

## Chapter 1

# ECONOMIC PERFORMANCE, OUTLOOK AND POLICIES

### 1.1 Overview

- Sri Lanka's economy registered an annual growth of 5.4 per cent in the real Gross Domestic Product (GDP) in 2004. The growth of over 5 per cent is a reflection of the economy's resilience to the many adverse shocks the country had to face during the year - the surge in international oil prices, a severe drought in the early part and the floods later on in the year and finally, the tsunami disaster. The growth was largely supported by the strong growth in exports, consumption and investment as well as the continuation of the ceasefire. However, the growth rate was much below the 6-8 per cent growth rate required for a sustainable reduction in unemployment and poverty in Sri Lanka. It is also noteworthy that the country's per capita GDP exceeded US dollars 1,000 for the first time. With this achievement, it is expected that Sri Lanka would make further progress in becoming an upper middle income country facing a new set of challenges.
- Investment improved while savings remained stable in 2004. The investment/GDP ratio improved to 25 per cent from 22.1 per cent in 2003, entirely due to increased private investment. The domestic savings/GDP ratio was 15.9 per cent in 2004, the same level as in 2003. National savings, which include net factor income and net private current transfers from abroad, also remained unchanged at 21.6 per cent of GDP. This led to a widening of the savings-investment gap, as also reflected by the widened current account deficit in the balance of payments (BOP), which was financed through increased utilisation of foreign savings and

official reserves. As these levels of savings and investment are not adequate to raise growth and the standards of living substantially, a concerted effort must be made to raise savings and investment at least up to 30 per cent of GDP in the near future. Increased investment needs to be channelled to improve essential infrastructure, which would be most productive in promoting a higher and regionally balanced growth.

- Healthy developments in the Services and Industry sectors contributed to economic growth in 2004 while the Agriculture sector faced a setback due to adverse weather conditions. The Services sector grew by 7.6 per cent in 2004 as reflected by the growth of wholesale and retail trade, hotels and restaurants, transport and communication, and financial, real estate and business services subsectors, and contributed 77 per cent to the overall growth. Strong external and domestic demand helped the Industry sector to grow by 5.2 per cent, contributing 25.7 per cent to the overall growth. The Agriculture sector faced a negative growth of 0.7 per cent in 2004.
- Sustainable growth in agriculture requires increased contributions from both plantation and non-plantation sectors. The plantation sector needs further increases in productivity and crop diversification. In the non-plantation small-holder sector, access to finance and land utilisation need to be improved, guidance through extension services should be provided, and improved new crop varieties and productivity enhancing methods should be introduced. In both sectors, the key to raising agricultural productivity lies

Chart 1.1  
Real GDP Growth and Inflation

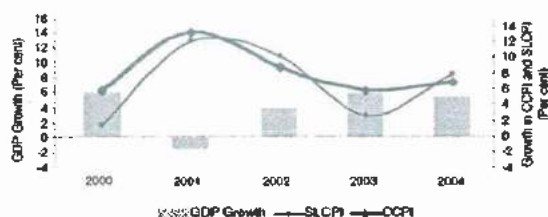
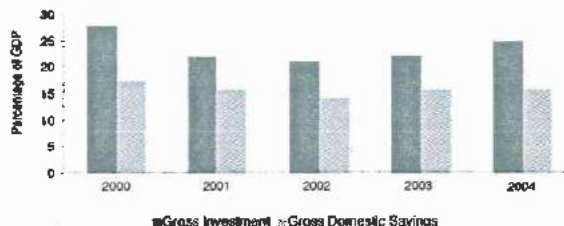


Chart 1.2  
Savings and Investment



in the introduction of high yielding varieties, the usage of new technology such as drip irrigation and poly tunnels, the adoption of research and technological developments, the use of advanced crop practices through international partnerships and the more efficient use of inputs.

- **Development of the irrigation infrastructure should be accelerated to further support the Agriculture sector.** Recent resurgence in developing and rehabilitating tanks and waterways management has a beneficial impact on the sector. Continued development will help the sector overcome any adverse impact of drought cycles.
- **Post harvest losses in agriculture, especially in perishable crops, continue to remain high.** Such losses, estimated to be around 30-35 per cent of production, result in lower incomes for producers and higher prices for consumers. Action, therefore, needs to be taken to reduce losses through proper packaging, improved transportation facilities and other means.
- **International oil prices increased sharply in 2004 raising Sri Lanka's average import price of crude oil to US dollars 37 per barrel from US dollars 29 per barrel in 2003, resulting an increase in the oil bill by US dollars 372 million.** This contributed to the worsening of the BOP and the fiscal situation with a substantial increase in subsidy payments to oil distributors, and the continuation of inefficient use of fuel since domestic prices have not been fully adjusted to reflect increases in international prices. The increased expenditure could have been utilised for raising the level of investment substantially, for instance, to cover the entire cost of a large investment project such as the Southern Expressway.
- **Inflation, which was mostly benign throughout 2003 began to rise in 2004 with the drought and the higher fuel prices leading to high cost-push inflation, while the increase in money supply and fiscal expansion, caused demand-pull inflation.** The annual average inflation rate based on the Colombo Consumers' Price Index (CCPI) rose

to 7.6 per cent in 2004, compared with 6.3 per cent in 2003. The Sri Lanka Consumers' Price Index (SLCPI) also showed a 7.9 per cent increase in 2004.

- **Both trade and current accounts in the BOP recorded deficits.** A high import growth of 20 per cent, largely due to high international fuel prices, surpassed the 12 per cent growth in exports and the 11 per cent increase in worker remittances. The surpluses in the capital and financial accounts were not adequate to cover the current account deficit due to lower than expected programme loans from the World Bank and the Asian Development Bank (ADB). Hence, the overall BOP resulted in a deficit of US dollars 205 million and the effective exchange rate (based on the 24 currency basket) depreciated by 11 and 1.1 per cent, in nominal and real terms, respectively.
- **The conduct of fiscal policy in 2004 was a challenge in the face of internal and external shocks that were threatening to slowdown the economy.** The government's overall fiscal deficit increased to 8.2 per cent of GDP compared with 8.0 per cent in 2003. The concomitant public sector deficit, which is the total of the government deficit and the operational losses of public sector corporations, was 8.4 per cent of GDP in 2004, compared with 7.8 per cent in 2003, mainly due to the operational losses of the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB). In this context, the government revised fuel prices upwards in 2004. Nevertheless, the revisions were not adequate and the spillover effects of increases in international prices continued to be a heavy burden on the public sector. The increased public sector deficit in 2004 was financed largely through borrowings from domestic sources due to a shortfall in foreign financing. However, government and public sector debt as percentages of GDP decreased marginally to 105.5 per cent and 107.5 per cent, respectively, in 2004 from 105.8 per cent and 107.9 per cent, respectively, in 2003, due to a higher increase in nominal GDP compared to the increase in debt stocks in 2004.

Chart 1.3  
Exports and Imports

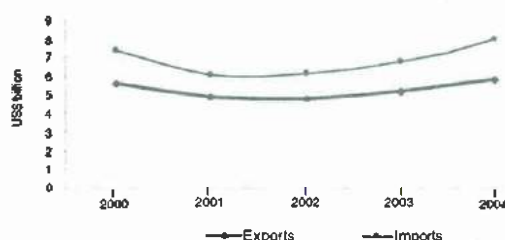


Chart 1.4  
Trade Balance, Current Account Balance and Overall Balance

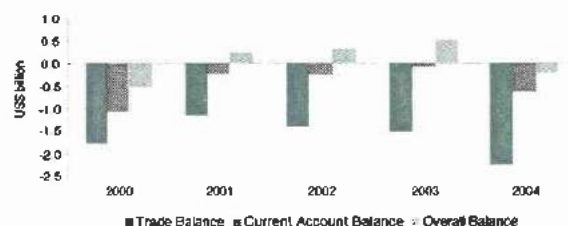


Chart 1.5  
Revenue, Expenditure and Budget Deficit

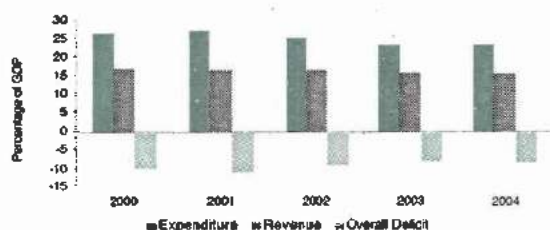
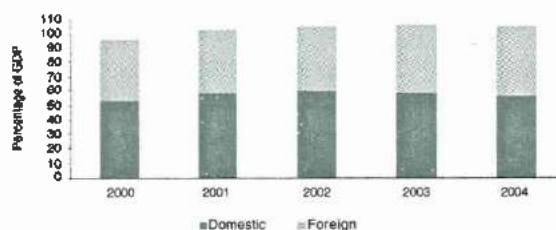


Chart 1.6  
Government Debt



- The fiscal consolidation process continued in 2004 with the government introducing a series of measures to improve the revenue performance and to rationalize expenditure. These included the strengthening of the tax administration, introduction of the Economic Service Charge (ESC), the revision of administered prices, the rationalisation of recurrent expenditure, the strengthening of public enterprises by setting up the Strategic Enterprises Management Agency (SEMA), and the establishment of the Administrative Reforms Committee (ARC) and the National Council for Administration (NCA). In addition, transparency in government procurement was strengthened by adhering to the reporting requirements of the Fiscal Management (Responsibility) Act (FMRA) and the setting up of the National Procurement Agency (NPA).
- Monetary policy was aimed at containing inflationary pressures while supporting economic growth. The rate of growth in monetary aggregates rose to a level above the desired path, particularly after mid 2004, driven mainly by the higher expansion in credit to both the private and public sectors. Reserve money rose by 21 per cent during 2004,

caused entirely by an expansion in net domestic assets of the Central Bank, as its net foreign assets declined reflecting the adverse BOP outcome. In response, the Central Bank tightened the monetary policy stance by implementing open market operations (OMO) more aggressively since June 2004 and raising its policy rates in November 2004.

- The government that took office after the general election in April, set new directions to the growth and poverty alleviation programmes with a greater focus on a regionally balanced growth as well as rural and small and medium sector development. Structural reforms were continued in 2004 as per principles laid down in the Economic Policy Framework of the Government of Sri Lanka (EPF-GOSL) released in July 2004. In this respect, several strategic enterprises supplying economic infrastructure facilities were brought under SEMA to improve their efficiency, within state sector ownership. These include the CPC, the CEB, the Sri Lanka Ports Authority (SLPA), the Sri Lanka Railways (SLR), the Airport and Aviation Authority of Sri Lanka (AAASL), the Sri Lanka Central Transport Board (SLCTB), cluster bus

Chart 1.7  
Growth of Reserve Money and Broad Money ( $M_2$ )

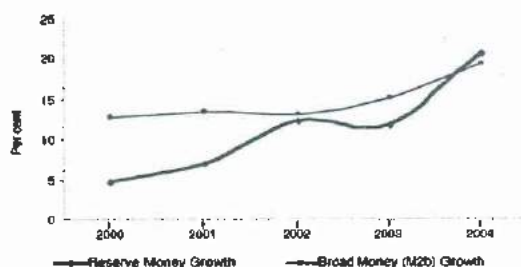
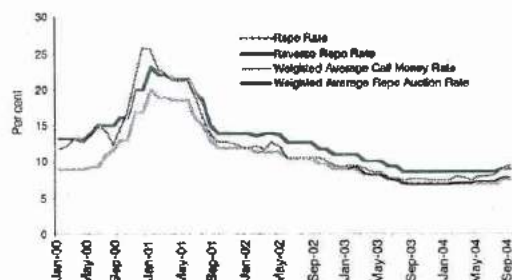


Chart 1.8  
Interest Rates





## Box 1

## The Tsunami Disaster

On 26 December 2004, an undersea earthquake registering 9.0 on the Richter scale, later upgraded to 9.3, struck in the Indian Ocean, off the Western coast of Northern Sumatra, Indonesia, at 6.59 a.m. Sri Lanka time. This has been the most powerful earthquake experienced since the earthquake that struck Alaska in 1964, which measured 9.2 on the Richter scale. The seismic movement triggered a series of tsunamis that caused the worst natural disaster in the modern history. Waves of up to 15 m (about 50 feet) in height travelling at a speed of more than 500 km per hour caused devastation along the coastlines of Bangladesh, India, Indonesia, Kenya, Malaysia, the Maldives, Mauritius, Seychelles, Somalia, Sri Lanka, Tanzania, and Thailand. Due to the distances involved, the tsunami took different time intervals ranging from fifteen minutes to seven hours to reach the coastlines of the various countries. The tsunamis reached the worst affected areas of Indonesia within minutes. Sri Lanka and the East coast of India were affected after about two hours. The death toll due to the tsunamis in all the affected countries is over 270,000.

Sri Lanka was severely affected by the tsunamis. They caused extensive damage along more than two thirds or over 1,000 km of the coastline extending from the Northern coast, through the Eastern and Southern coasts to the western coast. The first wave hit Kalmunai on the East coast of the country at 8.27 a.m. on 26 December. Thereafter, different parts of Sri Lanka were struck by the tsunamis between 8.27 a.m. and 10.30 a.m. About 31,000 human lives have been lost, over 4,000 persons are reported missing and nearly 550,000 were left homeless.<sup>1</sup> Coastal infrastructure and public and private property in the affected areas were severely damaged while economic activities, mainly fishing, tourism, trading and small-scale industries, have been

disrupted. The total damage is estimated to be around US dollars 1 billion (4.9 per cent of the GDP) and the reconstruction, which is likely to spread over a period of about three years, is estimated to cost around US dollars 1.8 billion (8.9 per cent of the GDP). Economic growth in 2005 has been revised downwards by about 0.5 – 1.0 per cent from the original estimate of 6.0 per cent, mainly due to disruptions to the fisheries and tourism sectors. However, the negative impact of these two sectors will largely be offset by the extensive reconstruction and rehabilitation activities planned for 2005.

As Sri Lanka lies in the large Indo-Australian plate far away from any of the plate boundaries, many believed that Sri Lanka was safe from risks associated with earth tremors. However, recent evidence indicates a possible splitting of the Indo-Australian plate just about 300 km from the Southwest coast of Sri Lanka, creating a new plate. Therefore, the vulnerability of Sri Lanka to earth tremors is higher now than before. This should be a serious concern in all aspects of planning in Sri Lanka.

Coping with natural disasters of this magnitude has to be done with extensive support from the public, private and non-governmental sectors as well as the international community. International support is needed especially in information sharing, technological developments, economic partnership as well as by way of assistance for rehabilitation and reconstruction. It is also vital to develop a comprehensive plan for disaster prevention, risk mitigation and disaster management with the support of all stakeholders in the country.

1 Source: National Disaster Management Centre, Ministry of Women's Empowerment and Social Welfare

companies (CBCs), and the National Water Supply and Drainage Board (NWSDB).<sup>1</sup> Reforms in both the healthcare and education sectors continued in 2004. These focussed on improving healthcare reach, promoting awareness, reforming organisational structure, developing financing mechanisms, encouraging private-public partnerships, and improving infrastructure, quality, and service delivery at all levels.

- The government's policy statement and the medium term macroeconomic framework (MTMF) announced with the Budget 2005 set out broad strategies to achieve macroeconomic stability and a regionally balanced economic growth rate of 6-8 per cent over the medium-term. The policy

envisaged prominent roles for both the public and private sectors, and pro-poor pro-growth strategies, while continuing market based economic policies pursued by successive governments over the past two and a half decades.

- While the country was preparing itself to face the challenges of growing macroeconomic imbalances, the year ended with an unexpected and unprecedented devastation caused by the tsunamis released by a massive undersea earthquake that occurred on December 26, 2004. This national tragedy caused a loss of over 30,000 lives, displaced over half a million people, brought about immense human suffering and destroyed a massive volume of physical property along more than two-thirds of Sri Lanka's coastline. Although the immediate macroeconomic impact of the tsunamis was limited to a few sectors, it significantly changed the macroeconomic outlook and posed new

1 Other strategic enterprises coming under SEMA include Bank of Ceylon, People's Bank, National Savings Bank, State Mortgage and Investment Bank, and the State Pharmaceutical Corporation.

challenges in economic management in view of the large resource requirement for rebuilding the affected areas and providing relief to affected people on a sustainable basis within the shortest possible time. In this regard, the country was fortunate to receive pledges of assistance for relief, rehabilitation and reconstruction (RRR).

