1. OVERVIEW

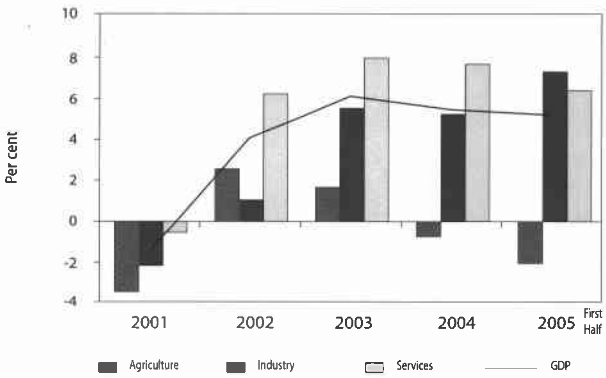
Sri Lanka's economy grew by 5.1 per cent in the first half of 2005 overcoming the setback caused by the tsunami disaster and benefiting from favourable weather and healthy international economic developments. The economy is progressing to record a growth of 5.3 per cent for 2005. The rising trend in inflation reversed at the end of the first half of 2005, due to falling food prices, but a substantial demand pressure prevails. Hence, monetary policy is being effectively directed at containing the demand pressure on prices, and the end- year inflation is expected to be around 10-11 per cent. International trade improved significantly with a 12.7 per cent growth in exports, and an 11.3 per cent growth in imports while services and remittance increased substantially during the first eight months of 2005. Aided by the high growth in remittances and other inflows, the overall balance of payments has turned to a surplus of around US dollars 190 million by the end of the first eight months of 2005. Prices of major exports improved but the terms of trade deteriorated by 2.2 per cent in the first eight months due to the relatively higher price of oil and other imports. The fiscal consolidation process continues, and the budgetary performance is in line with the revised estimates made in the Budget 2005. Meanwhile, the growth in monetary and credit aggregates is being contained with the tightening of the monetary policy stance. Given the current developments in international oil prices, Sri Lanka has to be cautious of the resulting negative impact on growth and inflation, and should be ready to implement the necessary measures to overcome any adverse impact. Prospects for 2006 are promising, with economic growth estimated to reach 6 per cent, inflation moderating with the implementation of the required monetary and fiscal policy measures and external trade and the balance of payments continuing to improve. The financial system will strengthen further, while providing the necessary services for the development of real sector activities.

Growth, Inflation and Employment

- **Sri Lanka's economy has continued to demonstrate its resilience to economic shocks with the growth of the real gross domestic product (GDP) reaching 5.1 per cent in the first half and the progress to a growth of around 5.3 per cent in 2005.** The tsunami disaster slowed down the growth of the economy to 4.4 per cent in the first quarter, with its negative impact on the tourism and fisheries sectors. Reflecting the faster recovery in the affected sectors, the economy grew by 6 per cent in the second quarter.

- **Inflation began to fall in the first half of 2005 due to favourable food prices, but the demand pressure continues.** Inflation measured as the point-to-point change in the Colombo Consumers' Price Index (CCPI) peaked in February 2005 at 15.9 per cent, but began to decline with the favourable weather lowering food prices. The current trends in economic

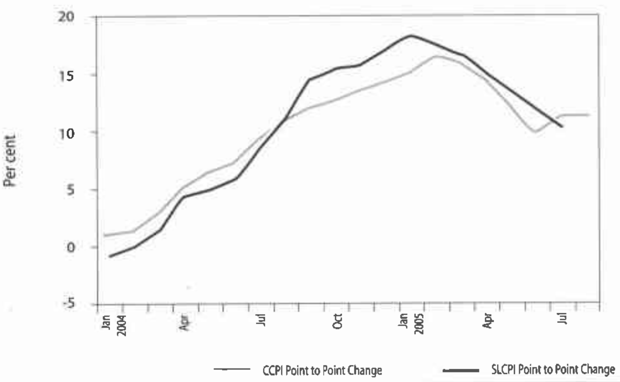
Chart 1.1
GDP and Sectoral Performance (Growth Rates)



developments indicate that inflation measured as the annual average change in the CCPI could reach around 10-11 per cent by the end of 2005.

