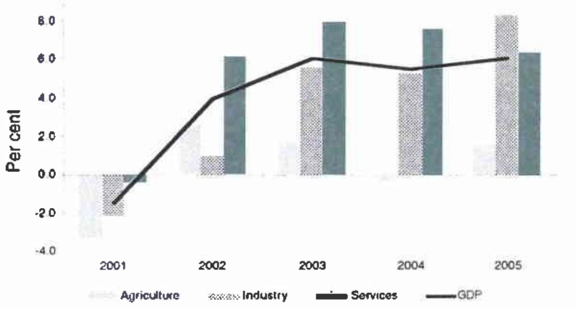
Chapter 2

NATIONAL OUTPUT AND EXPENDITURE

2.1 Overview

- **Gross Domestic Product (GDP) grew by 6 per cent in real terms in 2005 compared with 5.4 per cent in 2004.** The tsunami slowed down economic growth to 4.4 per cent in the first quarter, especially due to its negative impact on fishing and tourism. However the resilience of the economy enabled it to grow by over 6 per cent during the remaining three quarters of the year. This growth was commendable, as it was achieved amidst rising oil prices and strong international competition for exports. The adverse effects of the tsunami decelerated by the fourth quarter of the year.
- **Among the three major economic sectors, the industry sector achieved the highest growth rate of 8.3 per cent and contributed 36.3 per cent to the overall growth in 2005.** This growth was broad-based, reflecting improved performance in all four sub-sectors, mining and quarrying, manufacturing, construction and electricity and water. The factory industry sub-sector performed well, despite the challenges arising from high oil prices and abolition of the Multi-Fibre Arrangement (MFA). The continuing expansion in international markets and in domestic demand, as well as the resilience of the export manufacturing sector, contributed to this growth.
- **The services sector grew by 6.4 per cent and contributed 59.3 per cent to the overall growth.** The deceleration in this sector was mainly due to the drop in hotel activities and lower growth in import trade. Telecommunications, financial services and domestic trade contributed most to the overall growth in this sector.

Chart 2.1
Annual Growth Rates



- **The agriculture sector grew by 1.5 per cent and contributed positively to economic growth by 4.4 per cent, in contrast to 2004, despite the drastic slowdown in performance of the fishing sub-sector following the tsunami.** Favourable weather conditions supported both Maha and Yala paddy harvests to reach record levels. Also benefiting from favourable weather, high performance in minor export crops, subsidiary food crops and vegetables enabled the other agriculture sub-sector to contribute almost as much as paddy to the growth in the agriculture sector.
- **GDP at current market prices was estimated at Rs. 2,366 billion in 2005, recording an increase of 16.6 per cent in nominal terms.** This rate of increase was reflected by the acceleration in real economic growth coupled with a higher increase in the general price level compared to the previous year.
- **The overall price inflation as measured by the GDP deflator was 9.9 per cent, higher than 9.3 per cent recorded in 2004.** This increase is explained by higher input costs, including rising oil prices, and demand pressure on prices driven by high credit growth, as well as the increase in public sector wages. In contrast to 2004, the Sri Lanka rupee remained relatively stable, appreciating by 0.7 per cent, on average, during the year, and did not exert pressure on domestic prices.
- **The GDP per capita for 2005 is estimated at Rs. 120,282 an increase of 15.4 per cent over the previous year.** In US dollar terms, per capita GDP increased by 16.1 per cent to US dollars 1,197, from US dollars 1,030 in 2004.
- **The demand emanating from both external and domestic fronts, covering consumption and investment, contributed to GDP growth in 2005.** Export growth for goods increased, in real terms, by over 6 per cent in all four quarters of 2005, while domestic demand for domestically produced goods and services also grew, but at a slower pace than in the previous two years following the euphoria of the ceasefire in 2002. Also in contrast to the previous two years, domestic production grew at a faster pace than imports, in real terms, to meet the growth in demand.
- **The growth in consumption moderated in 2005.** Government consumption grew at a higher rate than private consumption, as government expenditure rose to meet a higher wage bill and humanitarian needs following the tsunami.

Table 2.1

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

Sector	Rate of Change (%)		Contribution to Change in GDP (%)		Share of GDP (%)	
	2004(a)	2005(b)	2004(a)	2005(b)	2004(a)	2005(b)
Agriculture	- 0.3	1.5	- 1.2	4.4	17.9	17.2
1. Agriculture, forestry and fishing	- 0.3	1.5	- 1.2	4.4	17.9	17.2
1.1 Agriculture	- 0.9	8.8	- 2.3	20.2	13.9	14.2
Tea	1.5	2.5	0.4	0.5	1.3	1.2
Rubber	3.2	10.8	0.2	0.6	0.3	0.4
Coconut	0.1	- 2.2	0.0	- 0.5	1.2	1.1
Paddy	- 15.1	24.4	- 8.8	10.4	2.6	3.0
Other	3.7	6.5	5.9	9.2	8.5	8.5
1.2 Forestry	1.3	1.7	0.4	0.5	1.7	1.7
1.3 Fishing	1.6	- 42.2	0.7	- 16.3	2.3	1.3
Industry	5.2	8.3	25.4	36.3	26.4	27.0
2. Mining and quarrying	7.9	14.1	2.5	4.0	1.7	1.9
3. Manufacturing	5.1	6.0	15.3	16.3	16.3	16.3
3.1 Processing of tea, rubber and coconut kernel products	1.3	2.7	0.4	0.8	1.7	1.7
3.2 Factory industry	6.1	6.1	14.9	13.6	13.4	13.4
3.3 Small industry	0.0	9.8	0.0	1.9	1.2	1.2
4. Electricity and water	- 2.5	23.3	- 0.7	5.6	1.5	1.7
4.1 Electricity	- 3.6	26.3	- 0.9	5.5	1.3	1.5
4.2 Water	5.2	3.8	0.2	0.1	0.2	0.2
5. Construction	6.6	8.9	8.3	10.3	7.0	7.2
Services	7.6	6.4	75.8	59.3	55.6	55.8
6. Wholesale and retail trade, hotels and restaurants	6.1	2.6	24.7	9.5	22.3	21.6
6.1 Import trade	9.0	2.3	16.3	3.8	10.2	9.8
6.2 Export trade	7.7	6.9	3.4	2.8	2.5	2.5
6.3 Domestic trade	2.0	4.2	3.4	6.3	9.0	8.8
6.4 Hotels and restaurants	13.1	- 29.0	1.6	- 3.4	0.7	0.5
7. Transport, storage and communication	13.7	12.7	33.9	30.8	14.6	15.5
7.1 Transport	4.2	3.3	6.3	4.5	8.1	7.9
7.2 Cargo handling and Storage and Warehousing	12.8	9.8	2.1	1.6	0.9	1.0
7.3 Post and Telecommunication	31.4	27.0	25.5	24.7	5.5	6.6
8. Financial Services, real estate and business services	5.6	6.5	12.0	12.7	11.7	11.7
8.1 Financial services	6.6	7.5	11.2	11.6	9.3	9.5
8.2 Real estate, renting and business services	1.7	2.8	0.8	1.1	2.4	2.3
9. Public administration, other government services and defence, other community, social and personal services	3.9	5.4	5.1	6.4	7.1	7.0
9.1 Public administration, other govt. services and defence	2.0	5.1	1.7	3.7	4.4	4.3
9.2 Other community, social and personal services	7.1	6.0	3.4	2.6	2.7	2.7
Gross domestic product	5.4	6.0	100.0	100.0	100.0	100.0
Net Factor Income from Abroad	19.3	46.2				
Gross national product	5.3	5.5				

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

- **The investment climate, which had improved considerably from the second half of 2003, continued in 2005 as well.** In the aftermath of the tsunami, a part of both private and public sector investment was channeled into urgently needed rehabilitation and reconstruction activities to normalise life in the affected areas. Meanwhile, investment activities in unaffected areas continued.

- **Total investment as a ratio of GDP rose from 25 to 26.5 per cent, entirely on account of government investment.** Government investment rose by 119.4 per cent, thereby almost doubling its ratio to 4.2 per cent of GDP. This increase more than compensated for the marginal declines in the public corporations and private investment ratios.

- **Although private investment continued, benefiting from growth in both external and internal demand, the pace had decelerated compared to the previous two years.** During the previous period, private investment had risen significantly in areas such telecommunications, transportation and factory industries following the ceasefire, as well as in readiness for removal of the MFA, resulting in a high base effect on investment growth.

- **The Gross National Product (GNP), defined as GDP adjusted for net factor income from abroad (NFIA), grew at a lower rate than GDP, by 5.5 per cent in real terms, marginally higher than in the previous year.** The NFIA remained negative and deteriorated by 46 per cent in 2005. The outflow of interest payments reduced due to the benefit of the debt moratoria, but the inflows declined relatively more as a result of the appreciation of the rupee and related valuation losses, thereby mitigating most of the positive impact of higher GDP growth on GNP.
- **Both domestic and national savings rose.** Private domestic savings increased on account of higher profitability in the corporate sector, while government dis-savings fell. Meanwhile, the increase in private transfer inflows outweighed the deterioration in NFIA, thereby supporting the growth in national savings.
- **The tsunami which struck the country on 26 December 2004 had a significant impact on the growth prospects of the areas that were affected.** This accounted for nearly two third of the coastal belt along the North, East, South and South West of the island and around 2 to 3 per cent of the population. While the lives and livelihoods destroyed by the tsunami can never be replaced, the damage caused by the tsunami has been estimated at around 4.5 per cent of GDP. The brunt of the economic impact for the future was felt in the fishing and tourism sectors, while wholesale and retail trade and transport, as well as small industries, were also affected on relatively lower scales. Fish production is expected to recover to pre-tsunami levels by end-2006. The recovery of tourism is far less predictable, with perceptions and attitudes of tourists playing a vital role in the recovery process. Although reconstruction activities took place in 2005, with building of temporary and permanent shelters and the restoration of transport routes and other infrastructure facilities, much more requires to be done in the coming years for the affected areas to restore them completely and to move forward. There are many projects in progress and in the pipeline to rebuild permanent housing units and to improve the infrastructure facilities in the affected areas.

2.2 Sectoral Policies and Institutional Support

- **The growth in national output in 2005 was the outcome of several favourable global and domestic factors, combined with the ability of the economy to face adverse global and internal developments and challenges as well.** In this context, the sectoral policies of the government under its new economic policy package, as well as institutional support provided by both the government and the private sector, created a favourable environment within which economic activity prospered. Institutional support to the agricultural and industrial sectors is described in this section, while their impact and implications are analysed in subsequent sections.

Agricultural Policy and Institutional Support

- **Successive governments during the last five decades have endeavoured to develop agriculture.** Since independence, substantial public investment has been made to support the development of agriculture. Investments have been made especially for irrigation infrastructure, and setting up of a network of agricultural institutions to promote policy development, research, extension services, marketing infrastructure, provision of subsidies and safety nets. Yet, the agriculture sector needs better co-ordination within this network aiming at more focussed and effective support for adoption of higher technology through demand driven research and extension services.
- **The new government that came to power in November 2005 proposed a comprehensive policy package aiming at the development of agriculture.** Agricultural growth is to be achieved through the provision of sufficient irrigated water, land for cultivation, good quality seeds, fertiliser at a subsidised price, agro-technology, financial resources, agricultural advisory services, infrastructure for purchasing and storage of agricultural produce, fiscal incentives for investment, special incentives for smallholders, and specific policies and incentives for the tea, rubber, coconut, dairy and fishery sectors. The Budget 2006 also introduced a series of measures to promote agriculture. These included granting subsidies to supply fertiliser to paddy farmers at Rs. 350 per 50 kg bag, in addition to the prevailing subsidy on Urea to all farmers at Rs. 550 per kg bag; raising the paddy purchase price to Rs. 16.50– Rs. 17.50 per kg from the 2005/06 Maha season; stipulating a condition on banks to increase credit facilities provided to agriculture to 10 per cent of total lending; exempting profits of processing of primary produce from tax; removing the 15 per cent tax on income from exporting agricultural products such as fruits, vegetables, rice, cut flowers, foliage plants and organic agricultural produce; establishing a revolving fund of Rs. 10 billion for the development of plantation crops with special emphasis on smallholders; increasing replanting and new planting subsidies for tea, rubber and coconut by 25 percent; reducing the Economic Service Charge (ESC) on tea, rubber, and coconut processing factories from 1 per cent to 0.5 per cent; increasing the government purchase price of milk; implementing special credit schemes to assist dairy farmers; and exemption of milk processing machinery from import duty and VAT.
- **A national plan has been prepared by the Ministry of Plantation Industries for the development of the plantation sector covering the tea, rubber, coconut, and sugarcane**

sectors. This long-term development plan envisages increasing competitiveness through improving productivity and quality, and reducing costs of production. The plan includes strategies to increase value addition; exploiting global opportunities; factory modernisation; and replanting and new planting programmes minimising environmental damage.

- **The Sri Lanka Tea Board (SLTB) took several measures to increase the production, yields and quality of tea.** SLTB made it compulsory to obtain prior approval for construction of new tea factories and has issued directions on minimum standards that should be maintained. In addition, the SLTB has introduced green leaf quality standards, the 'Ceylon Tea Quality Certificate' scheme and minimum quality criteria for export of tea to promote export of high quality tea. Tea factories are required to obtain Hazard Analysis and Critical Control Point (HACCP) certification to ensure maintenance of good hygienic and processing standards at every level in the manufacturing process to be able to export tea to the EU countries with effect from June 2006. At present, only about 25 factories have obtained this certification. For this purpose, the Ministry of Plantation Industries allocated Rs. 250 million under the Plantation Development Project (PDP) for factory modernisation and rehabilitation. The SLTB has also taken steps to closely monitor imports of tea.

