Chapter 2

NATIONAL OUTPUT AND EXPENDITURE

2.1 Overview

Sri Lanka's economy grew by an impressive 7.4 per cent in real terms in 2006, recording the highest growth since 1978 followed by a high growth rate of 6 per cent in 2005. This growth was commendable as it was achieved in a challenging environment marked by high and volatile oil prices, recurring natural disasters such as floods and landslides, and renewed terrorism activities. The per capita income also rose to US dollars 1,355 in 2006, from US dollars 1,197 in 2005. The expansion was broadbased, with all sectors of the economy registering positive growth. The services sector achieved the highest growth rate of 8.3 per cent and contributed 63 per cent to the overall growth.

This growth was underpinned by the healthy expansion in telecommunication,cargo handling and financial services. A recovery in tourism activities after the tsunami was witnessed in the first half of the year, which faded as a result of security concerns in the second half of the year. The industry sector grew by 7.2 per cent (8.3 per cent in 2005) and contributed 26 per cent to the overall growth. The deceleration in this sector was mainly due to lower growth in all the four sub-sectors (Mining and quarrying, Manufacturing, Electricity and water, and Construction) affected by increased costs of imports, raw materials and wages. The Agriculture sector grew by 4.7 per cent and contributed 11 per cent to the economic growth. The positive impact of the recovery of the fisheries sub-sector from the tsunami was felt during the year. The agriculture sub sector also grew by marginally benefiting from favourable weather conditions and fertiliser at subsidised prices. However, floods and landslides occurred in some areas hampering agricultural activities as well as transportation of the produce.

Gross Domestic Product (GDP) at current market prices was estimated at Rs. 2,802 billion in 2006, registering a nominal growth of 18.4 per cent. This higher rate of increase was reflected by the higher real economic growth and higher increase in the price level, particularly in the second half of the year.

The GDP per capita for 2006 is estimated at Rs.140,894 an increase of 17.1 per cent. In US dollar terms, per capita GDP increased by 13.2 per cent from US dollars 1,197 in 2005 to US dollars 1,355 in 2006.

The expansion in economic activity impacted positively on the labour market. The unemployment rate, which was 7.3 per cent in 2005 dropped to 6.5 per cent in 2006.

The GDP deflator, which measures the price changes of all goods, produced in the economy, increased by 10.3 per cent in 2006 compared with the rate of 9.9 per cent in 2005. High price increases were recorded in most sub-sectors except in mining and telecommunications, where prices were lower compared with the previous year. Higher fuel and material costs together with the depreciation of the Sri Lankan rupee during the year led to the increase in prices of most finished goods and services.

Chart 2.1 Annual Growth Rates

The higher expansion in the economy in 2006 was supported by higher consumption and investment demand. Though exports grew moderately amidst sharp competition from low cost producing destinations, imports grew at a higher rate of above 7 per cent.

The higher growth of private consumption was driven mainly by higher disposable income in both the household and the corporate sector on account of higher wages, higher commodity prices and higher profitability of the corporate sector. Government consumption grew by 30 per cent to meet increased salaries, pensions and rehabilitation expenditures including humanitarian needs following floods, landslides and displacements due to certain instances of tension in the eastern region.

The investment expenditure continued to increase at a higher rate in 2006. Total investment as a ratio of GDP rose from 26.5 to 28.7 per cent, mainly due to stronger growth in private investment by 31.7 per cent. Government investment rose by 8.5 per cent. As a percentage of GDP, private investment rose to 24.8 from 22.3 while government investment declined to 3.8 per cent from 4.2 per cent in 2005.

The Gross National Product (GNP) defined as GDP adjusted for net factor income from abroad (NFIA) grew by 7.0 per cent, a lower rate than GDP growth, The NFIA remained negative and deteriorated further by 31.1 per cent in 2006. This is mainly due to higher outflows of debt service payments, and repatriation of profits and dividends.

Notwithstanding stronger consumption spending in 2006, both domestic and national savings rose, as private domestic savings increased to Rs. 550 billion. The government dis-savings continued to fall as a percentage of GDP. Meanwhile, the higher increase in net import of goods and non-factor services than investment inflows resulted lower savings as a percentage of GDP in 2006.

2.2 Sectoral Policies, Institutional Support and Issues

The high economic growth achieved and increased investment were welcome developments in 2006. As this momentum continues, the economy is projected to grow at over 8 per cent in the medium term. However, given the low domestic savings rate, the foreign inflows would be critically important to finance the high investment that should accompany the projected high growth. Therefore, it is

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 (%)	
	2005(a)	2006(b)	2005(a)	2006(b)	2005(a)	2006(b)
Agriculture	1.9	4.7	5.8	11.1	17.2	16.8
1. Agriculture, forestry and fishing	1.9	4.7	5.8	11.1	17.2	16.8
1.1 Agriculture	9.4	0.5	21.6	1.0	14.3	13.4
Tea	2.5	-1.9	0.5	-0.3	1.2	1.1
Rubber	10.8	4.2	0.6	0.2	0.4	0.3
Coconut	- 2.2	7.6	- 0.4	1.2	1.1	1.2
Paddy	24.4	2.1	10.4	0.9	3.0	2.9
Other	7.5	-0.8	10.5	-0.9	8.6	7.9
1.2 Forestry	1.7	4.9	0.5	1.1	1.7	1.6
1.3 Fishing	- 42.2	51.7	- 16.3	8.9	1.3	1.8
Industry	8.3	7.2	36.6	26.3	27.0	27.0
2. Mining and quarrying	14.1	8.0	4.0	2.0	1.9	1.9
3. Manufacturing	6.0	5.3	16.3	11.8	16.3	16.0
3.1 Processing of tea, rubber and coconut kernel products	2.7	1.1	0.8	0.2	1.7	1.6
3.2 Factory industry	6.1	5.9	13.6	10.7	13.4	13.2
3.3 Small industry	9.8	5.3	1.9	0.9	1.2	1.2
4. Electricity and water	24.5	20.2	5.9	4.7	1.7	1.9
4.1 Electricity	27.7	22.2	5.8	4.6	1.5	1.7
4.2 Water	3.8	4.2	0.1	0.1	0.2	0.2
5. Construction	8.9	8.0	10.3	7.8	7.2	7.2
Services	6.2	8.3	57.6	62.6	55.7	56.2
6. Wholesale and retail trade, hotels and restaurants	2.8	5.9	10.3	17.3	21.6	21.4
6.1 Import trade	2.3	7.5	3.8	10.0	9.8	9.8
6.2 Export trade	6.9	4.4	2.8	1.5	2.5	2.4
6.3 Domestic trade	4.6	4.5	6.9	5.4	8.8	8.6
6.4 Hotels and restaurants	- 27.5	6.3	- 3.2	0.4	0.5	0.5
7. Transport, storage and communication	11.7	13.1	28.4	27.2	15.3	16.2
7.1 Transport	3.3	5.1	4.4	5.4	7.9	7.7
7.2 Cargo handling, storage and warehousing	8.4	13.2	1.3	1.7	1.0	1.0
7.3 Post and Telecommunications	24.7	22.7	22.7	20.1	6.5	7.4
8. Financial services, real estate and business services	6.5	9.7	12.6	15.5	11.7	12.0
8.1 Financial services	7.5	10.5	11.5	13.5	9.5	9.7
8.2 Real estate, renting and business services	2.8	6.2	1.1	1.9	2.3	2.3
9. Public administration, other government services and defence, other community, social and personal services	5.4	2.8	6.4	2.6	7.0	6.7
9.1 Public administration, other govt. services and defence	5.1	1.5	3.7	0.9	4.3	4.1
9.2 Other community, social and personal services	6.0	4.8	2.6	1.7	2.7	2.6
Gross domestic product	6.0	7.4	100.0	100.0	100.0	100.0
Net Factor Income from Abroad	-46.2	-31.1				
Gross national product	5.6	7.0				

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

imperative that the economic climate remains conducive to investment and investor confidence remains high. In this regard, securing a sustainable peace to the Northern conflict, speedy implementation of required initiatives to encourage investment, prudent macroeconomic management including greater fiscal discipline, greater political stability, improved infrastructure facilities, particularly power and roads, will be crucial factors that enhances the future potential of the economy.

Agriculture

The government's policy on agriculture emphasises enhancing the income and living condition of farmers through increasing productivity and other improvements, while ensuring the food security in the country and availability of safe food products to consumers. Accordingly, the Department of Agriculture (DOA) was engaged in a series of activities including agriculture research, improving extension services, increasing the production of high yielding seeds, product standardization and certification, and plant protection programmes during 2006. Priority was given to develop paddy varieties, suitable for drought prone areas and iron toxic soils and 7 such paddy varieties were released during 2006. To provide quality seeds and planting materials, steps have been taken to develop seed farms at Horana, Seetha Eliya, Girandurukotte and Labuduwa and Maha Illuppallama Field Crop Research Institute. Steps have also been taken to establish Dedicated Agricultural Product Zones.

The Budget 2007 proposed a policy package for further development of the agriculture. These policies included removing the duty waiver gradually on imported milk powder; promoting high value agriculture and processing activities;

implementing a comprehensive package providing credit and tax concessions for machinery, equipment and extension services for farmers engaged in such activities in agriculture, livestock, inland fisheries, prawn farming, fruit, vegetable, floriculture, seed development and production of organic fertiliser. To modernise rice flour processing, rice millers were given additional incentives including exemption from Value Added Tax (VAT) and import duties for importing machinery which are not manufactured locally. Nucleus farms are encouraged through tax and other incentives to develop fruit and vegetable cultivation based on the out grower system. Agricultural income including income from agricultural processing and value addition was exempted from income tax to attract more investors.

