

## 2. OUTPUT AND ECONOMIC GROWTH

The growth in output evident from the performance in the first half is expected to continue through 2004. In 2005, growth is expected to be faster and more broad based, pursuant on the necessary policy adjustments and implementation of the required structural reforms. The continuation of the ceasefire and progress in the peace process, as well as a clear commitment to policy consistency in macroeconomic management are critical to the achievement of these projections.

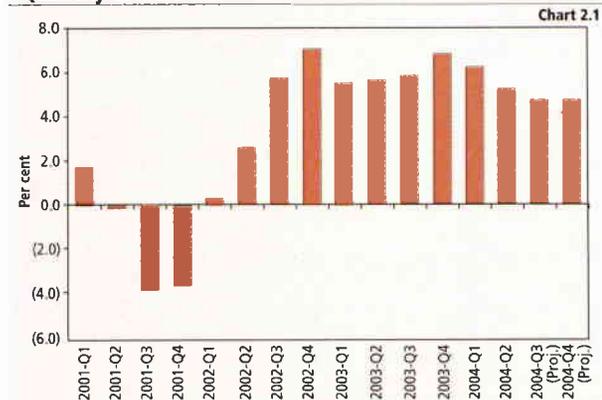
## Outlook for 2004

□ In 2004, the economy is projected to grow by 5.0 – 5.5 per cent. During the first half of the year, the economy grew by 5.7 per cent. The growth in the second half will be somewhat lower than during the first half. This growth reflects continuation of the growth momentum in the recent past with respect to industry and services. The projected deceleration in growth in 2004 is mainly the outcome of the poor performance in domestic agriculture due to the prolonged drought that adversely affected both Maha and Yala cultivation seasons and hydro electricity generation. The rise in oil prices will also impact negatively on value added in the industry and services sectors.

□ The growth momentum in economic activity that commenced in the second half of 2002 and continued in 2003 was mainly supported by two factors. The first was the continuation of the cease-fire and peace initiative between the government and the LTTE, which enabled comparatively free mobility of goods, services and labour throughout the entire country that created an environment conducive to the expansion of overall economic activities. The second was improved macro economic management, including prudent monetary management, greater fiscal discipline, and continuation of structural reforms, albeit with delays in some areas, that supported declining interest rates, a relatively stable foreign exchange market and falling inflation. This led to

increases in both aggregate demand and supply through a rise in both consumer and investor confidence. Consequently, the growth of 5.9 per cent in 2003 was relatively broad-based and consistent throughout all 4 quarters.

Quarterly GDP Growth Rates



□ Though the Sri Lankan economy has grown and prospered, benefiting from the initial peace dividends, the challenge ahead is achieving a long-term solution to the North-East issue to reap the immense benefits to the country arising from a sustainable peace. Deviation from the peace efforts will jeopardise future growth prospects and have an enormous cost to society. In this regard government's clear and continued commitment to find a negotiated settlement to the conflict is the positive factor in the peace process.

□ An equally important task is further improvement in macro-economic management. In the first half of 2004, some volatility was observed in the foreign exchange market, and market interest rates rose even before the declining trend in inflation reversed around

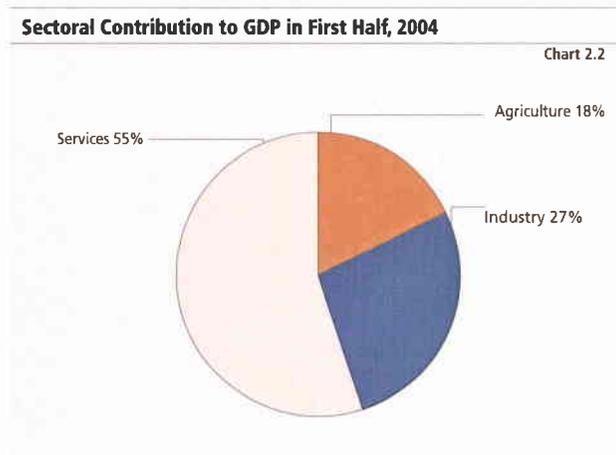
May, but stabilised thereafter. In order, therefore, to avoid a deteriorating of macro-economic fundamentals, adoption and speedy implementation of the necessary macroeconomic policy adjustments and structural reforms that have been delayed on account of elections and the ensuing political uncertainty and changes, reducing economic policy uncertainties, increasing transparency and accountability in public policy, effective utilisation of external assistance, and implementation of law and order, that critically impact on macro-economic developments and finally, on economic growth, are also required.