- **The MTMF presented with the Budget 2005, has been revised by taking into account the impact of RRR associated with the tsunami disaster.** The economic growth would suffer in 2005 albeit marginally, mainly due to the impact on the fisheries and tourism sectors. Increased rebuilding activities would compensate to some extent for the loss of economic activities in fisheries and tourism. The growth is expected to accelerate to over 6 per cent from 2006 onwards, spreading across all sectors and geographic regions with the renewed emphasis on regional development as well as the nation rebuilding programme by the government.
- **Several downside risks remain in achieving the immediate as well as the medium term targets.** First, the risk of further escalation of international oil prices still remain. Any further increase in oil prices could exert a heavy burden on the economy and the people. Second, the global economy has already shown signs of a slowing down in 2005. This may threaten Sri Lanka's export performance. Third, Sri Lanka's major export industry, textiles and garments, is faced with increased competition in the world market due to the phasing out of the Multi Fibre Arrangement (MFA) in 2005. Fourth, any delay in the disbursement of pledged foreign assistance may delay the urgent rehabilitation and reconstruction work, affecting overall economic performance in the medium term. Thus, the country needs to be prepared to face any of these adversities.
- **It is imperative to continue consolidating the progress made in achieving greater macroeconomic stability while taking actions to remove structural weaknesses inhibiting growth.** In this connection, curbing monetary expansion and completing the fiscal consolidation process are essential to improve the country's macroeconomic stability. Productive use of government expenditure and repositioning of the government sector delivery mechanism to reach all sectors of the economy need to be ensured by the phasing out of wasteful subsidies, which have hindered productive public investment. Fiscal revenue needs to be increased to generate fiscal surpluses thereby providing flexibility to both fiscal and monetary policies in combating sectoral imbalances and promoting both stability and growth. The efficient utilization of foreign assistance for reconstruction and rehabilitation without disturbing the macroeconomic stability and on going development processes in the other parts of the country requires a significant improvement in the absorption

capacity. It is also important to ensure that domestic economic imbalances arising from large inflows of foreign aid are appropriately addressed while taking steps to accelerate the rate of utilisation of foreign aid.

- **On the structural front, reforms are needed to improve institutions, markets and infrastructure.** The operational efficiency in the public enterprises needs to be improved, especially with respect to developing appropriate pricing mechanisms, enhancing competition and strengthening the organisational set up. A renewed emphasis has to be placed on overcoming the energy crisis in the country by restructuring the energy sector and shifting to alternative low cost sources. Sri Lanka's external competitiveness depends crucially on the availability of low cost energy, comparable with its competitor countries. Other reforms include increasing the efficiency in factor markets, enhancing access to finance by the rural sector and small and medium scale enterprises (SMEs), providing essential public goods, placing adequate public investment, enhancing civil service efficiency, improving physical and institutional infrastructure facilities, developing incentive schemes for the economic agents to become successful with their own resources without government handouts, developing human capital, and promoting new technology, as well as supporting research and development.
- **With respect to labour market reforms, it is important that both employers and employees recognise the benefits of productivity based remuneration schemes and the importance of maintaining market flexibility to ensure competitiveness of domestic production.** It is equally important to upgrade the skills of the labour force by appropriately improving secondary and tertiary education enabling Sri Lanka's labour force to cater to the demands of a dynamic and competitive economy.
- **Sri Lanka has made steady progress in financial sector reforms in improving efficiency in the banking sector.** Nevertheless, the interest spread of banks in Sri Lanka remained one of the highest in the region due to high staff costs of 1.9 per cent of average assets of the banking sector. Comparable staff costs in both India and Pakistan are 1.3 per cent of average assets. Thus, banks in Sri Lanka need to pay special attention to narrowing this gap through improved productivity.
- **Sri Lanka's potential in achieving a growth of 6-8 per cent lies in several areas.** The Services sector offers the greatest opportunities, given Sri Lanka's highly literate work force, Sri Lankans' eagerness to learn, and its strategic location close to major sea routes and international telecommunication lines. Financial services, the leisure sector, port services, and information and telecommunication display ample space to



## Box 2

## A Regional Comparison of the Interest Spread and the Interest Margin in the Commercial Banking Sector

The interest spread and the interest margin reflect the efficiency of financial intermediaries in an economy. The interest spread is defined as the difference between the average yield of interest earning assets and the average cost of interest bearing liabilities<sup>1</sup>. The interest margin is defined as the ratio of net interest income to banks' average assets<sup>2</sup>.

Several factors determine the interest spread and the interest margin. First, non-performing loans (NPLs) reduce the effective interest income of banks since banks have to make provisions out of interest income to cover losses due to NPLs. Second, banks have to cover administration and other operational costs. Third, in some countries, banks are required to maintain statutory reserves (i.e. statutory reserve requirement - SRR), as a part of monetary policy action with no remuneration thereon. Fourth, banks maintain cash balances to meet deposit withdrawals, which also do not earn any interest income. Fifth, structural limitations hinder competitiveness in the financial sector. Finally, macroeconomic factors such as legal and other procedural bottlenecks, and uncertainty in relation to the macroeconomic environment could add an extra premium to the cost of intermediation.

Tables 1 and 2 summarise the interest spread and the interest margin in Sri Lanka and neighbouring countries. The interest spread allows to identify the effects of NPLs, cash at hand of commercial banks and SRR, while the interest margin, allows to identify the effect of operational costs of banks.

Table 1  
Interest Spread in Selected South Asian Countries \*

Item	Per cent			
	India	Pakistan	Bangladesh	Sri Lanka
Interest Spread	2.6	2.2	1.6	4.7
Effect on Spread due to NPLs	0.3	0.4	1.2	1.1
Effect on Spread due to SRR	0.4	0.2	0.4	0.6
Effect on Spread due to Cash in Hand	0.1	0.5	0.1	0.4

\* Based on data for 2003

Table 2  
Interest Margin in Selected South Asian Countries\*

Item	Per cent of average assets			
	India	Pakistan	Bangladesh	Sri Lanka
1. Interest Income	7.3	4.6	6.4	8.5
2. Interest Expenses	4.4	1.6	4.5	4.4
3. Interest Margin (1-2)	2.9	3.0	1.9	4.1
4. Non Interest Income	2.0	2.1	1.6	2.7
5. Non Interest Expenses	2.2	2.5	1.8	4.2
5.1 Staff Cost	1.3	1.3	n.a.	1.9
5.2 Others	0.9	1.2	n.a.	2.3

\* Based on data for 2003

Both the interest spread and the interest margin show that the intermediation cost is higher in Sri Lanka than in neighbouring South Asian countries, mostly due to high operational costs in the domestic banking system. High interest margins in a banking system are indicative of deep rooted symptoms of inefficiency, absence of competition, non-diversification of income sources, skewed development of money and capital markets in favour of bank lending and inflexibility of rate adjustments symmetrically in response to market rate changes. Hence, to create public awareness of the issue and promote competition, the Central Bank commenced publishing lending and deposit rates of banks as well as fees and commissions charged by banks. In addition, banks were asked to display lending rates and deposit rates at their places of businesses so that the public could negotiate the best terms with banks.

The resolution of NPLs is affected by lengthy and cumbersome legal procedures, which also involve high costs. In this regard, the enactment of the necessary legal reforms and the implementation of a more effective institutional framework, perhaps with the setting up of asset management companies as done in several countries, would be useful. Promoting and developing the bond market is also important in bringing down the intermediation cost, as the bond market would exert pressure on banks to reduce their lending rates. Further, it is important that lending rates be based on the viability of the projects and proper assessments of the collateral offered, which will help reduce the intermediation cost.

$$\begin{aligned}
 1 \text{ Interest Spread (\%)} &= \frac{\text{Interest Income}}{\text{Average of (Interest bearing Assets + NPLs + Statutory Reserves with Central Bank + Cash in Hand)}} (\%) - \frac{\text{Interest Expenses}}{\text{Average Deposits and Borrowing}} (\%) \\
 2 \text{ Interest Margin (\%)} &= \frac{\text{Interest Income} - \text{Interest Expenses}}{\text{Average Assets}} (\%)
 \end{aligned}$$



grow. It is also necessary to re-emphasise that the Agriculture and Manufacturing sectors should raise their contribution to the economy. Growth in all these sectors needs to be promoted with enhanced productivity, technology adaptation and further deregulation, thereby developing a productivity conscious culture in Sri Lanka. To promote public-private partnership in policy formulation and implementation and to coordinate the government's efforts in developing growth initiatives needed for economic development, the government set up the National Council for Economic Development (NCED) in 2004.<sup>2</sup>

- With respect to the post tsunami disaster recovery efforts, it is encouraging to note that the government is engaged in developing disaster management policies and strategies, and a national rebuilding programme through its operational arms of Task Force for Rebuilding the Nation (TAFREN) and Task Force for Relief (TAFOR). The government is also actively engaged in consolidating the peace process, maintaining law and order, and improving governance. International organisations have already applauded Sri Lanka for its good governance and low levels of red tape and corruption compared to other countries in the region.<sup>3</sup>
- To further consolidate its achievements and propel the economy on to a higher growth path, the government has to increase the provision of public goods and services in the most efficient and equitable manner, while making room and providing a conducive environment for the private sector to unleash its creative energy. Since this process has already begun, the private sector too needs to take its own initiatives to support the growth process by taking steps to expand the production frontier through increasing productivity, continuously engaging in research and development, and facing challenges of globalisation while reaping benefits from it. Such a dynamic private sector will drive the economy forward, creating employment, reducing poverty and promoting corporate social responsibility for sustained economic development of the country.

## 1.2 External Economic Environment

- The external economic environment plays a key role in shaping Sri Lanka's socio-economic conditions. Being a small open economy with a heavy involvement in external

<sup>2</sup> NCED operates with 25 clusters to look into issues in each of the areas of Economic Policy, Financial Sector, Capital Markets, Trade and Tariff, Telecom, Transport, Tourism, Small and Medium Scale Enterprise Development, Apparel, Cost of Living, Agriculture, Livestock, Education, Donor Coordination and North and East Development, Investment Promotion, Employment Creation, Skills Development and Labour Relations, Plantation, Health, Export, Public Sector, Construction, Millennium Development Goals, Rural Development and Poverty Alleviation, Taxation and Legal.

<sup>3</sup> World Bank and Asian Development Bank, 'Sri Lanka: Improving the Rural and Urban Investment Climate', Colombo, 2005.

Table 1.1  
Global Economic Developments and Outlook  
(Annual Percentage Change Unless Otherwise Indicated)

	Actual		Projected	
	2003	2004	2005	2006
<b>World Output</b>	4.0	5.1	4.3	4.4
Advanced Economies	2.0	3.4	2.6	3.0
United States	3.0	4.4	3.6	3.6
Euro Area	0.5	2.0	1.6	2.3
United Kingdom	2.2	3.1	2.6	2.6
Japan	1.4	2.6	0.8	1.9
Developing Countries	6.4	7.2	6.3	6.0
Developing Asia	8.1	8.2	7.4	7.1
China	9.3	9.5	8.5	8.0
India	7.5	7.3	6.7	6.4
<b>World Trade Volume (Goods and Services)</b>	4.9	9.9	7.4	7.6
Imports				
Advanced Economies	3.6	8.5	6.5	6.3
Developing Economies	8.9	15.5	12.0	11.0
Exports				
Advanced Economies	2.8	8.1	5.9	6.8
Developing Economies	10.7	13.8	9.9	9.7
<b>Price Movements</b>				
Consumer Prices				
Advanced Economies	1.8	2.0	2.0	1.9
Developing Economies	6.0	5.7	5.5	4.6
Commodity Prices				
Oil	15.8	30.7	23.2	-5.9
Non-fuel	7.1	18.8	3.8	-5.1
<b>Six Months London Inter-bank Offered Rate (Per cent)</b>				
On US Dollar Deposits	1.2	1.8	3.3	4.1

Source: World Economic Outlook (April 2005), IMF

trade, a conducive external economic environment has a significant influence in improving Sri Lanka's wealth creation, living conditions, employment generation, and its ability to move along a sustainable long-term growth path. Hence, Sri Lanka is not insulated from economic prosperities and depressions in the rest of the world.

- The global economy in 2004 was marked by a widespread growth of 5.1 per cent, the fastest global economic growth recorded in the past few decades, despite the daunting surge in international oil prices. The main contributor to global recovery was the United States of America (USA), which grew at an estimated high growth of 4.4 per cent in 2004 due to the robust personal consumption expenditure and the continued positive investment expenditure. Japan's economy too recorded a strong performance in 2004 following several years of economic stagnation. In contrast, the Euro area grew at a lacklustre pace owing to subdued domestic demand and the appreciation of its currency, the euro, stunting the external demand. The oil price shock that hit the global economy in 2004 was very high in nominal terms, but not so severe in real terms, when compared with the severity of the oil price shock of the 1970s.

- **The growth in emerging market and transition economies has been widespread, largely benefiting from the improved economic performance in industrial economies as well as increases in commodity prices.** The emerging market economies in Asia continued to lead the growth with the two largest emerging economies, China and India, growing at 9.5 per cent and 7.3 per cent, respectively, in 2004. The transition economies of Europe, including Russia, Ukraine and new members of the European Union (EU) have improved their economic performance in 2004. Several countries in Africa and the Middle East have benefited from higher oil and commodity prices.
- **Accompanied by higher global economic growth, world trade grew by 9.9 per cent in 2004,** recording the highest rate of growth since 2000 and expanding opportunities for efficient and dynamic export oriented countries.
- **Dispelling the fear of continuing deflation, the historically low levels of global inflation that prevailed in 2003 bottomed out in 2004,** stimulated mainly by fiscal and monetary policies, the rising global demand and the surging oil prices. But, the policy overreaction has generated high inflationary expectations in most industrial countries, thereby bringing the earlier policy stimulus to an end, with resultant gradual increases in international interest rates.
- **The international financial market developments have been orderly and market adjustments have not posed a threat to financial system stability or the health of financial institutions.** However, on a negative note, the net capital inflows to emerging market economies have been estimated to decrease in 2004, worsening their BOP position.
- **The US dollar continued to depreciate against most major currencies during 2004,** albeit at a slower pace than the two previous years. The continuation of a large deficit in the US current account caused the weakening of the US dollar. However, the impact of this imbalance on the depreciation of the US dollar was partly offset by the rising US interest rates, which led the Asian economies with BOP surpluses to invest a large part of their official reserve accumulation in US government securities.
- **Currencies of most emerging market economies with flexible exchange rates appreciated against the US dollar,** while China, Malaysia and Hong Kong maintained the fixed parity against the US dollar. This indicated the need for exerting international pressure for greater flexibility in exchange rate management in the region, particularly on the countries that have been following fixed exchange rate regimes. Similarly, a closer macroeconomic policy coordination among the major industrial countries is necessary, as sharp fluctuations in the cross rates among

major currencies create difficulties in the macroeconomic management of developing countries.

- **The prospects for global economic growth in 2005 appear to be still favourable,** although the global economic growth has been projected to be lower at around 4.3 per cent. The growth in the volume of world trade is projected to decline to 7.4 per cent in 2005 from 9.9 per cent in 2004 reflecting the slower global economic growth. The terms of trade is expected to worsen for oil importing countries as oil prices have been projected to increase at a faster rate than other commodity prices. The continuation of significantly large twin deficits in the USA, fiscal deficit (estimated at 4.4 per cent of GDP in 2005) and external current account deficit (estimated at 5.8 per cent of GDP in 2005), has posed downside risks to the expected high growth in the USA and the global economy. The impact on Sri Lanka of any slowdown in the US economy would largely come through a lowering of exports, as the USA is Sri Lanka's largest export market.

### 1.3 Macroeconomic Performance and Policies in 2004

#### Economic Growth, National Income and Income Distribution

- **In 2004, GDP in real terms grew by 5.4 per cent demonstrating resilience in a challenging environment, marked by geo-political imbalances, adverse oil price shocks, drought, and political uncertainty.** Although this growth is lower than the growth of 6.0 per cent recorded in 2003, it has exceeded the annual growth trend of around 5 per cent maintained during the past few years. The deceleration in growth in 2004 was mainly the outcome of the poor performance in agriculture, due to the adverse weather conditions that affected plantation agriculture in certain areas as well as paddy production in both Maha and Yala cultivation seasons, and the reduction in hydropower generation. The rise in international prices of intermediate and investment goods, particularly of petroleum, has also had a negative impact on the cost of production in all three sectors, agriculture, industry and services.
- **GDP at current market prices was estimated at Rs. 2,029 billion in 2004, recording an increase of 15.2 per cent.** This is the outcome of a 5.4 per cent real economic growth and increase in the price level (GDP deflator) of 9.2 per cent. The GDP per capita at current market prices for 2004 increased by 14.1 per cent to Rs. 104,347 in 2004. In US dollar terms, per capita GDP increased by 8.8 per cent, from US dollars 948 to 1,031, surpassing US dollars 1,000 for the first time.