Provision of fertiliser subsidy was expanded in 2006, which yielded both favourable and unfavourable results. Under the fertiliser subsidy scheme, paddy farmers who are registered at the Agrarian Services Centres were eligible to obtain fertiliser at a subsidised rate of Rs. 350 per 50 kg bag. This was further extended to cover additional food crops such as chillies, maize, onion, big onion and vegetables, cultivated in paddy lands during the Yala season. Later, smallholders who own less than 5 acres of tea, rubber or coconut land were also provided with a 50 kg bag of urea at a less subsidised rate of Rs. 1,200. Higher subsidies may lead to inefficient distribution of resources. Different subsidy schemes for different crops would lead to producer dissatisfaction and market distortion. In addition, subsidies are involved with technology “lock-in” effect that may impede the shift to less environmentally harmful policies, leading to increase crop specification and reduce agro-biodiversity. Hence, a decrease in domestic support would favour the diversification of production, thereby improving agro-biodiversity.

The government took several measures aimed at establishing sustainable and reasonable marketing and selling network to protect producers as well as consumers. The Agricultural Products Marketing Authority (APMA) was established to enhance marketing and to ensure a fair price for agricultural produce. In 2006, the government allocated Rs. 3,387 million to purchase paddy at Rs. 16.50 - Rs. 17.50 per kilogram.

The government made tariff adjustments to protect certain domestic agriculture produces. A specific duty of Rs. 9 per kg on rice imports was increased to Rs. 20 per kg, while customs duty on wheat flour imports was increased from 2.5 per cent to 15 per cent or Rs. 4.50 per kg (whichever is higher). Customs duty on wheat grain imports increased from 2.5 per cent to 6 per cent. Customs duty on big onion imports increased from Rs. 10 per kg to Rs. 20 per kg and a cess of Rs. 10 per kg was introduced on imported big onions to ensure a fair price to local big onion producers.

Further incentives were given to enhance value addition in the plantation sector. Machinery and equipment imported for the modernisation of tea, rubber and coconut processing factories were exempted from VAT and customs duties. The Economic Service Charge (ESC) applicable to tea, rubber and coconut processing industries was also reduced from 0.5 per cent to 0.25 per cent in the Budget effective from January 2007. In order to offset the effort of increasing cost of energy, the government supported investments on power and energy saving technology, with financial loan assistance from the Asian Development Bank (ADB).

Due to global over-supply of tea, priority was given for quality enhancing programmes. Low interest rate credit facilities were arranged under the Tea Development Project to modernise tea factories to obtain the Hazard Analysis Critical Control Point (HACCP) certification. Consequently, about 34 out of 661 tea factories have obtained the HACCP certification from Sri Lanka Standard Institute (SLSI) and other recognised institutions. To increase the production of cut, tear and curl (CTC) and value added tea, the Sri Lanka Tea Board (SLTB) allowed additional CTC processing line to be maintained without converting existing facilities in the factory to meet the escalating demand.

The government aims to increase the extent under coconut cultivation up to 1 million acres within a few years. Under this programme, in 2006, the government distributed seedlings and fertiliser to the prospective planters, free of charge. The required funds were allocated through the cess fund. For the availability of seedlings for coconut growers, 35 nurseries were maintained in various areas and seedlings were sold at competitive prices. Coconut subsidy programme was revised in 2006 to attract more growers. As a new approach, with the assistance of state and private sector organisations, coconut lands damaged by the tsunami were rehabilitated and programmes were launched to replant or new plant coconut in Samurdhi recipients’ lands and fragmentised lands. Incentives given for rainwater harvesting and plantation of “Gliricidia” in coconut lands also continued in 2006.

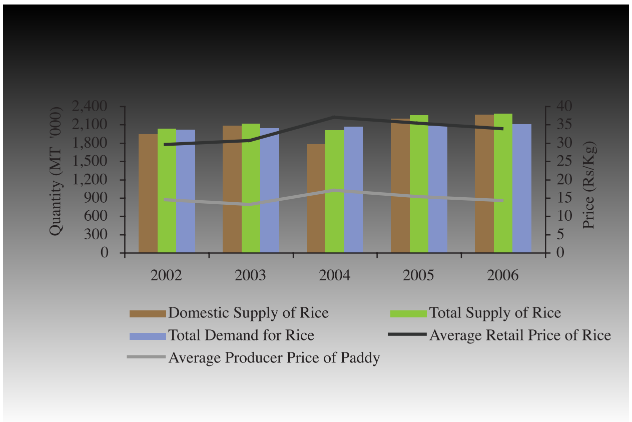
Several programmes were introduced to further develop the fisheries sector. In order to increase the capacity of fishing in deep-sea, 55 multi-day fishing boats were distributed while fingerlings were released to the reservoir tanks to promote fresh water breeding. To improve the infrastructure of prawn farming in the Puttalam District, 14 km length of highly silted canal at Mundalama North to Palaviya was rehabilitated. The ornamental fish exchange centre was opened to promote and popularise self-employment and high value added exports through ornamental fish projects. Animal feed plant, which uses fish waste, was established at the Beruwala fisheries harbour. Supply of prawns was exempted from VAT, while a cess was imposed on the importation of prawns.

The government is taking measures to increase the local milk production. At present, local milk production meets only about 20 per cent of the total demand and it is expected to increase this level to 30 per cent by 2010. Actions were taken to increase the productivity of domestic cattle and buffalo herds, while expanding milk marketing. The importation of cattle, buffaloes and goats, semen and embryo to be used in livestock breeding was exempted from customs duty and VAT in 2006. A policy decision was taken to set up a Veterinary Investigation Centre per District to improve animal health in the country and recruit 177 Veterinary Surgeons to the Department of Animal Production and Health. The role of the public sector is to be limited to regulatory functions for animal disease management and quality assurance of inputs and outputs, while the private sector is encouraged to undertake the raising of animals.

Sustainable agricultural growth can be achieved through focusing on policies on improving productivity and competitiveness. Agricultural research needs to be focused on improving agricultural productivity and formulating strategies to better manage natural resources. Encouraging demand-driven extension services, more efficient use of farm inputs and a reduction of post-harvest losses are necessary. More attention is required to discover non-rival technologies, developing new hybrid seed varieties and soil management technologies, rehabilitating small-scale irrigation tanks, promoting water management methods and decreasing salinity. The usage of low quality seeds, improper management of pests and diseases and incorrect or inadequate use of fertilisers have caused the lower productivity of most agricultural products, particularly vegetables.

Increasing private sector participation through providing better environment can minimise the burden on the national budget. Under the paddy purchasing mechanism, the government has to purchase quality paddy offered by the farmers at the government specified floor price, irrespective of the market price. Funding these purchases together with cost of storage and maintaining buffer stocks is often problematic and exerts a heavy burden on the national budget. Further, public sector intervention has little or even negative impact on the welfare of the farmers. Encouraging private sector involvement in paddy marketing, promoting farmers to enter into forward market contracts, facilitating to produce rice based products and popularising them, and enhancing milling capacity to produce super quality rice could help lessen the government intervention.

Chart 2.2 **Rice : Supply and Demand**



In the plantation sector, rising cost of production and shortage of labour are major concerns. Escalating energy costs (firewood, electricity etc.,), and increasing labour costs were major contributors for the significant increase of cost of production. Improving productivity, crop diversification, inner plantation and investing on alternate sources of energy would help to lower the cost of production. Lack of trained workers particularly for tea and coconut plucking, rubber tapping and cinnamon peeling are severe constraints in the plantation sector. The tea smallholder sector, which accounts for about 65 per cent of the total tea production, suffers from a lack of labour. The introduction of a productivity related wage structure would be a possible solution.

Given the healthy agro-climatic and investment atmosphere, there is a vast potential for rapid development of both inland and ornamental fishing industry. The country has natural resources in the form of water bodies and suitable land resources to breed ornamental and inland fish varieties, but still these resources have not been channelled productively to obtain maximum results due to some constraints. The lack of research and development (R & D), uninterrupted supply to meet demand, lack of technical know-how, inadequate stocking levels, low social acceptance, lack of public awareness programmes and inadequate private partnerships could be major contributory factors for this situation.

Some difficulties in the marine fisheries sector hinder its potential growth. Inadequate application of fishing technologies, poor fisheries infrastructure, non-application of post-harvesting technologies, lack of knowledge on fish handling and poor quality of fish landings have to be addressed if the growth of the fishing industry is to be expedited. Inadequate ice production and storage and transport facilities have also constrained the efforts of value addition, quality improvement and efficient distribution of fish. Despite the government promoting deep-sea fishing the influx of unplanned day-boats has led to depletion of fish in the shallow waters.

Industry

The thrust of the long-term industrial policy of the government is to develop a globally competitive, dynamic and technologically sophisticated industrial sector. Industrial policy, should encourage the innovation and productivity improvement in processes and services. In this process, the foreign investment is expected to make a vital contribution by providing capital, access to technology and access to markets. To facilitate such process, the government has initiated several measures aimed at strengthening the legal and regulatory framework, providing necessary infrastructure, improving corporate governance, enhancing quality and maintaining standards, improving competitiveness of industries, facilitating access to credit and developing human capital.

