Overview of Recent Economic Developments

Introduction

1. Sri Lanka's recent history attests to the economy's resilience to adverse shocks. The economy has been growing at around 5 percent for over two decades even during the conflict years. Much of this resilience has to do with the country's relatively well developed human capital and the continuation of market-friendly reforms since the late 1970s. However, it is surprising that the relative peace enjoyed since the ceasefire in February 2002 has not translated into higher growth.[1] Against this backdrop, recent statistics show that this past growth performance has not been adequate for significantly reducing poverty beyond the urban areas. To achieve faster growth and poverty reduction, Sri Lanka will need to address remaining structural constraints, including weaknesses in the macroeconomic environment.

A. Political Context

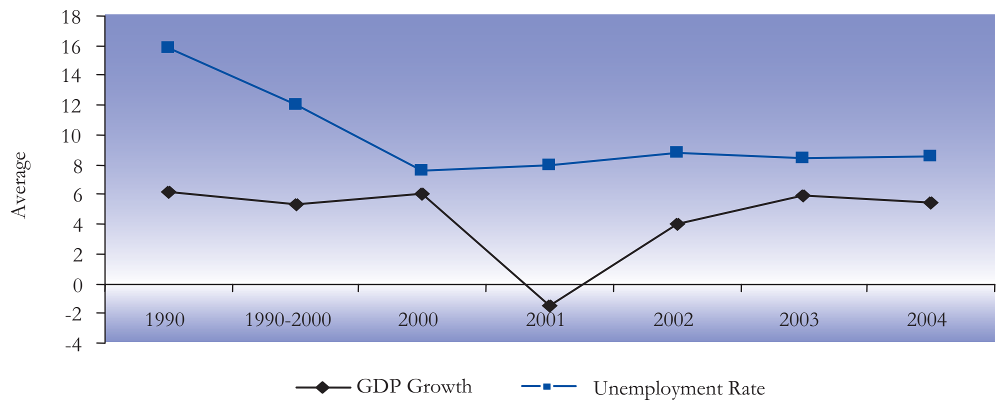
2. The country's recent political context has been marked by a number of important events which have influenced the decision-making process, including management of the economy. A ceasefire agreement was signed in February 2002 between the Government of Sri Lanka (GOSL) and the Liberation Tigers of Tamil Eelam (LTTE), putting a temporary end to hostilities and opening the way for peace negotiations and hopefully for durable peace. Although peace talks have been stalled since April 2003, the ceasefire has been holding for the third consecutive year, which is the longest period without open hostilities since the outbreak of the conflict in 1983. In addition, Sri Lanka has undergone two general elections in a period of less than three years leading to a change in leadership and a shift in the policy stance in certain areas such as the role of the state. Having won the December 2001 parliamentary elections by a slender majority, the United National Front (UNF) coalition was defeated by the United People's Freedom Alliance (UPFA) in the April 2004 elections held four years ahead of schedule. The UPFA-comprising the Sri Lanka Freedom Party (SLFP) and the Janatha Vimukthi Peramuna (JVP) as main co-partner-is just short of a parliamentary majority and rules through alliances with other minority groups. Finally, the split of the LTTE in 2004, following the break away of the Karuna faction, has introduced additional uncertainty with regard to the prospects for peace in the North and East.

B. Economic Outcomes

3. Sri Lanka recovered from the economic slump of 2001 when a series of adverse shocks (including a prolonged drought, the airport attack by the LTTE and falling export demand in the aftermath of September 11) led to a 1.5 percent contraction in real GDP-the first since Independence. Economic growth resumed in 2002 and has since averaged 5 percent annually, which is close to the growth rates achieved in the 1990s. The cessation of hostilities since the ceasefire agreement no doubt contributed to the recovery. Meanwhile, the rate of unemployment (excluding the North and East)[2] has fallen only modestly over the period - from 8.8 percent in 2002 to 8.5 percent in the past two years - and stayed above the all-time low achieved in 2000 (7.6 percent).[3]

1. According to the Central Bank, the conflict reduced real GDP growth by 2 to 3 percentage points a year.
2. The unemployment rate including the North and East averaged 8.8 percent in second and third quarter of 2004, but there are no comparable data for past years.
3. The rapid decline in the rate of unemployment during the 1990s reflected a faster rate of employment relative to the growth in the labor force.

