ECONOMIC AND FINANCIAL SITUATION

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Overall Growth

Sri Lankan economy progressed further in 2004 showing its resilience to both internal and external shocks. The economy grew by 5.4 per cent in 2004, amidst several adverse developments, namely, a severe drought in the early part of the year, the high international oil prices, floods towards the latter part of the year and the tsunami disaster in December 2004. The growth was underpinned by a broad-based recovery in industrial activity supported by strong external and domestic demand and a robust expansion in the services and industry sector, which accounts for more than 80 per cent of economic activity. However, adverse weather conditions affected agriculture sector, specially plantation agriculture in certain areas, as well as paddy production in both Maha and Yala cultivation seasons contributing negatively to overall output. The tsunami disaster caused extensive damages to human life, economic activities, infrastructure and private property. However, its negative impact on overall economic activity would be limited as the disaster affected the production capacity of a few provinces, which are highly concentrated in a few sectors such as fisheries and tourism. The economic growth in 2005 is therefore, expected to be lower only by about 0.5 percentage points, lowering the earlier expected growth rate of 6 per cent to around 5.5 per cent.

Inflation

Inflation, which was on a downward trend since 2002 started to pick-up from mid 2004 due to both the demand and supply side factors although the supply side developments were dominant. While the prolonged drought in certain areas from the latter part of 2003 through most of 2004, rise in international prices of key commodities, specifically that of petroleum products, sharper depreciation of the rupee generated a cost-push inflation, higher growth in money supply and increased budget deficit contributed to increase in the inflationary pressure from demand side. The average inflation as measured by the Colombo Consumers' Price Index (CCPI) rose to 11 per cent by end March 2005, while the average inflation based on Sri Lanka Consumers' Price Index (SLCPI) also showed a similar increase. Inflationary pressure is also expected to ease somewhat benefiting from the increased agriculture output with the favourable weather conditions, a greater stability of the exchange rate, easing pressure on reserves through medium-term financing of oil bills and due to appropriate monetary policy measures.

Savings and Investment

In 2004, domestic savings, which consist of private and government savings, increased by 15 per cent. This was the result of an improvement in private savings, along with increased corporate sector savings, in the context of higher profitability. With public sector dis-savings increasing in 2004, the domestic savings ratio, i.e., domestic savings/GDP, remained unchanged in 2004, at 15.9 per cent. Investment expenditure contributed significantly to economic growth in 2004, increased by 11.6 per cent in real terms. The investment/GDP ratio increased to 25 per cent in 2004 from 22 per cent in the previous year. Private investment expenditure accounted for 91 per cent of the total investment in 2004, with large investments being made particularly in the garments and tourism industries.

External Sector

On the external front, exports reported a healthy growth, aided by the recovery in the global economy, specially during the latter part of 2004. Exports expanded by around 12 per cent with the main contribution to this increase coming from strong growth in world demand and textiles and garments exports. However, expenditure on imports increased by 20 per cent partly due to greater expenditure on crude oil, fertilizer and other essential commodities such as wheat flour, sugar and milk powder.

As in the past, worker remittances, which helped offset a large part of the trade deficit, increased further. Inflows from tourism were also higher. Tourist arrivals increased by 13 per cent during 2004. Despite higher inflows from remittances and earnings from tourism, lower inflows to the capital and financial accounts has resulted in a deficit in the balance of payments (BOP) in 2004, exerting pressure on the exchange rate.

Growth in export earnings is expected to continue in 2005. The growth in garment and textiles exports could be affected marginally in view of the global competition following the phasing out of the MFA. Growth in imports would be higher in 2005 mainly due to imports for relief, rehabilitation and reconstruction in the areas affected by tsunami. Therefore, the trade deficit could be higher in 2005. However, the receipt of foreign inflows is expected to help mitigate the impact of trade deficit on the external sector.

Fiscal Developments

The government has shown its commitment to strengthen the fiscal consolidation process with the enactment of Fiscal Management (Responsibility) Act (FMRA) in 2002, which needs achievement of targets related to budget deficit and outstanding debt in the medium term. The FMRA was introduced with a view of promoting fiscal prudence and discipline by improving transparency and accountability in fiscal management. The Economic Policy Framework of the government also envisages to continue fiscal operations with a view of increasing government revenue while increasing the public investment programme to improve the quality of the infrastructure in the country.

In 2004, the overall deficit is estimated higher, in comparison to the original target of 6.8 per cent, mainly due to some adverse developments, i.e., the drought and high international oil prices requiring higher government expenditure. The current account deficit (government's dissavings) and primary deficit (overall deficit net of interest payments) are estimated at around 3.9 per cent and 2.12 per cent of GDP against the annual targets of 1.3 per cent and 0.8 per cent, respectively.

In 2005, the government Budget envisaged to contain the overall deficit to 7.5 per cent of the GDP and reduce it further to about 5 per cent by 2008 as expected under the FMRA. However, the government has to undertake the responsibility of providing relief and undertake rehabilitation and reconstruction work in relation to tsunami catastrophe which will result in a sharp increase in the overall deficit to around 9.6 per cent of GDP in 2005. This includes an additional expenditure related to the RRR amounting to Rs 50.5 billion.

A three-year post tsunami rehabilitation and reconstruction programme is estimated to cost about US dollars 1.8 –2.0 billion. The government expects the entire funding requirement from external donors, including a debt relief. The debt relief would help government to reduce its borrowings from domestic sources.

Due to the higher budget deficit, and the depreciation of the rupee vis-a-vis major foreign currencies, the outstanding debt stock as a per cent of GDP would increase to about 107 per cent from 105.8 per cent in 2003.