Table 1.2  
Gross National Product at Constant (1996) Prices

Item	Value (Rs. million)		Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2003 (a)	2004 (b)	2003 (a)	2004 (b)	2003 (a)	2004 (b)	2003 (a)	2004 (b)
<b>Agriculture Sector</b>	<b>176,450</b>	<b>175,182</b>	<b>19.0</b>	<b>17.9</b>	<b>1.6</b>	<b>-0.7</b>	<b>5.4</b>	<b>-2.5</b>
Agriculture	137,150	135,297	14.7	13.8	3.2	-1.4	8.0	-3.7
Forestry	16,887	17,107	1.8	1.7	1.4	1.3	0.4	0.4
Fishing	22,412	22,779	2.4	2.3	-6.9	1.6	-3.1	0.7
<b>Industry Sector</b>	<b>248,417</b>	<b>259,256</b>	<b>28.5</b>	<b>26.5</b>	<b>5.5</b>	<b>5.2</b>	<b>24.3</b>	<b>25.7</b>
Mining and Quarrying	15,699	16,946	1.7	1.7	5.7	7.9	1.6	2.5
Manufacturing	151,951	159,696	16.3	16.3	4.2	5.1	11.5	15.5
Construction	64,115	68,332	6.9	7.0	5.5	6.6	6.3	8.5
Electricity, Gas and Water	14,651	14,282	1.6	1.5	21.6	-2.5	4.9	-0.7
<b>Services Sector</b>	<b>507,191</b>	<b>545,487</b>	<b>54.5</b>	<b>55.7</b>	<b>7.9</b>	<b>7.6</b>	<b>70.3</b>	<b>76.8</b>
Transport, Storage and Communication	125,638	142,679	13.6	14.6	10.6	13.7	22.7	34.4
Wholesale and Retail Trade and Hotels and Restaurants	206,507	218,924	22.2	22.3	7.8	6.0	28.4	24.8
Financial Services, Real Estate and Business Services	108,578	114,717	11.7	11.7	8.8	5.7	16.6	12.3
Public Administration, Other Government Services and Defence and Other Community, Social and Personal Services	66,568	69,166	7.2	7.1	2.1	3.9	2.6	5.2
<b>Gross Domestic Product (GDP)</b>	<b>930,057</b>	<b>979,925</b>	<b>100.0</b>	<b>100.0</b>	<b>8.0</b>	<b>5.4</b>	<b>100.0</b>	<b>100.0</b>
Net Factor Income from Abroad	-9,468	-11,300			-32.2	19.3		
<b>Gross National Product (GNP)</b>	<b>920,588</b>	<b>968,625</b>			<b>6.8</b>	<b>5.2</b>		

(a) Revised

(b) Provisional

Source: Central Bank of Sri Lanka

- The Gross National Product (GNP), defined as GDP adjusted for net factor income from abroad (NFIA), grew by 5.2 per cent in real terms, compared to a growth of 6.6 per cent in 2003. The NFIA remained negative as in the previous years, but decreased further by 19 per cent in 2004, compared to improvements shown in the past few years. This was mainly due to higher outflows on account of foreign debt service payments and repatriation of profits and dividends by foreigners in 2004.
- During the last five decades, Sri Lanka's economy grew by an annual average rate of 4.2 per cent and it could not elevate the country to a high growth path due to deep-rooted deficiencies in growth promoting factors. The development of economic infrastructure needed for faster growth has to be accelerated through continued policy, market, institutional and infrastructure reforms. Amidst agitation from some sectors of the public, social infrastructure reforms that could create a sufficiently high level of human capital are also being implemented, while raising public awareness on their benefits. Technology and research and development are thinly spread across several sectors. Many government organisations suffer from chronic inefficiency problems, in addition to displaying anti-growth symptoms such as adverse selection and moral hazard. In those organisations, ample room exists in further enhancing

governance and accountability. The markets that are needed for ensuring a better allocation of resources remain thin in many areas of economic activities, especially in the financial sector.

- The regional distribution of GDP shows that the Western Province has contributed 49 per cent of GDP in 2003. This larger share is understandable, since economic activities are normally concentrated around better social and economic infrastructure, and the Western Province offers such facilities. Sri Lanka does not have any internal trade and investment barriers, and therefore, the existing geographic inequalities are due to other constraints such as inadequate provision of public goods and poor infrastructure facilities, mainly roads, electricity, and telecommunication facilities. Hence, to remedy the regional imbalances, it is necessary to supply the provinces with a wide range of supporting public goods and infrastructure facilities.
- Despite efforts by successive governments, the income distribution in Sri Lanka has remained relatively unchanged throughout post-independence history. As revealed by periodical consumer finance surveys conducted by the Central Bank, the Gini Coefficient depicting the degree of equality or inequality in income distribution has remained in a narrow range around 0.5 since 1953. The reason for the visible non-improvement in income

distribution has been the low economic growth attained by Sri Lanka during this period. As a result, new job creations have been low, thereby stunting the ability of the poor to cross the poverty line through the normal development process. The poorly targeted pro-poor policies too have not contributed to alleviate this problem. Hence, it is of utmost importance to continue to adopt a pro-poor pro-growth policy both to raise growth and to increase efficiency in targeting.

## Production and Sectoral Performance

### Agriculture

- **The Agriculture sector, which grew moderately in 2003, declined in 2004 due to a drop in paddy and coconut production.** The prolonged drought, resulting from the failure of the Northeast monsoon and the delay in the onset of the Southwest monsoon in 2004, was the main contributor to this decline. However, the production of other subsidiary food crops and vegetables improved, as farmers shifted from paddy to these crops to make maximum use of the available water. Tea production recovered partly from the flood damage in May 2003. Rubber production increased further, responding to attractive international market prices. Coconut output, which grew by 7 per cent in 2003, dropped marginally in 2004. Sugar production continued to increase with the active participation of the private sector. The livestock sector displayed a mixed performance, while the fisheries sector reported a marginal improvement.
- **The share of agriculture in GDP in 2004 was 17.9 per cent.** This share, though relatively lower than the contribution by the other two sectors, is significant when compared with the share of agriculture of other countries. In developed countries, this share is as low as 1-2 per cent, and in rapidly developing countries, it is around 10 per cent.
- **Over the years, the share of agriculture in GDP has declined internationally.** The declining share is due to several inherent drawbacks that limit agricultural growth and development. Major drawbacks are the income-inelastic nature of demand for agricultural products, fragmented and limited extent of land inhibiting the realisation of economies of scale, migration of labour to other human capital intensive sectors, and the difficulty in competing for factors of production with the Industry and Services sectors. In view of these, some countries with limited land area, such as Singapore have opted out of traditional agriculture, and others such as the USA, Japan and the EU provide substantial subsidies and protection to their Agriculture sectors, while promoting value added agriculture through research.
- **The key to raising agricultural productivity is the introduction of high yielding varieties, improved**

irrigation and water management practices, the use of new technology such as drip irrigation and poly tunnels, the adoption of research and technological developments and advanced crop practices through international partnerships, and the efficient use of inputs, such as fertiliser, pesticides and water. Sri Lanka has attempted to address these issues in the past through government led research and development programmes. While such research and development programmes have created a number of innovations, they have not kept pace with global developments, presumably due to the desire to conduct fundamental research, rather than adopting more pragmatic ways of adaptation and replication. Fundamental research takes a longer time to yield the desired results, the sector's issues are so acute that it cannot wait that long. The most urgent strategy should therefore, be to adopt the already developed advanced technology, high yielding crop varieties and more efficient agricultural practices at the field levels. For this purpose, mutually beneficial partnerships should be promoted between the local private enterprises and their counterparts in neighbouring countries.

- **Another requirement for the development of the Agriculture sector is to have a market oriented, consistent and well-specified trade policy in place.** The trade policy on certain agricultural commodities, especially import tariff, was revised in several instances in 2004 with the two competing objectives of reducing the cost of living and enhancing farmer incomes. Such ad-hoc policy changes harm the long-term sustainability of the Agricultural sector through their price-distortionary effects.

### Industry

- **Industry sector registered a growth of 5.2 per cent in 2004.** All sub sectors in the Industry sector, except the electricity and water sub-sectors, contributed to its high performance.
- **Factory industry, the largest sub sector in the Manufacturing sector, expanded by 6.1 per cent in 2004.** This sub sector contributed 59 per cent to the overall growth in industry in 2004. The growth was moderate in the first half, but picked up strongly in the second half of the year. As was the trend in the past, private sector industries accounted for an overwhelmingly high share of the output in the factory industry sector, which stood at 96 per cent in 2004.
- **The major contribution to the growth in factory industry in 2004 (over 90 per cent) arose from four of the nine major industrial categories, viz., textile, apparel and leather products; food, beverages and tobacco products; chemical, petroleum, rubber and plastic products; and non-metallic products.** Both export and domestic market oriented



## Box 3

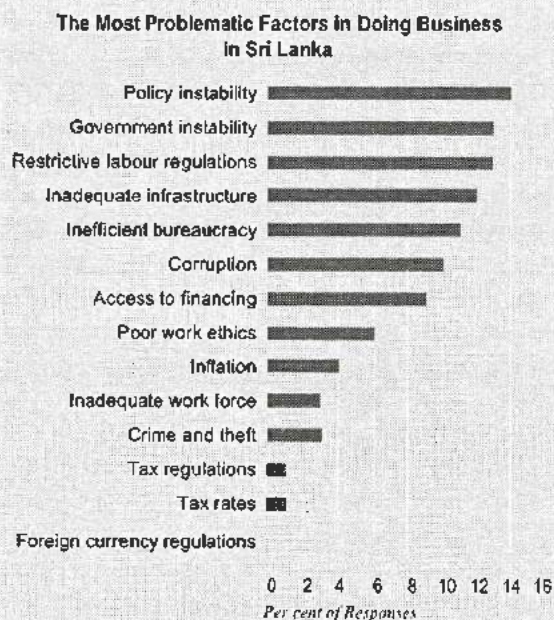
## Promoting Competitiveness in Sri Lanka

The competitiveness of a country is defined as its ability to achieve superiority or supremacy through managing its assets, people and processes. The prosperity of a nation and the living standards of its people are strongly affected by its competitiveness. Competitiveness is relative. It is also changeable. It depends on government policies and the business environment, which determine the ability to act and react within the competitive environment, the potential of people in implementing the necessary strategic changes and the sophistication of enterprises. Competitiveness can only be sustained if these factors continue to be present in an economy.

Competitiveness is generated by the decision making processes of enterprises at the micro level, operating in every sector of the economy. The policies aimed at promoting competitiveness should focus on minimising systemic risks and providing a sound business environment in which enterprises can choose from a vast range of options to improve their competitiveness. The enterprises will judge what is best for them and ultimately determine the competitive outcome.

The experiences of highly competitive countries in the world have shown that expanding a country's market share through providing subsidies or holding down wages does not increase its competitiveness on a sustainable basis. Subsidies have proved to be ineffective in enhancing competitiveness, as they provide only a temporary shelter for industries. The resources used to support these could be employed more productively elsewhere. It has been further proved that imposing artificial price adjustments on targeted sectors or bringing down input prices artificially too does not actually help a country to raise competitiveness. Sustainable competitiveness is created only through improvements in productivity. Higher productivity allows a country to support high wages, a strong currency and an attractive return on capital and, with them, high standards of living for people. Therefore, the role of the government should be to provide a sound macroeconomic and institutional framework, leaving enterprises to take business decisions towards the improvement of competitiveness across the economy.

In the current highly competitive market environment, several supply side factors such as a strong political will for continuing with free market policies, clear commercial,



Note: From a list of 14 factors, respondents were asked to select the five most problematic factors for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: Global Competitiveness Report 2004-2005, World Economic Forum

investment and exchange control laws, sufficient infrastructure facilities of a good quality, enforceable and fair regulatory procedures, a minimum and efficient bureaucracy, an independent and efficient judicial system, changing the mindset of the people, creating a level playing field and good governance are also required to create a culture that fosters competitiveness. The proper enforcement of law and order is also vital in creating a sound business environment in a country.

As indicated in the Global Competitiveness Report (GCR) 2004-2005 published by the World Economic Forum, the competitiveness ranking of Sri Lanka was 68 in 2004. Rankings of the countries in the region are Bangladesh - 95, India - 30, and Pakistan - 73. As noted in the World Bank and Asian Development study as well as in the GCR, Sri Lanka stood out as the highest in governance in the region. However, as indicated in the GCR, its problems lie in the areas of policy stability, government stability, labour regulations and infrastructure.



industries performed well in 2004. They benefited from the global economic recovery, increased domestic consumer demand, the low interest rate regime, continuation of the ceasefire, and improvements in basic industrial infrastructure facilities such as telecommunications, information technology, port services and the simplification of Customs procedures. The competitiveness in export-oriented industries was facilitated by the improvement in productivity and rationalisation of production costs.

- **The textile and apparel quota system, which was in place over the last two decades, came to an end on 01 January 2005.** However, its impact on industries in 2005 may not be significant. Since this was announced at least a decade ago, a gradual restructuring process has been taking place in Sri Lanka to face the competition driven trading system in a quota free world. The restructuring took place by way of product specialisation, acquisition and mergers, process improvements, technology developments, skills developments, forming strategic alliances, developing backward linkages and improving marketing capabilities. As a result, the industry was able to create a good image in the international markets for price, quality and speed of delivery. The sector will also benefit from concessions being negotiated with major trading partners.

#### Services

- **Over the years, the Services sector has generated impetus to economic growth in Sri Lanka, as experienced in many developed and developing countries. In 2004, the Services sector grew by 7.6 per cent contributing 77 per cent to the economic growth.** The sector covers a broad spectrum of services, with major contributors to overall growth being Wholesale and retail trade, hotels and restaurants (25 per cent), Transport, storage and communication (34 per cent), and Financial, real estate and business services (12 per cent).
- **In the wholesale and retail trade sub sector, trade relating to both exports and imports grew significantly in 2004, adding value to the Services sector.** Export trade grew by 7.7 per cent and import trade grew by 9 per cent. The domestic trade sub sector grew by a modest 1.7 per cent in 2004 reflecting the overall decline in the production of agricultural goods. The hotels and restaurants sub sector grew by 15.9 per cent in 2004 benefiting from the increase in tourist arrivals by 13.1 per cent to a record level of 566,202 arrivals.
- **The value addition in the Transport, storage and communication sector grew by 13.7 per cent in 2004.** The growth was driven by the noteworthy performance in the telecommunications and cargo handling sub-sectors. The telecommunications sub-sector, which has continued to grow at a high pace, expanded further by 31 per cent in 2004. The

port services recorded a healthy growth of 12.3 per cent in 2004 indicating the expansion in sea cargo handling activities. The transport sub sector, one of the largest services sectors in the economy, grew by 4.2 per cent.

- **The Financial services, real estate and business services sector grew by 5.7 per cent in 2004 as against 8.8 per cent in the year 2003.** The deceleration was mainly due to slower growth of the banking sub-sector after the high growth recorded last year. Although the credit growth in the banking sector was as high as 20 per cent, in response to low interest rates, the growth of net interest income earned from core banking activities was low compared to last year. Further, non-interest income had also fallen sharply due to the decline in gains from trading in securities. The insurance, leasing and non-bank financial institutions sub-sectors outperformed the banking sub sector.