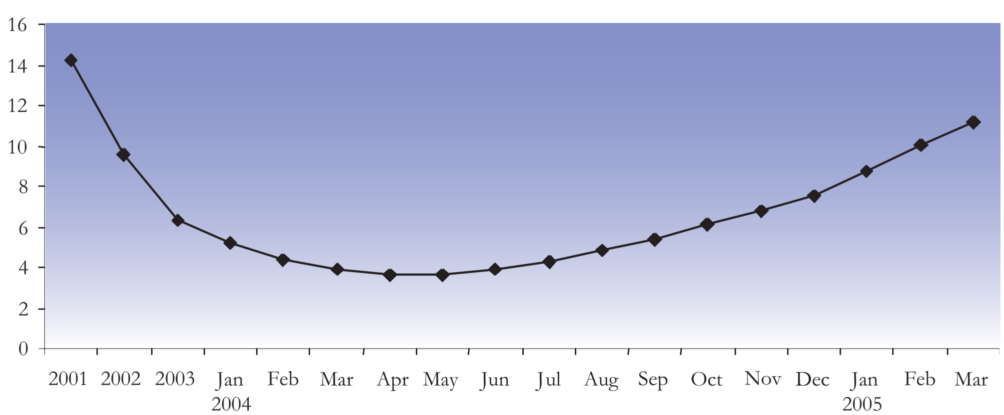
Figure 1: Real GDP Growth and Unemployment 1990-2004



Source: Central Bank of Sri Lanka Annual Report, multiple years.

4. Inflation moderated from an annual average of 14.2 percent in 2001 to 7.6 percent in 2004. However, after bottoming out during the second quarter of 2004 (around 3.5-4 percent), inflation has been rising reaching 11.1 percent in March 2005.[4] Despite a substantial decline in gross official reserves of over US$300 million (from 2.9 to about 2 months of imports), the rupee depreciated by 8 percent against the US dollar in 2004. While these outcomes reflect the impact of exogenous shocks such as higher world oil prices and a drought, expansionary fiscal and monetary policies also played a role. The budget deficit remained at around 8 percent of GDP and money supply growth accelerated to about 20 percent. Moreover, the pass-through of increased oil prices to consumers was delayed leading to substantial losses by the state-run Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB), which were financed through the budget and bank credit.

Figure 2: Inflation As Measured by the CCPI Annual Average 2001-2005

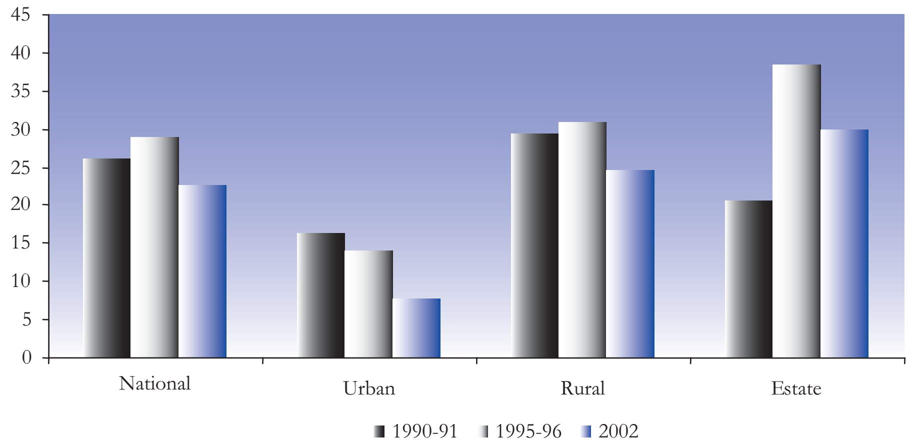


Source: Department of Census and Statistics.