- **The economy benefited from favourable domestic and external developments.** On the domestic front, the adverse weather that prevailed in 2004 became favourable, and the ceasefire continued. The global economy may continue to grow at around 4.3 per cent in 2005 and 2006, providing opportunities for Sri Lanka. However, downside risks to this high growth are emerging from rising oil prices, persistent global economic imbalances, growing protectionist tendencies in developed countries and spillover effects of natural disasters. Economic growth in the USA has eased moderately during the first half of 2005, but has been projected to remain around 3.3 per cent in both 2005 and 2006, underpinned by solid productivity growth, despite the moderate impact of the hurricanes Katrina and Rita. Growth prospects in the euro area have been revised downwards in view of weak domestic demand. In contrast, Japan is regaining momentum and is expected to grow by around 2 per cent in both 2005 and 2006. Growth prospects in emerging market and developing economies too remain robust with China and India poised to demonstrate a robust performance both in 2005 and 2006.

Chart 1.2
Inflation



- **Global inflation remains subdued, but could rise reflecting the impact of higher oil prices.** Inflation in developed countries is moderate, but inflationary pressures have risen in emerging market economies.

- **The favourable weather impacted positively on paddy production, which reached a record high level, other agricultural produce and hydropower generation, in the first half of 2005.** The paddy harvest increased by 20.5 per cent in the 2004/05 Maha season to a record level of 2012 thousand metric tons and tea production grew by 6.6 per cent during the first half of 2005. However, the drop in the rubber output due to rainy weather, the drop in the coconut output due to the lagged effect of the drought in the early part of 2004, and a substantial decline in fish production following the tsunami disaster resulted in the agriculture sector declining by 2.1 per cent in the first half of 2005.

- **Both the industry and services sectors have recorded higher growth rates, benefiting from favourable global economic developments and sustained domestic demand.** The Industry sector expanded by 7.3 per cent in the first half of 2005, reflecting the higher performance in all four sub sectors: Manufacturing, Mining and Quarrying, Construction, and Electricity and Water.

- **Factory industries, the largest sub sector in the manufacturing sector, has shown a healthy expansion.** The sector expanded by 5.9 per cent in the first half of 2005 compared with the 4.3 per cent growth in the first half of the previous year. The growth in factory industries in 2005 is expected to be broadbased and balanced across all sub sectors supported by the continuing expansion in international markets, and growing domestic demand. Facilitated by the duty concessions received from the EU under the GSP+ scheme and heightened domestic demand arising from tsunami reconstruction activities, the output of factory industries is estimated to grow by 6.0 per cent in the second half of 2005, culminating in an annual growth of 5.9 per cent in 2005.

- **The Services sector grew by 6.4 per cent during the first half of 2005.** The growth arose from developments in telecommunications, port services, storage and warehousing, public administration, other government services and export trade.

- **The unemployment rate hovers around 8 - 9 per cent.** According to the latest Quarterly Labour Force Survey conducted by the Department of Census and Statistics (DSC), the unemployment rate increased marginally to 8.2 per cent in the fourth quarter of 2004 from 7.9 per cent in the fourth quarter of 2003.

- **The workers taking up foreign employment continued to grow during the first half of 2005.** According to the Sri Lanka Bureau of Foreign Employment (SLBFE) the departures for foreign employment in 2005 are estimated at around 221,000, recording an increase of around 8,000 compared to 2004.

Savings and Investment

- **Domestic savings and investment are expected to improve in 2005 but remain well below the desired levels.** Domestic savings are projected to increase to 16.4 per cent from 15.9 per cent of GDP in 2004. Investment is expected to improve further to 27 per cent from 25 per cent of GDP in 2004.

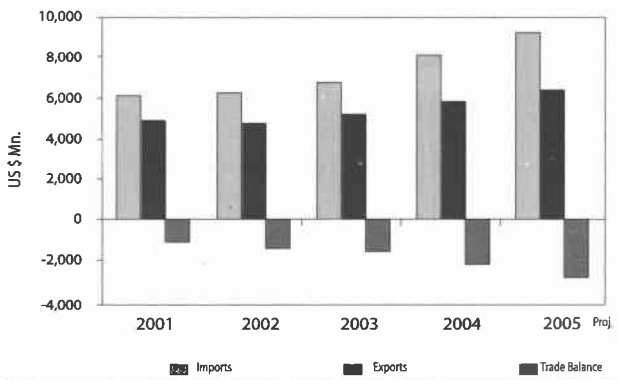
International Trade and Balance of Payments

