

Chapter 2

NATIONAL OUTPUT AND EXPENDITURE

2.1 Overview

In 2004, Gross Domestic Product (GDP) grew by 5.4 per cent. Although in line with the growth in the recent past of around 5 per cent per annum, it was somewhat lower than the 6 per cent recorded in 2003 indicating the need for accelerating the rate of growth to be compatible with the medium term targets. The Services and Industry sectors maintained similar growth rates as in the previous year with many sub-sectors achieving higher growth rates than in 2003. Consequently, the deceleration in growth in 2004 was mainly due to the poor performance in certain Agriculture sub-sectors and electricity generation. The adverse weather affected plantation agriculture in certain areas, as well as paddy production in both Maha and Yala cultivation seasons, and hydro electricity generation. The deceleration in growth re-iterated the necessity for addressing deep-rooted structural weaknesses in the economy, particularly in the agriculture and energy sectors, in order to ensure a sustainable high growth. The growth was supported by both consumption and investment demand, both of which grew healthily, at a somewhat lower pace in real terms than in the previous year. Investment as a share of GDP rose from 22 to 25 per cent, yet still below the desired level to maintain a higher and sustainable growth.

In the first quarter of 2004, the economy achieved well over 6 per cent growth in a stable foreign exchange market and a low inflation and low interest rate environment, although dry weather prevailed in certain districts. Strong global demand stimulated exports, while investment growth was healthy, particularly in the first half of the year. However, in the wake of adverse weather conditions, this higher growth momentum was not sustainable, and the GDP

growth decelerated somewhat thereafter. The lower growth rate, especially in the fourth quarter, also reflected the high base effect from the previous year. Meanwhile, the rise in international prices of intermediate goods, particularly oil, coupled with the depreciation of the Sri Lanka rupee and wage increases, raised the domestic costs of production. The terms of trade deteriorated by 5 per cent mainly driven by the high international prices of intermediate and investment goods, limiting the contribution from expanding external trade to economic growth and emphasised the need for raising productivity in the country.

As in previous years, the Services sector recorded the highest growth (7.6 per cent) and contributed 77 per cent of the overall growth. Telecommunications, import trade and financial services contributed most to the overall growth in this sector, while tourist related services, cargo handling and export trade also performed well. The Industry sector grew by 5.2 per cent and contributed 26 per cent of the growth. In this sector, strong performances recorded in the domestic, as well as the export oriented factory industries with the recovery of the global economy, and a buoyant construction sector supported this growth. The negative contribution of the Agriculture sector was due to dry weather in certain districts that affected paddy and coconut cultivation, although some domestic agriculture sub-sectors performed well, with farmers switching to less water intensive crops than paddy to make optimum use of the available water resources.

On the expenditure front, GDP at current market prices was estimated at Rs. 2,029 billion in 2004, recording an increase of 15.2 per cent. This higher rate of increase, despite a deceleration in real economic growth, was more due to the increase in the general price level. The overall price inflation as measured by the GDP deflator was 9.2 per cent, in comparison to 5 per cent recorded in 2003. The higher increase in the deflator was explained by the increases in public sector wages and international prices of intermediate goods such as petroleum products and other raw materials, and the depreciation of the Sri Lanka rupee by around 5 per cent, on average, against the US Dollar. The GDP per capita for 2004 is estimated at Rs. 104,347, an increase of 14.1 per cent over the previous year. In US dollar terms, per capita GDP increased by 8.8 per cent, from US dollars 948 in 2003 to 1,031 in 2004.

The economic recovery that took place in 2002 and 2003, from the first ever contraction in 2001, was driven in no small measure by consumer confidence, also supported by the recovery in exports. The continuation of cessation of

Chart 2.1
Annual Growth Rates

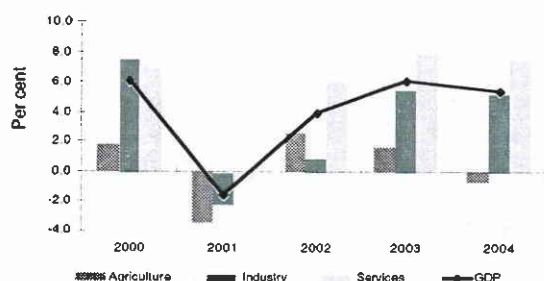


Table 2.1
Sectoral Composition and Increase in Gross Domestic Product at Constant (1996) Prices(a)

Sector	Rate of Change (%)		Contribution to Change in GDP (%)		Share of GDP (%)	
	2003(b)	2004(c)	2003(b)	2004(c)	2003(b)	2004(c)
Agriculture	1.6	-0.7	5.4	-2.5	19.0	17.9
1. Agriculture, forestry and fishing	1.6	-0.7	5.4	-2.5	19.0	17.9
1.1 Agriculture	3.2	-1.4	8.0	-3.7	14.7	13.8
Tea	-2.2	1.6	-0.5	0.4	1.3	1.3
Rubber	0.3	3.3	0.0	0.2	0.4	0.3
Coconut	8.0	-1.6	1.7	-0.4	1.3	1.2
Paddy	7.5	-15.1	3.9	-9.0	3.2	2.6
Other	1.9	3.2	2.9	5.1	8.6	8.4
1.2 Forestry	1.4	1.3	0.4	0.4	1.8	1.7
1.3 Fishing	-6.9	1.6	-3.1	0.7	2.4	2.3
Industry	5.5	5.2	24.3	25.7	26.5	26.5
2. Mining and quarrying	5.7	7.9	1.6	2.5	1.7	1.7
3. Manufacturing	4.2	5.1	11.5	15.5	16.3	16.3
3.1 Processing of tea, rubber and coconut kernel products	-0.1	1.2	0.0	0.4	1.8	1.7
3.2 Factory industry	4.6	6.1	10.3	15.3	13.3	13.4
3.3 Small industry	6.1	-0.6	1.3	-0.1	1.2	1.2
4. Electricity and water	21.6	-2.5	4.9	-0.7	1.6	1.5
4.1 Electricity	25.2	-3.5	4.9	-0.9	1.4	1.3
4.2 Water	1.3	4.7	0.0	0.2	0.2	0.2
5. Construction	5.5	6.6	6.3	8.5	6.9	7.0
Services	7.9	7.6	70.3	76.8	54.5	55.7
6. Wholesale and retail trade and hotels and restaurants	7.8	6.0	28.4	24.9	22.2	22.3
6.1 Import trade	11.2	9.0	17.5	16.6	9.9	10.2
6.2 Export trade	3.5	7.7	1.4	3.4	2.4	2.5
6.3 Domestic trade	4.5	1.7	7.0	2.9	9.3	8.9
6.4 Hotels and restaurants	26.4	15.9	2.4	2.0	0.7	0.7
7. Transport, storage and communications	10.6	13.7	22.7	34.4	13.5	14.6
7.1 Transport	4.6	4.2	6.3	6.5	8.2	8.1
7.2 Cargo handling and storage and warehousing	9.8	12.3	1.4	2.0	0.9	0.9
7.3 Post and telecommunications	23.9	31.3	15.1	25.9	4.4	5.5
8. Financial services, real estate and business services	8.8	5.7	16.6	12.3	11.7	11.7
8.1 Financial services	10.6	6.6	15.6	11.4	9.2	9.3
8.2 Real estate, renting and business services	2.4	2.0	1.0	0.9	2.5	2.4
9. Public administration, other government services and defence and other community, social and personal services	2.1	3.9	2.6	5.2	7.2	7.1
9.1 Public administration, other government services and defence	0.6	2.0	0.5	1.7	4.5	4.4
9.2 Other community, social and personal services	4.7	7.1	2.1	3.5	2.6	2.7
Gross domestic product	6.0	5.4	100.0	100.0	100.0	100.0
Net factor income from abroad	-32.2	19.3	-	-	-	-
Gross national product	6.6	5.2	-	-	-	-

Source : Central Bank of Sri Lanka

(a) Classification of the Services sector in this table has been revised to follow the International Standard Industrial Classification recommended in the System of National Accounts 1993 (SNA 93) (Please refer Box 5)

(b) Revised

(c) Provisional

hostilities since early 2002 and the resultant peaceful environment that prevailed in the country paved the way for consumption driven growth also fuelled by pent up demand. The investors' response was not as rapid and followed a "wait and see" policy during 2002 and early 2003. An improvement in investor confidence was first seen in the latter half of 2003. In 2004, with the pent up demand having been met, consumer expenditure decelerated, while the investment momentum continued, particularly in the first half, as indicated by high imports of investment goods, which increased, in real terms, by 55 per cent in the first quarter and by 30 percent in the second quarter. The high investor

confidence was also reflected in the record levels achieved on several market indicators in the Colombo Stock Market, while foreign direct investment grew by 13 per cent in US Dollar terms with the implementation of investment agreements signed in the previous year. These foreign inflows were led by investment catering to capacity expansion and productivity enhancement of the apparel industry, to meet the phasing out of the Multi Fibre Arrangement (MFA) in 2005, and of the tourism and communication industries, to cater to the growing demand. The acceleration in the expansion in private sector credit throughout the year also provided evidence of investor

Box 6

Reclassification of the Gross National Product Account

The growth in Gross Domestic Product (GDP growth rate) indicates the overall performance in the production of goods and services of a country within a year or a quarter relative to a previous corresponding period. The GDP is a summary statement on all such production activities compiled separately for individual sectors in the economy. The GDP performance is usually disseminated as a presentation on such economic activities classified into broad categories. This sectoral disaggregation is important, as it conveys details of which sectors grew faster and contributed most to the underlying economic growth, and which sectors lagged behind. This information is vital for policy makers, as they are able to make decisions based on which sectors were able to create new opportunities and which sectors were vulnerable and needed vigilance. A historical GDP data series thus provides, not only a record of the historical growth patterns, but also of structural changes that took place in the economy.

In estimating the National Accounts of Sri Lanka, the Central Bank has historically followed the recommendations in the publication "A System of National Accounts" (SNA) and supporting tables of the United Nations (UN), using the 1964 version with some revisions as recommended in the SNA 1968. Today, however, most developed and developing countries adopt, and are guided by, the methods and standards indicated in SNA 1993, the revised version of SNA 1968. The SNA 1993 recommends that all economic activities that produce goods and services in a given period of time be classified under the production account by using the International Standard Industrial Classification (ISIC) Revision 3, in order to harmonise the SNA with other international statistical standards. This would enable international comparison of National Accounts data and a broader, more meaningful view of the economy in the present context.

Until now, all economic activities in the country were classified and grouped under eleven main sectors as recommended in the SNA 1964. The ISIC Revision 3 classifies all economic activities into nine main sectors with detailed exposition of some important sub sectors, which were not available in the previous classification (Table I). Of the nine sectors, five belong to Agriculture and Industry, as in the previous version. The Services sector comprises the balance four sectors, instead of six sectors as in the previous version. This re-classification does not impact on sectoral GDP estimates that have already been published or future projections. It is merely a more meaningful re-arrangement in today's context, of what has already been published. This re-classification of the Services sector is the

second step, by the Central Bank, towards the implementation of SNA 1993 for Sri Lanka's National Accounts. In the 2002 Annual Report, as a first step, Private Consumption Expenditure (PCE) was re-classified and disseminated according to the Classification of Individual Consumption by Purpose (COICOP), which was also recommended in the SNA 1993.

The re-classification changes the broad sectors of the Services sector due to amalgamation of Ownership of dwellings and Services not elsewhere specified (n.e.s.) with the other four main sectors. The value added in the Ownership of dwellings sector, is the rental value adjusted for intermediate inputs of all houses, whether under tenancy or owner occupied. This has been included in the Real estate, renting and business services sub sector. The Services (n.e.s.) sector, which comprised all service activities that had not been included elsewhere in the previous classification, comprised community, social and personal services (such as private education and health services, repair services, recreation and entertainment, tailoring, laundry, hair dressing, gambling, lotteries etc.), business services (such as renting of machinery and equipment, advertising, private security and janitorial services, computer software development, employment agencies, accountancy, management, legal and secretarial services, etc.), hotels and restaurants and television and broadcasting services. Most of these economic activities which had been initially classified as n.e.s when they first emerged due to their low penetration and relatively low importance among economic activities at the outset, grew fast during the past three decades with the diversification in economic development the world over. The ISIC Revision 3, therefore, accommodates the move of these sub sectors from unclassified services to mainstream classification, in view of their increasing importance over time. Under the re-classification, community, social and personal services are re-grouped with public administration and other government services to the community at large; business services are re-grouped with financial services and real estate; the hotels and restaurants sub sector is now grouped with Wholesale and retail trade; while television and broadcasting falls under the Post and telecommunications sub sector.

Meanwhile, flexibility in categorisation is permitted under the SNA so that each national identity is not entirely lost in broad generalisations. For example, in the revised ISIC classification, Repair of motor vehicles, motor cycles, and the personal and household goods sub sector has been grouped with the Wholesale and retail trade sector, as in

Box 6 (Contd.)

most developed countries, trading is linked with after sales repair services. However, this is not the case in Sri Lanka, where most repair services are provided by garages, repair shops or by individuals. Therefore, in the new classification for Sri Lanka, this sub sector has been grouped with the Other community, social and personal services sub sector.