5. Sri Lanka's national poverty headcount ratio fell by only 3 percentage points to 22.7 percent between 1990 and 2002, despite a 3.5 percent annual growth in per-capita income over the period.[5] This modest decline underlies sharply unequal poverty trends across sectors and regions. Poverty incidence in urban areas was halved (to 7.9 percent) while rural poverty declined by less than 5 percentage points (to 24.7 percent) and poverty in the estate sector actually increased (to 30 percent). Similarly, differences in poverty ratios across provinces have been pronounced: in 2002 the poverty headcount ratio was 11 percent in the Western Province and around 35 percent in Sabaragamuwa and Uva.

4. As measured by the 12-month moving average.
5. Excludes the North and East because data for these provinces are not yet available.

Figure 3: Poverty Headcount in Sri Lanka 1990-2002



Source: Department of Census and Statistics.

C. Sectoral GDP Growth, Investment, and Savings

6. In contrast with the 1990s, real GDP growth since 2002 has been driven by the services sector (mainly transport and telecommunications), while industry has taken second place due to a considerable slowdown in manufacturing growth. Meanwhile, agriculture has continued to lag and virtually stagnated over the recent period.

7. **Slowdown in industry.** The industrial sector, which contributes about 26 percent of GDP, has recovered slowly with growth averaging 3.6 percent in 2002-04. This growth record is well below the rates achieved in the 1990s (6.8 percent on average) which in turn reflected strong manufacturing growth (8.1 percent on average). A primary reason is that the global economic slowdown during 2001/02 has limited the demand for Sri Lanka's manufactured exports, especially for textiles and garments, which are the country's largest export category. By 2004, textile and garment exports at about US$2.8 billion were below the levels attained in 2000 (US$3 billion).

8. **Thriving services.** The services sector, which accounts for about 55 percent of GDP, has been on the upswing in the course of the past three years growing by over 7 percent in 2002-04 compared to the average annual growth of 5.6 percent recorded in the 1990s. The telecommunications subsector has been at the forefront of this growth performance, reflecting the participation of the private sector in expanding the telecommunications network and provision for higher value added services growing on average by 25 percent the last three years. Healthy growth in transport, trade, and banking and real estate have also contributed to the expansion of the sector.

9. **Stagnating agriculture.** Agriculture (including forestry and fisheries) has continued to lag behind other sectors and virtually stagnated during 2002-2004, compared to an average growth of 2.5 percent during the 1990s. A drought in 2004 contributed to a 0.7 contraction in value added. The poor performance of the sector reflects its concentration on a few crops: paddy, tea, rubber, coconut, and a small number of other field crops. This concentration entails high risks and makes the sector highly vulnerable to weather conditions. Infrastructure bottlenecks continue to hamper the distribution of agriculture produce, and unpredictable tariff adjustments create uncertainty and discourage long-term investments in the sector.

10. **Investments picking up and savings stable.** Gross domestic investment remained somewhat subdued at around 22 percent of GDP in the immediate years after the ceasefire, but gained momentum in 2004 reaching an estimated 25 percent of GDP. Much of the rebound reflected increased demand for technology upgrades from the apparel industry in preparation for the abolition of the MFA, and new investments in tourism and telecommunications. Foreign Direct Investment (FDI) also rebounded to US$230 million in the last two years.[6] Nevertheless, its contribution to total investment is still fairly modest (1 percent of GDP or 5 percent to total investment). Meanwhile, national savings

6. If privatization receipts are excluded, FDI has almost tripled over the 2001 level (from US$82 to US$217 million).

Table 1: Sectoral GDP Growth Rates 1990-2004

	1990-2000 Average	2001	2002	2003	2004
Agriculture Sector	2.5	-3.4	2.5	1.6	-0.7
Industrial Sector	6.8	-2.1	1.0	5.5	5.2
Manufacturing	8.1	-4.2	2.1	4.2	5.1
Construction	5.2	2.5	0.8	5.5	6.6
Services Sector	5.6	-0.5	6.1	7.9	7.6
Transport, Storage, and Communications	6.4	3.8	7.6	10.2	13.7
Wholesale and Retail Trade	5.5	-6.7	5.6	7.3	5.7
Banking, Insurance, and Real Estate	7.7	7.9	11.1	10.6	6.6
Public Administration and Defense	3.5	1.0	0.0	0.6	2.0
GDP	**5.3**	**-1.5**	**4.0**	**6.0**	**5.4**
National Savings	19.8	20.3	19.5	21.3	--
Total Investment	25.2	22.0	21.3	22.3	25.0
Foreign Direct Investment ($ Mn)	164	172	197	229	227
Of which privatization proceeds:	39	90	5.0	30	10

