CER: SRI 2001-05

COUNTRY ECONOMIC REVIEW

SRI LANKA

February 2001

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CURRENCY EQUIVALENTS
(as of 20 February 2001)

Currency Unit	–	Sri Lankan Rupee/s (SLRe/SLRs)
SLRe1.00	=	$0.0115
$1.00	=	SLRs86.60

The exchange rate of the rupee is determined under a system of managed float against the currencies of Sri Lanka's major trading partners.

ABBREVIATIONS

GDP	-	gross domestic product
GNP	-	gross national product
GST	-	goods and services tax
LTTE	-	Liberation Tigers of Tamil Eelam

NOTES

(i) The fiscal year (FY) of the Government ends on 31 December.
(ii) In this report, "$" refers to US dollars.

CONTENTS

SRI LANKA
National Capital
Provincial Capital
City/Town
National Road
Provincial Road
Railway
River
Provincial Boundary
Boundaries are not necessarily authoritative.
80°00'E
81°30'E
9°00'N
7°00'N
Palk Strait
Palk Bay
Gulf of Mannar
Bay of Bengal
INDIAN OCEAN
NORTHERN
NORTH CENTRAL
NORTH WESTERN
CENTRAL
EASTERN
WESTERN
UVA
SABARAGAMUWA
SOUTHERN
Kankesanturai
Jaffna
Kodikamam
Kilinochchi
Mullaittivu
Muliyavalai
Talaimannar
Mankulam
Mannar
Horowupotana
Vavuniya
Horowupotana
Trincomalee
Anuradhapura
Tambuttegama
Puttalam
Kekirawa
Hingurakgoda
Wellikanda
Polonnaruwa
Dambulla
Kaikudah
Batticaloa
Chilaw
Madampe
Kurunegala
Matale
Kandy
Polgahawela
Mawanella
Negombo
Warakapola
Minuwangoda
Kegalla
Amparai
Gampola
Gampaha
Talawakelle
Nuwara Eliya
Badulla
COLOMBO
Avissawella
Hatton
Welmada
Bandarwela
Monaragala
Moratuwa
Ratnapura
Wellawaya
Kalutara
Pelmadulla
Halangoda
Aluthgama
Elpitiya
Ambalangoda
Hikkaduwa
Akuressa
Hambantota
Galle
Matara
Tangalle
N
0 10 20 30 40 50
Kilometers

EXECUTIVE SUMMARY

The Sri Lankan economy started to recover in the second half of 1999, and the recovery accelerated in 2000. Both internal factors such as weather conditions and political uncertainties, and external factors such as overall economic fluctuation in the wake of Asian financial crisis and high oil prices were key elements in determining the movement of the economy. However, another key factor that constrained the economy was the civil conflict that started in 1983 and intensified since April 2000.

In 1999, unfavorable external conditions slowed Sri Lanka's economic growth to 4.3 percent, lower than the 4.7 percent achieved in 1998; however, the economy started to recover in the second half of the year. The agriculture sector showed its highest growth since 1993. The annual growth rate of the industry sector was not high but, reflecting the recovery of industrial exports, performance in most industrial categories improved during the second half of the year. Output in the services sector grew even more slowly because of the continued slump in the wholesale and retail trade. In the production structure, the share of the services sector in gross domestic product (GDP) continued to increase.

An increase in corporate and household savings and a reduction in Government dis-savings contributed to the higher domestic savings. While public investment remained at about the same level as in the previous year, the higher private investment led to higher domestic investment. The gap between domestic investment and domestic savings widened.

Fiscal performance improved significantly despite the ongoing conflict in the north and the east. The overall deficit declined to 7.5 percent of GDP from 9.2 percent in 1998. This partially reflects the Government effort to reestablish the fiscal consolidation path achieved during 1995-1997. On the revenue side, the declining trend observed in the total revenue-GDP ratio in the recent past was arrested in 1999 with higher mobilization of tax revenue. On the expenditure side, noninterest current expenditure was maintained at about the same level as in 1998, growth of the wage bill was contained at a lower rate, and expenditure on purchases of goods and services declined. In particular, defense expenditure continued to decline at 4.4 percent of GDP, compared with 5.0 percent in 1998. Capital expenditure did not reach the originally expected level owing to significant shortfalls in expenditures in several major projects in ports, agriculture, railways, and energy. The stock of Government debt as a percentage of GDP increased to 95 percent from 91 percent in the previous year.

The monetary policy continued to focus on maintaining stability in the financial market, and further efforts were made to enhance the market orientation of the instruments of monetary policy. Except for a temporary instability in the financial market in April as a result of elections and labor unrest, both the call market and the exchange market exhibited considerable stability. A slight decline in short-term market interest rates reflected a low inflation rate and flexible monetary policy. Although there were some reductions in interest rates, they were much less than the fall in inflation, resulting in an increase in real interest rates. Faster growth in domestic assets was partly offset by a decline in net foreign assets, reflecting the deficit in the balance of payments. Monetary growth was higher than in 1999.

The inflation rate of 4.7 percent was the lowest since 1985. It was the outcome of improved monetary controls and fiscal discipline, rationalized tax and tariff structures, greater agricultural production, and improved domestic marketing network and dissemination of price information systems using modern communication media. In addition, the drop in the world market prices of major imported consumer items compensated for the upward pressure on prices through the currency depreciation.

External sector developments were dominated by the lagged effects of the depressed global demand and the resultant decline in commodity prices. Exports decreased by 3.9 percent, but imports increased by 1.5 percent because of the import of three aircraft by SriLankan Airlines. Consequently, the trade deficit widened. The current account deficit increased from 1.4 percent of GDP in 1998 to 3.6 percent. Coupled with a declining surplus in the capital and financial accounts, the overall balance of payments registered a deficit of 1.7 percent of GDP from a surplus of 0.2 percent in 1998. Exchange markets remained stable during the year in contrast to the high volatility in 1998. The Sri Lanka rupee depreciated by 8.2 percent against the dollar during 1999. Total external assets at the end of the year were equivalent to 4.6 months of imports of goods and services, while total official reserves were equivalent to 2.9 months of imports. The external debt stock increased and 94.8 percent of the total was medium- and long-term debts consisting mainly of concessional assistance. The total external debt-GDP ratio increased from 55.5 percent in 1998 to 57.4 percent. The debt service payments as a percentage of receipts from exports and services also increased.

During the first half of 2000, GDP grew by 7.0 percent helped by a favorable external trade environment that continued from the second half of 1999. While the high growth was broad-based, the industry sector outperformed the agriculture sector and the services sector. The inflation rate was higher than expected at 6.8 percent due to a high increase in food and energy prices. Exports continued to grow by 19.7 percent maintaining the growth momentum achieved in late 1999. The high export growth was accounted for by the strong economic growth in the United States (US) and European countries, and the recovery of the East Asian countries including Japan and the Republic of Korea. Reflecting the export-dependent import structure of Sri Lanka, imports also increased by 38.1 percent. Trade deficit was $1,139 million compared with $549 million in the same period in 1999.

In the second half of 2000, the economic trend of the first half is expected to continue. The real GDP growth rate is projected at 6.0 percent in 2000 and 4.5 percent in 2001. Exports are expected to increase by 19.8 percent, and imports by a higher rate, 22.4 percent due to higher oil prices. The ratio of the current account deficit to GDP is expected to be 6.0 percent in 2000 and 3.8 percent in 2001. High foreign direct investment, private capital flows and Government short-term capital flows will partially offset large current account deficit. The deficit in the overall balance of payments is projected to widen from 1.7 percent of GDP in 1999 to 3.4 percent in 2000. Despite continuing fiscal consolidation efforts, an increase in defense expenditure will reverse the downward budget deficit ratio to GDP. The ratio is expected to reach 8.7 percent in 2000, and only a small improvement is expected in 2001. Inflation will return to a higher level of 6-8 percent.

For sustainable and high economic growth, the Government needs to take the initiative in various areas. A consensus has emerged that a solution to the civil conflict which is estimated to lower GDP by 6 percentage points is a prerequisite to improve economic growth and poverty profiles. Mitigating the high fiscal deficit and public debt is imperative for flexible implementation of both fiscal and monetary policies. The Government must promote the private sector to meet the economy's expanding resource requirements while developing the appropriate market environment to promote efficiency. More efforts for generating demand should be made in the agriculture sector, an important foreign exchange-earning sector. To link highly developed human capital to high economic welfare, a more flexible labor market and narrowing down the gap between skills demanded and skills supplied are required.

I. RECENT ECONOMIC DEVELOPMENTS

A. Growth, Employment, and Savings and Investment

1. Aggregate Growth

1. The Sri Lankan economy started to recover in the second half of 1999, and the recovery accelerated in 2000. Both internal factors such as weather conditions and political uncertainties, and external factors such as overall economic fluctuation in the wake of Asian financial crisis and high oil prices were key elements in determining the movement of the economy. However, another key factor that constrained the economy was the ethnic conflict that started in 1983 and intensified since April 2000.

2. The average gross domestic product (GDP) growth in 1999 was slightly lower, 4.3 percent, than the 4.7 percent in 1998. This growth was also below the average rate of 5.2 percent for the past 10 years (1990-1999). Gross national product (GNP) grew by 3.8 percent in real terms, compared with 4.6 percent in 1998, and fell far short of GDP than it was in 1998. That was mainly due to a negative net factor income from abroad, i.e., a reduction in investment income receipts and an increase in interest payment on foreign debt in 1999. Although the natural increase in population declined, higher net in-migration increased the midyear population to 19.0 million, an increase of 1.4 percent compared with 1.2 percent in 1998. A per capita GDP in nominal terms decreased from $839 in 1998 to $829 in 1999.

3. The Sri Lankan economy fluctuated with the external environment in the wake of the Asian financial crisis. Depressed economic conditions persisted into the first half of 1999, with a growth rate of 3.0 percent. However, the third quarter recorded a growth rate of 4.0 percent, responding strongly to growth in external demand. In the fourth quarter, GDP growth reached 6.9 percent, indicating further consolidation of progress toward a higher growth path. The industry sector fared better later in the year, with export-oriented industries regaining their competitiveness with the gradual appreciation of the exchange rates of East Asian countries along with their economic recovery.

2. Sector Performance

4. The agriculture sector grew steadily at 4.5 percent in 1999 compared with 2.5 percent in 1998, due to favorable weather conditions throughout the year (Table 1). That growth was the highest since 1993. The industry sector grew by 4.8 percent in 1999, compared with 5.9 percent in 1998. The slower growth was largely due to a decline in foreign demand during the first half of the year as a result of the depressed world economic conditions. Reflecting the recovery of industrial exports, performance in most industrial categories was better during the second half of the year. Output in the services sector, which increased by 5.1 percent in 1998, grew by only 4.0 percent in 1999, because of the continued slump of wholesale and retail trade. The production structure, measured by current factor cost, has transformed slowly to increase the shares of the industry and services sectors (Figure 1). In 1999, agriculture, industry, and services sectors accounted for 20.7, 27.3, and 52.0 percent, respectively. The share of the manufacturing sector increased from 15.7 percent in 1995 to 16.4 percent.

a. Agriculture, Forestry, and Fishing

5. The high growth in the agriculture sector reflects higher output in the four major sub-sectors: paddy, coconut, tea, and rubber, in order of share of GDP. Paddy output improved by

6.6 percent and recorded the highest paddy production in recent years. Despite that satisfactory performance, however, Sri Lanka had to import 214,000 metric tons of rice in 1999. Coconut production improved by 9.1 percent and reached the highest output level since 1986. Tea production reached a new peak in 1999 (Figure 2). This was due mainly to improved management under private companies and better cultivation practices. Rubber production showed a small recovery after declining for several years. The prolonged effects of favorable weather conditions in 1998 and well distributed rainfall and increased fertilizer use contributed to increase output. The improved performance of the agriculture sector could stabilize domestic food prices, thus mitigating the inflationary pressure in the economy.