The 2004 Annual Report will introduce the revised

classification to the public and will publish both the former classification and the revised classification of GDP. With the dissemination of the 1st Quarter 2005 GDP estimates, scheduled to be released on 30 June 2005, and thereafter, the sectoral GDP performance will be disseminated only under the new classification.

GNP Reclassification - Services sector

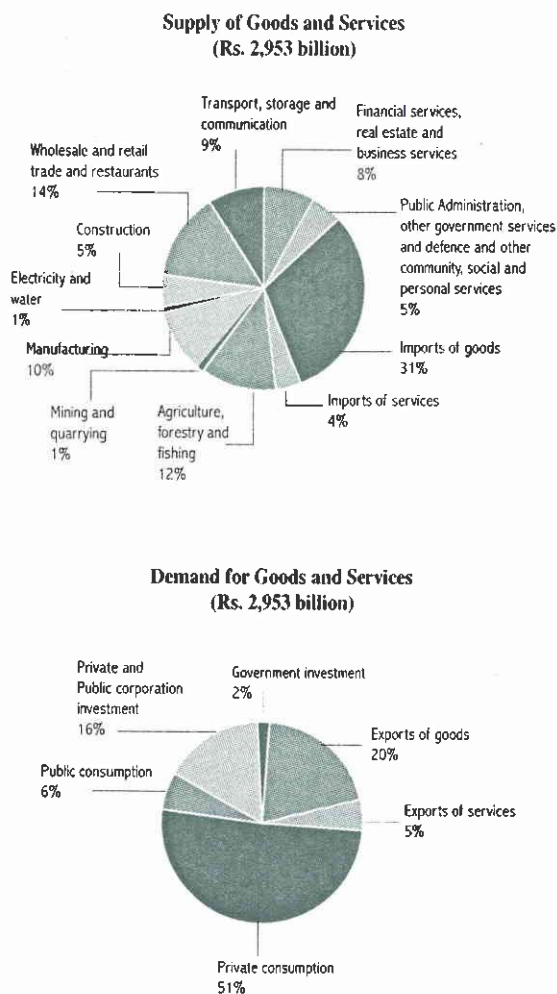
Previous Classification	New Classification
6. Transport, storage and communications 6.1 Port services 6.2 Telecommunications 6.3 Transport	6. Wholesale and retail trade, hotels and restaurants 6.1 Import trade 6.2 Export trade 6.3 Domestic trade 6.4 Hotels and restaurants
7. Wholesale and retail trade 7.1 Imports 7.2 Exports 7.3 Domestic	7. Transport, storage and communications 7.1 Transport 7.2 Cargo handling & storage and warehousing 7.3 Post & telecommunications
8. Banking, insurance and real estate 8.1 Banking 8.2 Insurance, real estate and other financial services	8. Financial Services, real estate and business services 8.1 Financial services 8.2 Real estate, renting and business services
9. Ownership of dwellings	
10. Public administration and defence	
11. Services (n.e.s.) 11.1 Hotels and restaurants 11.2 Other	9. Public administration, other government services and defence, other community, social and personal services 9.1 Public administration, other govt. services and defence 9.2 Other community, social and personal services

confidence, while the low real interest rate regime also supported this growth. The improved economic outlook with continuation of the ceasefire, strong corporate balance sheets at the end of the financial year, especially in the hotels sector with higher tourists arrivals, would have prompted higher capital spending. However, this growth decelerated during the second half of 2004. Investment in 2004 grew in nominal terms by 30.5 per cent, the combined outcome of an 11.7 per cent real growth and a 16.8 per cent increase in prices. Consequently, the real investment growth in 2004 was lower than in the previous year. Prices of imported investment goods, which had declined sharply in 2003, had risen significantly during 2004. A deceleration in the investment momentum from 2003 to 2004 was also seen in the approved and contracted investments under the Board of Investment

(BOI) that were somewhat affected by political uncertainty early in the year. Nevertheless, the investment ratio (total investment/GDP) increased by 3 percentage points to 25 per cent 2004. Meanwhile, investment expenditure grew in real terms at more than double the growth in consumption expenditure.

Consumption expenditure grew by 4.9 per cent, in real terms, in 2004. In both 2002 and 2003, the growth in consumption expenditure exceeded the real economic growth and stimulated the economic recovery. In 2004 too, the growth in consumption expenditure was healthy, although lower than in the previous two years. This deceleration in 2004 had been expected with the tapering off of the pent-up demand that had followed the ceasefire. Meanwhile, the findings of the Consumer Finance and Socio-economic

Chart 2.2
The Economy in 2004
(at current prices)



Survey (CFS 2003/04) recently conducted by the Central Bank of Sri Lanka indicate that, with economic development, the relative composition of household consumption expenditure has been changing towards non primary consumer items in the last decade. The importance of food and beverages, a basic human need, has gradually declined in the household consumption basket, and given way to categories of expenditure of choice, particularly services. Expenditure on services such as education, recreation and entertainment, hotels and restaurants and communication had risen significantly. This structural change was also reflected in national production data, where the Services sector has emerged clearly as the most dynamic sector now.

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 usual, but decreased further by 19.3 per cent in 2004, compared to improvements shown in the past few years. This was mainly due to higher outflows on account of debt service payments and repatriation of profits and dividends, despite an increase in interest earnings in 2004 on lower foreign reserves at higher global interest rates.

In 2004, in the aggregate supply of goods and services, 65 per cent was provided by domestic economic activities, while the rest was imported. Of the domestic supply, the supply of services outperformed that of goods, where the value of trading activities, transport, communication and financial services contributed most. The supply of imports comprised of intermediate goods (53 per cent), investment goods (18 per cent), consumer goods (16 per cent), and services (13 per cent). In the aggregate demand, consumption accounted for 57 per cent, nearly 90 per cent of which was private consumption. Capital formation accounted for 18 per cent of the aggregate demand, to which private capital formation contributed nearly 91 per cent. External demand, the demand for exports of goods and services, accounted for the remaining 25 per cent. Around 79 per cent of exports was of goods. The difference between external supply and demand emphasises that the available resources for utilisation exceed domestic production.

Against this background, the growth prospects for the economy need to be reviewed in the aftermath of the Tsunami tidal wave that hit about 85 per cent of Sri Lanka's coastline on 26 December 2004. The human tragedy is immeasurable, with around 30,000-40,000 lives lost and around 100,000 homes destroyed or damaged, leading to displacement and loss of livelihoods of around half a million people (2-3 per cent of the population). The economic sectors that were most affected were fisheries, tourism, small industry and small scale wholesale and retail trading. The destruction along the Southern and Eastern coastal belt has had an immediate impact on beach resorts in the tourist industry, while devastating the fisheries sector. In addition, small-scale industries, cottage industries and wholesale and retail trading establishments were destroyed or damaged, while telecommunications, electricity and water supply services were also affected temporarily in those areas.

Although minimal for the year 2004, the impact on economic activity in 2005 will largely depend on how fast these sectors will bounce back, as they have after previous setbacks, and the speed and efficiency of reconstruction and rehabilitation. In fact, certain sectors such as construction, import trade and port services are expected to grow at a higher rate with implementation of rehabilitation and reconstruction projects, while the badly affected sectors are not expected to achieve the growth rates anticipated prior to the disaster. However, the economy could perform even better, under strong commitment to, and efficient and timely implementation of, a well-planned reconstruction and rehabilitation programme for the country.

2.2 Sectoral Policies and Institutional Support

In 2004, the government indicated its support of economic activity in all three sectors through policies that encouraged private participation and focussed on addressing severe regional disparities in economic opportunities and improving sectoral productivity, while attempting to balance protection granted to market participants, both producers and consumers, as cost-push inflationary pressure accelerated, particularly in the latter half of the year. The government in its policy document has stated its commitment to revitalise the Agriculture sector with the broad objective of attaining food security while raising income levels of farmers, in the context of the smallholder nature of most of the Agriculture sector in the country. The main thrust of the new industrial policy of the government is to develop a globally competitive and vibrant industrial sector, thereby placing Sri Lanka as a preferred destination for investment. This is to be achieved by encouraging the participation of a strong, socially responsible private sector and a strong, facilitative public sector. The new industrial policy has emphasised the need for enhancing income generation activities and creation of employment through the opening of untapped domestic market opportunities in all regions, and local resources based export industries. The overall policy framework is to be based on market friendly and export-oriented strategies supported by a strong regulatory and legal framework. The government will play a key role in providing facilities for enhancing market access and competitiveness, while improving the business environment and governance.

Agricultural Policy and Institutional Support

In the context of this broad policy framework, the government's agricultural policy encouraged the sector through specific policies consistent with its key objective, while giving a greater role to the public sector. Towards this end, the government launched programmes to redesign policies, subsidise inputs, rehabilitate tanks, provide new technology, modernise agricultural research and training and encourage private sector participation in agriculture. Emphasis has also been placed on the development of horticulture and floriculture in view of the export earning and employment potential in these two sectors.

The overall trade policy measures in 2004, especially import tariff on agriculture, were directed to achieve the two objectives of reducing the cost of living and providing protection to the producers, which are difficult to achieve simultaneously. Specific import duties on potatoes, big onions and chillies were reduced by Rs. 1.50, Rs. 5.00 and Rs. 10.00 per kg, respectively, to Rs 18.50, Rs 3.00 and Rs 20.00, per kg, respectively, with effect from 1 February 2004, to reduce the cost of living. However, the specific duty on big onion was restored with effect from 16 September 2004 with the start of the harvesting season, to protect farmers. The specific duty of

Rs 4.50 per kg on sugar imports was waived with effect from 19 March 2004 to provide relief to consumers in the wake of increasing prices in the international markets. However, in order to lessen this impact on domestic producers, it was re-imposed for brown sugar from 1 October 2004. The specific duty of Rs 9 per kg on rice imports was waived for the period from 22 September 2004 to 15 January 2005 towards reducing high domestic rice prices caused by the production shortfall. The government also imposed a cess of 20 per cent on value or Rs.15 per kg on imported fruits with effect from 4 November 2004 to promote the consumption of local fruits among consumers.

With the objective of stabilising paddy prices at reasonable levels, the government announced a paddy-purchasing scheme, first for the 2004 Yala and later, for the 2004/05 Maha season, under which the government would purchase quality paddy at fixed prices from the farmer. However, in view of the supply shortfall, the scheme was ineffective during the Yala season.

The government continued to provide crop subsidies and various other forms of assistance directly and through other agencies to encourage expansion of production. The Tea Small Holdings Development Authority (TSHDA) continued to support the tea smallholders by providing necessary advisory and extension services and implementing new-planting and re-planting subsidy schemes. The subsidy scheme is financed by a cess on tea exports of Rs. 2.50 per kg. The cess fund, which receives around Rs. 750 million per annum, is also used for research and development, tea factory development and tea promotion activities. Considering the attractive prices received for natural rubber in recent years, the rubber cess was reintroduced in October 2004 to raise funds needed for the development of the rubber industry, mainly to provide subsidies for new planting and replanting and for research and development. The upward revision of the rubber replanting subsidy from Rs. 49,000 to Rs. 100,000 per ha and extension of subsidy schemes to cover plantation companies is expected to expand rubber cultivation. The government also intends to introduce a cess on imported edible oil to strengthen the coconut cess fund. Necessary action has been taken to amend the Fragmentation and Control Act of Tea and Rubber to include coconut, to prevent coconut land fragmentation. The Department of Export Agriculture (DEA) continued to play a key role in the development of the export agriculture sector by implementing subsidy schemes and providing necessary inputs, technical advice and extension services for cultivating and processing spices.

A new National Fisheries Policy has been drafted by the National Fisheries Policy Council (NFPC) aimed at promoting the local fishing industry with special focus on the development of small-scale fishermen. The development programmes consist of facilities to increase marine fish production by developing coastal aquaculture, introducing new fishing technologies, improving storage facilities and modernising

existing harbour facilities and promoting multi-day fishing. A project to upgrade inland fishery and aquaculture development was launched by the National Aquatic Development Authority (NAQDA) with donor assistance. For sustainable development of prawn farming, the government has allocated funds under the Budget 2005 for immediate infrastructure rehabilitation and environment protection.

At present, the local milk supply is only around 20 per cent of the demand. Hence, the government has paid special attention to improve milk production in the country. The government has introduced the Dairy Farmer Empowerment Project to provide training, help in marketing and conduct veterinary clinics for animals. In addition, action has been taken to set up 50 dairy villages with at least 20 dairy farmers in each village. The VAT on animal feed was removed to bring down the cost of production in the livestock industry. Steps are being taken to expand the supply of breeding animals, improve veterinary services and support the Veterinary Research Institute for further development of the dairy sector.