Source: Central Bank of Sri Lanka.

rates have remained relatively uniform since the 1990s at around 20 percent of GDP. Stability in national savings reflect the combined effects of even corporate sector savings, downward trend in Government dis-savings, and increased net inflows from abroad.

D. Status of Policy and Institutional Reforms

11. Sri Lanka has been ahead of other countries in the South Asian region in implementing first generation reforms such as trade liberalization. To a large extent these reforms explain the economy's resilience to adverse shocks, including the prolonged conflict. There have been recent efforts at fiscal consolidation, but the macroeconomic framework still remains fragile. In addition, while the role of the private sector has been growing, the state still dominates important economic and financial services (e.g., power, transport, and banking), key commodity inputs (paddy and agricultural inputs), and factor markets (land and labor). The state also remains in many ways the employer of first resort, absorbing about one half of formal sector employment.[7]

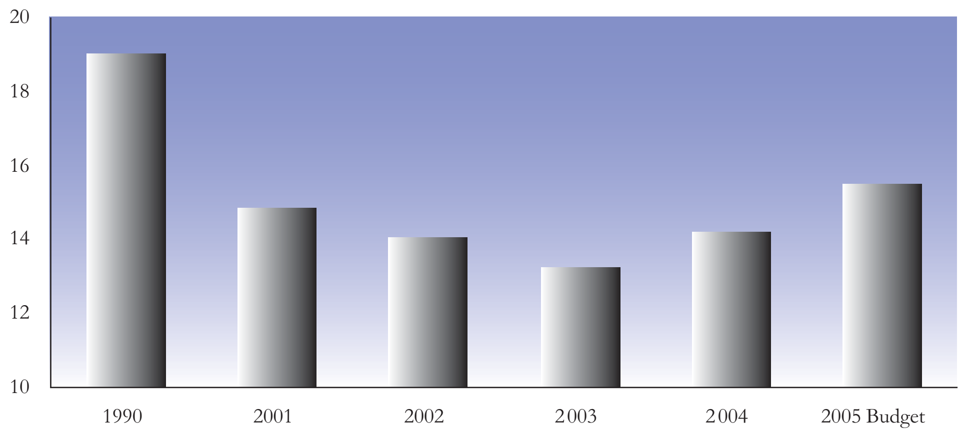
12. The UPFA coalition government elected in April 2004 has outlined its economic policy framework in the recently released *"Creating our Future, Building our Nation"*.[8] This document departs from the previous Government's policy framework in certain areas such as the role of the state. It also lays out the Government's broad areas of focus for reducing poverty-e.g., developing the rural economy, promoting Small and Medium Enterprises (SMEs), restructuring of strategic state-owned enterprises, reinvigorating the civil service and cutting the budget deficit. While the Government places a welcome focus on poverty reduction, it still needs to translate this broad framework into specific programs and actions in the form of a revised Poverty Reduction Strategy (PRS).

7. See Central Bank Annual Report, 2003.
8. GOSL (2004).

Macroeconomic Management

13. **Fiscal policies.** Large fiscal deficits led to mounting public debt during the 1990s. Several factors contributed to this situation, namely: (i) a downward trend in tax revenues (from 19 percent of GDP in 1990 to about 14 percent) reflecting reduced reliance on trade taxes as liberalization progressed; (ii) rising conflict-related defense expenditures; (iii) rapid increase in public sector employment, averaging 3.5 percent annually in the 1990s; and (iv) greater recourse to market-based domestic debt to finance the budget, resulting in a rising ratio of interest payments to GDP. These underlying pressures heightened by the 2001 economic downturn took the public debt to GDP ratio to over 105 percent, raising concern about the country's fiscal/debt sustainability.