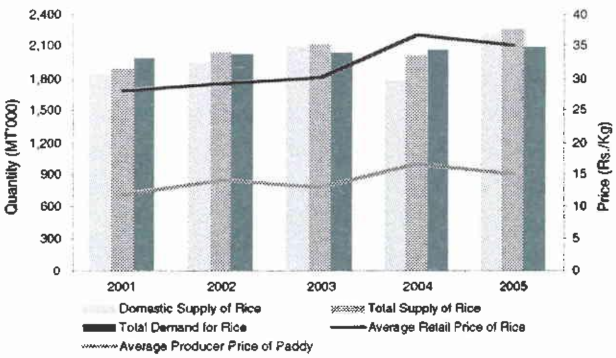
- **The government launched several programmes to improve rubber cultivation to reap the benefit of rising demand for natural rubber.** Rain guards were supplied at a subsidised rate to increase tapping intensity and fertiliser application was promoted in mature plantations under financial assistance from the 'Thurusaviya Fund'. Initial measures were taken to establish a substation of the Rubber Research Institute in Polgahawela to develop rubber cultivation in the North Western Province. The government also initiated a project to expand rubber plantation in Moneragala and Badulla districts.

- **Several measures have been taken to develop the coconut sector.** These include creating a second coconut triangle in the Southern province covering Middeniya, Tangalle and Matara, increasing the export cess for desiccated coconut (DC) to Rs. 2,000 per metric ton from Rs. 1,000 per metric ton with effect from 1 April 2005 and establishing the 'Kapruka Fund' for the revitalisation of the coconut industry. Legislation was also introduced to prevent excessive fragmentation of coconut land.

- **The export agriculture sector received continuous support from relevant institutions.** The Department of Export Agriculture (DEA) under its cluster villages system assisted the sector through distribution of inputs, providing post-harvest handling facilities and equipment, technical advice, establishing marketing links and providing financing facilities. Considering the lack of skilled peelers, the DEA established a cinnamon processing training centre in Kosgoda in 2005 to provide training on peeling methods. The Department of Agriculture promoted organic cultivation of crops and their export among farmers by providing technology, training and financial assistance for the production of organic fertiliser.

Chart 2.2

Rice : Supply and Demand



- **The government introduced several incentives to enhance sale of paddy and took several measures to stabilise paddy prices.** The repayment period of loans obtained by rice millers from banks during 2004/05 Maha season has been extended up to March 2006. The record output in paddy and the consequent fall in prices led the government to implement a paddy purchasing scheme in 2005. The government arranged for the purchase of paddy at the specified floor prices for different varieties through co-operatives, Agrarian Services Centres and farmer organisations. These floor prices ranged from Rs. 15.50 per kg (Nadu) to Rs. 16.50 per kg (for Samba and Red Rice). This scheme cost Rs. 1,325 million and Rs. 1,251 million, respectively, for the Maha and Yala seasons. Accordingly, around 83,000 metric tons of paddy (4 per cent of Maha harvest) were purchased during the Maha season and around 52,000 metric tons (4 per cent of Yala harvest) were purchased during the Yala season under this scheme. The limit of paddy purchasing loans under the New Comprehensive Rural Credit Scheme (NCRCS) was raised from Rs. 25 million to Rs. 50 million per purchaser during the Maha season and was further increased to Rs. 75 million per purchaser during Yala season to purchase paddy at floor prices.

- **Some progress was made in rice and sugarcane research.** the Rice Research Institute (RRI) developed several new hybrid short-duration rice varieties and drought resistant and flood proof varieties with 20 per cent more potential yield levels have been introduced. RRI has further introduced an improved method (parachute method) for sowing paddy, which significantly reduces the requirement of seed paddy and cost of labour. The Sugarcane Research Institute (SRI) continued its research activities and extension services to expand the local sugar industry. Feasibility studies were conducted for cultivating sugarcane as an inter-crop in coconut lands. SRI developed a new high yielding variety of sugarcane (SL94-3325) which could enhance yields by 54 per cent.

- **The dairy industry has been targeted for a revival with a series of policies introduced in recent years.** The government introduced the Dairy Farmer Empowerment Project to provide training for farmers and has taken steps to improve marketing and healthcare of animals. In addition, action was taken to set up 50 dairy villages with at least 20 dairy farmers in each village. To encourage dairy farming, the government raised the purchasing price of milk from Rs. 18 per litre to Rs. 20 per litre during the year. Steps were also taken to expand the supply of breeding animals, improve veterinary services and support the Veterinary Research Institute for further development of the dairy industry towards realising the government's five-year development plan of doubling domestic milk production.
- **The government introduced several measures to revive the tsunami affected fishery sector.** The government distributed boats with the assistance of donors and provided a diesel subsidy to affected fishermen. The Budget 2006 proposed to set up a Fishing Promotion Fund by allocating Rs. 700 million to develop the multi-day boat manufacturing industry and to provide easy payment schemes for fishermen to purchase such boats to promote offshore and deep-sea fishing. The government also allocated Rs. 50 million to promote ornamental fish exports through such projects. Meanwhile, steps were taken to revive prawn farming and Rs.100 million has been allocated to improve shrimp farming in Puttalam and Batticaloa districts.
- **The Forest Department conducted forestry development projects continuously with the assistance of foreign donors, particularly the Asian Development Bank (ADB).** In line with the Forestry Sector Master Plan, in 2005 the ADB funded Forest Resources Management Project was implemented and is in progress. With the participation of the community, some activities such as regeneration of cutting areas, roadside planting and coastal plantations were carried out to promote re-forestation. The Department conducted awareness programmes, including educational seminars, workshops, lectures, video film shows for school children and others with regard to biodiversity, forestry, environmental science and Sinharaja conservation.

Industrial Policy and Institutional Support

- **The thrust of the industrial policy of the government as reiterated in the Budget 2006 is to foster and facilitate a globally competitive and environment friendly industrial sector through enhanced investment and innovation with the participation of a socially responsible private sector and a strong, facilitative public sector.** The industrial policy further emphasises expansion of global market access, promotion of advanced technology, regional industrialisation, promoting small and medium enterprises (SMEs), developing backward linkages and encouragement of domestic resources based export industries. The government facilitation is aimed at enhancing market access, strengthening the legal and regulatory framework, improving corporate governance, facilitating easy access to foreign technology and foreign direct investment, providing a stable macroeconomic framework and enabling firms to better harness the benefits of investment in knowledge and human capital.
- **Increased attention was paid to enhance access to foreign markets.** The government had discussions on enhancing market access in the United States, the European Union through the GSP+ scheme, Pakistan through a Free Trade Agreement (FTA), India through extending the existing FTA to a Comprehensive Economic Partnership Agreement (CEPA), South and East Asian countries through BIMST-EC and SAARC countries through SAFTA.
- **The government has provided fiscal incentives for adopting advanced technology and taken measures to promote regional industrialisation with targeted incentives.** Fiscal incentives of permitting duty free imports of technologically advanced machinery are still in place. The industries identified for provision of incentives for adopting advanced technology include printing, health care, gem cutting and polishing, packaging and rice milling. Under this scheme, imported plant and machinery will be exempted from duty, subject to supervision by the relevant ministries, and the depreciation allowance will be increased to 33 1/3 per cent for estimation of taxable income. The plan of regional industrialisation is to set up 300 factories outside Colombo and Gampaha districts in the first phase, with at least one factory being set up in each Divisional Secretariat area outside these districts. To receive incentives, these factories should be established with a minimum capital of Rs. 30 million invested within 2 years from April 2006 and should employ a minimum of 200 workers. Incentives include exemption from income tax for 5-10 years and exemption from any duties and VAT on imports of new plant and machinery. Factories could claim the cost of relocation out of Colombo and Gampaha as a deduction from taxable income. Lending institutions have been incentivised to provide financing to those factories by exempting such interest income from tax.
- **A comprehensive package to develop SMEs has been proposed in the Budget 2006 to further strengthen existing efforts.** This comprises rationalising and simplifying the tariff structure aimed at eliminating tariff on raw materials and machinery imports, establishment of an Innovation Facilitation

Network (IFN), setting up of an Institution for International Relations and Strategic Studies (IRSS), and establishment of an Academy of Labour Relations (ALR) for SMEs. The SME Bank was set up in 2005 with an initial capital of Rs.5 billion to provide financing at concessionary interest rates through mortgage free lending instruments. Existing programmes for SMEs such as streamlining of bureaucratic procedures, simplified VAT applications, customs regulations and export procedures and providing institutional support for improving technical capabilities, quality management, productivity improvement, internet access, and obtaining quality certification towards development of SMEs were further strengthened in 2005.

- **The Budget 2006 placed emphasis on further development of the domestic textile industry.** The budget proposed the continuation of the ongoing debt restructuring programme in textile factories on risk sharing basis between the government and banks, and procurement of the entire requirement of uniform material for school children and the armed forces from local manufacturers with the aim of providing a secured market for them. In addition to the existing Horana Textile Processing Zone, Thulhiriya will be developed as a dedicated textile zone supported with incentives similar to those accorded to BOI approved industries.
- **The government has initiated several other measures to enhance competitiveness of the apparel industry as the industry is now exposed to intense global competition with the end of the quota system.** As spelled out in the National Council for Economic Development (NCED) policy document, the vision of the government is to transform the apparel industry from a contract manufacturer to a full service value added solution provider and to meet growth targets set out in the Five Year Strategy Plan for the apparel industry. The Budget 2006 proposed to set up a Textile and Clothing College (TACC) at Thulhiriya linked with similar international institutions for training in management, designing and finishing. The University of Moratuwa also introduced a design and product development degree programme in 2005. The Ministry of Industrial Development (MID) and Joint Apparel Association Forum (JAAF) launched several productivity improvement, image building and skills development programmes at factory level. The government also assisted manufacturers to improve their factories to comply with international standards in respect of labour, the environment and corporate governance, which will help them expand international market access.
- **Sri Lanka's location close to main sea and air routes provides a special opportunity for the country to be developed as an attractive apparel hub in the region.** For this purpose, foreign investment for mega shopping malls is encouraged through providing BOI incentives subject to the requirement of maintaining a minimum export quantum and being liable to VAT. Katunayake has been identified as the appropriate location for the proposed apparel hub due to its proximity to the free trade zone and international airport.
- **The special programme initiated in 2004 for enhancing competitiveness of targeted thrust industries of textile and apparel, footwear, leather products, ceramics, rubber, and wood and wood based industries continued in 2005.** Under this programme, major activities undertaken by the MID in 2005 included factory expansion and modernisation programmes, capacity building programmes, business development services and provision of technical advice to modernise the existing factories.
- **The Budget 2006 proposed special measures and duty concessions for further development of the printing and packaging industry.** The prevailing 15 per cent duty on all categories of imported paper will be removed, while the duty on imported cans will be reduced to 6 per cent, aiming at reducing the high cost of local printing and packaging. The import duties on raw materials will be placed at a lower tariff band to rectify anomalies in the existing tariff structure. A Packaging Development Centre equipped with a testing laboratory will be established by the government to enhance quality in the printing and packaging industry in Sri Lanka.
- **The government continued to resolve operational problems of industrialists and investors in 2005 through the Investor Facilitation Forum (IFF) that was established in 2004.** The IFF was established to facilitate large-scale investment projects and eliminate bottlenecks faced by industrialists in the areas of land acquisition, environmental clearance, and local and central government approvals. In addition to the IFF, the Export Development Board (EDB) also continued to resolve problems of exporters at the Exporters' Forum.
- **In 2005, the UNIDO cleaner production (CP) programme in collaboration with the government continued to expand its activities toward building national CP capacities, fostering dialogue between industry and government and enhancing investment for transfer and development of environmentally sound technologies.** Through this programme, the government is expecting to bridge the gap between competitive industrial production and environmental concerns.

2.3 Output

Agriculture

- **The Agriculture, Forestry and Fishing sector recovered from the setback in 2004 and registered a growth of 1.5 per cent in value added terms in 2005.** The record paddy harvest

Table 2.2

Agriculture Production Index (1997-2000 = 100)

Item	2004(a)	2005(b)	Rate of change (%) 2005/04
Agriculture and Fishing	102.7	103.7	1.0
1 Agriculture	102.4	110.1	7.5
1.1 Agricultural crops	100.4	108.7	8.3
Tea	107.7	110.4	2.5
Rubber	98.3	108.3	10.2
Coconut	93.3	90.6	-2.9
Paddy	98.6	121.8	23.5
Other Crops	101.0	106.4	5.3
1.2 Livestock	121.0	122.8	1.5
2 Fishing	104.9	59.8	-43.0

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

in both Maha and Yala seasons and a record production of tea were major contributors to this growth. Improved performance in other field crops and vegetables, rubber and other export agricultural crops also contributed to the recovery. Coconut output did not recover fully due to the lagged effect of the drought in the early part of 2004. Fish production, that was adversely affected by the tsunami in December 2004, also had not recovered fully by end 2005.

- **The share of the Agriculture sector in GDP declined further from 17.9 per cent in 2004 to 17.2 per cent in 2005.** The shrinking of the Agriculture sector's share with the relatively higher growth of the Services and Industry sectors was further exacerbated by the contraction in the fishing sub-sector after the tsunami.

Export Agriculture

- **Total tea production reached a new record of 317 million kg, registering a growth of 2.5 per cent in 2005. Tea fetched high international prices throughout 2005.** The increase in production was achieved through production increases of 8 per cent and 11 per cent in high and medium elevations, respectively. Tea responded well to favourable weather conditions that prevailed in those elevations, as well as the efforts made to achieve higher production induced by higher tea prices. However, production in low grown areas declined marginally by 1 per cent, since those areas did not receive sufficient rainfall, especially in the first quarter of 2005. The low incidence of labour disputes and strikes in Regional Plantation Companies (RPCs) may also have contributed to this increase. Total tea production consisted of 315 million kg of black tea and of 2 million kg of green tea. Black tea consisted of 299 million kg of orthodox tea and 16 million kg of cut, tear and curl (CTC) tea in 2005.

