a few days around Wesak in May, the surplus remained well above Rs. 10 billion during the early period under the present system indicating a long-term liquidity surplus. The following measures were implemented to reduce the liquidity surplus to around Rs.3-5 billion. There was a market consensus that around Rs.3-5 billion excess liquidity should be maintained to ensure a smooth flow of transactions in the market.

i. Outright sales of Treasury bills through auctions and direct sales.

ii. Non-renewals of maturing Treasury bills held by the Central Bank.

iii. Retiring Treasury bills held by the Central Bank when the government was in a position to do so.

The surplus was thereby brought down to below Rs. 5 billion by mid October 2003. Thereafter, the surplus was generally maintained around this level until the seasonal increase after Christmas. The Central Bank holdings of Treasury bills (net of repurchases), which were as high as Rs.29.5 billion at the commencement of the present system and moved up to Rs.37.0 billion in mid April, declined to below Rs. 4 billion by mid September 2003. Treasury bills to a face value of Rs.1.7 billion were sold through outright auctions though the success of these auctions was limited. In addition, Treasury bills to a face value of Rs. 0.7 billion were sold through direct dealing in 2003. Treasury bills to a face value of Rs. 6.0 billion out of CBSL holdings were retired prior to their maturity in September 2003.

The active operations to reduce excess liquidity had to be carried out in the face of a tendency for liquidity expansion due to the inflow of foreign exchange into the country. Central Bank's purchases of foreign exchange from the market to build its reserves (US dollars 375 million) injected about Rs. 35.6 billion of rupee liquidity to the market in 2003. In addition, net foreign loan receipts to the government were about Rs. 7 billion. These inflows, indicated the possibility that the Bank's holdings of

Box 4 (contd.)

government paper could be inadequate to absorb the excess liquidity. Therefore, as a proactive measure, Central Bank securities to a face value of Rs. 5.1 billion were issued in September 2003.

In October 2003, the possibility of the market liquidity surplus declining below Rs.1 billion due to a delay in the receipt of a foreign loan to the government was averted by retiring a part (Rs. 2 billion) of Central Bank securities issued to the Employees' Provident Fund. Similarly, market liquidity was stabilised when government retired a part of the US dollar denominated Sri Lanka Development Bonds through subscription to new Treasury bill issues and re-issue of maturing Treasury bills.

As can be seen from the foregoing, under the present system, market liquidity management has become a challenging task. Rather than passively reacting to market developments the Bank now takes proactive measures to manage market liquidity to ensure the realisation of monetary policy targets, while maintaining stability in market rates.

TABLE 1.9
Financial Statistics

Item	End 2003 Rs.bn.	Change			
		2002 Amount Rs.bn.	%	2003 Amount Rs.bn.	%
Monetary aggregates:					
Narrow money supply (M_1)	161.6	17.2	14.0	22.3	16.0
Consolidated broad money supply (M_{2b})	717.9	73.4	13.4	95.4	15.3
Consolidated broad money supply (M_4) (a)	928.3	97.6	13.9	131.0	16.4
Underlying factors (a)					
Domestic credit to :	731.9	41.5	6.5	51.5	7.6
Government (net)	176.2	-8.3	-4.1	-16.7	-8.7
Public corporations	36.2	2.2	5.4	-6.8	-15.9
Private sector	519.4	47.6	12.0	75.1	16.9
External assets (net)	167.1	36.5	49.3	56.4	51.0
Other items (net)	-181.1	-4.7	-2.9	-12.6	-7.5
Reserve money	141.4	13.9	12.3	15.0	11.9
Government (net)	42.1	-13.6	-16.1	-28.8	-40.6
Commercial banks	...	-0.1	-	-	-
External assets (net)	164.6	33.0	39.2	47.2	40.2
Other items (net)	-65.3	-5.4	-9.6	-3.4	-5.5

	End 2002	End 2003
Money multiplier (b)	4.92	5.08
Velocity (GDP/M_{2b})	2.70	2.65
Interest rates (end year)		
Repurchase rate (%)	9.75	7.00
Reverse Repurchase rate (%)	11.75	8.50
91 day Treasury bills (%)	9.92	7.35
Commercial banks' AWPR (c) (%)	12.24	9.26
Share Market		
All Share Price Index (1985=100)	815.1	1062.1
Market capitalisation (Rs. bn)	162.6	262.8

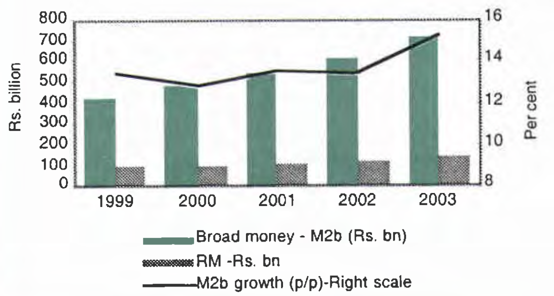
(a) M_4 includes M_{2b} and activities of licensed specialised banks and finance companies
(b) In relation to M_{2b}
(c) Average Weighted Prime Lending Rate

Source: Central Bank of Sri Lanka.

Chart 1.9
Financial Sector Indicators

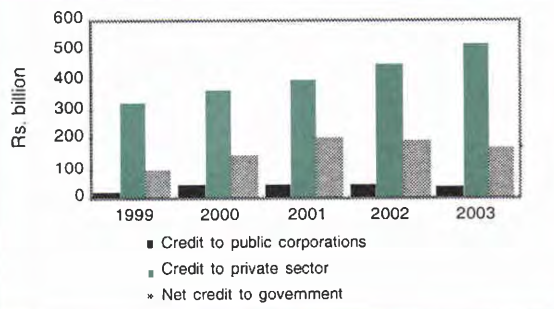
Monetary expansion within target

Chart 1.9.1
Broad Money, Reserve Money and Monetary Growth



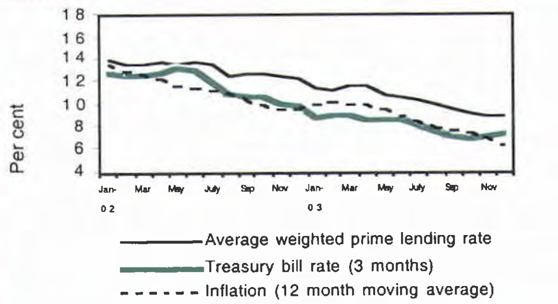
Increasing bank credit to the private sector, while declining credit to the public sector

Chart 1.9.2
Distribution of Domestic Credit



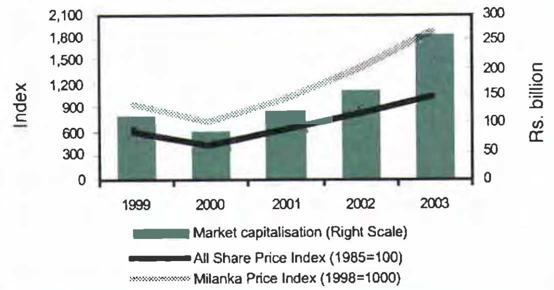
Declining interest rates with disinflation

Chart 1.9.3
Interest Rates



Sharply rising share prices

Chart 1.9.4
Share Market Indices



The continuation of the independently floating exchange rate regime enabled the Central Bank to focus more clearly on economic and price stability in the conduct of monetary policy. The floating exchange rate system served well in 2003, absorbing part of the pressure from increased foreign inflows, enabling the Central Bank to purchase of US dollars 375 million in the market to build up official reserves. It also helped in ensuring the country's external competitiveness, mainly in an international environment where the US dollar, the main currency used for the country's external transactions, depreciated sharply against all other major currencies. The activities in the foreign exchange market expanded further, particularly the volume and maturity of forward transactions, expanding risk management facilities to market participants and strengthening the stability in the exchange rate. The foreign exchange market remained stable, permitting the Central Bank to enhance limits on net open positions of commercial banks, giving them greater flexibility in their operations.

Money Supply: Growth in monetary and credit variables was broadly in line with monetary targets envisaged under the overall macroeconomic framework aimed at economic growth with price stability. As expected, large contributions to monetary expansion were made by expanding private sector credit and rising net foreign assets of the banking sector, supporting the objectives of private sector led growth and building up external reserves. Reserve money grew by Rs.15 billion (12 per cent) to Rs.141 billion, in comparison with an increase of Rs.14 billion (12 per cent) in 2002. From the perspective of contributory factors, the increase was entirely due to an increase in the net foreign assets of the Central Bank (Rs.47 billion), partly offset by a decline in its net domestic assets (NDA) (Rs.32 billion). The reduction in NDA was caused by the sterilisation policy followed through OMO, which reduced the Central Bank's holding of Treasury bills by Rs.29 billion in 2003. On the use side, a major part of the increase in reserve money was reflected in the currency in circulation (Rs.10 billion), partly on account of increased economic activity and increasing money demand in the North and the East with normalisation of economic activity. The Debits Tax on deposit withdrawals may also have increased currency holdings to some degree. The balance Rs.5 billion in the increase was recorded in the deposits of commercial banks with the Central Bank reflecting increased SRR with an expanding deposit base.

The growth in consolidated broad money supply (M_{2b}), which remained in a range of 12-13 per cent during the first three quarters, accelerated during the fourth quarter, reaching 15.3 per cent at end 2003, mainly due to an increase in credit to the private sector. The increase in money supply (Rs.95 billion) was mainly driven by increased NFA of the banking system (Rs.56 billion), reflecting a large surplus in the BOP and the increase in private sector credit (Rs.75 billion or 16.9 per cent) caused by increased credit demand in all major economic sectors with the economic recovery. High increases of private sector credit utilisation were mainly recorded in tourism, agriculture, manufacturing, housing and consumption. A reduction in public sector credit (about Rs.24 billion) partly offset the effect of increases in private sector credit, facilitating monetary management. Net credit to the government (NCG) declined by about Rs.17 billion with improved fiscal consolidation, while the credit utilisation by public corporations declined by about Rs.7 billion, mainly reflecting improvements in the cash flows of the CPC and CEB and the restructuring of CWE's credit through the issue of Treasury bonds.

Monetary aggregates (M_4) in the financial survey, which include the activities of licensed specialised banks and finance companies in addition to the activities of the Central Bank and commercial banks, recorded similar trends in 2003. Monetary growth, as measured by the increase in M_4, recorded an annual growth of 16 per cent in 2003 compared with the 14 per cent growth in 2002. NCG rose by Rs.4 billion in the financial survey, in contrast to a decrease by Rs.21 billion in the monetary survey, as the investment by LSBs in government paper increased by Rs.26 billion, mainly due to a substantial increase in investments by the NSB. This offset the reduction of NCG from the Central Bank and commercial banks. Credit expansion to the private sector in the financial survey rose by Rs.96 billion (16.8 per cent) in 2003 as against Rs.53 billion in 2002, reflecting significant resource flows to support private sector economic activity.

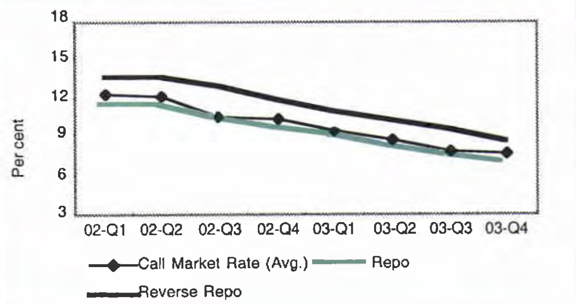
In 2003, reserve money and the money multiplier both contributed to the expansion of money supply. The money multiplier (M_{2b} multiplier) increased slightly from 4.92 in 2002 to 5.08 per cent, while reserve money rose by Rs.15 billion. A rising share of foreign currency deposits, which are not subject to SRR, and a decline in currency to deposits, enabled the banks to create more deposits and credit, thereby contributing to raise the money multiplier. Meanwhile, the income velocity of money (i.e., GDP at market prices/M_{2b}) declined to 2.65 in 2003 from 2.70 in 2002, reflecting declining inflationary expectations, expanding financial assets, and financial deepening in the economy.