The global market access of Sri Lankan exports was expanded further in 2006 with the continuous negotiations at multilateral, regional and bilateral fora. The country, while adhering to the commitments given to the World Trade Organization (WTO), engaged in bilateral trade negotiations with India, Pakistan and other regional countries. Trade negotiations with India in 2006 was mainly focused on resolving the problems relating to quantitative restrictions imposed by India for certain exports and further negotiation of a Comprehensive Economic Partnership Agreement (CEPA). Negotiations with the European Union (EU) continued, aimed at rationalizing the stringent rules of origin (ROO) criteria imposed under Generalised System of Preference (GSP+) scheme, which requires Sri Lanka to add at least 50 per cent value addition in case of apparel exports in order to qualify for such benefits.

The government reiterated its commitments to develop small and medium scale enterprises (SMEs). Developing SMEs is considered to be the gateway to broad-based industrialisation and employment growth and is to be strengthened by technology transfers through linkages with large scale and modern industrial enterprises. Further, SMEs are provided with incentives such as duty free imports, facilities for the payments in foreign currency for the supply of raw materials and other inputs by local industries, and incentives for improving productivity and developing backward linkages.

The government has taken several measures to promote regional industrialisation. In 2006, 8 new industries were established, 6 sick industries were revived and 3 industries were expanded while 8 existing industries were approved to relocate outside the Colombo and Gampaha Districts under *"Nipayum Sri Lanka"* 300 enterprises programme. Incentives given for such industries include exemption from income tax for 5-10 years and exemption from duties and value added tax (VAT) for import of new plant and technologically advanced machinery. This is a major challenge undertaken to bridge the gap between incentives granted for Board of Investment (BOI) and non-BOI projects. Under the 300 enterprises programme, many concessions given to BOI investors have been extended to local investors as well. Further, factories which are relocated outside the Western Province were provided with the incentive of deducting the cost of relocation of industries, from their taxable income.

The Budget 2007 provided measures to further develop domestic industry. The on-going debt restructuring programme in textile firms is expected to continue on a risk sharing basis between the government and the banks. Special attention has been placed on the establishment of textile processing zones to develop backward linkages in the apparel industry. Further, the Budget 2007 has also proposed the establishment of a nanotechnology institute under the supervision of the National Research Council. This is expected to improve the competitiveness of several industries, textile, rubber, electronic, and mineral.

The high tariff on electricity and industrial fuel is becoming a serious problem in maintaining international competitiveness of many energy intensive industries. To alleviate this problem, the Budget 2007 proposed an exemption of heavy fuel oil, furnace oil and electricity from VAT.

Institutional support continued in 2006 for the industrial sector development. Export and Enterprises Development Forum facilitated by the Sri Lanka Export Development Board resolved operational and other problems relating to the exporters and entrepreneurs in 2006, while Investor Facilitation Forum (IFF) under BOI helped investors to eliminate the existing bottlenecks faced by industrialists in acquiring land and obtaining environmental clearance, and other approvals from the central and local governments. The special programme initiated by the Ministry of Industrial Development in 2004 helped to enhance competitiveness of targeted thrust industries of textile and apparel, footwear, leather products, ceramics, rubber, and wood and wood based industries in 2006. It provided the necessary financial assistance for skill development, technical support for food processing industry, quality assessment and issuance of quality certificates in collaboration with United Nations Industrial Development Organisation (UNIDO), Sri Lanka Standards Institution and Industrial Technology Institute.

The industrial sector is facing several impediments in achieving a higher growth. Rising energy cost has become burdensome for high energy consuming industries such as ceramics, cement and glass. Supply of reliable and affordable energy to the industrial sector is extremely important to achieve a higher industrial growth. In addition, there is an urgent need for resolving the issue of inadequate infrastructure, rising cost of labour and raw material, lack of skilled labour, lack of technically qualified personnel in the construction industry, rigid regulations in the labour market and the inefficiencies in the public sector enterprises.

Further diversification of the industrial sector is essential to strengthen the resilience of the sector. Factory industry in Sri Lanka is highly dependent on a few categories of industries such as apparel, rubber based products and ceramic products. Hence diversification is essential to withstand external shocks.

Some of the existing producers in the country are alleged to increase business transaction costs and slow down the decision making process of firms. The rigid and complex procedures lead to corruption, delays and waste of resources. Registering new businesses and properties, dealing with licenses, labour regulations, and document handling in export and import procedures are the major areas need to be improved further. Industrial sector also find difficulties by the high litigation costs due to long delays in court proceedings, complexity of existing laws and limited capacity of the judiciary in commercial law matters.

Services

Faster implementation of the proposed infrastructure developments projects is an essential requirement for rapid expansion of the economy. Major development projects such as Colombo south harbour, coal and hydro power projects, express highways and railways need to be implemented without delays as they are essential for rapid and sustainable development of the economy. Given the fiscal constraint, public and private partnership should be encouraged in funding for such projects.

Operational efficiency of public enterprises providing infrastructure services, such as Ceylon Electricity Board, Sri Lanka Railways and Sri Lanka Transport Board should be improved to reduce high cost of operation and relieve the burden on the government budget. Introducing of institutional improvements, strengthening financial management, eliminating waste, introducing innovative products and other relevant measures would help to improve the financial position of these institutions.

2.3 Output

Agriculture

The Agriculture, Forestry and Fishing sector recovered significantly and recorded a healthy growth of 4.7 per cent in value added terms in 2006. The share of the agriculture sector of total GDP was 16.8 per cent. The record paddy harvest in 2006, considerable increase in rubber and coconut production and the strong recovery in fish production contributed to this growth. However, marginal decline in tea production, slowing down of poultry sector growth and drop in production of fruits and vegetables mainly due to extreme weather fluctuations diminished the potential growth in the sector.

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

Item	2005(a)	2006(b)	Rate of Change (%) 2006/05
Agriculture and Fishing	103.2	108.8	5.4
1 Agriculture	110.2	111.5	1.2
1.1 Agriculture crops	108.8	111.1	2.2
Tea	110.4	108.2	-2.0
Rubber	108.2	113.2	4.6
Coconut	90.6	96.7	6.7
Paddy	121.8	125.4	2.9
Other Crops	106.6	108.7	2.0
1.2 Livestock	123.4	114.9	-6.9
2 Fishing	59.8	92.0	53.9

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

Export Agriculture

Tea production declined marginally in 2006. Revision of the fertiliser subsidy scheme, extreme weather fluctuations and labour unrest during the latter part of the year contributed to decline in annual tea production by 2 per cent to 311 million kg, which is however still well above the average of the past five years production.

Table 2.3 Trends in Principal Agricultural Crops

Category	Unit	2005(a)	2006(b)
1. Tea			
1.1 Production (c)	kg mn	317.2	310.8
1.2 Total extent	hectares '000	222	222
1.3 Extent bearing	hectares '000	193	193
1.4 Cost of production (d)	Rs/kg	168.41	187.85
1.5 Average price			
- Colombo auction	Rs/kg	185.84	198.87
- Export (f.o.b.)	Rs/kg	263.31	279.97
1.6 Replanting	hectares	1,351	1,338
1.7 New planting	hectares	7	10
1.8 Value added as % of GDP (e)		1.9	1.8
2. Rubber			
2.1 Production	kg mn	104.4	109.2
2.2 Total extent (f)	hectares '000	116	118
2.3 Area under tapping (f)	hectares '000	91	95
2.4 Cost of production	Rs/kg	76.12	77.38
2.5 Average price			
- Colombo auction (RSS 1)	Rs/kg	147.41	187.97
- Export (f.o.b)	Rs/kg	147.73	204.70
2.6 Replanting (g)	hectares	1,257	1,122
2.7 New planting (g)	hectares	1,032	2,563
2.8 Value added as % of GDP (e)		0.7	0.9
3. Coconut			
3.1 Production	nuts mn	2,515	2,684
3.2 Total extent	hectares '000	395	395
3.3 Cost of production	Rs/nut	7.50	8.00
3.4 Average price			
-Producer price	Rs/nut	12.46	10.86
-Export (f.o.b.) (h)	Rs/nut	13.04	14.39
3.5 Replanting / Under planting (i)	hectares	1,668	997
3.6 New planting (i)	hectares	3,250	4,102
3.7 Value added as % of GDP (e)		2.1	1.7

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

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

Rubber production in 2006 continued to increase registering a growth of 4.6 per cent leading to 109 million kg, registering the highest production after 1996. Attractive prices, coupled with increased demand led to a series of productivity improvements such as increased tapping intensity, usage of rain guards, planting new high-yielding clones and application of fertilisers. Weather also played a major role in raising production. Significant upsurge in crude oil prices caused the synthetic rubber prices also to rise. As a response to higher international prices, rubber exports increased sharply by 48 per cent to 47 million kg in 2006. Although prices were high, its volatility was also high, both in the domestic and international markets. Cost of production however showed an increase. The productivity of rubber needs to rise further, for the industry to withstand the fluctuation of rubber prices in the world market.

Coconut production increased by 6.7 per cent in 2006 benefiting from the lagged effect of favourable rainfall distribution in almost all coconut growing areas. Increase in fertiliser application too contributed to raise production.

The output of other agricultural export crops such as cinnamon, cloves, pepper, nutmeg, coffee, cocoa and arecanuts showed mixed performance in 2006. The production of cinnamon, cashew kernels and pepper increased by 3.7 per cent, 7.3 per cent and 1.2 per cent respectively, mainly due to the productivity improvement through the implementation of replanting and rehabilitation programmes coupled with the usage of improved technology, planting material and training programmes provided to farmers. Increase in input prices has resulted in poor agro-management practices such as poor weeding and fertiliser applications.

