1. INTRODUCTION

The Sri Lankan economy began to show signs of recovery in 2002. Yet, the recovery is not sufficiently broad-based and is below the original expectations. This underscores the need for continuing with the reform programme with greater vigour, in order to push the economy on to a higher sustainable growth path. During the first half of 2002, the economic growth turned around to positive growth, albeit low; inflation decelerated, though still high; external reserves increased, though still below the required level for comfort; financial market and exchange rate stability strengthened; some fiscal consolidation was shown, with the implementation of the 2002 Budget proposals, and there are signs of improved business confidence. The major contributory factors for the achievements are the continuing cessation of hostilities, decline in interest rates, capital inflows, some degree of political stability, removal of the war risk insurance premium on vessels arriving in Sri Lanka, improved weather and some recovery in the world economy. Further improvement of these favourable developments is expected during the second half of the year, benefitting mainly from progress in the peace process, restoration of uninterrupted power supplies, and recovery in the demand for exports with the expected recovery in the world economy.

However, the revised annual macroeconomic framework for 2002 raises concerns about the pace of economic recovery and the continued vulnerability of the economy. It appears that economic growth, investment expansion and surplus in the balance of payments (BOP) would be lower, while inflation, unemployment, budget deficit, public sector borrowing, public debt burden and monetary expansion would be higher, in relation to expectations at the beginning of the year, as well as compared with the desired targets. These deviations are mainly due to factors, such as a continuing weak export demand, unfavourable terms of trade and the lagged effect of the severe drought and terrorist attacks experienced in 2001, all beyond the control of policy makers. An exacerbation of these deviations could be prevented by maintaining policy consistency and making timely policy adjustments and structural reforms.

As a highly trade-dependent country, Sri Lanka's economic difficulties are likely to be further aggravated by increasing competition in export markets. This competition arises particularly from low cost producing countries such as China, which have undertaken aggressive export drives. Further, the high frequency and the size of external shocks, in the absence of corrective measures, could lead to erosion of the resilience of the economy. Therefore, future economic prospects of the country depend heavily on the speed and the intensity of adjustments and reforms in the economy. Furthermore, recent studies[(1)] bear evidence that a fiscal policy stance resulting in a continuous high deficit and ballooning public debt, is neither desirable nor sustainable.

[(1)] IMF (2002), Sri Lanka : Selected Issues and Statistical Appendix, Washington D.C.

Given the need for the early resolution of the three major burning economic issues, viz., inflation, unemployment and poverty, economic growth on a sustainable basis becomes of paramount importance. This requires that the country moves to a higher sustainable growth path. The main problem is the resolution of the long standing recurrent and structural fiscal deficits. In order to achieve this objective, it is imperative that an economy-wide, deep structural reform programme, which has been initiated, should be pursued with vigour. These reforms should cover such areas as labour, land markets, the financial sector, public enterprises, the civil service, pension benefits, the judicial system, and the regulatory framework and governance. All these indicate the necessity for implementing strong medium-term fiscal adjustments and an accelerated structural reform programme without further delay.

The reforms initiated so far augur well and signify a strong commitment to improving economic performance. Among these have been the simplification of the tax system with the introduction of the more efficient VAT system, the implementation of an automatic pricing formula for petroleum products, the easing of restrictive and inefficient legal constraints on the labour market, improving targetting under welfare schemes, the continuation of restructuring and divestment of state owned enterprises, and greater use of private sector-public sector participation in economic activity.

In the short-run, such policy adjustments and structural reforms may entail imposition of temporary burdens on some sections of society. The nature of these burdens should be explained to the public in terms of short-term sacrifices for medium and longer-term gains. Such a move will help develop a national consensus and marshal support for the reforms. Similarly, it is essential to resist pressure coming from rent-seekers, who benefit from growth retarding regulations. The nation as a whole should be enlightened on the long-term benefits to society arising from high growth.

The strong initiatives taken for restoring peace are clearly of paramount importance in regaining economic prosperity for the country. The ceasefire has created confidence in economic activity. The initiation of the peace negotiations has also evoked strong support and goodwill from the international community. To maximise potential gains it is essential to take strong and clear policy initiatives. The successful completion of the Stand-By Arrangement (SBA) with the International Monetary Fund (IMF) has improved the credibility of the country's economic policy, creating an ideal opportunity for an early finalisation of the long overdue Poverty Reduction and Growth Facility (PRGF) negotiations with the IMF/World Bank. The PRGF will not only enable the country to obtain large external financial resources at concessional rates with longer maturities from the IMF and the World Bank, but also play a catalytic role by encouraging other donor support necessary for longer-term reforms in the economic structure. The international donor community will also offer substantial assistance for the restoration of peace, rehabilitation and reconstruction. Thus, conditions seem to be ideal to launch an economic reform programme containing strong adjustments and deeper structural reforms to revitalise the economy. Missing this opportunity now will not only entail huge opportunity costs, but will also inevitably necessitate more difficult and painful adjustments in the future.

