3. AGGREGATE DEMAND AND SAVINGS

Consumer demand was the driving force behind economic growth in the past two years, while external demand also supported the momentum. However, investment lagged behind. The provisional data for the first half of 2004 indicates a resurgence of investor confidence that began in the latter half of the previous year. This investor sentiment was a positive response to the cessation of hostilities, and the improvement in macroeconomic conditions and policies conducive to growth seen in the recent past. Therefore, the continuation of peace efforts and improvement in macro economic management will be crucial for the continuation of optimistic investor sentiment. The planned increase in government investment is a welcome move, and this needs to be managed with the available resource constraints.

Outlook for 2004

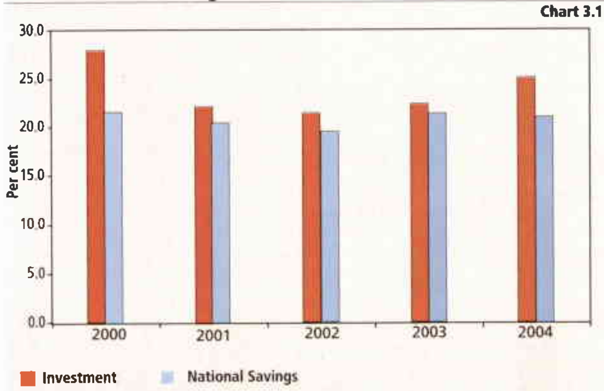
- The economic recovery in 2002 and 2003, from the first ever economic contraction in 2001, was driven in no small measure by consumer confidence, also supported by recovery in exports. The cessation of hostilities and the resultant peaceful environment that prevailed in the country paved the way for consumption driven growth. The investors' response was not as rapid and it was evident that investors preferred to follow a "wait and see" policy during 2002 and most of 2003. An improvement in investor confidence was first seen during the latter half of 2003. During the first half of 2004, investment expenditure grew, indicating that investment, rather than consumption, would provide the impetus for economic growth in 2004. This is heartening, as consumer driven growth is unlikely to be sustainable in the long run.

- The investment/GDP ratio, which declined to 22 per cent in 2001 from 28 per cent in 2000, deteriorated further to 21.3 per cent in 2002 even though economic growth turned around from negative to positive. In 2003, the ratio improved modestly to 22.3 per cent. This growth reflects the increase in investment expenditure that took place in the latter half of 2003. In 2004, investment expenditure at constant prices is projected to grow by 18.6 per cent, rasing the investment ratio up to 25.3 per cent of GDP. The turnaround in investment was clearly observed in the first half of 2004 as indicated by a sustained expansion in private sector credit and a noticeable increase in imports of investment goods during the period. The performance in the Colombo Stock Exchange also reflected positive investor sentiment. This increase in investment augurs well for achieving the targeted growth in 2005. The prevailing lower interest rates were another reason for investor confidence.

- Both private sector investment and public sector investment are expected to contribute to the growth in investment expenditure. Private sector investment, which contributes over 90 per cent of the total investment expenditure, is projected to increase by 28 per cent, in current terms, in 2004. It has been concentrated in power generation, telecommunication, transport, retail trading and the leisure industry; mainly in Services sector activities. This investment pattern indicates that the Services sector will continue to grow at a faster pace compared with the growth in the other two sectors.

Investment and Savings Ratio

Chart 3.1



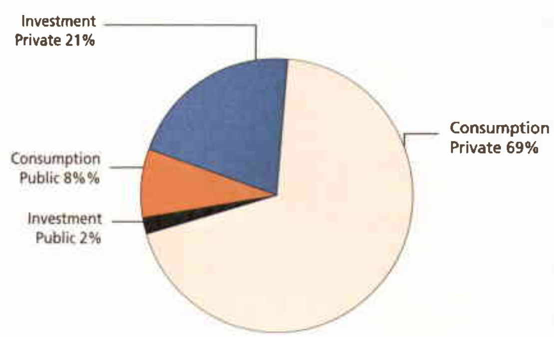
- Government investment (including both government and public corporations), which remained at a lower level in 2002 and 2003 than in 2001, partly due to the fiscal consolidation efforts of the government during that period, is projected to grow by 28 per cent in 2004, in current prices. Government investment has been concentrated on road development projects (Southern Highway Project and Road Network Improvement Project), irrigation projects, power, water supply, airport and port development projects.

