Chapter 1

ECONOMIC AND FINANCIAL STABILITY, OUTLOOK AND POLICIES

1.1 Macroeconomic Developments, Stability and Policy Responses in 2005

- **Sri Lanka's economy demonstrated its resilience once again in 2005 by growing at a rate of 6 per cent, exceeding the expectations in the immediate aftermath of the tsunami disaster of 2004. Inflation was subdued through prudent monetary policy measures and by the favourable developments in aggregate supply. The stability of the financial system was strengthened through improved supervision and regulation in line with international best practices.** The year started with several challenges posed by domestic and external shocks and their related uncertainties. The impact of the tsunami necessitated a massive volume of resources for a quick recovery, oil prices were escalating rapidly, the Multi-Fibre Arrangement (MFA) came to an end on 1 January 2005 and elections related uncertainty loomed large. Additionally, the peace process was at a standstill. As the year progressed, the uncertainties began to dissipate and the economy marched forward with a renewed vigour providing sufficient room for policy manoeuvrability to maintain both price and financial stability. High economic growth and relatively lower population growth pushed per capita income to a higher level of US dollars 1,197. Responding well to monetary policy measures and supported by favourable developments in aggregate supply, inflation declined from a peak 15.9 per cent in February 2005, to reach 8 per cent by December 2005. The annual average inflation in 2005 was 11.6 per cent. The unemployment rate declined to 7.7 per cent by August 2005 from 8.3 per cent in 2004. The balance of payments (BOP) recorded a surplus of US dollars 501 million, strengthening external reserves and contributing to exchange rate stability. The fiscal position was further consolidated, especially on the revenue front. The stability and resilience of the financial sector improved with higher profits, enhanced risk management and narrowed interest spreads, and the sector provided better access to finance.

- **Economic growth needs to be accelerated further to at least 8 per cent to alleviate poverty, reduce unemployment and raise the standard of living on a sustainable basis. The government's plans to achieve the desired growth have been articulated in several policy documents, most notably in the 'Mahinda Chintana' policy document.** The strategy of the government stresses the need for combining an efficient private sector with a facilitative public sector, while strengthening the pre-requisites for growth as well as growth promoting factors. The government's plans embrace infrastructure development thereby enhancing access to markets, investing in human capital and encouraging technology improvements by entrepreneurs, promoting investments throughout the country by ensuring policy stability and consistency, increasing institutional support and providing incentives for research and development. These efforts have to be complemented with required reform measures to further enhance the overall efficiency of the economy. A comprehensive public awareness program on the role and limitations of the public sector, the benefits of liberalisation and reforms and the role of the private sector in improving competitiveness and increasing access to both domestic and international markets through their own efforts, is needed to ensure public support for much needed economic reforms.

Chart 1.1

Quarterly Real GDP Growth and Inflation

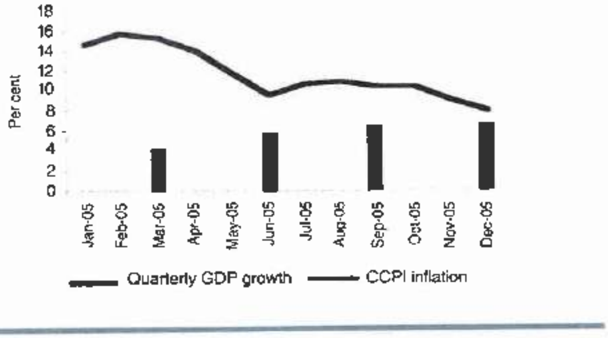


Chart 1.2

Savings and Investment

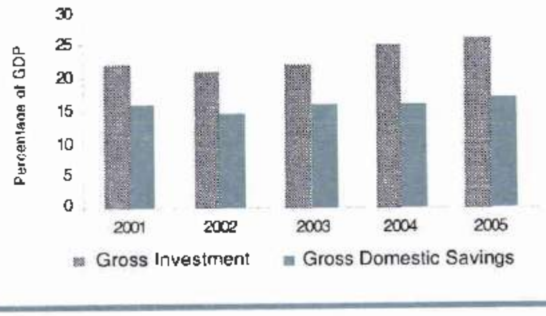


Table 1.1

Gross National Product at Constant (1996) Prices

Item	Value (Rs. in million)		As a Share of GDP (%)		Rate of Change (%)		Contribution to Change (%)	
	2004 (a)	2005 (b)	2004 (a)	2005 (b)	2004 (a)	2005 (b)	2004 (a)	2005 (b)
Agriculture Sector	**175,852**	**178,475**	**17.9**	**17.2**	**-0.3**	**1.5**	**-1.2**	**4.4**
Agriculture	135,967	147,909	13.9	14.2	-0.9	8.8	-2.3	20.2
Forestry	17,107	17,400	1.7	1.7	1.3	1.7	0.4	0.5
Fishing	22,779	13,166	2.3	1.3	1.6	-42.2	0.7	-16.3
Industrial Sector	**259,286**	**280,696**	**26.4**	**27.0**	**5.2**	**8.3**	**25.4**	**36.3**
Mining and quarrying	16,946	19,335	1.7	1.9	7.9	14.1	2.5	4.0
Manufacturing	159,721	169,337	16.3	16.3	5.1	6.0	15.3	16.3
Electricity, gas and water	14,287	17,610	1.5	1.7	-2.5	23.3	-0.7	5.6
Construction	68,332	74,414	7.0	7.2	6.6	8.9	8.3	10.3
Services Sector	**545,582**	**580,564**	**55.7**	**55.8**	**7.6**	**6.4**	**75.8**	**59.3**
Wholesale and retail trade, and hotels and restaurants	219,041	224,652	22.3	21.6	6.1	2.6	24.7	9.5
Transport, storage and communication	142,727	160,882	14.6	15.5	13.7	12.7	33.9	30.8
Financial services, real estate and business services	114,661	122,127	11.7	11.7	5.6	6.5	12.0	12.7
Public administration, other government services and defence and other community, social and personal services	69,153	72,903	7.1	7.0	3.9	5.4	5.1	6.4
Gross Domestic Product (GDP)	**980,720**	**1,039,735**	**100.0**	**100.0**	**5.4**	**6.0**	**100.0**	**100.0**
Net factor income from abroad	-11,300	-16,526			19.3	46.2		
Gross National Product (GNP)	**969,421**	**1,023,209**			**5.3**	**5.5**		

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

- **The reform efforts are timely, since Sri Lanka is gradually facing serious limitations to economic growth arising from insufficient capacity expansion.** The most notable limitation is seen in the power sector, which could stifle growth in all areas. Limitations in the capacity of roads, railways, port services, telecommunications and irrigation lead to serious drawbacks to investment, growth, regional development and international competitiveness. The rapid increase in housing development is adding pressure on the already strained public utilities. Inadequate capacity building in human resource development is reflected in the large number of persons travelling abroad to receive educational and health services, insufficient managerial skills and the low level of research and innovation activities in both the private and public sectors.
- **All major sectors of the economy grew at a healthy pace in 2005.** The Agriculture sector grew by 1.5 per cent, the Industrial sector by 8.3 per cent and the Services sector by 6.4 per cent. The three sectors contributed 4.4 per cent, 36.3 per cent and 59.3 per cent, respectively, to the GDP growth in 2005.
- **The Agriculture sector rebounded from the setback in 2004.** In 2005, both paddy and tea production reached new record levels. Paddy harvests in both Maha and Yala seasons reached