#### Consumption, Savings and Investment

- **The Gross Domestic Expenditure (GDE) increased by 18.4 per cent in 2004.** In national income accounting, the GDP of Rs.2,029 billion is represented on the expenditure side by total domestic demand plus net external demand which is measured in terms of net export of goods and non-factor services. The total domestic demand, which is also GDE is composed of domestic consumption and gross domestic capital formation, or investment. In 2004, GDE increased by 18.4 per cent to Rs.2,214 billion, and net external demand is estimated at a negative Rs.185 billion.
- **Consumption expenditure at current market prices was estimated at Rs.1,707 billion, an increase of 15.2 per cent over 2003.** This reflects an increase of 9.8 per cent in the average price level and an increase of 4.9 per cent in real consumption, which is lower than the growth in GDP in real terms. The pent-up demand for consumption following the ceasefire has already been met during the first two years of the ceasefire. Of the total consumption, private consumption as a per cent of GDP declined marginally from 76.2 per cent in 2003 to 76 per cent in 2004, while government consumption increased to 8.1 per cent in 2004 from 7.9 per cent in 2003. The higher import tariffs imposed on non-essential consumer items during the latter part of the year may have contributed to the slowdown in private consumption.
- **In 2004, the environment for investment was conducive, encouraged by low interest rates and the continuation of the ceasefire.** The investment expenditure (gross domestic capital formation) at current market prices was estimated at Rs.507 billion, an increase of 30.5 per cent over 2003. However, in real terms, the investment expenditure grew only by 11.7 per cent, indicating that the inflationary impact was much larger on the investment expenditure. The growth

Table 1.3  
Aggregate Demand and Savings-Investment Gap: 2003 and 2004

Item	Rs. billion		Per cent of GDP	
	2003	2004 (a)	2003	2004 (a)
1. Domestic Demand	1,870.0	2,214.0	106.2	109.1
1.1 Consumption	1,481.2	1,706.8	84.1	84.1
Private	1,341.9	1,542.1	76.2	76.0
Public	139.3	164.7	7.9	8.1
1.2 Investment (Gross Domestic Capital Formation)	388.8	507.2	22.1	25.0
Private	295.1	402.6	18.8	19.8
Public	93.7	104.6	5.3	5.2
2. Net External Demand	-108.8	-184.6	-8.2	-9.1
Export of Goods and Non-factor Services	632.9	738.7	35.9	36.4
Import of Goods and Non-factor Services	741.7	923.3	42.1	45.5
3. Total demand (GDP) (1)+(2)	1,761.2	2,029.4	100.0	100.0
4. Domestic Savings (3)-(1.1)	280.0	322.6	15.9	15.9
Private	338.2	400.8	19.2	19.8
Public	-58.2	-78.2	-3.3	-3.9
5. Net Factor Income from Abroad	-16.5	-20.7	-0.9	-1.0
6. Net Private Current Transfers from Abroad	116.3	136.6	6.6	6.7
7. National Savings (4)+(5)+(6)	379.7	438.6	21.6	21.6
8. Savings Investment Gap				
Domestic Savings - Investment (4)-(1.2)	-108.8	-184.6	-6.2	-9.1
National Savings - Investment (6)-(1.2)	-9.0	-68.6	-0.5	-3.4
9. External Current Account Deficit without Official Grants (2)+(5)+(6)	-9.0	-68.6	-0.5	-3.4

(a) Provisional

Source: Central Bank of Sri Lanka

in real investment is an indication of the continuation of improving investor confidence since the latter part of 2003. The investment/GDP ratio improved significantly to 25 per cent from 22.1 per cent in 2003, although the level of gross investment was still below the desirable levels required to achieve a sustainable high economic growth.

- Domestic savings, which include both private and government savings, were estimated at Rs.323 billion, an increase of 15.2 per cent over the previous year. This increase was solely due to the improvement in private savings by 18.5 per cent. The impetus for the growth of private sector savings was provided by the increased corporate sector savings, in the context of higher profitability and better performance. Public sector dis-savings, which improved during the previous two years, deteriorated in 2004, reflecting the increase in the government's recurrent expenditure. The increase in private sector savings was sufficient to offset the increase in public sector dis-savings and the total domestic savings ratio (domestic savings/GDP), which was 15.9 per cent in 2003, remained at the same level in 2004.
- The national savings estimated as the sum of domestic savings, net foreign private transfers and NFIA increased by 15.5 per cent to Rs. 439 billion. The national savings ratio (national savings/GDP) at 21.6 per cent also remained at the same level as in 2003. NFIA remained negative, and deteriorated further with the increase in interest payments on

external debt due to higher global interest rates. Net private transfers, which consists of worker remittances, improved at a higher rate, mitigating the negative impact of the NFIA.

- Consequently, the savings-investment gap increased to Rs.69 billion (3.4 per cent of GDP) in 2004 from around Rs.8 billion (0.5 per cent GDP) in 2003. This gap is reflected as the current account deficit of the BOP. Since foreign savings by way of net capital inflows were not sufficient to finance the wider savings-investment deficit in 2004, the country had to utilise its official reserves to fill the gap.

### Economic and Social Infrastructure

- A well developed infrastructure system generates a series of tradable services and supports continuous economic growth required for poverty alleviation. Failure to provide adequate infrastructure developments diverts the domestic demand for better services available abroad.
- The overall poor quality of economic and social infrastructure is manifested in several weaknesses. Sri Lanka's international competitiveness ranking is low, undermining its strategic advantages of proximity major sea routes, being an island nation and the prevailing high literacy rates, and liberal economic policies. Many essential services, such as healthcare and education, are being purchased abroad by Sri Lankans on an increasing scale, although they could have been developed as significant foreign exchange earners for the country. Natural resources

## Box 4

## Implications of Oil Price Shocks

International oil prices started to increase sharply in 2004 and reached historically high levels in early 2005. The price of Brent crude oil increased to US dollars 56 per barrel in March 2005, compared to the previous highest price of US dollars 52 per barrel in October 2004. The average crude oil import price of the Ceylon Petroleum Corporation (CPC) increased by 31 per cent to US dollars 38 per barrel in 2004 compared to US dollars 29 per barrel in 2003. This escalation of petroleum prices was due to several reasons. The global demand for oil grew at its fastest pace in 16 years with significantly higher demand from China, India, United States and Japan. China's oil consumption alone increased by 20 per cent in 2004. Political tensions in the Middle East, Venezuela and Nigeria coupled with adverse weather conditions caused supply disruptions. Further, the thin excess capacity, just about 1 per cent above the world's daily consumption of 82 million barrels, and the financial crisis that hit the Russian oil company, Yukos, which was the largest non-OPEC oil producer, also contributed to the oil price hike. Petroleum importing countries around the world, both developing and developed, are facing the challenge of handling these unexpected and unprecedented increases in petroleum prices, which are likely to continue in 2005 as well.

Sri Lanka imported around 30 million barrels of petroleum products in 2004. Of this, about 50 per cent was in crude form and the balance comprised various types of refined products, dominated by auto-diesel. Annual consumption of major petroleum products, i.e., petrol, kerosene and auto-diesel amounted to 2.6 billion litres. The transportation sector is the leading petroleum consumer followed by the power, industrial and household sectors. The demand for petroleum consumption in the transport sector has shown steady growth with the increasing number of vehicle registrations. Similarly, the use of petroleum products in power generation has also been rapidly increasing due to the increased use of thermal power, in the absence of alternative energy sources and the non-implementation of planned coal power and hydropower projects.

The economic impact of the oil price hike on oil importing developing countries such as Sri Lanka will largely depend on the resilience of the economy to external shocks and policy responses to mitigate the impact. The magnitude of the impact will also depend on the energy intensity of the economy and the availability of alternative energy sources such as natural gas, coal power, hydropower, etc. An oil price hike could lead to severe external and internal imbalances unless appropriate

corrective measures are taken. On the external front, sudden increases in oil prices will widen the trade balance, leading to a worsening of the overall balance of payments (BOP) and a loss of the country's foreign reserves and, exerting pressure on the exchange rate. The domestic imbalance will depend on whether a full pass-through of the high oil prices is allowed. A full pass-through will result in 'a one-off' inflation, but the absorption of high oil prices by the government through the payment of subsidies will lead to compounded economic issues such as the widening of the budget deficit, rising public debt and interest rates, crowding out private investment, widening inequality and long-term inflation.

High international oil prices would lead to serious macroeconomic imbalances through the deterioration of the BOP of the country unless early and timely corrective measures are taken. The total expenditure on petroleum imports in 2004 increased by US dollars 372 million (by 44 per cent) to US dollars 1,211 million, significantly contributing to the widening of the trade deficit and the deficit in the overall BOP. The worsening trade balance would also exert an adverse impact on the exchange rate and external reserves.

As per the pricing formula introduced in January 2002, the domestic prices of major petroleum products are expected to be revised monthly. However, the domestic prices have not been adjusted fully in terms of the pricing formula since January 2004. This resulted in heavy losses to petroleum companies requiring the government to provide subsidies. A subsidy of one rupee on a litre of petrol, diesel and kerosene amounts to a subsidy of Rs.2.6 billion per annum. The total subsidy commitments by the government to petroleum companies amounted to Rs.18 billion or about 0.9 per cent of the GDP in 2004.

To finance a large fuel subsidy, the government needs to increase taxes, or reduce its expenditure elsewhere, or borrow. If taxes are increased, everyone, both users of fuel and non-users are affected. However, because the taxation will usually be through indirect taxes, lower income groups will bear a greater burden of the tax than high-income groups. If the government has to reduce its expenditure elsewhere, then its ability to provide assistance to disadvantaged groups will be reduced or its ability to invest in infrastructure projects essential for long term economic development will be curtailed. If the government increases borrowing from the domestic market, this reduces the resources available for the private sector through crowding out or leads to inflation if borrowing is effected from the banking system. A rise in inflation due to increased



## Box 4 (Contd.)

government borrowings arising from the fuel subsidy would hurt the poor most as they will not have the ability to hedge against inflation. Such government borrowing will not only have an adverse impact on the well being of the current generation but also on the future generations. Further, a large part of the subsidy will go to the hands of the affluent, as they use higher amounts of subsidised fuel.

Increasing domestic prices on par with increases in international prices will reduce fuel consumption, especially by those who use fuel inefficiently. In the face of this global crisis, cautious use of fuel will help to reduce Sri Lanka's fuel imports and save foreign exchange. A 10 per cent reduction in oil consumption will save US dollars 150 million per year. This would enable the country to use the saved foreign exchange for other essential imports. For maximum effectiveness, the pass-through of the increased fuel prices should be allowed in other sub-sectors as well, such as passenger transportation and power generation,

in order to prevent the crisis from generating further crises in other sectors.

In addition to the implementation of the pricing formula to reflect international price changes in domestic fuel prices, there are several other supplementary measures that could minimise the adverse impact of high oil prices on the economy. For example, road congestion leads to large-scale wastage of fuel. Hence, developing appropriate systems to avoid road congestion should be a priority in city and highway designing and planning. Developing an efficient mass transport system will not only reduce the use of private vehicles thereby saving energy, but will also help protect the environment. Harnessing the best use of the existing railway system will help save energy used by private vehicles used for passenger and goods transportation. Further, developing coal power and other alternative energy sources could reduce pressure from petroleum imports for power generation.

such as water are being exploited in an unsustainable manner in the absence of proper pricing. Therefore, a renewed effort to develop the infrastructure is essential for the economy to grow in a sustainable manner.

- **In 2004, several enterprises supplying economic infrastructure were brought under the SEMA**, which was established to improve efficiency in those enterprises. The financial performance of CEB, SLR and CPC has seriously worsened. It could even threaten the macroeconomic stability given the strategic importance of the services they provide to the national economy.
- **The electricity sector suffered from twin shocks, the drought and the high petroleum prices in 2004, increasing the cost of power generation.** The unchanged prices led to the deterioration in the financial position of CEB, requiring greater budgetary support. The delay in implementing new power projects including the coal power plant, and the proposed reforms, and the continuation of high system losses compounded the issues in the electricity sector.
- **The petroleum sector suffered from a major international price shock in 2004, with a surge in international prices (Brent) by 35 per cent over 2003 adversely impacting on the Sri Lankan economy.** The delayed and inadequate adjustment of fuel prices undisturbed by the international price movements led to a continued increase in domestic consumption of fuel, losses incurred by the CPC and Lanka IOC (LIOC), consequential

subsidy payments by the government, and a deterioration in the BOP.

- **Sri Lanka enjoys a comparative advantage in international marine transportation, largely due to its strategic location, but, the competitiveness of the country depends largely on the efficiency of the port services and how well this network is linked with the internal transportation network.** Although the coverage of Sri Lanka's road network is satisfactory by international standards, the quality of roads is very poor. Major problems associated with road development in Sri Lanka are excessive delays in the implementation of planned road projects, and the inability to secure sufficient funds needed for new road projects and the maintenance of the existing road network.
- **Port services recorded a healthy growth in 2004, benefiting from the growth in international trade and productivity improvements.** However, port services continued to face challenges from regional competition. Further improvements to port efficiency and productivity and the timely completion of the proposed Colombo South Harbour project are needed to successfully face these challenges.
- **The road passenger transport sector continued to suffer from inadequate service, poor quality and low degree of passenger safety.** The state owned cluster bus companies (CBCs) were incurring huge losses leading to heavy

dependence on government assistance. The railway transportation system suffers from rigidities in pricing, management and labour, leading to poor quality of its services and heavy operational losses, thereby imposing a severe burden on the budget. To facilitate SLR to overcome its deficiencies within a corporate structure, it was converted to an Authority in 2003, but due to agitation by unions, the change was withdrawn in January 2005.

- **Benefited by the ceasefire, both domestic and international air travel increased during the last three years.** Vital reforms were brought into the civil aviation sector, leading to a greater degree of deregulation, and adopting bilateral liberalisation agreements to attract more international carriers and tourists to the country.
- **A sustainable water supply for both consumption and irrigation is a national priority.** Achieving sustainable use of water resources requires improved water management practices to prevent wastage and over exploitation. Two major factors threatening the long term sustainability of water resources in Sri Lanka are improper pricing and deficiencies in regulation. Pipe borne drinking water is subject to a price, with a cross subsidy segment, but other forms of water supply are not regulated to prevent over exploitation and environmental damages.
- **The public health sector suffered from several major setbacks in 2004,** mainly due to frequent labour disputes, the deteriorating quality of its services and an outbreak of Dengue Fever (DF) and Dengue Hemorrhagic Fever (DHF). These illustrate the continuing difficulties in maintaining the heavy public funding of the government health care programmes provided to all sections of the population without targeting. Proper targeting could save funds for improving preventive health care as private sector investors have no or minimal incentive in promoting preventive healthcare.
- **A continuously improving education system is a prerequisite for rapid growth and development.** The university education in Sri Lanka is the least developed as indicated by the large number of students who are unable to receive university education. Agitation within Sri Lanka has discouraged the government from deregulating the higher education sector, which is akin to regulating or restricting domestic production in favour of imports. However, it should be noted that at the time of Independence, Sri Lanka attracted students from many foreign countries due to its high quality university education, but the situation has changed significantly over the years. Sri Lankan students today proceed in large numbers to other countries including India and Nepal, for higher education due to inadequate availability of similar facilities in the country. The deregulation of the

university education has to be accompanied by a comprehensive scheme of accreditation, continuous monitoring and periodic evaluation to maintain the required standards.

- **Alternative means of supplying higher education need to be explored in considering of the serious deficiency in higher education opportunities in the country.** International studies show that the social rate of return on primary and secondary education is significantly higher than the private rate of return, justifying continuing the public investment in primary and secondary education. However, the private rate of return is higher in tertiary education, thus questioning the economic rationale behind Sri Lanka's continuous dependency on public investment for higher education.

### Prices, Wages and Employment

- **Inflation increased in 2004.** This was observed both in wholesale and retail price indices. The rising trend in prices was seen at the regional level as well, but price disparities among the regional centres narrowed due to improvements in distribution, flow of information and transport facilities.
- **Both supply and demand factors exerted pressure on inflation in 2004.** Among the supply factors, the prolonged drought in certain areas of the country and increased international prices of key commodities, specially petroleum, were prominent. These were exacerbated by the depreciation of the rupee against major international currencies, and the upward revision of the Value Added Tax (VAT) on imports. The expansion of the money supply at a high rate of around 20 per cent in 2004 compared to around 15 per cent in the previous year, added pressure on prices from the demand side. A higher budget deficit partly financed through banking sources, and an accelerated expansion in credit to the private sector also contributed to the pressure on prices.
- **Nominal wages in the public sector, which had remained unchanged in 2003, increased at both the beginning and the end of the year.** An average wage increase in the public sector was seen at the beginning of the year both in nominal and real terms. In contrast to public sector wage developments, some employee categories in the organised private sector faced reductions in real minimum wages, while nominal wages in the unorganised private sector generally kept abreast with inflation.
- **A new compensation formula applicable to termination of employment was introduced in March 2005.** In 2004, following the representations made by trade unions, the Ministry of Labour Relations and Foreign Employment

(MLRFE), through a cabinet decision on 26 May 2004, suspended the implementation of the amended Termination of Employment of Workmen Act (TEWA), which was subsequently implemented using a new compensation formula gazetted in March 2005.