Table 1: Annual Growth Rates by Economic Activity, 1995-1999
(percent)

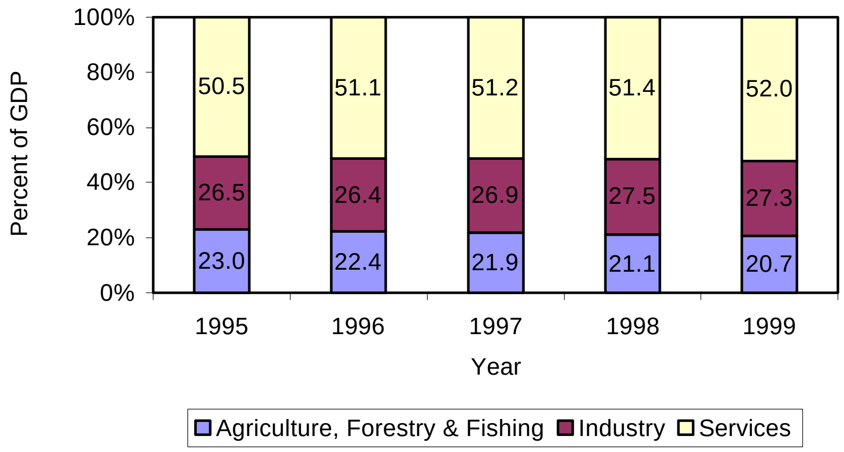
Item	1995	1996	1997	1998	1999
Agriculture, Forestry, Fishing	**3.3**	**-4.6**	**3.0**	**2.5**	**4.5**
Industry	**7.8**	**5.6**	**7.7**	**5.9**	**4.8**
Mining and Quarrying	3.4	8.9	3.8	-5.4	4.1
Manufacturing	9.2	6.5	9.1	6.3	4.4
Construction	4.9	3.4	5.4	7.1	4.8
Electricity, Gas, and Water	10.2	-2.0	8.1	10.1	9.5
Services	**4.9**	**6.0**	**7.1**	**5.1**	**4.0**
Transport, Storage & Communications	5.5	7.5	8.8	7.7	8.1
Wholesale and Retail Trade	3.6	5.2	6.3	4.5	1.0
Banking, Industries & Real Estate	10.5	10.1	10.3	6.4	4.6
Ownership of Dwellings	1.3	1.3	1.3	1.2	1.2
Public Administration and Defense	5.4	5.0	5.2	3.0	4.2
Other Services	4.5	4.0	6.1	3.7	9.8
GDP	**5.5**	**3.8**	**6.3**	**4.7**	**4.3**
GNP	**6.0**	**3.2**	**6.8**	**4.6**	**3.8**

GDP = gross domestic product, GNP = gross national product.
Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

6. The Government has made major efforts to transform the agriculture sector from subsistence production to production of high value-added products along with trade liberalization, better plantation management under privatization, improved cultivation practices, and more efficient distribution systems. The Central Bank initiated a forward market mechanism (*Govi Sahanaya*) in 1999, which encouraged farmers to enter into forward contracts with buyers at pre-determined remunerative prices. This scheme is expected to reduce the volatility of farmer incomes and to promote agrobusiness and agroprocessing enterprises. Further liberalization of the agricultural input and support services such as seed, planting materials, insurance and extension activities, created a more market-friendly atmosphere. However, the share of agricultural exports out of total exports continued to decline from 22.6 percent in 1998 to 20.6 percent in 1999. The commercialization of agriculture and the development of agroprocessing and agrobusiness activities require a new approach covering a range from the understanding of the situation to global marketing.

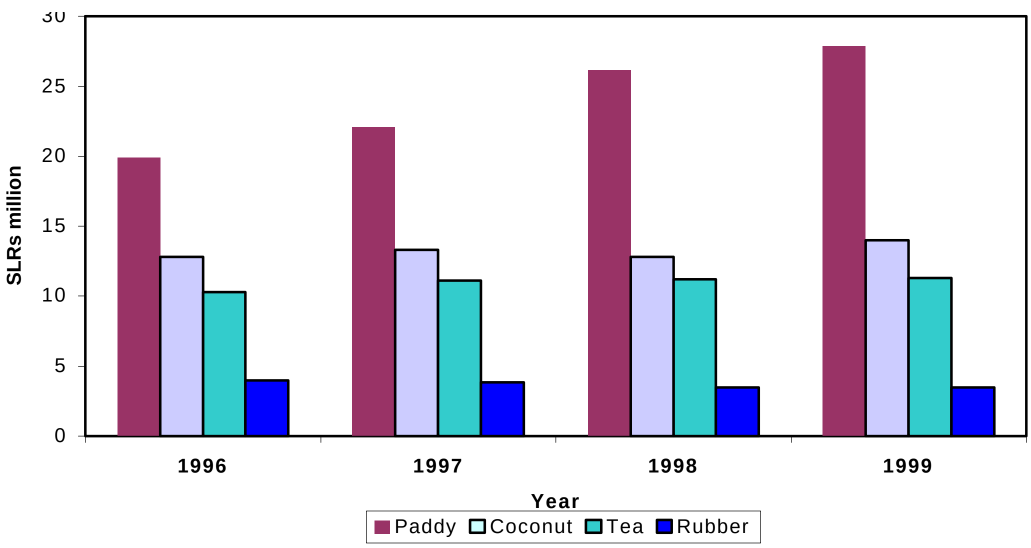
7. Fish and forest production increased by 7.6 percent and 1.3 percent, respectively. These two subsectors' contribution to GDP remained below 5 percent. The high growth rate of total fish production was due to the 20 percent growth in offshore and deep-sea sectors that accounts for about one third of the total marine fish produced. This improvement was attributed to an increase in assistance received by fishermen in the form of day and multiday boats, traditional craft, outboard motors, and fishing gear.

Figure 1: Composition of GDP by Industry, 1995-1999



GDP = gross domestic product.
Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

Figure 2: Agricultural Output of Principal Crops, 1999



Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

b. Industry

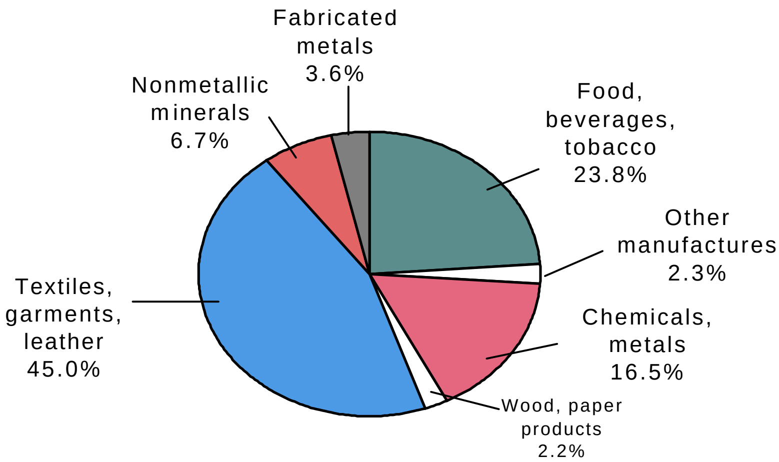
8. Overall industrial output grew by 4.8 percent in 1999, slightly lower than 5.9 percent in 1998 (Table A.2). In particular, the manufacturing sector accounting for 16.9 percent of GDP

grew by only 4.4 percent in 1999, compared with 6.3 percent in 1998. It contributed 20 percent to overall economic growth in 1999, compared with 23 percent in the previous year. The slower growth was largely due to a decline in foreign demand during the first half of the year as a result of the impact on several industries, mainly rubber and leather products, ceramic ware, and jewelry. However, the growth momentum in the industry sector improved steadily later in the year. The recovery was prominent in export-oriented industries as world demand started to pickup with the continued high growth in the United States economy, the robust growth in the European Union, and the recovery in Japan and East Asia. They also benefited from the depreciation of the real effective exchange rate, modernization of factories facilitated partly by fiscal incentives offered for adoption of new technology, and improved telecommunications and the development of other infrastructure facilities under the regional industrial parks program.

9. The output of factory industries that accounted for 84 percent of the manufacturing sector output showed a moderate growth of 4.5 percent in 1999 lower than 7.6 percent in 1998 amid the increased competition faced by the export sector. Growth of the private sector was faster than that of the public sector, as a result of the industrial policy in 1999 whose thrust was on developing private sector-led, export-oriented industries with sufficient diversification in relation to both products and geographic location. Subsequently, the share of the private sector increased from 93 percent to 94 percent of total industrial production.

10. Among three major subsectors, only textiles, wearing apparel, and leather products that accounted for the largest part of the total output of factory industries grew faster than in the previous year: by 7.4 percent in 1999 compared with 4.5 percent in 1998. With world trade recovery in the second half of 1999, the shift of production from lower-end toward up-end market items could boost the subsector. The second largest food, beverage, and tobacco subsector could grow by only 2.4 percent in 1999, far and smaller than the 9.7 percent in 1998; however, production of chemical, petroleum, rubber, and plastic products remained at the same production level. The subsectors' shares were 45.0, 23.8, and 16.5 percent in 1999, respectively (Figure 3).

Figure 3: Sectoral Structure of Manufacturing Output, 1999



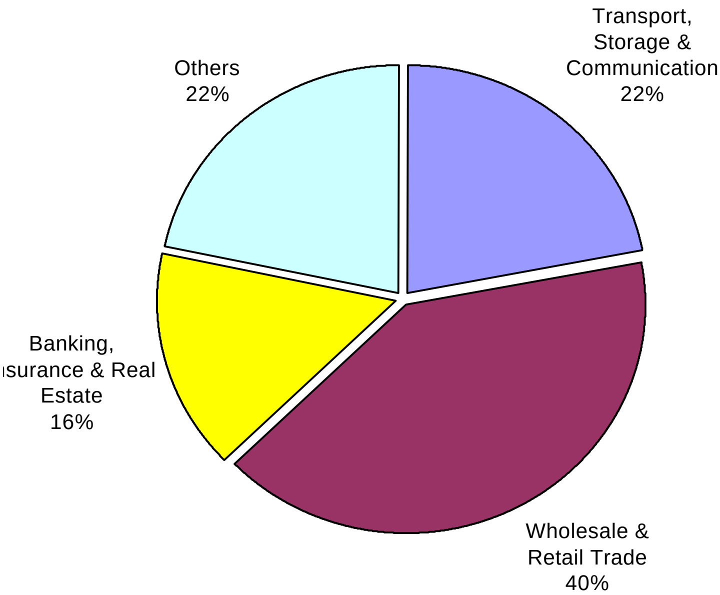
Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

11. The construction sector recorded a growth rate of 4.8 percent in 1999, lower than 7.1 percent in 1998. Its growth was mainly attributed to incentives given in the 1998 budget encouraging private sector participation in housing construction and other infrastructure development projects in the country. Further, the state housing program showed significant progress. The mining and quarrying sector recovered its growth of 4.1 percent from a 5.4 percent decline in 1998. Gem mining, which was badly affected by the East Asian crisis, has picked up since the second half of the year. Total electricity sales rose by 6.6 percent in 1999, lower than 12.0 percent in 1998, mainly due to lower demand from the rest of the industry sector.

c. Services

12. In the services sector, telecommunications provided the main impetus by growing by 39.2 percent. Hotel related services registered a 16.4 percent growth in 1999 due to the 15 percent growth of tourist arrivals in that year, coupled with a growing trend in domestic tourism. Transport and port services registered a slower growth, 3.0 percent and 1.2 percent, respectively. The deceleration in the growth in value-added in the banking sector is attributed to a slowing down of wholesale and retail trade, while activities in the insurance and leasing sectors expanded considerably in 1999. The largest wholesale and retail trade sector occupying 40.8 percent of GNP grew at 1.0 percent in 1999 compared with 4.5 percent in 1998 (Figure 4). The slow growth was mainly due to reduced imports.