Chart 1.3

Value of Petroleum Imports and Average Price of Crude Oil Imports

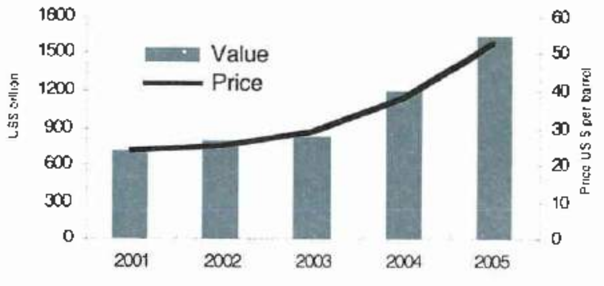
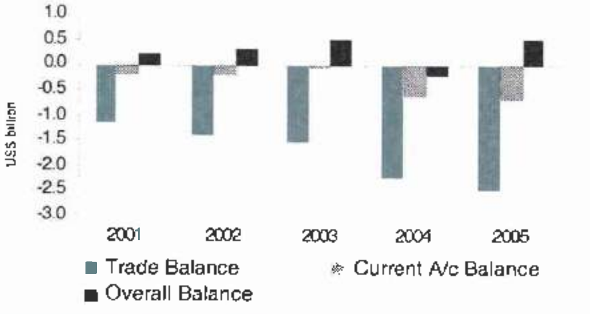


Chart 1.4

Balance of Payments



Box 1

Policies and Strategies to Accelerate Economic Growth and Regional Development

The government has articulated its policies and strategies to accelerate economic growth and development and to reduce regional imbalances and poverty on a sustainable basis in a number of policy documents. These are the Sri Lanka New Development Strategy - Framework for Economic Growth and Poverty Reduction 2005, Report by National Council for Economic Development, Millennium Development Goals - Sri Lanka Country Report 2005, Medium Term Expenditure Framework 2006-2008, Budget Speeches for 2005 and 2006 and Mahinda Chintana. In developing the policies and strategies, the government has recognised the pre-requisites for economic growth and development, and factors of economic growth and regional development. Key policies and strategies outlined in the above documents are as follows.

A. Promoting Pre-Requisites for Economic Growth and Development

- **Peace:** Pursuing a negotiated settlement for lasting peace by strengthening the ceasefire agreement and building consensus among the parties involved.
- **Legal and Regulatory System:** Modernising the country's legal and regulatory framework to promote the business environment and to reduce the transaction costs of business operations. Emphasis will be placed on commercial law reforms and capacity building in the judicial and legal profession through specialised training, modernisation of physical infrastructure and technology, and strengthening law reforms with capacity building and repealing or amending outlived legislations.
- **Improving Law and Order, Safety, Property Rights and Effective Enforcement:** Reducing the crime rate, enhancing public access to the judiciary and awareness of remedies available under the judicial system to promote the legal and regulatory environment to facilitate business development and protect property rights and enhance effective enforcement of law and order.
- **Policy Stability and Consistency, Transparency, Accountability and Governance:** Improving policy stability, maintaining policy consistency, transparency and accountability in procurement practices, capacity building and resolving policy related matters to strengthen and streamline the government procurement system to prevent delays and inefficiencies. Improving public access to information, timely publication of annual accounts of state enterprises and strengthening auditing and reporting standards and procedures.
- **Safety Nets and Social Protection:** Protecting, upgrading and empowering vulnerable groups and disadvantaged persons in society through appropriate policies and mechanisms, including facilitating most vulnerable groups to engage in productive economic activities, enhancing accessibility to care for the disabled and senior citizens, and improving the quality of such services.
- **Environment Protection:** Promoting sustainable development by giving due emphasis to environment protection.

B. Factors of Growth and Regional Development

- **Capacity Expansion:** Enhancing production capacity in all sectors of the economy by promoting public, private and foreign investment through appropriate reforms, such as institutional reforms, market reforms and public service reforms.
- **Human Resources Development:** Strengthening and upgrading primary, secondary and tertiary education institutions, maximising the available opportunities, enhancing access to education, and improving the quality and relevance of education at all levels. Providing high quality, equitable, cost effective, modern and sustainable heath care services.
- **Infrastructure Development:** Building modern, high quality and efficient infrastructure facilities to expand access to input and output markets. Maintaining and rehabilitating existing road network, construction of highways, increasing the availability of safe drinking water, upgrading the railway sector, expanding the supply of electricity, accelerating ongoing power sector reforms in transmission and distribution, and developing alternative energy to reduce the cost of power while taking into consideration the social problems and environmental implications and transforming port and airport sectors as an air-sea hub and logistic centre.
- **Improving Technology and Research and Development:** Promoting application of modern technology and undertaking research and development activities in the country to enhance competitiveness.

Box 1 (Contd.)

C. Policies and Strategies

- **The National Economic Policy Framework**: The overall economic policy is formulated by integrating the positive attributes of a free market economy, to ensure a modern and balanced approach, with the complementary participation of a socially responsible private sector and a strong public sector.
- **Demand Management Policies:** Maintaining a stable macroeconomic environment.

  Fiscal: Turning round revenue deficit to a surplus, increasing public investments largely through financing from concessionary foreign sources and long-term domestic market borrowings, eliminating domestic bank financing of the deficit and phasing out budgetary transfers to state enterprises. Strengthening public finances by improving public expenditure management systems, strengthening fiscal discipline, improving the effectiveness of tax administration and improving fiscal co-ordination.

  Monetary and Financial: Avoiding demand-fuelled inflation, ensuring the required credit growth for sustained economic activity and strengthening financial sector stability. Further strengthening the regulatory framework for banking, insurance and other financial services. Promoting a single regulatory arrangement for the non-bank financial sector. Introducing measures to reduce the high interest spread, strengthening state banks as strategic state enterprises by improving their financial viability and competitiveness.
- **Structural Reform Policies**

  Market Reforms: Reforming both product and factor markets to ensure efficiency and competitiveness of the economy. Major markets requiring reforms are the land, labour and financial markets. The continuation of an open and liberal economic policy regime in the product market has benefited the country.

  Infrastructure Reforms: The country requires an efficient and fast growing infrastructure system spread throughout the economy to help achieve regionally balanced growth. Public sector institutions, which supply vital services such as power, water, transport, and other services, are important service providing institutions of the government. Most of those institutions are monopolies, yet the quality and adequacy of the services they provide and their financial position are very poor. Hence, those institutions are earmarked for strategic reforms.

  Public Service Reforms: The public sector will engage in its critical role as facilitator, nurture, pace-setter and standard bearer. The entire perspective of the public service will have to focus on learning to anticipate change and meet the demands of the future in innovative ways.

  Institutional Reforms: The institutional reforms will be implemented to make the government's administrative machinery efficient, friendly and modern through reforms to rationalise functions of government agencies to ensure that they are focused on functions relevant to current needs, with special emphasis on transparency.

their historically highest levels of 2,013 thousand metric tons and 1,233 thousand metric tons, respectively. Tea production reached a record 317.2 million kg. Output of rubber, vegetables and other agricultural crops also increased in 2005. Coconut output declined and fish production did not recover fully, but showed signs of recovery by end 2005.