- Of the projected growth for 2004, the Services sector is expected to record the highest growth of 7.3 per cent and contribute around 77 per cent to overall growth. The Industry sector is forecast to grow by 4.9 per cent and will contribute 25 per cent to the overall growth. However, the Agriculture sector is expected to contract by 0.5 per cent and, as a result, its contribution to the overall growth will be negative, at around 2 per cent.
- The Services sector that provided the impetus for growth after the contraction in 2001, will play the leading role in 2004 as well. The faster growth of the Services sector, which has increased its relative share in the Sri Lankan economy, is in line with the normal trend that has been observed in the development process of a country. The consistency in the growth momentum in the Services sector indicates that in

the Sri Lankan economy, services activities enjoy a comparative advantage over the other two sectors. The ceasefire, at the outset, also stimulated services activities between the North and the East and rest of the country, thereby enhancing the relative importance of the Services sector within the economy.

- Of services activities, the Transport, storage and communication sector is projected to record the highest growth of 11.8 per cent. During the first half of the year, this sector grew by 13.6 per cent, as against a growth of 10.4 per cent during the first half of the previous year. The telecommunication sub-sector accounted for most of this growth, with output expanding by 30.2 per cent. The growth in this sub-sector was mainly driven by the upward trend in mobile phone usage, which increased by over 50 per cent over the first half of 2003. Value added in port services rose by 10.6 per cent during the first half of the year. This high growth reflects enhanced productivity at the Sri Lanka Ports Authority (SLPA) and aggressive marketing by the Jaye Container Terminal (JCT) and the South Asia Gateway Terminal (SAGT), both providing world class container terminal facilities. The recovery in world trade also impacted positively on the growth of port services. The growth in the transport sub-sector, by 5.3 per cent, reflects the increased activities of road haulage services, private omnibus transport services and air travelling services. However, a setback was observed in the services provided by Sri Lanka Railways and cluster bus companies. The growth in the Transport, storage

and communication sector is projected to continue during the rest of the year as well.



□ In 2004, the Banking, insurance and real estate sector is projected to grow by 8.2 per cent. During the first half of the year, this sector grew by 8.7 per cent, whereas the corresponding growth in 2003 was 12.8 per cent. The growth in the banking sector was mainly responsible for this growth. During the first half of the year, interest income of the banking sector contracted, but net interest earnings improved due to the decline in interest expenditure by a larger margin. Meanwhile, non-interest income of the banking sector increased by 19.5 per cent owing to increased activities in the foreign exchange market, dividends on securities/investments and earnings from commissions, fees, brokerage and other activities, signifying a positive expansion in the banking sector towards more fee based financial services. The insurance sub-sector also performed well. This trend in the financial services sector is expected to continue during the latter half of the year as well.

□ Meanwhile, the Wholesale and retail trade sector also grew by 7.4 per cent during the first half of the year. The growth in external trading activities provided the impetus for this growth. The import trade sub-sector grew by 12.9 per cent with investment goods imports growing by 40 per cent, in volume terms. The growth in consumer goods and intermediate goods imports were 3.1 per cent and 5.2 per cent, respectively. The export trade sub-sector performed well during the first quarter of the year, but suffered a setback during the second quarter. Altogether, the sub-sector is projected to grow by 5.2 per cent. Agricultural exports grew by 8.8 per cent, while the growth in industrial exports was 6.3 per cent (mainly due to the growth in petroleum exports by 14 per cent) and that in mineral exports was 7.9 per cent, during the first half of the year. This sector is projected to grow by 6.3 per cent in 2004.