With a view to encouraging private sector participation in agriculture, the government provided various incentives in the Budget 2005. These included exemption of income and profit on agriculture from taxes for 5 years, provision of technical know how and extension services to small and medium growers of floriculture and identification of lands for the private sector to be used as model farms. Seed and planting material imports were exempted from VAT. With a view to promoting organic agriculture, which has a niche export market, steps were taken to set up a certification system and to declare selected areas as protected organic products zones. Steps have also been taken to improve research and product development in the cinnamon industry and to set up a Cinnamon Development Fund to be funded by a cess on cinnamon exports. In the Budget 2005, the government also proposed a special credit line for small and medium scale paddy millers to modernise their mills.

Industrial Policy and Institutional Support

The present industrial policy has placed emphasis on rationalising and simplifying the existing tariff structure aimed at reducing the number of tariff bands. The long-term objectives of these initiatives are to bring down the tariff rate of raw materials and machinery to zero level, aiming at improving competitiveness of exports. The Tariff Council set up by the previous government in 2003 emerged as the trade and tariff cluster of the National Council for Economic Development (NCED) under the new government in 2004. The cluster was entrusted with studying the anomalies of the existing tariff structure and other concerns raised by the various chambers and trade associations. During the year, the Ministry of Industry and Investment Promotion (MIIP) also conducted investigations on tariff anomalies and made recommendations to minimise the negative impact of such distortions.

In 2004, the government made a special effort to enhance competitiveness of selected thrust industries. The targeted

thrust industries were textiles and apparel, footwear, leather products, ceramics, rubber, and wood and wood based industries. Major programmes implemented by the government in 2004 included product development programmes, factory expansion and modernisation programmes and capacity building programmes for business development service providers. In collaboration with the Joint Apparel Association Forum (JAAF), the MIIP launched several productivity improvement, skills development and image building programmes for that sector.

Recognising the potential of small and medium scale enterprises (SMEs) in creating employment and income generation activities, the government intends to promote the SME sector by establishing a multi-pronged support mechanism. Measures are to be taken to streamline bureaucratic procedures and regulations, value added tax administration, Customs regulations and export procedures, and increase training through universities and technical institutions. Institutional support would be provided for improving technical capabilities, quality management, productivity improvement, Internet access and to obtain ISO 9000/14000 certification. The government is also planning to take measures to increase their access to venture capital funds and credit at competitive interest rates. This will be achieved by establishing a new bank to promote SMEs. To improve the productivity and competitiveness of SME apparel industries in Sri Lanka, the Budget 2005 offered several incentives, including providing financial assistance for technology improvements, simplified VAT applications, and incentives to improve productivity and to develop backward linkages. The Budget 2005 also proposed several other incentives for human resources development and skills development by increasing the intake to vocational training institutes to 50,000, setting up a new University of Vocational Technology, restructuring the 'Tharuna Aruna' program into a Skills Development Fund and establishing a new incentive scheme to encourage SMEs to acquire advanced technology aimed at raising productivity and improving competitiveness.

2.3 Output

Agriculture

The Agriculture, forestry and fishing sector, which expanded by 1.6 per cent in value added terms in the previous year, contracted marginally by 0.7 per cent in 2004 mainly due to the impact of inadequate rainfall on certain major crops. The relative importance of the Agriculture sector continued to decline from 19 per cent of the GDP in 2003 to 18 per cent in 2004, owing to the low contribution from paddy production. The drought in the districts of Anuradhapura and Kurunegala in the Maha season due to the failure of the Northeast monsoon and the delay in the onset of the Southwest monsoon in the Yala season caused this decline. However, production of other subsidiary food crops and vegetables improved, as farmers

Table 2.2
Agriculture Production Index (1997-2000 = 100)

Item	2003(a)	2004(b)	Rate of change (%) 2004/03
Agriculture and Fishing	104.6	104.2	- 0.4
1. Agriculture	104.7	104.1	-0.6
1.1 Agriculture crops	103.2	101.8	- 1.4
Tea	105.8	107.5	1.6
Rubber	95.4	98.3	3.0
Coconut	92.3	92.1	- 0.2
Paddy	115.2	98.6	- 14.4
Other Crops	98.5	106.3	7.9
1.2 Livestock	117.7	123.6	5.0
2. Fishing	104.3	104.8	0.5

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

shifted from paddy to these crops to ensure maximum use of available water. In fact, the 'other agricultural crops' category which includes, vegetables, subsidiary food crops, minor export crops, animal husbandry, sugarcane, tobacco and fruits, expanded by 3.2 per cent in value added terms compared to 1.9 per cent recorded in 2003, while the value added in the fishing sector recorded an improvement of 1.6 per cent. In plantation agriculture, tea production partly recovered from the damage caused by floods in mid 2003, and rubber production further increased, benefiting from attractive prices, while coconut output fell.

Export agriculture: In 2004, most export crops, tea, rubber, and minor export crops performed satisfactorily, largely benefiting from attractive prices.

Tea production increased by 1.6 per cent to 308 million kg, partly recovering from the setback experienced due to floods in mid 2003. The recovery was solely due to a significant improvement in low grown tea production, which responded to favourable weather conditions that prevailed in the low grown areas. In contrast, tea production in the high and medium elevations declined by 9 per cent and 8 per cent respectively, due to the spell of dry weather that prevailed in those areas. The production of cut, tear and curl (CTC) tea declined for the second consecutive year by 9 per cent to 16 million kg, resulting from changes in relative prices in favour of orthodox tea production.

The smallholder tea sector continued to dominate by contributing 66 per cent of the total tea production in 2004. The average yield in the smallholder sector was 2,448 kg per ha in comparison to 1,275 kg per ha in the estate sector. The estimated national average yield was 1,863 kg per ha in 2004¹. The average cost of tea production increased by 16 per cent to Rs. 158.25 per kg in 2004 due to increases in input prices such as fertiliser, agrochemicals and fuel and the estate sector wage increase implemented under a collective agreement from November 2004.

1 Average yield of the estate sector is based on the bearing extents provided by the Plantation Companies, while the smallholder yields are provided by the TSHDA.

Rubber production grew by 3 per cent to 95 million kg in 2004 in response to higher prices. The increase in crude oil prices resulted in high synthetic rubber prices in the international market with a corresponding increase in natural rubber prices. However, the loss of tapping days due to rainy weather in rubber producing areas, particularly during the latter part of the year, reduced the potential output in 2004. Sheet rubber and crepe rubber production declined, while latex rubber production increased in 2004, in response to relatively higher demand. As with tea, the cost of production rose, by 16 per cent. Of the total production, 43 per cent was exported in primary form. The domestic consumption of rubber in industry increased by 5 per cent to 68 million kg, of which 16 per cent had to be imported, indicating the need for production expansion to meet the rising domestic demand. The national average yield of rubber at 1,064 kg per ha still remains significantly below the potential production level. Application of recommended fertiliser, usage of rain guards and adhering

Table 2.3
Trends in Principal Agricultural Crops

Category	Unit	2003(a)	2004(b)
1. Tea			
1.1 Production	kg mn	303.2	308.1
1.2 Total extent	hectares '000	180	180
1.3 Extent bearing	hectares '000	165	165
1.4 Cost of production (c)	Rs/kg	135.58	158.25
1.5 Average price			
- Colombo Auction	Rs/kg	149.05	180.74
- Export (f.o.b.)	Rs/kg	221.01	249.38
1.6 Replanting	hectares	935	1,135
1.7 New planting	hectares	642	22
1.8 Value added as % of GDP (d)		2.0	2.2
2. Rubber			
2.1 Production	kg mn	92.0	94.8
2.2 Total extent (e)	hectares '000	115	114
2.3 Area under tapping (e)	hectares '000	86	89
2.4 Cost of production	Rs/kg	63.30	73.39
2.5 Average price			
- Colombo Auction (RSS 1)	Rs/kg	102.50	110.75
- Export (f.o.b.)	Rs/kg	105.25	127.20
2.6 Replanting (f)	hectares	564	820
2.7 New planting (f)	hectares	450	519
2.8 Value added as % of GDP (d)		0.6	0.7
3. Coconut			
3.1 Production	nuts mn	2,562	2,557
3.2 Total extent	hectares '000	439	439
3.3 Cost of production	Rs/nut	4.90	7.50
3.4 Average price			
- Producer price	Rs/nut	9.77	9.83
- Export (f.o.b.) (g)	Rs/nut	9.98	11.03
3.5 Replanting / Under planting (h)	hectares	1,226	681
3.6 New planting (h)	hectares	1,098	483
3.7 Value added as % of GDP (d)		2.3	2.0

(a) Revised
(b) Provisional
(c) Include green leaf suppliers profit margin
(d) Include growing and processing, excludes trading
(e) Based on rubber land survey -2003 conducted by Dept. of Census and Statistics & Rubber Development Department
(f) Extents covered by cultivation assistance schemes of the Rubber Development Department
(g) Three major coconut kernel products only
(h) Extents covered by cultivation assistance schemes of the Coconut Cultivation Board

Sources:
Sri Lanka Tea Board
Rubber Development Department
Coconut Cultivation Board
Coconut Development Authority
Plantation Companies
Central Bank of Sri Lanka
Sri Lanka Customs

to systematic infilling are required to increase productivity. New planting and replanting of rubber increased in 2004 encouraged by attractive prices and incentives granted by the government. The government also took an initiative in 2004 to encourage rubber planting in non-traditional rubber growing areas such as Moneragala.

Coconut production dropped marginally by 0.2 per cent to 2,557 million nuts in 2004, following a 7 per cent increase in 2003. The reduction occurred entirely during the latter part of the year, due to the lagged effect of the drought in late 2003 and the spread of mite attack from mid 2004. As a result, the producer price of fresh coconut, which had declined during the first half, rose sharply by the end of 2004. Both desiccated coconut and coconut oil production increased by 19 per cent each during the year due to attractive prices throughout the year. The introduction of regional fresh coconut auctions in 2004 also helped coconut growers to receive remunerative prices for their produce. Meanwhile, the cost of production for coconut increased by 53 per cent due to relatively higher wage costs with the shortfall in production and increases in other input costs.

Among other export crops, production of cinnamon, cloves, cocoa, coffee, cashew and cardamom increased during the year, while production of pepper and nutmeg declined. Even though Sri Lanka is the largest producer and exporter of cinnamon in the world market, value addition for cinnamon is still at a low level. The proposed Cinnamon Development Fund is expected to support further development of the cinnamon industry, especially expansion of value added products.

The foliage and cut flower sector has expanded significantly in recent years with assistance provided by the Department of Agriculture (DOA) and the Export Development Board (EDB) and the active participation of private entrepreneurs. There is an attractive domestic market as well as a foreign market for foliage and cut flowers. The rising demand for landscaping for commercial buildings, hotels and residencies, as well as for floral arrangements for social

functions, and increased participation in the industry by small-scale entrepreneurs through plant sales and exhibitions indicate the rapid expansion of the sector in the domestic market. Furthermore, the export earnings from this sector were Rs. 915 million in 2004, at around the same level as in 2003 compared to Rs 776 million in 2002. The proposed assistance from the Budget 2005 to develop the floriculture sector would support further expansion of this sector.

Domestic agriculture: The domestic agriculture sector suffered a setback in 2004 mainly due to the significant shortfall in paddy production, the largest mono crop cultivated in Sri Lanka. However, production of other field crops such as big onion, red onion and vegetables increased, as farmers shifted from paddy to these crops to get maximum benefit from available water.

Paddy production declined by 14.4 per cent to 2,628,000 metric tons (126 million bushels) during the 2004 cultivation year from the peak output of 3,071,000 metric tons (147 million bushels) in the preceding year, following a drop of 21 per cent in the extent sown. However, annual average yield had increased by 9 per cent to a record level of 4.09 metric tons per ha, surpassing the previous peak yield level of 3.95 metric tons per ha achieved in 2001 reflecting the concentration of cultivation under irrigated conditions. The paddy output in 2003/04 Maha season dropped by 11.9 per cent, while the output in Yala season declined sharply by 18.6 per cent, due to reduction in both seasons in the extent cultivated under drought conditions.

The farm gate price of paddy remained attractive throughout the year due to the shortfall in supply as a result of the low production and low imports of rice during the first three quarters of 2004. Imports were delayed under market anticipation of a waiver from the relatively high specific import duty on rice that was finally given in mid September. Consequently, the average farm gate price in 2004 was Rs 16.17 per kg, an increase of 36 per cent compared to 2003. As

Table 2.4
Paddy Sector Statistics

Item	Unit	2003(a)			2004(b)		
		Maha	Yala	Total	Maha	Yala	Total
Gross extent sown	hectares '000	602	381	983	521	258	779
Gross extent harvested	hectares '000	560	352	911	469	251	720
Net extent harvested	hectares '000	499	317	817	417	226	643
Production	mt '000	1,895	1,177	3,071	1,670	958	2,628
	bushels '000	90,785	56,372	147,157	80,022	45,920	125,942
Yield (c)	kg / hectare	3,794	3,709	3,761	4,004	4,244	4,087
Credit granted	Rs.mn.	301	263	564	527	285	812
Rice imports	mt '000	-	-	35	-	-	222
Paddy equivalent of imports	mt '000	-	-	51	-	-	326

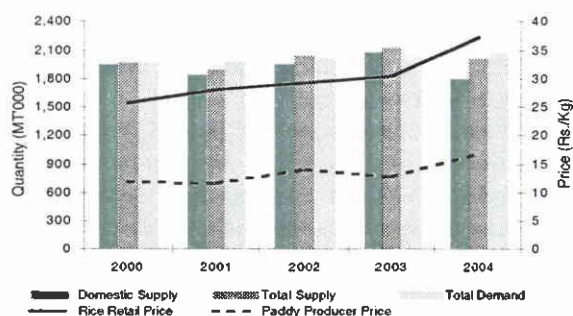
(a) Revised

(b) Provisional

(c) Yield per hectare for Maha and Yala are calculated using data from the Department of Census and Statistics which are based on crop cutting surveys while total yield is calculated by dividing total production by the net extent harvested.