- **Sustainable agricultural development requires measures to enhance productivity, as well as ways of improving access to finance, availability of land, infrastructure facilities, and market-based methods to deal with excessive price fluctuations.** Productivity and profitability could be improved through further development of technology, research, extension services and reducing post harvest losses. The government has already taken measures to improve access to finance and land, and to develop infrastructure facilities. Market based methods to encounter adverse price fluctuations are still being developed. The persistent drop in farm gate prices of paddy and many varieties of vegetables at the time of harvesting indicates the absence of competitive market forces. This could be due to anti-competitive practices prevailing in the regions of paddy and vegetable cultivation as well as weak infrastructure. Hence, the government needs to intensely examine the market practices to bring about a lasting market based solution to the low farm gate prices.
- **Industrial sector growth, particularly the growth in the textile and garments sub sector, continued despite the uncertainty that prevailed in early 2005 and the surge in oil prices to historically high levels.** With the termination of the MFA in 2005, the government aggressively pursued a strategy of enhancing access to major markets and these efforts were complemented by entrepreneurs' initiatives to capture new markets and consolidate existing markets through efforts at firm level. Sri Lanka's high labour and environment protection standards, a conducive trade and investment promoting policy atmosphere and high literacy of the labour force aided this process.

Table 1.2
Aggregate Demand and Savings Investment Gap - 2004 and 2005

Item	Rs. billion		Growth %		As a per cent of GDP	
	2004	2005	2004	2005	2004	2005
1. Domestic demand	2,213.9	2,584.9	18.4	16.8	109.1	109.3
1.1 Consumption	1,707.0	1,958.9	15.2	14.8	84.1	82.8
Private	1,542.1	1,763.8	14.9	14.4	76.0	74.6
Public	164.9	195.1	18.4	18.3	8.1	8.2
1.2 Investment (Gross Domestic Capital Formation)	506.9	626.0	30.4	23.5	25.0	26.5
Private	402.3	463.8	36.3	15.3	19.8	19.6
Public Corporations	59.3	62.9	12.1	6.1	2.9	2.7
Government	45.3	99.3	11.0	119.2	2.2	4.2
2. Net external demand	-184.5	-219.2	69.6	18.8	-9.1	-9.3
Export of goods and non-factor services	737.0	792.4	16.7	7.5	36.3	33.5
Import of goods and non-factor services	921.5	1,011.6	24.5	9.8	45.4	42.8
3. Total demand (GDP) (1)+(2)	2,029.4	2,365.7	15.2	16.6	100.0	100.0
4. Domestic Savings (3)-(1.1)	322.4	406.8	15.1	26.2	15.9	17.2
Private	400.6	470.4	18.5	17.4	19.7	19.9
Public	-78.2	-63.6	34.4	-18.7	-3.9	-2.7
5. Net factor income from abroad	-20.7	-30.0	25.3	45.1	-1.0	-1.3
6. Net Private Current Transfers from abroad	136.5	174.4	17.5	27.7	6.7	7.4
7. National Savings (4)+(5)+(6)	438.3	551.2	15.4	25.8	21.6	23.3
8. Savings Investment Gap						
Domestic Savings - Investment (4)-(1.2)	-184.5	-219.2			-9.1	-9.3
National Savings - Investment (7)-(1.2)	-68.6	-74.8			-3.4	-3.2
9. External Current Account Deficit without official grants (2)+(5)+(6)	-68.6	-74.8			-3.4	-3.2

Source: Central Bank of Sri Lanka

- **The Industrial sector should strive for global competitiveness and should depend less on protectionist measures.** Several Sri Lankan industries have already penetrated into foreign markets with a sizeable market share. Protection increases prices of domestic goods and services, which are inputs for many industries. Hence, higher prices due to protection seriously distort input prices of already competitive industries. Furthermore, competitive industries in the domestic market could pay higher wages and rents on labour and capital. Protection adversely affects competitive firms, initiating a vicious cycle of protection and inefficiency and eventually impacting negatively on efficient industries. An alternative for protection is improving productivity, which would lead to lower output prices, benefit all related industries and help achieve global competitiveness.

- **The Services sector maintained its growth momentum in 2005 especially in port, telecommunication, and financial services.** Its contribution to growth could have been far greater had the planned infrastructure development taken place, especially road development, port and airport development, as well as further development of social infrastructure, especially, education and health services. Capacity enhancement in the Services sector is vital for sustainable higher economic growth given its significant links with the other productive sectors.

- **Sri Lanka faced greater competition and further pressure on the liberalisation of trade in services in 2005.** The Services sector has been the main driver of economic growth in Sri Lanka as well as in the rest of the developing and developed world. The sector has been benefiting from globalisation and liberalisation especially in the areas of port services, telecommunication, construction and financial services. With regard to recent efforts to liberalise multilateral and bilateral trade, the Services sector has been earmarked for further liberalisation. Therefore, it is important for this sector to be prepared for increased competition while rules and standards of operation should be established to facilitate and benefit from liberalisation.

- **Both investment and savings improved in 2005.** Investment increased to 26.5 per cent of GDP from 25 per cent in 2004, while domestic savings increased to 17.2 per cent of GDP from 15.9 per cent in 2004. Private investment, as a percentage of GDP, declined marginally from 19.8 per cent in 2004 to 19.6 per cent in 2005. Public investment including investments by public corporations improved from 5.1 per cent of GDP in 2004 to 6.9 per cent of GDP in 2005. Domestic savings improved with private domestic savings increasing from 19.7 per cent to 19.9 per cent of GDP in 2005, with public dis-savings declining from 3.9 per cent of GDP to 2.7 per cent of GDP. The savings-investment gap and the corresponding current account deficit were financed through increased inflows from foreign direct investment, portfolio investment, and loans and grants to the government. Dependence on external loan inflows to meet the savings-investment gap could be reduced by encouraging foreign direct investment inflows.

Box 2

Liberalisation of Trade in Services and Limitations

An economy consists of three major sectors: agriculture, industry and services. Many developed and fast growing countries have experienced rapid expansion in the Services sector when compared to Agriculture and Industrial sectors. The Services sector is the fastest growing sector of the global economy and account for two thirds of global output, one third of global employment and nearly 20 per cent of global trade. In developed countries, the share of services in the economy typically lies between 60 and 70 per cent, while it is on average smaller in developing and least developed countries. In South Asian countries, the services sector accounts for a significant share of the Gross Domestic Product (GDP). In Sri Lanka, the contribution from the services sector increased to 57 per cent of the GDP in 2005 from 41 per cent in 1977.

The expansion in the services sector reflects the evolution of consumer tastes, increased economic interactions and tools of production. Back in 1857, German economist Ernst Engel observed that as families grew richer, they allocated a smaller portion of the household budget to food.[1] A nation with growing income would spend an increasingly smaller share of its income on food, shelter and other goods with physical manifestation. The demand is increasingly for services to make life more secure and enjoyable. The economy supplies more and more of such services to fulfil the demand, raising the services sector output.

Many services are major inputs of the national output. Education and health services enhance the quality of human capital needed for economic growth. Services such as information technology, telecommunication and financial services are essential for growing enterprises. Thus, if a country cannot produce those services adequately, it has to import them to support economic growth and development.

Unlike a product, which is traded mostly cross-border, a service can be traded internationally in four different modes.

Mode 1 - Cross-Border Supply - Services supplied from an institution based in one country to another country. This mode of supplying services is similar to the supply of goods across borders.

Mode 2 - Consumption Abroad - Consumers or firms in the home country making use of a service in a foreign country by visiting the foreign country. For example, Sri Lanka allows its residents to purchase services such as health care and education by travelling to a foreign country to receive such services, thereby enhancing access to services of foreign service suppliers.

Mode 3 - Commercial Presence - A foreign company setting up commercial enterprises to provide services in the home country. Foreign direct investment is attracted through this mode.

Mode 4 - Presence of Natural Persons - Individuals travelling from a foreign country to supply services in another country. In this mode, foreigners deliver various services to residents of Sri Lanka.