Domestic Agriculture

Paddy production registered a record high level of 3,342,000 metric tons (growth of 2.9 per cent) in 2006 despite the drop in production in 2006 Yala. Healthy weather conditions, ample application of fertiliser and high prices led to this achievement. The paddy output in 2005/06 Maha season increased by 6.1 per cent, while the output in Yala season declined by 2.2 per cent. The Yala decline resulted from the delay in monsoon rains.

Domestic sugar production recovered in 2006. Rising world sugar prices due to increased use of sugar-based bio-fuel further encouraged the domestic sugar production.

Forestry

In line with the Forestry Sector Master Plan, several initiatives were taken to promote forestry. Under the Forest Resource Management Project funded by a loan from the ADB, for the development of silviculture, 1,843 hectares of forest plantations were rehabilitated after clear felling mature teak and Eucalyptus plantations while 1,254 hectare of new plantations were raised. In 2006, 23 Regional Plantation Companies have also converted 22,300 hectares of unutilised land into forestry.

Table 2.5 Livestock Sector Statistics

Sub-Sector	2005	2006(a)
1. National Herd (No.) (mn)	1.5	1.5
Neat Cattle	1.2	1.2
Baffalo	0.3	0.3
2. National Milk Production (mn litres)	192.7	196.6
Cow Milk	162	165
Baffalo Milk	31	32
3. Milk Products (mn litres)	6.8	8.6
4. Producer Price - Cow Milk (Rs./litre)	20.55	21.00
5. National Egg Production (No) (mn)	865	901
6. National Poultry Meat Production (000' mt)	97.3	78.8

(a) Provisional

Sources: Department of Census and Statistics
Ministry of Agriculture and Livestock

Table 2.4 Paddy Sector Statistics

Item	Unit	2005(a) Maha	2005(a) Yala	2005(a) Total	2006(b) Maha	2006(b) Yala	2006(b) Total
Gross extent sown	hectares '000	581	357	937	591	319	910
Gross extent harvested	hectares '000	569	345	915	586	314	900
Net extent harvested	hectares '000	508	310	818	525	283	808
Production	mt '000	2,012	1,233	3,246	2,136	1,206	3,342
	bushels '000	96,445	59,116	155,561	102,350	57,814	160,164
Yield (c)	kg./ hectare	3,955	3,976	3,963	4,069	4,263	4,137
Credit granted	Rs.mn.	833	531	1,364	683	534	1,217
Rice imports	mt '000	-	-	52	-	-	12
Paddy equivalent of imports	mt '000	-	-	76	-	-	18

(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

Table 2.6 **Fish Production**

Sub-Sector	2005(a)	2006(b)
		Metric Tons '000
Marine (c)	130	216
Aquaculture and Inland Fisheries	33	35
Total	163	251

(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

Fishing

Annual fish production in 2006 increased by 54 per cent to 251 million kg reflecting a strong recovery. Both marine and inland and aquaculture fish production increased by 65.6 per cent and 7.5 per cent, respectively. However, marine fishing in some coastal areas remained restricted due to security reasons. Fishing industry is expected to recover fully in 2007 achieving a total fish production of around 300 million kg, exceeding the pre-tsunami production level.

Industry

During 2006 the industrial sector which includes mining and quarrying, manufacturing, electricity and water and construction grew by 7.2 per cent (8.3 per cent in 2005). The share of the industrial sector of total GDP remained unchange at 27 per cent. The share of the manufacturing sector which is the largest sub-sector declined to 16.0 per cent (16.3 per cent in 2005).

The output of the factory industries, which grew by 6.2 per cent in 2005 increased further by 5.9 per cent in 2006. This growth was achieved despite the challenges posed by the volatile oil prices, the intensified global competition in the apparel industry and the deceleration of economic activities in the Northern and the Eastern

Chart 2.3 **Composition of Industrial Production - 2006**

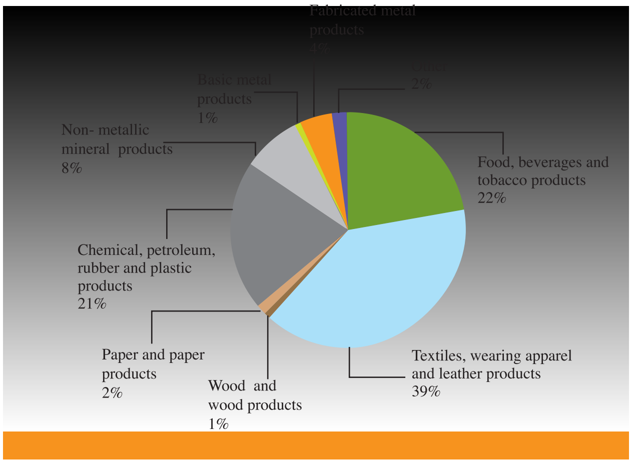


Table 2.7 **Value of Industrial Production (1990 Constant Prices)**

Category	Rs. million 2005	Rs. million 2006(a)	Rate of Change (%) 2005	Rate of Change (%) 2006(a)
1 Food, beverages and tobacco products	55,430	58,756	4.8	6.0
2 Textile, wearing apparel and leather products	97,576	101,772	4.9	4.3
3 Wood and wood products	1,659	1,709	3.1	3.0
4 Paper and paper products	4,000	4,136	3.0	3.4
5 Chemical, petroleum, rubber and plastic products	50,720	54,930	12.5	8.3
6 Non metallic mineral products	19,777	21,933	6.2	10.9
7 Basic metal products	2,600	2,759	5.9	6.1
8 Fabricated metal products, machinery and transport equipment	10,825	11,161	3.0	3.1
9 Manufactured products not elsewhere specified	5,366	5,548	3.1	3.4
Total	247,953	262,704	6.2	5.9

(a) Provisional

Source: Central Bank of Sri Lanka

Provinces due to the escalation of security concerns. Both the export market oriented industries and domestic market oriented industries contributed to this growth**.** Private sector industries, which accounted for 96 per cent of the output in the factory industry sector in 2006 grew by 5.8 per cent while public sector industries registered a 7.6 per cent growth. The two sub-categories of private sector industries, BOI and Non-BOI, grew by 5.9 per cent and 5.6 per cent respectively, and contributed 55 per cent and 45 per cent, respectively, to the overall factory industry output.

The impetus for growth in industrial output in 2006 arose mainly from four out of the nine industrial categories, viz., food, beverages and tobacco products; textile, apparel and leather products; chemical, rubber, plastic and petroleum products; and non-metallic mineral products. These categories accounted for around 90 per cent of the growth in the industrial sector in 2006.

The major drivers in the export oriented industries were textiles and apparel, rubber gloves and tyres, processed diamond, gem and jewellery, ceramic products, plastic products and petroleum products. These industries benefited from rapid global economic growth, expansion in trading activities with regional countries such as India and Pakistan under free trade agreements, penetration into new niche markets in Europe, Asia-Pacific and SAARC region, and increased demand from the US and the EU markets. The depreciation of the rupee, productivity improvements and enhanced marketing capabilities helped maintain the export competitiveness in the international market despite the relatively higher domestic inflation.

The domestic market oriented industries spread across a wide range of industrial products. These include

Table 2.8 **Ex - Factory Profit Ratios of Non - BOI Private Sector Industries (a)**

Category	Total Cost of Production (Rs. million)		Total Value of Production (Rs. million)		Factory Profit Ratio (percentage)	
	2005(b)	2006(c)	2005(b)	2006(c)	2005(b)	2006(c)
1 Food, beverages and tobacco products	85,934	94,086	100,615	110,365	14.6	14.8
2 Textiles, wearing apparel and leather products	22,546	23,532	25,734	26,942	12.4	12.7
3 Wood and wood products	1,689	1,813	1,913	2,050	11.7	11.6
4 Paper and paper products	5,107	5,721	5,820	6,544	12.3	12.6
5 Chemical, petroleum, rubber and plastic products	36,075	42,160	42,625	49,965	15.4	15.6
6 Non metallic mineral products	22,005	25,167	25,952	29,878	15.2	15.8
7 Basic metal products	2,461	2,832	2,865	3,305	14.1	14.3
8 Fabricated metal products, machinery, and transport equipment	13,794	15,258	15,933	17,679	13.4	13.7
9 Manufactured products not elsewhere specified	3,356	3,630	3,792	4,113	11.5	11.7
Total	192,967	214,199	225,249	250,841	14.3	14.6

(a) Based on information received from 510 non-BOI private sector firms
(b) Revised
(c) Provisional

Source: Central Bank of Sri Lanka

cement, building materials, ceramics, food, beverages, chemicals and fertiliser. The demand for these products grew in response to increased disposable income following the upward revision of salaries, growing construction industry and infrastructure development projects such as those related to roads, highways, telecommunication and ports. The establishment of new industries and relocation of industries under the *"Nipayum Sri Lanka"* 300 enterprises programme, the development of Thulhiriya textile complex and the progress in the *"Gamata Karmantha"* programme, are expected to expand the production capacity of domestic oriented industries further in the future.