Sources: Department of Census and Statistics
Sri Lanka Customs
Central Bank of Sri Lanka

Chart 2.3
Rice : Supply and Demand



paddy prices were high, many farmers sold their harvest without keeping adequate quantities of seed paddy. This led to a shortfall in quality seed paddy for the 2004/05 Maha season, as favourable weather conditions during the latter part of the year and good paddy prices encouraged farmers to extend the cultivation area in the 2004/05 Maha season.

Despite the drop in extent cultivated due to the drought, output of major field crops, particularly potato, big onion, red onion, kurakkan, green gram, groundnuts and maize, increased in 2004. However, a significant share of the domestic requirement of key items such as onions and potatoes continue to be imported. In 2004, the total supply of potato and big onion was lower than in 2003 due to a decline in imports following increases in import duties in 2004. Meanwhile, demand from both domestic consumers and the tourism sector rose. Hence, prices did not decline, despite the increase in production.

Vegetable production in both Maha and Yala seasons increased. Production of both up-country and low-country vegetables rose. However, although market prices fell following the Maha season, prices in 2004 did not come down in line with the increase in production due to the high cost of inputs and transportation. Fruit production in 2004 rose with higher output from banana (22 per cent), passion fruit (18 per cent), pineapple (4 per cent) and papaya (27 per cent) while prices remained at similar levels to the previous year. During 2004, imports of fresh and dried fruits amounted to 24,000 metric tons, a decline of 26 per cent over 2003. An additional cost of a cess on imported fruits was imposed in November 2004 to stimulate the local fruit farming industry.

Sugarcane production declined by 1 per cent in 2004 following a 42 per cent increase in the preceding year. However, sugar output at both Sevanagala and Pelwatta factories rose during the year. The extent under sugarcane as well as sugar production continue to increase since the private sector took over operation of these factories in 2002. A relatively low cane yield rate and sugar recovery rate resulting in a high cost of production and low profitability have been the

major constraints affecting the development of the sugar industry. Consequently, around 90 per cent of the domestic requirement continues to be imported.

The Livestock sector, which mainly consists of the dairy and poultry industries, recorded mixed performance during the year. It has been estimated that total milk production has grown by 3 per cent to 162 million litres in 2004. However, the total milk collection increased by 13 per cent in 2004 due to an improved collection network. Producer prices of milk paid by the two state-run market players increased twice during the year from Rs. 15 per litre to Rs. 16 per litre and further to Rs. 18 per litre to encourage dairy farmers. In parallel with the government's initiatives to increase production and popularise fresh milk consumption, private milk-processing companies introduced different liquid milk products to expand the market for milk. Furthermore, the private sector has invested in milk processing plants at regional level to expand fresh milk production and manufacturing of milk-based products to cater to the rising demand. The recently conducted CFS 2003/04 also revealed an increase in per capita consumption of milk products since the mid 1990s.

Poultry meat production is estimated to have increased in 2004 by 7 per cent to 94.7 million kg compared to 2003. However, egg production declined by 1.2 per cent to 871 million. An outbreak of the bird flu in East Asian countries in February 2004 adversely affected the domestic poultry industry too during the first half of the year, as domestic consumers were reluctant to consume poultry meat due to fear of the disease. The decline in demand badly affected the smallholder poultry sector due to a substantial decline in poultry meat prices and lack of cold storage facilities to store meat. However, the government and the private sector launched several public awareness programmes to educate consumers to minimise the impact. The ban on the import of parent stocks as a safety measure hindered the potential growth of both poultry meat and egg production in 2004.

Forestry: In 2004, the Forest Department continued several projects to develop the forestry sector with the assistance of foreign donor agencies. Under these projects, several activities were undertaken to promote re-forestation. Several plantation management companies have diversified their unproductive lands into forestry. According to the Ministry of Plantation Industries, the land area utilised for such diversification was 14,079 hectares. Compared to the previous year, this was a 48 per cent increase. Of these forest plantations, over 64 per cent are concentrated in the Nuwara Eliya and Badulla districts. There are many investors engaged in commercial forest plantations activities and therefore, the extent of newly planted area under commercial scale private forest plantations is expected to increase in the future. There is strong potential for increasing value addition in this sector, which remains yet untapped. In 2004, the State Timber Corporation continued to supply timber to the public and

Table 2.5
Fish Production

Sub-Sector	Metric Tons '000	
	2003(a)	2004(b)
Marine (c)	255	253
Aquaculture and Inland fisheries	30	33
Total	285	286

(a) Revised Sources: Ministry of Fisheries and
(b) Provisional Aquatic Resources Development
(c) Coastal and deep sea sector National Aquatic Resources Research and Development Agency

private sector. The total output of logs, sawn timber and firewood by the Corporation decreased by 11 per cent to 168,933 cubic meters over the previous year.

Fishing : Total fish production in 2004 increased marginally by 0.5 per cent over the previous year. This was the combined outcome of inland fish and aquaculture production increasing by 9.6 per cent and marine fish production declining by 0.6 per cent. Marine fish production contributed to nearly 90 per cent of the total fish catch, of which the coastal fish catch was 60 per cent. Even though the offshore fish catch reported an increase of 9 per cent, the coastal fish catch declined by 6 per cent, due to unfavourable weather conditions in most of the coastal belt, particularly in the latter half of 2004, thereby affecting overall marine sector production. The aquaculture based prawn industry has reported a setback in recent years causing heavy losses to investors. Illegal prawn farming without adhering to environmental regulations could lead to pollution and spreading of diseases, which has been the common cause of production losses. The Budget 2005 has allocated funds for immediate infrastructure rehabilitation work and environmental protection in this sector.

The fisheries sector was severely affected by the Tsunami tidal waves that hit two third of the coastline of the island. It is estimated that nearly 80 per cent of active fishermen were affected and more than 75 per cent of the fishing fleet was destroyed or damaged by the Tsunami. In addition, a large number of small-scale fishing craft and fishing gear were destroyed. Of the 12 fishing harbours, 10 were severely damaged, including breakwaters, buildings, machinery and equipment. In addition, public and private utilities such as ice plants, landing ports, markets, and houses of the fishing community were destroyed. Consequently, the full impact of the disaster will be felt in 2005, initially, on demand and, for a longer period, on supply. The full recovery of the sector will depend on the speed and efficiency of the recovery process.

Industry

The Industrial sector, spanning the four sectors of Mining and quarrying, Manufacturing, Construction and Electricity and water, registered a growth of 5.2 per cent in 2004. The share of the industry sector in GDP remained at the same level of 26 per cent as in 2003. The industry sector contributed 26 per cent to the overall growth in 2004. The manufacturing sector, the largest of the four sub-sectors, accounted for 16 per cent of

GDP and contributed 16 per cent to overall growth in 2004, the contribution being higher than in 2003. The construction sector also contributed significantly with a better performance in 2004. The Electricity and water sector was affected by the drought and contracted by 2.5 per cent. The Mining and quarrying sector did well with a growth of 7.9 per cent over the previous year.

Manufacturing: Factory industries, the largest sub sector in the Manufacturing sector, expanded by 6.1 per cent in 2004 compared to 4.6 per cent growth in 2003. 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. Private sector industries accounted for 96 per cent of the output in the factory industry sector in 2004. The two sub categories of private sector industries, BOI and Non-BOI, grew by 7.5 per cent and 4.4 per cent, respectively, and contributed 55 per cent and 45 per cent, respectively, to overall factory industry output.

The major contribution to the growth in factory industries 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 mineral products. These industries 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 and port services and simplification of Customs procedures. The competitiveness in exports was facilitated by the improvement in productivity, rationalisation of production costs and depreciation of the exchange rate. The fabricated metal products category also contributed to the growth, mainly responding to the rise in domestic demand. Growth of domestic market oriented industries, which gained momentum since the second half of 2003, continued in 2004. The growth was seen across all industrial categories. Greater economic activity, new demand arising from the North and the East, aggressive advertising, and changes in consumer preferences stimulated the demand for industrial products.

The textile, apparel and leather products sector grew by 7.9 per cent and contributed 51 per cent to the overall growth in real terms. The entire growth came from the apparel sector. With the expansion in international trade, apparel industries expanded by 9.9 per cent amidst stiff international competition, owing to improvements in productivity. The textile and apparel quota system under the MFA, which had been operating over the last two decades, came to an end on 1 January 2005. Since this was announced at least a decade ago, a gradual restructuring process has been taking place in Sri Lanka to face competition in a quota free market. The restructuring took place by way of product specialisation, acquisitions and mergers, process improvements, technology developments, skills development, developing strategic alliances, developing backward linkages and

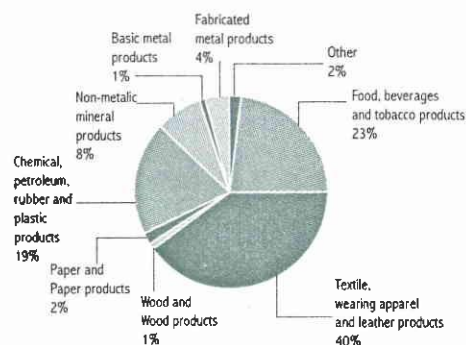
improving marketing capabilities. As a result, the industry was able to create a high image in the international markets through price, quality and speed of delivery.

The apparel sector in 2004 also benefited from the special duty concessions received from the EU under the Generalised System of Preferences (GSP) beginning from February 2004 on Sri Lanka's adherence to international labour standards. The apparel quota received from India under the Free Trade Agreement (FTA) was doubled in 2004. The forthcoming Comprehensive Economic Partnership Agreement (CEPA) with India and FTAs with Pakistan and BIMST-EC will further benefit the garment industry. Both USA and EU are now considering grant of greater access for Sri Lankan products to their markets as a measure of providing relief in view of the recent Tsunami disaster.

The output of food, beverages and tobacco products registered moderate growth in 2004 and contributed 17 per cent to the overall growth, driven by improved performance in food processing, beverages and liquor products. The growth was seen in processed meat products, biscuits, milk products, wheat flour processing, fruit and vegetable processing, tea processing and production of liquor, beer and animal feed. The growth of these industries was in response to the expansion in domestic demand with higher per capita income, the surge in the tourism industry, higher consumer credit, increased trading activities in the North and the East, the expansion of the distribution network and aggressive marketing campaigns.

Chemical, petroleum, rubber and plastic products, the third largest category among factory industries, showed a relatively higher growth in 2004, driven by rubber based industries. This sector contributed 15 per cent to the overall growth in factory industry. The healthy growth of the export oriented rubber based industry is attributed to its duty free

Chart 2.4
Composition of Industrial Production - 2004



access to India under the FTA, penetration into new markets in the Asia-Pacific and SAARC regions and higher demand from existing markets in UK, USA, France and Belgium. The rise in the vehicle fleet and improvement in transport activities in the North and the East fuelled the domestic demand for tyres and tubes. The domestic industry requirement, of which 16 per cent was imported, amounted to 72 per cent of total domestic natural rubber production, indicating the rising domestic demand.

The output of non-metallic mineral products grew by 7.6 per cent in 2004 and contributed 10 per cent to the overall growth in factory industries. This growth was driven by the production of ceramics, processed diamonds, cement, and roofing sheets, the latter two being in response to the demand arising from construction. Demand for these products is expected to grow further with the commencement of reconstruction activities in Tsunami affected areas. Major sub sectors in ceramics such as tableware, ornamental ware and ceramic tiles also grew in 2004 due to penetration into new external markets and continuous improvement of product quality.

The growth in fabricated metal products arose from higher production of agricultural machinery, water pumps, steel furniture, kitchen appliances, motor cycle assembling, manufacturing and repairing of ships and boats and production of aluminium products, light fittings and bulbs. The domestic demand for aluminium products, cables, bulbs and light fittings grew with the expansion in the construction industry, while the expansion of rural electrification programmes stimulated the demand for television sets, electrical items and kitchen appliances.

The output of public sector industries, which accounted for only 4 per cent of industrial output, grew by 5.1 per cent in 2004, with the uninterrupted production of the Ceylon Petroleum Corporation (CPC). The output of CPC, which accounted for over 90 per cent of the public sector industrial output, increased by 5.9 per cent in 2004. The other public sector industries which registered higher growth rates in 2004 were Lanka Phosphates Ltd (7.4 per cent) and Lanka Salt Ltd (4.3 per cent).