- **As in previous years, the smallholder tea sector continued to dominate and contributed 65 per cent of total tea production in 2005 due to both greater land area used as well as higher yields.** The average yield in the smallholder sector was 1,867 kg per ha in comparison to 1,358 kg per ha in the estate sector in 2005. This is attributed to relatively older tea plantations and the depletion of soil fertility consequent to sloping land terrain especially in high and mid-grown areas and ensuing soil erosion. However, the smallholder yield has been revised downwards following the latest census.[1] The estimated national average yield was 1,645 kg per ha in 2005, which remains below potentially achievable yields. The average cost of tea production increased by 7.3 per cent to Rs. 168.85 per kg

1 According to the Census of Tea Small Holdings conducted by the Department of Census and Statistics in 2005, land area has been revised upwards. Taking this into account, average yield in the smallholder sector has been revised downwards by the Tea Smallholders Development Authority (TSHDA). The average yield level in the plantation sector is based on the bearing extents provided by the plantation companies.

Table 2.3

Trends in Principal Agricultural Crops

Category	Unit	2004(a)	2005(b)
1. Tea			
1.1 Production (c)	kg mn	309.5	317.2
1.2 Total Extent	hectares '000	211	222
1.3 Extent bearing	hectares '000	166	193
1.4 Cost of Production (d)	Rs./kg	157.34	168.85
1.5 Average price			
- Colombo Auction	Rs./kg	180.74	185.84
- Export (f.o.b.)	Rs./kg	248.92	263.31
1.6 Replanting	hectares	1,245	1,333
1.7 New planting	hectares	22	7
1.8 Value added as % of GDP (e)		2.2	2.0
2. Rubber			
2.1 Production	kg mn	94.7	104.4
2.2 Total extent (f)	hectares '000	115	116
2.3 Area under tapping (f)	hectares '000	89	89
2.4 Cost of Production	Rs./kg	73.40	76.12
2.5 Average price			
- Colombo Auction (RSS 1)	Rs./kg	127.20	147.41
- Export (f.o.b)	Rs./kg	128.51	147.73
2.6 Replanting (g)	hectares	820	1,448
2.7 New planting (g)	hectares	518	504
2.8 Value added as % of GDP (e)		0.7	0.7
3. Coconut			
3.1 Production	nuts mn	2,591	2,515
3.2 Total Extent	hectares '000	395	395
3.3 Cost of production	Rs./nut	7.50	9.50
3.4 Average price			
- Producer price	Rs./nut	9.83	12.46
- Export (f.o.b.) (h)	Rs./nut	11.03	13.04
3.5 Replanting / Under Planting (i)	hectares	1,226	1,668
3.6 New planting (i)	hectares	1,098	3,250
3.7 Value added as % of GDP (e)		2.0	2.2

(a) Revised.
(b) Provisional.
(c) Including green tea
(d) Includes green leaf suppliers profit margin
(e) In gowing and processing only.
(f) Based on rubber land survey - 2003 conducted by the DCS and RDD
(g) Extents covered by cultivation assistance schemes of the RDD
(h) Three major coconut kernel products only
(i) Extents covered by cultivation assistance schemes of the CCB.

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

in 2005 due to increases in input prices such as fertiliser, agrochemicals and fuel, as well as wage increases.

- **Rubber production increased for the fourth consecutive year.** In 2005, production increased by as much as 10.2 per cent to 104 million kg. The rise in international oil prices led to a sharp increase in synthetic rubber prices which, in turn, raised prices of natural rubber. Domestic production of rubber rose through increased tapping and higher yields due to increased fertiliser usage, increased technology application such as rain guards, and better cultivation practices. The average yield of rubber increased from 1,064 kg per ha to 1,170 kg per ha in 2005. The average cost of production of rubber rose by 4 per cent mainly due to increases in wages. Attractive prices and subsidies have encouraged replanting of rubber which grew by 77 per cent to 1,448 ha in 2005. With the expansion of rubber-based industries, domestic demand for natural rubber also increased considerably by 34 per cent to 73 million kg in 2005.
- **Coconut output declined in 2005 due to the lagged effect of drought occurred in 2003 and early 2004 combined with a mite infestation.** The lowest monthly production was reported in February 2005. As the weather became more favourable, and the mite infestation was gradually brought under control, production began to improve from April 2005. However, total production in 2005 declined by 2.9 per cent to 2,515 million nuts. The cost of production of coconut increased by 27 per cent to Rs. 9.50 per nut in 2005.
- **The output of other export crops such as cinnamon, cloves, pepper, nutmeg, coffee, cocoa and arecanuts increased in 2005.** Production increased significantly for cloves (36 per cent), pepper (27 per cent) and nutmeg (23 per cent) in 2005, benefiting from research and extension services and favourable climatic conditions. Production of export agriculture crops grew by 28 per cent in volume terms and 24 per cent in value terms in 2005, recording the highest growth during the past three decades.

Domestic Agriculture

- **Paddy output increased to a new record level in 2005.** The paddy output in 2004/05 Maha season increased by 20.5 per cent to 2,012,706 metric tons, while the output in Yala 2005 season also increased by 28.7 per cent to 1,233,480 metric tons, raising annual output by 23.5 per cent to a record 3,246,186 metric tons in 2005. The well-distributed rainfall throughout the year led to an increase in cultivated extent in major paddy growing areas and on marginal lands. The motivation for cultivation was the attractive paddy prices that prevailed in 2004. The output received a further boost from improved cultivation practices in 2005. The lower yield in marginal lands contributed to an overall decline in the average yield from a record yield of 4.09 metric tons per ha in 2004 to 3.97 metric tons per ha in 2005.
- **Output of other food crops also increased, benefiting from favourable weather conditions.** Production of subsidiary food crops, such as kurakkan, maize, green gram, red onions and chillies and both up-country and low-country vegetables increased in 2005. Potato production declined marginally by 1.3 per cent. Prices of some vegetables, however, were higher due to high costs of inputs and transportation. Production of major fruit varieties such as mango, pineapple, and papaw also rose in 2005, while production of banana reported a decline.
- **Domestic production of sugar declined in 2005.** Domestic sugar production declined by 7 per cent in 2005 to 54,000 metric tons due to problems in the two factories, namely, a mechanical breakdown at Pelwatte sugar factory and labour disputes at Sevanagala factory. As sugar imports amounted to 418,000 metric tons in 2005, the share of domestic production

Table 2.4
Paddy Sector Statistics

Item	Unit	2004(a)			2005(b)		
		Maha	Yala	Total	Maha	Yala	Total
Gross extent sown	hectares '000	521	258	779	581	357	938
Gross extent harvested	hectares '000	469	251	720	570	345	915
Net extent harvested	hectares '000	417	226	643	509	310	819
Production	mt '000	1,670	958	2,628	2,013	1,233	3,246
	bushels '000	80,022	45,920	125,942	96,461	59,116	155,577
Yield (c)	kg/ hectare	4,004	4,244	4,087	3,960	3,976	3,966
Credit Granted	Rs. mn.	666	365	1,031	675	462	1,137
Rice imports	mt '000	-	-	222	-	-	52
Paddy equivalent of imports	mt '000	-	-	326	-	-	76

(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

in the total supply of sugar was around 11 per cent. International sugar prices increased steadily in 2005, due to the significant demand arising from the alternate use of sugarcane in the production of bio-fuels, thereby making the domestic cost of production competitive.

Livestock

- **Total milk production increased by 1.3 per cent to 193 million litres in 2005.** This consisted of 161.8 million litres of cow milk and 30.9 million litres of buffalo milk. The government has initiated several programmes to increase domestic milk production and popularise fresh milk consumption. However, current domestic milk production is around 15 per cent of the total milk requirement of the country and the balance is imported mainly in powdered form.
- **The poultry sector performed well during 2005.** Domestic chick production increased due to higher private sector investment in poultry breeding. Demand for poultry meat increased in 2005 in the wake of the shortfall in fish production after the tsunami. As a result, poultry meat production increased by 2.7 per cent to 97,256 metric tons in 2005. However, egg production declined by 1 per cent to 865 million eggs in 2005 compared to 2004. Sri Lanka imposed a temporary ban on import of live birds and poultry products from October 2005 to protect the domestic poultry industry from the bird flu. In December, this ban was relaxed to meet the domestic demand during the festival season and imports were allowed from countries free from the bird flu. It is important to encourage investment in local breeding farms for a steady supply of chicks at a lower cost and to minimise the exposure to poultry diseases from other countries.

Fishing

- **Fish production dropped sharply by 43 per cent in 2005 due to the impact of the tsunami.** Fish production fell by 77.6 per cent during the first quarter of 2005 when compared to pre-tsunami levels, but by the fourth quarter of 2005 the decline in fish production was contained at 18.7 per cent. This decline, however, was in addition to the 13.5 per cent contraction in the fourth quarter of 2004, which reflected the immediate impact of the tsunami of 26 December.

Table 2.5

Fish Production

Metric Tons '000

Sub-Sector	2004(a)	2005(b)
Marine (c)	253	130
Aquaculture and Inland fisheries	33	33
Total	286	163

(a) Revised
(b) Provisional
(c) Coastal and deep sea sector

Sources: Ministry of Fisheries and Aquatic Resources Development
National Aquatic Resources Research and Development Agency

- **Marine fish production declined by 48.5 per cent due to tsunami related loss of fishermen, fishing crafts and fishing gear, while inland and aquaculture fish production declined by 1 per cent as a result of the white spot disease in prawn farms.** The potential capacity of deep-sea fishing could not be achieved in 2005 due to inadequate multi-day boats and fishing vessels, combined with the slow growth of reconstruction of supportive infrastructure, such as fishery harbours, markets, and ice-making plants after the tsunami. It is expected that fish production would recover to the level recorded in 2004 by 2006.

Forestry

- **The government agencies as well as the private sector developed forestry to provide timber to industry.** In 2005, the corporate sector, which comprises 23 RPCs, and the Janatha Estates Development Board/Sri Lanka State Plantation Corporation have diversified a total extent of 627 hectares unutilised land into forestry. Meanwhile, the State Timber Corporation continued to provide timber to the public and private sector. The total output of finished goods of logs, sawn timber and firewood of the Corporation, increased significantly by 64 per cent to 285,634 cubic meters over the year.

Industry

- **The Industrial sector, consisting of the four sectors of mining and quarrying, manufacturing, construction and electricity and water, grew by 8.3 per cent in 2005 compared to 5.2 per cent in 2004.** The share of the industry sector in GDP increased from 26.4 per cent in 2004 to 27 per cent in 2005 and contributed to 36 per cent of the overall growth in 2005. 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 2005.
- **In the manufacturing sector, the output of factory industries, which accounted for over 80 per cent of manufacturing output, grew by 6.2 per cent in 2005.** This was achieved despite several challenges such as volatile oil prices, the abolition of the MFA and devastation caused by the tsunami. The momentum in the industrial sector gathered pace in 2005 with the robust growth in global trade in the early part of the year as well as growing domestic demand. The buoyancy in manufacturing activity has been well supported by export demand across a wide spectrum of industries, favourable weather, expansion of bank credit, rising capacity utilisation, sustained corporate performance and growing business and consumer confidence. The entire growth in factory industry has come from private sector industries, as output in public sector industries declined by 6.2 per cent in 2005.
- **The Industrial sector has been benefiting from the government's continuous efforts in expanding market**

access with the rest of the world through bilateral and multilateral trade negotiations. The process was aided by Sri Lanka's high labour and environment protection standards, a conducive investment promoting policy atmosphere and high literacy of the labour force. Intensified competition in the global market has encouraged a process of consolidation and restructuring of Sri Lankan industries in line with global supply and demand conditions.

- **The growth in factory industry was broad-based across all industrial categories.** However, the main drivers of growth were the industrial categories of textile, wearing apparel and leather products; food, beverages and tobacco products; chemical, rubber and plastic products; and non-metallic mineral products. These four industrial categories accounted for over 90 per cent of growth in the industrial sector.
- **The growth in rubber gloves, tyres, apparel, textiles, ceramic, plastic, leather and processed diamonds was mainly export-driven.** These industries benefited from the upturn in global demand, particularly in US and EU markets. Despite the relatively higher domestic inflation and sudden appreciation of exchange rates following the tsunami, export competitiveness was maintained with aggressive cost cutting. The competitiveness was further sharpened through product specialisation, streamlining production processes and catering to niche markets. These initiatives were supported by the intense application of information technology at various stages in the production and marketing process.
- **The growth of domestic market oriented industries was led by the high performance in the processed food, beverages, liquor, beer, milk products, cement, building materials, ceramic products, animal feed, soap and detergent and fabricated metal products categories.** The relatively low interest rate regime that prevailed in 2005 and the increase in per capita income of consumers encouraged consumer spending and expanded demand for these products. Post-tsunami reconstruction activities, as well as the growth momentum in the construction industry, raised demand for building materials.