- **The global economic expansion contributed to a substantial growth in Sri Lanka's international trade during the first eight months of the year.** Export earnings increased by around 12.7 per cent to US dollars 4,051 million during the first eight months of 2005. This growth momentum is expected to continue benefiting from the duty free access to the European Union under the GSP+ scheme and Free Trade Agreements with both India and Pakistan. For the year as a whole, exports in US dollar terms are expected to grow at a rate of around 10.6 per cent, compared with 12 per cent in 2004. Imports grew by 11.3 per cent to US dollars 5,626 million during the first eight months of 2005 compared to the significantly higher growth rate of 19.9 per cent in the corresponding period of 2004. However, imports are expected to grow at a higher rate during the second half of 2005 with the faster implementation of tsunami related reconstruction work and the continuation of high oil prices.

- **The trade deficit widened by 7.7 per cent to US dollars 1,575 million during the first eight months of 2005.** The deficit was partly offset by the surplus in the services account and a sharp rise in current transfers. The recovery in tourist arrivals after the tsunami, which was faster than anticipated, the continued growth momentum in port related activities and tsunami related insurance claims from abroad improved the net inflows to the services account while worker remittances and tsunami related current transfers improved inflows to the transfers account significantly.

- **The current account deficit narrowed down to US dollars 285 million in the first half of 2005** from a deficit of US dollars 352 million in the first half of 2004. However, with the commencement of the reconstruction and rehabilitation of tsunami-hit infrastructure facilities during the second half of the year, imports for reconstruction activities are expected to increase, considerably widening the current account deficit. The increased current account deficit is expected to be financed through concessionary donor funds.

Chart 1.3
International Trade and Trade Balance



- **Capital flows to the private sector by way of foreign direct investment, loan capital and portfolio investment showed a marked improvement in the first half of the year.** Foreign Direct Investment (FDI) has increased during the first half with the implementation of a large number of projects contracted during 2004 and the utilisation of loan facilities under the Indian Line of Credit by the Ceylon Petroleum Corporation. Net inflows to the stock market also increased significantly, especially from July, following the initial share offer made by Dialog Telekom Ltd, which was heavily over subscribed.

- **Inflows of foreign funds to the government are estimated to have increased substantially during the first half, mainly due to grants received, especially for the provision of relief to tsunami victims and the reconstruction of tsunami-hit infrastructure.** However, the loan inflows to the government during the first seven months of 2005 have declined marginally, mainly due to delays in the implementation of certain structural reforms. Loan inflows to the government are expected to increase during the second half with the faster implementation of tsunami related projects.

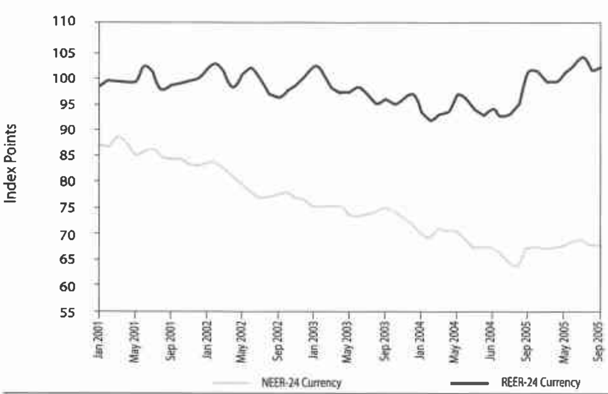
- **Net inflows to the capital and financial accounts during the first half were more than sufficient to offset the deficit in the current account.** Consequently, the overall balance of payments (BOP) recorded a surplus of US dollars 174 million during the first half of 2005, compared to a deficit of US dollars 223 million in the first half of 2004. The overall

BOP is projected to record a surplus of US dollars 295 million by end-year compared to the deficit of US dollars 205 million in 2004, largely due to the expected financial flows to the government and the debt relief.