□ The residual services category is projected to grow by 5.2 per cent in 2004. This growth will come mainly from the hotel and related services sub-sector reflecting the continuous expansion in tourist arrivals. During the first half of the year, this sector underperformed as the increase in tourists arrivals was only 4.1 per cent. The low growth was attributed to the parliamentary election held in April, the dengue epidemic, and some isolated but terrorism related incidents. This trend was reversed in July 2004 with 50,525 tourist arrivals, an all time record for the month. The leisure industry sector has been expanding to facilitate the growth in arrivals which is expected to continue in the remaining months of the

year and, arrivals for the year are projected to exceed the arrivals reported in 2003 by 10 per cent. In addition to hotel related services, activities such as advertising, private health services, educational services, and motor vehicle repairs performed well during the first half of the year. The expected growth in the hotel and related services sub-sector however will depend heavily on the continuation of a peaceful environment through the country.

- The Industry sector is projected to grow by 4.9 per cent in 2004. All sub sectors are expected to contribute to this growth, while the highest contribution is expected from the Construction sector. During the first half of the year, the Construction industry grew by 6.6 per cent. The industry was badly affected by the economic contraction in 2001 and the subsequent setback in investment expenditure in 2002. The recovery in investment activities since the latter half of 2003 has impacted positively on the construction industry. The increase in government investment was mainly concentrated on large-scale projects in road development and irrigation, while private sector construction activities focused on small and medium scale projects in housing construction and construction of supermarkets and retail outlets. Also, the boom in the tourist industry in the previous year has stimulated the refurbishment of existing hotels and construction of new small-scale hotels. This trend in the construction industry is expected to continue throughout the year. The increased activities in the construction industry were clearly reflected in

the statistics on local production, sales, and imports of construction materials.

- The Manufacturing sector is projected to grow by 4.8 per cent in 2004. Of this sector, the factory industry sub-sector, which covers large and medium scale industries, is projected to grow by 5.2 per cent. During the first half of the year, this sub-sector grew by 4.5 per cent. Export market oriented industries as well as domestic market oriented industries contributed to this growth. Of the export market oriented industries, the textiles, wearing apparel and leather products category grew by 4.3 per cent. Recovery in demand from USA and EU provided the impetus for this growth. In addition to the textiles sector, other export oriented industries, such as rubber products, ceramics and processed diamonds also performed well during the period. Domestic market oriented industries such as food and beverages, plastic and PVC products, pharmaceuticals and detergents, and cement and other building construction materials also performed well in response to domestic demand. However rising inflation and the increase in the prices of oil and utilities such as gas will be a deterrent to the expected performance, as the increase in the cost of inputs will reduce the value added as well as the export competitiveness of factory industries.
- Value added in the processing of plantation crops is projected to grow by 5.1 per cent in 2004 due to the projected increases in the production of all three major crops, viz. tea, rubber and coconut. However, the

small industry sub sector is projected to decline by 0.1 per cent. The decline in paddy production, in both Maha and Yala seasons, is expected to affect paddy milling, the most widespread small industry in the country. However, small industries such as timber milling and rock metal products that support the construction industry are projected to perform well due to the growth in the construction industry and this will partly offset the negative performance in the paddy milling industry.

□ The Electricity, gas and water sector, which grew by 21.7 per cent in 2003, is projected to decline by 4.6 per cent in 2004. This deceleration is due to the performance in the electricity sector. During the first half of the year, the value added in the electricity sector declined due to the significantly higher usage of thermal power, including hired power, which had higher generation costs, under the dry weather conditions that prevailed in the hydro catchment areas. However, some reversal in this trend is expected during the second half of the year.

□ The Agriculture sector, according to current projections, is expected to contract by 0.5 per cent. The dismal performance of the agriculture sub-sector catering to the domestic market is mainly responsible for the contraction. In the 2003/2004 Maha season, paddy production declined by 11.7 per cent. The decline followed the all time high production recorded in the previous Maha season. Dry weather in some paddy growing areas was the main reason for this low output. Paddy production in the Yala season is

also projected to fall, by 24 per cent. This trend was also reflected in the production of subsidiary food crops during the first half of 2004. However, production of vegetables, both up-country and low-country varieties, increased substantially during the same period and the resultant price declines of vegetables contributed to mitigating inflationary pressure during the first half. Plantation agriculture is projected to perform well during the year. Tea production, which grew by 1.8 per cent during the first half of the year, is projected to grow by 2.2 per cent for the year. Mainly in response to attractive international prices, rubber production is expected to grow by 8.0 per cent, while coconut production is predicted to grow by 7.3 per cent due to the lagged effect of the favourable weather conditions that prevailed in 2003.