Chart 2.3
Composition of Industrial Production - 2005

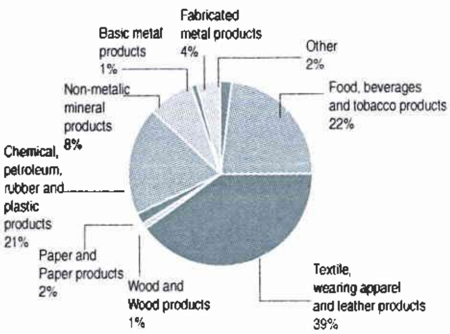


Table 2.6
Value of Industrial Production (1990 Constant Prices)

Categories	Rs.million		Percentage Change (%)	
	2004	2005(a)	2004	2005(a)
1 Food, beverages and tobacco products	52,912	55,430	4.5	4.8
2 Textile, wearing apparel and leather products	93,062	97,576	7.9	4.9
3 Wood and wood products	1,610	1,659	4.1	3.1
4 Paper and paper products	3,882	4,000	1.9	3.0
5 Chemical, petroleum, rubber and plastic products	45,098	50,720	4.6	12.5
6 Non metallic mineral products	18,631	19,777	7.6	6.2
7 Basic metal products	2,455	2,600	8.9	5.9
8 Fabricated metal products, machinery and transport equipment	10,512	10,825	4.3	3.0
9 Manufactured products not elsewhere specified	5,207	5,366	3.2	3.1
Total	233,369	247,953	6.1	6.2

(a) Provisional Source: Central Bank of Sri Lanka

- **The output of the textile, apparel and leather products category registered a 4.9 per cent growth in 2005 and contributed 31 per cent to the overall growth of factory industries.** The moderate growth of this sub-sector in 2005 was mainly due to a drop in prices of apparel products particularly during the second half of 2005. However, Sri Lanka was able to maintain its world market share due to the strength of some core categories of high quality apparel products mainly in the US market under a quota free market environment. Although, the European Union (EU) has given zero duty market access for apparel exports from Sri Lanka under the GSP+ scheme, the benefits gained were minimal due to the rigid rule of origin (ROO) criteria, which require products to contain more than 48 per cent domestic value addition to be eligible for receiving the duty concessions. The gradual restructuring process, which has been implemented during the last five year period, and improved backward and forward linkages greatly supported the growth of the sector in 2005.
- **The output in the food, beverages and tobacco category grew by 4.8 per cent in 2005 and contributed 17 per cent to factory industry growth in 2005.** Higher production was witnessed in all sub-sectors of food processing (5.1 per cent), beverages (3.3 per cent), liquor (7.5 per cent) and tobacco (3.0 per cent). Growth in the food sub-sector in 2005 is attributed to the improved performance in a wide range of products such as milk products, soy products, ice cream and fruit and vegetable processing and canning. The rising consumer expenditure due to relatively lower interest rates, increased salaries and increased harvest in agricultural areas has

Box 5

The Apparel Industry in Sri Lanka in the Aftermath of the Termination of the Multi Fibre Arrangement

The Multi-Fibre Arrangement (MFA), which governed international trade in textile and apparel through a system of quota, was abolished from the beginning of 2005. The experience up to end 2005 indicated that the impact of the abolition varied from country to country. Some large exporting countries such as China and India have gained, while some smaller countries have lost. Yet, a few small countries including Sri Lanka have been able to retain their market share. (Table B5.1).

In the quota free market environment, Sri Lankan apparel exports are mainly destined for two markets, the United States (58 per cent) and the European Union (37 per cent). The quota restriction in the EU market was removed in 2003 preferentially for Sri Lanka and until end of 2004, around 90 per cent of the garment exports to the US market faced quota restrictions. In the quota free market environment, apparel exports from Sri Lanka to the US market have increased both in terms of value and volume during the first nine months of 2005. This was achieved through Sri Lanka's key competitive advantage in the US market in some core categories of apparel products. However, apparel exports from Sri Lanka to EU have declined both in terms of value and volume during the first nine months of 2005. Concessions received under the GSP+ scheme from the EU did not materialise due to difficulties in complying with the rule of origin (ROO) criteria, which requires an over 48 per cent of value addition for apparel products in the exporting country.

With increased competition for apparel in the global market, some of the major firms in Sri Lanka have improved competitiveness through enhancing productivity, focusing on high value products, upgrading human capital, design and marketing skills, rationalising cost of production, enhancing supply chain management and developing forward and backward linkages.

Although larger firms have resources to shape their industry in line with global trends, the small and medium entrepreneurs (SMEs) have become increasingly vulnerable. SMEs have only limited direct marketing links and direct overseas buyer contacts. This forces them to depend on sub-contracts for larger players. The drop in prices of apparel in the international market and lack of resources to restructure their manufacturing process have adversely affected the SME sector. To address difficulties, the government announced several measures in the areas of financing, raw materials and training. The Joint Apparel Association Forum (JAAF), which is the key industry lobby, has also implemented a series of measures to upgrade the industry from a mere manufacturer to a provider of fully integrated services.

Table B5.1

Total Value and Volume of Apparel Exports to the USA and the EU by Selected Countries and the share in the World Market (Jan-Sep)

	Exports to USA						Exports to EU						Share in the World Market (value %)	
	Value (US $ mn.)			Volume (Sqr. meters mn.)			Value (US $ mn.)			Volume (Pieces/pairs mn.)				
	2004	2005	Growth %	2004	2005	Growth %	2004	2005	Growth %	2004	2005	Growth %	2004	2005
China	6,692	12,207	82.4	2,205	4,656	111.2	11,479	16,623	44.8	1,492	2,091	40.1	21.6	30.1
India	1,713	2,271	32.6	473	601	27.1	3,485	4,043	16.0	581	613	5.5	6.5	7.3
Indonesia	1,845	2,165	17.3	543	618	3.8	1,366	1,131	-17.2	210	86	-11.6	2.6	2.0
Bangladesh	1,476	1,769	19.9	698	841	20.5	3,026	2,768	-8.5	431	425	-1.4	5.7	5.0
Sri Lanka	1,123	1,252	11.5	307	344	12.1	642	602	-6.2	78	75	-3.8	1.2	1.1
Pakistan	845	920	8.9	388	426	9.8	1,762	1,542	-12.5	384	382	-0.5	3.3	2.8
Thailand	1,305	1,348	3.3	392	403	2.8	918	795	-13.4	110	117	6.4	1.7	1.4
Mexico	5,084	4,677	-8.0	1,453	1,311	-9.8	74	73	-1.6	15	19	26.7	0.1	0.1
Nepal	80	49	-38.8	28	15	-46.4	59	54	-8.5	6	5	-16.7	0.1	0.1
Vietnam	2,048	2,027	-1.0	593	594	0.2	579	552	-4.7	69	62	-10.1	1.1	1.0

Sources: US Department of Commerce, Office of Textile and Apparel
The European Commission Trade Statistics

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)	
	2004(b)	2005(c)	2004(b)	2005(c)	2004(b)	2005(c)
1 Food, beverages and tobacco products	77,174	86,052	90,275	100,950	14.5	14.8
2 Textile, wearing apparel and leather products	21,770	22,662	24,788	25,902	12.2	12.5
3 Wood and wood products	1,551	1,704	1,750	1,935	11.4	11.7
4 Paper and paper products	4,605	5,227	5,222	5,950	11.8	12.2
5 Chemical, petroleum, rubber and plastic products	29,798	36,400	35,100	42,975	15.1	15.3
6 Non metallic mineral products	19,137	22,410	22,465	26,461	14.8	15.3
7 Basic metal products	2,178	2,538	2,533	2,955	14.0	14.1
8 Fabricated metal products, machinery and transport equipment	12,341	13,871	14,203	16,030	13.1	13.5
9 Manufactured products not elsewhere specified	3,040	3,428	3,431	3,878	11.4	11.6
Total	171,594	194,292	199,768	227,036	14.1	14.4

(a) Based on information received from 490 non-BOI private sector firms Lanka

(b) Revised

(c) Provisional

Source: Central Bank of Sri Lanka

stimulated domestic demand for these products. The output of liquor increased by 7.5 per cent with growing domestic demand, despite an upward revision of excise duties. The output of mineral water also achieved a high growth.

- **The output of chemical, petroleum, rubber and plastic products, the third largest category of factory industries, grew by 12.5 per cent in 2005 reflecting the healthy growth in rubber-based products, chemical and fertiliser.** The sectoral contribution to factory industry growth was 39 per cent. The output of rubber-based products grew by 25 per cent in 2005, driven by external demand for rubber gloves and tyres, which absorbed 90 per cent of domestic production. The US remained the major export destination of Sri Lanka's rubber based products, followed by UK and Germany. New markets were found in Vietnam, the Russian Federation, Romania and the Asia-Pacific region. The domestic demand for plastic and PVC products grew substantially with the growing construction industry.
- **The non-metallic products category registered a 6.2 per cent growth in 2005 and contributed 8 per cent to the overall growth in factory industry.** Building materials such as cement, ceramics, and roofing sheets, faced a higher demand from state infrastructure developments projects, expansion of commercial construction and post-tsunami reconstruction activities. There has also been a progressive improvement in output of tableware and other ceramic products with the growing demand for these products from USA and EU. Major manufacturers expanded production capacity, while reducing the cost of production through the introduction of the latest technologies for energy saving. However, the over exploitation of essential raw material stocks such as China Clay could be a major problem for the ceramic industry in the long-run.
- **The output of fabricated metal products grew by 3.0 per cent in 2005 compared to 4.3 per cent growth in 2004.** The moderation of growth in this category was mainly due to the decline in certain exports such as electronic items and computer parts due to higher competition in global markets. However, domestic market oriented products such as agricultural equipment, manufacturing and repairing of boats, assembling of motorcycles, water pumps, steel furniture and electrical equipment registered a relatively higher performance in 2005. The demand for boats and other related equipment increased substantially in 2005 due to replacement of boats damaged by the tsunami. The motorcycle assembling industry also registered a higher growth due to rising income levels, availability of attractive financing packages, and the introduction of many affordable models. The demand for cables, bulbs and light fittings benefited from the expansion of the construction industry. The expansion of rural electrification helped boost the demand for electrical appliances.
- **The output of public sector industries declined by 6.2 per cent in real terms in 2005 compared to a 5.1 per cent growth in 2004.** The closure of the oil refinery of the Ceylon Petroleum Corporation (CPC) for routine maintenance work for one month in 2005 was the main reason for the reduction of the output in public sector industries. The output of the CPC, which accounts for over 90 per cent of the public sector industrial output, declined by 6.9 per cent in 2005. The output of Lanka Salt Ltd declined by 17.8 on account of damage caused by the tsunami to the salterns. Labour unrest resulted in a decline in output by 18.9 per cent in Sevanagala Sugar Industries Ltd. in 2005. The output of Lanka Phosphate Ltd. grew by 2.9 per cent owing to the higher demand for fertiliser from the domestic agriculture and plantation sectors.

- **The average ex-factory profit ratio in the non-BOI sector increased by 2.1 per cent to 14.4 per cent in 2005.** The profit ratio in the industrial sector was estimated on the basis of the excess ex-factory value of production over the total cost of production of 490 non-BOI firms surveyed in 2005. The improvement of profitability in 2005 is attributed to the expansion in domestic sales, and the effective pricing policies of manufacturers. The lower interest cost, waste reduction, better management of working capital and optimal use of raw materials helped contain costs of production. The stability of the rupee against the US dollar resulted in containing the growth in imported raw material costs, though the sudden appreciation of the rupee immediately following the tsunami adversely affected the profitability of the export oriented and import substitution industries. The relative share of imported intermediate inputs was high in garments, milk products, wheat flour products, apparel, and paper and paper products.

- **The wage bill in factory industries increased by 16 per cent in 2005 due to increases in the number of employees and in wage rates.** Many companies outsourced high cost units and introduced performance based salary increases to contain the excessive increase in the overall wage bill. The containment of the overtime bill through efficient deployment of workers also helped contain the total wage bill. The share of energy cost in total production cost increased from 5.9 per cent in 2004 to 6.0 percent 2005 with the upward revision of petroleum prices. The energy costs are a significant proportion of the cost of production in the cement and ceramic industries. The interest cost, as a percentage of total cost of production, which is relatively low, remained at the same level of 2.2 per cent as in the previous year.

- **Labour productivity, estimated on the basis of the change in the real value added per man-hour increased by 2.9 per cent in 2005 compared with a 2.6 per cent increase in the previous year.** Rapid expansion of information technology and the installation of automated systems, especially in ceramics, cement, bakeries and rubber gloves industries, helped improve labour productivity. The improvement of labour productivity in 2005 is also attributed to intense efforts by manufacturers to rationalise operations, more effective deployment of manpower, introduction of better management practices and skills development.

- **Processing of plantation crops grew by 2.7 per cent in value added terms compared to a growth of 1.3 per cent in 2004.** This was mainly due to higher tea and rubber production. Coconut production declined, which had a negative impact on the production of desiccated coconut and coconut oil.

- **The small industry sub-sector recorded a growth of 9.8 per cent compared to the negligible growth in the previous year.** The impetus to growth in small industry came from favourable agriculture sector performance. The record paddy harvest as well as the growth in subsidiary food crops increased paddy milling and other milling and grinding activities. The small scale production of coir, coconut shell and copra related items declined due to the fall in coconut output in the first half of the year. With continued expansion in the construction sector, value addition in timber milling, rock metal production and tiles, bricks, cement blocks and related production also increased significantly. In response to rising per capita incomes, small-scale production of take-away foods, clothing and footwear and jewellery also rose, but moderately.