Figure 4: Tax Revenues (As a Percentage of GDP) 1990-2005



Source: Central Bank of Sri Lanka.

14. In order to put the fiscal accounts on a sustainable path a Fiscal Management Responsibility Act (FMRA) was passed in December 2002. The Act set medium term ceilings on the fiscal deficit (to below 5 percent of GDP by 2006) and public debt (less than 85 percent of GDP by 2006 and 60 percent by 2013) as well as on government guarantees (to a maximum of 4.5 percent of GDP).

15. Despite some efforts at fiscal consolidation, the past two years have seen a slippage from the FMRA targets. The fiscal deficit was brought down from 10.8 percent of GDP in 2001 to 8 percent in 2003. However, the fiscal adjustment during the period was short of original targets and relied entirely on reduced expenditures (mostly in defense and capital) while tax revenues continued to fall, partly reflecting the complex transition from a sales tax to a two-tier Value Added Tax (VAT) system. Although the decline in tax revenues was reversed in 2004, additional election-related expenditures and petrol and food subsidies kept the deficit high at around 8 percent of GDP. This was above the original target of 6.8 percent of GDP which was later revised to 7.3 percent under the March 2004 Pre-Election Budgetary Position Report. Furthermore, the deficit does not reflect arrears payments due to public enterprises on account of petroleum and food subsidies (estimated at around 0.4 percent of GDP). Net domestic financing increased from 4.5 percent of GDP in 2003 to 6 percent in 2004, including a US$250 million dollar-denominated bond issue. Public debt stood at around 106 percent of GDP at the end of the year (of which 56 percent was domestic debt).

16. Recognizing the importance of attaining fiscal sustainability, the GOSL has announced its intention to adhere to the FMRA targets, albeit on a delayed timetable.[9] Accordingly, the 2005 budget contains positive measures to reduce the fiscal deficit to 7.6 percent of GDP, by substantially raising revenue (1.6 percent of GDP) and containing expenditure increases to 0.6 percent of GDP. Revenue projections however may be on the high side as administration has been made more complicated by the introduction of a three-tier VAT system[10] and numerous exemptions and cesses. Substantial expenditure increases were directed to wages[11] and domestically financed investment-of 1.2 and 1

9. See Ministry of Finance (2004).
10. The system includes a 15 percent VAT for most products, 5 percent for essential food items and 18 percent for luxury goods.
11. Reflecting a 40 percent wage hike to be spread over two years and hiring of 30,000 new graduates.

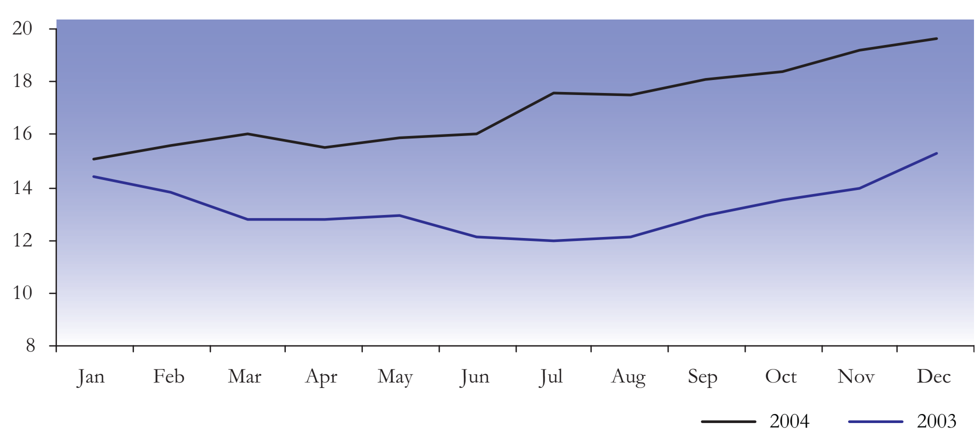
Table 2: Summary of Central Government Fiscal Operations (As a % of GDP) 2001-2005