Growth

- Growth in the gross domestic production (GDP) during the first half of 2002 was 1.4 per cent, a turnaround from the economic contraction of 3.5 per cent in the second half of 2001[1]. The economy is expected to perform better during the second half of the year (around 5 per cent), enabling an annual growth rate of 3 per cent, compared with a reduction in GDP by 1.4 per cent in 2001.

Chart 1.1
Quarterly Real GDP Growth Rate 1997 - 2002

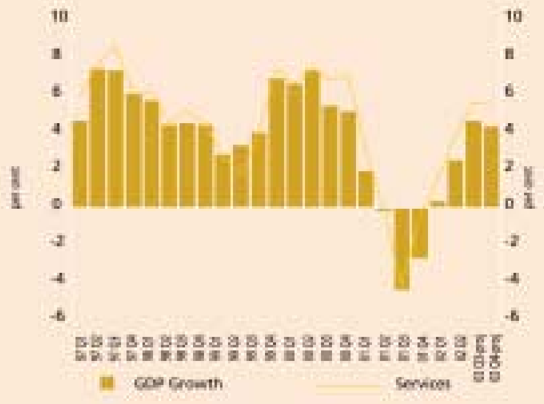
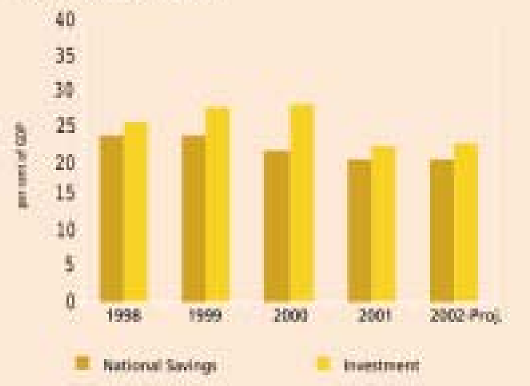


Chart 1.2
Investment and Savings



- However, this annual growth for 2002 is lower than the original expectation of 3.7 per cent, and the historical average of about 5.0 per cent. Slower growth comes from weak export demand and the lagged effect of the prolonged drought in 2001. This also reiterates the need for strong adjustments in the economy.

- The economic recovery is expected to be widespread, though it will be very low in the Industrial sector in response to slow recovery in export demand. The Agriculture sector, which grew by 3.2 per cent in the first half of 2002, mainly due to a good Maha paddy harvest, is estimated to grow at 1.9 per cent during the year with recovery in all major crops, except coconut, due to the lagged drought effect. The Services sector, which accounts for more than half of GDP, grew by 2.7 per cent in the first half and is expected to grow at 4.2 per cent annually with recovery in trade, tourism and port activities and continued high growth in the telecommunication sector. The Industrial sector, which recorded a negative growth of 2.5 per cent in the first half, is expected to recover only slightly, recording an annual growth rate of 1.3 per cent.

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(1) Provisional annual estimates for 2002 and projections for 2003 are based on data available at end September 2002.

- Within aggregate demand, domestic demand is estimated to make a large contribution to growth in 2002, while exports are estimated to have a contractionary impact. Investment as a ratio of GDP is estimated to increase to 22.5 per cent of GDP. However, this is still well below the average value of about 28 per cent in 1998-2000.

- The main contributory factors for the recovery in demand in 2002 are improved business confidence with clearer prospects of peace, removal of the war risk premium in March 2002, decline in interest rates, increase in capital flows, stable power supplies since May, higher rainfall and recovery in the world economy, albeit slow.