Figure 4: Composition of the Services Sector, 1999



Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

3. Employment and Wages

13. The unemployment rate continued to decline from 9.2 percent in 1998 to 8.9 percent in 1999, reflecting growth in both the private and the public sectors. Employment in the public sector tended to decrease, reflecting public enterprise reforms and privatization. In 1999, however, the Graduate Training Program that recruits graduates increased employment as well as the proportion of public sector employment in the total. A mismatch between skills demanded in the private sector and skills supplied by the schools made high unemployment among the youth and the educated a prominent feature of Sri Lanka's unemployment. The Termination of Employed Workmen Act that protects workers from nondisciplinary reasons kept the labor

market rigid and hampered the generation of new formal sector employment. An estimated 179,000 left for employment abroad in 1999.

14. There has been no change in the nominal wages of public sector employees since a 10.5 percent increase in 1998 when the second phase of the B. C. Perera Salary Review Committee proposals was implemented. Accordingly, real wages in the public sector deteriorated by 4.5 percent in 1999.

15. Real wages in the private sector vary across categories of employees. The overall real wages of the organized private sector[1] decreased by 2.1 percent. Workers in the sub-categories of agriculture, and industry and commerce experienced a decline in real wages by 2.9 and 1.9 percent, respectively. In contrast, the services sector real wages increased by 5.7 percent accompanied by a nominal increase of 10.6 percent. The unorganized private sector–paddy, coconut, and rubber cultivation and building construction–also experienced an increase in real wages. If inflation is not contained, an increase in wages of the organized private sector could be an issue.

4. Savings and Investment

16. Domestic savings increased from 19.1 percent in 1998 to 19.8 percent of GDP in 1999 (Table 2). Despite high real interest rates, private consumption expenditure that should fluctuate more smoothly than income decreased faster than GDP, or the ratio of private savings in GDP increased. Presumably precautionary savings in the wake of the Asian financial crisis were combined with the recent trend of increasing savings in Sri Lanka. On the other hand, the share of Government consumption in GDP decreased (Table A.4). Accordingly, an increase in private sector savings and a reduction in Government dissavings contributed to higher domestic savings in 1999. The national savings–the domestic savings plus net private transfers and net factor income from abroad–also increased from 23.4 percent of GDP in 1998 to 23.9 percent in 1999. Net private transfers from abroad, consisting mainly of compensation payments ($110 million) for the workers in Kuwait who were displaced during the Gulf war, accounted for around one fourth of national savings.

17. Domestic investment increased to 27.1 percent of GDP in 1999, up from 25.1 percent in 1998. While public investment remained around the same level as in the previous year, private investment showed higher growth due mainly to buoyant expansion in telecommunications services and the acquisition of aircraft by SriLankan Airlines, the privatized national airline.

18. Both gross domestic savings and investment ratios of Sri Lanka were the highest in South Asia, with investment growing faster than domestic savings. Therefore, both the national savings-investment gap and the domestic savings-investment gap increased from negative 1.7 percent in 1998 to negative 3.2 percent in 1999, and from negative 6.0 percent to negative 7.3 percent, respectively.

[1] Wage movements in the organized private sector are monitored by the minimum wage rate indices of wages boards trades.

Table 2: Savings and Investment, 1995-1999
(in percent of GDP)

Item	1995	1996	1997	1998	1999[a]
Domestic Savings	**15.3**	**15.3**	**17.3**	**19.1**	**19.8**
Private	18.6	19.4	19.6	21.5	20.8
Public	-3.3	-3.9	-2.2	-2.4	-1.0
National Savings	**19.5**	**19.0**	**21.5**	**23.4**	**23.9**
Domestic Investment	**25.7**	**24.2**	**24.4**	**25.1**	**27.1**
Private	17.8	18.0	18.1	18.7	20.5
Public	7.9	6.2	6.3	6.3	6.6
Domestic Savings-Investment Gap	**-10.4**	**-8.9**	**-7.1**	**-6.0**	**-7.3**
National Savings-Investment Gap	**-6.2**	**-5.2**	**-2.9**	**-1.7**	**-3.2**

[a] Provisional.
GDP = gross domestic product.
Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

B. Fiscal Developments

1. Fiscal Policy Strategy and Performance

19. Fiscal performance improved significantly in 1999, despite the constraint of the ongoing conflict in the north and the east. The overall deficit declined to 7.5 percent of GDP from 9.2 percent in 1998 (Table 3). This partially reflects the effort of the Government to reestablish the fiscal consolidation path achieved during 1995-1997.

20. On the revenue side, the declining trend observed in the total revenue-GDP ratio in the recent past was arrested in 1999 with higher mobilization of the tax revenue. Total revenue as a percentage of GDP increased from 17.2 percent in 1998 to 17.6 percent in 1999. The impact of the tax changes adopted in the 1998 budget, along with improved tax administration especially targeting the Goods and Services Tax (GST),[2] increased the tax revenue-GDP ratio from 14.5 percent in 1998 to 14.9 percent in 1999. Meanwhile, the nontax revenue as a percentage of GDP was sustained at 2.7 percent as in 1998. Accordingly, the share of the tax revenue in the total revenue increased slightly from 84.2 percent in 1998 to 84.7 percent in 1999. Income tax revenue, which had been virtually stagnant in the recent past, increased by 38 percent in 1999. Personal income taxes increased by 13 percent, and corporate taxes by 56 percent mainly due to taxes by the Sri Lanka Ports Authority and the Ceylon Petroleum Corporation. Taxes on goods and services accounted for 52 percent of total revenue, and income tax and taxes on international trade, for 14 percent each (Figure 5).

21. On the expenditure side, the growth of current expenditure has been kept below the growth rate of nominal GDP, and its ratio to GDP has been declining since 1995. This trend

[2] The Goods and Services Tax (GST) was introduced as the key element in the tax system in April 1998, replacing the Turnover Tax (TT) that existed since 1964. The GST is levied on a value-added basis with full credit given for all inputs. When the GST was introduced, there was not sufficient public understanding, the standard rate was decided at 12.5 percent that is lower than the estimated revenue-neutral rate, and generous tax exemptions were allowed for political considerations and simply to put the tax in place without causing any distortions. But the registration threshold was set at a low level–of SLRs1.8 million per year or SLRs500,000 per quarter–and a voluntary registration scheme was adopted. Those put a heavy burden on the administration. Later the voluntary registration scheme was abolished.

22. continued in 1999. Non-interest current expenditure was maintained around the same level as in 1998, the growth of the wage bill was contained at 9 percent compared with 21 percent in 1998, and the expenditure on purchases of goods and services declined by 9.6 percent in 1999. In particular, the defense expenditure continued to decrease from the peak of 6.5 percent of GDP in 1995 to 4.4 percent in 1999. Capital expenditure did not reach the originally expected level owing to significant shortfalls in expenditures in several major projects in ports, agriculture, railways, and energy. As a percentage of GDP, investment expenditure indicated a marginal decline, but remained higher than the level in 1996 and 1997. Among the current expenditures, the share of interest payments, the largest component, increased to 30 percent (Figure 6).

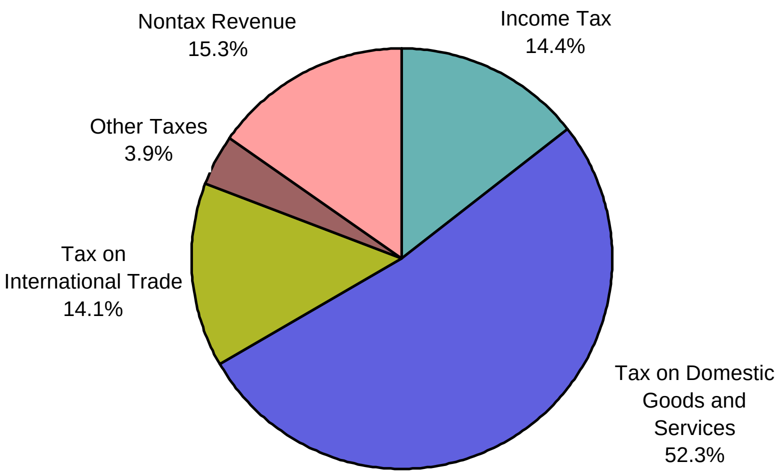
23. Fiscal incentives were granted to improve the capital and debt markets and for developing information technology and training in various skills. The tariffs on agricultural products were kept at 35 percent to provide protection under the current liberalized trade policy framework, while infrastructure development programs were undertaken to develop the sector. The poverty reduction program through Samurdhi income supplements and grants and schemes to help displaced families in the north and east were continued during 1999.

Table 3: Summary of Fiscal Operations, 1995-1999
(in percent of GDP)

Item	**1995**	**1996**	**1997**	**1998**	**1999**[a]
Total Revenue (I)	**20.4**	**19.0**	**18.5**	**17.2**	**17.6**
Tax	17.8	17.0	16.0	14.5	14.9
Nontax	2.7	2.1	2.5	2.7	2.7
Expenditure and Net Lending (II)	**30.5**	**28.5**	**26.4**	**26.3**	**25.1**
Current Expenditure	**23.1**	**22.8**	**20.8**	**19.6**	**18.7**
Goods and Services	11.3	10.4	9.4	9.6	8.8
Transfers	6.1	6.0	5.1	4.6	4.2
Interest	5.7	6.4	6.2	5.4	5.6
Capital Expenditure and Net Lending	**7.4**	**5.7**	**5.7**	**6.7**	**6.4**
Of which Lending less Repayments	1.1	0.8	0.7	1.4	1.0
Overall Balance (I-II)	**-10.1**	**-9.4**	**-7.9**	**-9.2**	**-7.5**
Financing	**10.1**	**9.4**	**7.9**	**9.2**	**7.5**
Grants	1.4	1.0	0.8	0.7	0.6
Foreign Borrowing	3.2	1.3	1.1	1.0	0.1
Domestic Financing	5.1	6.5	3.4	7.0	6.7
Nonmarket Borrowing	0.1	1.3	-1.1	-0.1	-0.1
Market Borrowing	5.0	5.1	4.5	7.1	6.8
Bank Borrowing	1.1	1.7	-0.2	1.9	2.3
Nonbank Borrowing	3.9	3.4	4.7	5.2	4.5
Privatization Proceeds	0.4	0.6	2.5	0.4	0.0
Memorandum Items					
Defense Expenditure	6.5	5.8	5.1	5.0	4.4
Interest Payment	5.7	6.4	6.2	5.4	5.6
Public Debt	95.2	93.3	85.8	90.8	94.7

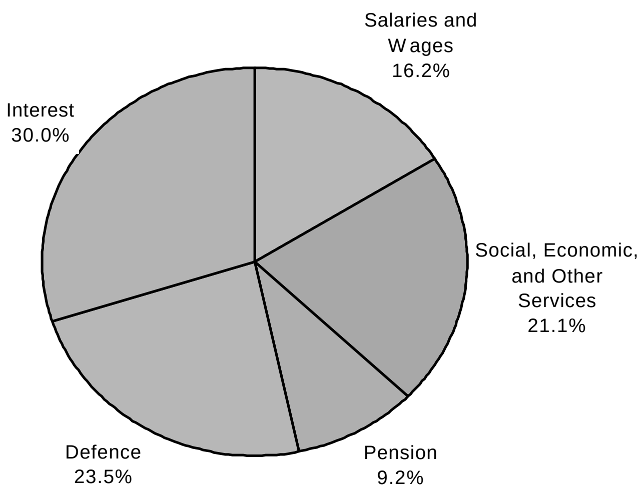
[a] Provisional.
Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo; and Ministry of Finance and Planning.

Figure 5: Composition of Revenue, 1999



Source: Central Bank of Sri Lanka*. 1999 Annual Report*. Colombo.