Sri Lanka's major exports of services are telecommunication, port, tourism and labour. In 2005 earnings from services accounted for 20 per cent of total export earnings (which include export earnings from both goods and services). This was an improvement from the share of 15 per cent in 2000.

The revolutionary growth in telecommunication, information technology and transportation has enabled international trade in services among countries. As international trade in services began to grow, the World Trade Organisation (WTO) established rules of trade under the Generalised Agreement on Trade in Services (GATS). Trade in services is gradually being incorporated to trade agreements, which used to be only limited to trade in goods. Following this trend, the Indo Sri Lanka Free Trade Agreement (ISLFTA) signed in 1998 is being upgraded to a Comprehensive Economic Partnership Agreement (CEPA) incorporating trade in services as a main component. Sri Lanka has already made a series of commitments to the WTO under GATS in relation to tourism, telecommunication and financial services. Liberalisation of those services has generated tangible benefits to the country as seen in the developments in those sectors.

Domestic regulations are more prominent in trade in services than in trade in goods. Regulations on trade in services have been formulated to maintain required standards, streamline payments, safeguard domestic employment and on the basis of related national issues. Examples are accreditation processes adopted in professional services, capital account restrictions preventing some financial services and regulations preventing the free entry of services and service providers into countries.

Sri Lanka possesses the potential for rapid growth in the export of services, if domestic restrictions are liberalised cautiously and the services sector institutions are strengthened. Insufficient understanding of the mechanisms of trade in services has led Sri Lanka to unduly restrict domestic production and exports of services such as education and health care in which Sri Lanka possesses a competitive advantage. At the same time the country is in effect promoting imports of those services through Mode 2. Some professional services do not have the means of establishing quality standards yet. Therefore, the relaxation of existing restrictions and further improvements in the institutional set-up need to be undertaken fast, if Sri Lanka is to benefit from the rapidly expanding trade in services.

1. Federal Reserve Bank of Dallas, 1994, The Service Sector: Give It Some Respect, Annual Report, Dallas.

Table 1.3
External Sector Developments

	US $ mn		Growth (%)
	2004	2005	
Exports	5,757	6,347	10.2
Agricultural products	1,065	1,154	8.3
Industrial products	4,506	4,948	9.8
Mineral exports	120	143	19.5
Other exports	66	101	53 3
Imports	8,000	8,864	10.8
Consumer goods	1,623	1,644	1.3
Intermediate goods	4,645	5,317	14.5
Investment goods	1,670	1,870	12 0
Other	61	33	-46.0
Trade balance	-2,243	-2,517	12.3
Services, net	419	338	-19.3
Receipts	1,527	1,540	0.9
Payments	1,108	1,202	8.5
Income, net	-203	-299	47.3
Receipts	157	35	-77.7
Payments	360	335	-6.9
Private current transfers, net	1,380	1,828	32.5
Private remittances, net	1,350	1,736	28 6
Receipts	1,564	1,968	25 8
Payments	214	233	8.8
Current account balance	-647	-650	0.5
Capital account	64	250	289.0
Financial account	567	974	71.8
Direct investment, net	227	234	2.9
Inflows	233	272	16.7
Outflows	6	38	564.4
Private long-term,net	14	11	-21.0
Inflows	169	197	16.6
Outflows	155	186	20.0
Government, long-term,net	440	553	25.8
Inflows	771	747	-3.1
Tsunami related inflows		93	
Outflows	331	194	-41.5
Short-term:	-112	176	-256.6
Portfolio investment, net	11	60	451.4
Errors and Omissions	-189	-72	
Overall balance	-205	501	
Gross official reserves	2195.8	2735.1	
Months of imports	3.3	3.7	
Total gross reserves	3438.5	4200.6	
Months of imports	5.2	5.7	
Debt moratorium		264.0	
Export price	95.7	98.9	
Import price	91.7	98.9	
Terms of trade	104.4	100.0	
Exchange rates (Average)			Rate of Appreciation (%)
Rs. / US $	101.19	100.50	0.7
Rs. / Yen	0.94	0.91	3.3
Rs. / Euro	125.79	125.10	0.6
Rs. / STG	185.35	182.87	1.4

Source: Central Bank of Sri Lanka

- **Sri Lanka succeeded in facing competition in international trade as a result of the combined efforts of entrepreneurs and the government to enhance market access.** Exports grew by 10.2 per cent to US dollars 6,347 million and imports grew by 10.8 per cent to US dollars 8,863 million in 2005. Industrial exports continued to drive export growth in 2005 with a dominant share of 78 per cent and contributing 75 per cent to overall export growth. Agricultural exports accounted for 18 per cent of total exports and contributed 15 per cent to export growth, followed by mineral and other exports, which accounted for 4 per cent of total exports and contributed 10 per cent to export growth in 2005. The expansion of economic activities in the country, facilitated by the appreciation of the exchange rate and the low interest rate regime, and post tsunami reconstruction activities, raised import demand, over the high base of the previous year, especially for intermediate and investment goods.

- **Historically high oil prices caused a severe strain on the financing of the country's import expenditure in 2005.** The expenditure on petroleum imports increased by 37 per cent to US dollars 1,655 million in 2005. This increase was due to an increase in prices of a similar magnitude. The domestic prices of petrol, diesel and kerosene rose only partially by 18 per cent, 19 per cent and 20 per cent, respectively, in 2005. The required adjustments in domestic consumption did not take place in 2005 due to only a partial adjustment of domestic prices. The largest petroleum user in Sri Lanka is the transport sector (50 per cent), followed by power generation (25 per cent). Industries, households and other sectors account for the other 25 per cent of consumption. Passenger transport prices and electricity prices were not fully adjusted in 2005 to reflect the actual cost of petroleum, thereby causing a heavy burden on the government's budget and the viability of related public sector enterprises.

- **Large inflows to the government and increased private remittances bolstered the external finance position, leading to a surplus in the balance of payments and an appreciation of the rupee.** The trade deficit widened to US dollars 2,516 million, but the current account deficit widened only marginally to US dollars 650 million largely due to a sharp growth of 22.6 per cent in worker remittances which, reached US dollars 1,918 million in 2005. As a ratio of GDP, the current account deficit declined from 3.2 per cent in 2004 to 2.8 per cent in 2005. Net inflows to the government increased by 51 per cent in 2005 with large tsunami related inflows, and lower debt service payments resulting from the debt moratoria following the tsunami, contributing to an overall BOP surplus of US dollars 501 million. These capital inflows raised gross official external reserves to US dollars 2,735 million (3.7 months of imports). This, in turn, improved debt servicing capacity and led

Chart 1.5
Government Revenue, Expenditure and Budget Deficit

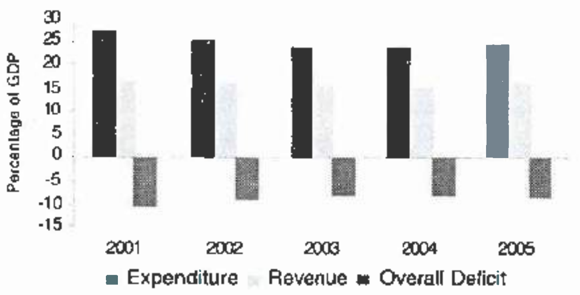
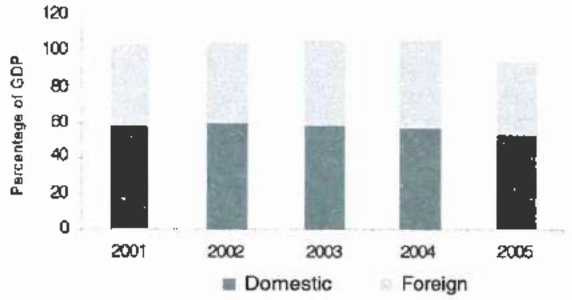


Chart 1.6
Government Debt



to a moderate appreciation of the rupee against major currencies.