- **Population growth slowed down marginally from 1.3 per cent in 2003 to 1.1 per cent in 2004.** Areas which were previously affected by the security situation registered relatively higher growth in population which has resulted in district-wise differences in growth rates.
- **The employment rate increased marginally with the expansion of economic activity, particularly in the Services sector, in 2004. However, the labour force participation rate had declined with the inclusion of the Northern Province, where the participation rate was relatively low.** The employment rate was also supported by the expansion in public sector employment opportunities under the policy of the new government and its drive to recruit graduates to the public sector. However, unemployment, recording a marginal rise during the year, remained an area of concern, particularly among the educated youth.
- **The impact of the tsunami disaster on prices, wages and employment will be seen particularly in the fisheries sector in 2005.** Fish prices did not rise immediately due to a temporary reduction in demand, but have risen since then with the increasing demand. The supply shortage is expected to continue until the required infrastructure is in place. Meanwhile, prices of other protein substitutes have already risen. Trading activities in the affected areas have also been disrupted. Marketing and distribution in coastal areas will take a while to recover, so that prices and wages in those economic sectors will also remain affected for sometime. The rehabilitation and reconstruction activities could also exert pressure on input prices, including wages of skilled labour, unless due consideration is given to the limitations of resource availability.

### International Trade and the Balance of Payments

- **External trade expanded considerably with an increase in both exports and imports.** Building on the recovery in 2003, the external sector in 2004 benefited from the highest global economic growth recorded in the past few decades, and demonstrated a higher growth in trade, but faced a number of challenges resulting from several internal and external shocks.
- **Exports in US dollar terms grew by 12.2 per cent in 2004 outperforming the 9.2 per cent growth in 2003, and recording the highest annual growth since 2000.** Export earnings increased as a composite outcome of the volume growth of 7.8 per cent and the unit price increase of 4 per cent, to US dollars 5,757 million. Industrial exports preponderate in export earnings with a high share of 78 per cent, while agricultural exports account for only 19 per cent. Hence, the contribution to the growth in exports in 2004 was mostly from the industrial sector, which contributed 85 per cent, while the balance came from agricultural and mineral exports. The growth of industrial exports by 13 per cent was led predominantly by the strong performance attained by textiles and garments, machinery and equipment, and rubber based products. This was supported by increased market access that was afforded to the sector through trade negotiations. The apparel industry was able to minimise the potential risks arising from the heavy concentration in the US market by expanding the market share in the EU. Garment exports to the EU market benefited from the special incentive arrangement with the EU under the Generalised System of Preferences (GSP) scheme since February 2004.
- **Imports grew by 19.9 per cent to US dollars 8,000 million, compared with 9.3 per cent growth in 2003, as a combined effect of increases in both volume (9 per cent) and prices (9.7 per cent).** The higher growth in imports reflects the impact of the economic expansion, the prolonged drought, the escalation of oil prices and the low interest rate regime. The economic expansion increased the imports of investment and intermediate goods, while the drought conditions led to an escalation of the import of food items, and petroleum products. Following the long-term trend, the share of consumer goods imports continued to shrink in 2004 to 20 per cent, while the share of intermediate and investment goods imports increased to 58 and 21 per cent, respectively. The sharp rise in the share of intermediate goods was partly due to the historically high international oil prices.
- **The terms of trade recorded a deterioration of 5.2 per cent in 2004.** This was led by the increase in import prices of both intermediate and investment goods, especially, petroleum, fertiliser, wheat, transport equipment and machinery and equipment. Although export prices of tea, rubber, other agricultural exports and industrial exports increased, it was not sufficient to improve the terms of trade.
- **The trade deficit widened to US dollars 2,243 million, which was partly financed by net earnings in the services account and remittances, thereby containing the impact of the widened deficits in the trade and income accounts on the current account.** The higher global economic growth and the peaceful domestic environment helped tourist earnings to continue their growth momentum, which contributed to a surplus in the services account. Worker remittances grew at a healthy rate of above 11 per cent in 2004, retaining their position as the largest net inflow to the country. The deficit in the income account widened by 19 per



cent to US dollars 204 million largely due to higher global interest rates, which increased outflows more than the increase in income from investment. However, the surpluses in the services and transfer accounts were not sufficient to fully offset the widened deficits in the trade and income accounts, thus worsening the current account balance to US dollars 648 million (3.3 per cent of GDP) from US dollars 71 million (0.4 per cent of GDP) in 2003.

- **The overall position of the external sector was further aggravated by the lower net inflows to the capital and financial account, mainly due to the lower than expected foreign aid disbursements to the government.** The total long-term inflows to the government decreased by 16 per cent to US dollars 771 million in 2004, while the outflows declined by US dollars 28 million to US dollars 331 million. The significant decline in programme loans to US dollars 30 million in 2004 from US dollars 226 million in 2003 was largely due to delays in the implementation of structural reforms. The disbursement of project loans, which also slowed down during early 2004, recovered later due to the faster implementation of projects towards the end of the year. As a temporary measure to overcome the shortfall in external financing on concessional terms, the government issued foreign currency denominated bonds on commercial terms.
- **The favourable developments in capital flows to the private sector partly mitigated the shortfall in official inflows.** Capital flows to the private sector by way of foreign direct investment, loan capital and portfolio investment improved significantly during 2004, reflecting improved foreign investor confidence. The implementation of a large number of BOI agreements that were contracted earlier contributed to the increase in realised FDI, including privatisation proceeds, by 2 per cent to US dollars 233 million during 2004. The successful US dollar 100 million bond issue by Sri Lanka Telecom was the main contributor to the increase in net foreign loan capital to the private sector.
- **Net inflows to the capital and financial account were not sufficient to offset the current account deficit, and hence, the overall BOP recorded a deficit reversing surpluses recorded in the previous three consecutive years.** This led to a decline in external official reserves to US dollars 2,196 million (3.3 months of imports) by end December 2004 from US dollars 2,329 million (4.2 months of imports) at end 2003, increasing the country's vulnerability to external shocks. By April 2005, the BOP position has turned positive and reserves have also risen.
- **In this adverse environment, the exchange rate became volatile, particularly during the middle of the year.** The rupee depreciated by 7.5 per cent against the US dollar during the year compared to the marginal depreciation of 0.01 per

cent during 2003. The interventions by the Central Bank up to net sales of US dollars 514.7 million smoothened out some volatility. Since the US dollar depreciated against other major international currencies, the rupee depreciated at even higher rates against those currencies. However, reflecting the relatively high domestic inflation, the real effective exchange rate (REER) depreciated, with respect to the 5 currency and 24 currency baskets, by 1.0 per cent and 1.1 per cent, respectively indicating a marginal improvement in Sri Lanka's competitiveness. Activities in the foreign exchange market also reflected the uncertainty as the share of forward transactions in the total volume of transactions dropped to 23 per cent in 2004 from 38 per cent in 2003. The forward premia also remained well above interest rate differentials during most of the year, reflecting the market expectation of a higher depreciation or a rise in interest rates. However, in the first four months of 2005, following the tsunami disaster, the rupee appreciated against all major currencies.

- **The country's total external debt as a percentage of GDP declined marginally, reflecting the lower net loan capital inflows during the year.** However, the debt stock increased by 7 per cent to US dollars 11,346 million at end 2004 mainly due to the depreciation of the US dollar against the Yen and the SDR, as 73 per cent of the total external debt was denominated in those two currencies. The debt service ratios deteriorated marginally due to the large repayment of IMF loans during the year. However, the ratios remained satisfactory, since over 90 per cent of the total external debt consists of concessional medium and long term debt of the government.

### **Fiscal Policy, Budgetary Operations and Public Debt**

- **Fiscal policy in 2004 was aimed at achieving the targets stipulated in the FMRA and the objectives laid down in the Economic Policy Framework of the Government of Sri Lanka released in July 2004.** Thus, the thrust of fiscal policy was placed on continuing the fiscal consolidation process, increasing public investment, strengthening debt management, developing debt markets, restructuring public enterprises, providing relief to the general public, and enhancing transparency and accountability in conducting fiscal operations, which will complement the sustainable medium term growth prospects in the economy.
- **Overall fiscal management and the achievement of fiscal targets, were a challenge in 2004,** due to adverse external and domestic shocks that led to a slippage in revenue collection and an over-run in recurrent expenditure. In addition, the delays and the lower than expected foreign financing and privatisation proceeds aggravated the difficulty in managing public finance.

- **The declining trend in the tax revenue/GDP ratio reversed in 2004, reflecting the impact of the widening of the tax base and improving tax collection.** The tax revenue increased to 13.9 per cent from 13.2 per cent of GDP in 2003, reflecting increases in revenue from VAT, import duty and excise duty, despite the reduction in the revenue from income tax. The revenue from VAT increased due to improvements in both VAT administration and the refund mechanism. The upward revisions of excise taxes and import duties coupled with increased values of production and imports which are subject to such taxes contributed to the increase in revenue.
- **The total revenue collection in 2004 was 15.6 per cent of GDP, that is, a shortfall of 0.9 per cent of GDP compared to the budgetary target of 16.4 per cent of GDP.** It was also marginally lower than the level of 15.7 per cent of GDP in 2003. The sharp reduction of non-tax revenue from 2.5 per cent to 1.5 per cent of GDP was mainly responsible for the reduction in total revenue in 2004. However, this was more due to the over-optimistic budgetary targets than the performance of non-tax revenue during the year.
- **The expenditure overrun in comparison to the envisaged budgetary target is estimated at about 0.3 per cent of GDP.** However, it declined marginally to 23.5 per cent in 2004, from 23.7 per cent of GDP in 2003.
- **The slippage in revenue and expenditure overruns resulted in an increase in the government's overall budget deficit from the original target of 6.8 per cent to 8.2 per cent of GDP in 2004.** The current account deficit which mirrors the savings position of the government increased to 3.9 per cent from 3.3 per cent of GDP and the primary deficit which reflects the outcome of the current year's fiscal operations increased to 2.2 per cent from 0.9 per cent of GDP in 2003. The concomitant public sector deficit increased to 8.4 per cent of GDP largely due to operational losses of non financial public enterprises, mainly, the CPC and the CEB.
- **The increased public sector deficits were financed largely through borrowings from domestic sources.** The total net domestic borrowings of the government increased to 5.8 per cent of GDP (Rs. 117 billion) compared to the original target of 3.2 per cent of GDP (Rs. 65 billion). Both government debt and public sector debt as a percentage of GDP decreased marginally to 105.5 per cent and 107.5 per cent, respectively, in 2004 from 105.8 per cent and 107.9 per cent, respectively, in 2003.
- **In 2004, the government introduced a series of measures to improve fiscal performance.** Major measures included reforming the tax and tariff systems, strengthening tax administration, inter-alia, by setting up of the Revenue Board, introducing the ESC, rationalising recurrent

expenditure, and revising administrative prices, reforming public enterprises by setting up the SEMA, strengthening administrative reforms by establishing the ARC and the NCA, and enhancing transparency in government procurement by adhering to the reporting requirements of the FMRA and setting up the NPA. In the context of a high degree of income disparity among provinces and low levels of investments in remote areas, priority was given to public investment to stimulate sustainable and regionally balanced economic growth. These measures would help resolve several major drawbacks on the fiscal front, such as declining revenue/GDP ratio, under-performance of the public investment programme, consistently high budget deficits and the high public debt burden. The timely rectification of those drawbacks is important, as their impact could spill over to the rest of the macroeconomic management efforts through high demand pressures, excessive resource requirements and crowding out of private investment.

- **The MTMF presented with the Budget 2005 aims at a steady improvement in fiscal performance, high savings and investment and high economic growth, moderate inflation, and improved external balances.** The medium term fiscal framework could be affected particularly by the tsunami disaster, as the government has to provide relief to affected people, while undertaking rehabilitation and reconstruction expenditure in connection with the damage to private as well as public property. The RRR would require an estimated resource requirement of about US dollars 1.8 billion in the medium term. In view of the domestic resource constraints, it is essential that the pledged foreign assistance is utilised in a timely manner for the government to make steady progress in this effort.

### **Monetary Policy, Monetary Aggregates and Interest Rates**

- **The focus of monetary policy in 2004 was on the need for minimising inflationary pressures and containing rapid growth of monetary aggregates, while facilitating the continuing growth momentum in the economy.** Monetary management, however, faced a challenge in 2004 given the need for supporting the growth momentum in a difficult macroeconomic environment created by several adverse external and domestic factors, including drought conditions, the escalation of international crude oil prices and increased public sector domestic borrowings.
- **The Central Bank conducted its monetary policy in an independently floating exchange rate regime within a framework of targeting monetary aggregates.** Monetary policy was implemented through active open market operations (OMO), which includes, as its main component, the interest rate corridor formed by the Repurchase (Repo)

rate and the Reverse Repurchase (Reverse Repo) rate. This was supplemented by maintaining the Statutory Reserve Ratio (SRR) unchanged at 10 per cent. In the context of continuous sales of foreign exchange by the Central Bank to prevent high exchange rate volatility, the Central Bank injected funds through the purchase of Treasury bills in the primary market, to prevent a liquidity shortage in the money market and any undue fluctuations in interest rates.

- **The difficult economic conditions that prevailed in 2004 required proper timing and sequencing of monetary policy tightening.** With the further acceleration of inflation and monetary growth by mid-2004, as the first step, the Central Bank began to conduct OMO aggressively in June 2004 and absorbed almost the entirety of the liquidity surplus, inducing an upward adjustment in the short-term cost of funds, so as to contain the growth in monetary aggregates. Second, the Bank's Repo and Reverse Repo rates were raised by 50 basis points each in November 2004. Meanwhile, to contain non-essential consumption such as the importation of motor vehicles, a 100 per cent margin deposit requirement was enforced on letters of credit opened for the importation of motor vehicles for private use.
- **Following the tsunami disaster, the Central Bank implemented several measures enabling a speedy recovery of the economy.** Immediate measures were taken to ensure the smooth functioning of the financial market and the payments and settlement systems. The daily OMO auctions were temporarily suspended from early January 2005 to end February 2005 to keep the money market liquid. A special loan scheme was formulated and implemented through the banking system to provide credit at a concessionary rate to help revive affected industries and to rebuild livelihoods of affected people.
- **Throughout 2004, monetary aggregates continued to expand above the desired path.** Reserve money, the operating target of monetary policy, has been about Rs. 6 billion higher than the expected level in the annual monetary programme. Meanwhile, broad money ( $M_2$ ), which is the intermediate target, also recorded a faster than expected growth due to higher increases in credit to both the public sector and the private sector.
- **The growth in reserve money was entirely a result of an increase in net domestic assets (NDA) of the Central Bank as net foreign assets (NFA) of the Central Bank declined,** reflecting the deficit in the balance of payments in 2004. The decline in NFA was mainly a result of delays in receipts of foreign programme financing to the government and the sales of foreign exchange by the Central Bank to contain excessive volatility in the foreign exchange market. The Central Bank resorted to purchasing Treasury bills from the primary market to prevent a potential liquidity crunch and to ensure the smooth functioning of the financial system. Consequently, NDA of the Central Bank increased sharply.
- **The expansionary impact of reserve money was reflected in the high growth in both narrow and broad monetary aggregates, which accelerated in the latter part of the year.** Narrow money supply, which comprises currency and demand deposits held by the public, expanded by 16.6 per cent in 2004. During the first half of the year, broad money ( $M_2$ ) growth was in the range of 15 – 16 per cent and fluctuated in a higher range of 17 – 19.6 per cent during the second half of 2004.
- **Private sector credit expansion, which increased at a faster rate towards the end of 2003, continued to accelerate in 2004, thereby contributing largely to the monetary expansion.** Private sector credit increased by Rs.115 billion in 2004, a point-to-point growth of 22 per cent compared with a growth of 17 per cent as at end 2003. The credit expansion of a higher magnitude was a reflection of the continued recovery in economic activities, expansion in foreign trade and the decline in lending rates in real terms. The composition of credit indicates that the high demand for credit in 2004 was mainly in respect of commerce, finance, housing and consumption related activities.
- **During 2004, net credit to the government (NCG) from the banking system increased at a higher than expected rate due to an increase in the budget deficit, and shortfalls in projected foreign financing and the realisation of privatisation proceeds.** Limitations in the availability of non-bank sector resources for budgetary financing led to this increase in bank credit to the government. Accordingly, NCG from the banking system increased by about Rs.44 billion in 2004. An increase in credit to public corporations by Rs. 5 billion in 2004, in contrast to the repayments expected at the beginning of the year also contributed to the growth in money supply.
- **Meanwhile, the contribution to monetary growth from NFA was lower than projected.** NFA of the banking system improved marginally in 2004, due to the improvement in NFA of commercial banks and a decline in NFA of the Central Bank. The contribution of NFA to the growth in money supply was about 2 per cent.
- **The declining trend in interest rates that prevailed throughout 2003 reversed with a marginal increase in 2004, due to rising inflation, higher inflation expectations, increasing credit demand and tightening of monetary policy.** In 2004, real interest rates in almost all markets also became negative as inflation increased at a faster rate than the increase in interest rates. Call money market rates were relatively more volatile, occasionally rising above the upper



bound of the Central Bank interest rate corridor in 2004. Both lending and deposit rates of commercial banks increased during the year. The average weighted prime lending rate (AWPR), and the average weighted deposit rate (AWDR) increased in the latter part of the year. Following the increases in international rates by the end of the year, commercial banks in Sri Lanka also increased their interest rates on foreign currency deposits and lending.