- **Gross official reserves increased to US dollars 2,367 million at the end of August 2005 from US dollars 2,196 million at the end of December 2004.** The reserves were sufficient to cover 3.3 months of imports. The factors contributing to the increase in the reserves were the receipt of emergency assistance from the IMF, a programme loan from the ADB, the mobilisation of foreign currency loans from local commercial banks, the debt moratorium, inflows of remittances and tsunami related inflows. The total external reserves of the country increased from US dollars 3,438 million (5.2 months of imports) at the end of December 2004 to US dollars 3,655 million (5.1 months of imports) at the end of August 2005.

- **A significant increase in oil prices in the international markets has caused a strain on the BOP position and the external reserves.** The average crude oil price increased to US dollars 48 per barrel during the first half of 2005 from US dollars 34 per barrel during the corresponding period in 2004. Higher petroleum prices led to an additional expenditure of US dollars 198 million for oil imports. The continuation of high oil prices will pose a downside risk to the expected surplus in the BOP and the improvement in external reserves, in addition to its impact on growth and inflation.

Chart 1.4
Real and Nominal Effective Exchange Rate Indices (1999 = 100)



- **The foreign exchange market remained stable during the first half of 2005 but became slightly volatile by the end of the second quarter.** The rupee vis-à-vis the US dollar began to appreciate in the immediate aftermath of the tsunami due to the expected inflows by way of financial assistance. It strengthened during the first nine months of 2005 by 3.3 per cent, compared to the depreciation of 6.7 per cent during the corresponding period in 2004. The strengthening was seen against almost all other major currencies, such as the euro (16.6 per cent), the Japanese yen (13.6 per cent), the sterling pound (12.8 per cent) and the Indian rupee (3.9 per cent). Reflecting these movements, the real effective exchange rate (REER) based on the 5 currency and 24 currency baskets appreciated by around 8.4 per cent and 8.5 per cent, respectively. The relatively higher domestic inflation in Sri Lanka in the first nine months of the year also contributed to this appreciation.

Fiscal Policy and Government Finance

- **The fiscal policy strategy announced in the Budget 2005 was based on the Medium Term Budgetary Framework (MTBF)** of the government formulated within the policy vision articulated in the Economic Policy Framework of the Government of Sri Lanka (EPF-GOSL).

- **The Budget 2005 reiterated the commitment to and the need for the phased reduction of the budget deficit in the medium term to ensure an orderly correction of the structural weaknesses in the fiscal system.** In view of the fiscal performance in the previous several years, the Budget 2005 anticipated a delay of two years in meeting the targets stipulated in the Fiscal Management (Responsibility) Act.

- **The overall budget deficit in the first eight months of 2005, as a percentage of the GDP, declined to 5.1 per cent from 5.4 per cent in the previous year.** The current account deficit (government dissavings) declined to 1.8 per cent of GDP from 2.2 per cent during the same period in 2004. However, the primary deficit, defined as the overall deficit net of interest payments, increased to 1.6 per cent of GDP in the first eight months of 2005, from 1.3 per cent in the corresponding period in 2004. The overall budget deficit in 2005 is estimated to be 8.2 per cent of GDP.

- **The outstanding debt stock is estimated to decline to 98.0 per cent of GDP by end 2005 from 105.5 per cent at end 2004.** This expected improvement in the debt/GDP ratio will be mainly due to the appreciation of the rupee against major foreign currencies and the higher nominal GDP growth, which would exceed the rate of increase in the government debt stock.

Monetary Policy, Money, Credit and Interest Rates

- **Monetary policy was tightened during 2005 to contain monetary expansion and to reduce inflationary pressures and expectations.** The adversity of the tsunami devastation prompted a cautious monetary policy at the beginning of the year. Accordingly, daily active open market operations (OMOs) were suspended on 05 January, 2005 to ensure the smooth functioning of the financial markets. Active OMOs were subsequently resumed in mid February 2005 as the threat of the impact of the tsunami on the financial sector and economic activities began to dissipate gradually.