Textiles, wearing apparel and leather products sector grew by 4.3 per cent in 2006 in comparison to the growth of 4.9 per cent achieved in 2005. This sub-sector contributed 39 per cent to the overall growth of factory industry in 2006**.** The slower growth in this sub-sector was mainly attributed to the decline in volume of apparel exports to the US market due to increased competition from low cost producing countries such as China, India, Vietnam, Bangladesh and Pakistan. However, this was partly offset by higher growth in exports to the EU market benefiting from the duty free concessions received under the GSP+ scheme. The apparel exports to the EU market in 2006 grew by 17.3 per cent. However, the full benefit of this scheme has not yet materialized due to difficulties in complying with the rigid ROO criteria which require apparel products to contain minimum 50 per cent of domestic value addition. Some manufacturers in the apparel industry were able to build up their strength through the gradual restructuring by way of increased product specialization, mergers and acquisitions, development of backward and forward linkages, improvements in quality of products and enhancement of marketing capabilities. The leather industry also performed well in 2006 with the concessions received under the GSP+ scheme.

The food, beverages and tobacco products, which are mainly catering to the domestic market, recorded a higher growth of 6.0 per cent and contributed 22 per cent to the overall growth in 2006. This higher growth is attributed to the improved performance in the processed food, beverages, liquor, ice cream, biscuits, milk products, mineral water, fruits and vegetables and canned products. Increased demand for fruits and vegetables from the UK and biscuits from regional countries and the Middle East countries, supported the growth of these industries. However, the output of tobacco products has declined, mainly due to the continuation of health awareness campaigns and the implementation of National Authority on Tobacco and Alcohol Act.

The output of chemical, petroleum, rubber and plastic products grew by 8.3 per cent in 2006. Major impetus to the growth of this sub-sector came mainly from the rubber based products, plastic and PVC products, chemical and petroleum products. The output of plastic and PVC products increased by 11.5 per cent with the growth of construction activities. The rubber based products grew by 10.4 per cent compared to 25.0 per cent growth rate achieved in 2005. This is mainly due to the deceleration of the export of tyres to the US market in 2006. However, the demand for rubber based products increased in the domestic market.

The output of non-metallic mineral products grew by 10.9 per cent in 2006. The high growth in this sub-sector was driven by cement, ceramics, building materials and processed diamonds. Cement, ceramics and building materials grew at a higher rate with the increased performance of the construction sector and the infrastructure development projects. Major manufacturers of cement and building materials have increased their capacities in order to meet the increasing domestic demand. Glass bottle manufacturing industry and gem and jewellery industry

2

NATIONAL OUTPUT AND EXPENDITURE

Table 2.9 Domestic Cost Structure of Non - BOI Private Sector Industries (a) (As a percentage of total cost of production)

	Category	Power & Fuel		Wage		Raw Material		Interest	
		2005	2006	2005	2006	2005	2006	2005	2006
1	Food, beverages and tobacco products	3.2	3.4	10.2	10.1	39.8	39.7	1.1	1.3
2	Textiles, wearing apparel and leather products	4.4	4.5	15.1	15.2	13.0	13.1	2.2	2.3
3	Wood and wood products	9.2	9.1	16.4	16.1	32.8	33.2	4.2	4.1
4	Paper and paper products	3.9	4.1	13.1	13.2	19.1	19.5	3.6	3.4
5	Chemical, petroleum, rubber and plastic products	6.0	6.4	13.0	13.3	29.8	30.4	3.4	3.5
6	Non metallic mineral products	19.3	19.9	14.9	14.9	28.9	29.2	2.9	3.2
7	Basic metal products	9.7	9.9	11.2	11.3	35.8	35.9	2.5	2.5
8	Fabricated metal products, machinery, and transport equipment	4.9	5.0	12.1	12.2	27.0	26.9	3.9	4.0
9	Manufactured products not elsewhere specified	5.3	5.2	11.9	12.0	34.8	34.6	1.5	1.4
	Total	6.0	6.3	12.0	12.3	31.4	32.1	2.2	2.3

(a) Based on information received from 510 non BOI private sector firms

Source: Central Bank of Sri Lanka

expanded their capacity and produced specialised items for the export market.

The fabricated metal products registered 3.1 per cent growth in 2006. The domestic demand continued to increase while exports also surged with the increased demand from the Middle Eastern countries.

The output of the public sector industries grew by 7.6 per cent in 2006 led by the Ceylon Petroleum Corporation (CPC), which accounted for 90 per cent of the public sector industrial output. The output in CPC grew by 7.8 per cent in 2006. The output in Sevanagala Sugar Industries and Lanka Salt Ltd grew by 27.4 per cent and 20.6 per cent, respectively, in 2006.

The profit ratio of the factory industry sector, estimated as the ratio of ex-factory value of production over the total cost of production of non-BOI firms surveyed in 2006 was 14.6 per cent and grew by 2.1 per cent compared with 2005. Increased domestic sales, effective sourcing of raw materials, better management of overhead costs, adoption of new technology, reduction of waste, enhanced labour productivity, better management of working capital, effective utilization of manpower, closure of non-profitable units and adoption of effective pricing policies helped to maintain the profitability of firms. Intensive utilization of information technology helped to improve strategic decision making and marketing which in turn led to the achievement of greater cost efficiency. The high costs of energy and imported raw materials increased the cost of production of firms during 2006. However, the rising cost of production was mitigated through the utilization of alternative energy sources.

Table 2.10 Labour Productivity Index in the Non-BOI Private Sector Industries (a)

1995=100

	Category	2005	2006	Change (%)
1	Food, beverages and tobacco products	132.5	135.8	2.5
2	Textiles, wearing apparel and leather products	113.2	117.3	3.6
3	Wood and wood products	103.1	105.5	2.4
4	Paper and paper products	103.7	106.3	2.5
5	Chemical, petroleum, rubber and plastic products	139.5	144.8	3.8
6	Non metallic mineral products	114.5	117.4	2.6
7	Basic metal products	103.0	105.3	2.3
8	Fabricated metal products, machinery, and transport equipment	123.8	127.5	3.0
9	Manufactured products not elsewhere specified	110.7	113.7	2.7
	Total	119.7	123.5	3.2

(a) Based on information received from 510 non-BOI private sector firms

Source: Central Bank of Sri Lanka

The wage bill of the factory industry rose by 17.4 per cent and as a percentage of total cost of production, increased from 12.0 per cent to 12.3 per cent in 2006. The wages, incentives and allowances were increased reflecting the impact of high inflation and inflation expectation on cost of production during the year. Firms have taken several cost reduction measures in order to control the rising wage bill. These include effective utilization of existing manpower, rationalising the overtime bill, improving productivity, outsourcing possible high cost units and engaging more casual or contract labour. Interest costs as a percentage of total cost of production increased marginally as the cost of borrowings continued to rise.

The value addition generated by the processing of plantation crops sub-sector was only marginal with a growth of 1.1 per cent particularly due to the drop in tea production, adversely affected by weather conditions and trade union actions during the latter part of the year. The growth in this sub-sector arose from the higher production in coconut and rubber with the increased demand for rubber at higher prices from both domestic and foreign markets.

The small industry sub-sector which recorded an impressive expansion of 9.8 per cent in 2005 decelerated to 5.3 per cent during 2006. The expansion in the construction sector exerted a positive impact on the small scale production of timber milling, rock metal production and tiles, bricks, cement blocks and related building materials. Small scale industrial activities of furniture and carpentry, bakery products, jewellery, garments and handlooms, leather footwear and other products also expanded in terms of value added contribution with the increased consumer demand. In tandem with the production of the agricultural outputs, paddy milling and other grinding activities expanded, but at a lower rate than that of the previous year.

The electricity and water sector continued to expand during 2006. This sector, which grew by 24.5 per cent in 2005, further expanded by 20.2 per cent during the current year . The high growth rate in this sector was realized through the expansion in the electricity sub-sector which grew by 22.2 per cent in value added terms during the year. The demand for electricity grew at a rate of 7.3 per cent from domestic, industrial and commercial and other sectors despite the increase in tariff rates, which were revised upwards twice during the year. In 2006, hydro power generation increased by 34.5 per cent while there was a drop in thermal power generation, as favourable weather conditions in the catchment areas induced the generation of hydro power which replaced the need for thermal power to some extent. Of the total power generation, the share of hydro power generation increased to 49.5 per cent from a share of 39.4 per cent in 2005. The water sub-sector, which includes collection, purification and distribution of pipe borne water, recorded a growth of 4.2 per cent (3.8 per cent in 2005). The various construction activities carried out during the year to make the basic need of water available to the masses contributed towards the growth.

The mining and quarrying sector expanded by 8.0 per cent in real terms, (14.1 per cent in 2005) supported by the boom in construction activities during the year which showed the quarrying sub-sector expanding in tandem. Mining sub-sector recorded a growth of 8.1 per cent in 2006. The growth in gem exports during the latter half of the year supported the growth in this sub-sector. Mining activities related to mineral sand and phosphate production declined during the year while there was an output increase in graphite production during the second half of the year.

During 2006 the construction sector recorded a growth of 8.0 per cent over a relatively high growth rate of 8.9 per cent in 2005. Tsunami related construction work continued to progress during 2006 as well, particularly in terms of housing projects, but at a lower growth momentum than in 2005 during which urgently required reconstruction activities took place. Construction activities related to the development of the road network and improvements in the power sector, together with projects to increase the public access to water resources consumed a significant portion of the spending from foreign funding. The expansion in the sector was also reflected in the growth in construction material consumption of both locally produced and imported items. Particularly cement consumption, which is a key indicator in the activity levels of the construction sector, continued to grow considerably in 2006 as well. Private sector construction in housing and condominium projects expanded during the year as reflected by the growth in advances obtained from the banking sector for the purpose of housing construction. But the significant price increase in construction materials had a dampening effect particularly on small scale construction activities. The overall price increase in building materials were observed in the price indices published by the Institute for Construction Training and Development (ICTAD) with an increase of 19 per cent over an increase of 14 per cent in 2005.