Chart 1.3
Labour Market

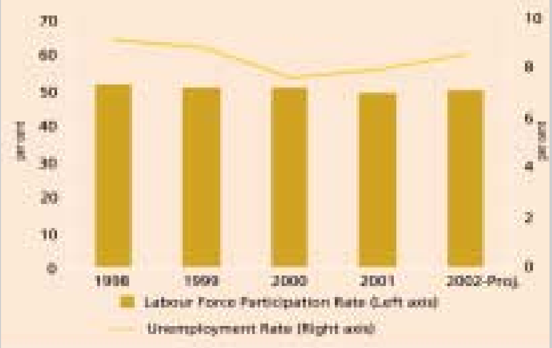
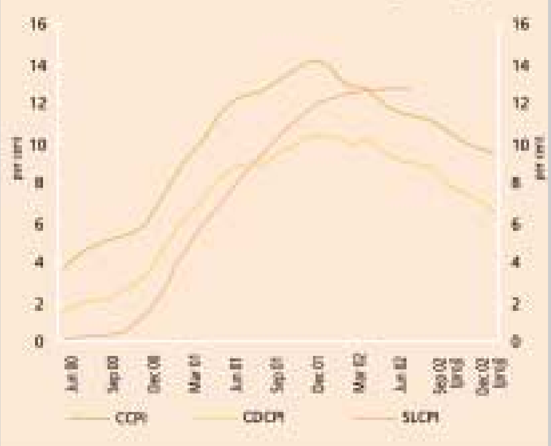


Chart 1.4
Consumer Price Indices (12 -month average change)



- With inadequate growth and investment, unemployment would increase to 8.5 per cent in 2002 from 7.9 per cent in 2001. The availability of foreign employment opportunities has been increasing but not sufficiently to absorb the entire increase in the labour force.

Prices and Wages

- The inflation rate decelerated in 2002 reversing the trend in 2001, but remains high. The annualised inflation rate declined from 10-14 per cent (depending on the selected consumer price index) at end 2001 to 9-13 per cent in June 2002, despite increases in some administered prices including electricity and water tariffs, transport fares and telecommunication rates. The downward trend in inflation is expected to continue, reducing the annual inflation to about 8-10 per cent by end 2002, in response to a prudent monetary policy stance, increasing domestic agricultural output, stability in the exchange rate, and lighter pressure from import prices, except petroleum. Furthermore, the removal of transport barriers with the peace process will also help to ease prices through a reduction in transport costs and delays.

- Pressures continue for high wage increases, but the ability to accommodate large wage increases in 2002 seems to be limited due to low growth momentum and the squeeze in profit margins in major export sectors. Workers in some sectors such as plantations received a high wage increase this year, but in general, sharp increases in real wages are not only not desirable in the present economic and fiscal situation, but would hinder the ongoing economic recovery. Developing a performance-based wage determination system is critical in containing the potential risk of a wage-price spiral as well as ensuring external competitiveness of the economy.

Chart 1.5
Budget Deficit

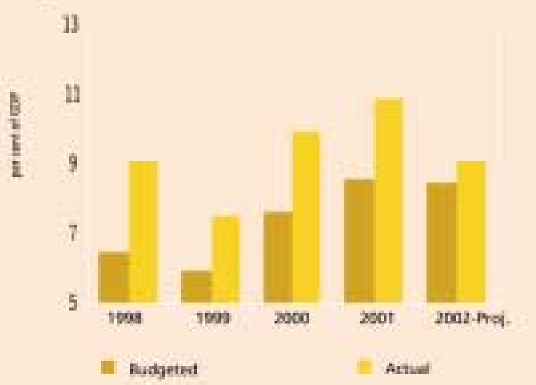


Chart 1.6
Government Revenue

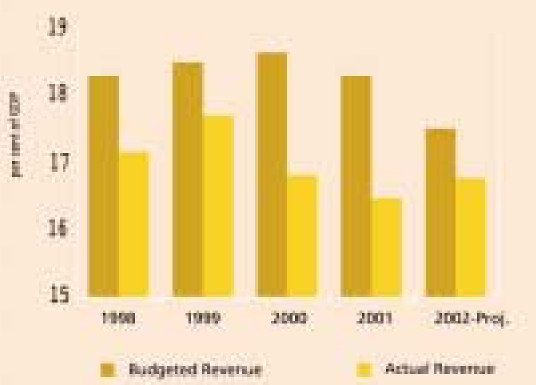
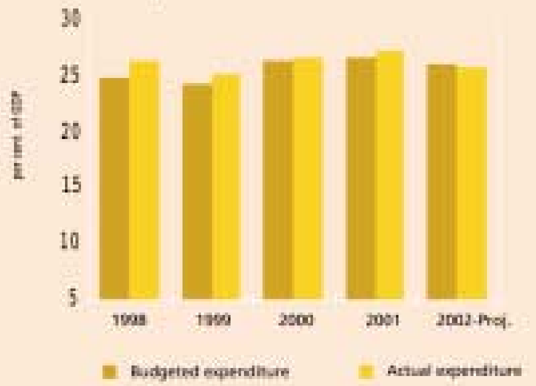


Chart 1.7
Government Expenditure



Public Finance

- As continuously high fiscal deficits had been the root cause of the main economic ills in the recent past, the consolidation of fiscal activities was the primary objective in Budget 2002. Accordingly, a series of measures was announced in Budget 2002 to rationalise all three key areas; taxation, expenditure and public debt management. Measures aimed at removing constraints to attract investment, and granting incentives to renew investor confidence were also included in the Budget to support economic recovery.