- **The policy rates were raised by 100 basis points in three stages, in addition to the implementation of**

Chart 1.5
Fiscal Sector Developments

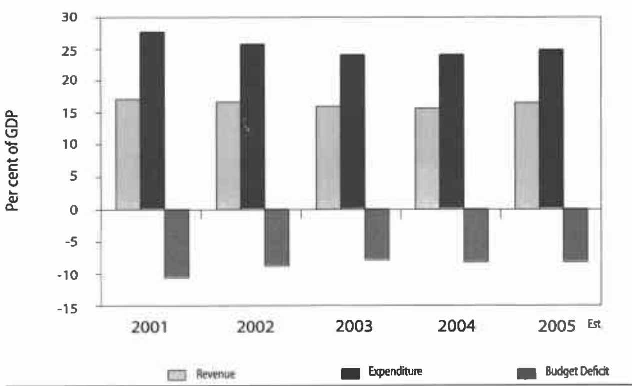
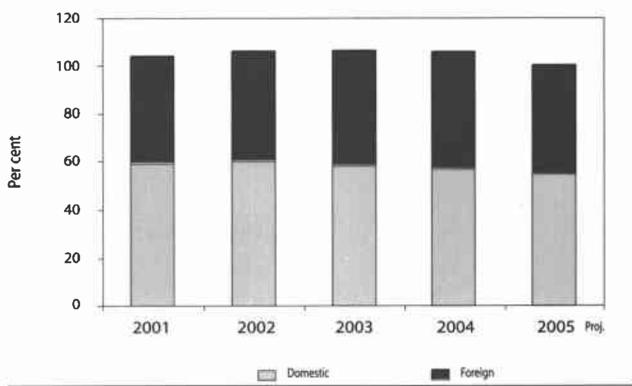


Chart 1.6
Government Debt as a Per cent of GDP



several other measures in 2005. These measures included the conduct of daily open market operations aggressively and the absorption of the excess liquidity on a permanent basis through outright sales of Treasury bills from the Central Bank's holdings.

- **The growth in monetary aggregates began to decline, responding to the tightening of monetary policy.** The growth in reserve money declined to around 18.7 per cent on a point-to-point basis by September 2005 from a high level of 21 per cent at end December 2004. Consolidated broad money (M_{2b}), which grew in a range of 19-21 per cent on a point-to-point basis, during the first half of the year, reached to around 20 per cent by Augest 2005. The contribution to monetary growth arose from both net foreign assets (NFA) and net domestic assets (NDA). The increase in NFA of the banking system was due to higher remittances, tsunami related transfers to the private sector and financial inflows to the government. Meanwhile, NDA of the banking system increased largely due to the higher increase in credit to the private sector with the expansion in economic activities and the prevailing low interest rates.

- **The interest rate structure moved upwards during the first nine months of the year.** Yields on government securities have increased across the maturities following the developments in inflation, inflation expectations and policy interest rates. A similar trend was seen in the lending and deposit rates of commercial banks. Many banks have raised their term deposit rates by a margin commensurate with the increase in the yields on government securities. However, the adjustment in the savings deposit rates was low compared to the adjustments in other rates.

Financial Sector Developments and Stability

- **Activities in the financial sector increased and the resilience of the financial system has strengthened further in 2005.** The performance of the banking sector improved, marked by enhanced capital funds, improving capital adequacy ratios and an increase in profits. Several measures have been taken to strengthen and improve the efficiency of the financial sector, improve risk management, enhance access to finance, strengthen the payment and settlement systems and improve supervision and regulation.

Chart 1.7
Changes in Policy Interest Rates

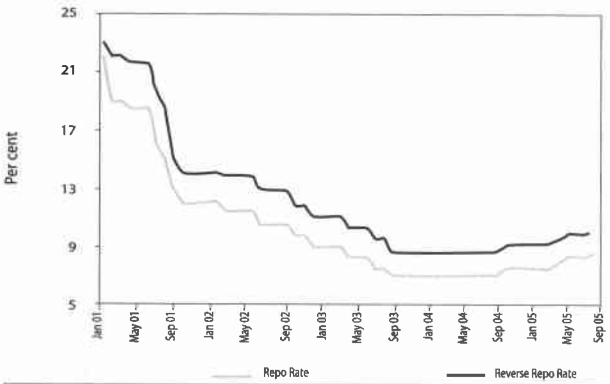
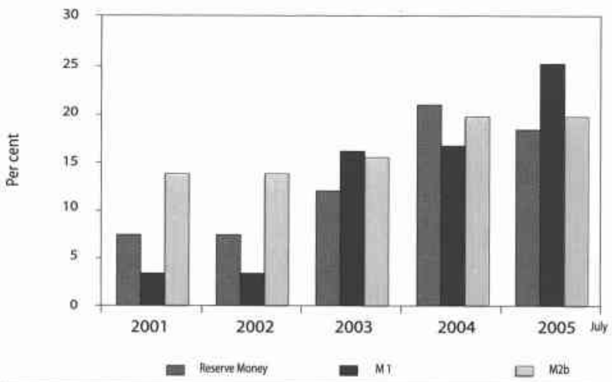