Financial Sector Developments

Monetary Policy: In 2004, the focus of monetary policy in 2004 was on the need for minimizing inflationary pressures, while facilitating the continuing growth momentum in the economy. However, the difficult economic conditions that prevailed in 2004 required proper timing and sequencing of monetary policy tightening. Accordingly, as the first step, open market operations were conducted aggressively since June by absorbing almost the entire liquidity surplus in the money market through daily auctions, which induced an upward adjustment in the short term cost of funds, so as to contain the growth in monetary aggregates. Subsequently, it was supplemented by raising the Central Bank policy rates by 50 basis points in November 2004. Meanwhile, to contain the higher demand for import credit and to discourage vehicle imports in an already glutted market, a 100 per cent deposit margin requirement against letters of credit (LCs) opened with commercial banks for the importation of motor vehicles for private use was introduced, as a temporary measure.

The Central Bank continued to adopt the monetary targeting policy framework with reserve money as main operating target. Towards this end, CBSL continued its system of active open market operations that was implemented in 2003. This was used in absorbing excess liquidity form the market on an overnight basis.

The Central Bank implemented a relief package by granting loans through the banking system at concessionary rates to help the economy to recover from the impact of the tsunami disaster. This involved taking measures to keep the money market liquid and to ensure the smooth functioning of the financial markets and the payments and settlement system. In this regard, daily OMO auctions were temporarily suspended in early January 2005. The auctions were subsequently resumed in February 2005. As the monetary growth inflation continued to remain high, the Central Bank continued conducting open market operations more aggressively to mop up excess liquidity from the market and contain the growth of reserve money

<u>Monetary Aggregates:</u> Monetary expansion has been somewhat above the expected path, particularly after April 2004. The relatively higher monetary expansion during 2004 was mainly driven by the higher expansion in credit to the private sector as well as to the public sector. The narrow money (M1) growth moved in a range of 14 – 21 per cent and the growth in broad money (M_{2b}) fluctuated in a range of 15 – 20 per cent during the 12 month period ended February 2005.

With the increase in foreign assets of the commercial banks, net foreign assets of the banking system increased. However, reflecting the deficit in the balance of payments in 2004, the NFA of the Central Bank declined. Increased receipts from remittances and tourism, receipts of privatization proceeds at the beginning of the year and the sale of foreign exchange by the Central Bank helped to improve the net foreign assets position of the commercial banks.

Net Credit to the government (NCG) from the banking system increased by Rs.43 billion during Feb. This was particularly due to the increased holdings of Treasury bills by the Central Bank.
The increase in credit to the private sector that began towards the latter part of 2003, continued in 2004. The low interest rate regime and the increase in demand for credit for housing, trading and industry have been major causes for the rapid expansion in credit. A major part of the credit expansion has been for commercial purposes, which include export and import trade. Credit for consumption related activities was the second largest. The other two sectors that have absorbed the bulk of the credit were the housing and property development and industrial sectors.

Interest Rates: The CBSL policy interest rates, which were reduced gradually since early 2001 until October 2003, were increased marginally in November 2004. Market interest rates also showed a declining trend between early 2001 and late 2003, but on average, they have increased with some volatility since then. The weighted average rate at the daily OMO Repo auction, which remained close to the lower bound of 7.00 per cent of the interest rate corridor, had gradually risen to around 7.88 per cent by 18 April 2005.

Market interest rates moved up during the year due to higher demand for credit and some increase in inflationary expectations. The average weighted call money market rate rose from 7.59 per cent by end 2003 to around 8.41 per cent by 18 April 2005. The average weighted prime lending rate (AWPR) also gradually rose from 9.26 per cent at end 2003 to 9.84 per cent by mid April 2005. Showing a similar movement, 364-day Treasury bill rate which was 7.24 per cent by end 2003 increased to 7.90 per cent by mid April 2005.

Financial Sector Stability: During the last two years, a number of measures were taken to further promote financial system stability, which is one of the core objectives of the Bank. The Central Bank focussed on stregenthening the resilience of the banking sector, which accounts for about 60 per cent of the assets of the financial sector. Attention was also paid to the development of the infrastructure of the payments and settlements systems and the development of the government bond market in order to enhance the efficiency, and stability of the sector. Revisions were also being drafted to laws important to financial sector to improve regulatory oversight to be in line with the changes in international best practices, while facilitating greater competition among financial institutions.

Future Economic Outlook

The economic growth is expected to increase in the medium term although the growth in 2005 would be affected due to the economic impact of the tsunami destruction. The broad economic policy framework of the government which is based on the continuation of the liberlised economic policy framework, with a regional balance growth with necessary policy reforms will provide the necessary background for continuing high growth.

The Economic Policy Framework of the Government of Sri Lanka has indicated that the government would make every effort to reduce the budget deficit within a medium term budget framework to a level below 5 per cent of GDP, in line with the provisions of the Fiscal Management (Responsibility) Act, while raising public investment from the current level of about 5 per cent of GDP to 8 per cent over the medium term and phase-out domestic borrowings.

The total cost of rebuilding tsunami affected areas, which would focus mainly on housing and basic infrastructure such as roads, railways, hospitals and schools, is estimated at about US$ 1.8-2.0 billion. As it is not possible to accommodate this expenditures within the government budget given its limitations, a medium term programme has ready been prepared to undertake the rehabilitation and reconstruction activity with the assistance of donor support.

As the government is expecting to finance tsunami related expenditure through foreign sources, the pressure to borrow from the domestic market would be lessened and the impact on domestic monetary management would be limited. Although monetary expansion is high at present largely due to the higher than expected expansion in private sector credit, the overall medium term monetary programme has been prepared permitting a monetary growth consistent with developments in other macroeconomic aggregates, without leading to any demand fuelled inflationary pressure in the economy.