- The highest priority has been given to reforming the existing tax system by minimising the complexity of the tax structure, eliminating ad hoc tax concessions, improving tax administration and strengthening tax collection. On the expenditure side, a hiring freeze in the public sector, lowering the provision for defence services, better targetting mechanisms in subsidy programmes and limited allocation for unclassified and unforeseen expenses were the major measures. The definition of government borrowing has been expanded to cover all instruments including bank overdraft facilities and import bills, which rose sharply in the recent past, while high-cost short-term borrowing has been converted to low-cost normal borrowing.

- However, the revised annual budgetary outturn for 2002 is out of alignment with the original expectations, with a rising fiscal deficit and increasing borrowing. The public debt burden is likely to rise to about 105 per cent of GDP by end 2002, emphasising the need for corrective measures to contain fiscal slippages.

- The revised deficit is likely to be about Rs.140 billion (i.e., about 8.9 per cent of GDP), compared with the target of Rs.135 billion (8.5 per cent of GDP). The main reasons for the widening deficit are the reduction in revenue by about Rs. 16 billion, largely due to shortfalls in tax revenue from GST/VAT and imports and lower non-tax revenue collection. However, a part of the increase in the deficit will be offset by a reduction in expenditure by about Rs. 11.6 billion, due to savings in current expenditure and lower public investment than expected, which could have adverse impacts on infrastructure development and the future growth prospects of the economy.

Chart 1.8
Public Debt

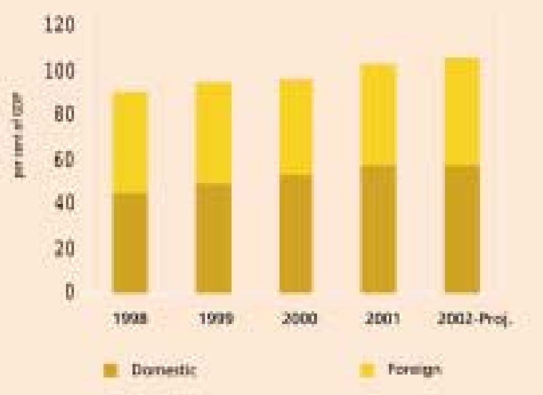
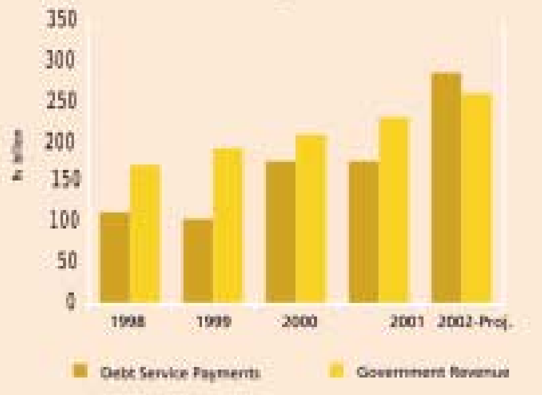


Chart 1.9
Government Debt Service Payments



- The total additional financing requirement (about Rs.16 billion) is larger than the increase in the fiscal deficit, due to a shortfall in expected foreign financing. It is not possible to finance this additional requirement through domestic non-bank borrowing due to resource constraints. Financing this gap by borrowing either from commercial banks or the Central Bank as an alternative, is not desirable, because, that may crowd out private sector credit, increase interest rates and raise inflationary pressure. Therefore, the least costly option is to contain this resource gap as far as possible and finance the balance, if any, with long-term foreign borrowing, together with an identified, clear long-term repayment strategy.

- The weight of the public debt became very clear in 2002, with a high public debt to GDP ratio (105 per cent) and annual debt service payments (Rs.327 billion) exceeding total receipts of the government (Rs. 322 billion),as indicated in

Budget 2002. However, with the rescheduling of some loan repayments, total debt service payments in 2002 are estimated to fall to Rs.286 billion. The present public debt service burden is mainly due to the large stock of domestic public debt, as about 93 per cent of existing foreign public debt is on highly concessional terms. Hence, it is critically important to continue to rely more on foreign concessional loans, while implementing a sustainable medium-term fiscal strategy to reduce the fiscal deficit as well as the public debt.