Interest Rates: The declining trend in market interest rates continued in 2003, despite some marginal reversals towards end of the year, shifting the entire interest rate structure downward and reducing active policy rates, money market rates and yields on government securities to single digit levels. The major contributory factors for the reduction in market rates were reductions in the Central Bank's policy rates, greater fiscal discipline and public enterprise reforms that reduced demand for domestic rupee funds, increased market liquidity and reduced inflationary expectations. Following the reduction in policy rates, call market rates declined by 280 basis points (bps) to 7.59 per cent in 2003 while its variation remained low, reflecting a greater stability in the money market. Similarly, decreases were seen in the overnight Sri Lanka Interbank Offered Rate (SLIBOR) (294 bps) and the Average Weighted Prime Lending Rate (AWPR) (298 bps). All Treasury bill auctions were oversubscribed and their yields decreased by 257-267 bps to a range of 7.24 – 7.35 per cent. The secondary market yields on government securities also recorded similar declines and resulted in a flatter yield curve indicating market expectations of lower inflation in the medium term. In this environment the government was able to issue Treasury bonds with long maturity (10, 15 and 20 years) at low rates of 6.08 – 9.08 per cent. These issues helped to develop a benchmark yield curve, which was a long overdue necessity in developing the domestic debt market. In general, commercial banks reduced their average lending rates less than their average deposit rates. The spread computed based on average interest yield and average interest cost, declined by about 50 bps towards the end of 2003, but was still high (see Box 19). The continuation of a high interest spread of 4 - 5 percentage points has raised concerns regarding the efficiency and competitiveness of the banking system. Major causal factors explaining this high spread are: high non-performing loans (NPLs), increased operational costs, high dependence on interest income, the lack of instruments with floating rates, weak competitiveness and inadequate availability of information. The Central Bank has already begun to publish bankwise interest rates and charges, while encouraging banks to publish their own rates in order to reduce the spread through competition. Continuation of financial sector reforms, improvement in risk management of commercial banks, improving credit repayment culture, strengthening competition and encouraging mergers are necessary to bring down the spread to a level comparable with other countries, i.e., 100 - 200 bps.

Internationally, interest rates remained low and even declined in some countries in 2003 as major countries eased

Declining policy rates and short-term market rates

Chart 1.10
Policy Rates and Call Market Rate



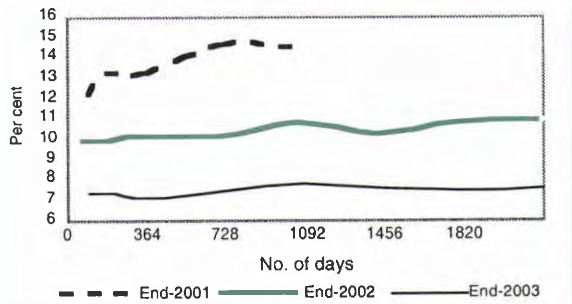
monetary policy to assist the recovery of their economies. For example the benchmark United States Federal Funds rate was cut by 25 bps to a 40-year low level of 1.00 per cent in 2003.

Activity in the Colombo Stock Exchange (CSE) increased significantly, with some market indicators registering record levels, reflecting the improved investor confidence and increased corporate sector profitability with the economic recovery. Heavy trading in the CSE was mainly driven by local investors, encouraged by high liquidity in the market and the decline of returns from fixed income securities. The All Share Price Index and the Milanka Price Index rose by 74 and 88 per cent, reaching their highest levels in October 2003, but declined by about 25 per cent during the balance period, reflecting the market uncertainty that resulted from political developments.

The improvement in the economy was also reflected in the non-bank financial institutions such as finance companies, leasing companies, merchant banks etc. The decreasing interest rates and the active share market had a beneficial effect on the operations of these institutions. Finance companies, which are a significant source of funds for economic activity, saw their assets rise by 20 per cent in 2003. Much of this increase was channeled through leasing and hire purchase finance, encouraging economic activity on the part of economic agents who did not have easy access to bank finance. The Central Bank took steps to strengthen the stability and resilience of finance companies by raising the required capital adequacy ratio to 10 per cent. The insurance sector too expanded, although insurance penetration remains very low in Sri Lanka[1]. Clearly, there exists considerable potential for expansion in this industry. A notable development was the divestiture by the government of Sri Lanka Insurance Corporation (SLIC) to the private sector. With this, the government has almost completely moved away from direct involvement in the insurance industry. In an environment of decreasing interest rates and heightened economic activity, merchant banks had record levels of operations and profits. This has helped to increase their capital and reserves, and consequently their ability to withstand temporary economic downturns. Their increasing activity also helps to broaden and deepen the financial sector. The resurgence in the stock market, after a number of dull years, helped to improve the performance of Unit Trusts.

A lengthening yield curve, shifting downward

Chart 1.11
Government Securities
Secondary Market Yield Curve



Progress was also achieved in financial sector reforms and strengthening financial system stability, though progress has been slow in some areas. The introduction of the RTGS system and the SSS system for government securities by the Central Bank has contributed to increasing the efficiency and reducing the risks in the payments and settlements system in the country. Action was also taken by the Central Bank to enhance the resilience of banks to risk by expanding the scope of prudential supervision. Measures taken in this regard included an increase of the minimum capital adequacy ratio, the imposition of key prudential requirements on foreign currency banking units and more prudent valuation of collateral. Greater transparency was also instituted through a requirement that all banks should publish their quarterly accounts. Legal reforms were initiated to increase the efficiency of the financial system and to improve regulatory oversight. Nevertheless, progress in reducing the level of non-performing assets of banks, narrowing interest rate spreads, restructuring state banks and introducing asset management companies was below expectations. Similarly, more action is required to increase competition in the financial market, for instance, by the development of the private debt market.

1.12 Economic Outlook for 2004 and Medium-Term Prospects

Sri Lanka's future is marked by favourable economic prospects. Yet, downside risks shadow its future, while the issues to be resolved pose new challenges. The main challenge

1 Insurance penetration (i.e., total gross premium as a percentage of GDP): Sri Lanka 1.4, Thailand 3.0, India 3.3, Malaysia 4.9, Hong Kong 6.6, Asia 7.6, World 8.1.

faced by the country is to attain permanent peace and lay the foundation for sustainable high quality economic growth. The success of these endeavours will depend mainly on the progress in the ongoing peace process, strengthening macroeconomic management, the speed and effectiveness of implementing structural reforms, development of infrastructure facilities, particularly power and transport, effective utilisation of foreign donor assistance, a conducive external environment and favourable weather conditions.

All these factors, except the last two, are directly under the control of the country, if a national consensus can be reached and the necessary measures are implemented effectively and in time. Given the high level of public debt and its adverse impact, strengthening macroeconomic management has to be centred on a medium-term fiscal sustainability strategy, consisting of a steady and faster reduction in the budget deficit and public debt as committed to in the Fiscal Management (Responsibility) Act. This would be attained through an enhancement of government revenue and a rationalisation of recurrent expenditure, while maintaining adequate public investment, particularly on infrastructure development. A time-bound comprehensive structural reform programme, consisting of reforms in all major sectors as identified in Sri Lanka's PRSP, i.e., labour market, regulatory system, utilities, civil service, public enterprises, financial sector, pensions and judicial system, will reinforce the improvement in macroeconomic management and enhance economic growth prospects by expanding capacity and improving factor productivity in the economy. Such measures will also help to complete successfully the major donor assistance programmes such as the PRGF with the IMF, the PRSC with the World Bank and the country assistance strategies with the ADB and Japan, thereby strengthening the country's policy credibility, encouraging more donor support and attracting long-term foreign private investment inflows. Consequently, improvements in macroeconomic management and the effective implementation of structural reforms with adequate emphasis on enhancing market access to the poor and thereby expanding their economic opportunities, will move the country to a sustainable high growth path with trickle down effects, enabling the country to resolve the major macroeconomic problems, viz., poverty, unemployment and inflation on a more sustainable basis.

An early and lasting peace is essential to ensure the country's future economic prosperity. Any delay on that front will deny the nation the immense potential benefits of peace. A reversal of the ongoing process will exert even greater economic, political and social costs, which the country cannot afford to bear. Therefore, every effort needs to be made to find a lasting political solution to the issue through building a national consensus. Further, building consensus on key political and economic issues among the major political parties, institutions and various segments of society, as a national priority, is critical to achieving the primary objectives of the country, viz, peace and sustainable economic development with greater equity, raising the living standard of the entire nation and strengthening the resilience of the economy to face potential external shocks.

World Economic Outlook for 2004

The on going recovery is expected to strengthen the global economy further in 2004. The major factors that would contribute to a stronger recovery are the economic stimulus policies already in the pipeline, improving corporate profits with a strong rebound in corporate projects, renewed strengths in the IT sector, wealth effects from the rise in equity markets, further pick up in inventories and declining geopolitical risks. The World Economic Outlook published by the IMF in April 2004, revised the global growth forecast for 2004 upwards by 0.7 percentage points to 4.6 per cent, from the earlier projection made in September 2003. The major downside risks to these projections are a disorderly resolution of global imbalances, notably the large US current account deficit and surpluses elsewhere, the medium-term fiscal situations in many industrial and emerging market economies, and managing the eventual transition to higher interest rates.

The recovery is projected to be strongest in the US with GDP growth rebounding to 4.6 per cent in 2004 from 3.1 per cent in 2003. Continued strong productivity growth and the impact of past fiscal and monetary stimulus would contribute to the stronger recovery in 2004. In Japan, GDP growth is projected at 3.4 per cent in 2004, an upward revision by 0.9 percentage points from the earlier projection, and the highest growth since 1996. The recovery in Japan would be mainly driven by external demand, notably from China, supported by domestic investment and a recovery in consumption. Even though the growth in the Euro area is also projected to be higher, 1.7 per cent, from the 0.4 per cent in 2003, this is a downward revision by 0.3 percentage points from the earlier projection. The major concern is the sharp appreciation of the euro, which would slow down the demand for exports from the Euro area. The signs of a pick up in fixed investments and rising financial markets are likely to support the gradual recovery in the Euro area. GDP growth in emerging markets and developing countries has been marked in almost every region. The growth momentum has been particularly strong in developing Asia, where GDP growth is projected at 7.4 per cent in 2004, making it the world's fastest growing region. Accommodative macroeconomic policies, competitive exchange rates, and the recovery in the IT sector would mainly contribute to the growth in developing Asia. In particular, buoyant growth in China and India is expected to provide important support to economic activity in countries within and outside region. However, potential downside risks persist, including remaining geopolitical uncertainties, oil price volatility and viral epidemics, most recently the avian flu.

Increasingly rapid global recovery, combined with a weaker US dollar, would feed through to commodity prices in 2004. The current volatility in oil prices indicates that average crude oil prices in 2004 would be around US dollars

32 per barrel, which is an upward revision of the earlier projection by US dollar 6.50 per barrel. Part of the upward revision reflects the depreciation of the US dollar, while the remainder reflects higher than expected demand, particularly from the US and China and the continued low level of inventories. The adverse impact of higher oil prices on oil importing developing countries would be partly offset by even higher growth expected in non-fuel commodity prices. Non-fuel commodity prices have already increased, with metals, food and agricultural raw materials experiencing the largest gains.

Despite the expected global recovery and higher commodity prices, inflation in industrial countries has been projected to fall to 1.7 per cent in 2004 from the estimated 1.8 per cent in 2003. The lower projection reflects continued excess capacity, weak labour markets and limited price fixing power of producers in the face of strong domestic and global competition. However, any upward prospects to global growth in the short run would impose a downside risk to the projected lower inflation in advanced economies. In emerging market and developing economies, inflationary pressures are expected to edge upwards in 2004.

The growth momentum in international trade is expected to continue in 2004. The world trade volume has been projected to grow by 6.8 per cent in 2004, the highest growth since 2000. The rapid recovery in the growth of imports reflects the projected growth in exports, particularly exports from advanced economies, which are expected to grow by 5.7 per cent in comparison to 3.5 per cent in 2003. Exports from emerging markets and developing countries are also expected to grow by 8.1 per cent, lower than the growth of 8.7 per cent in 2003, largely due to expected lower exports from fuel exporting countries. Import growth by advanced economies has been projected at 5.7 per cent in 2004 in comparison to 3.4 per cent in 2003. Imports by emerging markets and developing countries are expected to grow by an even higher rate of 10.2 per cent in 2004, reflecting growing trade among these countries.

World trade negotiations are expected to regain some momentum in 2004, although significant obstacles to achieving a meaningful agreement remain. A successful completion of the Doha round negotiations is particularly important for developing countries to which two thirds of potential gains would accrue through increasing market access. However, the major downside risk to the rapid recovery in global trade is the global imbalance, which increases the potential for protectionist pressures.

The current low global interest rates are expected to rise in 2004 but the timing and speed of future moves remain subject to considerable uncertainty. There is also a risk that asset prices, which have already rebounded due to the low interest rate environment, could go ahead of fundamentals. Any future interest rate rises, especially if abrupt, could lead to asset price volatility and possibly adversely affect the recovery. This is a particular concern in countries with buoyant property markets.

The major downside risk to the global recovery is the disorderly resolution of global imbalances. Key elements facilitating an orderly adjustment of imbalances include: a credible plan by the US to restore budgetary balance over the medium term; stepping up the face of structural reforms in the Euro area; banking and corporate sector reforms in Japan; and a gradual shift towards greater flexibility in exchange rates in most emerging markets, combined with additional structural reforms to support domestic demand. In the implementation of these adjustments, policy makers, particularly in major industrial countries, need to ensure that the recovery in the world economy is sustained through a credible and cooperative approach to addressing global economic imbalances. The lack of a credible and cooperative strategy among them to address the above problems remains a significant downside risk to the projected recovery in the global economy.