	Actual			Estimate	Budget
	2001	2002	2003	2004	2005
Total expenditures and net lending	27.5	25.4	23.7	23.5	24.8
Current expenditures	21.6	20.9	19.0	19.2	18.5
Subsidies and transfers	4.6	4.7	4.0	4.9	4.0
Wages and salaries	5.5	5.6	5.2	5.4	5.6
Interest payments	6.7	7.4	7.1	6.0	5.6
Capital expenditures and net lending	5.9	4.6	4.7	4.3	6.4
Total revenues	16.7	16.5	15.7	15.4	17.2
Tax	14.6	14.0	13.2	13.9	15.5
Non-tax	2.0	2.5	2.5	1.5	1.7
Current account balance	-4.9	-4.4	-3.3	-3.9	-1.3
Budget deficit w/o grants	-10.8	-8.9	-8.0	-8.2	-7.6
External financing	1.4	0.6	2.9	1.8	2.5
Domestic financing	8.8	8.0	4.5	5.8	4.6
Public debt	103.2	105.4	105.9	105.5	-

Source: Ministry of Finance estimates.

percent of GDP, respectively - but were to be partially offset by a 1 percent of GDP cut in subsidies and lower interest payments. The bulk of the capital budget increase was allocated to the creation of an SME bank and the remainder consisted of several smaller projects for rural development.

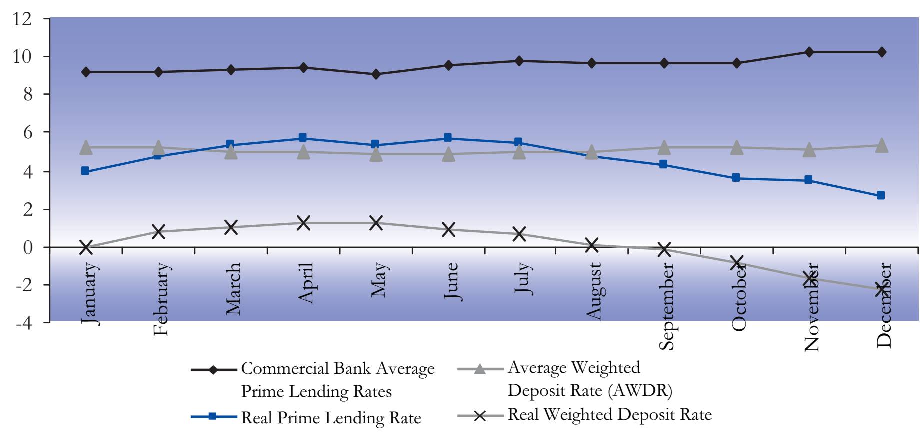
Figure 5: Annual Changes in Money Supply (M2) 2003-04



Source: Central Bank of Sri Lanka.

17. **Monetary policies.** Money supply growth accelerated in 2004 led by a rapid expansion of domestic credit. Broad money expanded by about 20 percent, compared to a target of 15 percent. Net credit to government increased by 25 percent and private sector credit expanded by 22 percent. The rapid credit expansion reflects increased financing of the government budget and higher private demand for credit in the context of declining real interest rates. The acceleration in money supply growth fueled inflationary pressures with the point-to-point inflation rate reaching 13.8 percent in December 2004 while the moving annual average reached 7.6 percent in the same month. Despite rising inflation, the Central Bank raised the overnight (repo and reverse repo) rates only by 50 basis points in November 2004 to 7.5 and 9 percent, respectively, but instead is relying on open market operations to mop up excess liquidity. It is hoped that these measures would be adequate to reverse the negative real deposit rates which are affecting the returns on savings; otherwise the Central Bank may need to consider further adjustments of policy rates.

Figure 6: Real Interest Rates 2004



Source: Central Bank of Sri Lanka.