- **The yields on government securities also increased, with long-term rates rising by a higher margin.** The yields at the weekly Treasury bill auctions increased during the first seven months of the year, but declined thereafter, as government borrowing shifted to foreign currency sources with the issue of Sri Lanka Development Bonds (SLDBs) and institutional investors increased their role in the primary Treasury bill market. Given investor preference for short-term instruments, treasury bond issues in 2004 consisted more of shorter maturities. The secondary market yields on government securities moved upward, with higher increases at the longer end, thus reflecting higher inflation expectations in the medium term.

### Financial Sector Developments and Stability

- **Benefiting from the continued economic growth, financial sector activities expanded further and the financial system remained resilient in 2004 amidst several internal and external shocks.** The array of financial instruments and services expanded, and trading volumes in financial markets increased in 2004 with many market indices reaching record high levels. Several initiatives were taken in 2004 to enhance access to finance, especially to strengthen the availability of financial facilities to micro-enterprises and SMEs. Meanwhile, the financial infrastructure was modernised with significant reforms in the payment system. During 2004, the regulatory and supervisory framework was further strengthened to improve the soundness of the banking system, while moving further in line with international best practice. A number of legislative and regulatory reforms were implemented in 2004 to strengthen the legal and regulatory framework and promote efficiency and stability in the financial sector.
- **The expansion in the financial system was evidenced by improvements in several financial sector indicators.** Among these were the increase in deposits, loans and advances granted, service outlets of the financial institutions, lease and hire purchase facilities, and insurance activities that have been expanding in a healthy and competitive market environment. Many financial institutions also expanded the array of financial services offered to their customers while introducing new value added services. Reflecting these developments, the total assets of the financial system in nominal terms expanded by 15 per cent in 2004. Value addition in the financial services increased by 6.6 per cent in 2004. However, this was lower than the 10.6 per cent growth registered in 2003 due to the combined outcome of the base effect of higher growth in profits in 2003, narrowing interest margin and the reduction in capital gains from investments.
- **Financial markets recorded a further expansion as seen in the trading volumes in many market segments.** Activities in the short-term inter-bank call money market and the primary market for government securities increased further, but the secondary market transactions in government securities declined in view of the uncertainties regarding interest rates. The volume of transactions in the foreign exchange market increased, benefiting from expanded external trade activity in 2004. The equity market showed an improved performance with share price indices, daily trading volumes and market capitalization reaching record levels in 2004. The nascent corporate bond market continued to suffer from issue costs, insufficient awareness of market participants and the availability of alternative easy bank financing, especially bank credit at attractive rates, particularly for blue chip companies.
- **Several measures were taken to upgrade and strengthen the payments and settlement system and the regulatory system in 2004, with a view to enhancing the efficiency, competitiveness, and resilience, and the soundness of the financial sector.** Further development of the payments and settlement system was undertaken by linking the Real Time Gross Settlement (RTGS) system implemented in 2003 with the Scripless Securities Settlement (SSS) system and the Central Depository system (CDS) for government securities to facilitate the settlement of government securities in scripless form.
- **The regulatory framework was further strengthened by introducing new laws and directions.** In this regard, the Central Bank applied the capital adequacy requirement on a consolidated basis covering the subsidiaries, streamlined provisioning requirements for non performing loans (NPLs), issued guidelines on external auditors and required banks to obtain and publish credit ratings by mid 2005. An amendment to the Banking Act was approved by the Parliament to strengthen the regulatory framework. A new Payments and Settlement Systems bill has also been drafted to strengthen the legal framework governing payments, clearing and settlements systems in Sri Lanka, while providing a comprehensive law on payment transactions.
- **The tsunami devastation at the end of 2004 has not posed a major challenge to the stability of the financial sector**

although there are several other downside risks to the maintenance of financial system stability in 2005. The world economic environment, though favourable at present, could become uncertain due to several factors such as the slowing down of global economic growth, continuing uncertainties in petroleum prices, rising international interest rates with the gradual removal of policy stimuli, and the continuation of significantly large twin deficits, i.e., the fiscal deficit and the external current account deficit in the USA. The domestic economic environment could also suffer from continuing uncertainties on inflation, aid flows, fuel prices, and the possible slowing down of international trade arising from the fall-out effects of the termination of the MFA and due to threats to achieving fiscal consolidation. High credit expansion could also pose a threat to the stability of the financial system, if care is not taken to ensure asset quality. However, the sector will be able to manage these risks successfully given the continued strengthening of financial institutions and improved risk management strategies for the payments and settlement systems, and strengthening of the regulatory and supervisory framework.

- In spite of the expansion in financial sector activity, there are some issues and challenges that require attention. One of the main issues is the relatively high intermediation cost. Two major factors that contribute to the high intermediation cost, as measured by the interest spread are poor credit management or high NPLs and high staff cost. Other issues and challenges requiring attention are the underdeveloped nature of the corporate bond market, lower insurance penetration, the low degree of integration in financial markets, and other market distortions such as those caused by the taxation of some financial services. Though the objective of taxing financial services is to enhance the revenue of the government, due attention needs to be paid to maintain uniform tax treatment across different markets, which may otherwise distort financial intermediation. In addition, preparedness of the financial sector to face natural disasters needs to be looked into in view of the recent tsunami disaster.

#### 1.4 Medium Term Macroeconomic Framework, Issues and Policies

- The tsunami disaster that struck in December 2004, which caused massive damage to both human lives and property and brought on immense suffering to Sri Lankans, changed the medium term macroeconomic outlook of Sri Lanka with a substantial resource requirements for RRR. The natural disaster has revealed several facets in the development process of Sri Lanka that require renewed recognition. The beneficial impact of globalisation enabling the sharing of information, knowledge and resources emerged as a fundamental factor that could have minimised the massive destruction. Dealing with disasters of such magnitudes require the collective efforts of all stake holders, national and international, underscoring the need for maintaining unity and goodwill among different domestic as well as international segments of the population and institutions. A serious need exists in strengthening capacity in financial, technological and managerial spheres to withstand and manage disasters.
- The MTMF presented with the Budget 2005, was subsequently revised to accommodate RRR. Due to the impact of the tsunami disaster on fisheries and tourism sectors, the economic growth would suffer in 2005, albeit marginally. Increased rebuilding activities would compensate to some extent for the loss of economic activities in fishing and tourism. From 2006, onwards the growth is expected to accelerate to over 6 per cent spreading across all sectors and geographic regions with the renewed emphasis on regional development as well as the nation rebuilding programme of the government. Consequently, unemployment will gradually decline with the expected increase in economic growth and concerted efforts by the government. National savings will increase especially due to the expected improvement in public savings. Investments, which would respond positively to political and economic stability, will increase, reflecting the benefits of incentives provided by the BOI and the government.
- Exports will continue to grow, benefiting from the global economic expansion, and the preferential trade treatment from the USA, the EU, India, and Pakistan, despite the impact of the phasing out of the MFA. The private sector entrepreneurship complemented by government efforts in promoting competitiveness of Sri Lanka and export led development strategies will enable the achievement of a high export growth.
- Imports will also increase in the medium term at a higher rate with the needs for RRR. However, the resulting increase in the trade deficit in the medium term will be financed through concessional foreign assistance. The continuation of the floating exchange rate regime and increased inflows will improve the balance of payments and hence the reserve position, thus minimising pressure on the exchange rate.
- Government expenditure will surge in the medium term with additional expenses on RRR, which is expected to be financed through foreign assistance without burdening domestic resources. Thus, the fiscal consolidation envisaged at the time of Budget 2005 may not be significantly threatened. The major pillars of such fiscal consolidation are the increased revenue, the rationalization of expenditure, and the generation of a surplus in the current account ensuring

Table 1.4  
Medium Term Macroeconomic Framework: 2005 - 2008

Indicator	Unit	2004 (a)	Pre-tsunami				Post-tsunami			
			2005	2006	2007	2008	2005	2006	2007	2008
Real Sector										
GDP at Market Prices	Rs. bn	2,029	2,297	2,605	2,914	3,242	2,343	2,658	3,000	3,371
Real GDP Growth	%	5.4	6.0	6.0	6.5	7.0	5.3	6.0	6.5	7.0
Inflation/GDP Deflator	%	9.2	9.0	7.0	5.0	4.0	9.7	7.0	6.0	5.0
Total Investment	% of GDP	25.0	28.0	30.0	32.0	34.0	30.0	32.2	32.8	33.9
Private Investment	% of GDP	19.8	21.1	22.7	24.2	25.9	21.9	22.7	24.2	25.9
Public Investment	% of GDP	5.2	6.9	7.3	7.8	8.1	8.1	9.5	8.6	8.0
Domestic Savings	% of GDP	15.9	18.4	20.8	22.4	25.6	17.0	20.8	22.2	24.8
Private Savings	% of GDP	19.8	18.8	20.1	20.6	20.1	18.6	20.3	19.8	21.2
Public Savings	% of GDP	-3.9	-0.5	0.7	1.8	5.5	-1.6	0.5	2.4	3.6
National Saving	% of GDP	21.6	24.0	26.4	28.4	31.5	23.1	26.1	27.6	30.1
External Sector										
Trade Gap	US\$ mn	-2,243	-2,518	-2,622	-2,928	-2,936	-3,370	-3,353	-3,478	-3,406
Exports	US\$ mn	5,757	6,305	6,821	7,383	8,027	8,354	8,860	7,343	7,978
Imports	US\$ mn	8,000	8,824	9,443	10,311	10,963	9,725	10,213	10,821	11,384
Services	US\$ mn	419	474	518	544	618	352	484	521	593
Receipts	US\$ mn	1,527	1,719	1,866	2,015	2,199	1,572	1,794	1,952	2,131
Payments	US\$ mn	1,108	1,245	1,348	1,471	1,581	1,220	1,310	1,431	1,538
Current Account Balance	US\$ mn	-648	-824	-792	-872	-672	-1,572	-1,505	-1,408	-1,133
Current Account Balance	% of GDP	-3.3	-3.9	-3.5	-3.5	-2.4	-6.8	-6.0	-5.1	-3.7
Overall Balance	US\$ mn	-205	97	108	73	202	101	176	200	250
External Official Reserves (Months of Imports)	Months	2.8	2.6	2.8	2.8	2.9	2.7	2.9	3.1	3.2
Debt Service Ratio (b)	%	11.5	11.8	10.5	9.5	9.6	7.4	11.1	10.0	9.7
Fiscal Sector										
Revenue	% of GDP	15.4	17.2	18.0	18.9	19.5	16.9	17.8	18.8	19.5
Expenditure	% of GDP	23.5	24.8	24.7	24.6	23.9	26.5	26.8	25.1	24.0
Current Account Balance	% of GDP	-3.9	-1.3	0.4	2.2	3.6	-1.6	0.5	2.4	3.6
Overall Budget Deficit	% of GDP	-8.2	-7.6	-6.7	-5.7	-4.4	-9.6	-9.0	-8.3	-4.4
Domestic Financing	% of GDP	5.8	4.6	3.5	2.7	1.6	3.6	2.9	2.0	1.6
Financial Sector										
Reserve Money Growth (c)	%	20.9	14.5	13.5	12.0	11.5	15.0	14.0	13.0	12.5
Narrow Money Growth (M <sub>1</sub> ) (c)	%	16.6	12.5	11.5	10.0	9.5	13.0	12.0	11.0	10.5
Broad Money Growth (M <sub>2</sub> ) (c)	%	19.6	14.5	13.5	12.0	11.5	15.0	14.0	13.0	12.5
Growth in Credit to Public Corporations (c)	Rs. bn	4.9	-15.0	-5.0	-5.0	-5.0	-15.0	-5.0	-6.0	-5.0
Growth in Credit to Private Sector (c)	Rs. bn	114.8	120.0	126.7	131.1	126.2	114.6	125.3	130.8	141.6
Growth in Credit to Private Sector (c)	%	22.1	18.6	16.6	14.8	12.4	18.0	16.7	15.0	14.1

Source: Central Bank of Sri Lanka

(a) Provisional

(b) Total debt service payments as a percentage of earnings from merchandise exports and services

(c) Point-to-point growth in end year values

debt sustainability. The proposed fiscal consolidation measures coupled with higher economic growth rates would lead to an increase in public investment and lower the ratio of debt to GDP in the medium term.

- The monetary expansion will be reined in to bring in price stability in the medium term. Monetary expansion is expected to be contained at 15 per cent in 2005 and lowered gradually to 12.5 per cent by 2008 facilitating the

achievement of economic growth above 6 per cent, while reducing the inflation rate gradually but consistently from 11 per cent in early 2005 to 5 per cent by end 2008. Monetary management will be facilitated by the expected decline in credit to the government and public corporations.

- There are several downside risks that would hinder the achievement of the targets in the MTMF. The most disturbing risks are any delays in the inflow of anticipated



foreign assistance, any other adverse domestic or external shocks, adverse developments in the peace process and slippages in macroeconomic management. The government has to speedily implement the rebuilding programme as planned so that foreign funds could be disbursed as planned to rebuild the nation, thereby increasing public confidence. Any unexpected adverse domestic or external shocks could disturb the growth momentum. Progress in the peace process should continue to maintain a conducive environment for developing confidence and promoting economic activities. Slippages in macroeconomic management could undermine the growth momentum, external balance, fiscal consolidation and monetary stability leading to high inflation, low employment, and the vulnerability of the economy.

- **Achieving a better performance than outlined in the MTMF depends crucially on addressing several important issues, which were repeatedly highlighted in the previous Central Bank Annual Reports, and facing effectively the challenges posed by the tsunami disaster.** In this regard the government is in the process of developing disaster management policies and strategies and developing a national rebuilding programme through its operational arms of TAFREN and TAFOR. The government is also engaged in restoring permanent peace, maintaining continuous political stability, maintaining law and order, improving macroeconomic management, and improving economic governance. It is also imperative to develop an incentive scheme for economic agents to succeed with their own resources without government handouts, undertaking vital structural reforms, developing economic infrastructure facilities, developing social infrastructure and human capital through reforms in health, education and safety nets, increasing productivity at all levels, promoting technology, promoting research and development, promoting further access to finance, ensuring greater equality in growth and income distribution, environmental protection for sustainable development and effectively integrating into the process of globalisation.
- **Disaster management has become a priority with the realisation that Sri Lanka has been battered by both natural and man-made disasters, throughout the post Independence era, with increasing frequency and intensity.** Several civil wars and conflicts have been inflicting a permanent damage to the country. Such disasters have forced a significant brain drain out of Sri Lanka, thereby denying the benefit of highly skilled human capital for the advancement of the country. In every four years, a drought cycle re-emerges with severe blows to agriculture, power generation, and all other power dependent economic activities. The over-dependence on hydropower and high cost thermal power has generated a deep business cycle downturn synchronised with the drought cycle. Droughts have usually been followed by floods, devastating most of the agriculture areas. The latest tsunami disaster reveals that the notion of relative safety of Sri Lanka from earthquakes and seismic movements generating tsunamis is no longer valid. Hence, national disaster avoidance and management strategies covering the entire economy need to be formulated using comparative advantages of every private, public, non-governmental and international organization.
- **The improvement in macroeconomic management is essential to develop a conducive environment for markets to operate effectively and the economy to remain stable as discussed in the previous issues of the Central Bank Annual Reports.** Current areas of improvement are the lowering of public debt to a manageable level, containing the primary deficit and current account deficit and generating surpluses needed for debt sustainability, containing excessive monetary expansion, addressing the issue of emerging negative real interest rates, and building up external reserves. The required strong and sustainable fiscal adjustment process is implied in the medium-term targets of the FMRA. Fiscal consolidation paves the way for the monetary policy to operate effectively in containing monetary expansion aimed at maintaining price stability. The continuation of the flexible exchange rate regime will avoid the build up of destabilising forces.
- **It is necessary to undertake essential structural reforms urgently and simultaneously with the improvement in macroeconomic management.** Continuing structural reforms are required to raise the potential output of a country by developing market based approaches, enabling the redistribution of human, physical and financial resources from less efficient sectors to those with high efficiency and greater social needs, while minimising potentially destabilising factors, that would negate the benefits of reforms. Over the years, the Central Bank Annual Reports have identified a large number of areas where structural reforms are needed. Reforms implemented since 1977 with the liberalisation of the economy have proven beneficial to operate a market based economic framework that generates a higher economic growth. Yet, further scope for reforms exists in the areas of labour and land markets, civil service, public enterprises, education, health, pensions, welfare and safety nets, financial sector, the judicial process and the regulatory system. In 2004, the government attempted several such reforms using the modality of SEMA.
- **Reforms should address the removal of inefficiencies in infrastructure facilities adequately to support growth, while ensuring that such facilities are made available at**

internationally comparable prices. A series of reforms would be necessary to develop economic and social infrastructure, essential for continuation of economic growth, generation of a series of tradable services and supporting poverty alleviation. The present serious supply shortages and regional disparities in roads, electricity, telecommunications, transportation and water supply sectors as well as in health and education facilities have constrained the growth. Pricing of services without covering at least the cost of production render the major institutions providing infrastructure facilities to depend on budgetary support from the government. Independent regulatory mechanisms are lacking in many sectors and the existing mechanisms are weak or ineffective. Health care is saddled with labour disputes, insufficient investment, and improper targeting. Education displays serious mismatches with market needs, and has not been able to generate and retain the required human capital needed for rapid economic development.