Chart 1.10
Tourist Arrivals - Monthly

Chart 1.11
Balance of Payments

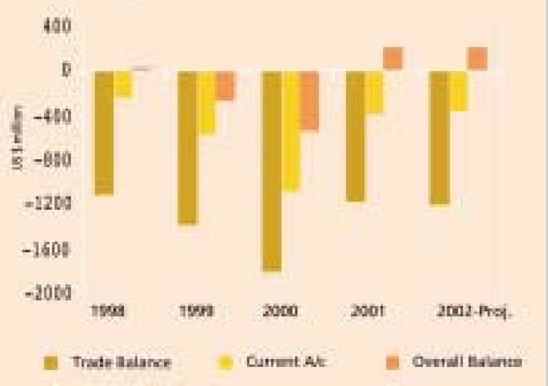
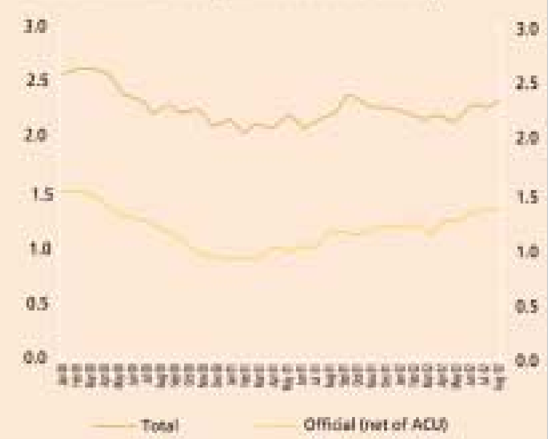


Chart 1.12
Gross External Reserves (in billions of US dollars)



- Meanwhile, it is very unlikely that bank credit to public corporations would be reduced by Rs.7 billion as expected, as the debt recovery component in the petroleum pricing formula has been removed without alternative measures, and the high cost which the CEB has to pay for purchases of power. A clear strategy consisting of automatic price adjustments and cost rationalisation measures is essential to contain further expansion in bank credit to public corporations and to reduce it from the present high level of about Rs.42 billion.

External Sector

- On the external front, the overall performance improved in the first half of 2002, recording a BOP surplus of US dollars 110 million, mainly benefitting from lower imports and high inflows under remittances and the capital account. Inflows from portfolio investment turned around from net outflows during the last three years to a net inflow of US dollars 19 million during the first half of 2002. However, there is considerable concern over the recovery of the external sector, due to still weak export demand.

- The situation is expected to improve further in the second half with some recovery in the world economy and higher tourist arrivals and port activity. The revised annual BOP projections for

2002 indicate an increase in the current account deficit to about US dollars 467 million (2.9 per cent of GDP) in 2002 from US dollars 272 million (1.7 per cent of GDP). However, the expected increase in private and government capital inflows would be sufficient to offset the current deficit and record an overall annual surplus of US dollars 337 million .

Chart 1.13
Effective Exchange Rate (1995 = 100)

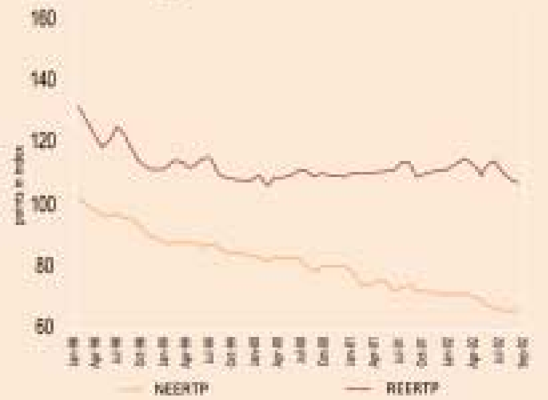


Chart 1.14
Variation of Forward Risk Premium and Volume in the Inter-Bank Market

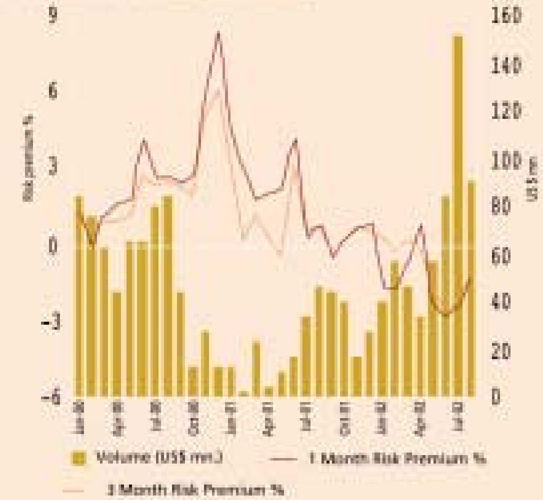


Chart 1.15
Interest Rates

- This BOP surplus, together with the receipt of the full amount under the SBA programme, would raise the gross official reserves to about US dollars 1,800 million (3.6 months of imports), while increasing the country's total external reserves to about US dollars 2,860 million (5.7 months of imports).