- However, the challenge is to continue this trend. The current trend in investment is a reflection of a number of positive developments experienced in the recent past. The continuation of the ceasefire since early 2002 was the most important factor that stimulated investor confidence. Improved macro economic management, especially the gradual decline in interest rates and continuously falling inflation also created a conducive environment for new investment. Any failure to continue the peace initiative will dry up investment flows, reducing the prospects for future growth. Therefore, strong commitment to a politically negotiated solution to the North-East conflict, by all major parties, is necessary to maintain momentum on the investment front. Similarly, containment of the public sector deficit will reduce the pressure on interest rates and make available more resources to the private sector, thereby encouraging investment expansion.

- Consumption expenditure, which provided the stimulus for growth in 2002 and 2003, is projected to grow by 4.0 per cent, in real terms, in 2004. In comparison, in 2002 and 2003, real consumption grew by 6.3 per cent and 5.9 per cent, respectively. The deceleration in real consumption is partly due to the fulfillment of the pent-up demand that rose after the ceasefire agreement between the government and the LTTE. The deceleration in consumer demand was also reflected in import statistics. Consumer goods rose by only 3.1 per cent, in volume terms, during the first half of 2004. The corresponding increases in 2002 and 2003 were 14.8 per cent and 16.5 per cent, respectively.

Domestic Demand -2004

Chart 3.2



- External demand, the demand for exports of goods and services, is expected to rise, in 2004, by 14.1 per cent, in rupee terms. The upturn in global economic activities has been beneficial for the external sector. However, the expenditure on imports of goods and services has been growing at a faster pace, partly due to the higher oil prices and depreciation of the Sri Lankan rupee, so that net external demand continues to be negative.

- On the resources side, domestic savings, as a ratio of GDP, are projected to increase marginally to 16.1 per cent from 16.0 per cent in 2003. This is entirely due to the expected increase in private savings by 16.0 per cent. The increase in corporate sector savings due to the profitability in that sector will be the source of higher savings by the private sector. The favouarable impact of the increase in private sector savings will be partly offset by the projected increase in government dis-savings (a situation where government's consumption is higher than its revenue). Government dis-savings as a ratio of GDP, which improved during the previous two years, from 4.9 per cent to 3.3 per cent, due to the fiscal consolidation efforts during the period, is projected to deteriorate marginally to 3.6 per cent. Meanwhile, the resource gap, the gap between savings and investment, as a ratio of GDP, is expected to increase, as the investment ratio is projected to grow faster than the domestic savings ratio.

Outlook for 2005

- In 2005, investment expenditure is expected to maintain its momentum, and, accordingly, the investment to GDP ratio is projected to reach 26 per cent. The prevailing profitability in the private sector is expected to continue, thus enabling the private sector to lead the growth in investment. Private sector investment is expected to concentrate on export manufacturing, the leisure industry, telecommunications and other services activities.

- Government investment is also expected to rise further in 2005. Public sector investment will continue to focus on infrastructure projects such as road development, power, port and air port services, and water supply.

- In 2005, consumption expenditure is expected to increase further, due to the expected economic growth and the expected increase in inflation. The improvement will depend on an increase in demand by households and the organised private sector, as well as the public sector.

- Domestic savings are expected to rise in 2005 and the private sector, especially the corporate sector, will contribute to this growth. The resource gap is expected to widen further as the expected increase in domestic savings will not be sufficient to maintain the expected increase in investment. The increasing trend in government dis-savings needs to be turned around to increase domestic savings.

- However, these projections are vulnerable to downside risks. The major potential threat to achieving the projected targets would be unexpected adverse developments on the peace front and political instability. Peace alone may not boost long-term investment. Speedy implementation of structural reforms would be required to gain sustainable investor confidence and improve productivity.