The outlook for the world economy in 2004 indicates that the expected developments would, in net terms, be positive for Sri Lanka. The continuing economic growth in the US and Japan, along with higher growth in the EU, would help to expand the demand for Sri Lanka's major exports. This, with the expected expansion in the Indian economy, would lead to greater output in port related services. The growing international income would also help sustain the continuing expansion in the tourist industry. International price movements are generally expected to move in Sri Lanka's favour, although the high price of petroleum products are a matter for concern.

Sri Lanka's Economic Outlook 2004

Despite the favourable external environment, the macroeconomic prospects for 2004 are mixed, mainly due to the continuation of dry weather conditions experienced since the last quarter of 2003, and the adverse impact of the political developments that led to a general election in April 2004. However, some of the impact that resulted from the political developments could be minimised if the government elected in April takes effective action early to arrest policy slippages, catch up with delays in project implementation and economic reform, and improve investor confidence and external donor support. The projections under the baseline scenario, which are prepared on the assumption of such early action and normalisation of weather conditions in the second half of the year, indicate a moderate economic growth, investment expansion, moderate inflation, stability in the exchange rate, creation of more employment opportunities, enhancement of external reserves, improvement in macroeconomic stability and strengthening of the resilience of the economy. The achievement of these goals in 2004 is necessary to lay the required foundation for a sustainable high growth with greater stability and equity in the medium to long-term. Thus, the early attention and strong commitment of policy makers, with effective action, are not only critical to ensure a better economic outlook in 2004, but also to improve economic prospects in the medium to long-term.

The realisation of these results is challenging and depends primarily on five factors, which are broadly under the control of the country. They are: (a) continuation of the ceasefire and early resumption of negotiations for a political settlement; (b) continuation of the improvement in macroeconomic management with policy adjustments centred around a medium-term sustainable fiscal strategy; (c) effective implementation of structural reforms aimed at removing constraints on investment expansion and productivity improvement without delays or reversals; (d) mobilisation of adequate external concessional assistance with the completion of requirements under the PRGF-EFF and PRSC as soon as possible; and (e) undertaking an effective public awareness programme explaining the benefits of peace, policy adjustments, structural reforms and external donor support, as well as the cost of not undertaking them or delaying them, to build a strong supportive constituency for these.

Growth: Real output (i.e., GDP at constant prices) is expected to grow by around 5.5 per cent in 2004 as a composite outcome of sectoral growth of 6.7 per cent in Services, 5.8 per cent in Industry and 0.6 per cent in Agriculture. This is lower than the growth rate of 6 per cent projected earlier for 2004, mainly due to the continuation of dry weather conditions at the beginning of 2004 adversely affecting agricultural production and hydropower generation. The Services sector is projected to account for 69 per cent of the overall growth in GDP, benefitting from a continuation of the growth momentum in trade, telecommunications, financial services, tourism and port services. The Industry sector is expected to account for a higher relative share of about 29 per cent in total GDP growth, compared with 25 per cent in 2003, reflecting growth in the manufacturing sector and expansion in construction activities. Higher dependence on high-cost thermal power generation due to poor rainfall would limit the potential high growth in the industrial sector and hence the realisation of maximum benefits from the favourable external economic environment. The contribution from Agriculture to the overall economic growth in 2004 is expected to be as low as 2 per cent due to the impact of adverse weather on paddy cultivation and some other short-term agricultural crops.

On the aggregate demand side, the economic growth in 2004 is expected to be driven by the increasing export demand, continuation of the momentum in domestic private consumption and a recovery in investment, albeit marginal. The export sector is expected to benefit from improved growth prospects in the USA and Japan, enhanced trade concessions from the EU to Sri Lanka[1] and expanding opportunities under bilateral trade agreements, particularly with India. The continuation of the ceasefire, increased real per capita income and the low interest rate regime would help to continue the momentum in domestic private consumer demand. Investment is expected to record at least a moderate improvement, benefitting from relatively low interest rates and available concessional external project financing. However, the continuation of market friendly economic reforms and timely implementation of public sector infrastructure development projects are necessary for achieving the expected improvement in investment. The achievement of the expected reduction in the current account deficit in the budget for 2004, continuation of the upward trend in private transfers supported mainly by increasing foreign remittances, improvement in corporate sector profitability, rising per capita income and continuation of positive real interest rates will help to improve national savings. However, improvement in foreign aid utilisation and strengthening of foreign investor confidence are critical to achieving the expected improvement in investment as the projected improvement in national savings would not be sufficient to offset the existing resource gap between investment and savings.

Inflation: Inflation based on consumer price indices is estimated to be in a range of 5 - 6 per cent in 2004. This is consistent with the inflation rate expected earlier under the medium-term stabilisation programme despite unenvisaged cost-push factors and a temporary reduction in supply of some domestic food crops due to the drought. A continuation of higher petroleum prices in the international market and wage increases exceeding productivity improvements would result in cost-push inflationary pressures in 2004. Meanwhile, short-term supply shortages resulting from reductions in paddy and some other agricultural food crops could also add pressure on prices. In this context, a continuation of a cautious monetary policy, supported by prudent fiscal policy and prevention of further excessive wage increases, is necessary to consolidate the recent achievements on the price stability front by reducing inflation, as well as inflation expectations, steadily. Such measures would also help to further strengthen exchange rate stability and hence to prevent moving towards a potential vicious circle between inflation and exchange rate depreciation, as well as between inflation and excessive wage increases.

Employment: Expected economic growth and expansion in investment are expected to generate more employment opportunities in 2004 primarily in the private sector. However, the expected new job opportunities are unlikely to be sufficient to cover the new entrants to the labour market (about 125,000 persons) in 2004 and reduce the existing unemployment (about 650,000) significantly. Meanwhile, the continuation of Sri Lankans leaving for foreign employment would provide a safety valve for releasing a part of the pressure in the domestic labour market, as was experienced in the past. Reflecting these expected developments in the labour market, unemployment

1 The special incentive arrangement (SIA) granted by the EU for Sri Lankan exports with effect from February 2004 provides an opportunity for exporters to increase their exports to the EU.

is estimated to be in a range of 7.0 - 8.0 per cent in 2004. However, any attempt to find a short-term solution to the unemployment issue by recruiting to the public sector, which is already over staffed, is not only an unsustainable solution to the problem, but will also increase the fiscal deficit and public debt if not supported with adequate government revenue enhancing measures, reversing the recent achievements under the fiscal consolidation process. Hence, the long-term cost of such a measure will be enormous.

External Sector: Improvements in the external sector are expected to continue in 2004, benefitting from potential high demand for exports, the tourism boom, expansion in port activities, continuation of private remittances, higher utilisation of foreign assistance and foreign investment inflows. Despite the expected increase in the trade deficit, particularly due to increases in domestic investment demand, food imports and high oil prices, the current account deficit is projected to remain at a manageable level of around 2 per cent of GDP, reflecting the benefits of high inflows expected mainly under the service account and transfers. Meanwhile, the expected surplus in the financial and capital accounts, reflecting increases in aid utilisation and private investment inflows, would be sufficient to cover the current account deficit and record a surplus (about US dollars 180 million) in the overall BOP, albeit lower than expected earlier, for the fourth consecutive year. Consequently, external resources of the country are expected to increase further, strengthening foreign exchange market stability and reducing external sector vulnerability. Nevertheless, the achievement of these results depends heavily on the continuation of the peace process, completion of the requirements under donor-supported programmes, particularly under the PRGF-EFF, the country assistance strategies of the World Bank and ADB, and programmes with Japan.

Under these external sector developments supported by improved macroeconomic management, the floating exchange rate regime is expected to operate successfully, safeguarding the country's external competitiveness by adjusting according to market forces, reflecting developments in the macroeconomic fundamentals of the country. As has been done since January 2001, the Central Bank will continue to limit its intervention in the foreign exchange market to prevent undue temporary excessive volatility and to further build up official external reserves by purchasing at market rates. Activities in the foreign exchange market are expected to further expand and deepen under a competitive environment with expansion in instruments, services and active players.

Fiscal Policy: Budget 2004 has been formulated within a three-year fiscal framework compatible with the medium-term fiscal consolidation strategy envisaged in the FMRA. Accordingly, a further consolidation of the recent achievements on the fiscal front is expected through reducing the overall fiscal deficit, as well as domestic financing requirement, while introducing more measures to address structural issues facing fiscal management. In this context, measures have been proposed for revenue enhancement through improvements in tax policy, as well as in tax administration, rationalisation of recurrent expenditure, and improvement in capital expenditure allocation and public debt management.

In line with the medium-term fiscal consolidation path, Budget 2004 has targeted to reduce the current account deficit by 2 percentage points to 1.3 per cent of GDP and the overall fiscal deficit by 1.2 percentage points to 6.8 per cent of GDP in 2004. These reductions are expected to be achieved by raising revenue mobilisation by 0.7 percentage points to 16.4 per cent of GDP and reducing current expenditure by 1.4 percentage points to 17.6 per cent of GDP, while raising public investment by 0.3 percentage points to 5.3 per cent of GDP. In financing the deficit (Rs.137.9 billion), heavy reliance has been placed on concessional external financing (Rs.59.9 billion) and privatisation proceeds (Rs.13.0 billion). Accordingly, the net domestic borrowing requirement is estimated to decrease to Rs.65 billion, leaving more domestic financial resources to the private sector and reducing the pressure on the interest rate. In fact, a repayment to the banking system of about Rs.27 billion is expected for the third consecutive year, continuing the reversal of the practice of inflationary deficit financing observed prior to 2002.

To enhance revenue mobilisation, the emphasis has been placed on both tax policy and improvements in tax administration. The proposed major revenue enhancement measures are an expansion in the tax base by reducing exemptions under VAT, introduction of an economic service charge of one per cent, capping carry-forward losses in income tax, taxing partnership income, and increasing excises and duties for certain items. Unification of VAT rates at 15 per cent and improvement in tax audits are also expected to improve tax collection. In the expenditure rationalisation efforts, major emphasis has been placed on continuation of strict controls over and streamlining recurrent expenditure. Restrictions on recruitment to the public services, except for technical and professional categories, better targetting of welfare programmes, containing transfers to public enterprises and curtailing non-priority expenses are expected to continue. Meanwhile, interest cost, the single largest expenditure item, has been expected to be contained by improving Treasury cash management and public debt management, and replacing high cost callable debt, with optional maturities with low cost long-term market borrowings.

However, achieving these fiscal targets is challenging, particularly during an election year. The situation has become more difficult with the continuation of the drought, price increases in some major essential imports and dissolution of Parliament, and the calling of a general election in April 2004. The Pre-election Budgetary Position Report issued on 27 February 2004 by the Ministry of Finance, as required under the FMRA, indicates potential deviations from the original targets.

Revised estimates given in this Report indicate a higher overall fiscal deficit and a larger domestic borrowing requirement than expected in the Budget due to a potential revenue shortfall, expenditure overruns and a shortfall in foreign financing. A potential revenue shortfall of about Rs.12 billion is estimated, reflecting the impact of overestimation of the revenue base in the original budget estimates, delays in implementation of new revenue measures and tax administration improvement measures due to the dissolution of Parliament, and tax relief granted to contain the rising prices of selected commodities. The Revenue Authority (RA) was to be established to improve tax administration and simplify the tax system, enabling higher collections in income tax as well as in VAT collection in 2004. However, the legislation to establish the RA has had to be postponed due to the dissolution of Parliament delaying the improvement in tax administration and hence tax collection. Under recurrent expenditure, an overrun of about Rs.6.6 billion is expected, mainly reflecting new allocations for drought relief, corrections of salary anomalies in the health sector, expenditure on Parliamentary elections, and additional transfers to the postal and transport sectors. In contrast, capital expenditure has been revised downward by about Rs.7.5 billion taking into account delays in investment projects due to the General election and delays in foreign funding arrangements.

Reflecting the changes in revenue and expenditure estimates, the fiscal deficit is estimated to increase by about Rs.11 billion to about Rs.149 billion (7.3 per cent of GDP). In financing the resource gap, a shortfall of about Rs.14 billion is estimated due to delays in disbursements in both programme financing and project financing. Meanwhile, an additional sum of about Rs.3 billion is expected under privatisation proceeds, reflecting a spillover of some of privatisation proceeds from the previous year. Finally, the increase in the deficit and the shortfall in foreign financing are expected to increase the net domestic borrowing requirement by about Rs.22 billion to about Rs.87 billion in 2004. The increased government domestic borrowing could exert pressure on interest rates and resource availability to the private sector though it could be limited as the estimated non-bank resource availability, at around Rs.105 billion, is higher than the revised domestic financing requirement. However, achievement of even the revised fiscal estimates requires strong commitment and effective implementation of measures after the General election.