Services

As in previous years, the growth in the services sector provided the major impetus for growth in 2006. The services sector grew by 8.3 per cent and accounted to a share of 56.2 per cent of the GDP. The continuation of the growth momentum reflected in the sector, has mainly been a response to increasing consumer demand, for services in the country. The continued investment on economic services and infrastructure and productivity improvements also paved the way for emergence of the services sector as the main contributor of the economic growth.

The Wholesale and retail trade, hotels and restaurants sector recorded a growth of 5.9 per cent (2.8 per cent in 2005), largely due to the improved performance of the import trade sub-sector, which grew by 7.5 per cent, recovering from low growth in the last year. The structure of import trade growth reflected the expansion in domestic demand. The import of consumer goods increased by 10 per cent, in volume terms, while that of investment goods increased by 8.8 per cent. Of consumer goods imports, imports of basic food items, such as wheat grain and sugar increased while rice imports dropped due to the bumper harvest recorded in 2006. Imports of other consumer goods, such as motor vehicles and household goods, grew by 11.7 per cent. Within the investment goods category, imports of building material increased by 3.4 per cent as against the high base reflecting the expansion in the construction sector. However, the import of transport equipment dropped by 2.6 percent as against 11.8 per cent increase in the previous year. The volume of intermediate goods imports also grew by 5.0 per cent with the increase in crude oil, other petroleum and raw material imports for industries catering to the export and domestic market.

Export trade sub-sector recorded a growth of 4.4 per cent in 2006 as against 6.9 per cent in the previous year. The deceleration was partly due to lower growth in industrial exports particularly in other industrial category which consisted of food, beverages and tobacco, rubber products etc. Textile and garment exports which is the major contributor to the industrial exports grew by 5.1 per cent and exports of petroleum products and other types of industrial exports grew by 27.4 per cent and 0.8 per cent, respectively. Agricultural exports increased by 5.6 per cent with high exports in all three main plantation crops. Rubber exports expanded significantly by 42.8 per cent during the year in relation to a 17.5 per cent drop in 2005. The increase in the international prices of rubber by 43 per cent on average, also stimulated the exports.

The domestic trade sub-sector expanded by 4.5 per cent, mainly driven by the satisfactory performance in both the domestic agriculture and industry sub-sectors. Paddy production, fishing, small industry and domestic factory industries heavily contributed to this growth. However, the recent strengthening of security measures somewhat constrained the expansion of the domestic trading activities in the country.

The hotels and restaurants sub-sector recorded a growth of 6.3 per cent with a 1.9 per cent increase in tourist arrivals over the low base post-tsunami. This sector was however affected by the escalation of security concerns in the country during the second half of the year. Although the tourism industry has made an almost complete recovery from the damages caused by the tsunami and has reported 20 per cent growth in the first half of the year, the industry reported 5.8 per cent drop in the second half of the year. Low occupancy in the last quarter of the year in resorts and city hotels around the country have impacted heavily on the tourism sub-sector. Tourist arrivals from Western Europe increased only by 0.6 per cent, while tourists from the Asian sub-continent continued to increase by 8.4 per cent during the year. Although the tourist arrivals increased marginally during the year, foreign guest nights of graded hotels increased by 15.4 per cent while local guest nights dropped marginally.

Within the services sector, Transport, storage and communication expanded by 13.1 per cent, (11.7 per cent in 2005) owing largely to robust expansion in the post and telecommunications sub-sector. This sub-sector, that had continued to grow at a high pace, expanded further by 23 per cent, benefiting from recent developments in telecommunication, particularly broad band networks and expansion in coverage with new technology in communication. Mobile and Fixed line service providing companies in telecommunication industry have had an excellent year, marking a significant 37 per cent growth in revenue. Clearing the backlog for fixed telephone lines with CDMA technology, subscriber levels of Fixed Access–Local Loop subscriber level recorded 651,681 new connections, an expansion of 52 per cent during the year. In the recent past, both CDMA and GSM technology had allowed rural residents to get phone services immediately. The subscriber level of mobile phones expanded further by 61 per cent and the subscriber level is reported to be 5.4 million. Meanwhile, the Internet and e-mail subscriber level grew by 13 per cent with developments in infrastructure which provide good quality, high speed data connectivity for internet access.

The cargo handling, storage and warehousing sub-sector expanded by 13.2 per cent during the year. Despite the work to rule campaign at the Jaya Container Terminal (JCT) by trade unions in the month of July, the number of containers handled, transshipment activities and total cargo handled had improved considerably. The commencement of new shipping services through the Port of Colombo by more international shipping companies also contributed to this growth. The Colombo Port including South Asia Gateway Terminal (SAGT) handled a significant volume of 3.08 million TEUs in 2006. The transshipment volume which usually accounts for around two thirds of the total throughput handled, expanded by 37 per cent, while domestic throughput volume increased marginally.

The transport sub-sector expanded by 5.1 per cent as against the growth of 3.3 per cent during the previous year. Growth in Road haulage activities by 5.3 per cent was mainly owing to satisfactory performance in external trade activities and was the reason for this growth. Aviation services grew further in 2006 with the total passenger kilometres flown by the Sri Lankan Airlines and domestic airlines had increased by 9 per cent, despite high fuel prices and a drop in tourist arrivals. The passenger kilometres operated by Sri Lanka Railways and Cluster Bus Companies had declined during the reference period.

The Financial services, real estate and business services sector, which includes banking, insurance and all other financial services, real estate, ownership of dwellings, renting and all other business service activities, grew by 9.7 per cent in 2006, as against 6.5 per cent growth in the previous year. Financial services reported 10.5 per cent growth with credit expansion of the banking sector and healthy performances in other financial services sub-sectors. During the year, income of the commercial banks expanded significantly with increase in interest income on advances and investments on securities. Meanwhile, non-interest income of the commercial banks improved owing to increased activities in the forex market. Leasing and registered finance companies also reported healthy growth during the year. The better performance in real estate and higher activities in certain business services had resulted in expansion of the real estate, renting and business services sub-sector by 6.2 per cent. The real estate sector recorded a significant growth with the boom in condominium development projects. Many conglomerates also invested in condominium industry during the year due to the profitability in real estate activities.

The Public administration, other government services and defence and other community, social and personal services sector grew by 2.8 per cent as against an increase of 5.4 per cent during the previous year. The Public administration, other government services and defence sector reported only a 1.5 per cent growth as there were no major public sector recruitment programmes during the year. However growth in this sub-sector was partly due to the expansion in armed forces. The other community, social and personal services sub-sector recorded a growth of 4.8 per cent partly due to healthy growth in the private health care industry, entertainment and educational services.

2.4 Expenditure

The aggregate demand generated by domestic economic activity is measured by Gross Domestic Expenditure (GDE), which is the sum of consumption and investment expenditure of the private and public sectors of the economy. In 2006, GDE (aggregate domestic demand) at current market prices was estimated at Rs. 3,125 billion, reflecting an increase of 20.9 per cent over 2005. The corresponding increase in domestic demand for 2005 was 16.7 per cent. The higher economic growth as well as higher growth in prices in 2006 stimulated the higher expansion of the GDE. GDE grew by 8.7 per cent in real terms as against a growth of 4.7 per cent in 2005. Although both private consumption and private investment expenditure rose during 2006, the share of consumption expenditure as a percentage of GDP declined to 73.8 per cent, which indicates a higher growth in investment activities in the economy. GDP at current market prices, which is the sum of GDE and net imports of goods and non-factor services, was estimated at Rs. 2,802 billion, a growth of 18.4 per cent.

Consumption

Consumption expenditure which captures both the private and government sector consumption of the economy has expanded by 18.6 per cent to Rs. 2,322 billion during 2006. This growth in consumption was a result of real consumption expanding by 7.2 per cent and of the overall increase in price levels by 10.7 per cent. Of the total consumption, Private Consumption Expenditure (PCE) constituted a share of 89 per cent, which showed a decline from a share of 90 per cent in 2005. In terms of origin of production, expenditure of locally produced goods and services has grown by 14.6 per cent whilst that of imported goods and non-factor services increased by a higher margin of 24.8 per cent.

The declining trend observed in the expenditure share of food and non-alcoholic beverages during the recent years reversed to some extent during 2006, where the share of this category showed a marginal increase to 33.1 per cent. Meanwhile, expenditure rose by 19.7 per cent in nominal terms during the year. Although expenditure on rice, which is the staple food, declined due to the drop in price levels with record harvests, many other food items such as fish, sugar and milk products showed an increase. Meanwhile expenditure on alcoholic beverages, tobacco and narcotics grew at a rate of 11.5 per cent, partly reflecting the upward revision in excise duties.