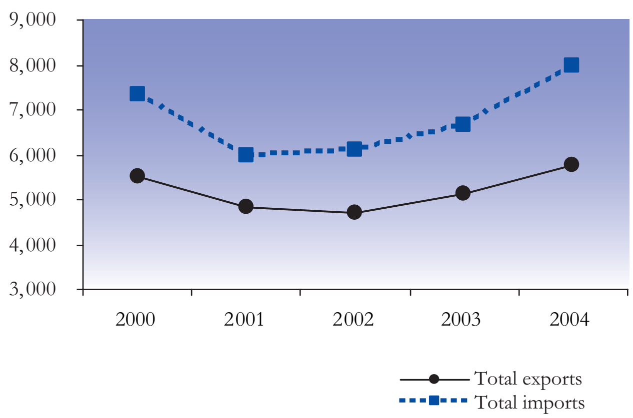
18. **External sector policies.** Sri Lanka's external position weakened in 2004 and the overall balance of payments recorded a deficit after being in surplus since 2001. Notably, the current account deficit (after grants) widened from 0.4 percent of GDP in 2003 to an estimated 3.3 percent of GDP in 2004, reflecting a significant increase in the trade deficit. Merchandise imports rose by 20 percent to about US$8 billion, as a result of substantial increases in both non-oil and oil imports (16.7 and 37 percent, respectively). A 30 percent hike in international oil prices and buoyant domestic demand account for the rise in imports. In addition to the expansive fiscal and monetary stance, lagged adjustments in domestic oil prices and the exchange rate kept up import demand (particularly for capital goods). Although merchandise exports performed well growing by 12 percent to US$5.7 billion, this level was just above the US$5.5 billion attained in 2000. At US$2.8 billion, garments exports were still slightly below the 2000 level, but higher export receipts from tea and rubber more than compensated for the shortfall. Positive net capital flows in the order of US$500 million were insufficient to prevent a deficit in the overall balance of payments and gross official reserves fell from US$2.1 to US$1.8 billion (from 2.9 to 2.1 months of import cover). Nevertheless, the rupee depreciated by 8 percent against the US dollar.

Status of Selected Reforms

19. **Public administration.** The past two decades have witnessed a substantial erosion of the institutional capacity and economic governance of the nation's administrative system. Despite the growing role of the private sector in the economy, the proportion of public sector employees both in absolute numbers and as a proportion of the labor force remains quite high. Around 13 percent of the labor force is employed in the public sector, which results in Sri Lanka having one of the largest bureaucracies in the developing world (3.9 civil servants per 100 people compared to an average of 2.6 per 100 people in Asia).[12] In the 1990s, public sector employment grew by 3.5 percent annually, outpacing population and labor force growth. Public sector workers at the lower ranks are paid higher than their comparators in

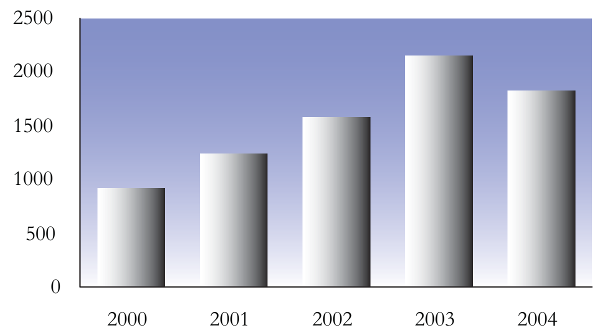
12. Includes only civilian public sector employees.

Figure 7: Exports and Imports ($ Mns) 2000-2004



Source: Central Bank of Sri Lanka.

Figure 8: Gross Official Reserves ($ Mn) 2000-2004



the private sector, while top policy-makers and professionals are insufficiently compensated. As a result, Sri Lanka's public sector compression ratio (about 8:1) is the lowest in South Asia. The inappropriate incentive system and administrative duplication/overlap combined with overstaffing contribute to inefficiencies and ineffectiveness in service delivery.