- **Sri Lanka obtained debut sovereign ratings from two international rating agencies in 2005.** The Fitch Ratings assigned the country rating of BB- (BB minus) while Standard & Poor's Ratings (S&P) Services rated Sri Lanka at B+ (B plus). These will facilitate the mobilisation of financial resources in international markets by both the government and the private sector.

- **Fiscal policy in 2005 was aimed at achieving pro-poor and pro-growth development objectives of the government, supporting a speedy recovery of the economy from the unexpected tsunami disaster and moving towards fiscal sustainability in the long run.** Overall fiscal management was challenging in 2005 as the government had to be involved in the tsunami rebuilding process, while facing the implications of the international oil price hike. This had to be achieved in an environment of rising interest rates while servicing the already high debt burden. The policy stance continued to be expansionary to address the immediate needs of the tsunami recovery as well as the adverse impact of high oil prices. The tsunami rebuilding process received the assistance of donors and the private sector in addition to the government's efforts.

- **Some positive developments were seen in the fiscal consolidation process in 2005.** The revenue collection rose to 16.1 per cent of GDP in 2005 from 15.4 per cent in 2004, as expected in the revised Budget 2005. Tax revenue increased to 14.2 per cent of GDP from 13.9 per cent in the previous year. Total expenditure and net lending, including tsunami expenditure amounted to 24.7 per cent of GDP in 2005, which is similar to the anticipated expenditure in the revised Budget 2005. This was due to the higher current expenditure of 18.7 per cent compared to the revised target of 18.4 per cent in 2005. Public investment including government on lending to public corporations in 2005 increased to 6.3 per cent from 4.8 per cent of GDP in 2004. The overall budget deficit of the government in 2005 amounted 8.7 per cent of GDP, an increase from the expected deficit of 8.2 per cent in 2005. The deficit, excluding tsunami expenditure in 2005, reached 7.3 per cent of GDP compared to the expected deficit of 6.8 per cent of GDP. The budget deficit was financed with domestic resources (5.2 per cent of GDP) and foreign resources (3.5 per cent of GDP).

- **The outstanding government debt declined to 93.9 per cent of GDP from 105.5 per cent in 2004.** This was mainly due to the appreciation of the rupee against major foreign currencies and the higher growth in nominal GDP. The total government debt increased by Rs. 82.8 billion to Rs. 2, 222.3 billion in 2005. Though the debt to GDP ratio declined in 2005, the government debt still remains high. This situation poses several threats including rising interest payment commitments, adverse implications for monetary and fiscal policies and reducing the country's ability to withstand external shocks. Thus, it underscores the need for strong measures to further improve the fiscal consolidation process to reduce the debt burden and achieve fiscal sustainability in the medium to long run.

- **The gradual tightening of monetary policy, begun in 2004, was continued in 2005 with the objectives of containing inflationary pressures, containing the rapid growth of monetary aggregates and facilitating the recovery of the economy.** The tsunami devastation prompted a temporary change in the focus of monetary policy in 2005. The daily open market operations (OMOs) were temporarily suspended from early in January 2005, to ensure the smooth functioning of financial markets during the early post-tsunami period. OMOs were subsequently recommenced late in February 2005 as the threat of the tsunami on the financial sector and economic activities began to dissipate gradually. Subsequently, OMOs had to be conducted aggressively to contain the inflationary pressures. The tightening of the monetary policy stance through aggressive OMOs was further buttressed by taking measures to contain the reserve money expansion. Accordingly, the Central Bank refrained from purchasing Treasury bills in the primary market as far as possible, conducted secondary market outright sales to mop up excess liquidity from the market permanently and raised the Central Bank's policy interest rates, *viz.* Repurchase and Reverse repurchase rates, in four steps: 25 basis points in May, 50 basis points in June, 25 basis points in September, and a further 25 basis points in December 2005.

- **The economy responded well to the tightening of monetary policy as made evident from the slowing down of monetary expansion, the moderation in inflation and the decline in inflation expectations.** Reserve money expansion decelerated to the targeted growth path by end December 2005 and broad money growth also slowed down, although the growth rate remained high. Greater stability in the external sector too supported monetary operations in achieving monetary policy objectives. Inflation decelerated from the high level in early 2005 by the end of the year, supported by monetary tightening, greater stability in exchange rates and favourable developments in the aggregate supply. A decline in inflation expectations was reflected in the lower secondary market yield rates pertaining to government securities and the lower premia in the foreign exchange forward markets.
- **The financial sector expanded with improved stability and resilience in 2005.** The performance of financial institutions improved in terms of profits, soundness and a widening of the array of financial products and services during 2005. Access to finance was further enhanced with financial institutions offering new facilities and with the setting up of a new institution catering especially to Small and Medium scale Enterprises (SMEs). Activities in financial markets surged to record high levels, particularly in the foreign exchange and share markets, with rising confidence in economic prospects.
- **During 2005, the Central Bank took several measures to further improve the stability of the financial system.** Financial sector infrastructure was further improved with measures being taken to increase the efficiency of the payment and settlement systems, the introduction of new legislation to facilitate the smooth functioning of the financial system, and improvements made to the regulatory and supervisory framework in line with international best practices. The Payment and Settlement Systems Act, No. 28, enacted in September 2005, enables the Central Bank to oversee the national payment and settlement systems. Further an amendment was made to the Banking Act in 2005 to prohibit fraudulent network marketing practices. The efficiency of the Real Time Gross Settlement (RTGS) system and the Scripless Securities Settlement (SSS) system was improved and access to those systems was widened. To improve the retail payment and settlement system, a Cheque Imaging and Truncation (CIT) system will be implemented in 2006. Financial institutions were requested to enhance their capital and new regulations have been issued in relation to the single borrower limit, related party transactions and disclosure of information. Banks have been advised to adopt the Basel II capital accord by 2008. The fit and proper criteria for selecting the board of directors of financial institutions have been further strengthened. The Central Bank continued its public awareness campaign aimed at educating the public on the risks of investing in unregulated and fraudulent financial institutions and investing in fraudulent net work marketing schemes. To enhance public confidence and to generate public awareness of the stability of the financial system, the Central Bank published the second Financial Stability Review 2005 updating the status of financial system stability.
- **The resolution of several important issues relating to the cost of intermediation, the supervision of conglomerates and improvements in corporate governance may further enhance the resilience and stability of the financial system while improving confidence in the financial system.** The intermediation cost of banks, represented by the interest spread, has declined in the recent past, but still remains high

Chart 1.7
Growth in Reserve Money and Broad Money

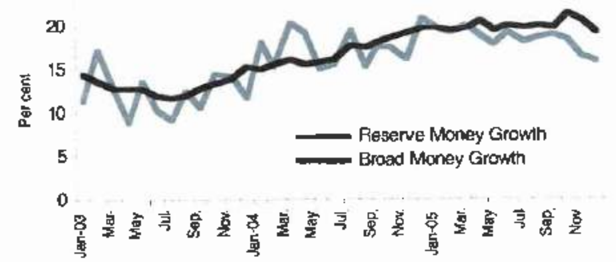
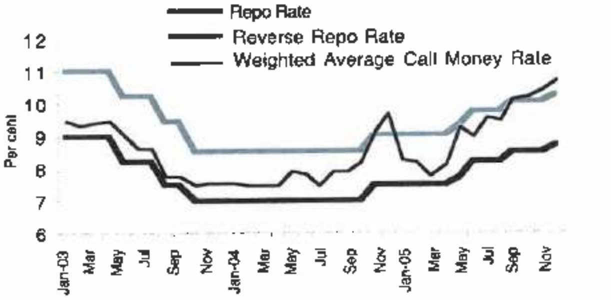


Chart 1.8
Interest Rate Movements



relative to regional standards. Efforts need to be made by banks to improve efficiency and productivity to lower the high intermediation cost. Recent issues relating to the concentration of share ownership of financial institutions, which undermines public and investor confidence, underscore the necessity for strengthening corporate governance in financial institutions. This has been evident in the cross shareholdings in financial conglomerates and the resulting conflicts of interest. The Central Bank has already taken initiatives to enhance corporate governance through strict enforcement of the Banking Act and imposing market discipline through greater disclosure of information by financial institutions.