Figure 6: Composition of Current Expenditure, 1999



Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

24. In financing the deficit, a sum of SLRs7,951 million from foreign grants and loans was utilized compared with SLRs17,397 million in 1998. Because a further sale of Sri Lanka Telecom shares was delayed, proceeds from privatization brought in only SLRs134 million in 1999 compared with SLRs8,000 million envisaged in the budget. Consequently, domestic borrowing was SLRs74,876 million in 1999, higher than SLRs71,362 million in 1998 (Table A.5). However, as a percentage of GDP, domestic financing declined to 6.7 percent in 1999 from 7.0 percent in 1998. Borrowing from nonbank sources decreased, but bank financing rose. Financing from the Central Bank was significant, partly reflecting the shift in the composition of holdings of Government debt securities from commercial banks to the Central Bank due to

additional liquidity needs of banks toward the end of 1999, in anticipation of Y2K (year 2000 compliant) problems.

25. The Government debt at end-1999 was SLRs1,051 billion ($14.6 billion), an increase of 14 percent over the debt stock at end-1998. Higher domestic borrowings and exchange rate variations were the main reasons for the increase. Domestic debt accounted for 52 percent of the total debt in 1999. As a percentage of GDP, the stock of Government debt, domestic as well as foreign, increased to 95 percent in 1999 from 91 percent in 1998. As a ratio of GDP, debt-service payments declined from 11.3 percent in 1998 to 9.3 percent in 1999, reflecting a reduction in amortization payments to the domestic sector due to the early retirement of Rupee loans in 1998 under the optional retirement facility.

2. Structural Reforms

26. Since the Government adopted opening and liberalizing the economy as a development strategy in 1977, there has been a noticeable evolution in the role of the Government. The achievement culminated in a reduction of fiscal deficit. Owing to the Government's continuing effort to address the high budget deficit, the ratio of fiscal deficit to GDP has declined from 10.5 percent in 1994 to 7.5 percent in 1999. However, the fiscal deficit and the role of Government in the economy are still too high to warrant sustainable growth with stable prices and efficient economic management. To reduce the fiscal deficit, the Government has made efforts on the sides of revenue, expenditure, and administration. The Government targets to reduce the fiscal deficit to 5 percent of GDP by 2002.

27. On the revenue side, the Government has focused on both broadening the tax base and rationalizing the tax system. To broaden the tax base, the National Security Levy (NSL) and excise taxes were mobilized in 1999. In 2000, first, the automatic waiver available under the Excise Special Provisions Act was amended to minimize the revenue loss involved in customs duty waivers. Second, the practice of granting duty-free facility for replacing vehicles by the companies operating under Board of Investment (BOI) was withdrawn. Third, NSL was extended to a wider range of the services sector. Fourth, administrative fees charged by the Department of Immigration and Emigration were revised. In total, the expected revenue from these changes is estimated at around SLRs1.9 billion.

28. To rationalize the tax system, first, a Revenue Protection Unit (RPU) comprising full-time officers representing BOI, Department of Customs, and Department of Inland Revenue was set up to strengthen the revenue enforcement laws and prevent abuses. However, this unit was dismantled subsequently. The Department of Inland Revenue will use GST and customs return to verify tax compliance. Second, the administration of GST was strengthened in 1999 with a major change effected to the GST refund system and an increase in field audits in 1999. In 2000, the GST law was amended to ensure smooth administration and to relieve difficulties experienced by some sectors.

29. To rationalize Government expenditure, a 2 percent cut was imposed on recurrent expenditure other than salaries, pensions, and interest payments in 1999. The cut in current expenses was imposed on all Government entities including institutions and corporations. In addition, 3 percent underexpenditure was expected in the public investment program while past experience shows about 10 percent underexpenditure in capital expenditures. In 2000, each head of a spending unit is required to generate 5 percent compulsory savings from recurrent provisions through cost-effective control mechanism, utility audit, and strict controls to be generated by Government agencies on procurement of material and equipment.

29. Audit and Management Committees were appointed to improve financial prudence in public enterprises and statutory agencies. This arrangement will be extended to Government departments and ministries to improve financial management of all spending agencies. A separate unit in the Ministry of Finance and Planning will be set up to evaluate Government expenditure in each spending unit in terms of purpose, cost efficiency, performance, and meeting targets.

30. Cash-flow management at the Treasury was further strengthened in 1999 by minimizing cash balances in public spending units and restricting bank overdraft facilities especially to the defense services. About 70 percent of total net domestic borrowings in 1999 were through Treasury bonds. To reduce debt services, the ongoing international listing of Sri Lanka Telecom is earmarked to be used for further retirement of debt. Additional Treasury bonds will also be issued for retiring outstanding liabilities to Bank of Ceylon. Over the past five years, salaries of public servants have increased by 50-80 percent according to recommendations of the Salaries Commission. A new Salary Commission was appointed to reexamine the salary structure of the public services, as well as performance-oriented incentive schemes.

C. Monetary Policy, Inflation, and Financial Sector Development

1. Monetary Policy

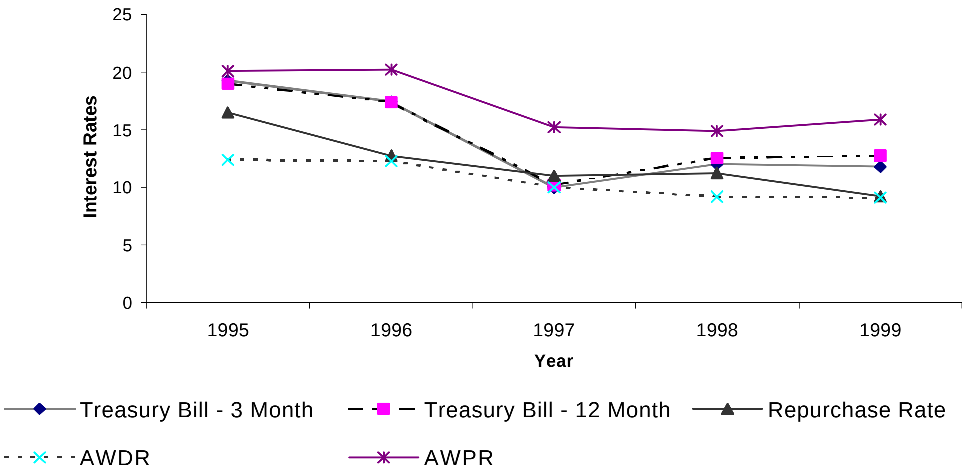
31. During 1999, monetary policy continued to focus on maintaining stability in the financial market, and further efforts were made to enhance the market orientation of the instruments of monetary policy. Except for a temporary instability in the financial market in April as a result of elections and labor unrest, both the call market and the exchange market exhibited considerable stability. Even in December, when general elections and the Y2K uncertainties created the potential for market instability, the markets remained relatively stable. Increased Government borrowings and the Y2K uncertainties increased the demand for liquidity. However, financial market stability, deficit in the balance of payments, and a continuous decline in inflation enabled the Central Bank to relax its monetary stance in the second half of the year.

32. Open market operations continued to be the major instrument for implementing a monetary policy and repurchase rate were the primary means of conveying signals to the market. The Central Bank effected a 200 basis point reduction in the overnight repo rate, which is the Central Bank’s main instrument for signaling the expected direction of the interest rates to the market. The rate of 11.25 percent at the end of 1998 dropped to 9.25 percent at the end of 1999, in several steps. In addition, the tenor of reverse purchase transactions, which is usually restricted to one day, was temporarily extended up to 30 days, so as to provide further stability to the money market in the context of the uncertainties created by the Y2K issue. The statutory reserve requirement (SRR) was reduced from 12 to 11 percent in August. The additional liquidity incurred by this measure was released to the market. The measure also enabled the Central Bank to reduce the Bank Rate, the rate the Central Bank applies for advances to commercial banks for their temporary liquidity purpose, from 17 percent to 16 percent.

33. A slight decline was seen in short-term market interest rates–primary market yield on 3-month Treasury bills, discount and rediscount rates of Treasury bills, and interbank call market rates–reflecting a low inflation rate and flexible monetary policy. The average weighted deposit rate (AWDR), which is based on all interest-bearing deposits of commercial banks, declined gradually from 9.2 percent at end of December 1998 to 9.1 percent at end of December 1999. In lending rates, however, the average weighted prime lending rate (AWPR) increased from 14.9 percent at end-1998 to 15.9 percent at end-1999 (Figure 7). Long-term rates for Government

securities were in a range of 11.00-12.25 percent in the previous year. These rates do not reflect market trends, as they are administratively determined. Even though there were some reductions in interest rates, they were much less than the fall in inflation, reflecting higher operating costs of the two leading state commercial banks. As a result, real interest rates increased. Furthermore, the Central Bank effort to lower interest rates was not well received in the market, and the gap between the repurchase rate of the Central Bank and market rates expanded.

Figure 7: Interest Rates



AWDR – commercial bank weighted average deposit rate.
AWPR – commercial bank weighted average prime lending rate.
Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

34. The growth of broad money (M2) was 13.3 percent in 1999, larger than 9.7 percent in 1998 (Table 4). The consolidated broad money (M2b), which includes the operations of foreign currency banking units[3] and is more meaningful in Sri Lanka than M2, also grew by 13.4 percent in 1999, close to 13.2 percent in 1998. A faster growth in domestic assets was partly offset by a decline in net foreign assets, reflecting the deficit in the balance of payments.

35. A sharp growth in net credit to the Government and credit to Government corporations, together with continued credit expansion to the private sector, led to a considerable increase in net domestic assets. Lower than expected budgeted revenues, a shortfall in privatization proceeds, and reduced foreign borrowings caused the Government to borrow more from the domestic banking system. An increase in credit to Government corporations was due mainly to increased international oil prices, growth in the use of domestic funds for investments, and expanded retail activity by some key state corporations. Credit to the private sector increased by only 9.9 percent during 1999 because of a contraction in imports and exports, and the slower overall growth in the economy tended to exert a dampening effect on the demand for credit.

36. Short-term market interest rates have risen from early 2000 due to the Government's higher-than-expected borrowing program to fund an escalating war. Until end-September the

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[3] Foreign currency banking units of banks are engaged in offshore banking activities and facilitation of the operations of companies in the export processing zones.

currency depreciated by 7.0 percent. To narrow down the gap between market and official interest rates and to arrest the local currency's slide against the dollar, the Central Bank raised the overnight repurchase rate from 9.25 percent at the beginning of 2000 to 13.0 percent by end-September, and the reverse repurchase rate from 13.48 percent to 16.0 percent during the same period.

Table 4: Monetary Statistics, 1995-1999
(percent change per annum)

Item	1995	1996	1997	1998	1999
Net Foreign Assets	**10.2**	**-2.6**	**43.5**	**16.7**	**-3.4**
Net Domestic Assets	**25.2**	**15.9**	**7.8**	**11.9**	**19.9**
Domestic Credit	27.5	11.3	10.5	14.4	17.1
Public Sector	21.5	20.5	-4.3	25.9	45.4
Government, Net	23.3	21.9	-4.0	42.8	45.3
Public enterprises	16.6	16.4	-5.4	-26.1	46.0
Private Sector	29.0	9.1	14.5	11.8	9.9
Other Items, Net	34.6	-1.7	19.6	22.0	9.5
Consolidated Broad Money (M2b)	**21.1**	**11.3**	**15.6**	**13.2**	**13.4**
Broad Money (M2)	**19.2**	**10.8**	**13.8**	**9.7**	**13.3**

Sources: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

2. Inflation

37. The decline of inflation to its lowest level since 1985 was one of the major favorable developments on the macroeconomic front during the year (Table 5). The Colombo Consumers' Price Index (CCPI) computed by the Department of Census and Statistics, indicated an inflation rate of 4.7 percent in 1999. As measured by the Colombo District Consumer Price Index (CDCPI), computed by the Central Bank, the annual average inflation in 1999 was 3.6 percent. These two indices as well as the Greater Colombo Consumers' Price Index (GCPI) showed substantial deceleration in the increase in consumer prices. The Wholesale Price Index (WPI) reflected a decline of 0.3 percent in 1999.