Table 2.8

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

Domestic Cost (percentage)

	Categories	Power & Fuel		Wage		Raw Material		Interest	
		2004	2005	2004	2005	2004	2005	2004	2005
1	Food, beverages and tobacco	3.3	3.2	9.7	10.2	37.8	39.8	1.5	1.1
2	Textile, wearing apparel and leather products	4.2	4.4	14.6	15.1	13.2	13.0	2.4	2.2
3	Wood and wood products	8.9	9.2	15.8	16.4	33.1	32.8	4.0	4.2
4	Paper and paper products	3.4	3.9	12.9	13.1	18.2	19.1	3.7	3.6
5	Chemical, petroleum, rubber and plastic products	5.9	6.0	12.3	13.0	29.2	29.8	3.2	3.4
6	Non metallic mineral products	18.9	19.3	15.2	14.9	28.4	28.9	2.3	2.9
7	Basic metal products	9.9	9.7	11.1	11.2	35.0	35.8	3.2	2.5
8	Fabricated metal products, machinery and transport equipment	4.5	4.9	11.3	12.1	26.2	27.0	3.3	3.9
9	Manufactured products not elsewhere specified	4.9	5.3	12.1	11.9	34.1	34.8	1.8	1.5
	Total	5.9	6.0	11.7	12.0	30.7	31.4	2.2	2.2

(a) Based on information received from 490 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)

1995 = 100

Categories	2004	2005	% Change
1 Food, beverages and tobacco products	129.4	132.5	2.4
2 Textile, wearing apparel and leather products	109.5	113.2	3.4
3 Wood and wood products	100.7	103.1	2.3
4 Paper and paper products	101.4	103.7	2.3
5 Chemical, petroleum, rubber and plastic products	134.7	139.5	3.6
6 Non metallic mineral products	112.0	114.5	2.2
7 Basic metal products	100.9	103.0	2.1
8 Fabricated metal products, machinery and transport equipment	120.0	123.8	3.2
9 Manufactured products not elsewhere specified	107.9	110.7	2.6
Total	116.3	119.7	2.9

(a) Based on information received from 490 non-BOI private sector firms

Source: Central Bank of Sri Lanka

- **The construction sector grew by 8.9 per cent during 2005 over a growth of 6.6 per cent during the previous year.** Various reconstruction projects were implemented during 2005 to rebuild housing and infrastructure damaged by the tsunami. These included building of temporary shelters as well as permanent shelters and other infrastructure projects such as railways and roads. Also, on-going foreign funded projects continued during 2005, particularly in road development, water supply and sanitation and irrigation. The growth in this sector was evident from the growth in import volumes and domestic production of building materials, including cement. Cement sales increased significantly during the first half of 2005 and increased at an even higher rate in the second half of the year. During the year, price levels of most construction materials increased significantly. According to the Institute for Construction Training and Development (ICTAD), the overall price level in construction had increased by 14 per cent compared to 2004.

- **The electricity and water sector expanded by 23.3 per cent in 2005 compared to a contraction of 2.5 per cent in 2004.** Electricity generation increased in 2005 with growing demand in the household, commercial and industrial sectors. Electricity generation expanded due to the growth in both hydro electric power and thermal power generation by 16.7 per cent and 4.6 per cent, respectively. About 61 per cent of the total power generation was met by thermal power. The decline in thermal power contribution from 63 per cent in 2004 was due to the higher generation of hydro electric power particularly during the last quarter of 2005. Value addition in the electricity sub-sector increased by 26.3 per cent due to higher hydro electric power generation and the shift in thermal power generation from thermal power hired by the CEB, at relatively higher costs, to private sector thermal power production, at relatively lower costs. Due to favourable weather conditions, CEB hydro electric power generation increased by 15.2 per cent, while CEB thermal power generation declined by 13.8 per cent and private sector hydro electric and thermal power generation increased by 36.1 per cent and 47.3 per cent, respectively. The share of private sector power generation increased from 34.5 per cent in 2004 to 39.1 per cent in 2005. Distribution of pipe borne water increased by 3.8 per cent in 2005, while tariff rates were revised upwards for both domestic and non-domestic consumers with effect from March 2005.

- **The mining and quarrying sector grew by 14.1 per cent in value added terms compared to a growth of 7.9 per cent during the previous year.** The mining sub-sector grew by a considerable 28 per cent due to the favourable performance of both gem mining and other mining activities during 2005. Gem exports increased by 20.2 per cent in volume terms while other mining activities increased by about 77.9 per cent in volume terms due to increased production of mineral sands and phosphate. While the production of graphite declined, value addition increased by producing higher quality graphite for the export market. The quarrying sub-sector also recorded a growth of 8.9 per cent with increased activity levels in the construction sector.

Services

- **The Services sector maintained its relative importance in the economy and contributed most to overall economic growth.** Many sub-sectors in the services sector have expanded steadily and healthily during the past few years to provide an enabling environment for greater efficiency and productivity in the other two sectors, agriculture and industry, through improvements in communication, financial services and other business services. However, capacity limitations and infrastructure inadequacies have limited expansion of the transport sector to somewhat moderate rates that are well below its growth potential. These limitations in transport have impacted on the growth potential in the domestic trade sector as well. Meanwhile, the hotels and restaurants sub-sector within the services sector contracted as a consequence of the tsunami.

- **As in previous years, the services sector provided the major impetus to economic growth.** In 2005 the services sector's contribution to the GDP was 56 per cent and it contributed 59 percent of the GDP growth. The sector reported 6.4 per cent growth in 2005 compared to the 7.6 per cent growth in 2004. This deceleration was mainly due to the lower growth in wholesale and retail trade, hotels and restaurants.

- **Wholesale and retail trade, hotels and restaurants recorded a growth of 2.6 per cent in 2005 as against 6.1 per cent in**

Box 6

Progress of Post Tsunami Recovery and Reconstruction Activities

The tsunami of 26 December 2004 caused loss of 35,322 human lives, injuring 21,441 persons, displacing about 500,000 persons and leaving 1,500 children without parents.[1] It caused extensive damage to physical property and infrastructure and loss of livelihoods. The immediate relief and rescue operations were carried out successfully with the help of local communities, the government, the private sector, bilateral and multilateral donors and local and international non-governmental organisations (NGOs). The government spent Rs.12 billion in 2005 to provide relief to tsunami-affected families. The recovery and reconstruction process is expected to take 3-5 years and cost about US dollars 2.2 billion. The international donor community has pledged US dollars 2.8 billion for recovery and reconstruction activities, while debt relief (principle and interest payments) amounted to US dollars 258.6 million (Rs. 26.3 billion).

Post tsunami recovery and reconstruction activities are implemented under four major programmes; (i) construction of houses, (ii) restoring livelihood, (iii) providing health, education and protection and (iv) construction of national infrastructure.

Construction of Houses: The total housing requirement was 87,525 which 32,000 was to be built under the Donor-built Housing Programme (DHP) and the balance 55,525 under the Home Owner Driven Programme (HODP). Under the DHP, Memoranda of Understanding (MoUs) have been signed for the construction of 29,640 housing units, of which 10,707 units were at various stages of construction by end 2005. Under the HODP, the government has disbursed Rs.3.6 billion by end 2005 to grant, in installments, Rs.250,000 for a fully damaged house and Rs. 100,000 for a partly damaged house for reconstruction purposes.

Restoring Livelihoods: Estimates show that about 150,000 livelyhoods were lost due to the tsunami; about 50 per cent in the fisheries sector, 45 per cent in the services sector including tourism, small businesses and trading and self-employment and 5 per cent in the agriculture sector. At the initial stages, the government arranged a cash grant of Rs.5,000 per household per month and a food ration of Rs.375 per person per week.

Financing schemes introduced by the Central Bank of Sri Lanka (CBSL), National Development Trust Fund (NDTF), commercial banks and NGOs helped to restore the livelihoods in tsunami affected areas. Under the Susahana loan scheme, CBSL has granted Rs.3.6 billion for 8,000 projects through financial institutions by end 2005. NDTF has granted 5,570 loans to the value of Rs.700 million. About 90 per cent of 24,185 fishing crafts destroyed or damaged due to the tsunami have been restored by end 2005. Fast recovery in the tourism sector also helped to regain livelihoods of many persons. By end 2005, about 70-85 per cent of the affected unemployed had regained their main source of income.

Providing Health, Education and Protection: A total of 97 health facilities were damaged due to the tsunami. Construction of these facilities and provision of essential medical supplies, mobilisation of health personnel, disease prevention, and addressing mental health problems were the priority areas of the health authorities. There was no outbreak of water borne diseases or any other communicable diseases reported in the affected area as prompt preventive measures were introduced by the health authorities. MoUs have been signed with donor agencies for the rehabilitation of all damaged health institutions. By end 2005, construction of 10 mother and child clinics and a central dispensary were completed. Over 500 community support officers in all affected districts have been trained to address mental health needs.

In the education sector, 182 schools were partially or fully damaged due to the tsunami directly affecting 100,000 students. In addition, 446 schools were used as camps affecting another 100,000 students. MoUs have been signed with donors to rebuild 180 schools, according to a standard child-friendly design. Construction of 18 schools had commenced by end 2005. Over 75 per cent of construction work of the damaged schools is expected to be completed by end 2006.

The Department of Probation and Child Care (DPCC) and National Child Protection Authority (NCPA) in coorporation with the relevant UN agencies and NGOs have made arrangements for child protection. Several legal clinics were conducted in tsunami-affected areas where individuals were provided with certified copies or new documents such as National Identity Cards, birth certificates, marriage certificates etc.

Upgrading National Infrastructure : The tsunami caused major damage to roads, railways, electricity, water supply and to port infrastructure. Approximately 800 kms of national roads and 1,500 kms of provincial and rural roads were damaged. Rehabilitation cost has been estimated at US dollars 356 million. Emergency repairs to damaged roads have been completed. Rehabilitation of the Kalutara- Matara road commenced in October 2005.

Total cost of damages to Sri Lanka Railways is estimated at Rs.1,485 million. The coastal railway services were resumed in February 2005. Rehabilitation of the damaged electricity distribution network and other damaged assets have been restored. Total cost of rehabilitation of the damaged water supply infrastructure and their improvement is estimated to be US dollars 201 million, while donor

Box 6 (Contd.)

commitments amounted to US dollars 165 million. Emergency repairs to ports of Galle, Trincomalee, Kankasanturei and Point Pedro have been completed.

Sri Lanka achieved significant progress in post-tsunami recovery and reconstruction albeit progress has been slow in certain areas/activities. The fisheries and tourism sectors, which have had significant impact on the economy are recovering faster than expected. The total government expenditure increased by 1.6 per cent of GDP in 2005, largely financed with concessional foreign assistance and temporary savings under the debt relief. The overall BOP recorded a surplus of US dollars 501 million in 2005 as against the deficit of US dollars 205 million expected at the beginning of the year.

the previous year. The deceleration came from lower growth in import trade and the decline in the hotels and restaurants sub-sector.

- **Import trade grew by 2.3 per cent in 2005 compared to a 9.0 per cent growth in the previous year.** The deceleration was seen in all three main import categories, namely, consumer goods, intermediate goods and investment goods. The import of investment goods increased in 2005 by 4.2 per cent in volume terms compared with an 18.4 per cent in 2004. In this category building materials, transport equipment and other investment goods imports increased, while machinery and equipment imports declined marginally. The volume of intermediate goods imports grew by 2.7 per cent, mainly driven by fertiliser imports and imports for the garment industry, compared to 6.6 per cent growth in 2004. Consumer goods imports increased by 0.9 per cent, as against the 3.9 percent growth in the previous year. Of consumer goods imports, imports of basic food items, such as rice, declined in the light of the increases in domestic production. Imports of other consumer goods, which mainly consisted of motor vehicles and pharmaceutical items and household goods, grew by 2.3 per cent compared to 8.5 per cent in 2004.

- **The export trade sub-sector expanded by 6.9 per cent in 2005**. Despite the phasing out of the MFA, the textiles and garments sector, which accounts for around 58 per cent of industrial export earnings, grew by 5.3 per cent. Meanwhile, all other industrial exports, excluding petroleum products, performed better, and grew by 11.5 per cent. Exports of agricultural products grew by 2.9 per cent, led by moderate growth in tea and high growth in minor agricultural exports. Exports of coconut products dropped by 9.3 percent as coconut production contracted by 2.9 percent during the year. Although rubber production increased by 10.2 per cent, higher and increasing demand from local rubber-based industries reduced exports of rubber in primary form. Consequently, rubber based export income grew by 37 per cent in current terms during the year due to higher value addition.

- **The domestic trade sub-sector, defined as the trading of domestically produced and traded goods grew by 4.2 per cent in 2005 as against the 2.0 per cent growth reported in the previous year.** This growth was stimulated by better performance in domestic agriculture, especially production of paddy, vegetables, subsidiary food crops and minor export crops. Further, satisfactory performance in factory industry and small industries also contributed to this healthy growth in domestic trade.

- **The hotels and restaurants sub-sector recorded a drop of 29.0 per cent with a 3 per cent decline in tourist arrivals during 2005.** The tsunami destroyed 46 registered hotels (around 4,000 of 14,350 rooms) in the Southern and Eastern coastal belt. Most partly damaged hotels were restored during the year. The total number of arrivals amounted to 549,308 in 2005 compared to the previous year's 566,202. Although tourist arrivals from Western Europe fell drastically by 20 per cent, higher arrivals from Asia (by 12.8 per cent), North America and Australia offset this decline to a certain extent. Arrivals from India were the highest at 113,323 and grew by 8 per cent over 2004. Traditionally strong UK came second with 92,629 arrivals, a drop by 13 percent during the year. Although the decline in arrivals was modest, foreign guest nights dropped by 40.1 per cent from the 14.4 percent increase recorded in 2004, as most of these tourists were business and transit travellers with relatively shorter durations of stay. Meanwhile local guest nights of all graded hotels recorded a decline of 14.7 per cent.

- **The transport, storage and communication sector reported a 12.7 per cent growth during 2005 as against the 13.7 percent growth in 2004.** This growth was mainly driven by the growth in telecommunications which continued to expand.

- **The telecommunication sub-sector grew further by 27 per cent during the year with network expansions and new value added services introduced with technological advancements.** This growth was mainly driven by the upward trend in mobile phone usage and popularisation of Fixed Access Wireless phones with the latest Code Division Multiple Access

(CDMA) technology and competitive prices among service providers. The traditional Fixed Access Wireline Local Loop subscriber level increased by 11 per cent to around 950,000 subscribers in 2005, compared to a 4.6 per cent growth in 2004. The Fixed Access Wireless Local Loop subscriber level expanded throughout the year, recording a growth of 122 per cent to increase to nearly 290,000 subscribers. Internet and email usage, which reported 9 per cent growth in 2004, recorded a significant increase of 23 per cent in 2005. Mobile phone usage increased by 52 per cent over 2004 and the subscriber level of mobile users had exceeded 3.3 million. Therefore, the mobile penetration ratio (mobile connections per 100 people) increased to around 17 at end 2005 from 11 at end 2004.