The expenditure on clothing and housing related goods and services grew in a range of 7 to 10 per cent in 2006. Meanwhile, expenditure on clothing and footwear articles grew at a lower rate than that of the previous year although footwear imports increased by a significant amount. Of the housing utilities energy needs increased with higher

Table 2.11 Aggregate Demand

Item	Current Market Prices (Rs.mn) 2004	2005(a)	2006(b)	Constant (1996) Prices (Rs.mn) 2004	2005(a)	2006(b)
A. Domestic demand						
Consumption	1,706,994	1,956,987	2,321,881	981,917	1,009,751	1,082,130
(% Change)	15.2	14.6	18.6	5.0	2.8	7.2
Gross domestic capital formation	506,942	627,533	803,366	294,255	326,587	370,229
(% Change)	30.4	23.8	28.0	11.7	11.0	13.4
Total domestic demand	2,213,936	2,584,520	3,125,247	1,276,172	1,336,338	1,452,358
(% change)	18.4	16.7	20.9	6.5	4.7	8.7
B. External demand						
Exports of goods and non-factor services	736,967	792,656	885,947	424,137	447,943	469,330
(% change)	16.4	7.6	11.8	7.6	5.6	4.8
Imports of goods and non-factor services	921,537	1,011,583	1,209,367	617,732	636,429	689,436
(% change)	24.3	9.8	19.6	9.1	3.0	8.3
Net external demand	-184,571	-218,927	-323,420	-193,595	-188,486	-220,106
C. Total demand	2,029,365	2,365,593	2,801,828	1,082,577	1,147,852	1,232,252
(% change)	15.2	16.6	18.4	5.4	6.0	7.4

(a) Revised
(b) Provisional

Source : Central Bank of Sri Lanka

Table 2.12 **Composition of Private Consumption Expenditure at Current Market Prices**

	Share of Total PCE (%)			Rate of Change (%)	
	2004(a)	2005(b)	2006(c)	05/04	06/05
01. Food amd non-aloholic beverages	32.6	32.5	33.1	13.9	19.7
02. Alcoholic beverages, tobacco and narcotics	4.4	4.3	4.1	13.6	11.5
03. Clothing and footwear	6.0	5.8	5.3	9.2	7.5
04. Housing and utility services	16.1	15.6	14.4	10.7	10.2
05. Household equipment and services	5.0	5.0	4.7	14.6	8.7
06. Health	3.7	3.8	3.5	16.0	10.0
07. Tramsport	12.1	11.9	13.5	12.1	33.3
08. Communication	2.4	2.8	3.4	34.8	42.7
09. Recreation and entertainment	3.5	3.7	3.6	22.5	11.8
10. Education	1.6	1.6	1.5	14.7	10.3
11. Restaurants and hotels	1.4	1.4	1.3	15.9	10.9
12. Miscellaneous goods and services (d)	11.3	11.6	11.4	17.7	15.1
Total private consumption expenditure	100.0	100.0	100.0	14.3	17.4

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

electricity tariffs and fuel costs while consumer spending on household appliances increased by 8.7 per cent.

Private spending on transport related activities grew by 33.3 per cent in nominal terms. The increase in motor vehicle purchases, as reflected by import statistics and the registration of new motor vehicles, was a source for the increased spending in this category. Also, expenditure on operation of personal transport equipment and transport services grew with increased bus fares and overall increases in fuel prices.

Out of all the expenditure categories, private spending on communication services continued to be the fastest growing consumer item as in the previous year. Consumer spending on telecommunication services continued to expand during 2006 with service providers expanding their reach in the market with new technological advancements and falling call rates. Meanwhile the nominal growth in expenditure in communication services was a significant 42.7 per cent. This category represents a share of 3.4 per cent of total expenditure.

During the year, expenditure on health services and education activities rose by 10 per cent in nominal terms showing a deceleration compared to 2005. As the population ages, the increase in health expenditure is an expected phenomena and the growth in medical and pharmaceutical imports also reflected a similar trend. Spending on education services diversified particularly with the active participation of the private sector.

Spending on recreation and entertainment activities together with restaurants and hotels grew by over 10 per cent. This shows a declining trend in growth momentum as compared with a growth rate of over 15 per cent recorded in 2005. Due to the escalation in security concerns, there was a decline in domestic tourist activities in the affected areas, but with changing lifestyles the spending on other recreation and restaurant activities increased although at a lower rate compared to that of the previous year.

During the past couple of years, PCE in general has seen a declining share in terms of spending on goods. However in 2006, there has been a deviation in this trend with spending on goods increasing at a higher rate. This partly reflected the impact of increasing price levels particularly during the latter part of the year.

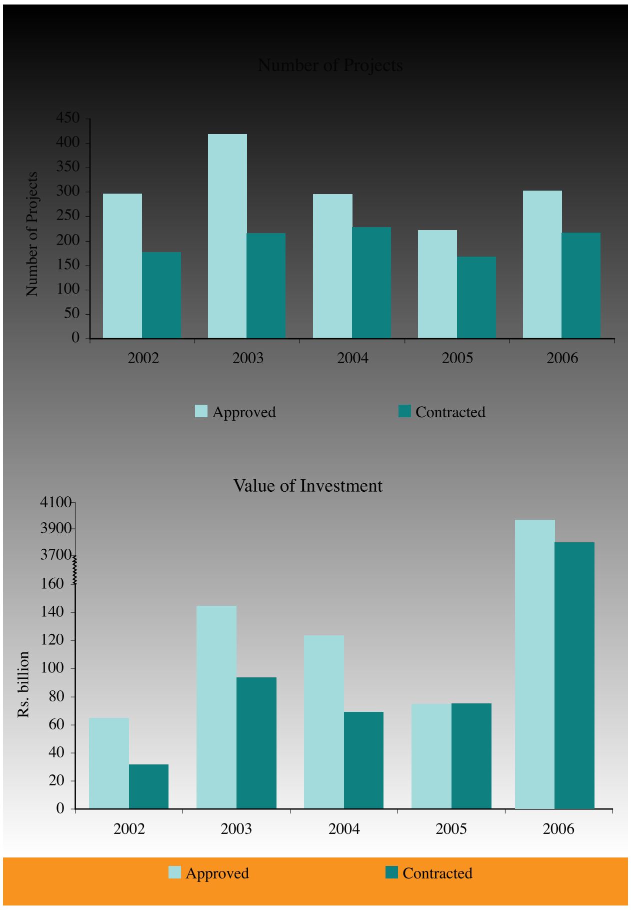
Government sector consumption increased by 29.9 per cent in nominal terms during 2006 compared to a relatively lower growth of 18.3 per cent in 2005. The increase in the government wage bill with higher salaries to public sector employees and the higher level of expenditure incurred in obtaining other goods and services with the security situation in the east as well as the natural disasters that occurred during the year contributed towards the expansion in government consumption. In addition, the government spending on interest payments and transfers to household sector, public enterprises and institutions also rose during 2006.

Investment

Investment expenditure (gross domestic capital formation) at current market prices was estimated at Rs. 803 billion, an increase of 28 per cent over 2005. In real terms, it grew by 13.4 per cent and as a ratio of GDP, investments further improved to 28.7 per cent (26.5 per cent in 2005).

Growth in private investment which includes public corporations, accelerated to 31.7 per cent in 2006 as business confidence strengthened with political stability. The stronger growth was mainly due to high capacity utilization arising from improved external and domestic demand. Higher capital expenditure was evident

Chart 2.4 **Investment in Approved and Contracted BOI Projects**



in the economy with the factory industry, construction and telecommunication sectors registering higher levels of investments during the year. The growth in private investment was also supported by increase in foreign direct investments and imports of investment goods.

The inflow of foreign direct investment increased substantially by 110.3 per cent to US dollars 604 million in 2006 showing an increasing trend in the recent past. This growth was achieved through increased efforts of the BOI facilitated by preferential tax rates and constitutional guarantees on investment agreements. Several investment promotion activities such as outward investment promotion missions with business delegations and exhibitions were undertaken in 2006 by the BOI to increase foreign inflows to the country. Of the total foreign direct investment in 2006, more than 60 per cent was invested in telecommunication sector, textiles, wearing apparel and leather industry. Under Sections 17 and 16 of the BOI Act, 354 projects were approved in 2006 with an investment commitment of Rs.3,991.6 billion compared with 374 projects approved in 2005 with an investment commitment of Rs.79.5 billion. There was also a local mega investment in the area of airline services in 2006. The accumulated realised investments in the BOI projects was Rs.468 billion and increased by 23.2 per cent in 2006 compared with Rs. 380 billion in 2005.

Of the 354 approved projects under Sections 17 and 16 of the BOI Act, 82 projects were fully foreign owned and 87 were joint ventures between Sri Lankans and foreign investors, while the rest were fully owned by Sri Lankans. The services sector was the major recipient of investment flows which absorbed 222 approved projects with an investment commitment of Rs.3,942.5 billion in the areas of airline services, telecommunication, housing property development and office complexes, hotels and restaurants, power generation, Information Technology (IT) and Business Process Outsourcing (BPO). Within the industrial sector, the largest share of investment was absorbed by textile wearing apparel and leather products, food, beverages and tobacco products, chemical, rubber and plastic product and non-metallic mineral products.