38. The low inflation was attributed mainly to greater agricultural production and increased availability of cheaper imported food items. Improved monetary control, fiscal discipline, and rationalized tax and tariff structures also eased inflation pressure. In addition, although the rupee depreciated against the US dollar by 6 percent in 1999, the drop in the world market prices of major imported consumer items such as rice, sugar, and wheat more than compensated for the upward pressure on prices through the currency depreciation.

39. However, the steady high market interest rates that did not follow the lowered Central Bank's repo rate showed that inflationary expectation continued to remain high, apparently the aftereffect of a long period of high inflation in the recent past. This reinforces the need to persevere with low inflation for some time, so that public perceptions could be fashioned appropriately. Eventually the Central Bank was pressured to raise the repo rate again to prevent distortion in the financial markets and reduce discrepancy between the market rates and Central Bank's target rate.

Table 5: Annual Average Price Changes, 1995-1999
(in percentage change)

Item	1995	1996	1997	1998	1999
Colombo Consumer's Price Index (CCPI)	**7.7**	**15.9**	**9.6**	**9.4**	**4.7**
Greater Colombo Consumer's Price Index (GCPI) All Items	**3.9**	**14.7**	**7.1**	**6.9**	**3.8**
Food and Drinks	2.3	17.9	7.5	7.7	2.8
Liquor, Tobacco and Betel & Arecanuts	17.3	9.6	9.0	8.2	18.4
Housing	0.2	0.1	0.1	0.1	0.1
Fuel & Light	8.5	7.6	5.2	6.4	1.3
Clothing and Footwear	6.4	3.7	4.0	1.9	6.3
Personal Care and Health Services, Household Goods & Services	10.5	11.0	11.9	6.9	6.4
Transport & Telecommunications	2.0	8.4	7.2	0.6	4.3
Miscellaneous	8.7	6.7	3.1	2.4	10.6
Wholesale Price Index	**8.8**	**20.5**	**6.9**	**6.1**	**-0.3**
GNP Deflator	**8.4**	**12.2**	**8.7**	**8.4**	**4.4**

Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo.

3. Financial Sector Development

40. An important development that took place in the banking sector was the completion of the restructuring program of regional rural development banks (RRDBs) by setting up regional development banks (RDBs), which commenced in 1998. All RRDBs have now been combined into six RDBs. Commercial banks increased the provision of facilities through the introduction of new products and use of rapid advances in technology. In particular, 11 commercial banks installed 44 new automated teller machines (ATMs), raising the total number of commercial banks' ATMs to 311. The total number of credit cards issued in 1999 was 43 percent more than in 1998.

41. The Credit Information Bureau of Sri Lanka, which was established in 1990, recorded an operational profit for the first time due to the upsurge in the demand for credit reports from shareholding lending institutions. Credit reports issued by the bureau increased by 23 percent in 1999. This trend reflects increasing patronage of the bureau by its clientele.

42. Although some improvements in stock market prices were seen at the Colombo Stock Exchange (CSE) in some months of 1999, as a whole share prices for the year declined. The decline was attributed to the uncertainty associated with elections and the poor performance of some major listed companies during the first half of the year. The All-Share Price Index declined by 4.2 percent and the new price index, the Milanka Price Index introduced in 4 January 1999, declined by 6.2 percent. However, the decline in prices was less than in 1998. Foreign investors continued to be net sellers, with the net outflow amounting to $13 million compared with a net outflow of $23 million in 1998, market capitalization decreased by 3 percent in 1999. The debt securities market saw further development with five listed debentures being issued during the year. The issues were made by five listed companies, and raised SLRs1,770 million.

D. External Trade and Balance of Payments

43. Sri Lanka's external sector developments during 1999 were dominated by the prolonged effects of depressed global demand and the resultant decline in commodity prices. The external trade and balance of payments weakened somewhat during the year. The deficit in the current account widened, and the overall balance of payments also deteriorated substantially to a deficit of $263 million in 1999 from a surplus $37 million in 1998.

1. Current Account

44. Exports decreased by 3.9 percent in 1999, but there was significant recovery in the last four months. Export prices decreased by 10 percent, while export volume increased by 6 percent mainly due to the resilience of the garments sector. Imports excluding three aircraft by SriLankan Airlines[4] declined by 3.5 percent due both to lower international commodity prices and a decline in the volume of imports. However, if the purchase of aircraft is included, imports increased by 1.5 percent. Consequently, the trade deficit widened by 25.5 percent to $1,370 million. The trade deficit as percentage of GDP thus increased from 6.9 percent in 1998 to 8.7 percent in 1999 (Table 6).

45. Increased tourist receipts helped to generate a surplus in the services account. However, lower income on direct investments and an increase in interest payments on foreign debt widened the income account deficit. Private transfer receipts increased owing to over 50,000 Sri Lanka expatriates in Kuwait who were displaced during the Gulf war. Overall, the current account deficit increased from $226 million to $566 million during 1999, or from 1.4 percent of GDP in 1998 to 3.6 percent in 1999.

2. Capital Account

46. The surplus in the capital and financial accounts declined from $414 million in 1998 to $330 million in 1999. While net capital transfers decreased from $80 million in 1998 to $75 million in 1999, the surplus in the financial account declined from $334 million to $255 million. The decrease in net capital transfers was attributed to lack of privatization proceeds despite an increase in net foreign direct investment from $137 million in 1998 to $177 million in 1999. The decrease in the financial account surplus was attributed to a reduction of foreign liabilities by commercial banks and a net outflow for portfolio investments, and a contraction in long-term borrowings by the Government despite an increase in the loan capital received by SriLankan Airlines, Sri Lanka Telecom, and the Development Finance Corporation of Ceylon (DFCC) Bank. Capital inflows to the Government declined significantly due to temporary delays in implementing some projects, a general decline in global aid flows to developing countries, and a drop in nonconcessional loan capital.

3. Exchange Rate

47. The Central Bank continued to quote daily buying and selling rates for the US dollar for transactions with commercial banks. The Sri Lanka rupee was calculated on a managed float by the Central Bank, and was valued on a daily basis against a basket of 24 international currencies and adjusted accordingly. Exchange markets remained stable during the year in contrast to the high volatility observed in 1998. The Sri Lanka rupee depreciated by 8.2 percent

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4 Privatized SriLankan Airlines imported three aircraft in 1999 at $298 million with a long-term debt according to a refleeting program. It will import six more aircraft: three in 2000 and three in 2001.

against the dollar during 1999, at a lower rate than in 1998. The declining trend in inflation eased the pressure on the exchange rate, particularly later in the year. The real effective exchange rate of the Sri Lanka rupee against the 24-currency basket depreciated by 7 percent in 1999, indicating a protection of the external competitiveness of the economy.

Table 6: Summary of Balance of Payments, 1995-1999

Item	1995	1996	1997	1998	1999[a]
	$ million				
Trade Balance	**-1,505**	**-1,344**	**-1,225**	**-1,092**	**-1,370**
Exports	3,807	4,095	4,639	4,798	4,610
Imports	5,311	5,439	5,864	5,889	5,980
Services and Income, net	-18	-92	0	-35	-107
Receipts	1,047	951	1,109	1,128	1,132
Payments	1,065	1,043	1,109	1,164	1,239
Private Transfers, net	675	710	788	848	887
Current Account Balance (Excluding Official Transfers)	**-848**	**-726**	**-437**	**-279**	**-590**
Official Transfers	61	49	44	52	24
Current Account Balance (Including Official Transfers)	**-786**	**-677**	**-393**	**-226**	**-566**
Capital Account, net	117	96	87	80	75
Financial Account	581	363	515	334	255
Long-Term	502	381	716	398	397
Direct Investment	53	120	430	193	177
Foreign Direct Investment	16	86	129	137	177
Privatization Proceeds	37	33	301	56	0
Private Long-Term, net	91	2	47	2	189
Government Long-Term, net	258	259	239	203	32
Short-Term	79	-18	-201	-64	-142
Errors and Omissions	140	150	-46	-151	-27
Overall Balance	**52**	**-68**	**163**	**37**	**-263**
Net International Reserves	-52	68	-163	-37	263
Use of Total Official Reserves	-41	126	-92	45	344
Central Bank Borrowing, net	24	-13	-4	0	19
Use of IMF Credit, net	-34	-45	-66	-82	-100
	% of GDP				
Trade Balance	-11.6	-9.7	-8.1	-6.9	-8.7
Exports	29.2	29.5	30.7	30.4	29.2
Imports	40.8	39.1	38.9	37.4	37.9
Current Account Balance (Including Official Transfers)	-6.0	-4.9	-2.6	-1.4	-3.6
Overall Balance	0.4	-0.5	1.1	0.2	-1.7

[a] Provisional.
GDP = gross domestic product, IMF = International Monetary Fund.
Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo; and IMF.

48. On 20 June 2000, the Central Bank allowed the rupee to depreciate by up to 6 percent against the US dollar. The foreign exchange buying rate was announced at SLRs75.60 and the selling rate at SLRs79.47 compared with the previous rates of SLRs73.69 and SLRs75.18, respectively. The Central Bank widened the spread between the two rates from 2 percent to 5 percent and at the same time the Sri Lanka rupee depreciated by 4 percent based on the middle of the range of rupee trades. The main reason for the Central Bank depreciation of the Sri

Lanka rupee, and widening of the band width of the spread was the decline in official international reserves by $500 million over the past 18 months and the resulting shortage of liquidity in the market. The spread was widened again in December 2000 from 6 percent to 8 percent as a proportion of the buying rate. The widening of the Sri Lanka rupee's trading band was also a step toward further liberalizing the management of the exchange rate. In line with the liberalization of the foreign exchange transactions, the Central Bank floated the rupee on 23 January 2001 and stopped announcing the buying and selling rates in advance. The rupee, whose value was SLRs80 per dollar at the end of 1999, depreciated sharply on the measure, but stabilized quickly at around SLRs86 per dollar at the end of January. The exports of garments and tea, and the tourist industry–i.e., the conglomerates and plantation sectors–will benefit the most from the depreciation since June 1999, but some manufacturers who rely on imported capital goods and intermediary goods will suffer from the increased cost. An increase in the consumer price index is also forecast.

Table 7: External Assets/Debt and Debt Services, 1995-1999
($ million)

Item	1995	1996	1997	1998	1999[a]
Total External Assets	2,902	2,717	3,132	2,907	2,582
(months of imports of goods and services)	5.8	5.3	5.7	5.2	4.6
Total Official Reserves	2,063	1,937	2,029	1,984	1,639
(months of imports of goods and services)	4.1	3.8	3.7	3.6	2.9
Total External Debt	8,694	8,486	8,197	8,749	9,049
Medium- and Long-Term Debt	8,152	7,988	7,719	8,264	8,574
Short-Term Debt	542	498	478	484	475
Banking Sector Liabilities	1,078	1,047	1,202	958	885
Total External Debt and Liabilities	9,772	9,533	9,399	9,707	9,934
Medium- and Long-Term Debt/Total Debt (%)	93.8	94.1	94.2	94.5	94.8
Total Debt/GDP (%)	66.7	61.1	54.3	55.5	57.4
Total Debt and Liabilities/GDP (%)	75.0	68.6	62.3	61.6	63.0
Debt Service Payment	764	746	733	759	846
Principal Amortization	452	439	430	469	550
Interest Payments	312	307	303	289	296
Debt Services/Exports of Goods and Services (%)	16.5	15.3	13.3	13.3	15.2
Debt Services/GDP (%)	5.9	5.4	4.9	4.8	5.4

[a] Provisional.
GDP = gross domestic product.
Source: Central Bank of Sri Lanka. *1999 Annual Report*. Colombo; and IMF.

