1 *OVERVIEW*

- **Sri Lanka's economy registered a growth of 6.6 per cent in real terms during the first half of 2008, in comparison to 6.3 per cent recorded during the first half of 2007.** This is an encouraging achievement, given the challenging environment stemming from tight monetary policy to check inflation on the domestic front, high and volatile oil prices, sharp increase in food prices and global economic slowdown in the backdrop of global financial crisis on the external front. The growth momentum is expected to continue into the second half of the year, though at a slightly slower pace and the economy is expected to record an overall growth of around 6.0 - 6.5 per cent in 2008, compared with 6.8 per cent registered in 2007.

- **The economic growth during the first half of 2008 was broad based with significant contributions from all key sectors.** The Services sector expanded by 6.7 per cent during the first half of 2008, compared to 6.8 per cent during the same period of the previous year. The growth in the Industry sector decelerated to 6.5 per cent compared to 7.2 per cent growth in 2007 mainly due to the global economic slowdown. The Agriculture sector recorded a growth of 6.6 per cent largely attributable to recovery in tea and paddy production during the first half of the year.

Chart 1.1
GDP and Sectoral Performance (Growth Rates)

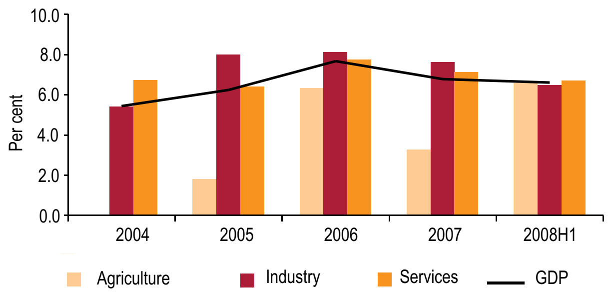
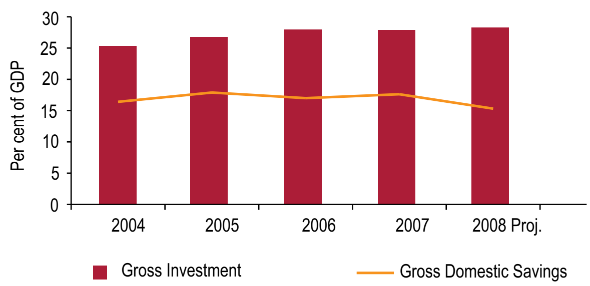


Chart 1.2
Savings and Investment



- **During the year as a whole, Industrial sector is projected to slowdown from 7.6 per cent in 2007 to 6.3 per cent in 2008, reflecting mainly the impact of global economic slowdown.** The Services sector growth momentum is expected to continue, but at a lower rate of 6.0 per cent. Meanwhile, the Agriculture sector is projected to expand by 6.6 per cent in 2008.

- **The investment is projected to expand around 28.3 per cent of GDP in 2008 compared to 27.9 per cent observed in 2007,** supported by higher public investment resulting from implementation of a series of infrastructure development projects. The increase in investment expenditure is also reflected in the import of investment goods which grew by 24.0 per cent, in US dollar terms, during the first six months of the year.

- **Domestic savings as a percentage of GDP is projected to be around 15.3 per cent in 2008 compared to 17.6 per cent in 2007.** The contraction in domestic savings could be attributable to the higher import bill projected for 2008 with the increase in crude oil and food prices. National savings are also projected to decline as a percentage of GDP to 20.9 per cent from 23.3 per cent in 2007.

- **The recent downward trend in unemployment continued, with the unemployment rate reaching 5.3 per cent in the second quarter of the year,** a significant decline from 6.5 per cent registered in the second quarter of 2007, reflecting a further expansion in employment opportunities.

- **Inflation increased significantly during the first half of 2008 due to the pass-through of external supply shocks as well as demand pressures in the economy.** Inflation, as measured by the year-on-year increase in the Colombo Consumers' Price Index was on a steady upward path during the first half and it reached 28.2 per cent by June 2008 from 18.8 per cent at end 2007. This was largely due to the upward adjustments in administered prices such as kerosene, petrol and diesel to reflect their international prices and the subsequent adjustment in transport fares. In addition, the continued increases in commodity prices in the international markets have had a significant impact on the prices of imported commodities. Against this high inflation, the Central Bank continued its tight monetary policy to effect a reversal in inflationary trends and it brought about a salutary effect of a substantial deceleration in money and credit growth. Hence, from July onwards, the inflation rate began to gradually decline, recording a rate of 24.3 per cent by end September 2008. It is expected that this declining trend would continue during the rest of the year, with the continuation of demand management policies adopted by the Central Bank.