Table 2.13 **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.)	
	2005(a)	2006(b)	2005(a)			2006(b)			2005(a)	2006(b)
			Foreign	Local	Total	Foreign	Local	Total		
BOI										
Projects Approved	374	354	31,511	47,961	79,473	229,363	3,751,113	3,991,576	35,971	80,107
Under Section 17	222	303	27,767	46,863	74,631	220,756	3,749,880	3,970,636	29,367	65,292
Under Section 16	152	51	3,744	1,098	4,842	8,607	1,233	20,940	6,604	14,815
Projects Contracted Under Section 17	167	217	32,363	42,562	74,925	38,756	3,699,328	3,738,085	24,536	41,559
Realised Investment Under Section 17 (c)	1,871	1,929	233,523	146,606	380,129	285,367	182,650	468,016	410,851	420,690
Commercial Operations (c)	2,463	2,456	183,186	164,205	347,391	183,202	170,669	353,871	395,201	379,945
Under Section 17 (c) (d)	1,642	1,615	166,596	153,267	319,863	166,278	159,711	325,989	357,681	341,909
Under Section 16 (c)	821	841	16,590	10,938	27,528	16,924	10,958	27,882	37,520	38,036
MID										
Projects Registered (c)	1,641	1,629	n.a.	n.a.	118,502	n.a.	n.a.	119,344	282,036	273,553

(a) Revised
(b) Provisional
(c) Cumulative as at end of year
(d) Includes expanded projects

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

Table 2.14 **Total Resources and Their Uses at Constant (1996) Prices**

Item	Percentage Share 2005(a)	Percentage Share 2006(b)	Percentage Growth 2005(a)	Percentage Growth 2006(b)
A. Resources				
Gross domestic product	64.3	64.1	6.0	7.4
Imports of goods and non-factor services	35.7	35.9	3.0	8.3
Total	100.0	100.0	4.9	7.7
B. Utilisation				
Consumption	56.6	56.3	2.8	7.2
Gross domestic fixed Capital formation	18.3	19.3	11.0	13.4
Private	14.7	16.1	-0.2	17.8
Government	3.6	3.2	105.7	-5.0
Change in stocks	0.0	0.0	23.4	5.2
Export of goods and non-factor services	25.1	24.4	5.6	4.8
Total	100.0	100.0	4.9	7.7

(a) Revised
(b) Provisional

Source :Central Bank of Sri Lanka

The number of projects contracted under Section 17 of the BOI Act increased to 217 compared with 167 projects in 2005. The services sector accounted for 99 per cent of the contracted investment in 2006. Airline services, real estate, power generation, ports and highways and telecommunication were the major recipients of the services sector while textiles wearing apparel and leather products, food, beverages and tobacco products and chemical, rubber and plastic products categories were among the major recipients of the factory industry.

Under Sections 17 and 16 of the BOI Act , 2,375 projects commenced commercial operation in 2006 compared with 2,385 in 2005. The Industrial sector which absorbed 50 per cent of these projects comprised of textiles, wearing apparel and leather products, chemical, rubber and plastic products, food, beverages and tobacco products and non-metallic mineral products. The Services and Agriculture sectors absorbed the remainder of the projects in 2006.

During 2006, 1,629 enterprises were registered under the Ministry of Industrial Development. Within the total registration of enterprises, textiles, wearing apparel and leather products category accounted for a large number of enterprises (405) followed by chemical, rubber, plastic and petroleum products (380), fabricated metal products (268), food, beverages and tobacco products (197), non-metallic mineral products (84) and of these enterprises, 83 per cent were located in the Colombo and Gampaha districts representing 94 per cent of total investment.

Government investment expenditure, which continued to increase, was estimated at Rs.108 billion. The investment was mainly focused on economic and social development of the country. Greater infrastructure facilities will create economic opportunities by attracting foreign as well as local investors. Government also paid an attention in 2006 to develop infrastructure facilities in the areas of roads and highways, railway lines and transport, telecommunication, ports and airports, coal and hydro power, irrigation and water supply. Meanwhile, government investment also focused on education and health development for maintaining the social standard of the country.

Availability and Utilisation of Resources

The total available resources in the country which consist of GDP (domestic resources) and imports of goods and non-factor services (foreign resources), were estimated at Rs. 4,011 billion at current market prices. This was an increase of 18.8 per cent (Rs. 634 billion) over 2005. Of this increase, Rs. 436 billion was domestic resources and Rs. 198 billion was foreign resources. In real terms, foreign resources grew by a higher rate of 8.3 per cent (3 per cent in 2005) so that the total availability of resources achieved a 7.7 per cent growth (4.9 per cent in 2005) as in the previous year, domestic resources accounted for 64 per cent while foreign resources added the balance 36 per cent, but there was a marginal shift towards foreign resources.

Chart 2.5 **The Economy in 2006 (at current prices)**

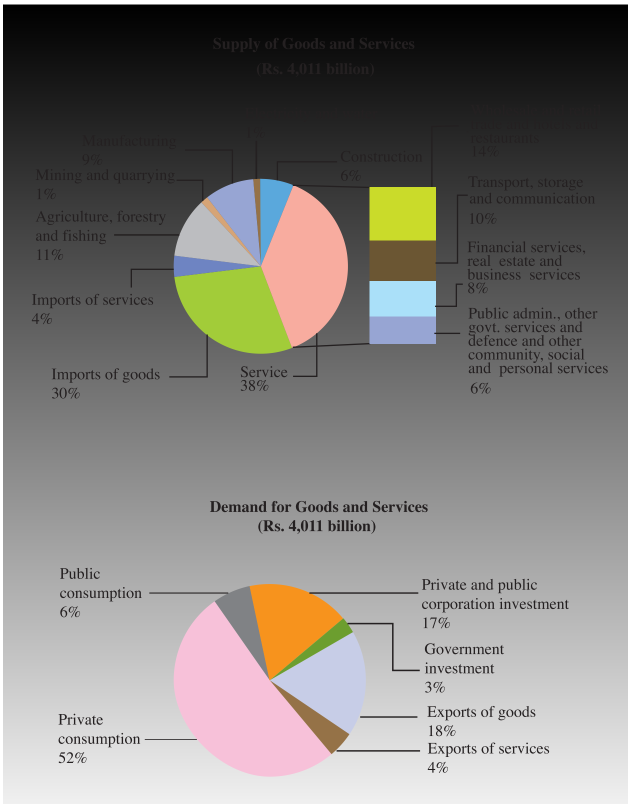


Table 2.15 **Consumption, Investment and Savings at Current Market Prices**

Item	Rs. million 2005(a)	Rs. million 2006(b)	Percentage Change 2005(a)	Percentage Change 2006(b)	Per cent of GDP 2005(a)	Per cent of GDP 2006(b)
1. Gross domestic product at market prices	2,365,593	2,801,828	16.6	18.4	100.0	100.0
2. Consumption expenditure	1,956,987	2,321,881	14.6	18.6	82.7	82.9
Private	1,761,894	2,068,512	14.3	17.4	74.5	73.8
Government	195,093	253,369	18.3	29.9	8.2	9.0
3. Investment	627,533	803,366	23.8	28.0	26.5	28.7
Private	528,202	695,609	14.4	31.7	22.3	24.8
Government	99,331	107,757	119.5	8.5	4.2	3.8
4. Domestic savings	408,606	479,947	26.8	17.5	17.3	17.1
Private	472,210	550,073	17.9	16.5	20.0	19.6
Government	-63,604	-70,126	18.7	-10.3	-2.7	-2.5
5. Domestic savings - investment gap	-218,927	-323,420	-18.6	-47.7	-9.3	-11.5
6. Net factor income from abroad	-30,049	-40,752	-45.3	-35.6	-1.3	-1.5
7. Net private transfers from abroad	174,426	215,093	27.7	23.3	7.4	7.7
8. National savings	552,983	654,287	26.2	18.3	23.4	23.4

(a) Revised
(b) Provisional

Source :Central Bank of Sri Lanka

The utilization of resources mainly consisted of consumption, fixed capital formation and export of goods and non-factor services. In 2006, consumption absorbed 56 per cent of resources, with a growth of 7.2 per cent (2.8 per cent in 2005), while fixed capital formation absorbed 19 per cent with a growth of 13.4 per cent (11 per cent in 2005) in real terms. Export of goods and non-factor services grew by 4.8 per cent, while its relative share dropped marginally to 24.4 per cent reflecting a lower growth rate than in 2005.

Of the total supply of goods and services at current prices, the share of domestic economic activities was 66 per cent, while the rest was imported. The supply of domestic services, which had a share of 38 per cent in the previous year remained unchanged in 2006 while the share of domestic goods went down to 28 per cent from 30 per cent, where contributions of manufacturing and agriculture sub-sectors fell by 1 per cent each. In contrast, the supply of imported goods increased to 30 per cent from 28 per cent and import of services remained unchanged at 4 per cent as in the previous year.

Of the total demand for goods and services, the shares of consumption and capital formation in current terms increased marginally to 58 per cent and 20 per cent, respectively while exports of goods and services declined marginally to 22 per cent, over the previous year. Of the total domestic demand, the private sector accounted for 87 per cent of investment (84 per cent in 2005) and around 89 per cent of consumption (90 per cent in 2005) following higher expansion in government consumption.

Savings

Although in 2006 both domestic and national savings grew at high rates, as a ratio of GDP it dropped marginally as the GDP at current market prices also increased at a higher rate. The resource gap, the difference between domestic savings and investment as a ratio of GDP, increased significantly to 11.5 per cent from 9.3 per cent, with the growth in the investment ratio rising faster than the growth in the domestic savings ratio.

Domestic savings which include both private and government savings increased by 17.5 per cent to Rs. 480 billion. The private sector savings increased by 16.5 per cent with increased corporate sector and personal savings while the government savings which is defined, as the current account balance of the government budget, was negative but improved as a percentage of GDP by a further 2.5 per cent compared to 2005.

National Savings the sum of domestic savings, net factor income from abroad (NFIA) and net foreign private transfers increased by 18.3 per cent to Rs. 654 billion. NFIA continued to be negative and deteriorated further to Rs. 41 billion with the increase in interest payment. The net private transfers which consists of worker remittances increased by 23 per cent to Rs. 215 billion.