Monetary Policy: The challenge to monetary management in 2004 would be the continuation of efforts in moving towards a low level of inflation, further consolidating the recent achievements, while supporting the economic recovery. Accordingly, the monetary programme for 2004 has been prepared targetting monetary expansion (M_{2b}) of about 13.5 per cent, to be compatible with the overall macroeconomic framework aimed at achieving economic growth with stability. This monetary expansion would be adequate to support an economic growth of around 5.5 per cent, while containing inflation to around 5 - 6 per cent in 2004. Improvements in both net foreign assets (NFA) and net domestic assets (NDA) are expected to contribute to the monetary growth. NFA of the banking system is expected to increase, reflecting the overall surplus expected in the BOP and contribute about 40 per cent of the increase in money supply in 2004. Meanwhile, the entire expansion in NDA is expected from private sector credit expansion of about 15.4 per cent, as the public sector is expected to make a repayment to the banking system for the third consecutive year. The expected commercial bank credit increase to the private sector of about Rs.80 billion, with additional new resources expected from non-commercial bank financial institutions of about Rs.18 billion, would help increase private sector economic activity including investment. The containment of the domestic borrowing requirement in the budget, even with the increase indicated in the Pre-election Budgetary Position Report, and available domestic non-bank resources in the economy, would enable the government to reduce its liabilities to the banking sector by about Rs.13 billion. Similarly, despite higher borrowing requirements of the CEB, liabilities of the public corporations to the commercial banks are also expected to decline by about Rs.6 billion in 2004, particularly due to the expected repayment by the CPC, using proceeds from the privatisation of some of its activities. Meanwhile, the velocity of money (i.e., GDP/M_{2b}) is expected to remain at around 2.68 reflecting low inflationary expectations. However, realisation of fiscal targets, the expected improvements in the financial position of public corporations and the achievement of the projected surplus in the BOP are critical to achieving these monetary targets.

The Central Bank will continue to rely more on active open market operations in achieving these monetary targets by closely and continuously monitoring developments to take prompt action. The CBSL intends to continue expanding its policy instrument mix to include long-term repos, secondary market auctions and direct sales in order to improve liquidity management under OMO. Such measures will also help deepen the money and capital markets. As already announced and published in its website, the Bank will continue to issue monthly press releases according to a pre-announced annual release calendar, explaining the reasons behind its monetary policy decisions. This will not only provide more information to the public, but will also improve the predictability and understanding of monetary policy, while improving the transparency of monetary management.

The continuation of efforts to reduce inflation and hence, inflation expectations is necessary in promoting long-term sustainable high growth. Low and stable inflation would encourage investment, by reducing uncertainty, improve resource allocation efficiency and save resources wasted in hedging against inflation. Low inflation would also support poverty alleviation efforts as the poor have to bear a relatively higher burden of inflation due to the lack of inflation hedging capabilities.

Risks: The economic prospects discussed above are subject to a number of risks. Faster progress in the peace process, a strong improvement in macroeconomic management, acceleration of structural reforms, early improvement in weather conditions, price reductions in major imports (oil, fertiliser, textiles and wheat) in international markets 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, there are more downside risks than these potential upside prospects. Any reversal of the peace process, large fiscal slippages, slowdown or reversals in economic adjustments and structural reforms, an increase in political uncertainty, deterioration of weather conditions or a slowdown in the recovery in the world economy could worsen the macroeconomic situation, causing severe difficulties in macroeconomic management. Therefore, every effort must be made to prevent adverse events that are directly under the control of the country, while it is essential to have contingency measures to meet promptly, challenges arising from other potential developments, which are not directly under the control of the country.

Medium-Term Macroeconomic Prospects

The medium-term economic prospects for Sri Lanka will depend significantly on finding a lasting solution to the issue of the North and the East, the intensity and speed of economic policy adjustments and structural reforms, consistency and predictability of policy changes, the strength of national consensus on major economic, political and social policy issues and developments in the international environment. The expected medium-term global economic recovery and international trade expansion would create greater opportunities for more liberalised trade oriented economies such as Sri Lanka. Increasing globalisation will not only offer more opportunities for developing countries but also create new challenges demanding improvements in efficiency and productivity. Meanwhile, the declining trend in official development assistance (ODA) and increasing per capita income in Sri Lanka indicate that the country will have to depend more on the international capital market for its external resource requirements in the long term. In this context, obtaining a country rating from reputed international rating agencies and maintaining it at or above the investment category are useful in encouraging foreign capital inflows and facilitating foreign market borrowings by the domestic private sector, particularly for long-term investment. Sri Lanka could maximise the realisation of benefits from the emerging international trends if timely action is taken to make necessary policy adjustments and implement reforms not only to resolve the existing inefficiencies and rigidities in the economy, but also to face effectively emerging new challenges in an increasingly uncertain external environment.

As the medium-term outlook is highly sensitive to the base assumptions on the above mentioned critical factors, four

TABLE 1.10
Medium-Term Macroeconomic Indicators

	Provisional 2003	Projections (a)			
		2004	2005	2006	2007
Mid year population (millions)	19.3	19.4	19.6	19.8	20.0
GDP growth (%)	5.9	5.5	6.5	7.0	7.2
Investment (% of GDP)	22.3	24.5	27.5	28.7	30.0
Private	17.3	19.6	21.9	22.7	23.6
Public	5.0	4.9	5.6	6.0	6.4
Domestic savings (% of GDP)	15.7	17.0	19.8	20.8	22.5
Private	19.0	19.2	20.3	20.0	20.4
Public	-3.3	-2.2	-0.5	0.8	2.1
CCPI annual average (% change)	6.3	6.0	5.5	4.5	4.0
Export volume (% change)	3.5	4.1	4.2	4.5	5.0
Import volume (% change)	11.2	5.4	7.5	8.2	8.2
External current account deficit (% of GDP)	-0.6	-2.2	-3.0	-3.4	-3.2
Official reserves (months of imports)	4.2	4.4	4.6	4.8	5.0
Government revenue (% of GDP)	15.7	15.8	16.4	16.9	17.2
Government expenditure (% of GDP)	23.7	23.1	22.5	22.1	21.5
Budget deficit (% of GDP)	-8.0	-7.3	-5.9	-5.0	-4.5
Broad money (% change)	15.3	13.5	12.5	12.0	12.0

(a) Baseline scenario projections. Basic assumptions are given under the section on Medium-Term Macroeconomic Prospects.

Source: Central Bank of Sri Lanka

alternative scenarios could be considered under different assumptions as in the previous year's Report – viz., a baseline scenario, a high growth scenario, a low growth scenario and a worst case scenario. Summary results of the baseline scenario are given in Table 1.10, while the results under all four scenarios are described briefly below.

Baseline Scenario: This is based on the assumptions of a satisfactory progress in the peace process, effective implementation of policy adjustments and structural reforms, safeguarding law and order, attainment of conducive political and social stability in the country and the completion of the requirements under donor supported programmes. Under this scenario, economic development is expected, broadly consisting of attaining an annual growth of about 7 per cent over the medium-term, a decline in inflation to around 4 per cent, a reduction of unemployment to about 5 per cent, an improvement in macroeconomic stability and a strengthening of the resilience of the economy to successfully face external shocks. A steady decline in the fiscal deficit will enable moving closer to the medium-term fiscal targets envisaged in the FMRA, while releasing more domestic resources to the private sector, which is expected to drive economic growth. Increasing domestic and foreign investment will expand the capacity in the economy and raise productivity. Increasing national savings will finance a large part of rising investment, helping to contain dependence on foreign savings. The external current account deficit would remain within a manageable level. The surplus in the capital and financial account, resulting from increasing utilisation of concessional assistance and private investment inflows, would be sufficient to offset the current account deficit and record a surplus in the overall BOP. Foreign reserves would rise to a comfortable level, improving exchange rate stability and reducing external sector vulnerabilities. The money supply would expand, supporting economic growth without building up inflationary pressures. Interest rates, as well as interest spreads, are expected to decline with downward adjusting inflationary expectations, improving competition in the financial sector and decreasing non-performing assets in the banking system. Lower population growth at around one per cent, with an economic growth of 5 - 7 per cent, will raise the average real per capita income by about 4 - 6 per cent annually. Rising per capita income, increasing job opportunities and expanding economic opportunities, particularly for the poor expected under the PRSP, will improve the general living standards of the people, reducing poverty on a more sustainable basis.

High Growth Scenario: The high economic development scenario envisages an early achievement of a lasting peace and accelerated implementation of policy adjustments and structural reforms, supported by a strong national consensus on major economic, political and social issues of the country and strict adherence to law and order. These would enable the country to meet the requirements under the donor supported programmes in time, improving donors' confidence and hence increasing opportunities for additional concessional assistance for the country. Under this scenario, achieving a faster economic growth of over 7 per cent with stability is possible, thus helping to raise the average income at a faster rate, reduce unemployment, and alleviate poverty more swiftly than in the baseline scenario. Similarly, achievement of the medium-term fiscal targets envisaged in the FMRA would be faster and the resilience of the economy would be stronger under this scenario, than in the baseline scenario.

Low Growth Scenario: In this scenario it is assumed that the ceasefire remains, but no further progress is achieved in the peace process, and only a few policy adjustments and structural reforms are implemented, with long delays. These would lead to postponement or even cancellation of at least some of the concessionary programmes providing foreign assistance. Under this scenario, economic growth would decline to below 4 per cent, worsening the basic existing economic problems such as inflation, unemployment and poverty, leading to economic, political and social instability in the country. The budget deficit and public debt would rise, increasing the risk of a debt crisis. The external sector would deteriorate, recording a deficit in the BOP and hence depleting external reserves and raising pressures on the exchange rate, leading to a vicious circle between inflation and exchange rate. Consequently, the market oriented economic policy regime would be difficult to continue and policy makers may be compelled to resort to non-market instruments such as controls and quotas, including foreign exchange controls, import controls and quota systems for distribution of imported essential goods.

Worst Case Scenario: This scenario is based on the unfortunate possibility of a resumption of hostilities, and reversals in economic policy adjustments and structural reforms. Under this scenario economic growth would decline below the population growth or even suffer a contraction and concessional foreign assistance would be not available from most donors. Inflation would accelerate, leading to hyperinflation or compelling the introduction of price controls, creating black markets. Rising unemployment and worsening poverty would increase the risk of social unrest and political crisis within a short period. A debt crisis would be almost inevitable, with a rising fiscal deficit and economic growth declining below real interest rates[1]. A widening current account deficit and declining capital inflows would reduce external reserves to a dangerously low level and depreciate the exchange rate sharply. Finally, policy makers would be compelled to resort to a controlled regime, strict controls on foreign exchange transactions and imports within a very short period, and hence, introducing rationing for distribution of goods and services. The worsening economic, security and

1 One of the basic requirements for long-term debt sustainability is an economic growth rate higher than the real interest rate.

social situation would lead the country to a severe crisis, destroying the hard-earned developments achieved over a long period.

Although these simulations are highly sensitive to changes in assumptions, they clearly reiterate the need for achieving a lasting peace early, implementing policy adjustments effectively and deepening structural reforms in time, while building up a strong national consensus on key economic and political policy issues.

1.13 Economic Issues and Policies

The challenge for the country in 2004 is to lay the necessary foundation, based on recent achievements, for a sustainable and high long-term economic growth with greater equity, while moving towards peace. This has to be accomplished while successfully achieving integration with globalisation and paying due attention to protecting the environment. The outward looking market oriented economic policy framework introduced in 1977 has served the country relatively better than the inward looking, public sector centred, economic policy regime that had been adopted earlier. The new economic framework increased economic growth, albeit less than expected, expanded investment, diversified economic activity and increased productive job opportunities, raised the living standards of the people, reduced poverty to some extent, and strengthened the resilience of the economy. The free-play of the market released human efforts for production and gainful employment. In the previous regime where goods were distributed under rationing and economic activities were regulated through bureaucratic controls, human efforts were wasted in acquiring goods or seeking applications for approval, thereby creating enormous deadweight losses in the economy. In the new regime, production and distribution activities have been modernised, while choices have been expanded for producers, as well as consumers.

Nevertheless, the achievements are far from the desired and well below the potential levels that would do justice to the country's human and natural resources, including its strategic location close to one of the busiest sea routes in the world. The basic economic problems such as poverty, unemployment and inflation continue to loom large. In fact, some economic issues, particularly the macroeconomic imbalances, debt burden and vulnerability to external shocks, have worsened during this period. As discussed in detail in the Central Bank's Annual Report 2002, three major factors were responsible for limiting economic development: the continuation of costly and destructive civil conflicts; the large macroeconomic imbalances that primarily resulted from the continuing high fiscal deficits; and the slow progress in economic liberalisation and other structural reforms. These factors prevented the country from realising the full benefits of the market oriented economic policy regime, resulting in a moderate and volatile annual economic growth with a weak trickle down effect, even though the average growth achieved was relatively higher than the growth during the previous regime. Therefore, it is essential to lay a strong foundation for a sustainable high quality (i.e., with greater equity and environment friendly) economic growth, based on experience, particularly by learning from previous mistakes and failures.