Chart 1.3
Unemployment Rate

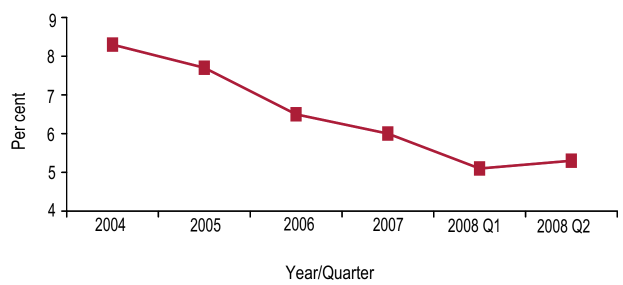
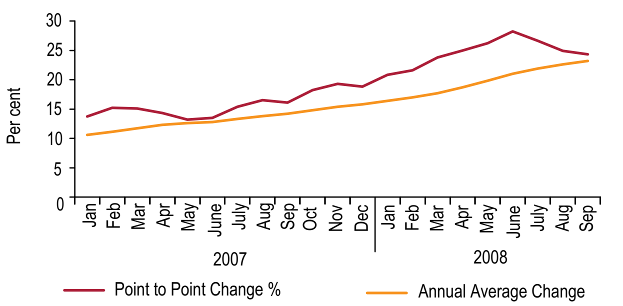


Chart 1.4
Inflation



- **The external sector continued to record a better performance during the first half of 2008 registering a surplus in the balance of payments (BOP)** largely supported by higher remittances flows from migrant Sri Lankans, increased foreign direct investment and higher debt flows to the government. However, the trade and current account deficits widened sharply due to increased import expenditure, resulting largely from higher petroleum and commodity prices.

- **Exports grew by 12.7 per cent during the first eight months of 2008 mainly driven by the improved performance of agricultural exports, particularly tea, rubber and other minor agricultural crops.** However, a sharp rise in imports by 35.3 per cent during this period, led by unprecedented increases in international prices of oil and other commodities, widened the trade deficit from US dollars 2,166 million in the first eight months of 2007 to US dollars 4,031 million in the corresponding period of 2008. The terms of trade deteriorated by 11.8 per cent during the first seven months of 2008.

- **The tourist arrivals during the first nine months of 2008 dropped by 9.5 per cent to 317,546 compared to the same period in 2007, mainly due to the travel advisories issued by some major tourist generating countries in view of the security situation in the country.** The Sri Lanka Tourism Development Authority developed a marketing strategy and activity plan for 2008 to 2010 mainly focusing on promoting tourism in four key markets; India, Russia, the United Kingdom and the Middle East, that have shown significant growth potentials.

- **Remittances by migrant Sri Lankans continued to remain as the main source of cushioning the adverse impact of higher import bills.** The worker remittances grew significantly by around

Chart 1.5
Foreign Direct Investment

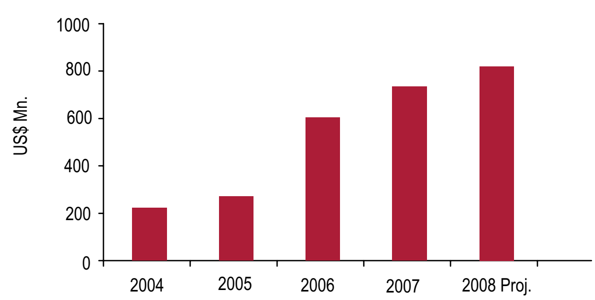


Chart 1.6
International Trade Performance and Trade Balance

21.8 per cent to US dollars 1,975 million in the first eight months of 2008 and projected to reach US dollars 3,000 million by end 2008. The increased remittances helped to finance around 49 per cent of the trade deficit in the first eight months of 2008.

- **The external current account deficit increased in the first half of 2008 largely due to widened trade deficits.** The current account deficit increased to US dollars 1,910 million in the first half of 2008 from US dollars 802 million in the first half of 2007. The current account deficit as a percentage of GDP is projected to be around 7 per cent in 2008. In order to mitigate adverse impacts of higher current account deficit in the medium-term, it is essential to mobilise as much as non-debt creating capital flows.

- **Net inflows to the capital and financial accounts by way of foreign investment and loans during the first half were more than sufficient to offset the current account deficit.** Financial flows to the government increased substantially during this period mainly due to disbursements of loans by multilateral and bilateral lenders for the implementation of projects, opening up of upto 10.0 per cent of total outstanding Treasury bills and bonds for foreign investors, and mobilisation of syndicated loans.

- **The overall balance of payments (BOP) recorded a surplus of around US dollars 390 million during the first half of 2008.** With the expected realisation of official financial flows to the government and Foreign Direct Investments (FDI), the overall BOP was projected to record a surplus in 2008. However, with the recent unexpected developments arising from the global financial crisis, the expected surplus is unlikely to be realised as there are several downside risks, such as possible delays in the realisation of projected external financing, particularly commercial borrowings, significant deviations in projected trade balance due to slowing down export volumes and prices with lower than expected global ecomonic growth.