- **The Cargo handling, storage and warehousing sub-sector grew by 9.8 per cent as against 12.8 per cent growth in the previous year.** The deceleration was mainly due to lower growth in domestic throughput volumes handled by the Colombo Port compared to the previous year. During the year, the Colombo Port, including the South Asia Gateway Terminal (SAGT), handled a volume of 2,455,295 TEUs, a 10.5 per cent increase over the previous year. This is the highest recorded TEUs handled by the Colombo port. Transshipment volumes, which account for over two thirds of the total throughput handled, expanded by 12.7 per cent compared to 13.5 per cent growth in 2004. The domestic throughput volume grew by 7.2 per cent, as against the 17 percent growth in the previous year, as import growth decelerated. Air cargo volumes grew moderately by 3.6 per cent reflecting the expansion in the aviation industry.

- **The Transport sub-sector, one of the largest service sectors in the economy, grew by 3.3 per cent as against 4.2 per cent in the previous year.** This deceleration reflected poor performance in bus and rail passenger transport and moderate expansion in the air travel category in 2005. Passenger kilometers operated by Sri Lanka Railways (SLR) dropped by 7 per cent compared with a 1.7 per cent growth in 2004. The adverse impact of the tsunami on rail transport and its reduced operated kilometers resulting from the heavy damage to the southern coastal rail track in December 2004 were reflected in the decline in the number of passenger kilometers operated by SLR in 2005. In public transport, the growth performance in the private bus category improved marginally, while that of the Sri Lanka Transport Board contracted. However, other private transport services, including three wheelers, hiring vehicles and private vehicles, reported considerable growth. Total passenger kilometers flown by Sri Lankan Airlines and other domestic airlines increased by 2.8 per cent, despite multiple crises, including the tsunami catastrophe and high fuel prices that impacted heavily on the aviation industry. Road haulage grew by 4.2 per cent, reflecting the expansion in goods transport activities with significant increases in domestic production and more moderate growth in import trade.

- **Financial services, real estate and business services performed well, recording a growth of 6.5 per cent, while contributing 12.7 per cent to the overall GDP growth.** The growth in financial services was mainly responsible for this growth.

- **Financial services reported a 7.5 per cent growth during the year, while the banking sector alone grew by 3.8 per cent.** Although lending rates did not increase significantly in 2005, the interest income of the banking sector reported a 22 percent increase in current terms, reflecting high credit growth. However, non-interest income from foreign exchange business and dividends on securities and investments dropped. Insurance and other financial services grew by 10.2 percent during the year with a significant increase in income from the leasing and hire purchase portfolio of finance companies and satisfactory performance in other financial institutions.

- **Real estate, renting and business services, which recorded a 1.7 per cent growth in 2004, grew by 2.8 per cent, reflecting the continuing demand for such services.** A number of companies involved in real estate development, including condominium and other types of housing projects, reported high profits for the year 2005. Business service activities, which included advertising services and computer software development activities, also recorded higher growth.

- **Public administration, other government services and defence, other community, social and personal services grew by 5.4 per cent as against an increase of 3.9 per cent during the previous year.** The intake of 42,000 unemployed graduates to the public sector in the fourth quarter of 2004 was assigned to different government institutions during the year, over one third of whom were absorbed into the government education service. The added output from this expansion was reflected in the public administration sub-sector, which grew by 5.1 in 2005, as against the 2.0 per cent growth in the previous year. The other community, social and personal services sub-sector recorded a growth of 6.0 per cent partly due to healthy growth in the private health care industry and educational services.

2.4 Expenditure

- **The aggregate demand generated by domestic economic activity, measured by Gross Domestic Expenditure (GDE), increased by 16.8 per cent to Rs. 2,585 billion (at current market prices) in 2005.** In 2004, the GDE (aggregate domestic demand) increased by 18.4 per cent. The GDE, which is the sum of consumption and investment expenditure of the private and public sectors of the economy, grew by 4.7 per cent in real terms in comparison to 6.5 per cent in 2004. In 2005, consumption grew at a somewhat slower pace in real terms. Investment growth continued to be higher than consumption growth in both nominal and real terms. The GDP at market prices, which is the sum of the GDE and net imports, was estimated at Rs. 2,366 billion, an increase of 16.6 per cent.

Consumption

- **Consumption expenditure increased by 14.8 per cent to Rs. 1,959 billion in 2005.** This increase is a culmination of the growth of real consumption by 2.9 per cent and average price levels increasing by 11.5 per cent. Of the total consumption, Private Consumption Expenditure (PCE) increased by 14.4 per cent over a growth of 14.9 per cent in 2004, while government consumption expenditure rose by 18.3 per cent over a growth of 18.4 per cent in 2004. The share of PCE remained around 90 per cent of total consumption expenditure in 2005. Of the total PCE, expenditure on locally produced goods and services increased by 18.6 per cent while that on imported goods and non-factor services increased by 4.6 per cent.

- **The share of food and non-alcoholic beverages in PCE declined marginally during 2005 to 32.3 per cent of total expenditure.** This yet again confirms that with improving living standards household expenditure is being diversified from this basic need into other areas, particularly towards services. With price levels of most food items increasing, the nominal expenditure on this category grew by 13.5 per cent. Due to the decline in fish production, consumption of other protein items such as meat and eggs increased. The consumption of starchy food, cereals and pulses also increased perhaps due to their higher production in 2005.

- **Expenditure on two other basic needs, clothing and housing and related services, grew in a range of 9 to 14 per cent in nominal terms.** The spending on clothing and footwear, which includes readymade garments, clothing material, other clothing accessories and footwear, grew by 9 per cent, with consumption of locally produced goods increasing at a higher rate than that of imported goods. Expenditure on household services such as household repairs, water, electricity, gas and fuel increased by 10 per cent with rising prices.

- **Although the share of expenditure on alcoholic beverages, tobacco and narcotics declined during the previous year, expenditure increased by 13 per cent in 2005.** This consumption increase was reflected in the production and expansion of alcoholic beverages as well. However, with excise duties being revised upwards, the share of expenditure remained almost unchanged.

- **Nominal expenditure on transport, education and health grew in a range of 12-15 per cent.** In an environment of increasing fuel prices, expenditure on transport grew by 12 per cent compared to a contraction of 1 per cent in 2004. Expenditure on both transport services, as well as operation of personal transport equipment, increased due to the upward revisions of bus and railway fares and higher fuel prices, but consumer spending on vehicle purchases had declined due to higher price levels of motor vehicles with the introduction of higher import tariffs during the latter part of 2004. Expenditure growth on education, which had recorded the highest growth in 2004 owing to private expenditure increasing with the expansion in private tuition and private education institutions, decelerated to some extent in 2005.

Table 2.10

Aggregate Demand

Item	Current Market Prices (Rs.mn)			Constant (1996) Prices (Rs.mn)		
	2003	2004 (a)	2005 (b)	2003	2004 (a)	2005 (b)
A. Domestic demand						
Consumption	1,481,164	1,706,994	1,958,887	935,238	981,917	1,010,296
(% Change)	9.4	15.2	14.8	6.2	5.0	2.9
Gross domestic capital formation	388,757	506,942	625,983	263,497	294,255	325,910
(% Change)	16.1	30.4	23.5	16.0	11.7	10.8
Total domestic demand	**1,869,921**	**2,213,936**	**2,584,870**	**1,198,735**	**1,276,172**	**1,336,206**
(% change)	**10.8**	**18.4**	**16.8**	**8.2**	**6.5**	**4.7**
B. External demand						
Exports of goods and non-factor services	632,907	736,967	792,415	394,284	424,137	447,943
(% change)	10.9	16.4	7.5	5.4	7.6	5.6
Imports of goods and non-factor services	741,667	921,537	1,011,583	566,367	617,732	636,429
(% change)	9.5	24.3	9.8	10.2	9.1	3.0
Net external demand	**-108,760**	**-184,571**	**-219,168**	**-172,083**	**-193,595**	**-188,486**
C. Total demand	**1,761,161**	**2,029,365**	**2,365,702**	**1,026,652**	**1,082,577**	**1,147,720**
(% change)	**11.3**	**15.2**	**16.6**	**6.0**	**5.4**	**6.0**

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

- **The highest growth category in PCE was communication services with a growth of 63.2 per cent in nominal terms.** The increased consumer spending on communication services is in tandem with the rapid expansion of the telecommunication sector in response to the continued demand for fixed and mobile phones and other advanced products in communication technology.
- **Although expenditure on recreation and entertainment and restaurants and hotels increased by over 15 per cent respectively, the growth momentum had slowed down relative to 2004.** The impact of the tsunami was felt in the decline in local tourists within the recreation sector. However, expenditure on miscellaneous goods and services had grown by 17 per cent.
- **The above analysis of PCE revealed that most consumption categories grew in real terms during 2005.** With the continued expansion of per capita income, consumption of services grew at a higher rate than that of most goods. This, yet again, confirms the changing life styles of the Sri Lankan population with development. Consumption is shifting from basic needs towards services.
- **Government consumption increased at a similar rate in 2005 compared to 2004.** The expansion in government expenditure was due to increased consumption of goods and services as well increased expenditure on salaries and wages. In the aftermath of the tsunami, government expenditure rose with spending on humanitarian aid and rehabilitation work, which was necessary to sustain and rebuild livelihoods affected by the tsunami. The intake of 42,000 graduates to the government sector, as well as the public sector salary increase during the latter part of 2004, had a bearing on the government wage bill in 2005.

Investment

- **Investment expenditure (gross domestic capital formation) at current market prices was estimated at Rs. 626 billion, an increase of 23.5 per cent over 2004.** In real terms investment grew by 10.8 per cent. The investment to GDP ratio improved to 26.5 per cent from 25 per cent in 2004. This was entirely on account of government investment, which rose by 119.4 per cent, whereas private investment grew by 14.1 per cent.
- **Meanwhile, imports of investment goods rose moderately, after two years of significantly high growth.** In 2003 and 2004, private investment had risen significantly in areas such as telecommunications, transportation and factory industries following the ceasefire, as well as in readiness for removal of the MFA, resulting in a high base effect. Although the import of investment goods recorded a marginal decline of 0.2 per cent during the first half of 2005, it grew at a faster pace in the second half of the year to register an annual growth rate of 4.2 per cent in volume terms. This growth was over a high base, following the 18.4 per cent growth in 2004. Consequently, unlike in the previous two years, in 2005, government investment played a significant role in investment growth.
- **In the aftermath of the tsunami devastation, public sector, as well as private sector investment had been channeled into urgently required rehabilitation and reconstruction activities in tsunami-affected areas.** Government investment had been channeled to reconstruction of roads, rail and other

Table 2.11

Composition of Private Consumption Expenditure at Current Market Prices

Item	Share of Total PCE (%)			Rate of Change (%)	
	2003	2004(a)(b)	2005(c)	2004/2003	2005/2004
01. Food and non-alcoholic beverages	34.3	32.6	32.3	9.0	13.5
02. Alcoholic beverages, tobacco and narcotics	5.1	4.4	4.3	-1.6	13.0
03. Clothing and footwear	5.6	6.0	5.7	24.6	8.8
04. Housing and utility services	14.1	16.1	15.5	31.7	9.9
05. Household equipment and services	4.4	5.0	5.0	30.2	14.2
06. Health	3.6	3.7	3.7	19.1	15.3
07. Transport	14.0	12.1	11.8	-0.9	11.5
08. Communication	2.2	2.4	3.4	22.4	63.2
09. Recreation and entertainment	3.0	3.5	3.7	33.7	21.7
10. Education	1.2	1.6	1.6	49.0	14.0
11. Restaurants and hotels	1.2	1.4	1.4	28.5	15.2
12. Miscellaneous goods and services (d)	11.2	11.3	11.5	15.4	17.0
Total private consumption expenditure	**100.0**	**100.0**	**100.0**	**14.9**	**14.4**

(a) Revised

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

(c) Provisional

(d) Includes Personal Care, Personal Effects, Social Protection, Insurance, Financial Services and Other Services n.e.c.

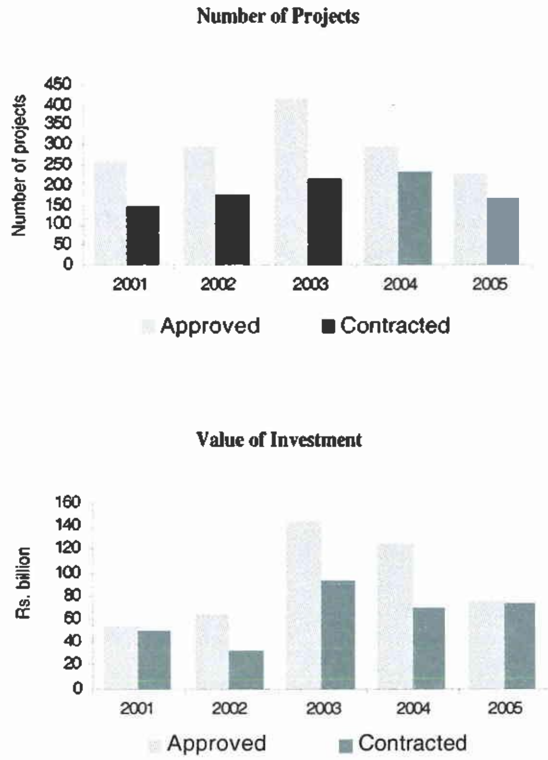
Source : Central Bank of Sri Lanka

infrastructure, while private local and foreign funds were used during the year in construction of temporary housing or shelters and later, permanent housing facilities and other relief work.