20. **Public enterprises.** A number of successful privatizations since the early 1990s have boosted growth in key sectors such as telecommunications, airline and ports. However, state-owned enterprises (SOEs) still continue to play a significant role in the energy, transport, water, and banking sectors, posing a heavy fiscal burden and delivering poor services. Most are overstaffed, incur operating losses, have large debts (mostly with the state-owned banks), and require large investments to provide adequate services. Total direct transfers alone represent 3 percent of GDP, which is above the entire education budget. This calls for urgency in improving the performance of SOEs by implementing restructuring plans and adjusting tariffs to reflect full cost recovery. Of particular concern is the situation of the Ceylon Electricity Board (CEB) which has accumulated a debt of over US$80million (0.4 percent of GDP) and is running substantial operating losses. While recognizing the need to improve the performance of SOEs, the government has ruled out privatization as an option and intends to restructure twelve strategic enterprises within a more autonomous corporate structure under the oversight of the recently established Strategic Enterprise Management Agency (SEMA). Business plans for all twelve have been completed and are being considered by Cabinet.

21. **Financial sector.** Sri Lanka's financial system has developed over the past decade reflecting a strengthened regulatory framework and greater private sector participation. The two state banks -the People's Bank (PB) and Bank of Ceylon (BC)-account for 46 percent of banking assets. After two recapitalizations in the 1990s, PB remains insolvent and both banks continue to have high non-performing loans. High intermediation costs (associated with overstaffing and loss-making branches) have contributed to the high cost of funds and large spreads. Earlier plans to commercialize the PB (and thus strengthen its governance structure) through privatization have now been ruled out and the government intends to restructure the bank under SEMA with the assistance of the Asian Development Bank (ADB). Although the financial performance of the banks improved in 2004, the financial position of the banks is at risk owing to increased lending exposure to CPC and CEB. The recent establishment of a State SME bank further raises the need for appropriate oversight in this sector.

22. **Social welfare.** Sri Lanka has a long legacy of social welfare ranging from free education and health to subsidies and cash transfers. However, Sri Lanka's largest cash transfer program, Samurdhi, while making up a significant proportion of public expenditures (0.6 percent of GDP) remains ineffective in providing a safety net to the poor. Samurdhi transfers minimal amounts of cash to almost half of the population and still significantly misses a large

proportion of the poor (40 percent of households in the two poorest quintiles). Early measures to address the mis-targeting in welfare programs involved setting up the Welfare Benefit Board under the Social Welfare Act of 2002 and developing objective criteria for selecting beneficiaries. However, it is still not clear yet whether the government will adopt and implement these newly developed criteria.

23. **Labor regulations.** Sri Lanka's complex and costly labor regulations constrain labor market flexibility and undermine the competitiveness of firms. Labor disputes can take over one year and retrenchment costs are high. Under the 1971 Termination of Employment of Workmen's Act (TEWA), firms with more than 15 workers are required to obtain the written consent of the employee and/or the permission of the labor commissioner for the termination of the employee on non-disciplinary grounds. Employers have responded by limiting job creation, suppressing base wages, and resorting to outsourcing and subcontracting. In 2003, TEWA was amended to require the application of a compensation formula for termination cases and thus improve predictability. The Industrial Disputes Act was also amended, setting timelines for tribunal cases, arbitration cases and termination applications. However, the compensation formula-revised last in March 2005-implies the payment at termination of 1.5-2.5 months wages for each year of service, which is high by regional and world standards.[13] Meanwhile, the system remains unpredictable as the Labor Commissioner's approval continues to be required. An unemployment benefit scheme is also planned (involving the payment of up to twelve month wages) to be funded by increased employer's contributions to the Employees Trust Fund (ETF). Employers have voiced concerns that these measures will undermine the competitiveness of Sri Lankan firms.

24. **Agricultural policies.** Reforms in agriculture and rural development have been limited, with the exception of the privatization of plantations in the early 1990s. A number of longstanding policy constraints have reduced the capacity of farmers to diversify production, enhance their productivity, and respond to market opportunities. These include unpredictable trade policies, highly restrictive seed and quarantine regulations, discretionary commodity price interventions, complex and restrictive land policies, and poorly functioning water delivery systems. Although several initiatives to address some of these constraints have been put forward since the late 1990s, much is still left to be done. The Government is in the process of revising land and water policies, and is reviewing regulations pertaining to access to technologies, but the content and timetable for implementation is still being developed.

13. The average for South Asia is 0.8 wages for each year of service.