- **The rupee-US dollar exchange rate remained stable and rupee appreciated against most of the major currencies during the first nine months of 2008.** The rupee-dollar exchange rate, which remained at Rs. 108.72 per dollar by end 2007, has appreciated by about 0.75 per cent to Rs. 107.91 per dollar by end September 2008. The rupee appreciated by 11.72 per cent against the Sterling pound and by a higher rate of 18.41 per cent against the Indian rupee during the same period. Higher foreign inflows by way of foreign investment in government securities, portfolio and foreign direct investment and suppliers' credit extended to Ceylon Petroleum Corporation (CPC) by Iran and other oil suppliers, and the weakening of US dollar in the international markets largely contributed to the appreciation of rupee during the first nine months of 2008. In the aftermath of the recent financial crisis, the rupee remained stable and appreciated further against most currencies as the Central Bank intervened to preserve the stability of the currency against the US dollar, which started to appreciate sharply against most currencies due to global investor preferences shifting towards safer US government securities.

- **In line with the policy of giving priority for revenue enhancement, the government continued to introduce measures to sustain the revenue growth witnessed in the recent past and further augment the revenue collection.** These measures were mainly in the areas of broadening the tax base, changing the tax rates while providing some exemptions as development measures for specific areas, and improving tax administration. Reflecting the positive impact of these efforts, government revenue increased by 21.0 per cent to Rs. 416.9 billion during the first eight months of 2008. However, the revenue performance so far in the year indicates a likely shortfall in 2008 against the budgeted revenue targets and it needs to be minimised with appropriate offsetting measures.

- **On the expenditure front, a number of measures were taken to contain recurrent expenditure.** In particular, the retail prices of petroleum products were continued to adjust to reflect the cost, while administered prices, such as electricity tariff, rail fares and passenger bus fares, were revised upwards in line with increased input costs. Despite these measures, the recurrent expenditure increased in a number of areas including salaries and wages, pension payments, interest payments and fertilizer subsidy during the first eight months of 2008. The capital expenditure and net lending, though increased considerably during this period, remained below the targeted level. Reflecting these developments, total expenditure and net lending amounted to Rs. 645.4 billion during the first eight months of 2008, indicating a 20.0 per cent increase over the same period in the previous year.

Chart 1.7
Fiscal Sector Developments

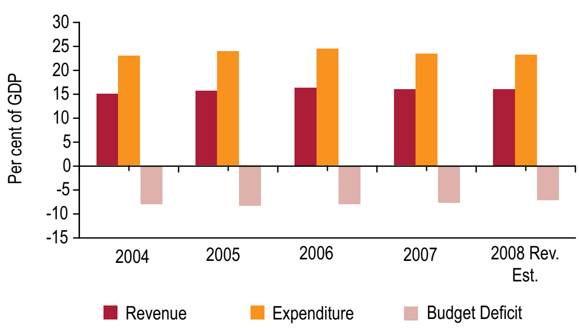
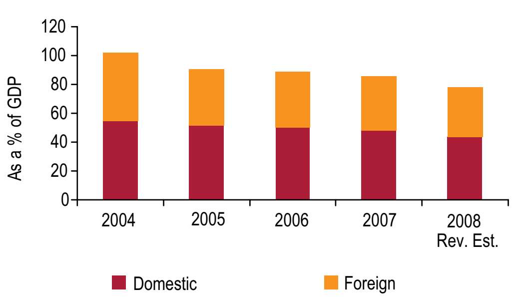


Chart 1.8
Government Debt as a Per cent of GDP

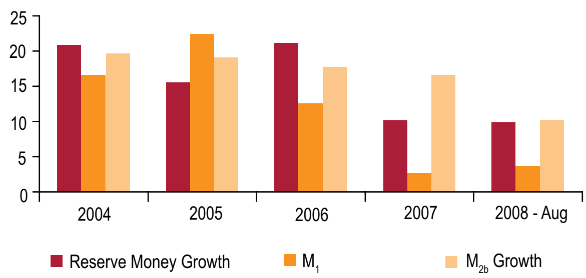


- **According to the revised estimates, the budget deficit is expected to be around 7.0 per cent of GDP in 2008 compared to 7.7 per cent recorded in 2007.** In contrast to the marginal surplus expected, there will be a deficit of about 0.8 per cent of GDP in the current account, in 2008. The primary deficit is expected to be within the original target of 2.1 per cent of GDP, which will also be a further decline compared to that of the previous year.