A close analysis would reveal that high economic growth, greater equity, environment protection and integration with globalisation are not competing objectives, but are complementary, reinforcing one another in the development process. A sustainable annual economic growth rate at around 8 per cent will double the country's output within 9 years, helping to reduce poverty, unemployment and inflation on a more sustainable basis and to raise the living standards of the people in the country. It is important to achieve such growth with a greater equity through pro-poor growth oriented policy measures enabling a large number of people, if not all, to contribute to the growth as well as to enjoy its benefits. Such a growth strategy would not only create a strong supportive constituency for difficult but growth oriented policy adjustments and deep structural reforms, but will also help to strengthen political and social stability. Similarly, sustainable growth has to be environment friendly, while the environment protection policies should not be obstacles to growth. Thus, the protection of the environment and a sustainable economic growth are closely interrelated, reinforcing each other under a well designed and coordinated policy framework. A sustainable high economic growth would generate adequate resources not only to protect the environment, but also to improve it. Conversely, improving the environment, would, in turn, make the high growth more sustainable in the long-term.

Similarly, high sustainable growth and successful integration with a globalised world are also two reinforcing complementary objectives. As a small island economy, Sri Lanka has to depend on export markets to enjoy the benefits of economies of scale in production. Integration with world markets is the only way to gain access to large and diversified markets for the country's exports, obtain modern technology and encourage capital inflows, which support investment expansion. These factors would help the country to achieve a high growth, strengthening its resilience to face effectively the challenges emerging in the global market.

With expanding and changing human demands, it is costly if not impossible, for a country to become self sufficient in all its needs. Effective integration into the process of globalisation would enable the country to concentrate on producing goods and services in which it has a comparative advantage, and maximise benefits by trading them with rest of the world, thereby improving the welfare of the people. Thus, a high economic growth has to be equitable, environment friendly and integrated with globalisation to be sustainable in the medium to long-term.

Actions are needed on the economic front, as well as in non-economic areas, to achieve a sustainable high quality economic growth. Among them, the major ones are: peace, political stability, and appropriate economic policy regime, prudent macroeconomic management, deep structural reforms, infrastructure development, human resource development, integration into globalisation, governance, and law and order.

Peace: The first and the most important requirement is the continuation of the ceasefire and moving towards a sustainable political solution to the issue of the North and the East. The benefits experienced during the last two years under the ongoing ceasefire clearly demonstrated the potential peace dividend, in contrast to the human and economic cost of war experienced during the previous period of about twenty years. Peace will help to save human lives, reduce the suffering of the people, improve their safety and strengthen confidence. It will raise growth by expanding investment, improving productivity and opening new markets. Expanding investment and increasing economic growth would create more productive job opportunities in the country, shifting resources from destructive activities to productive activities. Higher production of domestic food crops would contain inflationary pressure. Meanwhile, increasing productivity and reducing costs by removing transport barriers would help to contain cost push-inflation, further supporting price stability. Peace would also facilitate fiscal consolidation, reducing defence expenditure requirements and encouraging more concessional foreign assistance even to cover a large part of the reconstruction and rehabilitation expenditure. Falling defence imports, together with increasing exports, tourism, foreign investment and aid disbursement under a peaceful environment would enable the realisation of a surplus in the BOP and hence enhance external reserves, strengthen exchange rate stability and reduce external vulnerability. Rising production, decreasing transport costs, an improving fiscal position and strengthening external assets would facilitate monetary management, enabling interest rates to be reduced and low inflation to be achieved on a more sustainable basis. The availability of these economic benefits to the public, in turn, would strengthen the peace process, political stability and social harmony. Thus, peace and sustainable high quality economic growth are interrelated, reinforcing each other in their implementation process.

Political Stability: Political stability is essential for improving investor confidence and effective implementation of policy adjustments and structural reforms. Investor surveys in many countries have indicated that both domestic and foreign investors give more weight to political stability than tax concessions in selecting their investment destinations. In the recent past, Sri Lanka has had at least one election (i.e. presidential, parliamentary, provincial council or local government) almost every two years. Elections are necessary for the activation of democratic political systems. However, elections every year or two not only increase fiscal expenditure, but also create political uncertainty, discouraging investment, weakening macroeconomic management and delaying the implementation of structural reforms. It is necessary to build political consensus to find a solution to this problem, based on the experiences of other countries.

Macroeconomic Policy Regime: Experiences in Sri Lanka, as well as in other parts of the world, indicate that the selection of an appropriate economic policy regime is the most critical economic decision in achieving sustainable high quality economic development. In this context, it has become clear that the market oriented policy framework is the only choice, as all other alternatives have been unsuccessful, not only in Sri Lanka but also all over the world. It is also well accepted that in preparing an economic policy framework, country specific conditions need due attention to ensure strong public support and minimise potential conflict with non-economic objectives. However, such country specific features have to be incorporated within a market oriented economic policy regime without distorting its basic principles, i.e., allowing market forces, primarily price signals, to decide the three basic economic decisions: what to produce, how to produce and for whom to produce. Any government intervention has to be through a proper market incentive mechanism, rather than through non-market instruments. The development of effective and efficient regulatory systems simultaneously is essential to prevent potential shortcomings in the markets, primarily caused by non-competitive market activity. Sri Lanka made a correct decision by accepting the market oriented economic policy framework in 1977 and was the first South Asian country to do so. However, even twenty five years after its introduction, some major policies that were essential components of the system have not undergone adequate reform, as required, to be compatible with the basic principles of a market oriented policy regime. This factor has constrained the realisation of maximum benefits by the country. The inadequacy of progress in policy adjustments and implementation of reforms is very clear in the fiscal sector, public enterprises, labour and land markets, education, civil service, regulatory system, judicial process and infrastructure development. Meanwhile, some late comers in the South Asian region are moving well ahead of Sri Lanka in adopting major components of the market oriented policy regime thereby, raising economic growth and improving the living standards of the people.

In democratic societies, changes in policy regimes should have wide and continuous consultations with the public. Policies bring about changes and changes create uncertainty. In an uncertain world, through fear of loss or deprivation, sections of the public would naturally resist change, thereby making their implementation rather difficult. Hence, a continuous dialogue and awareness to remove the fear out of the minds of the public are necessary for building consensus about policy changes, thereby ensuring the continuity and long-term sustainability of such changes. It also substantially reduces the risk of policy reversals under different political regimes. Hence, effective marketing of policy changes is as equally important as the introduction of appropriate policy changes.

Macroeconomic Management: Improvement in macroeconomic management, with prudent fiscal, monetary and income policies, is essential to develop a conducive macroeconomic environment for operating the market oriented policy regime effectively and successfully. The continuation of a large public sector deficit (the sum of the deficits in the government and the public corporations) in Sri Lanka not only increased the public debt burden to over 100 per cent of GDP, but also crowded out more productive private sector capital expenditure, constraining investment expansion and productivity improvement, and hence lowering economic growth. Meanwhile, the existence of a high current account deficit in the budget (i.e., dissavings), prevented an improvement in domestic savings, despite gradual relaxation of financial repression by the government. The high fiscal deficit not only depressed economic growth, but also put pressure on prices and exchange rates, resulting in relatively high inflation and depreciation of the rupee. Thus, a strong and sustainable fiscal adjustment strategy is essential to improving macroeconomic management. The approval of FMRA with specific medium-term targets on the fiscal deficit and debt to GDP ratios is a major step in the right direction. The fiscal improvements achieved during the last two years are encouraging. Nevertheless, there is still a long way to go in order to ensure the medium-term fiscal sustainability as envisaged in FMRA as well as in PRSP. In this endeavour more attention is required to improving revenue mobilisation, as the declining trend in the revenue to GDP ratio has become a serious structural issue. Improvements in tax policy, expanding the tax base and strengthening tax administration by improving management, efficiency and effectiveness, and introducing effective incentive systems are the only ways to reverse this declining trend and ensure the mobilisation of adequate resources. Further improvement in expenditure rationalisation by containing the wage bill, improving the targetting of welfare schemes, reducing transfer requirements to public enterprises, while introducing automatic cost recovery price adjustments and minimising interest costs through improvements in deficit financing and public debt management are also necessary to support faster fiscal consolidation. A comprehensive civil service reform would raise the short-term fiscal cost even if concessional foreign assistance helps to cover a large part of the restructuring cost. However, it is a price worth paying, as it would help to contain the wage bill in the long-term and improve the efficiency in the public service.

A medium-term sustainable fiscal adjustment strategy would greatly facilitate monetary management aimed at sustainable low inflation and continuation of a successful flexible exchange rate system. Meanwhile, the continuation of financial sector reforms would improve the monetary policy transmission mechanism and expand the domestic capital and debt markets, which are still at a rudimentary stage of development compared with other countries. On the income policy front, it is critical to introduce a national wage adjustment policy based on productivity improvements. Such a policy would help contain cost-push inflation pressures and support productivity improvement efforts. Thus, the above mentioned improvements in fiscal, monetary and income policies would greatly help to develop a conducive macroeconomic environment, enabling the country to realise the maximum benefits through a private sector led sustainable high economic growth. It is also noteworthy that improvements in macroeconomic management and deepening of structural reforms would reinforce each other. Increasing economic growth, supported by appropriate macroeconomic policies, would create a conducive environment and provide resources required for deepening structural reforms. Similarly, the implementation of structural reforms would facilitate macroeconomic management directly, affecting economic policy adjustments such as fiscal consolidation, and indirectly through high economic growth.

Deepening Structural Reforms: The necessity for implementing structural reforms for a sustainable high quality growth was discussed in the previous issues of the Central Bank Annual Report and government policy documents, including the PRSP. Similarly, the reforms required have been clearly identified and discussed extensively covering all major areas such as public enterprises, labour and land markets, financial sector, civil service, education, health, judicial processes and regulatory systems. In brief, structural reforms are necessary to remove constraints on investment expansion and productivity increases, and hence, to promote economic growth. Such reforms would reduce the cost of doing business and improve investor confidence, leading to a faster expansion in investment. Similarly, they would improve efficiency in the economy, reduce waste and encourage innovation, helping to raise the productivity in the economy, which is very low. Reforms have been in the process of implementation since 1977 but the progress is inadequate and significant delays in implementation prevent full realisation of benefits. As the required reforms have been identified, what is needed now is strong commitment for their effective and timely implementation, and an effective public awareness programme explaining the benefits of reforms, as well as the costs of delaying or not implementing them. Such a public awareness programme is necessary to develop a strong pro-reform constituency, enabling to face effectively, the potential resistance against reforms from the beneficiaries of and rent seekers from structural rigidities.

Infrastructure Facilities: The availability of adequate, good quality physical and social infrastructure facilities at a competitive price, with an efficient and effective regulatory system, is a pre-requisite for a high sustainable economic growth. An efficient infrastructure network is a necessity for encouraging investment and improving factor productivity in the economy. Infrastructure facilities presently available in Sri Lanka are grossly inadequate. They are not adequate even to support a continuation of a moderate growth rate of around 5 per cent, let alone moving the country to a high economic growth path. Therefore, substantial improvements in infrastructure facilities, particularly in power, roads, public transport and the water sector are necessary to support high economic growth.

However, many enterprises supplying infrastructure facilities in Sri Lanka are still in the government sector and are monopolies, often providing inadequate, low quality services. Many of them are also run inefficiently, and at a financial loss. They do not have resources to expand their capacity adequately to meet the increasing demand or to improve the quality of services. Therefore, bold reforms are necessary to address these issues effectively, enabling the development of infrastructure facilities. In this endeavour, the active participation of the private sector in infrastructure development is critical as public sector investment is constrained by severe fiscal limitations. Such private sector participation would also be helpful in improving efficiency in the supply of infrastructure facilities. Changing the role of the public sector from a 'player' to a 'referee' has to be a major pillar in these reforms. The required reforms have been extensively discussed and some initial steps have already been taken in a number of sectors, but the progress has been woefully inadequate, and therefore requires acceleration in implementation.

Experiences in Sri Lanka as well as in other countries show that private sector led infrastructure developments respond positively to liberalisation and deregulation. The successful experience in the telecommunications industry in Sri Lanka, which has been recording a double digit annual growth rate since 1992, provides a valuable experience for developing infrastructure with private sector participation in a liberalised market environment. The regulatory system necessary for such private sector participation can be developed under the Public Utilities Commission.