1.2 External Economic Environment

- **With continuing growth and subdued inflation in the global economy, the external economic environment remains favourable to Sri Lanka's economic growth prospects.** Despite the continuous surge in international oil prices and the frequent occurrence of natural disasters, global GDP growth in 2005 reached 4.8 per cent. This followed the economic growth of 5.3 per cent in 2004, the highest in the past few decades. However, the growth in the volume of world trade slowed down to 7.3 per cent in 2005 from 10.4 per cent in 2004, reflecting the slow down in global economic growth. Global headline inflation picked up marginally in 2005 in response to higher oil prices, but core inflation remained stable and inflation expectations have remained well grounded given the gradual withdrawal of the monetary policy stimulus in many countries. Future prospects for global economic growth remain robust and the global GDP is projected to grow in 2005 at a slightly higher rate of 4.9 per cent in 2006. However, there are a number of downside risks to the projected global outlook. High and volatile oil prices and their impact on price levels could threaten the current stability in core inflation. The avian flu could become pandemic leading to extremely high human and economic costs. The rising global imbalances, especially the large current account deficit in the USA and its growing external indebtedness, pose the risk of disorderly adjustment if financing those deficits becomes difficult.

- **The economic growth of Sri Lanka's major export destination countries remains robust.** The projected growth in the USA is expected to moderate but will still remain relatively higher than the growth in other industrial countries. In Japan, economic activity is expected to pick up strongly, easing deflationary pressures. Despite the weak performance of the Euro area in 2005, its expansion gained momentum from the fourth quarter of 2005 onwards. The economic growth of emerging market economies and developing countries also remained robust, despite slowing down marginally to 7.2 per cent in 2005 from the 7.6 per cent growth in 2004. The rising oil prices, the slowing down of the global economy and country specific factors contributed to the marginal slow down. In emerging Asia, India and China continued to exceed expected growth rates, supported by strong domestic and external demand. Middle Eastern countries and the Commonwealth of Independent States benefited from rising oil prices. There are no signs of a slowing down of activity in emerging markets and developing countries.

Table 1.4

Global Economic Developments and Outlook

(Annual percentage change unless otherwise indicated)

	Actual		Projections	
	2004	2005	2006	2007
World output	5.3	4.8	4.9	4.7
Advanced economies	3.3	2.7	3.0	2.8
United States	4.2	3.5	3.4	3.3
Euro area	2.1	1.3	2.0	1.9
United Kingdom	3.1	1.8	2.5	2.7
Japan	2.3	2.7	2.8	2.1
Developing countries	7.6	7.2	6.9	6.6
Developing Asia	8.8	8.6	8.2	8.0
China	10.1	9.9	9.5	9.0
India	8.1	8.3	7.3	7.0
World trade volume				
(Goods and services)	10.4	7.3	8.0	7.5
Imports				
Advanced economies	8.9	5.8	6.2	5.6
Developing economies	15.8	12.4	12.9	11.9
Exports				
Advanced economies	8.5	5.3	6.6	6.1
Developing economies	14.6	11.5	10.9	10.3
Price Movements				
Consumer prices				
Advanced economies	2.0	2.3	2.3	2.1
Developing economies	5.7	5.4	5.4	4.8
Commodity prices				
Oil	30.7	41.3	14.8	2.9
Non-fuel	18.5	10.3	10.2	-5.5
Six month London interbank offered rate (per cent)				
On US dollar deposits	1.8	3.8	5.0	5.1

Source: World Economic Outlook (April 2006), IMF

- **Efforts to strengthen the rule based trading system continued and Sri Lanka made further progress in securing market access through multilateral, regional and bilateral trading arrangements in 2005.** Sri Lanka remained firmly committed to the multilateral trading system, being a founder member of the World Trade Organisation (WTO). At the Sixth WTO Ministerial Meeting in Hong Kong SAR held in 2005, some progress was achieved in implementing the Doha Development Agenda. Substantial progress was made in phasing out agriculture subsidies and granting extra concessions to Least Developed Countries. On the regional front, Sri Lanka agreed to convert the South Asian Preferential Trading Arrangement (SAPTA) into the South Asian Free Trade Area (SAFTA). A further stride in regional agreements was made with Sri Lanka achieving substantial progress in finalising the draft Free Trade Area (FTA) of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC). Sri Lanka continued to receive tariff concessions from member countries under the Global System of Trade Preferences (GSTP), which was established as a framework for the exchange of tariff preferences among developing countries. Bilateral negotiations between Sri Lanka and the European Union (EU) on the GSP+ scheme yielded a breakthrough in 2005, but further negotiations are required to reap its full benefits. Negotiations on the Comprehensive Economic Partnership Agreement (CEPA) between Sri Lanka and India continued in 2005. The bilateral framework agreement signed by Sri Lanka and Pakistan on trade became operational from June 2005, after resolving issues relating to concessions sought by both countries. Several other bilateral trade discussions took place in 2005 with Thailand, USA and Iran. It is important for Sri Lanka to rationalise the existing economic relations by taking into account the collective impact on the medium to long-term path of liberalisation and ensuing economic developments.

- **Global financial market conditions remained orderly in 2005.** Although short-term interest rates continued to rise due to the monetary policy tightening in the USA and the Euro area, long-term global interest rates remained low. Higher net savings by both emerging markets and the corporate sector in developed countries and increased oil revenues provided ample liquidity to global financial markets, which also helped maintain stable long-run interest rates. The short-run interest rate differential favourable to the US dollar led to greater financial flows to the USA and the appreciation of the US dollar which helped finance the growing current account deficit in the USA without causing any disorderly adjustments. A notable development in emerging Asia during 2005 was the introduction of more flexible exchange rate regimes in China and Malaysia, which relaxed their currencies' longstanding peg to the US dollar. This move is expected to partly address global current account imbalances. However, an orderly adjustment of global imbalances requires further appreciation of currencies in surplus Asian and oil producing countries against the US dollar. Many emerging markets and developing countries issued international bonds with favourable interest spreads to meet their borrowing needs.

- **High oil prices may prevail, but any further escalation remains uncertain.** A fundamental uncertainty about both demand for and supply of oil arises from the pace of global economic growth, usage of oil, continuing political uncertainty and limited spare capacity. The uncertain global energy situation requires Sri Lanka to be cautious in its energy policy. The undue fiscal burden due to fuel subsidies and high fuel consumption could be reduced through a consistent energy pricing policy that reflects international price movements. Energy producing state-owned enterprises need to be reformed to ensure their financial viability and thereby the provision of uninterrupted supply of energy at a competitive price.