- The foreign exchange market was more stable, while forward market activity increased sharply and the forward margin decreased, both reflecting increased market confidence in the independently floating exchange rate regime introduced in 2001. The Central Bank was able to purchase (net) US dollars 145 million from the forex market up to end September, thereby building up official foreign reserves.

- The exchange rate adjusted, under the new regime, according to the market forces resulting from changes in macroeconomic fundamentals. The rupee depreciated by about 3 per cent against the US dollar during the first 9 months of this year, while in real terms (REER), it depreciated by about 3 per cent despite domestic inflation remaining higher than in trading partner countries, thereby improving the country's external competitiveness.

- The external debt service ratio (i.e., payment of interest and capital of outstanding external debt, as a percentage of receipts from goods, services, income and current private transfers) will remain at a comfortable level of about 11 per cent.

Monetary Policy

- A prudent monetary policy stance, aimed at containing inflation while helping economic recovery, has been maintained. Accordingly, the Central Bank further reduced its major policy rates cautiously by 125 – 150 basis points, in line with the declining trend in inflation. Although recent inflation is primarily cost-push and supply driven, it is important to implement monetary policy in a manner that would not create demand-pull inflationary pressures.

- The market has responded positively to reductions in policy rates, reducing the entire interest rate structure (i.e., yield curve) downward. However, some lending rates have been declining relatively slowly.

- The market spread (i.e., difference between lending rates and deposit rates) remains high, mainly on account of high non-performing loans (NPLs), slow debt recovery processes, high overhead costs and low competitiveness in the banking system. The Central Bank commenced publishing bank-wise information on interest rates and charges/commissions in order to add more information to the market. Meanwhile, measures have been initiated to reduce NPLs in the banking system by encouraging improvement in risk management and credit evaluation. Similarly, the continuation of ongoing financial sector reforms will also help to reduce intermediation costs, which are high in comparison with other countries in the region.

- The reserve money expansion so far this year has remained within the target, but the expansion in broad money exceeded the target of 13 – 14 per cent, reaching about 17 per cent by mid 2002. As credit expansion to the public sector and private sector has remained moderate, this was mainly due to a higher increase in net foreign assets (NFA) of the banking system than expected in the original forecast.

- The annual monetary programme for 2002 has been revised by taking into account changes in real economic activity, the fiscal situation and the balance of payments. The revised annual monetary expansion (broad money), at 15 per cent, is higher than the original target of about 13.5 per cent. This would be mainly due to the non-realisation of the expected repayment of bank credit by the government (Rs. 21 billion) and public corporations (Rs.7 billion) in 2002. However, the money market would remain liquid, reducing pressure on interest rates, due to purchases of foreign currency by the Central Bank from the market and a lower credit demand by the private sector than expected.

- On the demand side, the additional increase would reflect the increasing demand for money related to unanticipated liquidity demand coming from the North and East following the progress in the peace process. Such an increase in demand for money would not create additional inflationary pressure, as it will take place simultaneously with increasing economic activity and the movement of goods as well as people between the North/East and other parts of the country. However, containing public sector borrowing, including borrowing by public corporations, is critical for successful monetary management to contain inflationary pressure in the economy.

- The Colombo stock market has shown increased activity since October 2001, reflecting improving business confidence, mainly following progress in the peace process. The All Share Price Index rose by 38 per cent from end 2001 to end September 2002 and the market transaction volumes and capitalisation increased sharply. Foreign investment in the stock market recorded a net inflow of US dollars 28 million during the same period, reversing the trend of a net outflow experienced during the last three years. Market activity will continue to improve with further progress in the peace process. Reforms aimed at capital market and debt market developments are crucial for long-term sustainable development.

Structural Reforms

- The government has persevered with structural reforms in order to encourage investment, increase efficiency and productivity, improve flexibility, raise external competitiveness and strengthen the resilience of the economy. Faster implementation of identified reforms, particularly in the labour market, civil service, pension benefits, public enterprises, financial sector, judicial system, education system, regulatory framework and governance is critical in raising the growth potential, flexibility and resilience of the economy. It is encouraging that the government has initiated reforms in almost all these areas. However, acceleration of implementing structural reforms is critical for enhancing the growth prospects in the economy.