Power: Sri Lanka's power sector has been experiencing chronic problems of inadequate capacity, poor quality with large voltage fluctuations and regular power failures, high cost[1], excessive system losses and the risk of power cuts in drought years. The poor quality of power supply not only raises the cost of production, but also damages sensitive modern electronic machinery, weakening the country's external competitiveness. Furthermore, problems in the power sector have become a major constraint in expanding investment in the economy. This unfortunate situation has been mainly a result of delays in power sector reforms and the postponement of the construction of low-cost large scale non-hydro power plants. The situation has been further worsened by the greater emphasis placed on expanding the consumer base through special schemes such as rural electrification, than on increasing the power generation capacity and reducing system losses.

Meanwhile, low-cost, large scale power generation plants have been in the project pipeline for a long period, without even their locations being finalised yet, even though the country has been experiencing severe power cuts regularly. It is estimated that the ratio of output growth to power demand is, on average, about 1: 1.5, i.e., for every 1 per cent growth in GDP, 1.5 per cent growth in power supply is required, due to increasing power intensity in the economy. Thus, in order to ensure 8 per cent annual GDP growth, power generation has to be expanded annually at least by about 12 per cent. This is a difficult challenge compared with the average annual growth of electricity generation during the last twenty years, which was about 7.0 per cent, but is not impossible to achieve. As the supply of adequate and uninterrupted power at competitive costs is critical for long-term investment and growth, the unbundling of the CEB should be carried out without further delay and locations for the proposed large generation plants must be identified to commence their construction early.

Transport: Available transport facilities are not adequate to support a high economic growth. The road network has been not expanded adequately and even the existing roads have not been properly maintained. Traffic has become a serious problem in almost all major cities. Similarly, the public passenger transport sector has been experiencing capacity limitations as well as low service quality. These problems in the transport sector adversely affect the overall economic growth by discouraging investment and constraining productivity improvement. They also have an adverse impact on poverty by restricting the access of the poor to markets and basic social services. A comprehensive road development programme, consisting of the rehabilitation of existing roads and the construction of expressways to connect major cities and production areas, is necessary in order to expand and integrate the domestic markets. The government has realised the necessity for road development and has prepared a comprehensive programme. In this context, promoting private sector participation in financing, building, operating and maintaining the road network is necessary to ensure efficiency and mobilise adequate financial resources, as available government resources are very limited. Similarly, major reforms are necessary in the public passenger transport system covering both bus transport and railway transport. Reforms in the Regional Transport Companies (RTCs) have to be planned carefully, as a number of reform initiatives implemented previously have not been successful. These companies have been depending heavily on budgetary resources to cover even their running expenses. Thus, they do not have resources to expand their capacity or improve service quality. A well planned private-public-partnership (PPP) system could be considered as a first step, if the privatisation takes a long

1 Sri Lanka has the highest average cost, in US cents per Kwh, at 7.5, compared with 5.3 in Singapore, 5.8 in Malaysia and 6.9 in Bangladesh.

time. Similarly, the quality of railway services is deteriorating continuously, and the number of fatal accidents is increasing. Meanwhile, it imposes a heavy fiscal burden, as the Railway Department's in1ticipation is necessary to make the railway an efficient and viable transport service.

Water: Sri Lanka is a water scarce country requiring regular large investment in water storage, purification and distribution. The availability of an adequate supply of water for production activities and drinking purposes is becoming a constraint to achieving high economic growth. This is largely due to inadequate investment, as well as the lack of an adequate incentive system for proper usage and conservation of water. Water is distributed free under the irrigation facilities without any incentive for water conservation, resulting in excessive usage and a high waste rate. The entire burden of irrigation investment, both initial capital expenditure and maintenance expenditure, is placed on the budget. As the availability of government resources is becoming scarce, a cost recovery mechanism has to be introduced at least to ensure regular maintenance activities in the irrigation sector. Such a cost recovery system, if designed properly, will provide net benefits to farmers as it can raise their income with improvements in water availability more than the cost they have to incur.

The National Water Supply and Drainage Board (NWSDB) is the major supplier of pipeborne water in the country. NWSDB has been expanding its capacity, but it has not been able to meet the increasing demand for drinking water. Meanwhile, poor quality water supply heightens the risk of water borne diseases and other public health hazards. 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. In order to meet this target, the estimated annual investment requirement is about Rs.10 – 12 billion, compared with the planned annual average public investment in the water sector of about Rs.5 billion. Thus, there is a clear need for private sector participation in the development of water supply. Meanwhile, the introduction of an automatic price adjustment mechanism for water tariffs, at least to cover the full operational cost and part of capital expenditure, is necessary to ensure viability of the water supply industry.

Health and Education: In Sri Lanka, the government has been investing continuously in health and education facilities, improving the human capital of the country. However, with increasing demand and rising costs, public investment has become inadequate to provide satisfactory health and education services. Public health services have been deteriorating quantitatively and qualitatively, due to resource limitations and weakening labour discipline. Meanwhile, private sector curative health facilities have been expanding at a faster rate in the recent past, even encouraging large foreign investment in the sector. However, the private sector has not shown much interest in expanding preventive health care facilities. Therefore, it is necessary to develop a national health sector development strategy, giving more emphasis to public sector involvement in preventive health care activities, while strengthening an effective regulatory system to ensure the quality of service, to support the private sector expansion in health services and encourage expansion of health insurance facilities.

The public sector continued to be the major supplier of education at all the three levels, i.e., primary, secondary and tertiary, accounting for about 96 per cent of school students and almost close to 100 per cent of university students. The school density, at one school per 6 sq km, and a pupil/teacher ratio at 21, indicate the availability of adequate primary and secondary educational facilities and a wide dispersion over the island. However, the deteriorating quality of public school education has become a major concern in the recent past. Several education development projects with international donor assistance have been initiated, but the progress has been very slow. Effective implementation of these projects, introduction and expansion of facilities for computer education, and strengthening school management through the recently established Schools Board and a School Based Management System are critical in raising the quality of the public school education system.

The situation in tertiary education is more serious than in primary and secondary education, as both capacity and quality of services available in universities, and skills development and training centres have become major economic, political and social issues. The continuing high structural unemployment among the educated youth, deteriorating social conditions and growing youth unrest clearly demonstrate the need for deepening educational reforms without further delay. The government's policy document, i.e., PRSP, also highlighted a number of constraints in the present educational system and the necessity of strong reforms to address them. The identified constraints are classified under four major categories: quality constraints, institutional constraints, language constraints and tertiary education constraints. Addressing these issues effectively requires adequate resources, strong commitment and wide public support. Given the tight fiscal situation, increasing demand for high quality education and rapidly changing technological developments, major components of the educational reforms would need to include opening education, including tertiary education, to the private sector, while finding adequate resources for the public sector to provide education in a competitive market environment. It would also be important to change supply-driven skills developments and vocational training facilities to demand-driven facilities.

Integration with Globalisation: Globalisation will continue, irrespective of individual views thereon, expanding opportunities as well as increasing challenges to countries. The effectiveness of traditional measures of protection and restriction are weakening rapidly, with improving technology, expanding factor mobility and changing production systems. Therefore, the only available choice is to integrate with globalisation, making every effort to maximise benefits from available opportunities, while minimising potential risks. As globalisation will severely punish inefficient and poor quality producers, improvement in efficiency, increase in dynamism and timely policy decisions are critical in realising the maximum benefits from integration with the world economy. As a small island economy, Sri Lanka has to depend heavily on the export of goods and services to achieve a high, sustainable growth given the small size of the domestic market. In expanding export markets and encouraging foreign investment, the recently concluded Comprehensive Economic Partnership Agreement (CEPA) with India and an early conclusion of a free trade agreement with USA would provide an ideal opportunity to move the economy towards a high growth path.

Governance and Law and Order: Improving governance and strengthening law and order have become major necessities in achieving high growth. Improvement in governance is necessary to reduce the cost of doing business in Sri Lanka, minimise delays in the approval and clearance processes, increase transparency and accountability of the public service and improve the public policy making process. Reforms centred around improving the effectiveness and efficiency of the public service and public policy management would not only support achieving high growth, but would also support poverty reduction through improvement in public service delivery systems, thereby ensuring equity, accessibility and efficiency. Deteriorating conditions relating to law and order not only discourage investment expansion, but also threaten the safety of private property rights, which are a fundamental requirement for the effective functioning of a market economy. Improvements in governance and law and order need to be complemented with reforms in the judicial processes aimed at reducing long delays in the legal process, improving efficiency in decision making and upgrading services, particularly by improving commercial aspects of the legal system to be compatible with a modern market oriented economy.

In summary, as the policy adjustments and reforms necessary for sustainable high quality growth are difficult and painful in the short run, a strong commitment and ownership of these are critical for successful implementation. Similarly, appropriate sequencing is necessary to ensure consistency and compatibility, in order to ensure maximum benefits. As the available domestic resources are limited, compared with the requirements for development, mobilisation of external resources is unavoidable. In this endeavour, it is essential that the government depend, as far as possible, on concessional foreign assistance to minimise the debt burden of the country. Similarly, all available external assistance to the country has to be allocated to the sectors generating an adequate rate of return in order to ensure an improvement in the country's repayment capacity.

Meanwhile, the large external financing requirements, and the continuing downward trend in official development assistance (ODA), consequent on the rising per capita income in Sri Lanka, which reduces its eligibility for concessional financing facilities from international organisations, emphasise the necessity for encouraging private capital inflows. In this context, obtaining sovereign credit ratings as soon as possible from reputed international rating agencies will be a major forward looking step, as it will encourage foreign private capital inflows and facilitate domestic private sector foreign borrowing, at the best interest rates. Furthermore, it will support improvement in policy discipline and political and social stability in the country, as such ratings will be upgraded regularly taking into account developments on all three fronts, i.e., economic, political and social.

As the financial sector has to play a crucial role in mobilising the domestic resources, as well as foreign resources, required in raising economic growth, special attention has to be given to financial sector stability and efficiency. Ongoing reforms and liberalisation have improved financial system stability, efficiency and competitiveness. Nevertheless, intermediation costs and non-performing asset ratios continue to remain relatively high, compared with other countries, and have risen above the desirable levels, while the domestic private debt market has not been developed adequately. The continuation of structural reforms, particularly in state sector financial institutions, improvement in risk management in financial institutions and strengthening competition through institutional consolidation are necessary to reduce the high intermediation cost and improve the resilience of the financial system.

All in all, Sri Lanka is at present at a crossroads. In the past, the country has lost many opportunities due to negligence or the pursuit of unsustainable ideologies. The cost of such failures is being borne by the people, especially the low-income people, of the country. When the rest of the world moved forward faster, Sri Lanka chose to be a laggard. A similar situation that has posed this hard choice to Sri Lanka has arisen today. If the country does not grab the opportunity and integrate itself successfully with the world economy, it will be another sad story of 'missed opportunities', involving heavy costs and still harder choices for Sri Lanka to regain the lost opportunities.

Box 5

Major Economic Policy Measures: 2003-2004[1]

Policy Measures Taken in 2003

	Effective Date	Policy Measures
Monetary Policy	7 Jan 2003	- Central Bank's Repo and Reverse Repo rates reduced by 75 basis points to 9 per cent and 11 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 primary market weighted average yield rate (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.
	3 Mar 2003	- Active Open Market Operations commenced.
	3 Apr 2003	- The basis of computing Statutory Reserve Requirement (SRR) of commercial banks was changed to calculate the required reserves based on the daily average balances of deposit liabilities and vault cash during the week ending the preceding Tuesday of the reserve week.
	9 May 2003	- Central Bank's Repo and Reverse Repo rates reduced by 75 basis points to 8.25 per cent per annum and 10.25 per cent per annum, respectively.
	15 Aug 2003	- Central Bank's Repo and Reverse Repo rates reduced by 75 basis points to 7.50 per cent per annum and 9.50 per cent per annum, respectively. - Bank Rate revised downward from 18 per cent to 15 per cent per annum.
	Sep 2003	- Central Bank issued its own securities for open market operations to mop up excess liquidity.
	16 Oct 2003	- Central Bank's Repo and Reverse Repo rates reduced by 50 basis points and 100 basis points to 7 per cent and 8.50 per cent per annum, respectively.
Financial Sector	1 Jan 2003	- Capital Adequacy Ratio (CAR) applicable to Domestic Banking Units (DBUs) 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 of the Central Bank 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 issued, extending the yield curve.
	21 Jan 2003	- The Statutory Liquid Assets Ratio was made applicable to Foreign Currency Banking Units (FCBUs) of Licensed Commercial Banks (LCBs), requiring FCBUs to maintain liquid assets in foreign currency.
	30 Jan. 2003	- Requirement to publish financial statements on a quarterly basis within two months of the close of the quarter imposed on LCBs and LSBs.
	1 Feb 2003	- Treasury bonds with a maturity period of 15 years issued, further extending the yield curve.
	14 Feb 2003	- Direction on Custodial and Trust Holdings of Scrip Securities was issued to protect the interests of the investors in government securities.

1 This includes major economic policy measures implemented during 2003 and the first four months in 2004. Policy measures that have already been announced and are to be implemented in 2004 are also included.