- **The continuing growth in many countries beyond the growth achieved through increased factor accumulation arises from technology improvement shaped by research and development.** Sri Lanka needs to facilitate both technology improvements and research and development activities to achieve sustainable growth.
- **Sustainable growth has to be environment friendly, and the environment protection policies should not be an obstacle to growth.** The protection of the environment and a sustainable economic growth should be promoted using a well-designed and coordinated policy framework.
- **The continuing income inequality could generate public agitation, if opportunities are not provided by addressing the above issues.** The regional inequality is a natural phenomenon where economic activities are concentrated around higher social and economic infrastructure, benefiting from positive externalities of various mutually beneficial economic activities. In a country without any internal trade and investment barriers, geographic inequality calls for attention if there are any hindrances limiting the extent of economic activities, and if there is a deficiency in the supply of growth supporting public goods and public investment. Therefore, relevant public goods and public investment have to be provided to create opportunities for all.
- **Enhancing access to finance by all sectors in the economy, especially SMEs, is necessary to further promote their contribution to the economy, and reduce regional income disparity.** A significant policy initiative towards fulfilling this objective has been taken by setting up of a specialised bank to cater to SMEs.
- **Countries with a growth potential make special attempts to be ranked high in international comparisons in human development, competitiveness, economic freedom, and transparency to attract further investment.** Making an effort to be ranked high could be a self-generated incentive for focusing efforts in a country to achieve the goal of growth and development. A recent publication by the World Bank and ADB has stated that Sri Lanka stands out among countries in the region for its good governance, and that firms benefit from the low levels of red tape and corruption.
- **Sri Lanka has to consolidate its achievements while facing immediate challenges.** The internationally recognized achievements in governance should be further improved. Productive use of government expenditure and repositioning of the government sector delivery mechanism to reach all sectors of the economy has to be ensured by phasing out wasteful subsidies, which have hindered productive public investment. Fiscal revenue needs to be increased leading to fiscal surpluses, thereby providing flexibility to both fiscal and monetary policies in combating sectoral imbalances and promoting economic stability and long-run economic growth.
- **The tsunami disaster has underscored the importance of being a member of the global family, be it for sharing information and technology, developing economic partnerships or for international financial assistance.** Expanding Sri Lanka's economic territory should continue facilitating the enlargement of its market and increase economic opportunities for Sri Lankans. Globalisation paves the way for Sri Lanka to expand its export market, while improving efficiency of factors of production through international relations. With expanding and changing human demands, it is costly, if not impossible, for a country to become self sufficient in all of its needs. The 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 the rest of the world, thereby improving the welfare of the people. Thus, a high economic growth has to be equitable, regionally balanced, environment friendly and integrated with the ongoing globalisation process to be sustainable in the medium and long-term.
- **Sri Lanka has to grapple with immediate challenges posed by the current high international oil prices and the tsunami disaster while focusing on medium term issues.** With the increasing thermal power generation in the absence of other alternate energy sources, the country's dependency on imports of oil has increased over the years. High oil prices, while exerting significant pressures on the BOP, the exchange rate and inflation, further weakened

the financial position of the CEB and CPC. The inevitable increases in subsidy payments add to the fiscal burden, unless appropriate price adjustments are made to ensure economy on consumption. Therefore, the country's ability to withstand pressure from high oil prices should be enhanced by adopting appropriate policies within the macroeconomic framework, developing alternative energy sources, minimizing inefficient usage of fuel, restructuring energy related public institutions and phasing out wasteful subsidies associated with high oil prices. In this regard, both CEB and CPC need restructuring on a priority basis. The CEB should gain capability of meeting the future electricity demand of the country, for otherwise, the high growth expectations in the medium to long run would be impeded by frequent black outs and brown outs. Similarly, the CPC should reduce its mounting debt obligations to the banking system by prudentially and rationally managing its assets structure. All stake holders should realise the need for the restructuring process and examine the issues more objectively.

- **The tsunami devastation poses new challenges, while reconstruction offers new opportunities.** However, it is important to ensure that the RRR will not become a fiscal burden undermining the on going fiscal reform towards reducing debt financing in the National Budget.

Similarly, additional current expenditure should not lead to a reduction in much needed investment expenditure. The efficient utilization of foreign assistance for reconstruction and rehabilitation without disturbing the macroeconomic stability and on going development processes in the other parts of the country requires a significant improvement in the absorption capacity. It is also important to ensure that domestic economic imbalances arising from large inflows of foreign aid are appropriately addressed while also taking steps to accelerate the rate of utilisation of foreign aid.

- **Finally, to further consolidate its achievements and to propel the economy on to a higher growth path, the government has to increase the provision of public goods and services, while providing a conducive environment for the private sector to unleash its creative energy.** Since this process has already begun, the private sector too needs to take its own initiatives to support the growth process by taking steps to expand the production frontier through increasing productivity, continuously engaging in research and development, and facing the challenges of globalisation while reaping benefits from it. Such a dynamic private sector will drive the economy forward while creating employment, reducing poverty and providing opportunities for all Sri Lankans.



## Box 5

Major Economic Policy Changes and Measures: 2004-2005<sup>(a)</sup>

## Real Sector

- |                   |  |
|-------------------|--|
| 1 March 2004      | - Rail fares applicable to Colombo and the suburbs were increased by 50 per cent, while long distance fares were increased by 40 per cent.   |
| May 2004          | <ul style="list-style-type: none"> <li>- The loan limits under Forward Sales Contracts were increased from Rs. 5 million to Rs. 25 million to encourage the buyers to purchase agricultural products.</li> <li>- Central Bank introduced a relief package for drought affected farmers.</li> <li>- Government announced a relief package to assist the Small and Medium Enterprises (SME) sector in general and medium paddy millers in particular.</li> </ul> |
| 16 June 2004      | - The Administration Reform Committee (ARC) was established  |
| June 2004         | <ul style="list-style-type: none"> <li>- The Strategic Enterprise Management Agency (SEMA) was set up to facilitate and ensure the efficient management of 12 strategic public enterprises in Sri Lanka.</li> <li>- The NCED was set up to facilitate and assist the government in the effective coordination and implementation of its policies and development programmes.</li> </ul>  |
| 1 July 2004       | - The Economic Policy Framework of the Government of Sri Lanka was released.   |
| 24 July 2004      | - The retail price of petrol was increased by Rs. 8 to Rs. 65 per litre.   |
| 29 July 2004      | - Under the graduate employment programme, the government launched a special orientation programme (preliminary training) for the first batch of 17,019 graduates.   |
| 4 August 2004     | - The National Council for Administration (NCA) was established.   |
| 13 August 2004    | - The retail prices of auto diesel and petrol were increased by Rs. 4 and Rs. 3 to Rs. 36 and Rs. 68 per litre, respectively.  |
| 19 August 2004    | - The programme for rehabilitation of 1,000 minor irrigation tanks was commenced.  |
| 1 September 2004  | <ul style="list-style-type: none"> <li>- Bus fares were increased by an average rate of 9 per cent.</li> <li>- Under the graduates employment programme, the government launched a special orientation programme (preliminary training) for the second batch of 24,601 graduates.</li> </ul>   |
| 24 September 2004 | - Colombo spot selling price of auto diesel increased by Rs.6 to Rs.42 per litre. A premium of Rs. 2 per litre was also imposed on diesel and petrol sales by retail outlets within Colombo Municipal limits. With this premium, prices of petrol and diesel in the Colombo Municipal limits increased to Rs. 70 and Rs. 44 per litre, respectively.   |
| 1 October 2004    | - Passenger bus fares were increased further by an average rate of 6 per cent to compensate the increase in the operating cost.  |
| 22 October 2004   | - Postal charges were increased by an average rate of 12 per cent  |
| 13 December 2004  | - 968 graduates were attached to the special orientation programme (preliminary training).   |
| 3 January 2005    | - 40,194 graduates, who participated in the special orientation programme, were attached to the Ministries as trainees (formal training).  |
| 4 January 2005    | - Sri Lanka Railways Authority (Repeal) bill was approved by the Parliament to reestablish Sri Lanka Railways.   |
| 15 March 2005     | - A new compensation formula was published in the gazette by the Commissioner of Labour under the Termination of Employment of Workmen (Special Provisions) Amendment Act of March 2005.   |
| 30 March 2005     | - A new bank was established by the government for SME sector development.   |
| 1 April 2005      | - Government initiated a housing loan scheme for government employees.   |

(a) This includes major economic policy changes and measures implemented during 2004 and the first four months in 2005. Policy changes and measures that have been announced and are to be implemented in 2005 are also included.



## Box 5 (contd.)

## External Sector

## Trade and Tariffs

1 January 2004

- Tariff bands were changed from 2.5 per cent, 5 per cent, 10 per cent, 15 per cent and 25 per cent to 3 per cent, 6 per cent, 12 per cent, 16 per cent and 27.5 per cent, respectively, while the 20 per cent tariff band remained unchanged.
- The surcharge of 20 per cent on import duties was reduced to 10 per cent.
- Following tariff revisions were introduced.

Item	Before Revision	After Revision
Wheat grain	0 %	3%
Selected Electronic goods	5%, 10%, 20% and 25%	3%
Cameras/watches	10%	3%
Jewellery	25%	3%
Plant and machinery	5%	3%
Dhal	5%	3%
Dried fish	10%	6%
Edible oil	15%	20%
Selected Electrical goods	20% and 25%	16%
Combined harvesters	10%	3%
Lorries and trucks	2.5%	6%
Sugar	Rs. 3.75/kg	Rs. 4.50/kg

- Customs duty exemptions were granted on crude oil, printed books, refined petroleum products, gem and gold, textiles, paddy, vegetable seed and pharmaceuticals.
- A full duty waiver of 3 per cent was granted on wheat grain.

1 February 2004

- Duty waivers were granted on the following items to reduce the cost of living.

Item	General Duty	Duty Waived
Masoor Dhal	3%	3% (full)
Split Yellow	3%	3% (full)
Potatoes	Rs. 20/kg	Rs. 1.50/kg
B.Onions	Rs. 8/kg	Rs. 5/kg
Chillies	Rs. 30/kg	Rs. 10/kg
Milk Powder	12%	6%

19 March 2004

- A full duty waiver of Rs.4.50 per kg. was granted on sugar.

16 September 2004

- Specific duty of Rs. 8 per kg. on B-onions restored.

20 September 2004

- Import duty applicable to importation of ethyl alcohol increased to Rs. 100 per litre from Rs. 60 per litre.
- Import duty on B-onions increased to Rs. 10 per kg. from Rs. 8 per kg.

1 October 2004

- A duty of Rs. 4.50 per kg was imposed on the import of brown sugar while white sugar continued to remain duty free until further notice.

5 October 2004

- Specific duty on rice imports of Rs. 9 per kg. was removed for all importers until 31 December 2004.

29 October 2004

- A cess of 5 per cent on CIF value was levied on the import of rubber based products.
- A cess of Rs. 4 per kg. was levied on exports of raw rubber.

4 November 2004

- A cess was imposed on selected imported items such as processed food, fresh or dried fruit, fruit juices and beauty and make-up preparations etc. under the section 14 of the Sri Lanka Export Development Act No. 40 of 1979.

19 November 2004

- Tariff bands were revised as follows:

Tariff bands before the Budget 2005	Tariff bands after the Budget 2005
3 per cent	2.5 per cent
6 per cent	6 per cent
12 per cent and 16 per cent	15 per cent
20 per cent and 27.5 per cent	28 per cent



**Box 5 (contd.)**

- 1 January 2005 - The 10 per cent surcharge on customs duty on all imported goods, except selected items, was extended till 31 December 2005.
- 3 January 2005 - The duty waiver of Rs. 9 per kg that was granted on rice imports till 31<sup>st</sup> December 2004, was further extended up to 15 January 2005.
- 1 March 2005 - A cess was imposed on selected imported items such as fruits and maize under the section 14 of the Sri Lanka Export Development Act No. 40 of 1979 in addition to the cess imposed on 4 November 2004.

**Exchange Management**

- 6 January 2004 - Commercial banks were permitted to release foreign exchange to gem dealers up to US dollars 15,000 (out of which US dollars 5,000 could be issued in currency notes) for the purchase and import of rough stones from Madagascar. On 24 August 2004, this facility was extended to purchase and import of foreign stones from Myanmar as well.
- July 2004 - Payment in foreign currency on credit cards for pyramid schemes and other unauthorized purpose was prevented.
- 3 November 2004 - Permission was granted to National Savings Bank (NSB) to open Non Resident Foreign Currency (NRFC) and Resident Foreign Currency (RFC) accounts in favor of its customers.

**Fiscal Sector****Government Revenue**

- 1 January 2004 - VAT rates of 10 per cent and 20 per cent were unified at 15 per cent.
- The turnover threshold of Rs.500,000 per quarter of payment of VAT was raised to Rs.750,000 per quarter and annual threshold was increased from Rs. 1.8 million to Rs. 3 million. (However, this was reversed to the original position on 1 July 2004 to be effective from 1 January 2004).
- Excise duty on cigarettes was raised based on the length of cigarettes.
- Excise duty on aerated water was increased to Rs. 5.50 per litre.
- Excise duties on petrol and diesel were reduced to Rs. 20 and Rs. 2.50 per litre, respectively.
- License fee on tapping of kitul was reduced to Rs. 50 per tree.
- Excise duties on malt liquor of less than 5 per cent of absolute strength and more than 5 per cent absolute strength were increased to Rs. 22.50 and Rs. 38.50 per litre, respectively.
- Excise duties on molasses, palmyrah, coconut and processed arrack were 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. 108,000 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 April 2004 - An Economic Service Charge (ESC) of 1 per cent was imposed on turnover or total asset value for entities carrying on trade, business, a profession or a vocation that have a turnover in excess of Rs. 20 million or total asset value in excess of Rs. 10 million. (Subsequently, the ESC rate was changed to 0.25 per cent, 0.5 per cent and 1 per cent and turnover threshold was increased to Rs. 50 million (the asset limit was removed) with the effective date unchanged at 1 April 2004).
- Personal income tax rates were revised as follows:
 

(1) First Rs. 300,000	= Nil	(2) Next Rs. 240,000	= 10%
(3) Next Rs. 240,000	= 20%	(4) Balance	= 30%
- Tax on terminal benefits for employment were revised as follows:
 

(1) First Rs. 2,000,000	= Nil	(2) Next Rs. 500,000	= 5%
(3) Next Rs. 500,000	= 10%	(4) Balance	= 15%
- An upfront tax of 10 per cent was imposed on the divisible profit and other income of all partnerships.