Table 2.6
Value of Industrial Production
(1990 Constant Prices)

Categories	Rs. million		Percentage Change (%)	
	2003	2004(a)	2003	2004 (a)
1 Food, beverages and tobacco products	50,656	52,912	6.3	4.5
2 Textile, wearing apparel and leather products	86,247	93,062	2.7	7.9
3 Wood and wood products	1,547	1,610	5.5	4.1
4 Paper and paper products	3,810	3,882	4.5	1.9
5 Chemical, petroleum, rubber and plastic products	43,100	45,098	5.0	4.6
6 Non metallic mineral products	17,311	18,631	6.1	7.6
7 Basic metal products	2,254	2,455	4.6	8.9
8 Fabricated metal products	10,079	10,512	6.7	4.3
9 Manufactured products not elsewhere specified	5,046	5,207	6.9	3.2
Total	220,050	233,369	4.6	6.1

(a) Provisional

Source: Central Bank of Sri Lanka

Table 2.7
Ex - Factory Profit Ratios of Non - BOI Private Sector Industries (a)

Categories	Total Cost of Production (Rs. million)		Total Value of Production (Rs. million)		Factory Profit Ratio (percentage)	
	2003(b)	2004(c)	2003(b)	2004(c)	2003(b)	2004(c)
1 Food, beverages and tobacco products	71,441	79,071	83,264	92,590	14.2	14.6
2 Textile, wearing apparel and leather products	18,816	21,305	22,400	25,424	16.0	16.2
3 Wood and wood products	1,349	1,489	1,542	1,713	12.5	13.1
4 Paper and paper products	4,391	4,719	4,950	5,356	11.3	11.9
5 Chemical, petroleum, rubber and plastic products	27,354	30,531	31,478	35,255	13.1	13.4
6 Non metallic mineral products	17,615	19,608	20,554	23,041	14.3	14.9
7 Basic metal products	1,953	2,232	2,250	2,592	13.2	13.9
8 Fabricated metal products, machinery, and transport equipment	11,476	12,644	13,100	14,567	12.4	13.2
9 Manufactured products not elsewhere specified	2,857	3,115	3,214	3,519	11.1	11.5
Total	157,251	174,714	182,752	204,058	14.0	14.4

(a) Based on information received from 480 non-BOI private sector firms.

(b) Revised

(c) Provisional

Source: Central Bank of Sri Lanka

The profit ratio of the factory industry sector, estimated as the ratio of ex-factory value of production to the total cost of production, increased marginally in 2004. Continuation of increasing domestic demand, a notable improvement in exports and depreciation of the rupee helped the increase in revenue. Cost of production also increased in 2004, due to higher fuel and other utility prices, and the high cost of imported raw material, but remained below the revenue increase.

The wage bill of the manufacturing sector in factory industry rose by 12 per cent in 2004, but its share in the total cost of production declined marginally due to higher increases in other input costs. The labour cost was contained by outsourcing production activities and containing the overtime bill. Although costs of petroleum and gas were high, the share of energy cost in the total cost of production increased only marginally due to various energy saving measures taken by the producers. Interest costs as a percentage of the total cost of

production declined marginally, mainly due to the falling interest rates and improvement in working capital management. Labour productivity in the manufacturing sector, estimated as the change in the real value added per man-hour, increased by 2.6 per cent in 2004. This productivity improvement was seen in all industrial categories and resulted from the use of new technology, skills development and the low incidence of industrial disputes in 2004.

Within the manufacturing sector, processing of plantation crops grew marginally due to moderate growth in the output of tea and rubber, while that of coconut increased sharply due to the increase in export volumes of desiccated coconut and coconut oil, despite the drop in production during the latter part of the year.

The small industries sub sector contracted marginally compared with the high growth recorded in the previous year. The paddy milling industry, the most widespread small industry

Table 2.8
Domestic Cost Structure of Non - BOI Private Sector Industries (a)
(As a percentage of total cost of production)

Categories	Domestic Cost (percentage)							
	Power & Fuel		Wage		Raw Material		Interest	
	2003	2004	2003	2004	2003	2004	2003	2004
1 Food, beverages and tobacco	3.1	3.3	9.8	9.7	37.1	37.8	1.5	1.5
2 Textile, wearing apparel and leather products	4.2	4.2	14.8	14.6	13.8	13.2	2.4	2.4
3 Wood and wood products	8.9	8.9	15.4	15.8	33.6	33.1	4.0	4.0
4 Paper and paper products	3.5	3.4	12.0	12.9	18.6	18.2	3.8	3.7
5 Chemical, petroleum, rubber and plastic products	5.2	5.9	12.8	12.3	30.4	29.2	3.7	3.2
6 Non metallic mineral products	18.1	18.9	16.1	15.2	27.9	28.4	2.3	2.3
7 Basic metal products	9.1	9.9	10.2	11.1	34.9	35.0	3.5	3.2
8 Fabricated metal products, machinery, and transport equipment	3.9	4.5	10.8	11.3	25.8	26.2	3.6	3.3
9 Manufactured products not elsewhere specified	4.5	4.9	12.6	12.1	33.9	34.1	1.8	1.8
Total	5.5	5.9	11.9	11.7	30.6	30.7	2.4	2.2

(a) Based on information received from 480 non-BOI private sector firms.

Source: Central Bank of Sri Lanka

Table 2.9

Labour Productivity Index in the Non-BOI Private Sector Industries (a)

Categories	2003	2004	1995 = 100 % Change
1 Food, beverages and tobacco products	126.7	129.4	2.1
2 Textile, wearing apparel and leather products	105.9	109.5	3.4
3 Wood and wood products	98.0	100.7	2.8
4 Paper and paper products	98.8	101.4	2.6
5 Chemical, petroleum, rubber and plastic products	130.1	134.7	3.5
6 Non metallic mineral products	109.7	112.0	2.1
7 Basic metal products	98.4	100.9	2.5
8 Fabricated metal products, machinery, and transport equipment	116.5	120.0	3.0
9 Manufactured products not elsewhere specified	105.3	107.9	2.5
Total	113.3	116.3	2.6

(a) Based on information received from 480 non-BOI private sector firms. Source: Central Bank of Sri Lanka

in the country, suffered due to the low paddy harvest, while the small-scale production of coir, coconut shell and copra related products declined due to the fall in coconut output towards the end of the year. The garments and handlooms industry performed well, with the improved performances of the large and medium scale garment factories, while timber mills, rock metal products, and tiles, bricks, cement blocks and related products benefited from the growth in the construction industry.

Construction: The Construction sector grew by 6.6 per cent in 2004, compared with 5.5 per cent growth during the previous year. The expansion was mainly due to refurbishment and expansion in the hotel sector, and increased activity in housing construction, including apartment complexes and condominiums. On-going foreign funded infrastructure projects in water supply, roads, power and port sector development also contributed to the growth performance of this sector. The growth was reflected in high imports of building materials, sale of cement and other construction materials, despite high prices, and disbursement of housing loans by the banking sector. The demand for residential houses was stimulated by attractive loan packages offered by financial institutions. Prices of residential houses as well as high-rise units increased during the year, with the rising demand and cost of building materials. The price indices published by the Institute for Construction Training and Development (ICTAD) indicates that prices in construction activities had increased by 18 per cent during the year in comparison with the previous year.

Electricity and water: The Electricity and water sector contracted by 2.5 per cent in 2004 in contrast to the 21.6 per cent increase in the previous year. Electricity generation and the demand for electricity increased by 5.6 per cent and 7.4 per cent, respectively, due to expanding demand from households and the commercial sector. The CFS 2003/04 recorded that

around 75 per cent of households in the country had access to electricity by 2004. The rise in demand for electricity was met by increasing thermal power generation by 18.1 per cent, as the hydropower generation dropped by 10.7 per cent over the previous year. During the year, 63 per cent of the total electricity was generated thermally, in comparison to 56 per cent in 2003. Consequently, value addition in the electricity sub sector decreased by 3.5 per cent as a result of higher usage of thermal power, including hired thermal power under dry weather conditions, which had significantly higher generation costs. Due to the drought conditions, hydropower generated by the CEB recorded a decline of 13.7 per cent during the year while the thermal power generated by the CEB increased by 14.3 per cent. Although private power producers, both thermal and hydro, were able to increase their generation during the year, the additional demand had to be met by hired thermal power. The water sub sector, which includes collection, purification and distribution of pipe borne water, recorded a growth of 4.7 per cent compared with 1.3 per cent growth in the previous year. The CFS 2003/04 recorded a significant increase in the share of households with access to pipe borne water inside their homes since the mid 1990s.

Mining and quarrying : The Mining and quarrying sector expanded by 7.9 per cent. The Mining sub sector performed well during the year with better performance in gem mining and other mining activities. The gem mining sector, the largest sector in terms of value addition, performed strongly in 2004 benefiting from increased export demand. However, mining activities in relation to graphite, phosphate and mineral sands also increased significantly. The quarrying sub sector grew by 6.6 per cent reflecting the increased demand for building materials from the construction industry.

Services

As in 2003, the growth in the Services sector provided the major impetus for growth in 2004. The service sector grew at 7.6 per cent, a marginal deceleration from the growth in 2003, and contributed a major share of the overall growth. The increase in value added in several Service sub-sectors was instrumental in this growth.

Wholesale and retail trade and hotels and restaurants: The Wholesale and retail trade, hotels and restaurants sector recorded a growth of 6 per cent in 2004 as against 7.8 per cent in the previous year. The deceleration was mainly due to lower growth in trading activities related to domestically produced agricultural goods, and a relatively lower growth in import trade at 9 per cent, compared to a high 11 per cent in 2003. The structure of import trade growth reflected the domestic economic expansion. The growth in consumer goods and intermediate goods imports were 3.9 per cent and 6.6 per cent in volume terms, respectively, while investment goods imports grew at a higher rate of 18.4 per cent, reflecting the expansion in investment. The import volumes of intermediate goods grew

healthily despite a high increase in prices, reflecting increased demand for inputs mainly from the industrial and service sectors. Of consumer goods imports, total imports of food and drink declined in volume terms at higher prices, while imports of other consumer goods grew healthily. The export trade sub sector grew by 7.7 per cent in 2004, benefiting mainly from the expansion in industrial exports dominated by textiles and garments. Industrial exports recorded a growth of 9.1 per cent in 2004 as against 3.1 per cent in the previous year. Agricultural exports also contributed positively to the growth in export trade reflecting increases in export volumes of all major plantation crops. The deceleration in the domestic trade sub sector in 2004 compared to 2003, indicates the overall decline in the production of agricultural goods traded in the domestic market, particularly rice. The hotels and restaurants sub sector, which is included with the wholesale and retail trade sector under the new classification, grew by 15.9 per cent in 2004. The sub sector, which has expanded significantly with the increase in tourist arrivals after the ceasefire in early 2002, further expanded in 2004 with tourist arrivals increasing by 13.1 per cent to a record 566,202. In 2004, the average hotel occupancy rate rose to 59 per cent as against 53 per cent recorded in the previous year. The foreign guest nights of all graded hotels recorded an increase of 10.9 per cent, while the local guest nights recorded a very marginal increase. The value addition in the sector rose following the recent investment towards upgrading and capacity expansion.

Transport, storage and communications: Value added in the Transport, storage and communication sector increased by 13.7 per cent in 2004, compared to 10.6 per cent in 2003. This sector recorded the highest sectoral growth and was driven by noteworthy performances in the telecommunications and cargo handling sub-sectors. The telecommunications sector, which has continued to grow at a high pace over the past few years, expanded further by 32 per cent. The Fixed Access-Wireless Local Loop subscriber level, which stagnated during the past two years, expanded throughout the year, recording a growth of 12.7 per cent. Mobile phone usage increased by 52 per cent over 2003 and by the end of 2004, the subscriber level of mobile users had exceeded 2.1 million. However, growth in Internet and e-mail usage moderated in the current year, indicating that the pent-up demand for these services may have been fulfilled to a great extent, thus far.

Within the Cargo handling, storage and warehousing sub-sector, port services recorded a growth of 13.3 per cent in 2004, reflecting the expansion in sea cargo handling activities. The Port of Colombo handled the highest ever annual container throughput of 2.22 million Twenty Foot Equivalent Unit (TEUs) in 2004 recording an increase of 13.3 per cent. Improved performance at both Jaye Container Terminal (JCT) and South Asia Gateway Terminal (SAGT)

contributed equally to this performance in port services. With the opening of the Unity Container Terminal (UCT), the container handling capacity of the Port of Colombo increased by 250,000 TEUs per year. Transshipment volumes, which usually account for two-thirds of throughput, recorded a growth of 13.5 per cent, while domestic container throughput increased by 17 per cent. However, ship arrivals during the year declined marginally by 1.6 per cent reflecting a shift to larger vessels. Meanwhile, air cargo volumes expanded by 26 per cent.