Box 5 (contd.)

Effective Date	Policy Measures
1 Apr 2003	- CAR for Primary Dealers (PDs) increased to 5 per cent from 3 per cent. - Minimum Capital Requirement for PDs increased by Rs. 50 million to Rs.200 million, with Tier 1 capital of at least Rs.150 million. - Direction on Forward Rate Agreement (FRA) and Interest Rate Swaps (IRS) was issued to manage interest rate risks. PDs are required to maintain an additional capital at 12 per cent of Risk Weighted Assets.
25 Apr 2003	- Quoting of buying prices for foreign currency notes to the market was discontinued by the Central Bank.
29 Apr 2003	- The process to obtain a sovereign credit rating for Sri Lanka in order to establish a benchmark in the international capital market was initiated.
07 May 2003	- The government reduced the on lending rate applicable for short term cultivation loans under the New Comprehensive Rural Credit Scheme (NCRCS) from 12 per cent to 8 per cent. The rate applicable to government interest subsidy provided to lending banks under NCRCS was also reduced from 10 per cent to 8 per cent.
12 Jun 2003	- LCBs and LSBs requested to satisfy themselves with 'Know-Your-Customer' rules and maintain adequate records pertaining to customer identification in respect of customers investing in and encashing Certificates of Deposits.
16 Jun 2003	- Applying 'Know Your Customer' rules and maintaining adequate records in respect of customers investing in and encashing Certificates of Deposits made mandatory for LCBs and LSBs.
30 Jun 2003	- With respect to off-shore banking business of commercial banks, 50 per cent of the specified CAR (i.e. not less than 2.5 per cent of core CAR and 5 per cent of total CAR) was made applicable.
1 Jul 2003	- Requirement to maintain a core capital adequacy ratio of not less than 5 per cent and a total capital adequacy ratio of not less than 10 per cent of risk weighted assets was imposed on finance companies. - Requirement to maintain capital funds at a level not less than 10 per cent of the deposit liabilities of all finance companies was introduced.
23 Jul 2003	- Direction on Firm Two-Way Quotes (bid and offer prices) for benchmark maturities was issued to promote the liquidity of medium and long term markets.
27 Jul 2003	- LCBs and LSBs informed that the requirement to maintain details pertaining to customer identification of persons encashing CDs were not applicable in respect of CDs issued before 30 June 2003.
Jul 2003	- The on lending rate applicable to Tea Development Project and Second Perennial Crop Development Project was reduced from 12 per cent to a range of 8.49 per cent and 10.5 per cent.
1 Aug 2003	- Early retirement of high cost callable Rupee loans amounting to Rs. 33.4 billion, which carried interest rates of 13 per cent and above, was commenced in order to reduce the interest cost.
15 Aug 2003	- Direction on minimum subscriptions levels for Treasury bill and Treasury bond auctions issued. Accordingly, each PD is required to subscribe a minimum 10 per cent of the amount offered for each maturity at each Treasury bond and Treasury bill auction in order to ensure that the auctions are fully subscribed. - Requirement of considering only 75 per cent of the forced sale value (FSV) of a property, based on a current valuation report, as the value of security at the time of first provisioning for a loan, and applying progressive discounts to the FSV as the loan is transferred to the 'loss' category, imposed on LCBs and LSBs.

Box 5 (contd.)

Effective Date	Policy Measures
21 Aug 2003	- Every registered finance leasing establishment other than licensed banks and finance companies, which are governed by the Banking Act No. 30 of 1988 and Finance Companies Act No. 78 of 1988, respectively was made liable to submitting specified information on a regular basis to monitor their performance.
1 Sep 2003	- Net Open Position (NOP) of commercial banks in foreign currency operations raised from 15 per cent of capital and reserves to 20 per cent of capital for banks with the required capital adequacy ratio.
8 Sep 2003	- Real Time Gross Settlement (RTGS) system introduced.
1 Oct 2003	- Treasury bonds with a maturity period of 20 years issued.
8 Oct 2003	- In computing the liquid assets ratio for the DBUs of LCBs, a requirement to limit to 20 per cent the placements of DBUs with its own FCBU, and include the full amount of the placements in the liability base of the FCBUs, imposed.
20 Oct 2003	- Requirement imposed on foreign bank branches to ensure that an Internal Audit Unit of their own be established, or, alternatively, that the Head Office or the Regional Office of such bank carries out an audit of the branch at least annually.
28 Oct 2003	- LCBs and LSBs requested to compile a representative list of their interest rates on deposits and advances and their buying and selling rates for foreign currency, and to display such information to the general public in all branches and other banking outlets.
17 Nov 2003	- A screen based Bloomberg Bond Trading platform for PDs was introduced in order to provide basic market infrastructure necessary for trading in government securities.
18 Nov 2003	- LCBs and LSBs were informed that an increase in the capital funds of an LCB/LSB subsequent to its incorporation may be considered for the computation of the Single Borrower Limit, provided that an increase as a result of a new issue or a rights issue is considered from the date on which the proceeds were received by the bank and accounted for in its books and; in the case of an increase in capital funds due to capitalised profits, external auditors have certified such profits as being capitalised profits. LCBs and LSBs were also informed that capital funds should be reduced to reflect losses incurred during the current year or any reduction in the retained profits due to payment of dividends etc.
21 Nov 2003	- Requirement of ensuring that the risk exposures tied to capital funds are maintained within the specified prudential limits, imposed on all LCBs and LSBs.
28 Nov 2003	- Direction on Special Risk Reserve issued to promote safety, soundness and stability of the PD system and to build the PD capital base. With effect from 1 July 2004, PDs are required to transfer a specified percentage of the profit after tax to a Special Risk Reserve.
	- Direction on Minimum Capital Requirement was issued. Accordingly, PDs would be required to increase their minimum capital to Rs. 350 million by 31 December 2004 and Rs. 400 million by 1 July 2005.
1 Dec 2003	- Colombo Stock Exchange (CSE) reduced the transaction fees applicable for secondary market equity transactions. Fees charged on transactions upto Rs. 1 million reduced from 1.4 per cent to 1.225 per cent, while the fee on transactions over Rs. 1 million reduced from 1.15 per cent to 1.025 per cent.
4 Dec 2003	- CSE entered into a Memorandum of Understanding (MOU) with the Karachi, Lahore and Islamabad Stock Exchanges to promote mutual assistance between the parties involved to enhance the co-operation for development of the securities market.
19 Dec 2003	- Direction on Accounting for Repo Transactions was issued. Under this, PDs are required to record all repurchase and reverse repurchase transactions to reflect the true commercial effect or substance of the transaction.

Box 5 (contd.)

	Effective Date	Policy Measures
External Sector	21 Jan 2003	- Restrictions on rupee lending to foreign controlled companies approved under Section 17 of the Board of Investment Act removed.
		- Forward purchases of foreign currency for repayment of foreign loans extended up to 720 days.
		- Forward purchases of foreign currency for imports, from banks other than those handling import documents, permitted.
		- Conversion into foreign currency of rupee proceeds realised on the sale of assets mortgaged for foreign currency loans permitted in the event of default of such loans.
		- Issue of bid bonds and performance bonds in favour of persons resident outside Sri Lanka permitted without 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, 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, permitted.
	27 Feb 2003	- Payment terms stipulated for imports relaxed to permit the release of all imports by Sri Lanka Customs without referring to Exchange Control.
	27 Mar 2003	- The World Bank approved the Poverty Reduction Strategy Credit (PRSC) to Sri Lanka.
	18 Apr 2003	- International Monetary Fund (IMF) approved the Poverty Reduction and Growth Facility (PRGF)/Extended Fund Facility (EFF) to Sri Lanka.
	9-10 Jun 2003	- Donor's conference on reconstruction and development of Sri Lanka held in Tokyo, Japan.
	9 Dec 2003	- Commercial banks permitted to repatriate to a non resident an amount equivalent to the foreign exchange brought in for the purchase and development of a residential property by the non resident, on the sale of such property, retaining any capital gain earned in a blocked account.
	10 Dec 2003	- Sri Lankans employed abroad permitted the facility of obtaining foreign currency loans from domestic banks for any purpose in Sri Lanka against the pledge of their NRFC balances, subject to the repayment of the loan being made out of the foreign exchange earnings of the borrower.
Trade and Tariff Policy	1 Jan 2003	- Ports & Airports Development Levy reduced from 0.75 per cent to 0.5 per cent for imports solely used for export purposes.
		- The Agreement on Customs Valuation (officially called the Agreement on Implementation of Article VII of GATT 1994), was implemented in Sri Lanka.
	5 Mar 2003	- Import duty on rice and bicycles increased to protect local producers while duty on selected raw materials reduced.
		- Commitments under the Indo – Sri Lanka Free Trade Agreement due at the end of the 3rd year of entry into the Agreement were honoured by granting further concessions on selected items.
	25 Mar 2003	- A duty waiver granted for motor vehicles, up to 10 years old, and designed for motor homes (caravans and mobile homes), for the period 25 March 2003 to 31 December 2003, for tourism and accommodation related purposes. This was made available due to the lack of hotel and accommodation facilities in the East, which is a constraint for the development of the tourist industry. However, vehicles more than 3 years old are subject to import licences.
	28 Mar 2003	- Ministry of Defence was exempted from the requirement of obtaining import control licence for importations done in respect of state security services.

Box 5 (contd.)

	Effective Date	Policy Measures
	13 Jun 2003	- All imports of rough diamond are required to be certified that such imports have been handled in accordance with the provisions of the Kimberley Process Certificate Scheme which certify the authenticity of such trading activity.
	25 Jun 2003	- A few machinery parts were removed from licensing requirement.
	21 Aug 2003	- Specific duty on import of rice increased from Rs.7 to Rs 9 per kg.
		- A licence fee was imposed on the c.i.f. value of imports when import licences are issued for used vehicle seats (20 per cent), used furniture and cut portions of motor vehicles (50 per cent each), used refrigerators, deep freezers and air conditioners for personal use (5 per cent each) and commercial quantity (10 per cent each).
	4 Sep 2003	- The 2 per cent tariff band, introduced on 6 November 2002, replaced with 2.5 per cent.
		- Specific duty on import of big onions, preserved and dried onions increased from Rs.6 per kg to Rs. 8 per kg.
		- Specific duty on import of sugar increased from Rs.3.50 to Rs 3.75 per kg.
	9 Sep 2003	- Import duty on liquor revised upward.
	21 Oct 2003	- Special purpose vehicles, agricultural and construction machinery older than 10 years were brought under the licensing requirement.
	Oct 2003	- The Joint Study Group submitted the framework for a Comprehensive Economic Partnership Agreement (CEPA) between India and Sri Lanka.
	17 Dec 2003	- The time period available to importers between the date of advance payment and goods receipt was increased from 30 days to 90 days.
Fiscal Sector	**Revenue Measures**	
	1 Jan 2003	- Tax free limit on interest, under the 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 LCBs and LSBs. Exemption of the Debits Tax on withdrawals increased to Rs.20,000 per month.
		- Coverage of VAT extended to banks and other financial institutions.
		- 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 earlier exempt from the VAT, brought under the 10 per cent rate.
		- Tree Tax on tapping kitul trees for toddy reintroduced at Rs. 250 per tree.
		- The flat fee of Rs. 25 per garment sold in the local market, which is already applicable to manufacturers supervised by the BOI, extended to manufacturers supervised by the Sri Lanka Customs.
	1 Apr 2003	- Maximum 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.
		- Current system of taxation of remittances of non-resident companies (33.33 per cent and 11.11 per cent, if remittances are less than one third of the taxable income and more than one third of the taxable income, respectively) replaced with a remittance tax of 10 per cent.
		- The income tax exemption of public sector employees was limited to employment income and their employment income counts towards statutory income threshold for tax purpose of other income.
		- Duty free allowance for migrant workers increased from US dollars 1,500 to 1,750.
	9 Apr 2003	- Excise tax on auto trishaws (HS codes 8703.31.05 and 8703.31.06) and several other items (HS code 8711.90) abolished.

Box 5 (contd.)