## Box 5 (contd.)

- A 10 per cent withholding tax was 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 Foreign Currency Banking Units (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 organizations, other income (excluding donations and grants) of institutions approved under Section 8(a) of the Inland Revenue Act, in excess of Rs.200 million was made liable to tax at 10 per cent. Dividends and interest earned by such institutions continue to be liable to the withholding tax.
- May 2004 - The restructuring programme of Inland Revenue Department was commenced.
- 1 July 2004 - The supply and import of fertiliser and agricultural machinery exempted from VAT.
- Schools funded by the government by way of paying salaries to staff or pension to ex-staff exempted from VAT.
- July 2004 - The government appointed a Revenue Board (RB) comprising Secretary to the Treasury, heads of Inland Revenue Department (IRD), Customs department, Excise department and the Board of Investments (BOI).
- 7 September 2004 - A Finance bill was approved by the Parliament to give legal effect to the measures proposed in Budget 2004 on taxes and fees.
- 8 September 2004 - Following bills were passed by the Parliament.
  - Value Added Tax (Amendment) bill
  - Inland Revenue (Amendment) bill
  - Tobacco Tax (Amendment) bill
- 22 September 2004 - Inland Revenue (Regulation of Amnesty) bill was passed by the Parliament to repeal the Inland Revenue (Special Provisions) Act No. 7 of 2002 and Inland Revenue (Special Provisions) Act No. 10 of 2003.
- 1 October 2004 - Collection of VAT on sugar and lentils was suspended.
- 5 October 2004 - All non-citizens purchasing property were made liable to a tax on transfer of property in such sums as is equivalent to the value of the property purchased.
- 15 October 2004 - Excise duty on cigarettes was raised based on the length of cigarettes.
- Excise duty for kerosene reduced from Rs. 1.50 per litre to Rs. 1.25 per litre.
- Excise duty for the diesel engines, not exceeding three years of age, increased from 48 per cent to 95 per cent.
- Excise duty on import of selected vehicles was raised based on fuel type and engine capacity of the vehicles.
- 19 November 2004 - Excise duty on liquor revised upward.
- Excise duty on mineral and aerated water, containing added sugar or other sweetening matter or flavored, and non- alcoholic beverages was raised to Rs.6.00 per litre from Rs. 5.50 per litre.
- A new VAT rate of 5 per cent was imposed on selected commodities i.e. sugar, dhal, potatoes, onions, dry fish, milk powder and chillies.
- A 5 per cent markup was imposed on the CIF value for charging VAT on imports.
- 22 November 2004 - Ports and Airports Development Levy (PAL) increased from 1 per cent to 1.5 per cent.
- November 2004 - The Cluster on Taxation was established under the National Council for Economic Development (NCED).
- December 2004 - A Code of Conduct was circulated among employees in IRD.
- 28 December 2004 - The government allowed the clearance of imported medical supplies and selected items that are to be provided for tsunami victims, with free of import duty, VAT, PAL and other taxes.
- 1 January 2005 - A new VAT rate of 18 per cent was imposed on selected items.
- Agriculture seeds and plants, leasing three wheelers, financial services on stock market transaction, animal feed, shrimp feed, providing electricity to rural areas were exempted from VAT.



## Box 5 (contd.)

- Gem and gold made liable to VAT at the rate of 15 per cent.
  - Exemption on tax on income earned from the sale of gem, gold and jewellery was removed. However, income earned from export of gold, gem and jewellery exempted from income tax.
  - The rate of ESC was reduced to 0.5 per cent from 1 per cent to the wholesale or retail trade whether they are trading local or imported goods.
  - The income/ profit arising from cultivation of land with plant of any description and sale of such unprocessed products were exempted from income tax.
  - The PAL on imports for processing and exports was reduced from 0.5 percent to 0.25 per cent.
  - Betting and Gaming Levy was increased.
  - A Social Responsibility Levy (SRL) of 0.25 per cent was imposed on tax and levies collectable under the Excise (Special Provisions) Act No.13 of 1989, The Excise Ordinance (Chapter 52), The Customs Ordinance (Chapter 235) and the Inland Revenue Act No. 38 of 2000 (excluding Withholding Tax and Dividend Tax).
- 8 February 2005
- The following bills were approved by the Parliament.
    - The Finance bill ( to give legal effect to the measures proposed in Budget 2005).
    - The Increase of Fines bill (in keeping with the government's commitment to make law enforcement more effective)
    - The Value Added Tax (Amendment) bill (to give legal effect to the measures proposed in Budget 2005)
- February 2005
- Four dedicated tax courts were setup in Gampaha, Kandy, Galle and Anuradhapura for the purpose of speedy dispensation of tax related cases including tax recovery and compliance cases.
  - An Appeals Unit was setup in the Department of Inland Revenue (IRD) to deal with settlement of appeals made by tax payers against assessments send by assessors.
  - An information centre came in to operation at the IRD to collect and analyze information on tax evades thereby strengthening the surveillance mechanism.
- 1 April 2005
- Personal income tax rates revised as follows:
 

(1) First Rs.300,000 = Nil	(2) Next Rs.300,000 = 5%
(3) Next Rs.200,000 = 10%	(4) Next Rs.200,000 = 15%
(5) Next Rs.200,000 = 20%	(6) Next Rs.200,000 = 25%
(7) Balance = 30%	
  - Tax on terminal benefits for employment revised as follows:
    - The present exemption of Rs. 2 million applicable to terminal benefits such as Provident Fund and Employees' Trust Fund (ETF) was made available only if the period of contribution is more than 20 years.
    - If the period of contribution is less than 20 years, the applicable exemption was limited to Rs. 1 million.
    - The balance is taxed at following concessionary rates.
 

(1) First Rs.500,000 = 5%	(2) Next Rs.500,000 = 10%	(3) Balance = 15%
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  - An upfront tax of 10 per cent was imposed on the divisible profit and other income of all Partnerships.
  - Restrictions were imposed on various deductions which are applicable to both corporate and non-corporate sectors.
- Forthcoming
- Appointing an independent Tax Ombudsman.

**Government Expenditure**

- 1 January 2004
- A monthly salary increase of 10 per cent of the present salary or Rs. 1,250 whichever is higher was granted to government employees.
- January 2004
- Pension payments were increased by 10 per cent.
- February 2004
- A relief package was approved by the government to households in drought-affected areas.
  - The government rectified the salary anomalies in the health sector.



## Box 5 (contd.)

- 1 May 2004 - The fertiliser subsidy was increased from Rs. 9,000 to Rs. 15,000 per metric ton.
- July 2004 - The National Procurement Agency (NPC) was established.
- 2 October 2004 - The fertiliser subsidy was further increased from Rs. 15,000 to Rs. 23,000 per metric ton with effect from October 2004 up to 31 December 2004.
- December 2004 - A 40 per cent increase of the current basic salary was granted to public servants subject to a minimum of Rs. 3,250 per month and a maximum Rs. 9,000 per month. The implementation takes place in two stages.
- A 15 per cent pension increase was granted to pensioners subject to minimum increase of Rs. 750 and maximum increase of Rs. 1,500 per month.
- 5 January 2005 - The government decided to provide Rs. 15,000 for each death due to tsunami disaster without considering the income limits of affected people.
- 11 January 2005 - The government decided to provide a ration of Rs. 375 per week for each person in an affected family due to tsunami disaster.
- The government commenced providing Rs. 2,500 to each Tsunami affected family to buy kitchen utensils.
- 17 January 2005 - The government commenced to granting of Rs. 5,000 per family (Rs. 2,500 per single person family) through the People's Bank branches as an start up allowance for tsunami affected people.
- April 2005 - The government commence the programme for the provision of Rs. 250,000 for a fully damaged house and Rs. 100,000 for a partly damaged house of tsunami affected people through state banks.

**Public Debt**

- 6 January 2004 - Existing legislation was amended to enable the issue and trading of scripless securities and dematerialization of the existing scrip securities.
- Short selling of securities (selling of securities without actually holding them in their portfolio) by primary dealers (PDs) was banned.
- 21 January 2004 - Operation of the Debt Securities Trading System (DEX) by the Colombo Stock Exchange (CSE) commenced.
- 30 January 2004 - Converting outstanding scrip securities into scripless securities commenced.
- 3 February 2004 - Operations of the Scripless Securities Settlement (SSS) system and the Central Depository System (CDS) for government securities commenced.
- 7 June 2004 - A direction was issued to PDs to refrain from using away prices (prices that are not prevailing in the market at the time of the transaction) for recording transactions.
- 28 June 2004 - Sri Lanka Development Bonds (SLDBs) amounting to US dollars 144.75 million were issued.
- 1 July 2004 - PDs were required to transfer a percentage (25 per cent and 50 per cent depending on the capital base) of their after tax profit annually, to a special risk reserve.
- 15 July 2004 - Government borrowings from FCBUs of US dollars 100 million were rolled over.
- 12 August 2004 - SLDBs amounting to US dollars 50 million were issued.
- 20 September 2004 - SLDBs amounting to US dollars 55.25 million were issued.
- 10 December 2004 - The statutory limit applicable for Treasury bills was increased by the parliament by Rs. 50 billion to Rs. 300 billion.
- 29 December 2004 - Registered Stocks and Securities Ordinance (RSSO) and Local Treasury Bill Ordinance (LTBO) were amended introducing a new account type i.e. Trust Account.
- March 2005 - US dollars 135 million was borrowed by the government from FCBUs.
- Forthcoming - Raising minimum capital requirement for PDs from Rs. 200 million to Rs. 350 million.
- Adoption of International Securities Market Association (ISMA) & International Swaps and Derivatives Association (ISDA) master agreement for repo transaction.
- Appointment of audit committees in PD companies to strengthen the risk monitoring.
- Adopting of new version of Commonwealth Secretariat Debt Recording and Management System (CS-DRMS 2000+) for recording foreign debt.
- Inclusion of database on domestic debt in CS-DRMS 2000+.



## Box 5 (contd.)

## Financial Sector

- |                 |   |
|-----------------|---|
| 1 January 2004  | - The single borrower limit (SBL) was made applicable to off-shore banking units (OSBUs).<br>- 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 licensed commercial banks (LCBs) and licensed specialised banks (LSBs).   |
| 6 January 2004  | - All LCBs and LSBs were informed that the proceeds of redeemable cumulative preference shares would constitute part of capital funds of banks for the purpose of the Banking Act, and directions issued there under, relating to the basis for the computation of the single borrower limit and investments in equity.   |
| 19 January 2004 | - Requirement of obtaining a credit rating from an independent rating agency acceptable to the Central Bank 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 bank's rating. Banks which have not obtained a rating are required to disclose that they have not obtained a rating.  |
| 27 April 2004   | - All approved external auditors were required not to undertake any consultancy or other specified non-audit service contemporaneously with the external audit of a bank. This restriction applies to entities where a partner of an audit firm is a director or has a significant share holding. The auditors are required to submit the management letter together with the published audited accounts to the bank they audit within five months of the end of the financial year.  |
| 20 May 2004     | - Clarification on the maintenance of the statutory liquid assets ratio (SLAR): All LCBs were required to maintain a SLAR of an amount not less than 20 per cent of total liabilities, less liabilities to the Central Bank and to the share holders, in respect of the domestic banking unit (DBU) in rupees and in respect of the OSBU in US dollars, for each month commencing May 2004. The penalty for any shortfall in the SLAR will be payable in Rupees in respect of the DBU and in US dollars in the case of OSBU.  |
| 13 July 2004    | - All LCBs and LSBs were informed that obtaining professional valuation reports for the purpose of classification of advances and specific provisions and revaluation of fixed assets for the computation of the capital adequacy ratio, means obtaining reports from external independent valuers. Loans and advances of Rs. 250,000 or below in the case of LSBs and Rs. 1 million or below in the case of LCBs are exempted from this requirement subject to the availability of a current internal assessment. A current internal assessment is defined as an assessment that is not more than two years old, and should be signed by the Assistant General Manager or such other senior officer of the bank in charge of credit.   |
| 16 July 2004    | - LCBs incorporated outside Sri Lanka, which consider advances as the basis for the computation of their SBL, are required to treat the DBU and the OSBU separately and to limit the SBL in these units to 15 per cent of the accommodation of the respective units.<br>- A bank may apply an SBL of 15 per cent of the consolidated accommodation of the DBU and the OSBU, in US dollar terms, to the OSBU, provided that any excess over 15 per cent of the OSBU accommodation is supported by a head office guarantee or undertaking.<br>- Where a single customer enjoys facilities from both the DBU and the OSBU of the same bank, the combined exposure to such customer should be limited to 15 per cent of the total accommodation of either the DBU or the OSBU, whichever is higher.<br>- From 2005, the monthly average of total accommodation of the preceding year, as certified by a firm of external auditors is to be the basis for computing the SBL of LCBs incorporated outside Sri Lanka, that have opted to base their SBL on advances (however, the basis of calculation has been changed to 30% of capital funds subsequently). |
| 11 October 2004 | - Guidelines were issued by the Central Bank to LCBs on Foreign Exchange Swaps in US dollars/ Sri Lankan Rupees (LKR).  |



## Box 5 (contd.)

- 22 October 2004 - Central Bank imposed a 100 per cent margin deposit requirement against the Letters of Credit (LCs) opened with LCBs for the importation of motor vehicles, mainly for private use, as a temporary measure to contain the increase in the import volume.
- 11 November 2004 - Central Bank's policy rates i.e. the Repurchase (Repo) rate and the Reverse Repurchase (Reverse Repo) rate were increased by 50 basis points to 7.50 per cent and 9.00 percent per annum, respectively.
- 31 December 2004 - The restriction on payment of interest by LCBs for a particular month in respect of savings accounts where there are more than 4 (four) withdrawals during the month was removed.
- The inclusion of the invoice value of goods under consignment in respect of shipping guarantees, instead of the book value, in the computation of the CAR and the SBL was permitted.
- Banks were advised to adopt the following accounting procedure in respect of property acquired by foreclosure of collateral/part settlement of debt:
- (i) Accounting for property acquired by foreclosure of collateral/ part settlement debt should not be accounted for as investment property or as part of the assets of the bank and should be recorded on a memorandum basis.
  - (ii) The related facility should remain classified in the books of the bank until such property is disposed of and the proceeds realised by the bank.
- January 2005 - Central Bank started the SUSAHANA loan scheme to assist tsunami affected SMEs.
- 1 February 2005 - Registered finance companies were allowed to accept savings deposits.
- A ceiling on the interest rates was imposed for savings deposit of Finance Companies.
- Registered finance companies were directed to maintain liquid assets not less than 20 per cent of the outstanding value of savings deposits.
- Registered finance companies were allowed to lodge Treasury bills and other securities with either LCBs or PDs. Earlier they could hold such securities only with LCBs.
- Registered finance companies are required to obtain the approval of the Director/SNBFI Department to close their office/s for business on any day of the week Monday to Friday, which is not holiday declared by the Ceylon Chamber of Commerce. Prior to this, they were required to get approval of the Governor of the Central Bank of Sri Lanka.
- 10 February 2005 - In terms of the Banking (Amendment) Act No. 2 of 2005, following major policy changes have been introduced;
- Permitting LCBs and LSBs to engage in Islamic Banking.
  - Application of 'Fit and Proper' criteria to directors, Chief Executive Officer and other officers carrying out executive functions as determined by the Monetary Board and major share holders of LCBs and LSBs.
  - Permitting LCBs to deduct liabilities to the holders of non-redeemable debt instruments and liabilities on repurchase agreements in relation to Treasury bills or securities issued or guaranteed by the government of Sri Lanka or on such other assets as determined by the Monetary Board, from the liability base for maintenance of the statutory liquid assets ratio.
- 11 February 2005 - Limit applicable for lending to directors of LCBs and their close relations was determined as Rs. 500,000 for Credit Cards, other accommodation (accommodation against cash - 90 per cent of deposit).
- February 2005 - Loan limits for purchasing paddy and other crops under Forward Sales Contract was increased from Rs. 25 million to Rs. 50 million.
- 7 March 2005 - The basis of the computation to the Single Borrower Limit (SBL) of foreign banks to be revised as 30 per cent of capital funds from the current basis of 15 per cent of accommodation (total advances including contingent liabilities) to be the same as the basis for SBL of the locally incorporated banks. The foreign banks that do not have sufficient capital to meet their current SBL will be given time till 31.12.2005 to augment their capital, provided that at least 50 per cent of shortfall in capital is met by 30.06.2005.