Chart 1.8
Growth Rates of Monetary Aggregates



- **The Central Bank has taken several measures to further improve the safety of the payment and settlement system.** In September 2005, the Payment and Settlement Systems Act was passed in the Parliament. It facilitates the regulation of payment, clearing and settlement systems, the disposition of securities on the books of the Central Bank, the regulation of providers of money services and electronic presentment of cheques. The preparatory work in respect of the Cheque Imaging and Truncation Project, which will improve the efficiency and the speed of the cheque clearing process, has progressed satisfactorily. Commercial banks have also been requested to provide a disaster recovery management and business continuity plan to ensure the continuity of business operations of banks.

- **The share market continued to improve during the first nine months of 2005 with the Colombo Stock Exchange emerging as one of the best performing markets in the world by end September 2005.** The improved earnings outlook and the financial health particularly of the major blue chip companies, the inclusion of Sri Lanka by the California Public Employees' Retirement System (CALPERS), the largest public pension fund in the USA, in its emerging markets investment eligibility list, and the improved foreign investor sentiment with two initial public offers in the service sector attracting a new investor base impacted positively on market activity.

- **The regulatory and supervisory framework was further strengthened to ensure the smooth functioning of the financial system of the country during the first half of 2005.** The minimum capital requirement of banks and primary dealers was increased. The basis for calculation of the Single Borrower Limit (SBL) of licensed commercial banks (LCBs) was further streamlined. Disclosure and reporting requirements of banks were enhanced. The Central Bank has commenced preparatory work to adopt BASEL II rules, which are the internationally accepted risk based standards for supervision of banks set out by the Basel Committee for banking supervision.

Prospects for 2006

- **In 2006, the favourable economic environment is expected to continue.** The domestic environment will remain favourable with the continuing ceasefire agreement, improved political stability and the continuation of favourable weather conditions. Since the next drought cycle is not expected to emerge until 2008, both agriculture and hydropower production are expected to expand further. Furthermore, the effective implementation of tsunami related reconstruction could further boost aggregate demand and output. Global economic developments are also expected to remain benign in 2006, although some downside risks are posed by rising oil prices.

- **Output is expected to grow at about 6 per cent in 2006** with the implementation of the necessary reforms and policies. Economic growth is projected to be broad based with the expected recovery in the fisheries and leisure sectors. The agriculture sector is expected to grow by 1.9 per cent while the industry and services sectors are estimated to grow at higher rates of 6.0 per cent and 7.1 per cent, respectively.

- **Inflation is expected to moderate in 2006 in view of the expected favourable developments in both demand and supply factors and policies.** Among the demand factors, an early containment of the monetary and credit expansion is critical in ensuring this moderation. On the supply side, the expansion of production together with improved distribution systems is expected to have a favourable impact on prices. However, the looming risk of higher oil prices could exert inflationary pressures.

- **Sri Lanka's external sector is also expected to improve further in 2006, recording an overall BOP surplus for the second consecutive year,** thereby increasing the country's external reserves and reducing pressure on the exchange rate. Critical to this favourable outcome are the stability of oil prices, the continuing recovery in industrial countries, the faster realisation of expected tsunami related financing and the effective utilisation of available foreign assistance.

- **The fiscal outcome for 2006, based on the estimated outcome of 2005 and the government's medium term policy direction enunciated in the Budget, indicates that the** overall deficit in 2006 could be below 8 per cent of GDP. To achieve this, revenue has to be enhanced further through additional measures, and expenditure has to be rationalized. Public investment also has to be enhanced to support higher economic growth.

- **Appropriate monetary and fiscal policies are required to contain the expansion in domestic credit to achieve the monetary targets.** The growth in money supply is to be maintained at around 14 -15 per cent, which is consistent with the expected GDP growth of around 6 per cent and the increase in the GDP deflator of around 8 per cent.