1.3 Medium Term Macroeconomic Outlook, Challenges and Policies

- **The Medium Term Macroeconomic Framework (MTMF) presented with the Budget 2006 expects the country to move onto a higher growth path with improved macroeconomic stability in the medium term.** In the next four years, GDP growth is expected to accelerate substantially bolstering regional development as well as the nation rebuilding programme of the government in the aftermath of the tsunami devastation. The growth is intended to be achieved through enhanced savings and investment supported by productivity and capacity improvements. The external sector is expected to further improve in the medium-run benefiting from the improving political and macroeconomic environment, domestic supply improvements, global demand, higher inflows through remittances and foreign direct investment, and greater utilisation of foreign assistance. The fiscal consolidation process will also be continued through further measures to increase revenue, and to rationalise expenditure, leading to a surplus in the current account. Benefiting from the strengthened fiscal consolidation and the higher economic growth rate public investment may rise and the debt burden may decline. Monetary policy and monetary management over the medium term will continue to aim at maintaining price stability while facilitating economic growth.

- **Achieving the targets of the MTMF depends on several crucial factors.** Restoring permanent peace would boost investor confidence and accelerate expansion in economic activities. Prudent macroeconomic policies have to be put in place to ensure macroeconomic stability. The capacity of the economy to grow can be significantly enhanced through a comprehensive reform programme that would encompass the development of pre-requisites for economic growth and fostering of growth supportive factors. These include countering asymmetric information problems such as the principal agent problem and rent seeking and enhancing public sector accountability as well as the delivery mechanism. These efforts have to be complemented by conducting a comprehensive public awareness program on the role and limitations of the public sector, benefits of liberalisation and reforms, and the role of the private sector in improving competitiveness and increasing access to both domestic and international markets through their own efforts. A successful outcome in oil exploration could turn Sri Lanka into a trade surplus country, providing resources to further accelerate the growth process.

Box 3

Welfare Cost of Subsidies

Subsidies are of different types: transfers of budgetary resources, tax holidays, tax concessions, supplying goods or services below cost and policies that create transfers through the market mechanism. Subsidies are popular means of providing relief by governments to categories of persons (*e.g.* farmers), private agents and public enterprises, enabling them to either purchase or sell a good or a service at a cost below the market price.

The welfare cost of subsidies is multi faceted. They lead to governments incurring a budgetary burden, which has to be met through either increased taxing of the population or increasing the government's indebtedness or covering the cost by cutting fiscal expenditure, frequently by reducing expenditure on public investment. Thus, subsidies often involve a serious opportunity cost of growth and development with the reallocation of resources from productive public investment to current expenditure. Furthermore, lower prices, mostly below the cost of production paid by economic agents on goods and services could lead to over exploitation and misallocation of resources. Utilities such as water, electricity and petroleum in many countries are subject to subsidies and those resources are being over exploited. Such over exploitation could lead to a worldwide shortage of resources.

In Sri Lanka, subsidies are widespread. Annual subsidies for fuel and fertiliser amount to Rs.26 billion and Rs.6.8 billion, respectively. These subsidies amounted to 1.4 per cent of GDP in 2005, which could be compaired with the total public spending on health in 2005 (Rs.44.8 billion) and the cost of the Norochcholai power project (Rs.47.9 billion). It is almost equal to the total estimated cost of the Southern Highway (Rs.33.9 billion). This is several times higher than the allocation (Rs.0.35 billion) made for the new Uva Wellassa University in 2005. The annual cost of subsidies could be utilised to construct about 1,300 schools or about 160 base hospitals per year. In addition to these, a wide range of corporate tax holidays and tax concessions exists leading to a loss of fiscal revenue.

The key issues in managing subsidies are the size, incidence and distortions in allocation. The adverse implications of subsidies could be minimised by their reduction through provision of subsidies only to the needy through proper targeting. Though the need for reducing subsidies has been recognised, intervention by various pressure groups and insufficient consensus on reforming subsidies, often does not allow the implementation of such policies.

Rationalisation of subsidies can remove economic distortions, thereby improving efficiency and growth, reduce the budgetary burden and significantly enhance much needed public investment.

- **The government has shown its commitment to achieving a durable and lasting peace.** Peace talks recommenced in February 2006 bolstering market confidence and prospects for economic development.
- **Further consolidation of macroeconomic stability that has been achieved so far is essential to developing a conducive environment for markets to operate effectively and the economy to remain stable.** Though the debt to GDP ratio declined in 2005, the relatively higher level of debt poses a threat to long-term debt sustainability. Further improvements are needed to contain the primary and current account deficits thereby generating surpluses needed for debt sustainability and building up of external reserves. A strong and sustainable fiscal adjustment process is implied in the medium-term targets of the *Fiscal Management (Responsibility) Act (FMRA)*. Fiscal consolidation would pave the way for monetary policy to operate effectively in containing monetary expansion and maintaining price stability. To contain further monetary expansion, the growth of its major components, namely, private sector credit and net credit to the government, needs to be restrained. The expansion of credit to the private sector from banks has to be curtailed in a manner that is not harmful to private investment while government borrowing from the banking sector has to be reduced. The continuation of the flexible exchange rate regime will prevent the build up of any destabilising forces.
- **The current high international oil prices may cause a destabilising effect unless long-term solutions are found.** With the increase in thermal power generation in the absence of other alternate energy sources, the country's dependence on imports of oil has increased over the years. High oil prices, while exerting significant pressures on the government budgetary resources, BOP, the exchange rate and inflation, could further weaken the financial position of the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC) unless appropriate price adjustments are made to economise consumption. The country's ability to withstand pressure from high oil prices should be strengthened by adopting appropriate policies within the macroeconomic framework, developing alternative energy sources, minimizing

Box 4

Prevalence and Macroeconomic Impact of the Principal Agent Problem and Rent Seeking

Many developed and developing countries suffer from problems associated with asymmetric information and, especially, rent seeking, due to two reasons. First, the non-recognition of the prevalence of those problems and second, although the problems are recognized, measures to counter them are inadequate.

Asymmetric information problems refer to problems arising from one party in a transaction or a contract having more or better information about the transaction or the contract to make accurate decisions. The presence of asymmetric information leads to adverse selection, moral hazard and associated principal-agent problems, and rent seeking, impacting on the economy and sometimes causing market failure.[1]

The principal agent problem is a moral hazard problem that arises when managers in control (the agents) of a firm or of the economy act in their own interest rather than in the interest of the stakeholders or owners (the principals), because the managers have less incentive to maximise profits than the stockholder-owners do. This is especially relevant to managing state owned enterprises when the government (or the public), as the principal has to depend on appointed agents to run those enterprises. Agents may not manage the enterprises in a way that principals would like them to if an appropriate incentive/penalty system were not put in place.

Rent seeking also arises from moral hazard, where individuals or firms lobby governments or the caretakers of the country's resources to grant them favours unduly or allocate some of the resources for their private use, causing a substantial social cost. Rent seeking is found commonly in lobbying for lowering taxes, imposing tariff to avoid competition, obtaining subsidies, obstructing the provision of public goods such as roads, and in bureaucrats and politicians unduly rewarding special interest groups. The Budget 2005 highlights that *'In fact, tax concessions, customs duty reductions, exemptions, VAT rebates, and such other concessions that the business community constantly seeks and secures from the Treasury, are much more than the entire budgeted subsidy bill. These are hidden subsidies, which the more affluent and influential sections of our community enjoy in our country placing a tremendous burden on the country's annual budget.'*

Rent seeking imposes a significant cost on the economy and retards economic growth through altering the incentive system, misallocation of resources, and breeding inefficiency. Firms may begin to spend resources on rent seeking rather than improving competitiveness through productivity enhancement and innovation. Further, the receipt of undue benefits by special interest groups may cause disappointment and frustration among others leading to lacklustre performance in the economy.