□ The Agriculture sector has not achieved the dynamism of the other two sectors, Industry and Services, and continues to lag behind due to inherent rigidities. The deterioration in state managed agricultural extension services, inadequate availability of high yielding seed and planting varieties, high post-harvest losses, marketing problems, restrictions in the land market, inefficiency in water management, and the continuation of distortionary government interventions are key issues that need to be addressed urgently. The effective resolution of these issues through a market based sustainable strategy is necessary to ensure a high growth in the Agriculture sector.

### Outlook for 2005

- ❑ The Sri Lankan economy is projected to grow by 5.5 per cent in 2005. This growth is projected to be broad-based, with growth in all three sectors, agriculture (2.7 per cent), industry (5.3 per cent) and services (6.4 per cent).
- ❑ In the Agriculture sector, in domestic agriculture, paddy production is expected to recover with improved weather conditions. The planned improvements in water management will also impact positively on production of paddy and subsidiary food crops. However, attention needs to be focused on the fertiliser subsidy. This is not only a burden on the government budget, but may not be achieving its desired objective. The relatively low price of urea, consequent on the subsidy, may lead to the increased application of urea at the expense of other fertilisers, leading to an increased incidence of pests and disease. In plantation agriculture, tea and rubber production are also projected to increase and reap the benefits of price increases in international markets. Coconut production, however, is expected to decline due to the lagged effect of the adverse weather conditions in 2004. In the medium to long-term, it is essential to increase productivity in the agriculture sector and reduce post harvest losses, if this sector is to remain viable.
- ❑ All sub-sectors in the Industry sector are projected to grow in 2005. Export manufacturing, electricity generation, construction and mining activities will

contribute to the projected growth. The output in factory industry is expected to grow by 5 per cent in 2005 compared to the estimated growth of 5.2 per cent in 2004. The impetus to growth in industrial output in 2005 is expected to come from four major industrial categories, viz. food, beverages and tobacco products; textiles, wearing apparel and leather products; chemical, petroleum, rubber and plastic products; and non-metallic mineral products, which together will account for nearly 90 per cent of the growth in the industrial sector in 2005. The overall growth will be a composite outcome of an expansion of output in BOI industries, estimated at 3.9 per cent, and non-BOI industries, estimated at 4.6 per cent. The output of public sector industries is expected to decline by 5.9 per cent due to the expected interruption to production at the oil refinery on account of routine maintenance work scheduled in 2005. Although the phasing out of the Multi-Fibre Agreement is expected to create a temporary shock, the textiles and apparel product category is expected to grow by around 3.5 per cent, with a recovery in international markets, continuous improvements in product quality, and closer relations with international buyers. The government would need to play a strong facilitating role, as it has in the past. Efforts to enter into a free trade agreement with the US needs to be pursued vigorously, as this would lend strong support to growth in the apparel sector. The output of domestic market oriented industries is also expected to grow in response to consumer demand. The construction industry is expected to maintain its growth momentum, with higher government

investment in infrastructure projects and private sector investment in production and services related activities.

- The Services sector will continue be the fastest growing sector, as well as the highest contributor to overall economic growth. This sector will benefit from the continued growth momentum in telecommunications, external trade, port services, financial services and tourism. The telecommunications sector is expected to show continued growth momentum in 2005. Many telecommunication service operators have planned network expansion projects and some of them are already off the ground. With these expansions, the

telecommunications sector, in terms of subscriber network, is expected to grow by 20 per cent in 2005. With expected growth in the global economy and productivity improvements, port services are expected to maintain their growth momentum in 2005. Total container handling at the Port of Colombo is expected to grow by around 8 per cent in 2005. The tourism sector is expected to benefit from continuation of the cease-fire and new investments in the leisure industry to expand facilities and opportunities. The increase in competition among different categories of service providers and the recent technological improvements introduced in payments and settlements systems will increase efficiency and value addition in the financial sector.