4. External Assets/Debt and Debt Servicing

49. The total external assets of $2.6 billion at the end of 1999 were equivalent to 4.6 months of imports of goods and services for 1999, while total official reserves of $1.6 million were equivalent to 2.9 months of imports (Table 7). The external debt stock increased by 3.4 percent in 1999. Of the total debt, 94.8 percent was medium- and long-term and comprised mainly concessional assistance from the Asian Development Bank (ADB), Japan, and the International Development Agency (IDA). Of the debt increase, 65 percent was attributed to the exchange

rate factor, particularly the significant strengthening of the Japanese yen against the US dollar later in the year. The total debt-GDP ratio increased from 55.5 percent in 1998 to 57.3 percent in 1999. The debt service payments as a percentage of receipts from exports and services also increased from 13.3 percent in 1998 to 15.2 percent in 1999. The worrisome movements of total official reserves, debt, and debt service ratio could partially be accounted for by the aircraft import, however, recent data show that they are not short-term phenomena. The ongoing conflict can also accelerate the adverse movements.

E. Civil Conflict and the Economy

50. The civil conflict between the Singhalese majority and the Tamil minority started in 1983.[5] The conflict escalated after the Government forces withdrew from the Elephant Pass, a strategic position in the north, in April 2000 as a result of intense attack by the Liberation Tigers of Tamil Eelam (LTTE). The LTTE proposed an unexpected temporary cease-fire in December, but the Government did not respond because of skepticism on the LTTE's strategic intention. Instead, the Government forces recovered areas in the Jaffna peninsula that were lost to the LTTE in the spring in 1999. In the meantime, the Norwegian peace facilitator has contacted the Government and the LTTE separately since the election in October 2000, and some encouraging signs of peace talk have emerged. On the other hand, the Government is committed, but with no firm timetable, to having its new constitution bill passed by Parliament, since it sees this as a means towards ending the long-running civil conflict. The new constitution bill aims at substantial devolution of power to the provinces especially the north and east. Passage of the bill will require the support of two-thirds of the members of Parliament.

51. The conflict has been very costly for the economy because it has diverted financial and political resources from development goals. Direct costs of the conflict include additional defense expenditure and refugee care, the expansion of fiscal deficit, and loss of capital assets and labor: indirect costs include capital flight and decrease in foreign investment, decline in the tourism industry, and emigration of skilled labor. However, if one counts intangible impacts such as higher uncertainty, poor policy formulation and implementation, and delay of structural reforms, the costs would be much larger.

52. Because of the conflict, the contribution of the Northern and Eastern provinces to national GDP has fallen from 15 percent in the 1980s to as little as 4 percent in 1997. The total costs of the conflict were until recently estimated as 2-3 percentage points of GDP annually by the Central Bank,[6] however the intensification of the conflict since April 2000 magnified the costs of conflict to 6 percentage points of GDP.[7] The impact of such a growth rate gap on the size of an economy is enormous. If an economy grows at a lower rate than the normal economy by 6 percentage points, the damaged economy would amount to only about 75 percent and 55 percent of the normal economy in five years and ten years periods, respectively. On the poverty front, the conflict resulted in not only deterioration of the physical assets, but also a humanitarian loss. In Northern and Eastern provinces, a large number of people are living in

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5 In 1983, anti-Tamil violence in the south of the country, and in the capital, Colombo, led to a mass exodus of Tamils and persuaded significant sections of the Tamils to lend their support to an armed struggle for a separate Tamil state comprising Northern and Eastern provinces of the country, led by the Liberation Tigers of Tamil Eelam (LTTE).

6 Central Bank of Sri Lanka Annual Report. 1999. In an earlier study, the comprehensive economic cost of the war during 1984-1996 was estimated by twice the 1996 GDP (Arunatilake, N., S. Jayasuriya, and S. Kelegama. 2000. "The Economic Cost of the War in Sri Lanka" Research Studies: Macroeconomic Policy and Planning Series No. 13, Institute of Policy Studies, January.

7 Speech Delivered by H.E. Chandrika Bandaranaike Kumaratunga, President of Sri Lanka, at the Sri Lanka Development Forum in Paris during 18-19 December 2000.

abject poverty. In other areas, the poor are not sufficiently taken care of by the Government that is occupied in the conflict at the same time. Therefore there is a strong linkage between poverty and the civil conflict.

II. SHORT- AND MEDIUM-TERM ECONOMIC PROSPECTS AND POLICY ISSUES

A. Short- and Medium-Term Economic Outlook

53. During the first half of 2000, GDP grew by 7.0 percent, helped by a favorable external trade environment that continued from the second half of the previous year. The high growth was broad-based, but the industry sector grew fastest by 10.4 percent, outperforming the 2.9 percent of the agriculture sector and 7.1 percent of the services sector. Consequently, the unemployment rate also declined to 8.0 percent. The high economic growth was partly due to the poor performance in the first half of 1999, the basis of comparison. Total tourist arrivals were slightly lower than last year's level, reflecting concerns over safety. M2b grew by only 11.4 percent as of end-June 2000 year-on-year; however, the annual inflation rate was lower than expected at 3.3 percent as of June 2000 due to improved agricultural production, lower international prices of imported food items, and containment of money supply.

54. Exports continued to grow by 19.7 percent during the first half of 2000 maintaining the growth momentum achieved in late 1999. The high export growth was attributed to the strong economic growth of the US and European countries, and the recovery of the East Asian countries including Japan. The main contributor to export growth was textiles and garments that increased by 24.0 percent. Imports increased at a much faster rate of 38.1 percent than exports. Reflecting the export-dependent import structure of Sri Lanka, imports of intermediate goods such as crude oil and textiles increased by 34.0 percent. However imports of investment goods such as transport equipment—excluding three aircraft—and machinery and equipment showed a lower growth rate of 19.6 percent.

52. The economic trend of the first half of 2000 continued in the second half. Reflecting better performance in the second half of 1999, however, the growth rate was lower than in the first half. Overall, real GDP growth is projected at 6.0 percent in 2000. Light consumer goods, building materials, and agrobased industries maintained high growth rates. The services sector grew by 5-6 percent, with higher growth reflected in the electricity and communications sectors. In 2001 and 2002, economic growth is expected to be lower than in 2000, reflecting mainly a worsening external demand (Table 8).

53. Exports increased by 19.9 percent in the second half of 2000, and imports, excluding aircraft, by a higher rate, 20.9 percent due to higher oil prices, and imports of machinery, equipment and building materials. As a result, the trade deficit reached 10.9 percent of GDP in 2000, compared with 8.7 percent in 1999. The ratio of the current account deficit to GDP is expected to be 6.0 percent–3.4 percent, excluding aircraft–in 2000. High foreign direct investment, private capital flows, and government short-term capital flows will partially offset high current account deficit. The deficit in the overall balance of payments consisting of $1.8 billion in trade account deficit, and $1.0 billion in current account deficit, is projected to widen from 1.7 percent in 1999 to 3.4 percent in 2000. Subsequently gross official reserves are expected to decline from 2.9 months of imports of goods and services in 1999 to 1.5 months in 2000. Debt service payments as a ratio of exports of good and services are projected to decline from 15.2 percent in 1999 to 13.8 percent in 2000.

Table 8: Projection of Key Economic Indicators

Key Indicator	Actual 1999	Projections 2000	2001	2002
Output and Prices (% change)				
GDP Real Growth Rate	4.3	6.0	4.5	5.0
GDP Deflator	4.4	6.1	7.5	5.5
Consumer Price Index	4.7	6.2	8.0	6.0
Savings and Investment (% of GDP)				
Gross Domestic Investment	27.1	29.0	27.0	27.5
Gross Domestic Savings	19.8	19.0	18.5	19.3
Fiscal Indicators (% of GDP)				
Total Revenue	17.6	18.4	19.5	21.5
Total Expenditure (incl. net lending)	25.1	27.1	28.0	29.8
Overall Deficit (excl. grants & privatization proceeds)	-7.5	-8.7	-8.5	-8.3
Money Sector (% change)				
Consolidated Broad Money (M2b)	13.4	13.0	14.0	11.3
Credit to Private Sector	9.9	12.8	13.5	11.5
External Sector				
External Current Account Balance/GDP (%)	-3.6	-6.0	-3.8	-2.5
Gross Official Reserves (in months of imports)	2.9	1.5	1.7	2.0
Total External Debt/GDP (%)	57.4	57.7	61.4	65.0
Debt Service Ratio (% of exports)	15.2	13.8	13.7	13.6

GDP = gross domestic product.
Source: Central Bank of Sri Lanka, Ministry of Finance and Planning, and staff estimates.

54. Despite continuing fiscal consolidation efforts, an increase in defense expenditure will reverse the downward budget deficit ratio to GDP. In the initial budget for 2000, the ratio of defense expenditure to GDP was expected to be as low as 3.9 percent compared with 4.4 percent in 1999. However, the intensification of the conflict in April reversed the trend and the ratio rose to 5.1 percent. As parallel measures, the Government has raised the national security levy and excise taxes on alcohol and tobacco, and reduced nonessential capital expenditure by about 10 percent. However, the rigid budget structure could not help but allow the fiscal deficit to increase to 8.7 percent of GDP from 7.6 percent in the initial budget for 2000, although the fiscal condition is expected to improve slightly in 2001. In deficit financing, the delay in privatizing Sri Lanka Telecom to 2001 made the Government resort to financial sector resources. This resulted in a crowding-out effect in the financial market and a pressure on the monetary policy. Under these economic conditions, the consolidated broad money (M2b) grew at 12.9 percent in 2000 and is expected to increase slightly higher in 2001. The inflation rate returned to a higher level of 6.2 percent by December, mainly due to administered price revisions following the increase in world prices of essential imports including oils. The prices of essential commodities such as food, water, electricity, and transport have risen. The impact of currency depreciation since June 2000 will factor in the high inflation in 2001.

B. Risk Factors

55. The Government is committed to building up momentum to achieve a high and sustainable economic growth of 7-8 percent by 2004.[8] Favorable factors that warrant higher growth than in the 1990s include stable macroeconomic management backed up by an open-economy policy, fiscal consolidation, and monetary policy; and microeconomic policy complying market mechanism such as public sector reform, privatization, financial reform, and price liberalization. Nevertheless, the economy remains at risk.

56. The impact of the ethnic conflict on the economy and poverty is estimated to be substantial. Accordingly, a consensus has emerged that the resolution of the conflict is a prerequisite to improve economic performance including fiscal deficit, capital flows, local currency value, aggregate economic growth, and poverty profiles. The result of ongoing efforts of the Norwegian delegates and other donors' support for the movement has yet to be seen.

57. Parliamentary elections on 10 October 2000 have added uncertainties to the Sri Lankan economy. Both incumbent and opposition parties were committed to opening and liberalizing the economy.[9] However, until such legacy of economic policy is verified and until good coordination between the Government and the Parliament is confirmed, impaired economic activities and delayed investment decisions are unavoidable. In the elections, the People's Alliance (PA), the ruling party, won 107 of the 225 seats in Parliament. The PA was short of 6 seats to form a governing majority in Parliament, but obtained the support of two minority parties and an individual group to secure 116 seats. Therefore, solid coordination between the Government and the Parliament needs to be confirmed.

58. The deterioration in terms of trade, which worsened from 114.2 in 1998 to 106.8 in 1999, is another concern. Sri Lanka is not only a small open economy; it also has a rigid trade structure where the promotion of exports requires a simultaneous increase in imported intermediate goods. In particular, in terms of current US dollars, the prices of the first two major agricultural exports of Sri Lanka are projected to either decline or show only a marginal increase.[10] Coconut oil prices that showed a 12.0 percent increase in 1999 are expected to decline by 11.8 percent and 3.8 percent in 2000 and 2001, respectively. Tea prices that declined by 10.1 percent in 1999 will only marginally increase by 1.1 percent and 0.5 percent in 2000 and 2001, respectively. These price movements will reduce exports. Considering that these exports amount to 16.3 percent of total exports, balance of payments and economic growth will be adversely affected.