The transport sub sector, one of the largest services sectors in the economy, grew by 4.2 per cent in comparison to 4.6 per cent growth in the previous year. This increase was the outcome of the combined performance of passenger and freight transport. Road haulage grew by 3.7 per cent reflecting the improvements in goods transport activities coupled with the increase in domestic production and international trade. Performance of the Sri Lanka Railways was sluggish. In the passenger transport category the growth performance in the private bus category improved marginally, while that of the Cluster Bus Companies contracted during the year. In the air travel sub-sector, total passenger kilometers flown by Sri Lankan Airlines increased by 20 per cent during the year. However, there was a decline in passenger kilometers flown by domestic airlines, indicating a drop in internal air travelling after the pent-up domestic demand for travel to the North following the ceasefire tapered off. This decline was also attributed to the non-operation of one of the three domestic airlines during the latter part of the year. As indicated by the Registrar of Motor Vehicles (RMV), registration of motorcars and dual-purpose vehicles had dropped, while that of three-wheelers, buses and motor cycles had increased.

Financial services, real estate and business services: The Financial services, real estate and business services sector, which includes banking, insurance and all other financial services, real estate, ownership of dwellings, renting and all other business service activities that were included in the services (n.e.s) of the previous classification, grew by 5.7 per cent in 2004 as against 8.8 per cent in 2003. The deceleration was mainly due to slower growth of the banking sub sector after the high growth recorded last year. In 2003, interest rates declined sharply. In contrast in 2004, interest rates remained almost unchanged at a lower level. Consequently, although the credit growth in the banking sector was as high as 20 per cent, 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 of securities. During the period, the insurance, leasing and non-bank financial institutions sub sectors out performed the banking sub sector. Highly diversified non-bank financial institutions supported the value added growth of the financial services sector, where strong growth was recorded in fund-

based activities and fee-based services. Higher growth in insurance premiums from both general and life insurance products further contributed to the growth. The business service activities sub sector, which included advertising services, private security and janitorial services and computer software development activities, grew at a moderate rate.

Public administration, other government services and defence and other community, social and personal services: The Public administration, other government services and defence and other community, social and personal services recorded a growth of 3.9 per cent in 2004. The growth in public administration was mainly due to the intake of 42,000 unemployed graduates to the public sector in the fourth quarter of 2004. The other community, social and personal services sub sector registered a higher growth of 7.1 per cent against 4.7 in 2003, as the private healthcare industry continued to expand strongly in response to increased demand for such healthcare services.

2.4 Expenditure

The aggregate demand generated by domestic economic activity is measured by Gross Domestic Expenditure (GDE), which is the sum of consumption and investment expenditure of the private and public sectors of the economy. In 2004, GDE (aggregate domestic demand) at current market prices was estimated at Rs. 2,214 billion, reflecting an increase of 18.4 per cent over 2003. The corresponding increase in domestic demand for 2003 was 10.8 per cent. However, in 2004, the GDE grew by 6.4 per cent in real terms in comparison to 8.2 per cent in 2003, which was a consequence of the lower growth in private sector real consumption and investment. GDP at market prices, the sum of GDE and net imports, was estimated at Rs. 2,029 billion, an increase of 15.2 per cent.

Consumption

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 of real consumption by 4.9 per cent. Of the total consumption, private consumption expenditure (PCE) rose by 14.9 per cent in comparison to the 10.5 per cent reported in 2003, while government consumption increased by 18.3 per cent following the marginal decline in 2003. Consequently, the share of PCE in the total consumption dropped to 90 per cent from 91 per cent reported in 2003. In PCE, the expenditure on locally produced goods increased by 13.7 per cent, while the expenditure on imported goods and non-factor services increased by 17.7 per cent.

In compliance with the restructuring of PCE in 2002 based on the System of National Accounts-1993 (SNA 93), a base year revision to the PCE was made in 2004. This revision was based on the latest household expenditure survey, the CFS 2003/04. In comparison to the previous base revisions in 1997, some variations in consumption patterns were observed by 2004. With the improvements in living standards and quality of life, the relative share of PCE on basic needs such as food and beverages had shifted to other service sectors.

In keeping with the improvements in economic well-being arising from economic development seen in Sri Lanka during the recent past, in 2004 too the share of PCE on food and non-alcoholic beverages fell further to 32.6 per cent. Nominal expenditure on this category had risen by 9 per cent, due to the increase in prices of food items, but showed no improvement in real terms. Despite price increases, nominal expenditure on Alcoholic beverages, tobacco and narcotics declined, thereby reflecting that real

Table 2.10
Aggregate Demand

	Current Market Prices (Rs.mn)			Constant (1996) Prices (Rs.mn)		
	2002	2003 (a)	2004 (b)	2002	2003 (a)	2004 (b)
A. Domestic demand						
Consumption	1,353,428	1,481,164	1,706,823	880,725	935,238	981,236
(% Change)	14.2	9.4	15.2	6.6	6.2	4.9
Gross domestic capital formation	334,804	388,757	507,189	227,250	263,497	294,288
(% Change)	8.1	16.1	30.5	5.8	16.0	11.7
Total domestic demand	1,688,232	1,869,921	2,214,012	1,107,975	1,198,735	1,275,524
(% Change)	13.1	10.8	18.4	6.4	8.2	6.4
B. External demand						
Exports of goods and non-factor services	570,833	632,907	738,687	374,115	394,284	425,160
(% change)	8.6	10.9	16.7	6.3	5.4	7.8
Imports of goods and non-factor services	677,180	741,667	923,258	513,732	566,367	618,985
(% change)	10.4	9.5	24.5	11.2	10.2	9.3
Net external demand	(106,347)	(108,760)	(184,571)	(139,617)	(172,083)	(193,825)
C. Total demand	1,581,885	1,761,161	2,029,441	968,358	1,026,652	1,081,699
(% change)	12.6	11.3	15.2	4.0	6.0	5.4

(a) Revised

(b) Provisional

Source : Central Bank of Sri Lanka

Box 7

Changing Lifestyles in Sri Lanka

1. Introduction

The 8th Consumer Finances and Socioeconomic Survey (CFS 2003/04) was conducted by the Central Bank from October 2003 to October 2004, and covered the entire country, except Kilinochchi, Mannar and Mullativu districts in the Northern Province¹. A major achievement of this survey was its coverage of a greater part of the North and East after a lapse of 20 years. This multi purpose household survey series that began in 1953 provides a continuous series of information on key socio economic developments in the country. The survey findings provided evidence of changing lifestyles in the country since the previous survey was conducted in 1996/97.

2. Findings²

● *The average number of persons and dependents in a household are falling.*

In the last 40 years, household size had declined from nearly 6 persons to around 4-5 persons in all 3 sectors. During this period, the number of income receivers per household had risen overall, while rising in the urban and rural sectors and declining in the estate sector. Overall, the dependents per income receiver ratio in a household had declined. With the population aging, young dependents were being replaced by older dependents, but at a significantly slower rate. The gender (males per female) ratio in the household population showed a slow, but steady, decline.

● *The quality of housing and access to household amenities and utilities are improving*

Housing had improved, and over 80% had permanent walls, flooring and roofing. In addition, households with access to electricity (75%), a safe source of water (62%) and sanitary toilet facilities (77%) had risen. However, the main source of energy for cooking continued to be firewood (83%). Despite improvements, housing conditions remained poorest in the estate sector. Access to electricity was lowest in Uva (UP) (57%), while access to safe water and sanitation was poorest in the Eastern (EP) and Northern (NP) Provinces.

Radios and TVs were available in over 70% of households, while 30% had refrigerators. Access to motorized transport and telephone facilities had increased from 15% and 5% to 22% and 25%, respectively. Again, the estate sector lagged behind, despite improvements over

time. Housing conditions and access to utilities and amenities improved dramatically with income level and were significantly better in the Western Province (WP) compared to all other provinces.

● *Educational attainment is rising. Yet, waning confidence in the formal education system has driven students at all levels to private tuition classes.*

The literacy rate was over 90%. Among the older population (25 years and over), literacy rates declined with age and were lower in all age groups for women than for men. Literacy rates were highest in the urban sector and lowest in the estate sector and were relatively lower for women in the Central (CP), EP, UP and Southern (SP) Provinces. Higher and more equitable literacy rates among sectors and gender within the youth and young adults (aged 5-24 years) signified better, more equal educational opportunities over time.

Educational attainment in the population had risen. The share at primary school level or lower had declined (44% to 38%) since the last survey with a commensurate improvement in those with secondary education. Those with post secondary education had remained at around 21%. Education levels among females had improved. However, the share of females with no schooling remained at 14-17 % in the EP, UP and CP.

Among the school-going population, around 50% took private tuition compared to 35% during the last survey. The incidence of tuition rose with education level, from 40% in primary grades to 70% in post-secondary grades.

● *Unemployment is a problem among educated youth, and a greater problem among females than males. The majority of the unemployed prefer clerical jobs, while the lowest preferences were for jobs in agriculture and fisheries.*

The labour force participation rate (LFPR) remained around the same level, with the male LFPR around twice the female LFPR and the ratio rising with age cohort. Despite the lower LFPR, the unemployment rate among females was over double that for males. It was higher in all age categories by different magnitudes. In the pool of unemployed, the share was higher among the more educated young adults, with a greater share, particularly females, in higher income households. Among the unemployed, 22% expected clerical jobs. Only around 1% specified a preference for jobs in agriculture or fisheries.

The employment structure recorded around 33% in the Agriculture Sector, another 25% in Industry and the balance 42% in Services. The shift over time away from Agriculture to Industry and, more particularly Services, continued, consistent with overall economic development in the country. Around 70% of the employed were in the informal sector, which provides no formal social security benefits after retirement. Wage earners accounted for 57%, while

1 The Census 2001 was not completed in 3 districts, Kilinochchi, Mannar and Mullativu, due to the security situation. Hence, the CFS excludes these 3 districts for which there was no household frame from which to select a sample. This amounts to just 2% under-coverage of the estimated 4.8 million housing units in the country

2 Supporting statistics for the findings reported here are presented in the Special Statistical Appendix Tables 9 and 10

non-wage earners - the self-employed, employers and unpaid family workers - accounted for the rest. The non-wage earner share of employment was highest in Agriculture.

● *Household income in all income quintiles and sectors had risen. Yet, though the overall structure remained unchanged, income distribution had further skewed slightly towards the richest.*

Household income in real terms (deflated by the SLCPI) had increased annually by 2.4%. The real change rose with each quintile from 0.4% to 3.3%. Income distribution had not changed significantly. The Gini Coefficient (0.46) had risen marginally since the 1996/97 survey and was around the same as in 1986/87. Per capita incomes were lowest in the UP (Rs. 2,570), next Sabaragamuwa (SaP) (Rs. 2,894) and then EP (Rs. 2,905). They were significantly higher in the WP (Rs. 5,999) than the country average (Rs. 3,969).

The structure of income had hardly changed since the last survey. Occupation income accounted for 64%, while the imputed value of rent (9%), transfer income from friends and relatives locally (6%) and abroad (6%) accounted for relatively higher shares. In the estate sector, the relative share of occupation income had declined from 84% to 77% since the last survey, to be replaced by local transfer income.

The structure of income varied with income levels. The share of occupation income fell from 73% to 62% from lowest to highest quintile, while those of imputed rent, transfers from abroad and investment income rose. The shares of pensions and local private transfers rose up to middle-income levels, and then fell. The share of government transfers other than pensions fell with income levels, but were visible up to the highest income quintile.

● *With the increase in income levels, consumption had shifted from food to communication, education, recreation, housing and utilities.*

The expenditure share on food and beverages had declined from 48% to 38% between survey periods, to be replaced by many categories of non-food expenditure. In fact, expenditure on food and beverages had declined marginally in real terms. The highest annual average real increases were for communication (21%) and education (11%), albeit from a low base, followed by recreation and culture (10%), furnishings, household equipment and maintenance (6.5%) and housing and utilities (6%). Household expenditure had increased annually by 2.5% in real terms.

Within sectors, patterns were similar to the overall changes, but at different levels, with the estate sector's share of expenditure on basic needs such as food and clothing being relatively higher.

Expenditure shares on food and alcoholic beverages declined with income, while shares for most other

categories rose, except clothing and household furnishings and maintenance, which remained relatively stable. The expenditure share on education also remained stable, at around 2%, until the highest quintile, when it rose to over 3%.

Consumption of key food items had not changed dramatically. Per capita consumption of rice and coconut had remained the same, while that of wheat flour, bread and sugar had fallen. The decline in per capita bread consumption was the most significant and seen across all sectors. Consumption of fish, meat and vegetables had risen marginally, while consumption of alcohol and cigarettes had declined, in per capita terms.

● *Households borrowed mainly to finance consumption expenditure. The expansion of formal financial sector institutions had helped households to diversify their loan portfolios. Meanwhile, the role played by money-lenders appears to be diminishing.*

The highest number of loans (58%) continued to be taken for consumption. However, in terms of amounts, the largest shares were for business and trade (27%) and housing (21%), while consumption loans, including for ceremonies, accounted for 20%. However, there was no discernible shift in the overall structure of loans from 1996/97 to 2003/04.