- **The contractionary monetary policy stance of the Central Bank has been successful in maintaining the expansion in reserve money and broad money growth well within the targets during the first three quarters of the year.** This helped checking the nominal aggregate demand with a sharp decline in credit to the private sector. However, credit to the government by the banking sector increased above the targeted path by August 2008. Meanwhile, credit to public corporations declined largely due to repayments made by the CPC.

- **Interest rates in all market segments remained relatively high with some volatility in short-term interest rates during the first nine months of 2008.** The tight monetary policy measures and resulting contraction in market liquidity has led to an upward adjustment in market interest rates. The volatility however, has been contained since November 2007, with the introduction of the penal rate of 19 per cent, at which unlimited access to Reverse repurchase facility of the Central Bank is available when the market is short or broadly in balance in liquidity. Meanwhile, yield rates on government securities

Chart 1.9
Growth Rates of Monetary Aggregates



declined somewhat, partly due to the opening of Rupee denominated Treasury bills to foreign investors in May 2008.

- **In the face of the adverse developments in the global financial markets, the Central Bank implemented precautionary measures in October 2008 to avoid any liquidity constraint in the market.** The Statutory Reserve Requirement (SRR) on all Rupee deposit liabilities of commercial banks was reduced by 75 basis points to 9.25 per cent from 10 per cent with effect from 17 October and thereby released additional liquidity of Rs.7.5 billion to the market. Also, the limit on the access of commercial banks and primary dealers to the Reverse repurchase facility of the Central Bank at the Reverse repurchase rate when the market liquidity is short was enhanced from 3 times per calendar month to 6 times and further to 10 times in October 2008.

International Economic Environment

- **The slowdown in the world economy is expected to continue in 2008.** The world economy is expected to grow by 3.9 per cent in 2008 and 3.0 per cent in 2009. Most of the advanced economies are expected to remain sluggish or even contract during the remaining period of 2008 and first half of 2009, before a modest recovery in the second half. Accordingly, the growth projections in the advanced economies will decelerate to 0.5 per cent in 2009 from 1.5 per cent in 2008. Emerging economies will continue to grow at a higher rate of 6.9 per cent in 2008 and 6.1 per cent in 2009. However, there are downside risks to the world economic growth outlook mainly stemming from elevated financial risks in the form of rising losses of financial sector due to write offs and risk averseness, thereby increasing cost of capital and credit availability.

- **Inflation in advanced economies is expected to decelerate to 2.0 per cent in 2009 from 3.6 per cent in 2008,** as domestic demand is expected to decelerate responding to tight monetary policies implemented in 2008 and supported further by lower aggregate demand arising from expected recessions in advanced economies. However, the inflationary pressures in emerging economies still remain high as food and fuel make up a larger share of their consumption basket and growth supported by accommodative macroeconomic policies continues to be above the trend. Inflation in emerging economies is expected to reach 9.4 per cent in 2008 and decelerate gradually to 7.8 per cent in 2009.

Prospects for 2009

- **In 2009, Sri Lanka's economy is projected to grow at a rate between 6.5 - 7.0 per cent.** The implementation of several planned mega infrastructure projects such as expressways, highways, Ports and Airports, acceleration of development projects in the Eastern and Northern provinces and expansion in agricultural production supported by higher commodity prices are likely to boost aggregate demand and output. Economic growth is projected to be broad based with the expected growth in all key sectors. The Agriculture sector is expected to grow moderately while the Industry and Services sectors will grow at higher rates. The higher growth projected for 2009 would be supported by the expected increase in investment expenditure by both private and public sectors. However, the recent global financial crisis and looming global recession pose significant downside risks to the projected growth in 2009.

- **Following the turnaround in inflation observed in July 2008, inflation is expected to continue to decline during the remainder of 2008 and in 2009.** While the easing of commodity prices in international markets would lessen the external pressures on domestic prices, the containment of monetary expansion through the continued tight monetary policy stance would reduce demand driven inflationary pressures in the economy. However, any rebound in international commodity prices including the price of oil, could threaten the continued deceleration in inflation despite more stringent monetary policy measures being adopted by the Central Bank.

- **Sri Lanka's external sector is expected to improve in 2009 recording an overall BOP surplus, thereby increasing the country's external reserves.** However, a recovery in industrial countries, continuation of concessionary access to EU countries under GSP+, stability of commodity and oil prices, strengthening of foreign investor confidence, realisation of project related foreign financing and effective utilisation of available foreign assistance are critical in ensuring the realisation of a favourable outcome.

- **The fiscal outturn for 2009, based on the government's medium term policy direction enunciated in the Medium Term Macroeconomic Framework (MTMF), indicates that the overall budget deficit in 2009 would be contained at around 6.5 per cent of GDP.** To meet this target, necessary policy measures need to be introduced in the areas of enhancement of revenue through additional measures and improved tax administration, rationalisation of recurrent expenditure and improvements in the government debt management.