- **Private investment expenditure expanded by 14.1 per cent in 2005 and accounted for 84 per cent of total investment.** However, while the government investment to GDP ratio rose sharply, the private investment to GDP ratio fell from 22.8 per cent in 2004 to 22.3 per cent in 2005, as that of public corporations and private investment both declined marginally. Apart from private investment that flowed in for tsunami reconstruction work, including rebuilding of affected hotels, other industrial and services sector activities also attracted investments towards productivity improvements, capacity expansion and start up new industries.

- **Foreign direct investment inflows to Sri Lanka, increased by 22.6 per cent to US dollars 287 million in 2005, around 5 per cent of total investment.** The BOI, the main investment promotion institution of the country, approved 374 projects in 2005 under Sections 16 and 17 of the BOI Act with an investment commitment of Rs. 79.4 billion, compared to 526 projects approved in 2004 with an investment commitment of Rs. 142.3 billion. The decline in both the local and foreign components of approved projects was mainly due to strict screening procedures followed by the BOI. While the number of projects contracted under Section 17 of the BOI Act decreased to 167 in 2005 from 228 in 2004, the value of contracted investment increased by 8 per cent to Rs. 74.3 billion in 2005 on account of the high value of the domestic investment component. The realised investment in BOI industries amounted to Rs. 61 billion in 2005 reaching a cumulative realised investment of Rs. 380 billion as at end 2005.

Chart 2.4
Investment in Approved and Contracted BOI Projects



- **Of the 374 projects approved under Sections 16 and 17 of the BOI Act in 2005, 150 were foreign owned and 119 were joint ventures, while Sri Lankans owned the rest.** The non-factory industry sectors continued to be the major recipients of investment flows, particularly in the new growth areas of real estate, communication, hotels and restaurants and business services. These sectors attracted 245 approved projects with an investment commitment of Rs 53 billion in 2005. The factory industry sector absorbed 126 approved projects with an investment commitment of Rs. 26 billion in 2005. Of the approved projects in this sector in 2005, the largest share of investment was absorbed by food, beverage and tobacco products (15 projects) followed by textile wearing apparel and leather products (34 projects), fabricated metal products (20 projects) and chemical, rubber and plastic products (12 projects).

- **The factory industry sector absorbed 17 per cent while other sectors absorbed the balance of total contracted investment in 2005.** Similar to approved investments, major recipients of investments in contracted projects included real estate, power generation and communication services. Within the factory industry sector, major recipients of investment were the textile wearing apparel and leather products, followed by food, beverage and tobacco products and chemical, rubber and plastics products categories.

- **The number of enterprises in commercial operation has declined marginally from 2,360 in 2004 to 2,338 in 2005.** Among the factory industry sub-sectors, 390 projects were in the textiles, wearing apparel and leather products category, 190 in the food, beverages and tobacco products category, and 187 in the chemical, rubber and plastics products category. The share of foreign investment commitment for these projects was 53 per cent of the total investment. Of these operating projects, about 1,263 projects, or 54 per cent, were located outside the export processing zones and 28 projects in exclusive industrial locations such as Export Processing Zones, Information Technology Parks and Industrial Parks.

- **Of the 1,641 enterprises registered under the Ministry of Industrial Development as at end 2005, a large number of**

Table 2.12

Investment and Employment in the Enterprises Registered Under Board of Investment of Sri Lanka (BOI) and Ministry of Industrial Development (MID)

	No. of projects		Envisaged and Actual Investment (Rs.million)						Employment (No.)	
	2004(a)	2005(b)	2004(a)			2005(b)			2004(a)	2005(b)
			Foreign	Local	Total	Foreign	Local	Total		
BOI										
Projects Approved	526	374	87,629	54,667	142,296	31,510	47,859	79,369	49,131	35,972
Under Section 17	296	223	69,706	53,777	123,483	27,768	46,765	74,533	41,002	29,382
Under Section 16	230	151	17,923	890	18,813	3,742	1,094	4,836	8,129	6,590
Projects Contracted Under Section 17	228	167	36,536	32,248	68,784	32,363	41,902	74,265	35,614	24,536
Realised Investment Under Section 17(c)	1,867	1,871	208,696	110,769	319,465	233,522	146,607	380,129	437,698	410,851
Commercial Operations (c)	2,360	2,338	169,743	144,272	314,015	175,110	154,313	329,423	392,259	387,811
Under Section 17 (c)	1,602	1,571	153,650	132,950	286,600	158,934	142,976	301,910	355,455	350,758
Under Section 16 (c)	758	767	16,093	11,322	27,415	16,176	11,337	27,513	36,804	37,053
MID										
Projects Registered (c)	1,604	1,641	n.a.	n.a.	115,498	n.a.	n.a.	118,502	278,397	282,036

(a) Revised
(b) Provisional
(c) Cumulative as at end of year

Sources: Board of Investment of Sri Lanka
Ministry of Industrial Development

enterprises were in textiles, wearing apparel and leather products category (415 enterprises). This was followed by the industrial categories of chemical, petroleum, rubber and plastic products (385 enterprises), fabricated metal products (276 enterprises), food, beverages and tobacco products (195 enterprises) and non-metallic mineral products (82 enterprises). About 1,133 enterprises with an estimated investment of Rs. 102,110 million were located in the Colombo District, followed by 240 enterprises with an estimated investment of Rs 9,788 million in the Gampaha District. Accordingly, these two districts account for 84 per cent of the registered enterprises and for 94 per cent of total investment.

- **Government investment expenditure increased significantly by 119.4 per cent to Rs. 99 billion in 2005.** This investment was mainly focused on rehabilitation and reconstruction of tsunami affected roads and rail tracks and other infrastructure such as the Southern Highway, power, water supply and airport development activities.

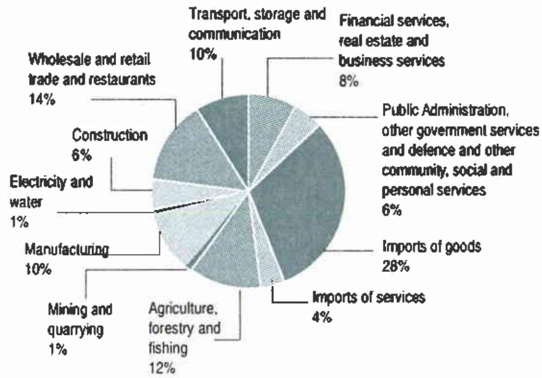
Availability and Utilisation of Resources

- **The total available resources, which consist of GDP (domestic resources) and imports of goods and non-factor services (foreign resources), were estimated at Rs. 3,377 billion at current market prices. This is an increase of 14.4 per cent over the previous year.** This increase was generated by an increase of Rs. 336 billion in domestic resources and Rs. 90 billion in foreign resources. In real terms, the availability of resources grew by 4.9 per cent, lower than in the previous year. This includes real growth of domestic resources by 6.0 per cent and import of goods and non-factor services by 3 per cent. Domestic resources accounted for 64 per cent and foreign resources for the balance 36 per cent, recording a marginal shift

Chart 2.5

The Economy in 2005
(at current prices)

Supply of Goods and Services
(Rs. 3,377 billion)



Demand for Goods and Services
(Rs. 3,377 billion)

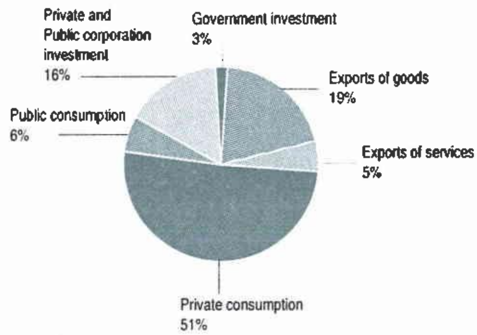


Table 2.13

Total Resources and Their Uses at Constant (1996) Prices

Item	Percentage Share		Percentage Growth	
	2004(a)	2005(b)	2004(a)	2005(b)
A. Resources				
Gross domestic product	63.7	64.3	5.4	6.0
Imports of goods and non-factor services	36.3	35.7	9.1	3.0
Total	100.0	100.0	6.7	4.9
B. Utilisation				
Consumption	57.7	56.6	5.0	2.9
Gross domestic fixed capital formation	17.3	18.3	12.2	10.7
Private	15.5	14.7	14.0	-0.5
Government	1.8	3.6	-0.9	105.6
Change in stocks	0.0	0.0	-87.6	23.4
Export of goods and non-factor services	24.9	25.1	7.6	5.6
Total	100.0	100.0	6.7	4.9

(a) Revised
(b) Provisional

Source :Central Bank of Sri Lanka

in favour of domestic resources. The shift reflects the outcome of the relative growth rates of the two sources of resources.

- **The composition of resource utilisation in 2005 shifted marginally in real terms from consumption to investment compared to 2004, with lower rates of increase in all three major categories.** Consumption absorbed 57 per cent of resources, with a growth of 2.9 per cent, while fixed capital formation, absorbed 18.3 per cent and grew by 10.7 per cent in real terms. Export of goods and non-factor services grew by 5.6 per cent, while its relative share remained at around 25 per cent, as in 2004.

- **Of the total supply of goods and services at current prices, the share provided by domestic economic activities was 68 per cent, while the rest was imported.** The supply of domestic services, with a 38 per cent share, outperformed that of domestic goods at 30 per cent, where the value of trading activities, transport, communication and financial services contributed significantly. In contrast, the supply of imports consisted mainly of goods at 28 per cent, with a share of 4 per cent for imports of services.

- **Of the total demand for goods and services, the share of consumption in current terms stood at 57 per cent and capital formation at 19 per cent, with exports at 24 per cent.** Meanwhile, of the total domestic demand, the private sector continued to account for around 90 percent of consumption, but a lower share, 84 per cent, of investment than in the previous year, following the considerable expansion in government investment.

Savings

- **Both domestic and national savings grew at significantly higher rates compared with 2004.** Domestic savings rose due to the increase in private corporate sector savings resulting from improved efficiency and productivity and a significant improvement in government dis-savings. The higher influx of worker remittances from overseas raised the growth in national savings. Meanwhile, the resource gap, the difference between domestic savings and investment, as a ratio of GDP, increased slightly from 9.1 per cent to 9.3 per cent with the growth in the investment ratio rising faster than the growth in the domestic savings ratio.

- **Domestic savings, both private and government savings, were estimated at Rs. 407 billion, an increase of 26.2 per**

Table 2.14

Consumption, Investment and Savings at Current Market Prices

Item	Rs. million		% Change		Per cent of GDP	
	2004(a)	2005(b)	2004(a)	2005(b)	2004(a)	2005(b)
1. Gross domestic product at market prices	2,029,365	2,365,702	15.2	16.6	100.0	100.0
2. Consumption Expenditure	1,706,994	1,958,887	15.2	14.8	84.1	82.8
Private	1,542,107	1,763,794	14.9	14.4	76.0	74.6
Government	164,887	195,093	18.4	18.3	8.1	8.2
3. Investment	506,942	625,983	30.4	23.5	25.0	26.5
Private	461,681	526,702	32.7	14.1	22.8	22.3
Government	45,261	99,281	11.0	119.4	2.2	4.2
4. Domestic savings	322,372	406,815	15.1	26.2	15.9	17.2
Private	400,577	470,419	18.5	17.4	19.7	19.9
Government	-78,205	-63,604	34.4	-18.7	-3.9	-2.7
5. Domestic savings - investment gap	-184,571	-219,168	69.7	18.7	-9.1	-9.3
6. Net factor income from abroad	-20,688	-30,049	25.1	45.3	-1.0	-1.3
7. Net private transfers from abroad	136,607	174,426	17.5	27.7	6.7	7.4
8. National savings	438,290	551,192	15.4	25.8	21.6	23.3

(a) Revised
(b) Provisional

Source :Central Bank of Sri Lanka

cent over the previous year. The increase in domestic savings was due to the improvement in private savings by 17.4 per cent. As in 2004, increased corporate savings, through higher profitability, provided the impetus for this high growth in private savings. Government savings, which is defined as the current account balance of the government budget, was negative but improved by 18.7 per cent compared to 2004. This was achieved through higher revenue generation and the debt moratorium on certain foreign debt service payments after the tsunami. The domestic savings ratio (domestic savings/GDP) increased to 17.2 per cent in 2005 from 15.9 per cent recorded in 2004.

- **National savings, the sum of domestic savings, net factor income from abroad (NFIA) and net foreign private transfers increased by 25.8 per cent to Rs. 551 billion.** NFIA continued to be negative and deteriorated at a faster rate to Rs. 30 billion in 2005. This was mainly due to exchange losses exceeding gains in income from higher interest rates, with the appreciation of the Sri Lanka rupee in December 2005 compared to December 2004. The decline was despite the debt moratorium received for certain foreign loans after the tsunami. However, net private transfers, the other component of national savings, which consists of worker remittances, improved at a higher rate of 28 per cent to Rs. 174 billion, thereby completely off-setting the negative impact of the deterioration in NFIA. Consequently, the national savings ratio (national savings/GDP) increased to 23.3 per cent in 2005 from 21.6 in 2004.

2.5 Policies and Issues

- **Agricultural policy has to maintain balance between the two objectives of making available affordable and high quality food and non-food products for consumers and industries and raising farmers' incomes.** The nature of the Agriculture sector in many developing countries is that it provides employment opportunities for the rural masses disproportionately to its value addition to the country. Thus, to ensure employment and to safeguard the livelihood of agricultural producers, countries tend to protect the agricultural sector from external competition through tariff, subsidies and other measures. These unsustainable measures incur an extra cost on consumption and a burden on budgetary resources. Less burdensome and sustainable measures that countries adopt are enhancing productivity, improving infrastructure, developing new varieties through research, propagation of new technology and research outcome through extension services, reducing post-harvest losses and developing market based methods to deal with price fluctuations.