Of the total lending, 61% was from institutional sources. There was no shift in the number of loans taken between institutional (43%) and non-institutional sources (57%). However, the amount taken from commercial banks had fallen (51% to 34%), to be replaced by loans from other financial institutions and friends and relatives.

3. Conclusions

The survey results complemented other findings on regional economic disparities. The Western Province reflected higher living standards than other provinces, commensurate with better education, employment and income-earning opportunities that related to its contribution to overall economic activity and development in the country. At the other end of the spectrum, the Eastern and Uva provinces, with limited economic activity and opportunity, lagged behind on most socio-economic indicators. The other six provinces lay between these two extremes. The demographic structure and living conditions in the Northern, Eastern and North Central provinces reflected the adverse impact of the civil conflict of 20 years. Historical and continuing disparities among the three sectors, urban, rural and estate, were reflected in these regional disparities. The CFS 2003/04 findings re-emphasise what policy-makers in successive governments have been highlighting in recent years, namely, the need to address these regional disparities and create income generating opportunities that would provide economic options for citizens everywhere.

Box 7 (Contd.)

Table 2.11

Composition of Private Consumption Expenditure at Current Market Prices

Item	Share of Total PCE (%)			Rate of Change (%)	
	2002	2003(a)	2004(b)(c)	2003	2004
01. Food & non-alcoholic beverages	37.4	34.3	32.6	1.6	9.0
02. Alcoholic beverages, tobacco and narcotics	5.3	5.1	4.4	6.1	(1.6)
03. Clothing and footwear	5.8	5.6	6.0	5.7	24.6
04. Housing and utility services	14.3	14.1	16.1	9.3	31.7
05. Household equipment and services	4.7	4.4	5.0	4.6	30.2
06. Health	3.6	3.6	3.7	10.0	19.1
07. Transport	10.5	14.0	12.1	47.9	(0.9)
08. Communication	1.8	2.2	2.4	33.1	22.4
09. Recreation and entertainment	3.2	3.0	3.5	2.5	33.7
10. Education	1.3	1.2	1.6	6.0	49.0
11. Restaurants and hotels	1.3	1.2	1.4	4.4	28.5
12. Miscellaneous goods and services (d)	10.9	11.2	11.3	14.1	15.4
Total private consumption expenditure	100.0	100.0	100.0	10.5	14.9

(a) Revised

(b) Provisional

(c) Based on the Consumer Finance and Socio Economic Survey (CFS) 2003/04

(d) Includes Personal care, Personal effects, Social protection, Insurance, Financial services and Other services n.e.c.

Source : Central Bank of Sri Lanka

consumption had dropped sharply. The only other sector in which nominal expenditure had declined and the PCE share had fallen was transport. The PCE on transport, which recorded the highest growth of 48 per cent last year, had declined by about one per cent in 2004 and its relative share had fallen by about 2 percentage points. The higher import tariffs imposed during the latter part of the year and the subsequent price hikes of vehicles may have restrained consumer spending, since then, on vehicle purchases, the single largest item in this category. The PCE on all other categories rose in nominal terms at varying rates of between 15 and 49 per cent and increased their shares in PCE, reflecting both real growth and the higher price levels in 2004. Among all expenditure categories, the highest growth was recorded by education, although on a very small share of less than 2 per cent even after this growth. This growth reflects higher spending on private tuition at all levels of education and private educational institutions that have expanded in numbers in recent years, as was seen in the findings of the CFS 2003/04. The categories of recreation and entertainment, housing and utility services, household equipment and services and restaurants and hotels, grew in nominal terms by between 28 and 34 per cent. The relative share on housing and utility services increased by 2 percentage points to 16 per cent in 2004 due to the higher spending on housing repairs, rents, electricity and water. PCE on communication had increased at a lower rate than in 2003, which may indicate a gradual deceleration of the growth in the communication market, especially the telecommunications sector, which had expanded very rapidly over the past few years. PCE on health had risen, in keeping with the expansion in such services reported in the previous section.

Government consumption expenditure increased by 18.3 per cent in 2004, due to higher expenditure on salaries and wages, as well as goods and services. The salary increase at the beginning of the year was reflected in higher expenditure on emoluments, while the intake of 42,000 graduates to the public sector under the government's graduate employment programme towards the end of the year also contributed.

Investment

In 2004, investment, even more than consumption, provided the impetus for economic growth. 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. In real terms, the investment expenditure rose by 11.7 per cent, whereas the corresponding growth in 2003 was 16 per cent. The investment/GDP ratio further improved to 25 per cent from 22.1 per cent in 2003. The increase in imports of investment goods by 18.4 per cent, in volume terms, clearly indicated that investment demand out-performed consumption demand and provided the impetus for the growth in 2004. The recovery in investment expenditure was led by the private sector, where private investment expenditure accounted for 91 per cent of the total investment and expanded by 32.7 per cent in 2004. The private sector investment/GDP ratio continued to grow from 19.8 per cent in 2003 to 22.7 per cent in 2004. Large investments flowed in to the garment industry to improve their productivity and prepare for challenges that lay ahead with the phasing out of the MFA in 2005. Revival of tourist arrivals after the ceasefire agreement was a cause for higher investment in the leisure industry where many hotels were refurbished, expanded or upgraded and many new boutique tourist resorts opened in 2004 to cater to niche market HNW (High Net Worth) tourists. The telecommunication, transportation,

Table 2.12

Investment and Employment in the Enterprises Registered Under Board of Investment of Sri Lanka (BOI) and Ministry of Industry and Investment Promotion (MIIP)

	No. of projects		Envisaged and Actual Investment (Rs.million)						Employment (No.)	
	2003(a)	2004(b)	2003(a)			2004(b)			2003(a)	2004(b)
			Foreign	Local	Total	Foreign	Local	Total		
BOI										
Projects Approved	601	524	81,135	67,750	148,885	87,527	53,151	140,678	69,396	49,141
Under Section 17	419	294	77,689	66,861	144,550	69,604	52,261	121,865	64,521	41,012
Under Section 16	182	230	3,446	889	4,335	17,923	890	18,813	4,875	8,129
Projects Contracted Under Section 17	216	228	44,291	49,346	93,637	36,536	31,037	67,573	41,320	34,860
Realised Investment Under Section 17(c)	1,766	1,867	186,782	90,699	277,481	208,696	110,770	319,466	431,050	437,698
Commercial Operations (c)	2,137	2,194	150,011	129,534	279,545	157,007	137,988	294,995	368,867	380,519
Under Section 17 (c)	1,516	1,556	136,251	119,771	256,022	143,042	128,216	271,258	336,959	348,300
Under Section 16 (c)	621	638	13,760	9,763	23,523	13,965	9,772	23,737	31,908	32,219
MIIP										
Projects Registered (c)	1,588	1,604	n.a.	n.a.	113,977	n.a.	n.a.	115,498	278,397	279,012

(a) Revised

(b) Provisional

(c) Cumulative as at end of year

Sources: Board of Investment of Sri Lanka
Ministry of Industry and Investment Promotion

information technology, printing and construction industries also attracted new investment in 2004.

Foreign direct investment inflows to Sri Lanka rose by 13 per cent in US Dollar terms during 2004. The BOI, the main investment promotion institution of the government also approved 524 projects under Sections 16 and 17² of the BOI Act with investment commitments of Rs. 140.7 billion, a decline of 5.5 per cent from 2003 entirely due to reductions in the local and foreign investment components for projects under Section 17. Although the number of projects contracted increased marginally to 228 in 2004, the value of the contracted investment declined by 28 per cent on account of both the domestic and foreign components. The decline was partly explained by the fall in investment during the period of political uncertainty in the first half of the year and more stringent screening processes introduced by the BOI. With the realisation of investment in agreements signed and contracted in the previous year, the accumulated realised investments in BOI projects increased by 15 per cent to Rs.319,466 million in 2004. Meanwhile, with the inclusion of 40 new projects under Section 17 in 2004, the increase in investment on projects in commercial operation was 6 per cent.

Of the 524 projects approved under Section 17 and 16 in 2004, 235 were foreign owned and 170 were joint ventures, while Sri Lankans owned 119. The Services and Agriculture sectors absorbed 76 per cent of the approved

local investment component, while the Industrial sector absorbed the rest. The decline in the local component of investment in contracted projects was mainly due to the reduction of joint venture collaborations between foreign investors and Sri Lankans. The industrial sector absorbed 36 per cent and the Services and Agriculture sectors absorbed the rest of the total contracted investment in 2004. Within the industrial sector, the textile, wearing apparel and leather products category attracted the largest share of investment, followed by the food, beverages and tobacco products category. Of the 40 projects that commenced commercial operation in 2004, 35 were in the Industrial sector. Of 638 projects approved under Section 16 of the BOI Act in commercial operation at end December 2004, 233 were in the Industrial sector, and 405 in the Services sector.

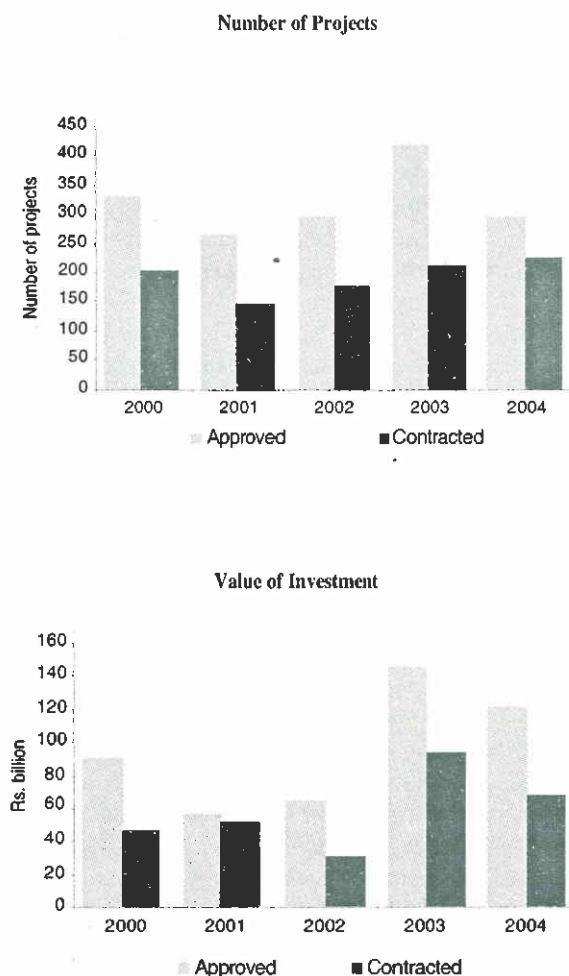
Of 1,604 enterprises registered under the MIIP as at end 2004 about 1,120 enterprises with an estimated 88 per cent share of investment were located in the Colombo District, and 228 enterprises with an estimated 7 per cent share of investment were in the Gampaha District. Accordingly, these two districts accounted for 84 per cent of the registered enterprises and for 95 per cent of total investment.

During the year, credit extended by commercial banks to the industrial sector benefited from the low interest rates that prevailed during the year and grew by 19.7 per cent during the 12 months ending September 2004 to Rs. 50 billion. Most of this credit was granted to three categories in the manufacturing sector, namely, petroleum, beverages and apparel. However, the long and medium term credit granted by the two main development finance institutions declined by 8.9 per cent in 2004.

Government investment expenditure, which continued to increase, was estimated at Rs. 45 billion, an increase of 11 per cent in nominal terms over 2003. Government investment was mainly focused on road development projects

2 Approval under Section 16 of the BOI Act permits foreign investment entry to operate only under the 'normal laws' of the country; that is, for such enterprises, the provisions of the Inland Revenue, Customs and Exchange Control Laws shall apply. Under Section 17 of the Act, the BOI is empowered to grant special concessions to companies satisfying specific eligibility criteria, which are designed to meet strategic economic objectives of the government. The mechanism through which such concessions are granted is the Agreement, which modifies, exempts and waives identified laws in keeping with the BOI Regulations. These laws include Inland Revenue, Customs, Exchange Control and Import Control.

Chart 2.5
Investment in Approved and Contracted BOI Projects



(including the Southern Highway Project and Road Network Improvement Project), irrigation, power, water supply, airport and port development projects. Also, investments were made in health, education and, particularly in the Agriculture sector. With the development of agriculture and fisheries given special attention in its policy framework, the government's investment in this sector was mainly concentrated on irrigation projects, research and development, fisheries development and crop planting and replanting projects.