Future Economic Prospects and Projections for 2003

- Future economic prospects of the country will depend significantly on the intensity of policy adjustments, speed of economic reforms, progress under the peace process and finding a lasting solution to the North/East issue. As a highly trade dependent economy, as well as the most liberalised country in the South Asian region, developments in the international economy will have a significant impact on the economic prospects of Sri Lanka.

- The accelerating globalisation of economic activity provides greater opportunities and poses greater challenges to a small trade dependent country like Sri Lanka. Therefore, a dynamic policy strategy is necessary to face emerging challenges effectively, while maximising benefits and minimising losses from unavoidable changes in the world economy.

- Alternative simulation exercises under different policy scenarios indicate that the early achievement of a lasting peace and implementation of strong policy adjustments and deeper reforms are essential to ensure sustainable economic growth and macroeconomic stability in the medium-term.

Projections for 2003

- Economic projections for 2003 are based on the assumptions of progress in the ongoing peace process, strengthening political stability, rapid implementation of domestic economic adjustments and reforms, recovery in the world economy and finalisation of the long overdue Poverty Reduction and Growth Facility (PRGF) with the IMF and the World Bank.

- Political stability and national consensus on key political and economic issues are essential as a national priority in achieving the twin objectives of peace and high sustainable growth. An early political solution to the North and East issue will increase growth prospects significantly, while any reversal in the peace process will have huge economic, political and social costs.

- World economic growth and expansion in international trade are expected to improve in 2003, resulting in a favourable external environment. World output is expected to grow by 3.7 per cent, arising mainly from the recovery in major industrial countries. The World Economic Outlook (WEO) issued by the IMF in September 2002 predicts the world trade volume in goods and services to grow by 6.1 per cent in 2003. Imports into advanced countries are expected to grow by 6.2 per cent, while exports from developing countries are expected to grow by 6.5 per cent, expanding opportunities for trade dependent countries like Sri Lanka. Interest rates in major international capital markets are expected to remain low, with some marginal increases towards the end of 2003. However, some downward risks remain in the continuation of the present recovery in the world economy.

- The present projections made as the baseline scenario for 2003 assuming normal rainfall and the favourable external environment discussed above, indicate the existing potential for achieving a strong economic recovery, higher investment expansion, greater stability in prices and the exchange rate, higher external reserves, more employment opportunities and greater macroeconomic stability.

- The economy is expected to grow at a rate of 5-6 per cent, reflecting recovery in all major sectors; Agriculture (about 2 per cent), Industry (6-7 per cent) and Services (6-7 per cent).

- Agriculture sector growth is mainly driven by expectations of a normal monsoon, recovery in coconut production from the severe drought affected crop in 2001/2002 and continuation of strong export demand for minor agricultural exports. The Industrial sector growth will be fuelled by improved performance in export manufacturing industries and in the Construction sector. Expanding activities in trade and transport, recovery in tourism and port services, and the continuation of a high growth momentum in the telecommunications sector will be the primary factors behind high growth in the Services sector, which accounts for more than half of the GDP.

- On the aggregate demand side, both domestic demand, driven mainly by increasing business confidence, and increased export demand with the expected recovery in the world economy, would support the realisation of high growth in 2003.

- Inflation would continue to trend down in 2003, reflecting the benefits of increasing domestic agricultural supplies, rising productivity, greater stability in the exchange rate and prudent monetary policy aimed at maintaining monetary growth consistent with macroeconomic fundamentals. Containment of the budget deficit within the medium-term fiscal stabilisation strategy as indicated in the Fiscal Management (Responsibility) Act is critical to achieving the expected decline in annual inflation to about 8 per cent and to reduce inflationary expectations.

- Lower inflation would reduce the pressure for excessive wage increases. The expected productivity increase from structural reforms would enable workers to realise an increase in real wages without that increase resulting in cost-push inflationary pressure.

- Increasing economic activity and larger investment would create more employment opportunities in the private sector, reducing unemployment (to about 7-8 per cent) and underemployment, which are still high. Widespread economic recovery and expanding income opportunities are expected to improve living standards, supporting the poverty reduction drive.

- Sri Lanka's external sector is expected to recover strongly in 2003 benefiting mainly from the global economic recovery, particularly in the US and the European Union, increasing business confidence and the implementation of structural reforms. Even though the current account deficit may increase due to increased imports, caused by increasing demand for intermediate and capital goods imports, net capital inflows are expected to be sufficient to record a surplus in the overall BOP, enabling an increase in the country's external reserves.