Effective Date	Policy Measures
19 Jun 2003	- The Betting and Gaming Levy (Amendment) Bill passed by Parliament incorporating measures to reduce the levy on 'rudjino' (game of card) from Rs. 12 million per annum to Rs. 500,000 per annum and licence fees for betting centres from Rs. 500,000 to Rs. 30,000 per annum.
1 Jul 2003	- Input tax credit entitlement on assets acquired to be made available under a finance lease agreement restricted to 10 per cent in all cases.
	- Persons supplying financial services that were exempted under the Value Added Tax Act (other than life insurance, crop and livestock insurance and Agrahara insurance) made liable to pay VAT on a monthly basis at 10 per cent on the value addition of the business.
	- Income tax on on-shore banking transactions of Foreign Currency Banking Units increased from 15 per cent to 30 per cent.
1 Aug 2003	- Excise duty on petrol and auto diesel increased by Rs.1.00 and Rs.0.50 to Rs.22.00 and Rs.3.50 per litre, respectively as a Road Tax.
7 Aug 2003	- Tax amnesty extended up to 15 August 2003.
22 Aug 2003	- Tax amnesty further extended up to 31 August 2003.
26 Aug 2003	- Excise duty on cigarettes raised based on length of cigarettes.
1 Sep 2003	US dollars 5 was added to the existing Embarkation Tax of US dollars 10 on every international flight ticket to or from Sri Lanka to finance tourism promotion activities by the Tourism Development Council, a private-public partnership.
	- A levy of 1 per cent was introduced on the turnover of all Tourist Board licensed institutions. The proceeds of this levy will be earmarked for the Hotel School.
9 Sep 2003	- Excise duty on molasses, palmyrah, coconut and processed arrack increased to Rs.330 per proof litre. Excise duty on country made foreign spirits increased to Rs. 440 per proof litre.
1 Oct 2003	- The input tax under VAT restricted to 10 per cent with the exception only of the VAT paid in respect of lorries, vans and wagons.
20 Nov 2003	- Excise duty on malt liquor of less than 5 per cent absolute strength and more than 5 per cent absolute strength increased to Rs.20 and Rs.35 per litre, respectively.
Expenditure Measures	
03 Jan 2003	- Disposal of discarded or unserviceable idle assets belonging to ministries and departments lying in stores, garages, yards and other premises was commenced.
03 Mar 2003	- 2 per cent of the budgetary provisions on recurrent expenditure other than on salaries, pension, interest payments and medical supplies were frozen.
31 Mar 2003	- Guidelines for hiring/renting of vehicles and purchase of vehicles for the government were issued.
2 Jun 2003	- Public Enterprises Guidelines for Good Governance were issued.
30 Jun 2003	- A system to monitor the financial performance of recurrent budget and domestically funded capital budget was introduced.
Other Fiscal Measures	
1 Jan 2003	- Fiscal Management (Responsibility) Act No. 3 of 2003 came into effect.
19 Feb 2003	- Contributory Pension Fund Bill passed by 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 5 (contd.)

	Effective Date	Policy Measures
	6 Mar 2003	- Steering Committee appointed to take initiatives to set up an independent Public Debt Management Office.
	30 Jun 2003	- The 'Mid Year Fiscal Position Report – 2003' tabled in Parliament under the Fiscal Management (Responsibility) Act.
	23 Jul 2003	- The Sri Lanka Railways Authority Act No 60 of 1993 (other than Section II) came in to operation with the issuance of the Gazette notification by the Minister of Transport, Highways and Civil Aviation.
	1 Aug 2003	- A project office was set up and a project team was appointed to study and make recommendations on the setting up of an independent Public Debt Management Office.
Other Policies	1 Jan 2003	- A separate unit in the Employees' Provident Fund department was set up to manage the Contributory Pension Fund for new recruits in the government and local government services, for a period of 2 years.
	7 Jan 2003	- Industrial Disputes (Amendment) Act No. 11 of 2003, Industrial Disputes (Hearing and Determination of Proceedings) (Special Provisions) Act No. 13 of 2003, Termination of Employment of Workmen (Special Provisions) (Amendment) Act No. 12 of 2003 and Employment of Women, Young Persons and Children (Amendment) Act No. 8 of 2003 were passed in Parliament. These Acts came into effect from 31 December 2003.
	9 Jan 2003	- Consumer Affairs Authority Bill passed by Parliament.
	10 Jan 2003	- A new insurance scheme for greenhouses and crops grown under a controlled environment introduced under the Agricultural and Agrarian Insurance Act No. 20 of 1999.
	2 Feb 2003	- The Telecommunication Regulatory Commission (TRC) called for applications from interested parties to obtain licences to operate External Telecommunication Gateways.
	Feb 2003	- A Dedicated Economic Centre was opened at Meegoda.
	17 Mar 2003	- The Consumer Affairs Authority (CAA) set up.
	Mar 2003	- Lanka Indian Oil Corporation (LIOC) commenced retailing of petroleum products in the local market ending the monopoly held by Ceylon Petroleum Corporation (CPC) in petroleum importation and distribution.
	3 Apr 2003	- Sri Lanka Insurance Corporation privatised.
	7 May 2003	- Seed Act presented to Parliament and passed with amendments.
		- The Tea Sector Association of Sri Lanka, registered under the Companies Act in October 2002, commenced business.
	15 Jun 2003	- The first industrial incubator 'Nawabima' to assist start up businesses set up at the Moratuwa University.
	1 Jul 2003	- The National Transport Commission (NTC) approved an increase of bus fares by an average rate of 8.5 percent.
	18 Jul 2003	- Gem and Jewellery Trade Promotion Council established.
	1 Sep 2003	- Sri Lanka Telecom Ltd. raised its domestic tariff by an average rate of 15 per cent.
	11 Nov 2003	- Ceylon Petroleum Storage Terminal Ltd (CPSTL) was incorporated to function as the common user facility company in the petroleum sector.
	19 Nov 2003	- The government announced a relief package for farmers who were unable to settle their cultivation loans due to crop failures since 1994.
	9 Dec 2003	- Introduction of 10 digit numbering system for fixed and mobile telephone services was completed.
	31 Dec 2003	- Under the Termination of Employment of Workmen (Special Provisions) (Amendment) Act No. 12 of 2003, a compensation formula was published in the Gazette by the Commissioner of Labour.

Box 5 (contd.)

Policy Measures Taken in 2004

	Effective Date	Policy Measures
Financial Sector	2 Jan 2004	- CSE launched a Total Return Index (TRI) series, which reflects returns of shares due to both price changes and changes in dividend income in addition to the All Share Price Index (ASPI) and Milanka Price Index (MPI), which reflect only the price movements of the underlying shares. The ASPI on total returns will be known as ASTRI and the MPI on total returns will be known as MTRI.
		- Requirement of maintaining a Capital Adequacy Ratio of at least 10 per cent in relation to risk weighted assets, with core capital constituting not less than 5 per cent, both on a bank only basis and on a consolidated basis (i.e. including the bank and all subsidiaries), was imposed on all LCBs and LSBs.
	6 Jan 2004	- Existing legislation amended to enable the issue and trading of scripless securities and dematerialisation of the existing scrip securities.
		- All LCBs and LSBs were informed that the proceeds of redeemable cumulative preference shares would constitute a part of Capital Funds for the purpose of the Banking Act and directions issued thereunder relating to the basis for the computation of the Single Borrower Limit and Investment in Equity.
	19 Jan 2004	- Requirement of obtaining a Credit Rating from an independent rating agency acceptable to the Central Bank of Sri Lanka on or before 30 June 2004 and disclosing the rating in all advertisements soliciting deposits and other debt instruments, with effect from July 2004 imposed on all LCBs and LSBs. Local branches of foreign banks may disclose their parent banks' rating. Banks which have not obtained a rating, required to disclose that they have not obtained a rating.
	21 Jan 2004	- Operation of the Debt Securities Trading System (DEX) by the CSE commenced.
	30 Jan 2004	- Converting outstanding scrip securities into scripless securities commenced.
	3 Feb 2004	- Operations of the Scripless Securities Settlement System (SSSS) and the Central Depository System (CDS) for government securities commenced.
External Sector	6 Jan 2004	- Gem traders travelling to Madagascar were permitted to take with them foreign exchange upto US dollars 15,000 (of which upto US dollars 5,000 could be in the form of currency notes) for the purchase of rough gem stones in Madagascar.
Trade and Tariff Policy	1 Jan 2004	- Tariff bands were changed from 2.5 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent and 25 per cent to 3 per cent, 6 per cent, 12 per cent, 16 per cent, 20 per cent, and 27.5 per cent, respectively.
		- Import duty on sugar and a few categories of edible oil increased, while the duty on some categories of plant and machinery, jewellery, a few categories of electrical items, red lentils and dried fish reduced.
		- Wheat grain imports, which were free from import duty, brought under 3 per cent band.
		- Surcharge on imports was reduced to 10 per cent from 20 per cent.
	1 Feb 2004	- Duty waivers were granted on masoor dhal and whole spilt lentils (3 per cent), big onions (Rs. 5 per kg), chillies (Rs. 10 per kg), potatoes (Rs. 1.50 per kg) and milk powder (6 per cent).
Fiscal Sector	**Revenue Measures**	
	01 Jan 2004	- VAT rate was unified at 15 per cent.
		- The turnover threshold of Rs.500,000 per quarter of payment of VAT raised to Rs.750,000 per quarter and annual threshold increased to Rs.3 million.

Box 5 (contd.)

Effective Date	Policy Measures
	- Excise duty on cigarettes raised based on length of cigarettes. - Excise duty on aerated water increased to Rs.5.50 per litre. - Excise duty on petrol and diesel reduced to Rs.20 and Rs.2.50 per litre, respectively. - License fee on tapping of kitul reduced to Rs.50 per tree. - Excise duty on malt liquor of less than 5 per cent of absolute strength and more than 5 per cent absolute strength increased to Rs.22.50 and Rs.38.50 per litre. - Excise duty on molasses, palmyrah, coconut and processed arrack increased to Rs.351 per proof litre. Excise duty on country made foreign spirits increased to Rs.470 per proof litre. - A levy of 2.5 per cent was imposed in respect of all charges payable by mobile phone subscribers. - The withholding tax exemption limit of Rs.9,000 per month or Rs.108,00 per year applied to total interest income from all deposits in any individual bank or financial institution. - The withholding tax free limit increased to Rs.25,000 per month or Rs.300,000 per annum for individuals whose sole or main source of income is interest income.
1 Apr 2004	- An Economic Service Charge (ESC) of 1 per cent was imposed on turnover or total asset value for entities carrying on trade, business, profession or vocation that have a turnover in excess of Rs.20 million or total assets value in excess of Rs.10 million. - The personal income tax rates were revised as follows First Rs.300,000 — Nil Next Rs.240,000 — 10 per cent Next Rs.240,000 — 20 per cent Balance — 30 per cent - Terminal benefits for employment were revised as follows: First Rs.3.5 million — Nil Next Rs.500,000 — 5 per cent Next Rs.500,000 — 10 per cent Balance — 15 per cent - An upfront tax of 10 per cent imposed on the divisible profit and other income of all partnerships. - Withholding tax of 10 per cent levied on any annuity or royalty paid by any person or partnership in excess of Rs.50,000 in any month or Rs.500,000 in any year and 5 per cent withholding tax on any management fee or similar payments. - Off shore transactions of the FCBUs of any bank operating in Sri Lanka, which had previously been exempted, were made liable to tax at 20 per cent. - Profits earned from sale of shares (including rights, bonuses and warrants and shares in BOI companies) that are issued by any company made liable to tax at 15 per cent. - With the exception of international and multilateral organisations, other income (excluding donations and grants) of institutions approved under the Section 8(a) of the Inland Revenue Act, in excess of Rs.200 million made liable for tax at 10 per cent.
Expenditure Measures	
1 Jan 2004	- A monthly salary increase of 10 per cent of the present salary or Rs. 1,250, whichever is higher, granted to government employees. - Pension payments increased by 10 per cent.

Box 5 (contd.)

Effective Date	Policy Measures
Other Fiscal Measures	
27 Feb 2004	- Pre-election Budgetary Position Report issued by the Secretary to the Ministry of Finance.

Policy Measures Proposed to be Implemented in 2004

- Replacement of the existing Exchange Control Act by Foreign Exchange Management Act (FEMA).
- Permitting persons to hold foreign assets including bank accounts abroad provided that such foreign assets had not been derived from the conversion of Sri Lanka currency or the disposal or conversion of assets in Sri Lanka or the provision of a service within Sri Lanka.
- Further liberalisation of capital transactions under the proposed FEMA.
- Consolidation of Treasury bond issues to the existing series in order to reduce the number of series of future issues and to enable the development of a benchmark yield curve
- Issuance of inflation linked bonds, provided that market conditions are conducive for issuing such instruments.
- Introduction of a Risk Weighted Capital Adequacy Framework for PDs.
- Introduction of trade date accounting to record off balance sheet exposure of PDs.
- Introduction of an Audit Committee of PDs to strengthen corporate governance and internal control systems.
- Introduction of extensive risk monitoring through Bloomberg Risk Monitoring System.
- Introduction of an amendment to the EPF Act to allow the existing approved provident funds to enroll new members and receive contributions.
- Development of a specific plan for the amalgamation of EPF and ETF.
- Presentation of the Superannuation Regulatory Commission Act to repeal the amendment of 1975 to the EPF Act, with a view to establishing new approved provident funds.
- Provision of assistance to regulate microfinance institutions with necessary policy and legal adjustments under the Rural Financial Sector Development Project.

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