Rent seeking results in a sub-optimal allocation of resources and may reduce efforts to enhance productivity. Those with authority could favour their special interest groups who may campaign to elect them again. Under such circumstances, bureaucrats and politicians may not act in the best interest of society. These actions would distort the structure of economic and social incentives and lead to a misallocation of resources, resulting in welfare losses and hindering economic growth.

The incidence of asymmetric information related problems could be reduced through improved governance, ensuring accountability, proper auditing, public disclosure of transactions, and conducting public awareness programs. Efforts of the civil society as watchdogs of governance, the environment, human rights, *etc.*, also help mitigate these problems.

1. Akerlof, George A., "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." Quarterly Journal of Economics, 84(3), pp. 488-500, 1970; and Tullock, G. (1967). 'The Welfare Costs of Tariffs, Monopolies and Theft' Western Economic Journal, 5, pp. 224-232.

inefficient use of fuel, restructuring energy related public institutions and phasing out wasteful subsidies associated with high oil prices. In this regard, the CEB should develop the capability to meet the future electricity demand of the country, for otherwise, the high growth expectations in the medium to long run would be impeded. Sri Lanka may be fortunate to find petroleum resources as indicated by a recent seismic survey, which shows the existence of oil deposits in off-shore areas of the Western and North-Western regions. However, while those efforts are intensified, Sri Lanka has to develop alternative energy sources and enhance the efficiency of transportation and other energy users.

- **It is necessary to undertake critical structural reforms urgently since the current state of infrastructure has posed a serious capacity limitation on continuing growth.** A series of reforms would be necessary to develop economic and social infrastructure essential for the continuation of economic growth, the generation of a series of tradable services and supporting poverty alleviation. The present serious supply shortages and regional disparities in roads, electricity,

Table 1.5
Medium Term Macroeconomic Framework 2005 - 2009

Indicator	Unit	2005(a)	Projections 2006	2007	2008	2009
Real Sector						
GDP at Market Prices	Rs bn	2,366	2,732	3,139	3,563	4,018
Real GDP Growth	%	6.0	6.9	7.4	8.1	8.4
Inflation-GDP Deflator	%	9.9	8.0	7.0	5.0	4.0
Total Investment	% of GDP	26.5	30.0	32.0	33.9	34.8
Private Investment	% of GDP	19.6	21.6	24.3	26.2	27.0
Public Investment	% of GDP	6.9	8.4	7.7	7.7	7.8
Domestic Saving	% of GDP	17.2	20.5	22.0	24.8	26.4
Private Saving	% of GDP	19.9	21.4	21.5	22.7	23.5
Public Saving	% of GDP	-2.7	-0.9	0.5	2.1	2.9
National Saving	% of GDP	23.3	26.5	27.8	30.5	31.9
External Sector						
Trade Gap	US $ mn	-2,516	-2,916	-3,372	-3,443	-3,560
Exports	US $ mn	6,347	6,995	7,748	8,585	9,460
Imports	US $ mn	8,863	9,911	11,120	12,028	13,021
Services	US $ mn	338	409	411	474	504
Receipts	US $ mn	1,540	1,737	1,888	2,062	2,245
Payments	US $ mn	1,202	1,328	1,477	1,589	1,741
Current Account Balance	US $ mn	-650	-866	-1,124	-1,009	-973
Current Account Balance	% of GDP	-2.8	-3.3	-3.8	-3.1	-2.7
Overall Balance	US$ mn	501	400	320	210	353
External Official Reserves (Months of Imports)	Months	3.3	3.3	3.3	3.2	3.2
Debt Service Ratio (b)	%	7.9	10.9	9.9	10.6	10.0
Fiscal Sector (c)						
Revenue	% of GDP	16.1	17.8	18.1	18.5	18.6
Expenditure	% of GDP	24.7	26.9	25.3	23.5	23.6
Current Account Balance	% of GDP	-2.7	-0.9	0.5	2.1	2.9
Overall Budget Deficit	% of GDP	-8.7	-9.1	-7.2	-5.7	-5.0
Domestic Financing	% of GDP	5.2	4.5	3.2	2.2	2.4
Financial Sector (d)						
Reserve Money Growth	%	15.8	15.0	14.9	14.5	13.0
Broad Money Growth (M_{2b})	%	19.1	15.0	14.9	14.5	13.0
Narrow Money Growth (M_1)	%	22.4	13.0	12.9	12.5	11.0
Growth in Credit to Private Sector	%	21.5	16.0	19.3	17.0	13.6
Growth in Credit to Public Sector	%	0.7	4.2	-5.7	-5.0	-5.1

(a) Provisional.
(b) Total debt service payments as a percentage of earnings from merchandise exports and services.
(c) Includes tsunami expenditure.
(d) Point-to-point growth in end year values.

Sources: Budget 2006
Central Bank of Sri Lanka

telecommunication, transportation, water supply, health and education facilities constrain growth. Anticipated regional development cannot be achieved without an efficient system of infrastructure linking economic centres to the peripheral rural sector. The continuing regional disparity could generate public agitation, if opportunities are not equitably provided, by addressing the infrastructure limitations. Institutions supplying those services need to be strengthened and a higher level of efficiency and accountability has to be ensured. Pricing of services without covering at least the cost of production forces institutions providing infrastructure facilities to depend on budgetary support from the government. Independent regulatory mechanisms are lacking in some sectors and some of the existing mechanisms are weak. Health care is saddled with labour disputes, insufficient investment and improper targeting. Education displays serious mismatches with market needs, and has not been able to generate the required human capital needed for rapid economic development.

- **The over-dependence of the private sector on the government for social equity, protection and subsidies needs to be rationalised in view of short-term budgetary constraints and long term economic costs.** Any successful economy, for the most part, is driven by the efforts of private agents. The skill, entrepreneurship and resource endowments of the private sector drive the economy to generate higher income. The private sector needs to take their own initiatives to intensify competitiveness through increasing productivity, continuously engaging in research and development activities, and facing the challenges of globalisation while reaping benefits from it, without seeking any undue protection from the government at a high social and economic cost. The effectiveness of protection from domestic and international competition is usually short-term since efforts by domestic and international competitors in technology improvements enhances productivity and lowers production and transport costs thereby enabling easier access to markets. Measures to provide protection in one sector raises the cost of production in all other sectors leading to lower competitiveness of the nation and hence results in a large economic cost. Poorly targeted and undue subsidies drive budgetary resources away from productive investment. Therefore, the general public must be enlightened about the benefits of free and liberal economic policies, structural reforms, competition, and the welfare cost of protection and subsidies.

- **Finally, the government's dependence on the public sector institutions to enhance service delivery and the domestic private sector institutions to provide impetus to growth has to be validated by putting in place mechanisms to enhance productivity, accountability and improved governance.** The government being the principal has to depend on appointed agents to manage public sector institutions. Thus, there has to be mechanisms and a reform programme to ensure that those agents perform their tasks to generate benefits to the country rather than seeking personal benefits. Rent seeking occurs when individuals and firms receive benefits through lobbying the government, which could cause serious social and economic costs. Most of the existing subsidies, concessions and measures of protection have imposed serious social and economic costs though they benefit a select few. The public sector has to be subject to a proper mechanism to ensure accountability and efficiency.