Availability and Utilisation of Resources

The total available resources in a country consists of GDP (domestic resources) and imports of goods and non-factor services (foreign resources). This was estimated at Rs 2,952

Table 2.13
Total Resources and Their Uses at Constant (1996) Prices

Item	Percentage Share		Percentage Growth	
	2003(a)	2004(b)	2003(a)	2004(b)
A. Resources				
Gross domestic product	64.4	63.6	6.0	5.4
Imports of goods and non-factor services	35.6	36.4	10.2	9.3
Total	100.0	100.0	7.5	6.8
B. Utilisation				
Consumption	58.7	57.7	6.2	4.9
Gross domestic fixed capital formation	16.4	17.3	16.9	12.2
Private sector and public corporations	14.5	15.5	13.8	14.1
Government	2.0	1.8	46.0	-0.9
Change in stocks	0.1	0.0	-50.4	-87.6
Export of goods and non-factor services	24.8	25.0	5.4	7.8
Total	100.0	100.0	7.5	6.8

Source : Central Bank of Sri Lanka

(a) Revised
(b) Provisional

billion, at current market prices, an increase of 18 per cent over the previous year. This increase was generated by an increase of Rs 268 billion (15.2 per cent) in domestic resources and an increase of Rs 182 billion (24.5 per cent) in foreign resources. In real terms, the availability of resources grew by 6.8 per cent, slightly lower than in the previous year. This includes real growth of domestic resources by 5.4 per cent and of imports of goods and non-factor services by 9.3 per cent. The corresponding growth rates in 2003 were 6.0 per cent and 10.2 per cent, respectively. There was little change in the relative shares of domestic and foreign resources.

With regard to utilisation of resources, consumption absorbed 58 per cent, with a growth of 4.9 per cent, in real terms. This indicates a deceleration of the growth in consumption, as consumption grew in real terms by 6.6 per cent and 6.2 per cent respectively, in the past two years. Resources utilisation for fixed capital formation, in real terms, grew by 12.3 per cent in 2004 reflecting a continuation of investment activities, but at a somewhat lower growth rate than in 2003. Resources utilisation for export of goods and non-factor services grew at a higher rate compared with the growth recorded in 2003, reflecting the recovery in world demand. The growth in investment expenditure improved the share of capital formation from 16.5 per cent to 17.3 per cent, at the cost of the consumption share. This was a welcome development, as the relative share of capital formation had deteriorated continuously in the past three years compared with the level that prevailed in 2000 and the actual investment was well below the investment of 30 per cent of GDP required for achieving a growth rate of over 8 per cent in the economy. The relative share of exports of goods and non-factor services had not changed.

Table 2.14
National Savings at Current Market Prices

Item	Rs. Million	
	2003(a)	2004(b)
1. Gross domestic product at market prices	1,761,161	2,029,441
2. Domestic savings	279,997	322,619
3. Net factor income from abroad	-16,535	-20,688
4. Net private transfers from abroad	116,308	136,607
5. National savings (2+3+4)	379,770	438,537
6. Domestic savings ratio (2 as a % of 1)	15.9	15.9
7. National savings ratio (5 as a % of 1)	21.6	21.6

(a) Revised

Source : Central Bank of Sri Lanka

(b) Provisional

Savings

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. Public sector dis-savings, which had improved during the previous two years, deteriorated in 2004, reflecting the increase in government recurrent expenditure. The increase in private sector savings was more than sufficient to offset the increase in public sector dis-savings. However, the domestic savings ratio (domestic savings/GDP) remained at the same level, 15.9 per cent.

National savings, the sum of domestic savings, net foreign private transfers and NFIA increased by 15.9 per cent to Rs 439 billion. As the growth of national savings was parallel with that of GDP at market prices, the national savings ratio (national savings/GDP) remained at 21.6 per cent. NFIA continued to be negative, and deteriorated further to Rs 20.7 billion with the increase in interest payments. However, net private transfers, which consists of workers remittances, improved at a higher rate to Rs. 137 billion, thereby completely mitigating the negative impact of the deterioration in NFIA. Net private transfers currently account for around 7 per cent of GDP.

2.5 Issues and Policies

Over the past few decades, inconsistent and ad-hoc changes in trade policy have continuously been a major constraint for investment expansion and development of the Agriculture sector. Even in 2004, the trade policy on certain agricultural commodities was revised several times with the two objectives of reducing the cost of living and providing protection to farmers, which are difficult to achieve simultaneously. Specific import duties on key food items had been reduced and later raised, or vice versa. These decisions gave conflicting signals to the market, both producers and importers, while their inappropriate timing created price pressure and supply shortfalls. A major requirement for the development of the agriculture sector is to have a market oriented, consistent and well-specified, long-term trade policy in place, which will not

distort the short-term supply situation due to ad-hoc tariff changes, at a cost to both producers and consumers. Ad-hoc trade policies, in fact, often harm the groups which are targeted to be supported, in the long run.

The issue of government interventions through subsidies to certain sectors and market interventions by the means of guaranteed prices to others has been long debated in Sri Lanka. A fertiliser subsidy could encourage otherwise unprofitable economic activities, thus creating negative value added to the overall economy. A subsidy on one type of fertiliser (eg: Urea), distorts the cost structure of inputs and encourages farmers to use subsidised fertiliser intensely, though inappropriately, thus lowering the Agriculture sector total factor productivity. The government's intervention in the market as a purchasing agent with a guaranteed price for selected agricultural crops impacts on farmers' decisions on what to produce and distorts market signals that finally lead to inefficient resource allocation in the Agriculture sector. Further, these activities, not only create fiscal burdens that cannot be sustained in the long run, but also discourage development of private sector agricultural processing, packaging and storage activities which provide benefits to both producers and consumers. In 2004 too, the government continued to provide such subsidies and intervene in the market to purchase paddy at fixed prices. The total fertiliser subsidy commitment increased to Rs. 5.3 billion in 2004 from an initial allocation of Rs.2.0 billion in the Budget. At the same time, revenue was also lost with the removal of the VAT on fertiliser from July 2004 to further cushion the farmer from the impact of input prices. Such policies gain popular support, although their potential distortionary impact on the economy through their short-term and long-term effects on both revenue and expenditure are not always clearly understood by the stakeholders. It is important to raise public awareness of such trade-offs for the stakeholders, so that decisions taken could be of optimum benefit to the economy as a whole.

In the aftermath of the Tsunami disaster and its adverse impact on the fishing sector, the NFPC would need to review their recent policy proposals, using the disaster as an opportunity to restructure and rebuild the fisheries industry into a modern and dynamic sector that would provide sustainable incomes to the fishing community while improving the affordability of fishing products to the consumer, through enhanced productivity.

In summary, the performance of the Agriculture sector in the recent past clearly shows that the technological and research driven improvement in agriculture which has taken place in fast developing countries, has not been taking place in Sri Lanka, irrespective of substantial human capital employed in research and development relating to agriculture. The inevitable result has been that the country's centuries old agriculture concentration and specialisation have not gone through a structural change, limiting Sri Lanka's specialisation to a few crops. The prominence of paddy, tea, rubber, coconut and a few other field crops, which are

subject to vagaries of weather, poor water management, archaic land laws and international commodity prices, increases producer risks and reduces their income. The resultant need for ad-hoc and short-term government intervention in securing income and providing subsidies for the sector causes major detrimental effects to the economy, especially in the sphere of fiscal consolidation. Furthermore, sector specific incentives and subsidies bring in uneven and distortionary developments in the Agriculture sector as well as the economy as a whole. In fact, despite considerable government resources flowing into the sector since Independence, and with a large public sector workforce supporting agricultural research and extension services, the growth rate in the sector has been volatile and fluctuating around a low average for over 50 years. Although around 30-35 per cent of the employed work force are in the Agriculture sector, the CFS 2003/04 recorded that only one per cent of the unemployed wished for employment in this sector. In fact, labour productivity (GDP per employee) in the Agriculture is less than half that in the other two sectors and falls well below the national average. Consequently, the other two sectors have grown at a faster pace and contributed significantly more to the economy in recent decades. The Agriculture sector will continue to operate below the desired level, unless a rational, clear, consistent policy is developed and implemented to move away from traditional methods, to a modern, sustainable growth path that would focus on productivity improvements and address current limitations in the availability of land and water, and provide adequate incomes to the agricultural worker, while competing with international markets to enable affordable products to consumers. In this context, the necessity for addressing key issues and establishing clear policies relating to the land market, water management and utilisation, seed procurement, extension services, subsidies and tariff cannot be underestimated. Else, even the present supply of labour and investment in the Agriculture sector would move elsewhere.

There exists an urgent need for raising productivity and yields to make Sri Lanka's agriculture competitive with that in other countries. The fundamental research conducted has generated some innovations, but Sri Lanka's neighbouring countries have moved much faster ahead in this field, raising the yield levels of many crops in those countries much higher than in Sri Lanka. Sri Lanka should also follow a pragmatic approach in raising productivity by adopting already developed technology and research elsewhere in the world.

Despite recent achievements, the Industrial sector suffers from several impediments. Among them are insufficient skilled human capital, inadequate infrastructure facilities, high cost of energy, insufficient progress in restructuring public sector enterprises, labour market rigidity and the absence of proper bankruptcy legislation. Some regulations in certain activities, such as time-consuming reporting requirements and burdensome approval procedures, have increased business

transaction costs. The long delays in court proceedings, complexity of existing laws and lack of adequate commercial courts in the country have increased litigation costs. Although amendments were made to several labour laws in 2003, towards improving flexibility in the labour market, active implementation of key amendments remains uncertain. In particular, although a new formula for computation of the compensation payment for laying off of workers was finalised in March 2005, its potential impact on future investment remains under debate, particularly among employers. The environmental pollution created by industrial waste and the lack of proper legal provisions to protect the environment, are also becoming causes for concern.

Furthermore, provincial GDP estimates show that 50 to 60 per cent of industrial sector activity is concentrated in the Western province, with an even higher share of investment in industry concentrated there. There is an urgent need to geographically diversify industrial location to reduce existing regional disparities in employment and income generating opportunities for a sustainable high growth in this sector. Against this background, existing impediments to the Industry Sector need to be removed if Sri Lanka is to move to a higher growth path.

The Services sector has been the driving force behind economic growth in the recent past. Labour productivity has been highest in this sector, more than double that in agriculture. In particular, sectors such as external trade, telecommunications, port services, hotels and restaurants, and personal services such as private education, health, advertising and business services have been growing in response to the demand arising from rising consumer incomes and changing preferences. Many of these sectors have grown healthily under market forces. In fact, following on liberalisation and the move away from state monopolies of key sectors such as ports, telecommunications and even import trade, those sectors have shown dynamism, responding well to market forces. Perhaps it is timely to learn from such positive lessons of the recent past in the Services sector. A review of the state's role in the success of certain economic activities clearly signals a need to limit its involvement to a facilitatory role and allow market forces and the private sector to drive the growth in all sectors, while ensuring that the legal framework and regulatory provisions are in place to safeguard national priorities such as the environment, public health, public safety, national security, law and order that would create an environment conducive to sustainable economic growth.

In 2004, per capita income surpassed US dollars 1,000 (Sri Lanka rupees 100,000) for the first time in history. Though the per capita income at national level has exceeded this barrier, the disparity in the provincial income distribution raises concerns. According to provincial GDP estimates for year 2003 disseminated by the Central Bank of Sri Lanka (Statistical Appendix Table 3), the Western Province alone

claims 45 per cent of the total GDP, while the Northern, Eastern, Uva and Sabaragamuwa provinces emerge as the poorest provinces. In fact, the provincial disaggregation shows that only the Western Province has exceeded the per capita threshold of US dollars 1,000 and the per capita incomes in some provinces are still below the US dollars 500 level. The high concentration of economic activity in the Western Province does not augur well, even for the Western Province, as rising population, environmental concerns and related problems undermine the economic achievements in the province. Therefore, attention to this issue is critical, as these regional disparities not only affect the achievement of high overall economic growth directly, but also indirectly, through their potential impact on social and political stability in the country.

The response of the economy to the environment created by the ceasefire agreement since early 2002, first in terms of consumer confidence and later, investor confidence, clearly emphasised the potential for growth in the country. Two critical areas need further improvement, in order to achieve this potential. First, the current level of investment needs to rise even further towards capacity expansion. Second, overall productivity needs to improve towards most efficient use of scarce resources. Given the low domestic savings rate, foreign

inflows would be critically needed to finance high investment. Therefore it is imperative that the investment climate remains buoyant. In fact, although the increase in investment in 2004 was a welcome development, the investment ratio was far below the investment of about 30 per cent of GDP required to achieve a desirable annual growth of over 8 per cent. Achievement of such a high level of investment will ultimately depend on a number of factors that raise investor confidence. Securing a lasting peace to the civil conflict, speedy implementation of reforms to remove structural impediments, prudent macro-economic management including greater fiscal discipline, political stability, improved infrastructure facilities, particularly power and roads, and reducing economic policy uncertainties will be the crucial factors that enhance the future potential of the economy.

The Tsunami disaster had the goodwill of the entire world at Sri Lanka's door. Out of such a human tragedy the country has been given an opportunity to build bridges among ethnic, religious, political and private vs. state factions and to unite to restructure and rebuild. A clear policy commitment that would maintain the investor confidence that grew from the ceasefire is critically needed at this juncture, if yet another opportunity to move Sri Lanka onto a higher and sustainable growth path is not to be missed again.