59. The Sri Lankan rupee depreciated against the dollar by 9.8 percent during 2000. The depreciation is expected to improve the external sector performance. However, since the industry sector relies heavily on imported intermediate goods (50.6 percent of total imports in 1999), depreciation coupled with high crude oil prices will also bring about higher production costs, and eventually high imported inflation. High inflation will lead to higher interest rates, which will in turn depress investment and cause the fiscal burden of the already highly indebted

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8 *Vision for the 21st Century*, or *Vision 21*, was outlined on the occasion of the 5th Anniversary of the People's Alliance (PA) Government on 21 August 1999.

9 The opposition United National Party initiated the free-market policies when it was in power and the incumbent People's Alliance party followed up the policies. Previously, the People's Alliance party had a parliamentary majority of just one seat.

10 World Bank Commodity Price Projections, April 2000.

Government to balloon. On the other hand, recently the currencies of other counterparts also depreciated fast.[11] On balance, the net effect of depreciation in Sri Lanka is yet to be seen.

60. Development of the labor market is an important indicator in determining the competitiveness of the economy. However, Sri Lanka's relatively rigid labor market, compared with those of other advanced or developing countries in Asia–in particular, crisis-affected countries have achieved remarkable progress in labor market flexibility–has impeded channeling domestic capital and foreign capital into domestic investment. The long-term prospect of economic growth depends heavily on the development of tripartite coordination among the Government, employers, and workers.

C. Major Policy Issues

61. High fiscal deficit is not a new issue in Sri Lanka, but is an urgent concern of macroeconomic management. Rigid expenditures due to increasing needs for defense and the social safety net, and increasing debt services due to high real interest rates require a stringent commitment from the Government. The ratio of fiscal deficit to GDP has been declining from over 9.2 percent in 1998 to 7.5 percent in 1999; however, the ratio returned to a higher level, 8.7 percent. On the revenue side, given that the efficacy of GST has to be widely understood by the public as well as by revenue officials, the optimal combination of tax rate, tax base, and registration threshold has to be recalculated, taking into account administrative efficiency. On the expenditure side, compulsory savings from recurrent provisions cannot be a fundamental rationalization of the expenditure. The impact can be easily offset by rebounding expenditures in the following years. Therefore, the Government needs to consider comprehensive medium-term measures including a zero-base budget, civil service reform, and contributory pensions for sustainable expenditure rationalization.

62. Reflecting long-standing high fiscal deficit and high interest rates, domestic and external public debt has accumulated fast. In 2000, public debt will reach 95 percent of GDP. This is higher than in all other Asian crisis-affected countries except Indonesia. Consequently, interest payments will remain the single largest expenditure component, accounting for 21.3 percent of total expenditure. Excessive accumulation of public debt can adversely affect the financial markets and the Government’s development efforts. In particular, interest payments on a large stock of public debt could constrain fiscal expenditure and prevent the Government from focusing on investments in physical and social infrastructure. Moreover, a rising interest burden can easily allow public debt to spiral out of control. These concerns will, in turn, impair the autonomous management of the monetary policy by driving the monetary authority to increase inflation and lower interest rates. More fundamentally, room for managing aggregate demand to mitigate economic fluctuation, a key role of the monetary and fiscal policies, is very limited in Sri Lanka. The Government and the Central Bank have to strengthen their coordination in macroeconomic policy to reduce public debt as well as fiscal deficit.

63. According to *Vision 21*, the Government is targeting an economic growth rate of 7-8 percent; this is ambitious, considering the actual 5.2 percent growth rate during the 1990s. For the Sri Lankan economy to grow on a sustained basis and pass on to a higher growth regime, it must mobilize larger amounts of resources, raise factor productivity, and move to a higher value-added and more efficient production structure. Taking into account limited public

64.

[11] Among Southeast Asian countries, the currencies of Indonesia, Philippines, and Thailand depreciated by 26.0 percent, 19.2 percent, and 10.4 percent, respectively, during the same period. The currencies of India and Japan also depreciated by 7.0 percent and 10.4 percent, respectively. The euro depreciated by 8.0 percent.

resources and potential inefficiency resulting from nonmarket-based allocation of resources, the Government must rely on the private sector to meet the economy’s resource requirements while developing the appropriate market environment to promote efficiency. More specifically, the Government needs to narrowly focus on ensuring the sustainability of it’s program of privatizing public enterprises (PEs) engaged in commercial activities and commercializing the operations of other PEs; developing the enabling environment for private sector entry and participation in infrastructure development; enhancing the market system by ensuring equal opportunities and promoting fair market competition and appropriate regulation of private sector activity; increasing labor market mobility while providing adequate protection to workers; and providing greater private sector access to finance.

65. The contribution of the agriculture sector to GDP has been 21-22 percent. While this ratio is lower that that in Bangladesh, India, and Pakistan, the development of the agriculture sector is more important in Sri Lanka that in other agrobased countries. Sri Lanka's agriculture sector is clearly distinguishable from that of other countries in the region because it not only provides output for subsistence, but also plays a key role in earning foreign exchange. The share of tea and coconut in total exports continued to increase from 15.5 percent in 1995 until 1998, but dropped from 18.2 percent in 1998 to 16.3 percent in 1999. In a 1999, although tea production was at a record high, its export decreased by 20.2 percent: 10.1 percent due to lower export prices, and the rest to a smaller export volume. To maximize the foreign exchange earnings of the agriculture sector while reducing its volatility, a balance has to be struck between a supply-push policy based on more input including cheaper raw materials and a demand-pull policy. In tea and coconut, in particular, efforts have to be doubled to generate global demand to improve productivity, expand cultivated land, diversify products, and differentiate products from those of competing countries. On the other hand, stabilization of the agriculture sector is important from the monetary policy perspective. The underline inflation that the monetary policy will eventually regard as an ultimate target does not count prices vulnerable to external shocks, such as food and oil prices. In various consumer price indices in Sri Lanka, the weight of food is over 60 percent. Therefore, without price stabilization of agricultural products, the underline inflation cannot play its role as a monetary policy target; accordingly, monetary policy cannot be properly managed.

66. Human development achievements in Sri Lanka have been remarkable considering the country's relatively low per capita income. The 2000 Human Development Report of the United Nations Development Programme (UNDP) ranked Sri Lanka 84th among 174 countries in the world on the Human Development Index. Sri Lanka also has an enviable record in the equitable provision of basic education and this is in part reflected in the country's high literacy rate (91 percent). However, 22 percent of the population are poor based on the Human Poverty Index. This contrast between high human development and high poverty implies that highly developed human capital is not properly linked to high economic welfare. For example, around 30 percent of university graduates are unemployed. Therefore, human capital should be used as capital to achieve high economic growth and high income. Part of the solution is a more flexible labor market. Like the agricultural issue above, generating employment opportunities for the highly educated workforce (demand for labor) has to be emphasized as much as enhancing human capital itself (supply of labor). A skills gap between labor demand and supply has to be narrowed down by linking academia and the business sector. Given this approach, the opportunity for tertiary education could be further widened to develop marketable skills, prevent discontinuation of education, and provide the human capital necessary to transform the agriculture-based economy into a highly value-adding, industry-based economy.

APPENDIX

Table A.1: Key Macroeconomic Indicators

Item	1995	1996	1997	1998	1999[a]
A. Measures of Growth					
1. GNP per Capita ($, current)	710	748	804	823	807
2. GDP (1982 factor cost; % growth)	5.5	3.8	6.3	4.7	4.3
a. Agriculture	3.3	-4.6	3.0	2.5	4.5
b. Industry	7.8	5.6	7.7	5.9	4.8
c. Services	4.9	6	7.1	5.1	4.0
B. Saving and Investment (current, market prices)	% of GDP				
1. National Savings	19.5	19.0	21.5	23.4	23.9
2. Domestic Savings	15.3	15.3	17.3	19.1	19.8
3. Domestic Investment	25.7	24.2	24.1	25.0	27.1
a. Public	3.5	3.1	3.1	3.3	3.1
b. Private	22.2	21.1	21.0	21.7	24.0
4. National Savings-Investment Gap	-6.2	-5.2	-2.6	-1.6	-3.2
5. Domestic Savings-Investment Gap	-10.4	-8.9	-6.8	-5.9	-7.3
C. Prices	% growth				
1. Colombo Consumer Prices	7.7	15.9	9.6	9.4	4.7
2. Wholesale Prices	8.8	20.5	6.9	6.1	-0.3
3. GNP Deflator	8.4	12.2	8.7	8.4	4.4
D. Money Supply	% growth				
1. Narrow Money (M1)	6.7	4.0	9.8	12.1	12.8
2. Broad Money (M2)	19.2	10.8	13.8	9.7	13.3
3. Consolidated Broad Money (M2b)	21.1	11.3	15.6	13.2	13.4
E. Government Finance	% of GDP				
1. Revenue	20.4	19.0	18.5	17.2	17.6
a. Tax	17.8	17.0	16.0	14.5	14.9
b. Nontax	2.7	2.1	2.5	2.7	2.7
2. Expenditure and Net Lending	31.0	28.8	26.6	26.3	25.1
a. Current	23.1	22.8	20.8	19.6	18.7
b. Capital and Net Lending	7.9	6.0	5.8	6.7	6.4
3. Overall Surplus/Deficit (-) (before grants)	-10.1	-9.4	-7.9	-9.2	-7.5
4. Financing (excluding grants)	10.1	9.4	7.9	9.2	7.5
a. Foreign Borrowing	4.5	2.3	1.9	1.7	0.7
b. Domestic Borrowing	5.1	6.5	3.4	7.0	6.7
i. Bank	1.1	1.7	-0.2	1.9	2.3
ii. Nonbank	4.0	4.8	3.6	5.1	4.4
5. Privatization Proceeds	0.4	0.6	2.5	0.4	–
F. Balance of Payments	% of GDP				
1. Trade Balance	-11.6	-9.7	-8.1	-6.9	-8.7
a. Exports	29.2	29.5	30.7	30.4	29.2
b. Imports	40.8	39.1	38.9	37.4	37.9
2. Current Account Balance	-6.0	-4.9	-2.6	-1.4	-3.6
G. Terms of Trade Index (1997 = 100, % change)	-1.0	-0.5	6.8	14.2	-6.4
H. External Payments Indicators					
1. International Reserves ($ million)	2,063	1,937	2,029	1,984	1,639
(months of imports of goods and services)	4.1	3.8	3.7	3.6	2.9
2. Debt-Service Ratio	16.5	15.3	13.3	13.3	15.2
3. External Debt (% of GDP)	66.7	61.1	54.3	55.5	57.4
4. Exchange Rate (SLRs per $)	51.25	55.27	58.99	64.59	70.39

[a] Provisional .

GNP = gross national product, GDP = gross domestic product.

Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

Table A.2: Gross National Product by Industrial Origin at Constant (1996) Factor Cost Prices

Sector	1996	1997[a]	1998[a]	1999[a]
	SLRs million			
A. Agriculture, Forestry, and Fisheries	**156,108**	**160,753**	**164,804**	**172,238**
1. Agriculture	122,594	126,107	128,337	133,952
a. Tea	10,332	11,069	11,195	11,341
b. Rubber	4,011	3,795	3,452	3,487
c. Coconut	12,838	13,258	12,829	13,996
d. Paddy	19,892	22,122	26,165	27,892
e. Others	75,521	75,863	74,696	77,236
2. Forestry	14,751	14,942	15,122	15,319
3. Fishing	18,763	19,704	21,345	22,967
B. Industry	**184,056**	**198,149**	**209,761**	**219,769**
1. Mining and Quarrying	13,927	14,460	13,677	14,238
2. Manufacturing	112,724	122,929	130,702	136,498
3. Construction	48,234	50,842	54,461	57,075
4. Electricity, Gas, Water, and Sanitary Services	9,171	9,918	10,921	11,958
C. Services	**355,770**	**380,861**	**400,231**	**416,333**
1. Transport, Storage, and Communication	73,784	80,268	86,442	93,444
2. Wholesale and Retail Trade	155,316	165,132	172,486	174,160
3. Banking, Insurance, and Real Estate	49,675	54,767	58,247	60,926
4. Ownership of Dwellings	14,232	14,416	14,592	14,767
5. Public Administration and Defense	35,215	37,055	38,170	39,773
6. Other Services	27,548	29,223	30,294	33,263
D. GDP at Constant Factor Cost	**695,934**	**739,763**	**774,796**	**808,340**
E. Net Factor Income from Abroad	-11,258	-8,816	-9,888	-13,987
F. GNP at Constant Factor Cost	**684,676**	**730,947**	**764,908**	**794,353**
	Annual % changes			
Agriculture	-4.6	3.0	2.5	4.5
Industry	5.6	7.7	5.9	4.8
of which: Manufacturing	6.5	9.1	6.3	4.4
Services	6.0	7.1	5.1	4.0
GDP at Constant Factor Cost	3.8	6.3	4.7	4.3
GNP at Constant Factor Cost	3.2	6.8	4.6	3.8

[a] Provisional.
GNP = gross national product, GDP = gross domestic product.
Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

Table A.3: Gross National Product by Industrial Origin at Current Factor Cost Prices

Sector	1996	1997[a]	1998[a]	1999[a]
	SLRs million			
A. Agriculture, Forestry, and Fisheries	**156,108**	**175,774**	**192,665**	**205,599**
1. Agriculture	122,594	138,999	153,335	163,481
a. Tea	10,332	12,685	14,448	12,295
b. Rubber	4,011	3,132	2,462	2,253
c. Coconut	12,838	14,960	15,573	17,675
d. Paddy	19,892	24,469	26,842	30,197
e. Others	75,521	83,753	94,010	101,061
2. Forestry	14,751	15,362	15,669	16,280
3. Fishing	18,763	21,413	23,661	25,838
B. Industry	**184,056**	**216,177**	**251,401**	**271,388**
1. Mining and Quarrying	13,927	16,587	17,433	18,322
2. Manufacturing	112,724	131,876	151,007	163,103
3. Construction	48,234	56,434	69,301	75,538
4. Electricity, Gas, Water, and Sanitary Services	9,171	11,280	13,660	14,425
C. Services	**355,770**	**411,747**	**468,773**	**517,743**
1. Transport, Storage, and Communication	73,784	86,327	101,620	113,814
2. Wholesale and Retail Trade	155,316	177,123	196,262	211,376
3. Banking, Insurance, and Real Estate	49,675	59,610	69,267	80,696
4. Ownership of Dwellings	14,232	15,769	17,346	18,387
5. Public Administration and Defense	35,215	40,990	48,040	52,412
6, Other Services	27,548	31,928	36,238	41,058
D. GDP at Current Factor Cost	**695,934**	**803,698**	**912,839**	**994,730**
E. Net Factor Income from Abroad	-11,258	-9,409	-11,556	-17,813
F. GNP at Current Factor Cost	**684,676**	**794,289**	**901,283**	**976,917**
	Annual % changes			
Agriculture	13.4	12.6	9.6	6.7
Industry	15.9	17.5	16.3	8.0
of which: Manufacturing	19.8	17.0	14.5	8.0
Services	17.8	15.7	13.8	10.4
GDP at Current Factor Cost	16.3	15.5	13.6	9.0
GNP at Current Factor Cost	15.8	16.0	13.5	8.4

[a] Provisional.
GNP = gross national product, GDP = gross domestic product.
Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

Table A.4: Expenditures on GNP in Current Market Prices

Item	1995	1996	1997[a]	1998[a]	1999[a]
	SLRs million				
A. Consumption	**565,661**	**650,437**	**736,035**	**823,251**	**890,230**
1. Government	76,604	81,021	92,196	99,745	99,851
2. Private	489,057	569,416	643,839	723,506	790,379
B. Investment	**171,825**	**186,264**	**217,103**	**255,889**	**301,529**
1. Gross Fixed Capital Formation	170,875	183,509	216,873	255,714	301,434
i. Government	23,595	23,328	29,923	33,960	34,916
ii. Private	147,280	160,181	186,950	221,754	266,518
2. Change in Stocks	950	2,755	230	175	95
C. Exports of Goods and Nonfactor Services	**237,711**	**268,640**	**325,289**	**368,957**	**391,740**
D. Less: Imports of Goods and Nonfactor Services	**307,425**	**337,213**	**388,154**	**430,111**	**472,846**
E. GDP at Market Prices	**667,772**	**768,128**	**890,273**	**1,017,986**	**1,110,653**
1. Net Factor Income from Abroad	-6,958	-11,258	-9,409	-11,556	-17,813
2. Statistical Discrepancy	-1,764	428	-880	-4,530	-2,487
F. GNP at Market Prices	**659,050**	**757,298**	**879,984**	**1,001,900**	**1,090,353**
	Annual % changes				
G. Consumption	**15.2**	**15.0**	**13.2**	**11.8**	**8.1**
1. Government	36.8	5.8	13.8	8.2	0.1
2. Private	12.4	16.4	13.1	12.4	9.2
H. Investment	**9.8**	**8.4**	**16.6**	**17.9**	**17.8**
1. Gross Fixed Capital Formation	10.8	7.4	18.2	17.9	17.9
a. Government	34.0	-1.1	28.3	13.5	2.8
b. Private	7.8	8.8	16.7	18.6	20.2
2. Change in Stocks	-57.8	190.0	-91.7	-23.9	-45.7
I. Exports of Goods and Nonfactor Services	**21.4**	**13.0**	**21.1**	**13.4**	**6.2**
J. Less: Imports of Goods and Nonfactor Services	**16.4**	**9.7**	**15.1**	**10.8**	**9.9**
K. GDP at Market Prices	**15.3**	**15.0**	**15.9**	**14.3**	**9.1**
L. GNP at Market Prices	**14.5**	**14.9**	**16.2**	**13.9**	**8.8**

[a] Provisional.
GNP = gross national product, GDP = gross domestic product.
Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

Table A.5: Government Budget

Item		1995	1996	1997	1998	1999[a]
		SLRs million				
A.	**Revenue**	**136,258**	**146,279**	**165,036**	**175,032**	**195,906**
	1. Tax	118,543	130,202	142,512	147,368	166,029
	2. Nontax	17,715	16,077	22,524	27,664	29,877
B.	**Expenditure**	**203,484**	**218,660**	**235,097**	**268,179**	**278,865**
	1. Recurrent	154,159	175,149	184,749	199,648	207,271
	2. Capital	41,723	37,638	43,982	54,160	60,046
	3. Lending minus Repayments	7,602	5,873	6,366	14,371	11,548
C.	**Budget Deficit**	**-67,225**	**-72,381**	**-70,061**	**-93,147**	**-82,961**
D.	**Financing of Budget Deficit**	**67,225**	**72,381**	**70,061**	**93,147**	**82,961**
	1. Domestic Nonmarket Borrowings	548	10,363	-9,369	-930	-842
	2. Domestic Market Borrowings	33,424	39,391	39,644	72,292	75,718
	a. Bank	7,065	13,090	-2,172	18,954	25,995
	b. Nonbank	26,359	26,301	41,816	53,338	49,723
	3. Foreign Financing	30,252	17,899	17,287	17,397	7,951
	a. Net Foreign Borrowings	21,224	10,160	9,958	10,197	1,190
	b. Grants	9,028	7,739	7,329	7,200	6,761
	4. Privatization Poceeds	3,001	4,728	22,499	4,389	134
		Annual % changes				
E.	**Revenue**	**23.8**	**7.4**	**12.8**	**6.1**	**11.9**
	1. Tax	19.2	9.8	9.5	3.4	12.7
	2. Nontax	66.8	-9.2	40.1	22.8	8.0
F.	**Expenditure**	**21.3**	**7.5**	**7.5**	**14.1**	**4.0**
	1. Recurrent	21.3	13.6	5.5	8.1	3.8
	2. Capital	37.3	-9.8	16.9	23.1	10.9
	3. Lending minus Repayments	-26.1	-22.7	8.4	125.7	-19.6
G.	**Budget Deficit**	**16.4**	**7.7**	**-3.2**	**33.0**	**-10.9**
H.	**Financing of Budget Deficit**	**16.4**	**7.7**	**-3.2**	**33.0**	**-10.9**
	1. Domestic Nonmarket Borrowings	-182.3	1791.1	-190.4	-90.1	-9.5
	2. Domestic Market Borrowings	-12.9	17.9	0.6	82.4	4.7
	a. Bank	510.6	85.3	-116.6	-972.7	37.1
	b. Nonbank	-29.2	-0.2	59.0	27.6	-6.8
	3. Foreign Financing	51.0	-40.8	-3.4	0.6	-54.3
	a. Net Foreign Borrowings	80.2	-52.1	-2.0	2.4	-88.3
	b. Grants	9.3	-14.3	-5.3	-1.8	-6.1
	4. Privatization Proceeds	0.2	57.5	375.9	-80.5	-96.9

[a] Provisional.

Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.

Table A.6: Domestic Liquidity and Components of Money Supply

Item	1995	1996	1997	1998	1999
			SLRs million		
A. Net Foreign Assets	**64,745**	**63,074**	**90,502**	**105,648**	**102,092**
B. Net Domestic Assets	**194,696**	**225,582**	**243,166**	**272,093**	**326,228**
1. Domestic Credit	262,670	292,395	323,046	369,518	432,888
a. Public Sector	51,967	62,622	59,908	75,454	109,731
i. Government, Net	38,662	47,131	45,250	64,618	93,915
ii. Public Enterprises	13,305	15,491	14,658	10,836	15,816
b. Private Sector	210,703	229,773	263,138	294,064	323,157
2. Other Items, Net	-67,974	-66,813	-79,880	-97,425	-106,660
C. Consolidated Broad Money (M2b)	**259,441**	**288,657**	**333,667**	**377,741**	**428,319**
1. Narrow Money (M1)	75,217	78,203	85,851	96,268	108,554
a. Currency	42,198	42,565	45,679	51,767	58,481
b. Demand Deposits	33,019	35,638	40,172	44,501	50,073
2. Quasi Money	184,224	210,454	247,816	281,473	319,765
a. DBUs	171,157	195,672	227,963	257,995	298,158
b. FCBUs	13,067	14,782	19,853	23,478	21,607
D. Broad Money (M2)	**228,536**	**253,201**	**288,257**	**316,174**	**358,076**
			Annual % changes		
E. Net Foreign Assets	**10.2**	**-2.6**	**43.5**	**16.7**	**-3.4**
F. Net Domestic Assets	**25.2**	**15.9**	**7.8**	**11.9**	**19.9**
1. Domestic Credit	27.5	11.3	10.5	14.4	17.1
a. Public Sector	21.5	20.5	-4.3	25.9	45.4
i. Government, Net	23.3	21.9	-4.0	42.8	45.3
ii. Public Enterprises	16.6	16.4	-5.4	-26.1	46.0
b. Private Sector	29.0	9.1	14.5	11.8	9.9
2. Other Items, Net	34.6	-1.7	19.6	22.0	9.5
G. Consolidated Broad Money (M2b)	**21.1**	**11.3**	**15.6**	**13.2**	**13.4**
1. Narrow Money (M1)	6.7	4.0	9.8	12.1	12.8
a. Currency	8.5	0.9	7.3	13.3	13.0
b. Demand Deposits	4.6	7.9	12.7	10.8	12.5
2. Quasi Money	28.1	14.2	17.8	13.6	13.6
a. DBUs	25.2	14.3	16.5	13.2	15.6
b. FCBUs	83.8	13.1	34.3	18.3	-8.0
H. Broad Money (M2)	**19.2**	**10.8**	**13.8**	**9.7**	**13.3**

DBU = domestic banking unit, FCBU = foreign currency banking unit.
Source: Central Bank of Sri Lanka. *1999 Annual Report.* Colombo.