- The trade deficit is expected to widen to about 9.3 per cent of GDP compared with 8.2 per cent in 2002. The expected recovery in tourism, port activity and telecommunication services and increasing transfers are expected to contain expansion in the current account deficit to about 3.6 per cent of GDP.

- Foreign direct investment and portfolio inflows are expected to continue to increase in 2003 with progress in the peace process and growth enhancing structural reforms. The availability of concessionary external assistance is expected to increase with the finalisation of the PRGF programme, but an improvement in foreign aid utilisation is necessary to gain the maximum benefits. Meanwhile, obtaining a sovereign rating for the country will expand borrowing opportunities for the private sector.

- The expected surplus in the BOP for the third consecutive year will increase the external assets of the country, and reduce the pressure on the exchange rate. The balance of payments is expected to run a surplus of about US dollars 241 million, without including programme financing assistance. This would increase the level of external reserves to 5.8 months of imports.

- On the fiscal front, Budget 2003 is expected to be prepared within the medium term fiscal consolidation strategy indicated in the proposed Fiscal Management (Responsibility) Act, under which the overall deficit is required to be reduced to 5 per cent of GDP by 2006, and maintained below that level thereafter.

- Accordingly, it is expected to contain the overall budget deficit below 7.5 per cent of GDP in 2003. Such fiscal consolidation has to be achieved mainly by reducing expenditure, rather than by increasing revenue, taking into account the potential adverse impact of high revenue efforts on growth. Within the expenditure, it is essential to achieve the required reduction through the rationalisation of current expenditure, as capital expenditure is required for infrastructure development.

- The expected reduction in the budget deficit would not only reduce the future public debt burden, which is high, but also reduce pressure on domestic interest rates and release more financial resources to the private sector.

- The monetary policy stance would continue to maintain a balance between containing inflationary pressure in the economy and providing adequate liquidity to support economic recovery. The Central Bank will continue to place increasing reliance on open market operations in monetary management.

- Given the expected economic growth of about 5.5 per cent, it is necessary to maintain monetary expansion at around 13.5 per cent in 2003 in order to contain annual inflation to about 8.0 per cent.

- With the expected increase in net foreign assets in the banking system, reflecting a surplus in the BOP and high private sector credit demand expected with economic recovery, it is essential to contain public sector borrowing to achieve the desirable monetary target. The government would be able to reduce its debt to the banking sector with expected fiscal consolidation. Similarly, reforms in public enterprises, including the introduction of automatic price adjustments, cost rationalisation and private sector partnerships are critical to reduce bank credit to public corporations. These measures would not only reduce heavy public debt, but also permit a greater flow of resources to the private sector.

- Interest rates are expected to continue to trend down with lower inflation and the containment of public sector borrowing. However, an adequate real rate of return has to be maintained in order to encourage domestic savings, which are still low compared with other countries in the region and inadequate to pay for the required investment.

- Meanwhile, financial sector reforms aimed at improving efficiency and competition are expected to reduce intermediation costs (i.e. mainly the interest rate spread), which are still high.

- Similarly, the continuation of reforms is critical to developing the domestic debt market, which is still shallow and narrow. It is critically important to extend the maturity periods in market oriented public debt instruments to develop a long overdue yield curve in the financial market.

- The momentum in the stock market is expected to increase in 2003 with improving business confidence and recovery in economic activity. Addressing the existing weaknesses in the regulatory framework would improve business confidence, adding further impetus to stock market activity.

- The government has decided to undertake strong economic adjustments and deeper reforms to raise economic growth to a high and sustainable level. For this purpose, government will encourage investment, increase efficiency, raise productivity, improve flexibility and strengthen external competitiveness. Reforms required for these purposes have been identified in the labour market, land market, investment policy, the financial sector, public enterprises, pension benefits, the civil service, education, the judicial system, regulatory systems and governance, as listed in the draft Poverty Reduction Strategy Paper (PRSP).

- It is encouraging that a series of legislative amendments and new bills have already been tabled in Parliament in order to facilitate economic reforms. It is a welcome step that the government has proposed to enact the Fiscal Management (Responsibility) Act, which would make fiscal discipline mandatory. However, given limited domestic resources and institutional capacity, it is essential to prioritise these reforms and enhance external concessional assistance. In this context, accelerating the finalisation of the long overdue PRGF for Sri Lanka is critical. It would make feasible a comprehensive reform programme to enhance growth and reduce poverty on a sustainable basis.