- **Agriculture sector development in Sri Lanka is inhibited by a series of inherent problems.** Major problems include the fragmentation and limited extent of land inhibiting the realisation of economies of scale, the difficulty in competing for factors of production with the Industry and Services sectors and withstanding domestic and international competition for final products. International developments in technology continue to depress commodity prices, while expansion in other sectors domestically as well as internationally raises the demand for inputs such as land and labour, thereby raising the cost of production. In view of these constraints, some countries with limited land area, such as Singapore, opted out of traditional agriculture very early, and others such as the USA, Japan and the EU continue to provide substantial subsidies and protection to their agriculture, while promoting value added agriculture through technology and research. The limitations on agricultural development could be faced successfully through the development of more liberal factor and product markets, maintaining policy consistency and predictability, developing infrastructure, upgrading research and development, adopting higher technology, and expanding extension services.

- **Both the government and the private sector have to play complementary roles in developing agriculture.** The government has to establish a suitable regulatory framework while providing infrastructure facilities and engaging in research and development activities particularly when such services and activities are too costly to be provided by the private sector or are of a 'public goods' nature.

- **The budgetary burden arising from subsidies and the welfare cost of excessive protection of domestic agriculture has to be gradually eliminated through improvements in productivity towards self-sustainability of the sector.** Subsidies are contentious issues, not only in Sri Lanka, but in other countries as well. The cost of subsidies has to be borne by the public since it has to be met through current or future taxation. Subsidies to producers finally benefit consumers as well, through lower costs of production, while both producers and consumers are affected by the ensuing taxation. Protection of domestic production through tariff increases on imports, especially on food items, affects the poor the most. The current fertiliser subsidy scheme, specifically to paddy farmers, has several other drawbacks as well, as the process incurs high administrative costs for monitoring and controlling leakages to other sectors. A ferlitiser stamps scheme for targeted small farmers will provide a more effective mechanism until productivity is raised to the required levels.

- **Equally important as productivity improvements are efforts required to meet international standards for processes and products, as well as to eliminate unfair trading practices by other countries.** An important issue emerged in 2005 with the EU planning to implement new food hygiene legislation with effect from 1 January 2006, which includes the application of the HACCP standards. Though the effective date was extended till June 2006, this could have an impact on agriculture exports, especially on tea, unless the required factory modernisations are completed on time. Many developed countries provide excessive protection to agriculture through subsidies, tariff and other safeguard measures, which could have a detrimental effect on domestic producers in developing countries. Sri Lanka should continue to use multilateral fora to address those issues.

- **In the wake of global concerns and media publicity regarding fast spreading diseases, such as bird flu, the country should adopt strict quarantine measures and other safety precautions, while also raising public awareness of real versus perceived threats to the country.** Awareness programmes on the importance and techniques of bio safety for poultry farmers as well as the general public, while strengthening technical capacities for the same, is important to mitigate potential damage to poultry production from the disease, as well as from adverse, inaccurate public perceptions about the spread of the disease.
- **Marketing of paddy becomes difficult and paddy prices decline sharply, soon after the peak harvesting period when there is a glut in the market, thereby depriving farmers of a dependable income.** With a view to maintaining the market price at a reasonable level, the government intervened in the market at a specified purchasing price. However, government efforts were not adequate, largely due to shortage of state funds, insufficient transport and storage infrastructure and inadequate systems for sustainable purchase and disposal mechanisms, including cash-flow management. The persistent drop in farm gate prices of paddy 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 cultivation. Therefore, the government needs to carefully examine the market practices to bring about a lasting market based solution to the low farm-gate prices of paddy during harvesting season.
- **Weak extension services inhibit the conveyance of research and development findings to cultivation.** Changes in the institutional framework and withdrawal of the agriculture extension offices at the village level have hindered the effective flow of information between researchers, agricultural administrators and farmers. The gap created between farmers and researchers has led to lower adoption of new research findings and technologies, thereby depriving the sector of opportunities for productivity enhancement. While recent policy action taken in this regard is commendable for its timeliness, adequate planning and co-ordination for such extension service delivery, with accountability, is urgently required.
- **Several impediments have prevented the industrial sector from attaining its maximum growth potential.** These include insufficient skilled human capital, inadequate infrastructure facilities, particularly energy, roads and railways, high costs of energy, insufficient progress in restructuring public sector enterprises, concerns relating to law and order, labour market rigidities and the absence of proper bankruptcy legislation. While successive governments have recognised these constraints and attempted to address them, the effective outcome has been inadequate. Better co-ordination and commitment to longer term goals would be required if the country's potential for industrial sector growth is to be achieved.
- **Poor service delivery with regard to regulatory requirements and legal proceedings have increased business transaction costs, including litigation costs.** These include time-consuming reporting requirements and burdensome approval procedures, in addition to long delays in court proceedings, complexity of existing laws and lack of adequate commercial courts in the country. At the same time, the lack of proper legal provisions to protect the environment is also becoming a cause for concern, with the rise in environmental pollution created by industrial waste. A review of existing laws with regard to expansion of the industrial sector and related issues, including environmental concerns, and their implementation, is required for long-term sustainability of industrial expansion in the country.
- **The narrow concentration of industries increases the vulnerability to exogenous shocks on industry.** The industrial sector in Sri Lanka has concentrated on a few product categories such as apparel, rubber based products, ceramics and processed foods. The removal of existing impediments to the expansion of other industrial sectors will lead to a more broad based and resilient industrial sector.
- **The economic growth in 2005 was higher than the growth in 2004 and reflected both the resilience and the vulnerability of the country's economic structure.** The tsunami affected around 3 per cent of the population adversely and two sectors, fishing and tourism, that contribute less than 5 per cent of the economic output. However, displaying resilience, the final growth outcome in 2005 was similar to that expected prior to the tsunami due to higher than projected growth in another sector, namely, agriculture. At the same time, a breakdown of the outcome in 2005 indicates vulnerability, as the higher GDP growth was mainly due to the favourable weather conditions in 2005 which were conducive to higher domestic agricultural output and more value addition in electricity generation with the increased share of hydro electric power generation. The contribution from these two sectors more than made up for the drop in contribution from the fishing and hotel and restaurant sub-sectors, as well as the lower contribution from import trade.

Box 7

Avian Flu and its Impact on Sri Lanka

There is growing concern about the possibility of an avian flu pandemic (AFP) and its implications for humans and the global economic and financial system.[1] Avian flu is an infectious disease caused by strains of the influenza virus, which was first identified in birds about a century ago in Italy. Health experts are particularly concerned about the current strain of the virus H5N1. This strain has spread quickly in bird populations, caused high mortality among poultry, and occasionally infected humans, with about half of the cases proving fatal. But human infections remain rare as the strain has not been spreading easily from birds to humans, nor has it been spreading from person to person.

According to the World Health Organisation (WHO), evolution in influenza viruses cannot be predicted. Hence, it is difficult to know if or when a virus such as H5N1 might become easily transmittable among humans and its severity. However, the WHO considers that, once a virus mutates into a form that allows for efficient human-to-human transmission, a pandemic could occur. Because of high global mobility and interconnection, illness could spread quickly, and, if the virus has a high fatality rate, threaten millions of lives around the world. The pandemic might emerge in repetitive waves with varying intensity, including durations beyond 6 weeks, as was the experience with past pandemics.

The outbreak of the H5N1 in Hong Kong in1997 resulted in severe destruction to its poultry industry and caused 6 human deaths. Recent outbreaks of the disease began in 2003 in several South East Asian countries and spread to 47 countries (as at 21 March 2006), including Europe, the Middle East and Africa. All reported human infections in those countries are among those who have had direct contact with dead or live infected birds.

Sri Lanka has not had any cases of H5N1 so far, but remains vulnerable, as countries around Sri Lanka such as India, Pakistan, Cambodia, China, Indonesia, Malaysia, Myanmar, Thailand and Vietnam have contacted the disease. It could be brought into the country by migratory birds, imported birds and poultry products and tourists arriving from affected countries. As in many Asian countries, Sri Lankan rural families keep backyard chicken causing high risk of spreading the disease to humans. Another high-risk area is live poultry markets, where chances of contacting the virus to humans are higher.

Poultry is one of the most important sources of dietary protein in Sri Lanka, and the industry provides employment to about 75,000 persons directly and to about one million people indirectly. Those indirectly involved include feed producers and millers who supply inputs to the industry. About 80 per cent of the poultry farmers fall into the small farmer category, while the balance 20 per cent belong to medium to large-scale category. Consumer demand for poultry meat and eggs has declined significantly with the spread of the Avian flu in neighbouring countries thereby causing prices to drop below the cost of production, adversely affecting poultry farmers, input producers and their families.

The Department of Animal Production and Health (DAPH) has already taken preventive measures by restricting imports of live birds and poultry products from affected countries. Veterinary surgeons have been urged to be vigilant and report any cases of high mortality rates in poultry farms immediately. The DAPH has initiated active surveillance in 'hot spots' where migratory birds have habitats in water reservoirs. Funds have been allocated to start prevention programmes and to strengthen the capacities of the DAPH by improving laboratory facilities and testing facilities, which would facilitate early detection and prevention of the disease. The DAPH, together with other relevant organisations have started awareness programmes to educate poultry farmers and other stakeholders on the symptoms of the disease and, steps to be taken if there is any suspicion of infection among birds.

The Ministry of Health has established the National Technical Committee on Avian Influenza (NTCAI) to compile a National Influenza Pandemic Preparedness Plan (NIPPP) in collaboration with DAPH and other relevant ministries. The Plan sets out the strategies and activities to be undertaken by the Ministry of Health in close collaboration with other relevant key ministries, to prevent an outbreak of the disease and in the event of an outbreak, to control the spread of the disease. NIPPP identified five key strategies for preparedness and response to the pandemic of avian influenza. It includes:

- Planning and coordination: defines the roles and responsibilities of agencies involved in implementing preparedness plan and coordinated procedure for decision making.
- Surveillance and early warning: consists of strengthening of disease surveillance in animals and humans and strengthening of laboratories.
- Prevention and control: consists of specific approaches for minimising the spread of influenza in humans by implementation of public health measures, availability and stockpiles of vaccines.
- Response of Health system: consists of reinforcing the healthcare system to adequately deal with the increased demand on hospitals and health services required for an emerging pandemic.

1 Pandemic is an epidemic that is geographically widespread; occurring throughout a region or even throughout the world.

Box 7 (Contd.)

- Risk communication: consists of a comprehensive communication strategy to provide updated information to the public, healthcare personnel, and other stakeholders during each pandemic phase.

The Director General of Health Services has already issued 'Guidelines for the Preparedness and Response to an Avian Influenza Pandemic Threat' to all relevant officials including details of the disease identification, control and preventive measures. The estimated funding requirement for the activities of the Ministry of Healthcare and Nutrition and the DAPH to implement the plan for a three-year period (2005/06 -2008) is approximately US dollars 7.5 million. Financial and technical constraints exist for implementing pandemic preparedness plan as adequate quantities of necessary antiviral drugs, vaccines and necessary laboratory equipment and hospital facilities are still not available.

The severity of a pandemic on an economy depends on the capacity and the level of preparedness of the healthcare system of a country. It also depends on the availability of financial resources to purchase and distribute drugs, vaccines, and facilities etc. for timely treatment and possible travel restrictions. There are potential fiscal implications to the economy due to upfront cost enhancement for healthcare facilities on preventive and curative measures, stockpile of food items for preparedness planning, compensation payments for losses from culling birds in poultry industry during pre-pandemic period, losses in tourism and loss of revenue from business performance during the pandemic period.

Considering the economic implications of the possibility of an avian flu pandemic (AFP), it is necessary to prepare Business Continuity Plans (BCP), covering all key institutions to carryout their services without interruption.

- **Economic growth that is significantly dependent on weather for a better performance in agriculture and power generation is not sustainable in the long term.** Consequently, a stronger commitment to longer term sustainable economic development goals that includes infrastructure improvements and changes to legislation and its effective implementation, that were outlined earlier for expansion of both the industrial and agricultural sectors, and are as relevant to the services sector, is a key policy priority for Sri Lanka to reach a higher growth path of 6-8 per cent.
- **On the expenditure front, real growth in both external and domestic demand provided the impetus for the growth in output.** While the growth in external demand had moderated from 2004, it remained healthy in the face of aggressive global competition. This reflects the concerted efforts made at productivity improvements and cost cutting through skills development and introduction of new technologies in private manufacturing and the success of their restructuring process to meet global challenges. With the giant economies of Asia, India and China, expanding at a very fast pace, this productivity improvement process will need to continue to ensure continuity in external demand for Sri Lankan products.
- **The impetus to output from domestic demand, both consumption and investment, had also moderated compared to the euphoric situation in the two years following the ceasefire.** During 2003 and 2004, output grew to meet the pent-up demand across the country, where total domestic demand grew in real terms at over 8 per cent and 6 per cent, respectively. Further expansion in productive investment and higher productivity levels, together with real and sustainable growth in domestic demand for goods and services, would signify higher levels of economic development in the country. It is essential that government policies focus on creating a holistic enabling environment towards achieving this overall growth momentum.
- **While it is necessary for successive governments to address the problems of the consumer and the domestic producer in the short term, as important is the need to address impediments to future capacity expansion through expansion in productive investment.** The slow down in non-consumer imports, both intermediate and investment goods, in 2005 cannot be taken lightly, as both categories are leading indicators of future economic activity and expansion. In certain sectors, the growth had slowed down due to capacity limitations, while in other sectors, the growth was below achievable potential due to inadequate infrastructure and inefficient processes and procedures. Here again, Sri Lanka can only achieve a sustainable high growth path, if priority is given to improve on existing infrastructure facilities, processes and procedures for smooth functioning of labour, capital, land and goods markets, consistent with the potential for expansion in those sectors that have the capacity to do so.